



30 June 2017

**TO: ALL LIFE INSURERS**

## **APPROVAL OF REINSURANCE ARRANGEMENTS UNDER PRUDENTIAL STANDARD LPS 230 REINSURANCE ATTACHMENT B**

This letter provides guidance to life insurers on APRA's interpretation of *Prudential Standard LPS 230 Reinsurance* (LPS 230), including APRA's approach to considering applications for approval of reinsurance contracts under that Standard.

### **Introduction**

LPS 230 sets out, amongst other things, requirements for insurers to apply to APRA for approval prior to entering into reinsurance contracts that are potentially financial reinsurance contracts. Given the potential adverse prudential consequences of financial reinsurance contracts, and the difficulty of precisely defining when a reinsurance arrangement may be financial reinsurance, LPS 230 deliberately subjects a wide range of contracts to an APRA approval requirement.

### **LPS 230 in practice**

APRA has observed that this approach has resulted in:

- APRA approval being technically required for significant numbers of contracts, about which APRA is not concerned from a prudential perspective; and
- the possibility that some insurers have not sought APRA approval for contracts that would come within the broad definitions of LPS 230.

### **Guidance to life insurers on LPS 230**

Through its supervision activities and previous applications for approval received under LPS 230, APRA is aware of a wide range of reinsurance contract features. Some of these features are of significant interest to APRA, others are not.

Attachment A to this letter provides guidance for life insurers on:

- examples of contract terms that APRA expects would result in an application for approval (including where an existing arrangement is being amended and it already contains or now will contain such terms); and
- circumstances where APRA's prior approval would generally not be required.

These examples are not exhaustive. APRA expects insurers to review proposed reinsurance contracts bearing in mind the broad application of LPS 230 and determine whether an application for approval is necessary. Where it is determined that an application is not required, the reasons for this should be documented adequately. This material is likely to be reviewed by APRA supervisors in future.

## Expectations of life insurers

APRA expects life insurers, when preparing the annual reinsurance report required under paragraph 3 of LPS 230, to consider the guidance contained in this letter. If a reinsurance arrangement has not previously been approved by APRA, the life insurer should provide information in the report regarding any existing reinsurance treaties that include terms that would require the insurer to seek APRA's prior approval under LPS 230.

APRA expects this to be based on an assessment by the Appointed Actuary, and that this information will be included in the annual reinsurance report as soon as practicable (and in any case by no later than 31 December 2018).

APRA does not require insurers to seek retrospective approval for any current reinsurance arrangements. APRA supervisors, however, may review individual circumstances to ascertain whether further review of some treaties is necessary.

## Next steps

The proposals in this letter are intended to serve as an interim arrangement. LPS 230 is due to expire on 1 April 2018, and a review will be undertaken of whether any revisions to the Standard or guidance material are appropriate. APRA expects to consult on any proposed revisions to LPS 230 or any proposed guidance arising from the review later this year. In the meantime, if any insurer wishes to convey any views on the matters covered in this letter, please contact your responsible supervisor.

Yours sincerely,



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## Attachment

### Issue 1 - exemption of premium as a financial benefit from the insurer to the reinsurer

Under LPS 230 Attachment B paragraph 3(a), premium payments are only excluded from being a financial benefit if the calculation of premium does not take account of any financial benefits provided by the reinsurer. To rely on this exclusion, the insurer must be able to establish that any financial benefit provided by the reinsurer is a free benefit i.e. it is not priced into the premium.

### Issue 2 - high initial commissions

Under LPS 230 Attachment B paragraph 2(b), payment of reinsurance commission is an excluded financial benefit. APRA's view is that where a reinsurance commission exceeds 100 per cent of the premium to which it relates, it contains an element which cannot be described as reinsurance commission and is therefore not an excluded financial benefit for the purposes of paragraph 2(b).

Therefore, APRA's prima-facie expectation is that any arrangement with an initial commission which is not an excluded financial benefit in terms of the above criteria would result in an application for prior approval. However, APRA generally would not expect to receive an application for prior approval where all the following elements are present:

1. the reinsurance arrangement applies only in respect of new business;
2. the initial commission is not significant relative to the insurer's capital base;
3. reinsurance initial commission, relative to the present value of acquisition expense recovery components in the insurer's gross premiums, does not exceed the proportion of the insurer's gross claims ceded to the reinsurer;
4. the initial reinsurance commission is effectively lost to the reinsurer and ordinarily can only be recouped via its share of future premiums and other non-excluded cash flows arising from the block of business reinsured, i.e. the reinsurer is fully exposed to the actual lapse experience of the business; and
5. any recapture provision meets the additional requirements outlined below.

An insurer should seek prior approval where a reinsurance arrangement involves reinsuring (or modifying the reinsurance on) existing retained business and involves an up-front payment to the insurer from the reinsurer.

Any application should include details on whether the up-front payment will remain in the statutory fund, e.g. to support new business growth, and the impact of the arrangement on existing policy owners including whether it may result in any unfairness to them.

### Issue 3 - recapture of business

While LPS 230 contemplates the termination of the reinsurance contract (e.g. paragraph (j) of Attachment A), this typically involves the reinsurance treaty being closed to new business and remaining on foot for the run-off of existing business.

Arrangements that involve payments for the termination of a reinsurance arrangement and its subsequent recapture will prima-facie give rise to financial benefits that are not excluded under LPS 230. Such provisions are inconsistent with the general intent that reinsurance is in place for the life of the block of business being reinsured under the arrangement.

However, APRA generally would not expect to receive an application for prior approval where all the following elements are present:

1. the reinsurer has no legal right to directly or indirectly trigger recapture;
2. recapture by the insurer is subject to APRA prior approval (APRA will need to be satisfied the insurer will be adequately capitalised after the recapture);
3. there is a clear and defined basis for determining the amount of the recapture payment; and
4. the recapture amount is not calculated in a manner that ensures a minimum level of return to the reinsurer or insulates it from adverse lapse experience e.g. it is not based on modelled/expected unamortised initial commission or deferred acquisition costs or any other amount related to the initial funding provided.

#### **Issue 4 - payment netting clauses**

Reinsurance arrangements often contain a payments netting or set-off clause whereby payments due to and from the insurer/reinsurer are settled on a net basis on a common date e.g. quarterly or monthly. Such payment netting arrangements can give rise to non-excluded financial benefits to both parties and thus trigger the requirement to seek APRA's prior approval pursuant to LPS 230.

Generally an application for prior approval would not be required where the payments being netted are payments due to or from a single statutory fund of the insurer and payments due from or to a single statutory fund of the reinsurer (where the reinsurer is authorised by APRA).

Arrangements may contemplate netting of amounts across different statutory funds or between a statutory fund and the shareholders' fund. APRA would expect to receive an application for prior approval where this is the case because such arrangements may give rise to significant issues in ensuring compliance with the statutory fund separation requirements of the *Life Insurance Act 1995* (Life Act). Any such application should include legal advice describing how the arrangement meets the requirements of the Life Act.

While a payment netting arrangement may be approved for the purposes of LPS 230, recognition of the net amount will not automatically carry over for the purposes of *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117) paragraph 17. In order to be recognised under paragraph 17 of LPS 117, there must be a legally enforceable right of offset at all times and in all circumstances. In particular, the right of offset must operate without fetter in the wind-up of either the insurer or reinsurer; as well as in the case of either party entering into any resolution regime prior to a winding-up (including judicial management for an APRA authorised entity). APRA's view is that general contractual netting arrangements will have considerable difficulty in complying with this test.

#### **Issue 5 - other clauses intended to reduce reinsurance counterparty exposures**

In addition to payment netting clauses, reinsurance arrangements may contain other features designed to reduce counterparty credit exposures of the insurer or reinsurer. Examples include 'funds withheld' and 'deposit back' arrangements or other collateral requirements.

These security features may be documented as part of a particular reinsurance contract or under one or more separate arrangements between the relevant entities. Prima-facie, such arrangements give rise to non-excluded financial benefits to both parties and so require approval under LPS 230.

Paragraphs 17 and 25 to 28 of LPS 117 set out requirements that must be met for security arrangements to be recognised for the purpose of reducing counterparty credit exposures for capital adequacy purposes. Additionally, APRA may adjust, in relation to a particular insurer, the operation of specific provisions of LPS 117 on a case-by-case basis under paragraph 30. APRA is willing to consider applications from insurers to recognise collateral trusts as reducing counterparty credit exposures for capital adequacy purposes, applying the principles outlined in paragraph 6 of Attachment B of *Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge* applicable to general insurers.

Where an insurer has established, to APRA's satisfaction, its security arrangement meets the relevant requirements of LPS 117 then it will be deemed accepted for the purposes of LPS 230 without the need for an additional approval.

### **Issue 6 - interest payments**

Since interest payments/accruals are often a critical component of financial reinsurance deals, interest payments/accruals are not covered under the definition of excluded benefits in LPS 230 Attachment B paragraphs 2 and 3. Therefore a reinsurance arrangement which contains interest payment provisions generally should be the subject of an application for APRA's prior approval.

However, APRA generally would not expect to receive an application for prior approval where all the following elements are present:

1. interest only applies to an overdue amount after the expiration of a grace period (this may be a 'net' amount in the case of payment netting clauses);
2. both the insurer and reinsurer can be required to pay interest; and
3. the circumstances in which interest may accrue, and the basis for determining the interest rate, must be clearly defined and reflect arm's length, market terms and conditions at the outset of the arrangement.