New Zealand Society of Actuaries (Inc)

3 October 2014

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Dear Cavan

Solvency requirements for Variable Annuities - Consultation Draft 5 September 2014

The New Zealand Society of Actuaries ("the Society") welcomes the opportunity to comment on the Solvency Requirements for Variable Annuities.

Overall Comments

Traditional annuities are no longer a viable product in New Zealand, due to a number of factors including the capital requirements. The last provider of annuity products has ceased writing new business. However there is still a need for retirement income products, particularly as Kiwisaver maturities become more significant.

We appreciate and support the Reserve Bank being open to accommodating innovation in the insurance market, including with respect to retirement income products.

We note that a variable annuity product is fundamentally a unit linked product with in built guarantees. Future products of this nature may have a wide spectrum of different guarantees and it is important that the approach is able to cope with different product designs.

With regard to the proposed approach outlined in the consultation paper, the Society supports the use of an actuarial modelling approach to determining capital requirements, but agrees that this requires a sound governance framework in which to operate.

Variable annuities introduce significant complexity and risk, which will require the insurer to develop a robust and well-developed risk management framework.

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Answers to Consultation Questions

1. ***Do you agree with these priors? Please elaborate?***

We agree with these priors, but note that the term "dynamic hedging" may be too narrow. There may be alternative ways of achieving the same risk management outcomes.

2. ***Do you have any comments on the Reserve Bank's proposal to refrain from prescribing particular modelling methods, distributions and calibration levels?***

It would be difficult for the Bank to be prescriptive in this case. Referring to international best practice and regulatory precedent is therefore sensible.

We agree that it is sensible not to double count conservatism in the assumptions, however the independent actuary and appointed actuary should comment on how the conservatism in best estimate assumptions is evaluated to assess any offset that may be taken in the capital models.

3. ***Do you agree that the quality and sophistication of the modelling and hedging should affect the capital allowance?***

This is fine in principle; however it will take significant expertise to evaluate the models.

4. ***Do you agree with the proposed approach for determining the capital calculation of variable annuity products when dynamic hedging is used?***

There may be methods other than dynamic hedging and the approach should allow for this. We suggest using a more generic term like "risk management mechanisms" such as dynamic hedging, reinsurance or similar.

5. ***Do you have any comments on the concept of capping this allowance at a predetermined levels and making the actual amount of credit dependent on the quality and sophistication of the underlying modelling and hedging?***

There is always a risk that any hedging or other risk management strategy is not 100% effective and capping the allowance to some extent is a way of allowing for this. Where other risk management methods are used like reinsurance, a different approach may be needed, which will consider the nature of the reinsurer and the contract for example.

The quality and sophistication of the modelling will require specialist expertise to evaluate. The Bank will need to source this expertise from somewhere - APRA may be an option. The Bank should not be solely reliant on the Independent Actuary's report in order to form a view. In our view it is sensible to draw on APRA's experience with internal models from the insurers and the governance around this.

6. In your view, is the proposed maximum allowance, ie the proposed weightings, adequate?

The maximum factor of 0.6 is less than used by APRA of 0.7. In our view it would be more consistent to use the same factor but with a pathway to get there as experience develops. Whilst the variable annuity market is small and undeveloped, the underlying risks of interest rates, investment markets and longevity are similar and not market size dependent.

7. Do you think the Reserve Bank is right in requiring an actuarial report and a hedging programme?

Yes, both of these requirements are essential to sound governance of this type of product. As stated before this should be wider than just hedging and cover the whole financial risk management programme.

8. Are there any other items that should be included in either report? Please specify with supporting reasons.

Both of these reports should be comprehensive risk and capital management reports and cover all relevant risks and capital management requirements. Provided this is clear we do not see any reason to include anything else.

Appendix – draft new attachment to Life Insurance Solvency Standard

Role of the Independent Actuary

It is vital that the capital models are done competently and by a practitioner that has sufficient expertise in the area. There will be a limited number of practitioners that will have the capability to do this analysis. It is most likely that a firm of consultants with global expertise that includes a track record in asset liability modelling will need to be engaged.

We note that as drafted there is strict separation of the three roles of Appointed Actuary, Independent Actuary and hedging strategy adviser. In addition, the auditor may also need to use an actuary to audit the accounts and solvency returns. In that case there would be 4 advisers all of who would need to be independent of each other.

We suspect that this would cause difficulties as the number of consultants available, even globally, may be restricted. The Bank could consider allowing a suitably qualified adviser to perform more than one of these first three roles. The Australian's went through a similar dilemma with the peer review actuary, and the solution was to allow the auditor's actuary to perform the peer review role.

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Assessing the competence of the Independent Actuary will be crucial. To do this successfully will need clear guidelines to avoid significant effort by the Reserve Bank to evaluate competence. In our view the Independent Actuary would ideally need to be from a consulting firm of significant size and capability. They will need to be able to demonstrate a track record of similar work undertaken previously and have demonstrated capability to use global expertise where required.

Longevity Risk

Depending on the design of the product, mortality risk could be significant component of the risks modelled. This will be incorporated in the modelling done by the independent actuary. We wold like to see a little more guidance about how this is done. e.g.

4.5 The mortality assumptions and scenarios must consider the impact of selection and mortality improvement and explicitly model reinsurance or other risk mitigation.

Yours sincerely

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