PACIFIC LIFE RE

Race for capital optimisation

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With local regulatory regimes making the transition to global reporting standards, Mitsuhiro Tanaka and Vasan Errakiah of Pacific Life Re say it is all the more crucial that the industry plan ahead and look at efficient capital management urgently.

Efficient capital management has become an increasingly important area in recent years within Asia. This is especially so as local regulatory regimes make the transition to global reporting standards, such as IFRS and economic capital. This includes China Risk Oriented Solvency System (C-ROSS), Korea IFRS 17, Singapore RBC II, and other regimes currently being studied.

There are added complexities for international companies, for instance, local regulatory restrictions with regards to capital outflow. Although capital injections are often only needed for a temporary period, for example, during high production of new business with acquisition strain under local practices, capital repatriations to international parents or holding companies are often restricted by local guidelines or limited by local regulators.

This leads to material over-capitalisation and in some cases, international players have had to pass promising opportunities elsewhere due to capital trapped in certain markets. This hinders any effort of managing capital efficiency globally.

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LOOKING AT REINSURANCE SUPPORT

Heavy statutory requirements also cause insurers to face material acquisition strain in early years.

Most companies are keen to distribute the high acquisition cost evenly over the term of the business which is better aligned with modern Key Performance Indicators for international companies instead of incurring large losses in the first year and high profits in following years.

A potential approach to solve this matter is to obtain reinsurance support via a coinsurance agreement on original terms (the reinsurer pays a share of all the cashflows the insurer incurs).

This arrangement typically involves limited risk transfer such that reinsurers are able to accommodate such transactions at lower costs to achieve their targeted performance measures while meeting the insurers' needs at the same time. At a high level, reinsured profits are used to amortise the acquisition cost, supported by the reinsurer, which usually spans a time period of five to seven years, after which the arrangement typically expires via the recapture by the insurer or through other similar methods.

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PROVIDING ALTERNATIVE CAPITAL AT A REASONABLE COST

The objective of any capital optimisation arrangement is to provide alternative capital at a reasonable cost, typically up to a few hundred basis points of the capital relieved, where reinsurance cash flows are intended to recoup the temporary capital.

These transactions pass wider business risks to reinsurers but are typically designed with less sensitivity to traditional risks such as mortality, morbidity, or persistency. Besides original terms coinsurance structure, other structures can be considered, taking into account the relevant environments, and most importantly, for such transactions to be fully compliant with local regulations.

SEEKING REGULATORY BUY-IN

In order to develop a workable solution, a clear understanding of local statutory requirements versus economic valuation bases is required. Some of the key considerations include differences in treatment of negative liabilities, future improvement assumptions and tail risks.

As with any non-conventional arrangements, regulatory buy-in must be sought before capital solutions can be adopted widely. While the approach has been accepted in some countries, regulatory bodies in countries where these types of arrangements have been less common in the past have approached this with caution. This is partly driven by the uncertainties with regards to the appropriate accounting treatment, misconceptions of the arrangement, and understanding the motivations for it.

Reinsurers can play a critical role in this arena by proactively engaging with regulators to fully explain the structure to help alleviate any residual concerns.

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AIMS OF CAPITAL SUPPORT ARRANGEMENTS

Capital optimisation arrangements, as is the case for any traditional reinsurance solutions, are not specifically meant to resolve evident issues that affect the economic value of the business, for example, negative spread or a chronic shortfall in investment gains to contracted investment credit.

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These issues need to be taken care of by a comprehensive review of the underlying product design and reinsurers must be willing to support insurance companies through this process. In other words, motivations for attempted transactions need to be carefully examined so that capital support arrangements are utilised only for the purpose of supporting healthy growth of financially sound insurers.

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PLAN AHEAD TO ADJUST TO NEW REQUIREMENTS

All in all, the race for capital optimisation is expected to gain more traction over the short to medium term as Asia gets closer to adopting international reporting standards.

It is imperative that the industry plans ahead to ensure that new regimes are implemented with no material immediate impact on capital position, solvency ratio, and has sufficient time to transition to the new requirements.

Reinsurers can also help to provide interim solutions or alternative low cost capital for such transition periods.

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ABOUT PACIFIC LIFE RE

Pacific Life Re works with clients in Europe, Asia, Australia, and North America to manage their mortality, longevity, and morbidity risk. We have built a strong, experienced team with a reputation for technical expertise, responsiveness, innovation, and excellence in service delivery to our clients.

Pacific Life Re is a wholly-owned subsidiary of Pacific LifeCorp, the parent company of Pacific Life Insurance Company.

For more information about Pacific Life Re, please visit our website www.pacificlifere.com or follow us on LinkedIn.

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