**2014 S1**

**Q2** a) *Responses to the CFO’s questions regarding the differences in US GAAP and MoS reporting are as follows:*

* [State the obvious] Assets on the MoS Balance Sheet are shown at their market value whereas assets are shown at book value for the required US GAAP approach taken;
* In addition, under MoS the liabilities are valued based on current market rates rather than locked in rates under US GAAP;
  + As a result, changes in market interest rates will impact both the asset and liability side of the balance sheet (with any mismatch resulting in a direct impact on the profit / loss of the insurer) whereas under the US GAAP used by the company, a change in market interest rates will not impact either side of the balance sheet.
* Under US GAAP, there is an explicit DAC asset on the balance sheet whereas under MoS there is no explicit DAC but rather a negative policy liability;
* US GAAP includes PADs and has a benefit reserve based on a net premium valuation, whereas the MoS reserves do not incorporate any PAD. Given the US GAAP reserves have a PAD, they are likely to be higher than the MoS reserves given this added conservatism versus a best estimate;
* Loss recognition under US GAAP for the company is done across similar business in the Asia-Pacific whereas for MoS, the loss recognition needs to be done at a related product group for business in Clooney Life;
* The reserves for disabled lives and IBNR use the same assumptions.

b) TO: CFO

FROM: Actuary

You have asked me to detail the potential negative implications for Clooney Life of reinsuring its life insurance business within the group as opposed to the current arrangements with an outside reinsurer who is designated as a “specialist reinsurer” by APRA. These negative implications and potential solutions, are listed below:

1. Increased Local Capital Requirements

**Issue**

* Under the Australian Capital requirements (known as LAGIC) asset concentration limits apply for various classes of assets. Where an asset exceeds those limits, the amount of that asset in excess of that limit becomes inadmissible for capital purposes.
* The reinsurance of Clooney Life’s business is currently undertaken by a “specialist reinsurer”. Asset exposures to this class of reinsurer has a limit under LAGIC of the greater of 25% of the value of the assets of the statutory fund or $20m.
* However, if Clooney life were to reinsure its business with a company within the group, a lower limit of the greater of 2.5% of the assets of the statutory fund or 12.5% of the capital base would apply.
* Consequently, should Clooney Life move their insurance within the group, the capital held by Clooney Life may have to increase if the low limits described above are exceeded.

**Solutions**

* For the parent company to post with Clooney Life collateral against the reinsurance asset to reduce the asset concentration below the lower limit;
* For the parent company to apply to APRA to become a “specialist reinsurer”. It is worth noting that this is likely to require considerable effort and the outcome is uncertain;
* Working with a specialist reinsurer to take on the reinsurance and then to retrocede this to the parent. I note however, that the reinsurer is likely to charge a fee to provide this service.

2. Greater Volatility of Group Profits

**Issue**

* Currently profit volatility for the group is managed by passing on risks to the reinsurance market. By keeping reinsurance risk within the group, the results of the group will likely be subject to greater volatility due to the results of Clooney Life.

**Solution**

* Consider using external reinsurers for high surplus covers and catastrophe type risks. Quota share type reinsurance may then be retained within the group.

3. Less Access to Reinsurance Expertise

**Issue**

* Reinsurers have a view of a large section of the market. They also have specialised technical teams such as underwriting and claims management that can provide valuable support to their insurance partners.
* Moving the reinsurance of this business to the parent company from the current reinsurance partner will reduce Clooney Life’s access to this reinsurance support.

**Solutions**

* Increase Clooney Life’s expertise in those areas where reinsurers are providing support. This may for example require Clooney life to increase the size of its R&D function or to make greater use of consulting partners;
* Consider splitting the reinsurance between the current reinsurer and the parent company. In this way, Clooney Life will be able to continue receiving access to the services of the specialist reinsurer.

4. Cost of the Change

**Issue**

* The administration of the reinsurance will need to be undertaken by the parent company. The cost of such administration will currently be covered by the reinsurer currently who is likely to benefit from economies of scale and will hence have a lower cost of performing such administration. The cost to the parent of undertaking this administration for Clooney Life, and no other companies, is likely to be significant.

**Solutions**

* Consider using third party providers with expertise in reinsurance administration to set up processes.
* Consider simpler to administer reinsurance contracts for internal reinsurance (e.g. simple quota shares or stop loss arrangements) rather than more complex structures.