New Zealand Society of Actuaries (Inc)

4 March 2013

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Dear Ian

Insurance solvency standards: the quality of capital and regulatory treatment of financial reinsurance

The New Zealand Society of Actuaries ("the Society") welcomes the opportunity to comment on the consultation paper issued by the Reserve Bank of New Zealand (RBNZ) on 7 December 2012, on the insurance solvency standards. Our response is attached with this letter.

Input to this submission has been provided by both the Society's Life Insurance Practice Committee and the General Insurance Practice Committee, and has been approved by the Council.

In addition, to commenting specifically on the consultation paper, we have also taken the opportunity to comment on some additional changes and points of clarification in relation to the Solvency Standard for Life Insurance Business, we believe should be incorporated into any revision to the standard.

Yours sincerely
for New Zealand Society of Actuaries (Inc)

Catherine Johnston
Life Insurance Committee (Convenor)

Ross Simmonds
General Insurance Committee (Convenor)

RBNZ Consultation Paper: Insurance solvency standards: the quality of capital and regulatory treatment of financial reinsurance

Submission by New Zealand Society of Actuaries

Part One: The quality of capital

1. **Do you agree/disagree with the definition of capital for solvency purposes?**

We agree that a definition of capital is required for solvency purposes. However we believe that the definition of capital is not entirely transparent. The inclusion of paragraph 16(d) of the consultation paper implies the need to exclude amounts of capital (in the form of reserves) for a range of potential operational aspects. If 16(d) is intended to cover certain contractual agreements we believe these should be explicitly stated as an additional section within deductions from capital, rather than being covered by the current generic definition.

Paragraph 16(d) also seems to be inconsistent with paragraph 18 which states there are no proposed changes to deductions from capital.

2. **Do you agree/disagree with the overall characteristics of high quality capital?**

We agree with the overall characteristics of high quality capital.

3. **Do you agree/disagree with the general requirements for capital instruments?**

We agree with the general requirements for capital instruments.

4. **Do you agree/disagree with the qualifying criteria for capital instruments for**
   a) **Ordinary shares**
   b) **Reserves**
   c) **Preference shares**
   d) **Credit union securities**

Paragraph 17 indicates that perpetual non-cumulative preference shares without full voting rights may not constitute more than 50% of capital for a licensed insurer that is a mutual insurer and 25% for all other licensed insurers. In contrast, paragraph 34 indicates that ordinary shares must carry full voting rights to qualify as Capital. The differing treatment of ordinary and preference shares with regard to whether they carry full voting rights does not appear to have any particular basis or rationale and we do not understand why they should be treated differently.

Whilst ordinary shares that are fully paid generally carry full voting rights, this is not always the case with part-paid ordinary shares. We submit that part-paid ordinary shares without full voting rights should qualify as Capital, with the same constraints as for preference shares (that is, they cannot constitute more than 50% of capital for a licensed insurer that is a mutual insurer and 25% for all other licensed insurers).

For the qualifying criteria for Reserves, we believe that paragraph 16(d), which is repeated in paragraph 36, will require a detailed review of all contractual arrangements an insurer has. For a large insurer this is a substantial undertaking, and one that is not covered by the Appointed Actuary's normal responsibilities. This will require substantial input from an insurer's finance department, which we do not believe is justified given the characteristics of high capital set out earlier in the standard.

In addition, as noted above, if 16(d) is intended to cover certain contractual agreements we believe these should be explicitly stated as an additional section within deductions from capital, rather than being covered by the current generic definition of Capital, and be restricted to material items only.

5. **Are the proposed qualifying criteria for capital instruments appropriate for licensed insurers to manage their current and future capital requirements?**

The qualifying criteria provide a guide to the characteristics that capital must have to be considered. We are concerned that the need to consider contractual agreements may result in an onerous capital requirement for the industry. We believe there should be further consultation between RBNZ and the industry on what sort of contractual agreements should be deductions (and why), and which may not require a deduction. The lack of transparency around the definition of Reserves, as noted above, may create a potential degree of volatility around the level of Reserves. However assuming a consistent approach is applied, we believe a licensed insurer will be able to manage their capital requirements over time.

Part Two: Regulatory treatment of financial reinsurance

Our comments regarding Part 2 of the consultation paper are more generic in nature.

The RBNZ has outlined in paragraphs 19 – 21, the overall characteristics of high quality capital. As noted in paragraphs 82 and 83, in relation to financial reinsurance, the RBNZ has concerns regarding the ability of some such arrangements to meet those stated characteristics, for example, permanency and loss absorbency.

We believe it is important, in considering any options relating to financial reinsurance, that the RBNZ continue to maintain compliance with the stated characteristics, and not allow a different and/or lesser set of characteristics to apply to financial reinsurance. A financial reinsurance arrangement could be considered to be covered by paragraph 36, and a such consistency of treatment between different arrangements (be they financial reinsurance or otherwise) is important.

It should be possible to evaluate each financial reinsurance arrangement against the qualifying criteria. Essentially the criteria are achieving the same outcome as requiring full risk transfer to the reinsurer, including persistency risk. This could be assessed by stress testing the portfolio and determining if there is any residual obligation to the reinsurer.

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Part Three: Other revisions to solvency standards

1. **Do you agree/disagree with the proposed other revisions to the Reserve Bank's solvency standards?**

We agree with the proposed revisions.

2. **Are there any technical or implementation issues? If so, what are they and how could they be addressed?**

- Change 2, paragraph 6: There doesn't look to be any change to this paragraph – was there intended to be?

- Change 2 in relation to paragraph 138 of the Life Solvency Standard requires disclosure in the Insurer's annual financial statements of the solvency margin for each Life Fund from its most recent annual solvency return. However due to the timing of completion of the financial statements, which can be as little as one month from the balance date, the most recent annual solvency return may actually be for the balance date a year ago.

  Life insurers are required under NZ IFRS 4 Appendix C paragraph 17.8 to disclose their solvency position at the current balance date in the financial statements.

  Here needs to be the ability to show the solvency margin for the current balance date on a best endeavours basis within materiality for the financial statements, but for this to be fine-tuned for the annual solvency return.

  Website disclosure should then reflect the solvency position in the latest annual solvency return, rather than in the latest financial statements.

- Change 3 – we note that reference should actually be made with respect to the Life Solvency Standard to paragraph 45 rather than 38. There would then also be a need to add a new paragraph to section 2.3 of the Life Solvency Standard – possibly paragraph 50a.

  In terms of the wording of the change, we believe it would be better stated as "not freely available to meet losses ... **outside of those overseas branches**" rather than "outside its branch(es)", as the latter potentially also includes any New Zealand branch.

- Change 7 refers to table 2 of the Non-life Captives solvency standard, this should be table 1.

- Change 10 includes the requirement that a section 78 report be included with the annual solvency return. There does not appear to be any allowance for small insurers which are exempted from this requirement in the regulations. Noting the exemption for small insurers in the solvency standards would address this issue.

We have also identified some other additional changes and points of clarification in relation to the Solvency Standard for Life Insurance Business, we believe should be incorporated into any revision to the standard. These are as follows:

Paragraph (or Section) of Life Solvency Standard	Comment
14 – Definition of "Best Estimate Liability"	Neither the New Zealand Society of Actuaries Professional Standard 3 (PS3) nor NZ IFRS 4 Appendix C defines a Best Estimate Liability for business that is classified as a "life investment contract" under NZ IFRS 4. Such business is accounted for under NZ IAS 39 as a financial liability. "Life Investment" business in the main consists of investment linked (unit linked) and investment account type business. The definition of "Best Estimate Liability" needs to be expanded to cover such business. We recommend that the amount of the financial liability held for accounting purposes (generally the funded value of units or equivalent, which would match the value of assets backing the liabilities) would be appropriate for such contracts. The Best Estimate Liability, in contrast to the definition of Policy Liability, should not include allowance for any deferred acquisition cost asset.
16 – Definition of "Current Termination Value"	The CTV includes amounts to be paid to the policyholder on termination or wind up. It is also possible that on termination or wind up there is also a liability to the reinsurer. Should this be taken into account in calculating the CTV? We acknowledge that this may now be covered by the proposals in Part 2 of the RBNZ consultation paper.
20 – Life Fund	Paragraph 20 implies that an insurer can only have one Life Fund outside their statutory funds. Some insurers may wish to have more than one.
44 - Capital	44(a) restricts ordinary share capital to that with full voting rights, whereas 44(b) allows perpetual non-cumulative preference shares (to specified limits) when they don't carry full voting rights. This appears inconsistent and it is not clear what the rationale for the differing treatment is.

Paragraph (or Section) of Life Solvency Standard	Comment
83 – Off Balance Sheet Exposures	Clause 83 indicates that off-balance sheet contingent liabilities must have an asset charge as if they are assets however it is unclear which category of table 2 they would fall under. Item 8 of table 2 refers to "Off balance sheet exposures not covered elsewhere". If covered elsewhere, it would be good to clarify whether the categorisation should be related to the asset being guaranteed (eg if the guarantee relates to a particular AA fixed interest investment the charge is 2%) or whether it should relate to the rating of the underlying counterparty providing the guarantee.
Table 2 – Cash	There is a need to clarify the treatment of bank term deposits with respect to Table 2. Should some term of TD (90 days? 150days? anything up to 5yrs?) be classified the same as Cash at Bank on call. We understand that the RBNZ has given separate guidance to some entities on this matter although this is not widely known. Further guidance within the Solvency Standard is required.
Table 2 – Category 11	We believe the word "agents" includes sales advisors of any type but this is not clear. It would be useful for the term "agents" to be better defined. For example, when should a loan be included as an unsecured loan to an "agent" in Category 11 and when as a direct loan (secured or not) in Category 13. In addition, what should the treatment of a loan 'secured against future commissions' be?
88	Is there supposed to be an interest rate risk on Bank term deposits?
93	The formula for ΔAAIS as written is acceptable, but the wording "decrease (+ve) or increase (-ve)" could be better expressed.
94	We suggest the wording of paragraph 94 be amended as indicated in bold: "The above calculation specifies asset/liability scenarios which must be tested to arrive at a capital charge for the most adverse scenario. Where the circumstances of the Life Fund are such that other scenarios are potentially more adverse **(within the Actuary's reasonable expectation of extreme events)** then they must also be tested in order to arrive at the most adverse scenario."

Paragraph (or Section) of Life Solvency Standard	Comment
104	For clarification, we recommend that paragraph 104 specifically make reference to paragraph 66 (and possibly 64) if this is what is being referred to by "reinsurance assets arising as a result of recoveries on catastrophe reinsurance". References to "catastrophe reinsurance" can be confusing when the reinsurance allowance within paragraph 66 may be normal reinsurance that is in place that would be payable in the event of death of any kind, including a pandemic, and is not additional reinsurance specifically for the purpose of a catastrophe.
117	Paragraph 117 implies that the "unvested policyholder benefits liability" should form part of Other Liabilities, while the definition of Policy Liabilities suggests otherwise as these reserves would form an integral part of the Life Insurance Contract liabilities under IFRS 4. Furthermore, the statutory fund regulations refer to "unvested policyholder benefits" as "policyholder retained earnings". The treatment of "unvested policyholder benefits liability" needs to be clarified and the terminology aligned with the regulations.
127 – Treatment of Deferred Tax Assets	There are several comments: • It appears that RBNZ are interpreting wind up in a literal way whereas solvency liabilities for traditional business are generally calculated assuming a run off of the business. Net result is that valuation basis for assets and liabilities are inconsistent. Is "wind up" to be interpreted as immediate or over a reasonable period over which existing business would be wound up? What allowance could be made for profits expected to emerge over a wind up period or is the implication that the entity would be in dire straits? • Some insurers can "sell" tax losses within their wider tax group. It is unclear whether this is permitted to be taken into account. • The whole section is somewhat confusing and many insurers are calculating charges gross of tax and deducting from capital the Deferred Tax Asset (if any) at the balance date, which is a conservative approach.