



27 August 2009

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Dear Richard,

### **Solvency Standard for non-Life Insurance**

The New Zealand Society of Actuaries welcomes the opportunity to comment on the solvency standard for non-life insurance companies.

#### **Consultation process**

In order to gain the widest consultation and consensus, we circulated the draft solvency standard and discussion paper to our members on 7 July.

Meetings to discuss the solvency standard were held in Auckland and Wellington on 3 and 5 August respectively. Those meetings were attended by 26 and 16 actuaries respectively.

The general insurance, health insurance and life insurance practice committees then reviewed this response, which has been approved by the Council of the New Zealand Society of Actuaries.

#### **Support for standards**

The New Zealand Society of Actuaries is supportive of mandatory solvency standards for insurance companies. We welcome the involvement that we have had so far and look forward to continuing engagement to finalise the standards

#### **Separate standards**

There was a consensus that the standard for non-life insurers may differ from the standard for life insurers. This will enable a practical approach to be taken reflecting the different nature of risks and relative impact of different factors. However, standards for different forms of insurance should not be contradictory with each other. In particular, health insurance may be regulated under either life or non-life, albeit that health insurance in a life company is likely to be held outside the life insurance statutory fund.

We now discuss the areas in the discussion paper for which comments were sought.

## **Definition of Capital**

Although one class of capital is simple, it could be inconsistent with regulation of other financial institutions and inconsistent with regulation in Australia.

If capital is restricted to ordinary equity, this may be tighter than Tier 1 capital for banks and APRA's definition of capital. For consistency, long-term subordinated debt should be capable of being included in solvency capital, as envisaged in section 20 of the draft standard.

The Reserve Bank should have flexibility to approve other forms of capital such as long-term debt and reinsurance. The key test should be whether the capital is secure, i.e. permanent and freely available to absorb losses.

## **Role of appointed actuary**

The Society supports the requirement for all insurers to appoint an actuary to assess the strength of technical insurance liabilities and prepare a Financial Condition Report (FCR) for the insurer.

The FCR will include analysis and commentary on the application of the solvency standard both at the balance date and a forward looking basis.

An appointed actuary for general insurers is consistent with the approach recommended by the International Association of Insurance Supervisors and Australian practice.

The requirement for general insurers to have an appointed actuary meets international obligations and convergence towards best practice in developed markets.

An FCR completed by an Actuary provides Boards with a forward looking assessment which is an actuarial strength.

A standard may not cover every conceivable situation. Thus, referring some items to the judgement of an appointed actuary is appropriate.

An actuary will be able to apply statistical techniques to test whether the technical reserves are adequate under a range of scenarios and whether the company is likely to remain solvent taking account of a number of factors including planned new business, adequacy of premium rates, investment policy, reinsurance program and fixed costs.

Fellows of the New Zealand Society of Actuaries will have passed stringent actuarial examinations, maintain ongoing competence via Continuing Professional Development and prepare reports in accordance with the Society's Code of Professional Conduct and Professional Standards.

The scope of work for NZ-based General Insurance actuaries will expand in many cases.

The Society supports paragraph 105 of the Standard allowing actuaries to seek advice from other relevant experts, as envisaged by section 5.2.1 of the NZSA code of professional conduct. The actuary will disclose the nature of any reliance.

## **Actuarial Assessment of Technical Liabilities**

The Society will update Professional Standard No. 4 (General Insurance Business) to take account of the new solvency standard and take account of international guidelines and comparable standards in Australia.

The actuary should also examine and report on projected solvency for a period of at least 12 months from the date their report is considered by the Board.

A longer projection period may be prudent depending on claims development pattern and data credibility. For example, the time-horizon under the current HFANZ standard is three years.

Paragraphs 94(c) and 99 require the actuary to assess Liability Adequacy Test at 75% having regard to any consequent write-down of Deferred Acquisition Cost or additional provisions for unexpired risk. This should be incorporated into the solvency test (c.f. outstanding claims in paragraphs 36 - 39).

## **Scope of Financial Condition Report**

A Financial Condition Report (FCR) provides succinct, high-level guidance to Boards of Directors on all relevant factors that affect the **ongoing** financial strength of an insurer.

It is imperative that the FCR remains confidential. The FCR could contain commercially sensitive information. The actuary must feel free to give uninhibited advice to the Board.

The primary purpose of the FCR is to inform the Directors, and often the Senior Management, about the past, current and future financial position of the business. It is then up to the Directors to make any policy decisions regarding the Company taking into account the information set out in the FCR.

The supervisory regime should ensure that companies get relevant comprehensive advice and then seek confirmation from the directors that they have considered and acted upon recommendations in a prudent manner.

The scope set out in Section 5.2 is appropriate to enable the actuary to provide relevant advice. However it is incumbent on the insurer to provide the actuary with all necessary data so that a full assessment can be made.

The obligation to have a Financial Condition Report prepared could generate additional work and cost for some smaller insurers. Thus, Reserve Bank might consider approving transitional arrangements on the scope of FCR for smaller insurers. For example, the FCR could be restricted to issues set out in paragraph 104 dealt with at a high level, with scope gradually expanded.

## **Dealing with rapid growth**

The Society suggests the Financial Condition Report should include scenarios with different levels of growth.

Due to the complexities involved (class of business, rate of growth, historical experience to base pricing or reserving analysis), it may not always be appropriate to use a standard formula to assess the impact of rapid growth on capital requirements.

'50% uplift in risk capital factors when growth exceeds 30%' could have a greater impact on newer companies. A business plan or FCR may be better for ensuring start-ups and high growth insurers remain solvent.

A minimum level of capital could serve the same function as the expense reserve in Life Insurance in insuring the company can meet its fixed costs during run-off.

The discussion paper did not suggest a minimum size of capital (\$ y million). Too small a number could endanger solvency. Too large a number could restrict competition from New Zealand companies that are newly established or operating in small geographic or niche segments.

### **Premium adequacy and deferred acquisition costs**

The Liability Adequacy Test in NZIFRS4 does not specify a probability of adequacy. APRA requires risk margins to be adequate at the 75% percentile for premium and claim liabilities. The Society believes that this proposed approach would be adequate.

### **Related Party Assets**

Excluding all related-party assets is simple and would prevent shareholder equity being lent back to the holding company. However, it could be harsh to set the value of subsidiary companies with unencumbered tangible assets to zero.

Thus, the Society recommends related party assets should only be disallowed after consolidation of any subsidiary companies owned by the insurer; i.e. looking through to the underlying assets, excluding related party investments.

There may also be a case for allowing investment grade listed bonds and other secured assets to be admissible, subject to prudential concentration limits.

We consider this to be a complex area and a more detailed discussion of these issues by the RBNZ would be extremely welcome.

### **Liquidity Risks**

Liquidity is usually not a concern for insurers. However, it could become an issue after a large catastrophe or in the event an insurer goes into 'run-off'.

It is possible that the introduction of regulation and new solvency standards could force some companies to go into run-off. Reserve Bank might wish to have discretion to grant transitional relief to insurers with a credible business plan to rectify shortcomings.

Liquidity should mean realisation without material loss. The amount should be known within two working days with settlement within five working days (to allow for standard settlement systems in secondary capital markets).

## **Assets readily realisable in New Zealand**

The Society supports regulation to require the title to assets to be:

- (i) legally owned by the NZ entity,
- (ii) unencumbered without any lien and
- (iii) realisable only by the NZ entity (not its parent or other related party).

The assets do not need to be NZ assets, so long as the assets are ring-fenced with unencumbered title held by the NZ entity. If assets are not ring-fenced, local policyholders could be left out in the cold if an offshore parent gets into trouble.

The responsibility to ensure sufficient assets are readily realisable in New Zealand to meet the policy liabilities and minimum solvency rests with the local Board and Officers.

The actuary may not be immediately aware if assets are repatriated to the parent and this jeopardises the security of local policyholders. However, when an appointed actuary becomes aware or suspects that assets have been siphoned-off by the overseas parent, he may have an obligation to inform the regulator and be legally immune to any sanction as a result of whistle blowing in good faith.

## **Long Term Risk**

Determining the additional risk charges for long-term asset or liability risks is a well established area of activity for actuaries.

The duration of certain classes of business, such as premium liabilities for liability insurance risks or ACC-style bodily injury risks, can be quite long and matching by term becomes relevant.

The treatment described in paragraphs 63-65 for asset-liability mismatch and paragraphs 40-44 for long-term liabilities are adequate.

We now comment on some specific items in the standard.

The Society is in agreement with items in the draft standard that are not specifically commented upon below.

### 15. Non-insurance activity

Risk management activities should be considered a core insurance activity alongside claims management and direct insurance sales.

### 16. Minimum Solvency Capital

Section 16 defines the solvency margin as the excess of actual solvency capital over minimum solvency capital. The minimum solvency capital is defined in section 9 as an amount to be determined. These definitions need to be reconciled.

### 23. Deductions from Capital

Some subordinated securities that are listed on a stock exchange and are investment grade might be better quality than first ranking securities.

We are unclear why equity or subordinated debt issued by other financial institutions should always be deducted from capital, if those instruments are held as investments in non-connected firms, particularly if those financial instruments are listed on the stock exchange.

A number of insurers hold subordinated debt of New Zealand financial institutions with AA credit rating and we believe such assets should be admissible.

### 34. Underwriting risk capital charge

It may be better to apply a (higher) underwriting risk capital factor to the (adequate or appropriately adjusted) Unearned Premium Reserve (UPR) rather than the annual Net Written Premium (NWP).

Use of factors applied to NWP for the year could overstate the risk for policies with a term of less than one-year (e.g. travel insurance or UPR linked to a monthly or fortnightly premium) or understate the risk for policies with a term of more than one-year (e.g. a multi-year extended warranty or consumer credit protection).

For some insurers the impact may not be material. However, for other insurers, including those that write predominantly business with terms not equal to one year, the effect could be very significant.

Comparison of the results from the proposed calculation with those using the APRA calculation is however resulting in capital charges that are as much as 40% to 50% higher and this cannot all be explained by the above issues.

The main reason for a materially higher capital charge is that the premium liability in the APRA calculation is after deduction of Deferred Acquisition Costs (DAC). The net amount is thus much less than 50% of NWP. The proposed approach omitted to make an adjustment for DAC in line with the APRA adjustment.

A capital charge that is materially higher than APRA could lead to reinsurance arbitrage, transfer of capacity from New Zealand to Australia and make it harder for local companies to compete on a level playing field.

Whilst a simpler approach based on NWP has some intuitive appeal, it would create unintended capital strain on well-run insurers.

The Society recommends this unintended outcome is rectified by using an approach closer to APRA's premium liability.

For example, we could retain an approach based on NZIFRS 4 accounts if the calculation is based on an adjusted UPR.

35. Insurance Risk Capital factors (table 1)

The average duration of travel insurance is shorter than other classes, so a lower risk capital factor may be reasonable, if annual net written premium is retained.

55. Asset Risk Capital Factors (table 2)

The factors are inconsistent with APRA. For example, the deduction for Property is 40% in table 2 compared with 20% in the equivalent APRA standard. The proposed factors are also higher than the prudent level in current HFANZ standard.

Similar differences with APRA also arise for “Other Fixed Interest” and “Listed Equities and Trusts”. We do not see any rationale to use risk factors different from those applied by APRA.

56. Asset concentration

We are not sure if it is consistent to give local government and SOE debt favourable treatment in section 56 but not in section 55.

61. Off-balance sheet exposure

Companies often try to identify suitable assets to back certain liabilities, having regard for example to currency and duration. Before considering the asset / liability mismatch there should be a hypothecation of specific assets to matching liabilities.

We are not sure whether assets in excess of liabilities should not be included in the asset exposures when calculating the Asset Risk Capital Charge.

65. Asset Liability mismatch

We note that if a duration mismatch is longer than one-year, a rules based Capital Charge will apply on a basis to be determined. The spreadsheet provided to illustrate the solvency calculations includes a formula for this Capital Charge.

The spreadsheet calculation compares the duration of the insurer’s total assets (including shareholders funds) to the duration of the insurer’s liabilities (which are mainly insurance liabilities).

Generally, shareholder funds do not match any specific liability and are often invested for a longer duration than assets set aside to meet the insurer’s policy liabilities (‘technical funds’).

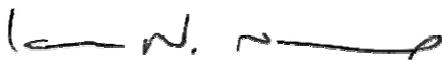
Unfortunately, the spreadsheet calculation does not hypothecate assets between technical funds to meet policy liabilities and shareholder funds.

The spreadsheet calculation appears to give rise to a Capital Charge on both technical reserves and shareholder capital. This is inconsistent with hypothecation for life insurance (see: section 12.4 of Professional Standard No. 5.01 Solvency Reserving for Life Insurance Business).

The Society recommends the Capital Charge calculation is modified to compare the duration of the insurer's assets, excluding shareholder's funds, with the duration of the insurer's liabilities. A Capital Charge would be applied if there is a mismatch of greater than one year between technical funds and policy liabilities.

Finally, the Society is willing to provide further comment on any aspect of the regulations and we would very much appreciate the opportunity to meet with the RBNZ to discuss matters further and work together to finalise the Standards.

Yours sincerely  
for/ New Zealand Society of Actuaries (Inc)



Ian New  
**President**



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