



4 March 2019

TO: ALL LIFE INSURERS

**OFFSHORE REINSURERS AND THE REVIEW OF PRUDENTIAL STANDARD LPS 117
CAPITAL ADEQUACY: ASSET CONCENTRATION RISK CHARGE**

APRA is seeking input on its review of *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117). The review was foreshadowed in a letter to industry dated 15 December 2017 and is being undertaken to ensure the standard remains fit for purpose and in line with the objectives of APRA's mandate.¹

The review is being undertaken in the context of APRA's observation of a recent increase in the use of offshore reinsurers, particularly in the group risk market. If the use of offshore reinsurers continues to increase, APRA's ability to effectively supervise the Australian life insurance industry as a whole could be put at risk. This gives rise to prudential concerns for APRA, and these concerns are particularly heightened in relation to the group risk market, which plays an important role in Australia's superannuation system.

In light of these prudential concerns, APRA is now commencing consultation on options for revising the existing restrictions on exposures to offshore reinsurers in LPS 117 to ensure that the risks are constrained within APRA's appetite. This letter seeks feedback from stakeholders on APRA's prudential concerns relating to offshore reinsurers, matters that APRA should consider when balancing the different aspects of the APRA mandate in the context of this review, and views on a set of policy responses that APRA is considering. This input is intended to assist APRA in further developing a set of policy proposals for a second round of consultation in the second half of 2019.

Attachment A provides the background and reasons for this review, as well as outlining the main areas where APRA is considering options for revising LPS 117.

APRA invites written submissions on the options contained in Attachment A. Submissions should be sent to insurance.policy@apra.gov.au by 10 May 2019.

If you have any questions regarding this letter, please contact Ann Dobinson (ann.dobinson@apra.gov.au or 02 9210 3468) or your responsible supervisor.

Yours sincerely

Geoff Summerhayes
Executive Board Member
Australian Prudential Regulation Authority

¹ APRA, *Review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (Industry Letter, December 2017) available at: <https://www.apra.gov.au/sites/default/files/review-of-lps-117-15-dec-2017.pdf>

Attachment A

1. Introduction

This attachment explains APRA's position on offshore reinsurers, provides a high-level outline of the options for revising LPS 117 currently being contemplated, and poses questions for consideration by interested stakeholders.

1.1. Background

APRA communicated its intention to review LPS 117 in its letter to industry dated 15 December 2017. The decision to review LPS 117 follows evidence that registered life companies have increased their use of offshore reinsurers. This has prompted APRA to review the asset concentration limits contained in LPS 117 to ensure their continuing appropriateness.

APRA defines offshore reinsurers as life insurance companies not registered under the *Life Insurance Act 1995* (Life Act) who reinsure risk for life companies registered under the Life Act. An exception is that APRA does not classify appropriate retrocessionaires of specialist reinsurers as offshore reinsurers.²

Although the impetus for this review comes from issues relating to offshore reinsurers participating in the life insurance market, APRA views this as an opportunity to also review the definitions and treatment of risk mitigants under LPS 117. This aspect of the review will explore opportunities to establish alignment with relevant general insurance requirements, as well as consider ways to introduce greater clarity regarding the definition and use of risk mitigants.

1.2. LPS 117 information request

APRA sent an information request to life companies in early 2018. The information request sought to:

- capture a holistic view of each life company's reinsurance arrangements, as well as high level counterparty information; and
- collect information on all arrangements that have the effect, intended or otherwise, of reducing the impact of the Asset Concentration Risk Charge (ACRC) as it pertains to reinsurance counterparties.

Analysis of the information received through this exercise has been used to inform the scope of this review and the options outlined in this attachment.

2. Scope of review

LPS 117 prescribes the method for calculating the ACRC component of the prescribed capital amount for a life company. The purpose of the standard is to ensure a life company maintains adequate capital against the asset concentration risks associated with its activities.

This review considers, among other things, aspects of LPS 117 which relate to prudential requirements in relation to reinsurance arrangements. Specifically, APRA is reviewing:

² *Prudential Standard LPS 001 Definitions* (LPS 001) defines specialist reinsurer as a statutory fund of a registered life company where all policies referable to the fund are reinsurance policies and none of the policies is owned by a related entity of the life company.

- asset concentration limits in Attachment A of LPS 117 relevant to exposures arising from reinsurance arrangements (section 3);
- the treatment of risk mitigants under LPS 117 (section 4); and
- other issues including investment risk sharing and consequential amendments (section 5).

APRA welcomes input from stakeholders on the proposed scope for this review.

2.1. Offshore reinsurers

Reinsurance is a vital element of a robust insurance market. Recent developments in the life insurance market have caused APRA to examine the impact offshore reinsurers are having on the market, and to consider whether the increased use of offshore reinsurers may pose a prudential concern.

Historically offshore reinsurers have predominantly assumed niche risks not supported by the local reinsurance market. Through its supervision activities APRA has, however, observed increased offshore reinsurance within the group risk market in the past three to four years. These observations are supported by the data collected in the LPS 117 information request. While the use of offshore reinsurers can bring about benefits, such as diversification, innovation and competitive pricing, APRA is concerned that it gives rise to potential prudential risks.

APRA's concern lies with its ability to maintain effective oversight and supervision of the risk profile of the Australian life insurance industry in the face of reduced visibility and prudential control over the activities of reinsurers, which plays a crucial role in supporting a strong and stable life insurance market. APRA recognises that some visibility of offshore reinsurers is afforded by its oversight of the use of reinsurance by registered life companies. However APRA does not feel that the level of oversight and access provided through this avenue is sufficient, especially in the event that the use of offshore reinsurance continues to increase.

Of particular concern to APRA is the growing use of offshore reinsurance in the group risk market. Given insurance is a mandatory part of the default superannuation arrangements, there is a strong case for APRA to maintain robust controls over reinsurance supporting insurance offered through superannuation.

In addition to the risks posed to APRA's ability to maintain an appropriate level of oversight over the life insurance industry, risks also emerge from the possibility that offshore reinsurers may not take a long-term perspective when operating in the Australian market. APRA's view is that a long-term perspective is essential for a stable life insurance market.

The regulatory framework already recognises the potential risks arising from life companies excessively utilising offshore reinsurers. Sensitivity to these risks is built into the different limits currently in LPS 117 for exposures arising from reinsurance arrangements with registered life companies and exposures arising from arrangements with reinsurers that are not registered. These existing requirements may not be sufficient to address the emerging prudential concerns outlined in this section, as they allow for a potentially significant increase in exposures beyond the current position.

APRA welcomes comments and feedback from stakeholders on the concerns and risks outlined in this section.

2.2. Balancing financial safety with other considerations

In developing options for revising LPS 117, APRA is seeking to strike an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, whilst promoting financial stability.

APRA's initial view is that some of the options outlined in this attachment may have a marginal impact on competition, but that this is likely to be outweighed by improved safety and stability.

APRA is seeking feedback from stakeholders regarding how the options considered in this attachment impact the various aspects of APRA's mandate.

PRIMARY OBJECTIVES	
Financial safety	Financial system stability
APRA's initial view is that the options improve financial safety as they seek to ensure that APRA has an appropriate level of prudential oversight over the life reinsurance market, and an ability to promote financial safety across the life insurance industry as a whole.	APRA's initial view is that the options would promote stability by ensuring the life insurance market is supported by reinsurers that are taking a long-term perspective.
OTHER CONSIDERATIONS	
Efficiency	<p>Given the capacity of the local reinsurance market, APRA's initial view is that the options would have no material impact on efficiency.</p> <p>APRA welcomes input regarding the possible impact of the options in this paper on the economic efficiency of the market.</p>
Competition	<p>The options aim to ensure the use of offshore reinsurers is capped within reasonable prudent limits. APRA's initial view is that the options may marginally reduce competition in the life reinsurance market.</p> <p>APRA welcomes input which may help measure the potential impact of the options on competition. This may include, among other things, views on how the options may impact the cost of reinsurance.</p>
Contestability	<p>While the options may restrict the use of offshore reinsurers, APRA's initial view is that they do not affect the ability of new entrants to enter the life insurance industry.</p> <p>APRA welcomes input regarding the possible impact of the options in this paper on market contestability.</p>
Competitive Neutrality	<p>This concept refers to ensuring state-owned and private businesses compete on a level playing field. APRA does not anticipate that the options will impact the competitive neutrality of the life insurance market.</p>

3. Asset concentration limits

APRA is considering options for changing some limits in Attachment A of LPS 117 relevant to exposures arising from reinsurance arrangements. APRA could adopt any or all of these options, or make no change to the current standard. Stakeholders are invited to provide general feedback to APRA on the merits or otherwise of these options.

3.1. Exposures to offshore reinsurers

At present, an exposure to an offshore reinsurer with a counterparty grade of 1, 2 or 3 is subject to the limit prescribed in Attachment A part (g) of LPS 117. This limit is the greater of 5 per cent of the value of the assets of the fund (VAF), and 25 per cent of capital base.³ Exposures to offshore reinsurers with a lower counterparty grade are subject to a limit half this size.

APRA is considering an option that LPS 117 include a requirement for exposures to offshore reinsurers with a counterparty grade of 1, 2 or 3 be measured in aggregate, and that this aggregate exposure be subject to the greater of 5 per cent of VAF, and 25 per cent of capital base, with a 2.5 per cent of VAF limit on individual offshore reinsurers. Aggregate exposures to offshore reinsurers with a lower counterparty grade would be subject to a limit half this size. The collective exposures to offshore reinsurers with higher and lower counterparty grade would also be subject to a 5 per cent of VAF limit.

Applying aggregate limits would continue to allow for a moderate level of offshore reinsurance, while mitigating against the prudential concerns arising from their increasing use by life companies.

3.2. Related party exposures

The limits suggested in the above option may not be suitable for related party arrangements. APRA has more visibility over related party reinsurance arrangements and recognises that in some cases, the use of related party reinsurance can be a prudent measure for managing insurance risk within a group.

APRA is therefore considering the option of setting the limit to exposures arising from reinsurance arrangements between a life company and a related party to 12.5 per cent of VAF. Access to this higher limit would however be subject to an approval process, similar to the approach used for appropriate retrocessionaires for specialist reinsurers. Through this process, APRA would determine whether the counterparty is appropriate prior to granting access to this higher limit. If approval is not granted, the aggregate limits for offshore reinsurers would apply.

3.3. Measurement of limits

Most limits in Attachment A of LPS 117 are expressed as the greater of a percentage of VAF and a dollar amount, or a percentage of the capital base.

How the limits are currently expressed brings about a number of issues, including different outcomes depending on the type of business held in the fund (for example a fund with investment business as well as risk business is currently able to reinsure a higher proportion of its risk business with a single counterparty than if the fund consisted of risk business only).

³ Asset concentration limits for reinsurance assets are determined using a stressed basis, in accordance with paragraph 15 of LPS 117.

This issue is more pronounced when the non-risk business includes assets backing participating policies, as these assets are not generally available to mitigate against risks arising from exposures to reinsurers of non-participating risk business.

During this review, APRA will assess the feasibility of changing the reinsurance exposure limits to be expressed solely as a percentage of the capital base.

4. Risk mitigants

Under LPS 117 life companies are able to reduce the impact of applying the asset concentration limits by holding certain types of collateral against an asset, or where the asset has been guaranteed, as a means of reducing risk. The information collected by APRA in the first half of 2018 showed that a number of methods are being used to reduce reinsurance counterparty exposures.

This section includes discussion regarding options APRA is considering relating to risk mitigants under LPS 117. APRA could adopt any or all of these options, or make no change to the current standard. Stakeholders are invited to provide general feedback to APRA on the merits or otherwise of these options.

4.1. Definitions and use of risk mitigants

APRA is aware that, at present, there are differing interpretations among life companies of the definitions of risk mitigants and also how these risk mitigants can be accounted for when calculating the ACRC.

APRA intends to identify options to tighten and refine these definitions. The objective of this is to introduce an appropriate level of prescription in the standard to facilitate consistent interpretation. It is expected that an appropriate level of prescription would give rise to efficiencies for industry and APRA.

During this process APRA also intends to analyse whether collateral trust structures should be explicitly permitted under the standard. Collateral trusts do not meet the definition of Eligible Collateral under LPS 117. APRA has however exercised its adjust and exclude power under LPS 117 in a limited number of cases to permit the use of collateral trusts as if it comprised eligible collateral when it has been satisfied that an appropriate amount of security is provided by the structure. APRA is considering amending the standard to allow the use of collateral trust arrangements as risk mitigants subject to appropriate controls.

APRA requests that stakeholders explain any concerns they have with the current definitions of risk mitigants in LPS 117 and also any suggestions they may have regarding appropriate ways to introduce clarity. Stakeholder perspectives on permitting collateral trusts as Eligible Collateral are also welcome.

4.2. Limiting recognition of mitigation for capital purposes

LPS 117 presently does not place any limit on how much the impact of applying the asset concentration limits can be reduced through risk mitigants. As a result, life companies can currently have unlimited exposure to offshore reinsurers where recognised risk mitigants are in place.

While collateral and other risk mitigants may limit exposure to counterparty credit risk, unlimited use of risk mitigants undermines the effectiveness of the limits in addressing the prudential concerns noted by APRA in this letter. That is, they facilitate increased involvement of offshore reinsurers to levels that may weaken APRA's ability to effectively supervise the life

insurance industry. They may also give rise to operational risks, particularly if the effectiveness or quality of the mitigant has not been tested.

As part of this review APRA is considering the option of capping the extent that life companies can use risk mitigants to lessen the impact of applying the limits in LPS 117 and comments are welcome on this option. This option may help reduce operational risk, and in the context of offshore reinsurers, ensure that APRA has adequate oversight over the life insurance market as a whole.

4.3. Governance

Excluding the circumstances where APRA has adjusted the requirements of LPS 117 to permit the use of a certain risk mitigant, APRA has minimal visibility of quality of the risk mitigants being used by life companies when calculating the ACRC.

To ensure the quality of the risk mitigants which life companies are taking credit for when calculating the ACRC, APRA is considering the possibility of introducing governance and oversight requirements. The specifics of the governance and oversight requirements have not been determined and suggestions are welcome, however it could include a requirement for independent legal advice and other expert review, as well as more detailed reporting to APRA.

5. Other

5.1. Investment risk sharing

APRA has identified a deficiency in how LPS 117 accounts for reinsurance arrangements which have investment risk sharing elements. This deficiency arises because the calculations for the ACRC only include insurance stresses and not asset stresses. This means, if there is investment experience sharing in an arrangement, future counterparty exposure could potentially increase under adverse investment conditions (and this is not accounted for under LPS 117).

APRA is considering addressing this deficiency in a manner that would mean that the asset concentration limit for reinsurance assets would be determined taking into account both an insurance, and asset stress (rather than only an insurance stress).

5.2. Consequential amendments to other prudential standards

APRA recognises that its options for revising LPS 117 will result in the need for consequential amendments to other prudential standards. Consequential amendments will be made to other prudential standards to ensure consistency throughout the life insurance capital framework. APRA intends to consult on draft standards that require consequential amendments in the second half of 2019.

APRA anticipates that there will be consequential amendments to *Prudential Standard LPS 114 Capital Adequacy Asset Risk Charge* (LPS 114), and relevant reporting standards.

6. Consultation and next steps

6.1. Consultation questions

Submissions are welcome on all aspects of the options contained in this attachment. To assist interested stakeholders in providing feedback, APRA offers the following questions to guide, but not limit, responses:

Question 1	APRA's position on offshore reinsurers is outlined in this letter. Are the concerns identified realistic and relevant?
Question 2	In the context of the options discussed in this paper, what issues should APRA consider to ensure it strikes an appropriate balance between the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, whilst promoting financial stability?
Question 3	This letter outlines a number of options APRA is currently considering as part of the review of LPS 117, including but not limited to, those relating to asset concentration limits and risk mitigants. APRA requests feedback on the appropriateness, feasibility and effectiveness of these options.
Question 4	APRA is considering responding to increasing use of offshore reinsurers by changing LPS 117. Are there other policy responses which APRA should consider?

6.2. Request for submissions

APRA invites written submissions on the options contained in this attachment. Written submissions should be sent to insurance.policy@apra.gov.au by 10 May 2019 and addressed to:

General Manager, Policy Development
 Policy and Advice Division
 Australian Prudential Regulation Authority

6.3. Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence.

Automatically generated confidentiality statements in emails will not suffice for this purpose.

Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA).

APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in a submission about any APRA-regulated entity that is not in the public domain and that is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and will therefore be exempt from production under the FOIA.

6.4. Next steps

APRA anticipates that, following its consideration of submissions received, it will progressively release more detailed proposals through draft revised prudential standards.

APRA expects to release a discussion paper, accompanied by draft revised prudential standards, for consultation in the second half of 2019.