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24 February 2012

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APRA REVIEW OF CAPITAL STANDARDS FOR LIFE AND GENERAL INSURERS

ONEPATH LIFE SUBMISSION ON THE 9 DECEMBER 2011 RESPONSE PAPER AND DRAFT PRUDENTIAL STANDARDS

Dear Mr Grummit

This paper is OnePath Life's fourth submission to APRA's ongoing review of the Life and General Insurance Capital Standards. The first two submissions addressed the issues in the May 2010 Discussion Paper, technical papers and first Quantitative Impact Study. The third paper addressed the results of the second Quantitative Impact Study conducted in July 2011. This paper addresses the issues in the 9 December 2011 response paper and draft prudential standards.

Response to Submissions

OnePath Life welcomes the changes made in the draft standards to adjust the asset risk parameters, the simplification around the insurance risk short-term loss test and the additional detail that has been provided with regards to taxation. OnePath Life welcomes the additional clarity provided in the "Supervisory review and assessment" chapter of the response paper, particularly around the ICAAP. It would also further assist the industry in meeting the ICAAP requirements if the related Prudential Practice Guides are released as soon as possible.

Areas of Concern

While the current proposals represent an improvement, OnePath Life has a number of observations and specific areas of concern and these are addressed below.

Relationship Between Funds

The removal of the ability to recognise offsets between Statutory Funds under a single worst asset scenario does not recognise that the Board oversees all Statutory Funds in one legal corporate entity with authority to transfer between funds where necessary. Asset risks are different to insurance risks in that shocks to the latter can be product specific, however asset shocks are, by nature, exogenous. To be required to provide capital coverage in a scenario where a particular stress is both rising and falling will require capital at a greater than 99.5% confidence for the company as a whole.

In calculating the asset risk charge, APRA has stated that each fund should be treated as a standalone entity because in severely stressed circumstances, a life insurer cannot guarantee that it will be possible to transfer capital between funds.

However, OnePath Life suggests that the Board of a life company can have a policy in place that recognises the ability of assets to be transferred as required, to meet the impact of asset shocks. Such a policy would need to consider the various economic scenarios, their impacts on the funds, potential transfer levels and the post-transfer position of each fund. The ability to recognise potential transfers would be limited to the reduction in the asset risk component of capital in each scenario. This means that negative asset risk would not provide an offset to other funds, but would be capped at nil.

An example is included as an attachment.

Illiquid Liabilities

OnePath Life recognises that APRA requires the application of capital standards to be clear and unambiguous. OnePath Life believes this requirement is not inconsistent with a definition of Illiquid Liabilities that includes income protection claims in the course of payment. Both annuity and claim reserves are independent of policyholder behaviour.

OnePath Life manages the asset reserves for both of these portfolios using a consistent approach and expects that this is common across the industry. The introduction of a differentiator between the two would increase complexity and reduce the effectiveness of asset liability management.

Volatility

While volatility is not a material driver of OnePath Life's capital position due to the low volumes of the variable annuity product, it is noted that the proposed formula does not recognise the different nature of volatility as compared to other asset returns. Volatility is the rate of change in a return and as such exhibits different behaviour to the absolute level of interest rates or equity markets. As such, the shock applied should recognise the demonstrated mean-reversion that volatility does exhibit.

Tax Treatment

The detail provided in the response paper and the draft prudential standards with regards to the adjustment for tax benefits and management actions has helped to clarify APRA's required approach.

OnePath Life suggests that the guidelines that accompany the prudential standards and the return workbooks themselves should be extremely transparent to ensure consistent treatment across the industry in this complex area. In particular, the QIS2 workbooks provided little detail on the tax treatment with one cell in the spreadsheet requiring input for all inadmissible tax assets.

ICAAP Implementation

The development of a full ICAAP policy, process and report is an extensive undertaking. APRA has verbally acknowledged that companies will require a number of years to fully embed the ICAAP. It would assist OnePath Life and the industry if APRA provided more guidance on the development path for the ICAAP. Even though the draft standards do set out minimum requirements, these are still quite broad and subject to interpretation. A guide as to best practice in the development of an ICAAP would allow companies to direct resources appropriately and design the process in line with APRA expectations. The absence of more specific guidelines may lead companies to developing a process that is suboptimal compared to APRA's expectation.

Draft Reporting Standards and Workbooks

The provision of reporting standards and accompanying workbooks is scheduled for release in June 2012. The QIS workbooks were particularly helpful in guiding the calculation process and complementing the documented proposals. An earlier release of workbooks would assist in guiding the build across the industry and provide better clarity and consistency. The majority of companies would be currently close to commencing the process of building final systems and processes. The second half of the year is also dominated by year end reporting for a large proportion of companies. Therefore, while acknowledging the work required to produce the workbooks, there would be significant long term benefits if APRA is able to accommodate this request.

OnePath Life would welcome the opportunity to discuss these issues in more detail at APRA's convenience.

Yours sincerely

John Frechtling
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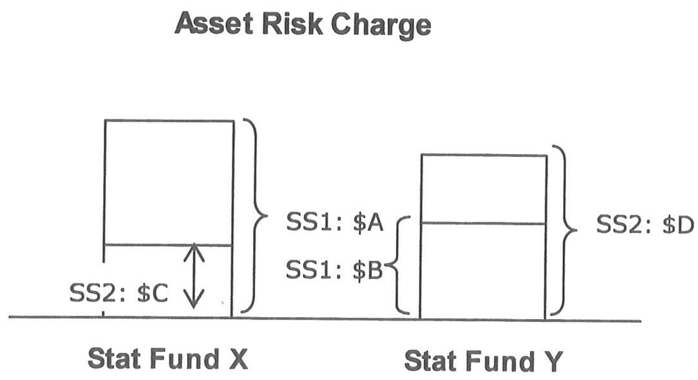
ANZ Wealth

Nick Kulikov
Appointed Actuary
OnePath Life Limited

Attachment: Asset Risk Cross Fund Offsets

The diagram on the right depicts the asset risk charge calculated for Statutory Funds X and Y under two stress scenarios (SS1 and SS2).



In this example, the SS1 asset risk charge of $(A+B) is greater than that in SS2 of $(C+D).

Currently, the capital requirement would be $(A+B), however APRA's proposal requires the higher risk charge in each fund which results in a total charge of $(A+D). This is an amount that exceeds the combined at-risk capital for the company.

Further, the target capital requirement could not offset this amount as it would need to protect the higher requirement. If an offset were allowed in target capital, it would reduce its level of sufficiency relative to the Prudential Capital Requirement.

In this example, the occurrence of scenario SS1 would not require any transfers. Scenario SS2 would require the transfer of a component of $(A – C) from Fund X sufficient to fund $(D – B) in Fund Y. Post the shock and the transfer, both funds would be able to fund their liabilities.