



20/20 **All** Actuaries

# Virtual Summit

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Through the consumer lens

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# APRA's review of LPS 117 – Capital and Collateral in a post-CoVID world

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# Introduction

In the March 2019 letter to Life Insurers APRA raised concerns regarding **offshore reinsurers** and proposed changes to **LPS 117** (Capital Adequacy: Asset Concentration Risk Charge)

This was the culmination of a series of communications from APRA regarding the **use of collateral trust arrangements and other instruments to mitigate counterparty credit exposures**

This presentation covers:

- A review of the market circumstances that led to increased participation by offshore reinsurers
- A summary of the communications from APRA
- Actuaries Institute response (developed by the LIWMPC Working Group) to the March 2019 APRA letter
- CoVID-19 considerations

# Summary of Developments

Market

APRA

2013

2014

2015

2016

2017

2018

2019

2020+

**2013**  
Introduction of **LAGIC LPS 117**  
50% limit for 'appropriate retrocessionaire'  
5% limit for other related party exposures

**2015 onwards**  
A number of bespoke ACRC mitigation arrangements approved and implemented

**July 2017 - APRA LPS 230**  
APRA may adjust the operation of LPS 117 on a case-by-case basis to allow 'collateral trust' mitigation of ACRC counterparty exposures

**2017 onwards**  
Concern from local reinsurers about increased participation of offshore reinsurers 'lack of level playing field'

**Dec 2017 - APRA Review of LPS 117**  
Suspension of discretionary approvals for mitigation of ACRC exposures pending review of LPS 117

**Late 2017**  
Industry feedback on Dec 2017 letter

**2013 onwards**  
Increasing offshore ownership of Australian life insurers

**2013 - 2015**  
Retail IP and Group TPD losses  
Contraction in local capacity  
Offshore capacity sought

## Focus of this presentation

**March 2019**  
**APRA Offshore Reinsurers & Review of LPS 117**  
Proposed revision of LPS 117 to revise limits and increase governance and transparency of ACRC mitigation

**Mid 2019**  
Industry feedback on March 2019 letter

**TBC?**  
APRA LPS117 Review Outcome

**Ongoing**  
APRA IDII Thematic Review and Supervisory Adjustments

**Ongoing**  
COVID-19 Pandemic

# Stakeholders

- Well regulated market
- Competitive terms for members
- Security of claims
- Reasonable return on capital for (re)insurers

**APRA**  
Financial safety  
and stability

**Superannuation  
Funds**  
Affordability  
Member  
protection

**Offshore  
Reinsurers**  
Competitiveness  
Global risk  
diversification

**Onshore Reinsurers**  
Level playing field  
Access to parent  
capital and global  
risk diversification



**Insurers**  
Competitiveness  
Access to capital

**Brokers**  
Competitiveness  
Access to diversity  
of risk appetite

# APRA Letter LPS 230 30 July 2017

## Approval of reinsurance arrangements under *Prudential Standard LPS 230* *Reinsurance Attachment B*

### Issue 5 – other clauses intended to reduce reinsurance counterparty exposure

- Reinsurance arrangements may contain features to reduce counterparty credit exposures of the insurer/reinsurer including ‘**funds withheld**’ and ‘**deposit back**’ arrangements or **other collateral requirements**

*“APRA may adjust the operation of LPS 117 on a case-by-case basis ...  
APRA is willing to consider applications from insurers to recognise **collateral trusts** as  
reducing counterparty credit exposures for capital adequacy purposes<sup>\*\*</sup>”*

<sup>\*\*</sup> applying the principles outlined in paragraph 6 of Attachment B of Prudential Standard GPS 114  
Capital Adequacy: Asset Risk Charge applicable to general insurers

# APRA Letter LPS 117 15 Dec 2017

## Review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge

- APRA received representations regarding the increasing use of offshore reinsurers (not registered under the Life Act)
- APRA had in some cases adjusted the requirements of LPS 117 to allow **collateral trust arrangements**\*\* to be used to mitigate exposures to non-registered reinsurers for the purpose of calculating the ACRC which facilitated involvement of non-registered reinsurers in the Australian market

***“APRA is not inclined to grant any further discretionary approvals to allow entities to mitigate exposures to non-registered reinsurers for the purposes of calculating the ACRC until the outcomes of a review of LPS 117 are known (including an assessment of the future use of collateral trust arrangements and whether they should be permitted for the purposes of LPS 117)”***

\*\* ‘funds withheld’ arrangements are no longer mentioned

# APRA Letter LPS 117 4 March 2019

## Offshore Reinsurers and the Review of LPS 117

### Proposed changes to LPS 117:

- Exposure to offshore reinsurers limited to 5% in aggregate and 2.5% per reinsurer (currently 5% per reinsurer)
- Related party exposure limit increased from 5% to 12.5%
- Tighten and refine the definition of risk mitigants used in the calculation of the ACRC
- Allow use of collateral trust arrangements as ACRC risk mitigants ('Eligible Collateral') subject to appropriate controls
- Capping the extent to which risk mitigants can be used to reduce the impact of ACRC limits



# APRA Letter LPS 117 4 March 2019 (cont'd)

## 4 March 2019 – Offshore Reinsurers and the Review of LPS 117

### **Governance and Oversight:**

- APRA has limited visibility of the quality of LPS 117 ACRC risk mitigants
- Specifics have not been determined

What is best practice? For example:

- Reinsurance and Retrocession treaty terms specifying recourse to mitigants
- Regular monitoring and reporting of quality and quantum of risk mitigants
- 'Look through' considerations – where is the risk ultimately ending up?

# Actuaries Institute Response

The Actuaries Institute response to APRA was supportive of:

A limit on offshore reinsurance exposures, individually and in aggregate

A higher limit than 5% for related party exposures, subject to an approval process (e.g., similar to that required for a local reinsurer retroceding to an appropriate retrocessionaire) and dependent on counterparty grade

Permitting collateral trusts to be considered as eligible collateral; proposing definition of eligible collateral be expanded to include other arrangements (including letters of credit and funds withheld arrangements)

Capping the extent to which risk mitigants can be used to lessen the impact of LPS 117 limits in proportion to the relevant net exposure limit and having regard to the quality of risk mitigant

APRA publishing pre-approved templates of risk mitigants (e.g., collateral trusts, letter of credit arrangements, funds withheld arrangements) and where APRA approves such arrangements, having market transparency of the general nature and form of collateral being approved

# Actuaries Institute Response (cont'd)

Other observations:

- Definition of 'competitive neutrality' broadened to consider concept of a level playing field
- How collateral trusts can be accommodated under Section 38 of the Life Act
- Support ring-fencing of participating assets
- Support addressing any deficiency in treatment of asset risk in the determination of the ACRC
- Consideration of a principles based approach:
  - Are there alternatives to tweaking the limits in LPS 117
  - At what point is the scale and frequency of offshore reinsurer operations considered to be 'carrying on a business' in Australia
  - 'top-down macro-prudential' approach whereby exposure limit of an offshore related party would be set with reference to the market's aggregate exposure rather than the statutory fund of an individual insurer

# CoVID-19 Implications for Capital

- The CoVID-19 pandemic and associated economic fall-out in Australia is widely expected to impact Income Protection insurance policy experience (Retail, and to a lesser extent, Group) and disrupt asset markets leading to the following potential areas of capital strain:
  - Reduction in P&L earnings
  - Write-down of balance sheet assets
  - Strengthening of best estimate assumptions, LAGIC risk margins and/or Target Surplus
- This will potentially increase pressure on insurers (and reinsurers) to make optimal usage of capital instruments, and consider global (as well as local) sources of capital
- Constriction of availability of capital may lead to a reduction in insurer/reinsurer capacity
- The APRA IDII Thematic review is also expected to impact capital availability (funding Supervisory Adjustments) and capacity (reduced appetite for certain risks)
- The global implications of CoVID-19 may impact offshore reinsurer appetite in the Australian market

# Discussion