



23 February 2022

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Mr Jason Lange
Executive Director
Office of Best Practice Regulation
Department of the Prime Minister and Cabinet
1 National Circuit
BARTON ACT 2600

Email: helpdesk-obpr@pmc.gov.au

Dear Mr Lange,

CERTIFICATION OF APRA’S REVIEW: REVIEW OF OFFSHORE REINSURERS AND PRUDENTIAL STANDARD LPS 117 CAPITAL ADEQUACY: ASSET CONCENTRATION RISK CHARGE (LPS 117)

I am writing to certify that APRA’s development of its review of offshore reinsurers and *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117) involved a process and analysis equivalent to a final Regulation Impact Statement (RIS).

I certify that the review has adequately addressed all seven RIS questions. The attached document sets out how APRA has addressed these questions.

As set out in the attachment, APRA considered a number of policy options in developing LPS 117 reforms. These ranged from no change to LPS 117 to options that would strengthen APRA’s prudential oversight of the life insurance industry, enhance the capital framework and clarify existing expectations. In developing the revised LPS 117, APRA also considered alternative options for specific amendments, many of which were suggested by stakeholders during consultation. These are discussed in APRA’s April 2021 response paper (see attached).

Using the regulatory burden measurement framework, APRA estimates APRA-regulated life insurers (including reinsurers) will incur additional compliance costs from APRA’s LPS 117 reforms. In aggregate, APRA estimates these costs at around \$323,671 per year, over the next 10 years (see Table 1 below). In APRA’s view, these costs will be more than offset by the benefits from APRA’s reforms, which seek to ensure policyholders remain protected and regulatory requirements are clear and fit for purpose.

Table 1: Estimate of regulatory burden

Annual regulatory costs, averaged over 10 years				
Change in costs	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$323,671	Nil	Nil	\$323,671

Accordingly, I am satisfied that the attached report now meets best practice consistent with the *Australian Government Guide to Regulation*.

Yours sincerely

A handwritten signature in cursive script that reads "Helen Rowell".

Helen Rowell

Deputy Chair

Attachments

Attachment A: APRA's Regulation Impact Analysis

Attachment B: APRA Consultation Letter – Offshore reinsurers and the review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge, March 2019

Attachment C: APRA Response to Submissions – Revisions to Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge, April 2021

ATTACHMENT A: APRA'S REGULATION IMPACT ANALYSIS

Consistent with the Australian Government Guide to Regulation, APRA has followed a similar process to that required for a Regulation Impact Statement (RIS). APRA's evaluation of the impact of policy changes to LPS 117 is summarised below.

In its 2019 Consultation Letter, APRA set out the problem and why regulatory action was needed.¹ APRA observed an increased use of offshore reinsurers. If the use of offshore reinsurers continued to increase and no regulatory action was taken, APRA's ability to effectively supervise the Australian life insurance industry could be put at risk, threatening its ability to adequately protect policyholders. Regulatory action is needed to ensure that the risks associated with the increased use of offshore reinsurance are appropriately mitigated and managed.

APRA's 2019 Consultation Letter also outlined other proposed technical amendments to LPS 117 aimed at enhancing the clarity of the standard, facilitating the use of risk mitigation techniques by life insurers and ensuring requirements in the standard remain adequate given market developments. These issues and revisions are collectively referred to below as 'technical issues' and 'technical amendments'.

APRA has undertaken two rounds of public consultation in revising LPS 117. While the consultations were open to all interested stakeholders, submissions were received primarily from life companies during both consultations. As detailed in its 2021 Response Paper, APRA has considered options presented by stakeholders as well as revised and clarified its proposed revisions to LPS 117 having considered feedback.²

Summary of policy options

APRA considered three broad policy options for responding to prudential concerns arising from increased use of offshore reinsurers and to technical issues with LPS 117. These policy options are set out in Table 2 below. Within option 3 (revise requirements), APRA considered a range of specific approaches, including a number that were raised by stakeholders through the consultation process.

Table 2: Policy options

Option 1 - No revisions	Make no revisions to prudential requirements nor provide additional guidance in response to either concerns regarding offshore reinsurers or technical issues with current requirements.
Option 2 - Additional guidance	Provide additional guidance in response to concerns regarding offshore reinsurers and technical issues with current requirements, but make no revisions to prudential requirements.
Option 3 - Revise requirements	Revise prudential requirements in response to concerns regarding offshore reinsurers and to address technical issues with current requirements.

¹ APRA, *Offshore reinsurers and the review of Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (Consultation Letter, 4 March 2019)

² APRA, *Revisions to Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (Response Paper, 8 April 2021)

APRA’s analysis of the comparative costs and benefits of each option is set out below:

Option 1 – No revisions to prudential requirements and no additional guidance

Under Option 1, there would be no change to APRA’s existing prudential requirements and no additional guidance would be provided to industry to respond to APRA’s concerns regarding offshore reinsurers. If this option were adopted, it is likely that the use of offshore reinsurance would continue to grow and the risks associated with this would not be appropriately managed or mitigated.

This option would not give rise to compliance costs associated with implementing revised requirements. However, taking no action to address prudential concerns regarding the increased use of offshore reinsurers would likely reduce APRA’s ability to fulfil its mandate to protect policyholders given it is not able to effectively supervise insurance risk which is placed with an offshore reinsurer.

Unlike locally regulated reinsurers, offshore reinsurers are not subject to or familiar with APRA’s regulation or prudential requirements. APRA does not have prudential oversight of the reinsurer when it is offshore. APRA is therefore unable to take regulatory actions such as issuing directions or imposing supervisory capital adjustments, as would be the case, for example, with a locally regulated reinsurer where APRA identified deficiencies in its financial or operational risk management. There is therefore a heightened risk that the reinsurance from an offshore reinsurer is not available when needed.

Furthermore, enhancements to LPS 117, to address the technical issues such as lack of clarity and restrictive requirements around use of risk mitigation techniques, would not be made. This would increase compliance costs for life companies in the medium- and long-term. Without these enhancements to address technical issues APRA may need to clarify, and sometimes amend, the requirements on a case by case basis. The application and approval process to amend requirements for individual insurers can take a significant amount of time and resources for insurers.

On balance, APRA considers there to be a long-term net cost associated with option 1. While there are no upfront compliance costs associated with this option, not making these enhancements would result in heightened compliance burdens for APRA and industry on an ongoing basis. This is primarily due to the likely need for APRA to take alternative actions to respond to heightened risks emerging in the industry and to address technical issues with the current requirements.

Table 3: Option 1 - Estimate of regulatory burden

Annual regulatory costs, averaged over 10 years				
Change in costs	Business	Community organisations	Individuals	Total change in costs
Total, by sector	Nil	Nil	Nil	Nil

Option 2 – Additional guidance only

Under Option 2, APRA would issue additional guidance to industry on how insurers should manage risks associated with increased use of offshore reinsurance and also regarding the technical issues in LPS 117. No new prudential requirements would be introduced under this option.

Guidance would not lead to compliance costs associated with implementation, given life companies are free to adopt guidance in a manner which reflects their business size and complexity. While this approach may address some risks and issues, life companies are not required to follow guidance, which may lead to inconsistent adoption across the industry. Inconsistent adoption may lead to additional compliance burden due to the need to address these inconsistencies and ensure risks are adequately mitigated where guidance is not adopted.

Table 4: Option 2 - Estimate of regulatory burden

Annual regulatory costs, averaged over 10 years				
Change in costs	Business	Community organisations	Individuals	Total change in costs
Total, by sector	Nil	Nil	Nil	Nil

Option 3 – Revise prudential requirements

Under Option 3, prudential requirements in LPS 117 would be revised to respond to prudential concerns associated with the increased use of offshore reinsurers and to ensure additional risks present due to the use of offshore reinsurers are managed and mitigated. The key proposed changes are limits on the use of offshore reinsurers above which additional capital charges apply. These limits would be calibrated to stop growth in the use of offshore reinsurers reaching excessive levels, rather than materially impact current practices, hence reducing the costs associated with these proposals.

APRA would also make enhancements to LPS 117 to address technical issues with how the standard is operating. These amendments aim to make the standard clearer and easier to implement, reducing the need for ad hoc clarifications and therefore also the medium-term compliance burden for industry.

Option 3 would result in a small increase in compliance costs. However, addressing technical issues with LPS 117 and making revisions in response to the prevalence of offshore reinsurers would likely provide a net benefit.

Table 5: Option 3 - Estimate of regulatory burden

Annual regulatory costs, averaged over 10 years				
Change in costs	Business	Community organisations	Individuals	Total change in costs
Total, by sector	\$323,671	Nil	Nil	\$323,671

Assessment of net benefit

As outlined in APRA's 2019 Consultation Letter and 2021 Response Paper, there are net benefits of APRA's approach to revising LPS 117 (Option 3):

- Revising LPS 117 will allow APRA to continue to have the oversight of the life insurance market needed to provide protection to policyholders.
- Revising LPS 117 allows life insurers to continue to access offshore reinsurance markets within prudent levels, ensuring greater industry stability. If an insurer exceeds the limits

on the use of offshore reinsurers, additional capital will need to be held to reflect the heightened levels of risk.

- Revising LPS 117 will aim to ensure risks associated with using offshore reinsurers are appropriately mitigated or managed.
- The technical revisions made to LPS 117 will make regulatory requirements clearer, reducing the need for industry and APRA to clarify, and sometimes amend, the requirements on a case by case basis. The application and approval process to amend requirements for individual insurers can take a significant amount of time and resources for insurers. Reducing the need for these individual amendments is therefore expected to reduce regulatory burden.

Conclusion: comparison of policy options

When developing policy, APRA is required to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality, while promoting financial system stability in Australia. APRA considers that, on balance, Option 3 will enhance prudential outcomes and improve financial system safety and stability in Australia.

While Option 3 has a marginally higher compliance cost, the prudential benefits associated with addressing prudential concerns arising from increased use of offshore reinsurers and deficiencies in the standards are materially higher.

Table 6: Comparison of options

	Option 1	Option 2	Option 3
Regulatory costs	No change	No change	Low to moderate
Protection of policyholders when reinsurance is acquired from an offshore entity	Does not meet this criterion	Partly meets criterion	Meets this criterion
Facilitate use of risk mitigation techniques	Does not meet this criterion	Does not meet this criterion	Meets this criterion
Clarification of requirements	Does not meet this criterion	Partly meets criterion	Meets this criterion
Requirements address current market risks	Does not meet this criterion	Does not meet this criterion	Meets this criterion
Overall	Net costs	Net costs	Net benefit

Implementation and review

As delegated legislation, prudential standards impose enforceable obligations on APRA-regulated institutions. APRA monitors ongoing compliance with its prudential framework as part of its supervisory activities. APRA has a range of remedial powers available for non-compliance with a prudential standard, including issuing a direction requiring compliance, the breach of which is a criminal offence. Other actions include imposing a condition on an APRA-regulated institution's authority to carry on its business or increasing regulatory capital requirements.

Under APRA's policy development process, reviews of new measures are typically scheduled following implementation. Such a review would consider whether the requirements continue to reflect good practice, remain consistent with international standards, and remain relevant and effective in facilitating sound risk management practices. APRA will also act within a shorter timeframe where there is a demonstrable need to amend a prudential requirement.