3 November 2014

Felicity Barker
Adviser
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
WELLINGTON 6140

Dear Felicity,

Submission on the Solvency Standard Re-issue 2014

The New Zealand Society of Actuaries ("the Society") welcomes the opportunity to comment on the re-issued Solvency Standards as part of the consultation material released in September 2014. The Society appreciates the recent process of the Reserve Bank consulting on key issues prior to re-issuing Solvency Standards.

The Society currently represents over 300 members, including most Appointed Actuaries of NZ insurers, covering both the Life and Non-Life (general) insurance sectors. This submission combines the views of both the Society's Life and General Insurance practice committees.

Overall, the Society has 10 submission points, below, across both the Solvency Standard for Life Insurance Business ("Life Standard") and the Solvency Standard for Non-Life Insurance Business ("Non-Life Standard"). Points 1 to 4 are general comments applicable to both Solvency Standards; points 5 to 8 are comments applicable to the Life Standard; and Points 9 and 10 are comments applicable to the Non-Life Standard.

1. The lack of clarity in the identification of contingent liabilities is a significant concern for the Society given the increased disclosure requirements placed on Appointed Actuaries. We **submit** that more guidance be provided in this area.
2. The Society supports some form of capital charge for contingent liabilities. However, the proposed charges for contingent liabilities, within the Asset Risk Capital Charge, will often be much higher than a reasonable value of the underlying risk. We **submit** that a probability weighted assessment of the contingent liability be considered, prior to applying a capital factor.
3. The Society is concerned about the short timeframe for implementation and questions the need for regular incremental change to Solvency Standards. We **submit** that the timeframe for implementation be extended and there be less frequent changes going forward.

4. Changes with respect to taxation in the Solvency Standards contradict comments in the associated regulatory impact statement. We **submit** that the Reserve Bank should consider their long-term position on taxation and make this clear in the final re-issued Solvency Standards.
5. We **submit** that health insurance business should be allowed within a statutory fund if it qualifies under section 85 of the Act.
6. It is not clear whether projected new business should be allowed for within the stress testing of reinsurance contracts. We **submit** that further clarification is necessary in this area.
7. The specified event test does not deal with situations where reinsurance premiums are a percentage of gross office premiums or if both the reinsurer and the direct insurer might increase their premiums together. We **submit** that this situation be allowed for in calculating the repayable amount.
8. We **submit** that the insolvency reference within Paragraph 41 be clarified as to whether it refers to technical insolvency or breaching regulatory minimum standards.
9. The intention of including EQC recoveries in the Reinsurance Recovery Risk Charge is unclear. We **submit** that the reference to EQC recoveries be excluded from the Reinsurance Recovery Risk capital charge.
10. Our views in respect of the Catastrophe Risk Capital Charge remain unchanged.

Further detail on the 10 submission points, including potential solutions, are provided in an Attachment to this submission. The Society is particularly concerned about extending the obligations of the Appointed Actuary to include analysis and discussion of contingent liabilities where there is limited guidance in this area.

As always, we remain available to answer any questions you may have on this submission.

Yours sincerely
for New Zealand Society of Actuaries (Inc)

Paul Rhodes
President

Attachment: Detailed submission points

The following sections provide further detail on the submission points from the Society. The first section relates to General Comments, which apply to both re-issued Solvency Standards. The second and third sections relates to specific comments on the Life Standard and Non-Life Standard, respectively.

General Comments

1. **The lack of clarity in the identification of contingent liabilities is a significant concern for the Society given the increased disclosure requirements placed on Appointed Actuaries.**

   The Life and Non-Life Solvency Standards both require a broader interpretation of contingent liabilities than the NZ GAAP Accounting Standards. However, there has been no indication or further guidance on the extent of this breadth.

   Under the accounting standard on contingent liabilities (IAS 39) contingent liabilities are not required to be recognised on the balance sheet but will need to be disclosed in the notes to the financial statements unless their likelihood of occurrence (within the next three years) is 'remote'. It would therefore appear very unlikely that there exist any material contingent liabilities that are not already disclosed in the financial statements.

   We understand that the Reserve Bank's intent is that highly improbable events need not be considered in solvency calculations. However, this is not clear because the broad definition in the Solvency Standards implies that contingent liabilities beyond a remote likelihood of occurrence need to be considered. This could lead to very different interpretations being taken by various parties. In one extreme, every possible conceivable contingent liability of the insurer might be considered, which would result in the insolvency of most insurers in New Zealand.

   Furthermore, solvency returns are required to be audited and, under this proposal the auditor, will potentially have to sign-off on two conflicting interpretations of contingent liabilities.

   The actuarial profession is very concerned by this lack of clarity and guidance, particularly now that there are increased obligations on the Appointed Actuary to disclose information on all known contingent liabilities in the Financial Condition Report. An actuary's area of expertise has not traditionally included the identification of contingent liabilities, which means that these increased obligations without appropriate guidance present a significant challenge for Appointed Actuaries.

   We **submit** that the Reserve Bank clarify the breadth of contingent liabilities through a more prescriptive definition, further guidance or specific examples of what is (or what is not) considered to be a contingent liability. One option may be to align the definition to NZ GAAP because we do not believe that remote contingent liabilities should be included. Providing more clarity will ensure more consistency in interpretation across the industry and make it easier for actuaries, auditors and directors to fulfil their duties.

2. The Asset Risk Capital Charge in respect of a contingent liability will often be much higher than a reasonable value of the underlying risk.

Overall, the Society supports a capital charge in respect of contingent liabilities. An insurer with many contingent liabilities is more risky than one without and this should, therefore, be reflected in the minimum solvency requirements.

The re-issued Solvency Standards require that a contingent liability be quantified assuming it is paid, or if it uncertain the value estimated at a prudent amount. This amount is then multiplied by a 'resilience capital factor' charge depending on the credit rating of counterparty (or, if no counterparty, 20%). We believe that the amount used and factor applied will over-state the true underlying risk of contingent liabilities in many cases.

Determining the full value or prudent value of a contingent liability might not necessarily be a straight forward exercise. There may be a range of possible outcomes, depending on the allowances made for variations permitted within contracts and the extent of costs or damages awarded through litigation.

More importantly, however, is that the probability of a contingent liability converting into an actual liability for an insurer is not considered. This approach is not consistent with the valuation of any insurance liability, any embedded guarantees, or other solvency liabilities within the Solvency Standards. We consider this wholly inappropriate. The impact of not making a probability weighted assessment will be particularly material for those contingent liabilities that have a remote likelihood of occurrence.

With respect to the resilience capital factor applied, there may be no counter-party, or no relevant credit rating of the counter-party, related to the contingent liability. In such cases the Solvency Standards require a factor of 20% to be adopted, regardless of the driver behind the liability. This 'one size fits all' approach will not always lead to sensible outcomes.

We **submit** that the Asset Risk Capital Charge in respect of contingent liabilities consider the likelihood of occurrence, prior to applying an appropriate capital factor. We also **submit** that the resilience capital factor applied be more closely linked to the driver behind the liability, rather than a counter-party credit rating (as there may not be anything suitable).

PO Box 10 087, Wellington | Tel: 04 815 8179 | Fax: 09 479 4530 | Email: society@actuaries.org.nz | Website: www.actuaries.org.nz

3. **The Society is concerned about the short timeframe for implementation and questions the need for regular incremental change to Solvency Standards.**

   The timeframe for implementation of the re-issued Solvency Standards is very tight. In our view, this is not in the spirit of effective prudential supervision because there is pressure on insurers and industry bodies to rush their responses. The Society is relatively small compared to overseas actuarial bodies and, as a result, we do not have as much capacity to absorb changes quickly.

   We are also concerned over the verbal signalling that incremental change is likely to be a regular feature for some time. Every change requires effort in understanding the changes, changing calculation methodologies, reviewing target surplus requirements and communicating the impact of the changes to management and directors. Regular change therefore makes it hard to "future proof" operational changes, raising the risk that insurers rely on manual processes and "one offs". This is inefficient and, in our view, unnecessary as the majority of the industry is already well-capitalised.

   We **submit** that the timeframe for implementation should be extended and for future changes to be made to Solvency Standards only where it is absolutely necessary.

4. **The Reserve Bank's intention with respect to taxation needs to be clearer over the long-term.**

   Both the Life Standard and the Non-Life Standard now state that all numeric factors and charges are gross of tax. The change could result in material changes in an insurer's minimum solvency capital requirement and the clarification is welcomed by the Society.

   However, the regulatory impact statement associated with the consultation material notes that taxation is an area where the Reserve Bank will look at in the future. Therefore, there is considerable uncertainty as to whether the proposed changes in respect of taxation will be permanent or not.

   We **submit** that the Reserve Bank should consider their long-term position on taxation and make this clear in the final re-issued Solvency Standards. This approach will avoid multiple changes in a short period of time to an area that has the potential to have a material impact on an insurer's solvency margin.

Comments applicable to the Life Standard only

5. **Health insurance business should be allowed within a statutory fund if it qualifies under section 85 of the Act.**

   Paragraph 7 of the re-issued Life Solvency Standard states that health insurance business must be dealt with in a life fund outside the statutory funds of the life insurer. This is a subtle change in wording that we believe is an unintentional change and contradicts the Insurance (Prudential Supervision) Act 2010 (“the Act”).

Section 85 of the Act deals with composite policies, which can exhibit both Life and Non-Life characteristics. Health insurance business can be deemed to be ‘life policies’ if the premium is less than 25% of the total premium for a life insurance product line. In such cases, health insurance can then be permitted to be accounted for within a statutory fund.

We **submit** that Paragraph 7 be amended to allow for health insurance business within a statutory fund, provided that business meets other requirements of the Act.

6. It is not clear whether projected new business should be allowed for within the stress testing of reinsurance contracts.

Paragraph 148 (f) requires life insurers to stress test its reinsurance contracts initially, then re-visit this stress testing if there are significant changes to the agreement.

We note that often when a reinsurance contract is first incepted it will apply primarily to future new business. However, sometimes a reinsurance contract will cover existing policies as well as new policies. New business volumes are, however, relevant to stress testing newly written reinsurance contracts and the outcomes will be sensitive to the new business assumptions.

Furthermore, the paragraphs relating to stress testing in Appendix E do not mention new business volumes as a relevant parameter for stress testing.

We **submit** that further clarification is necessary as to whether projected new business volumes are included in the stress testing. We **suggest** (projected) new business should be included in the stress-testing of reinsurance contracts. We note in particular that if the modelling from inception is only intended on existing business in-force at the time the contract was first effected, then this would in many cases be very small and perhaps even immaterial. However, its materiality will increase substantially over time.

With regard to 148 (f) ii and iv, we make the point that applying modelling from inception to existing treaties could be very difficult. The assumptions and business in-force at the time of inception of an existing reinsurance contract may be very difficult to find or verify; particularly if the treaty was effected many years ago. We **suggest** that the standard should allow stress-testing for existing treaties on their current position (including projected new business where relevant) in the first FCR where their stress tested position is reported, as an alternative approach to modelling from inception, where the actuary considers that the outcome of the stress test on the current basis would not give a different result to modelling from inception.

Alternatively if, for an existing treaty, the Solvency Reinsurance Balance is less than zero we **suggest** such stress testing need not be carried out; with this revisited at any time in future if the Solvency Reinsurance Balance does become positive.

7. The specified event test does not deal with situations where reinsurance premiums are a percentage of gross office premiums or if both the reinsurer and the direct insurer might increase their premiums together.

The specified event test includes circumstances where the insured is under obligation to pay the reinsurer, including in the event of poor experience (Appendix E, Paragraph 10).

However, it is likely that if poor claims experience does eventuate under some agreements a reinsurer may increase their reinsurance premiums. This may, in some circumstances, be only if the insurer themselves increases premiums, or it may be limited to reasonable price rises given adverse circumstances (where the direct insurer would also be expected to increase premiums).

We **submit** that if the reinsurer has the option to increase premiums under adverse claims conditions, for example, but this would only occur when an insurer themselves increases office premiums, or the insurer has the ability to increase office premiums then this should not form a repayable amount.

We also **submit** that 'affected' should be replaced by 'effected' in Paragraph 11 (d) (B) of Appendix E.

8. The insolvency reference within Paragraph 41 needs clarification.

On the proposed changes to the Insurance Capital Charge, Paragraph 41 the last line reads "in the event of insolvency of the licensed insurer".

We **submit** that this needs to be clarified as to whether insolvency in this context refers to insolvency under the Companies Act or failing to meet the Reserve Bank minimum solvency requirement.

Comments applicable to the Non-Life Standard only

9. The intention of including EQC recoveries in the Reinsurance Recovery Risk Charge is unclear.

Paragraph 90 states that reinsurance includes any coinsurance recoveries that become receivable from the EQC through government direction. The interpretation of this is unclear as coinsurance items are not included in an insurer's accounts. Furthermore, it is unclear why the EQC is identified as a coinsurer that is potentially more risky than other coinsurers.

We **submit** that the reference to EQC recoveries be excluded from the Reinsurance Recovery Risk capital charge.

10. Our views in respect of the Catastrophe Risk Capital Charge remain unchanged.

We would also like to note our previous submission, dated 7 July 2011, in relation to the Catastrophe Capital Charge. Our views in relation to the unnecessary high level of sufficiency required for this capital charge are unchanged.