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REVIEW OF LPS230 REINSURANCE
DEFINITION/MEANING OF LIMITED RISK TRANFER

We refer to the Review of Prudential Standard LPS230 Reinsurance, as addressed in a letter to all life insurers date 3 November 2017.

We would like to provide some comments on one aspect of the proposed new LPS230; the definition of "Limited Risk Transfer Arrangements".

The definition of "Limited Risk Transfer Arrangements" is expressed in terms of arrangements that "....typically: (a) do not involve significant transfer of insurance risk over the life of the arrangement between the life company and the reinsurer, including the life of the arrangement to any point in time at which the contract may be closed to new business or subject to recapture or otherwise terminated; and/or (b) involve significant financing elements."

This definition seems to be based largely on the equivalent concept and definition in GPS230.

While that definition would seem to be reasonably clear in terms of typical general insurance reinsurance arrangements that:

- Involve arrangements that cover one or a limited number of event years, and/or operate on a year-by-year basis; and
- Involve claims development and run-offs that are often longer than the cover period itself.

Establishing "significant transfer of risk over the life of the arrangement" is typically not controversial for such standard general insurance reinsurance arrangements. The potential for reinsurance losses for the period of the arrangement is reasonably clear.

The situation for a standard life reinsurance arrangement is less clear.

If one considers a standard life reinsurance arrangement per the following example:

- A 50% quota share risk premium arrangement, covering death covers;
- Auto-acceptance of policies written over a period while the treaty remains open;
- On closure, policies run off and remain reinsured under the arrangement until natural expiry of the policies (could be over 50 years);
- The reinsurer has the right to reprice premiums based on experience (life company also has the right to reprice premiums to the underlying policyholders).

While we are sure that such an arrangement is clearly meant to be a standard full risk transfer, uncontroversial, reinsurance arrangements under the proposed LPS230, it is not obvious that the actual wording of the definition of Limited Risk Transfer would come to that conclusion. Given the very long duration of the premium term of such an arrangement even if the arrangement was originally open for only one year (potentially 50 years or more for the one year of policies to run-off), and given the ability of the reinsurer to modify pricing over the run-off period, it could be concluded that the overall insurance risk (at the pool level) actually reverts from the reinsurer back to the life insurer “over the full life of the arrangement”.

In noting this, it is also noted that the lapse risk (mass lapse and non-recovery of acquisition costs etc) is fully transferred to the extent that acquisition costs are incurred or supported by the reinsurer (although if acquisition cost funding is material it may be deemed a financing arrangement anyway).

If we take the above example and exchange the right of the reinsurer to reprice at its discretion with a fixed, automatic experience credibility adjustment mechanism, this can make the assessment of significant risk transfer even more problematic on a whole pool, whole of life of the arrangement basis. An actuarial projection of such an arrangement over 50 years may show only a low probability of eventual loss for the reinsurer, even though conceptually, replacing a unilateral optional repricing right with a defined repricing formula should actually reduce the reinsurer’s control and should theoretically increase the reinsurer’s risk.

We also note that there is now a reasonable body of accounting (IFRS/A-IFRS) interpretation of “significant risk transfer” which generally:

- Considers significance in terms of insurance risk transfer in respect of the individual underlying risk (at the level of the risk by policy as issued by the life insurer); but
- Ignores (or not count) risk transfer in terms of other risks such as lapse risk.

Given APRA's broader actual risk transfer and related capital support objectives under LPS230 (GPS230), such accounting interpretations may be of less direct relevance, nonetheless these exist and have to be applied by life insurers and it is unclear how the different concepts work together (or not).

Given these points, we think that some further guidance from APRA on the interpretation of B.1 would be very helpful. In particular, that significant risk transfer for the purposes of LPS230 (assuming APRA intends this):

- Includes lapse risk transfer;
- Prospective premium rerating rights or mechanisms (that reflect normal non-guaranteed premium re-rating rights) do not prima facie imply reduced risk transfer, especially where the earning of such future re-rated premiums is subject to future lapse risks;
- Prospective premium rerating or experience refund mechanisms in respect of past claims experience do not prima facie imply limited risk transfer in respect of the exposure years that give rise to the rerating or refunds;
- Mechanisms that operate on a net (differential) outcome basis to limit credit exposures between the insurer and reinsurer do not of themselves prima facie imply limited risk transfer; and that
- The key test should actually be the response of the reinsurance arrangement to provide actual financial (risk) support from the reinsurance to the insurer under the relevant scenarios that drive the regulatory (and ICAAP) capital requirements of the life insurer.

Further Observations and Comments

In making the above observations and comments, we note a few points about the current life insurance industry in Australia:

- The industry is no longer dominated by the provision of death covers. Death risk may represent as little as 30%-35% of new life risk insurance. 65%-70% is now living and disability benefits. The exposure to living and disability benefits will likely only increase in future.
- Living and disability benefits are complex and in particular disability benefits are heavily economic cycle affected, which means systemic claims risk is very significant even for the largest life insurers. Claims cycles can be substantial and run over quite long time frames, indeed some years (as per recent IP experience).
- Increasing use of reinsurance by all industry participants to manage these risks is inevitable and sensible. Australian life insurers should rationally seek to diversify

systemic Australian disability risks into the broader international reinsurance pool. It is uneconomic to attempt to retain and fund such risks within the nation's borders (as many large companies have come to realise in the last few years in current post high-growth Australian economy).

  - While some in the industry wish to focus on mental health and "gold plated product terms" as drivers of recent poor IP experience, in our view the key underlying driver is actually the economic cycle and its impact on aspects such as income replacement ratios. Whatever change is made to product terms, these drivers of future experience will remain and will have to be better managed via both industry pricing responses and risk transfer/amortisation mechanisms.

- To be economic, such reinsurance arrangements need to mostly assist with "averaging" (for want of a better expression) of experience impacts across economic cycles, rather than simply deal with temporary "volatility" risk which has been the historic focus of life reinsurance in the past. Such arrangements are likely to be complex and involve what would historically be regarded as unusual premium and experience adjustment mechanisms over time.
- In dealing with IP business, claims reserves can become very large. Under regulatory capital tests these can too easily exceed APRA asset concentration limits. Given recent developments on the inability to use collateralisation mechanisms to secure these exposures, future reinsurance arrangements will need to include further complexity in approach to properly deal with such issues as well.

The interpretation of LPS230 should be clear enough to properly recognise such arrangements as legitimate life reinsurance arrangements and not as limited risk transfer or financing arrangements. As currently worded in the proposed LPS230, this is not clear to us.

We would be pleased to provided further input or help with suggested wording if that would be of assistance to APRA.

Yours faithfully,

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