New Zealand Society of Actuaries (Inc)

9 August 2013

Felicity Barker
Advisor
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Dear Felicity

Insurance solvency standards: guarantees and off-balance sheet exposures

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 ("the Bank") in May 2013, on the insurance solvency standards. Our response is attached with this letter.

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

Yours sincerely
for New Zealand Society of Actuaries (Inc)

Paul Rhodes
President

RBNZ Consultation Paper: Insurance Solvency Standards: guarantees and off-balance sheet exposures

Submission by New Zealand Society of Actuaries

Summary

Guarantees
• We support the use of guarantees by insurers as a valid risk mitigation technique. • We support the Bank's proposal to allow partial recognition of guarantees of shorted duration than the underlying asset. • We also support the transitional arrangements. • Guarantees are similar to reinsurance contracts that attract a 2-4% capital charge for a reinsurer with a rating of A or more. Given this point we do not agree that there should be a 15% limit on the recognition of those guarantees as this is inconsistent with reinsurance. We would recommend that the 15% limit be removed from Appendix1: Guarantees. • We have no further points to add in relation to Appendix 1.
Off Balance Sheet Exposures
• We would encourage the Bank to put in place transitional arrangements for Off Balance Sheet Exposures. • We support the Bank's view that these exposures should be allowed for. • We have concerns that the proposed changes to the Solvency Standard is in relation to a number of specific issues that could be better dealt with through licensing or other regulatory tools. • Our concerns focus on the wording "…*or which are able to be reasonably identified and give rise to a possibility, even if remote, of a net outflow of resources from the licensed insurer over the next 3 years."* • We would like further clarification of "contingent liability", "*able to be reasonably identified*" and "*even if remote"* as we believe this wording will have unintended consequences and will be difficult for our members to interpret. • We recommend that the Bank provide definitions in the Solvency Standard for "Exposure" and "off balance sheet liabilities". • We recommend that off balance sheet exposures are treated separately from assets in the Solvency Standard. • We recommend that these off balance sheet exposures are dealt with within the 3 year solvency projection which allows for future profits.

General comment

When the Reserve Bank of New Zealand ("Bank") was in the initial stages of drafting the Solvency Standards ("Standards") it held public presentations with various industry bodies. These were extremely useful as it enabled the Bank to provide the context and the intention of the wording within each Solvency Standard. We would strongly encourage the Bank to adopt a similar approach for this and subsequent material changes to the Standards.

General comments on Guarantees

The treatment of guarantees in the Standards recognises the underlying credit exposure by looking through to the ultimate counterparty and its credit rating. This concept is used throughout the calculation of the asset charge. The use of guarantees is a valid risk mitigation technique which we support and we do not agree with the view that the use of guarantees to receive "very large reductions in the Asset Risk Capital Charge" is a problem. Insurers have a number of tools to reduce their risk exposure, including reinsurance and re-balancing of investment portfolios.

The consultation document notes that a guarantee gives rise to "legal risk arising from improper contract formation", which is a concern to the Bank. Anecdotally it is our understanding that in some instances the Bank have been reviewing the contracts before accepting them as part of the solvency process. If the Bank has concerns over the contracts then in our view it would be better to raise that with the parties concerned rather than undermine the use of guarantees for all market participants. It appears inconsistent in the approach adopted for guarantees compared to other areas such as investments and reinsurance that also are open to this type of risk.

The consultation document notes that a guarantee gives rise to the "risk of a sudden change in Minimum Solvency Capital requirements as a result of non-renewal", which is a concern to the Bank. This issue is not restricted to guarantees. Many insurers rely on reinsurance for solvency, and if reinsurance was not renewed it would also give rise to a sudden change in Minimum Solvency Capital requirements. Once again this approach appears inconsistent with the treatment of reinsurance. We would suggest that this risk be more appropriately dealt with within the Financial Condition Report and the 3 year solvency projection calculation.

In the preceding paragraphs a comparison has been made to reinsurance contracts, and we feel that there is a strong link between the two. In both cases the insurer is relying on a third party to deliver material reduction in risk through a purchased contractual arrangement. However, the Bank proposal will result in a material difference in the way the two are treated.

Currently the Bank applies a Reinsurance Recovery Risk Capital Charge to cover the probability of a reinsurer not paying what it owes (i.e. credit risk and legal risk). The charge is 2-4% for a reinsurer with a rating of A or more. The Bank does not apply a charge to cover the likelihood of non-renewal of reinsurance.

Paragraph C of Appendix 1 is quite restrictive and may limit the possibility for insurers to benefit from this inclusion. Given the restrictions in place as to what constitutes an allowable guarantee, we don't believe it is necessary to limit the substitution allowance to 15%.

Given the above we believe that there should be no limit to the use of guarantees and that restricting the use of the guarantee appears to be inconsistent and overly conservative. The proposed treatment makes no allowance for the quality of the guarantees or the diversity of them (if more than one is used).

Specific comments on Appendix 1

Apart from the proposed limit on the use of guarantees which we believe should be removed for the reasons above, we have no specific comments and the proposed treatment is reasonable.

General comments on Off-balance sheet exposures ("Exposures")

We note that in paragraph 26 of the consultation paper there are transitional arrangements proposed for the treatment of Guarantees but no such arrangements for the treatment of Exposures. Given that both could have a material impact on Insurers' solvency we feel that transitional arrangements should also be put in place for Exposures. This would allow Insurers to mitigate any potential adverse impact and assist in an orderly transition to the revised Standards.

In principle we agree that some allowance should be included for Exposures in the Solvency assessment but we have reservations over the Bank's proposed treatment. We believe that the proposed wording may be designed to capture certain specific Exposures, such as lease commitments, but the wording is open to wide interpretation. Our concern is that the proposed wording will have unintended consequences as discussed below and will significantly increase the level of complexity in the solvency return calculations.

If the Bank is looking to capture a specific item such as lease commitments then it should be transparent and explicitly state this. Whilst we appreciate that the Bank wants to ensure that it has flexibility to capture future items that aren't contemplated yet, we feel the proposed wording is too broad. We also note that the Bank has specific powers whether with the use of specific licensing conditions or the issuing of specific solvency standard requirements to deal with individual insurers' Exposures. However, in our view the Bank needs to provide transparency to demonstrate that there is consistency across the industry. It would be damaging for insurers' relationships with the Bank if it was construed that the Bank had not been consistent.

We note that in paragraph 28 the Bank states that "Some insurers have been unclear which category various Exposures ought to fit into, or what constitutes an Exposure." We suggest that the Bank include within the Solvency Standard Definitions the definition for both Exposure and contingent liability to avoid confusion. We also suggest that a separate section be created in the Standard to deal with these Exposures rather than dealing with them within the asset section given that these Exposures are liabilities.

Specific comments on Appendix 2

Whilst understanding the reasons for drafting paragraph 95 contained in Appendix 2, we have concern over the drafting of this paragraph. The wording "*…or which are able to be reasonably identified and give rise to a possibility, even if remote, of a net outflow of resources from the licensed insurer over the next 3 years."* is very open and could lead to unintended consequences. Can the Bank provide clarification over the wording in particular around "*able to be reasonably identified*" and "*even if remote"*?

For example "*able to be reasonably identified*" can be construed in a number of ways as detailed below and it would be appropriate to provide further guidance as to the Bank's intentions.

- An obligation that may arise from an event that has already happened?

- An uncertain future event?
- An obligation that will or may arise if an uncertain future event occurs?
- Some combination of these?

The definition of "remote" in the Oxford English dictionary states "(Of a chance or possibility) unlikely to occur". This wording would require the actuary to take into account in the solvency calculation a wide range of possibilities from the entirely reasonable list set out in the appendix to others that can be identified but still fall short of the 'meteorite wiping out Auckland' scenario. For example:

- Inadvertent omission of facultative reinsurance request
- Employee fraud
- Redundancy payments
- Future salary increase and bonus payments
- Litigation (employment, tax, supplier)
- A 50% fall in asset values
- Change of ownership
- Change in regulation

It appears that paragraph 95 would require the actuary to analyse and allow for the cashflow associated with scenarios which are mutually exclusive and allowing for all of them. For example:

- An insurer winding up
- An insurer closing to new business
- An insurer continuing to write new business

In the case of the first two points, an assumed occurrence date would also be required, and different cash flows would result from different assumed dates.

As paragraph 95 is concerned with the net outflow of resources over the next 3 years, we believe that allowance for such events should not be made within the solvency calculation with a capital charge but could instead be considered in the three year solvency projection. An Insurer is required to report to the Bank if it is likely to fail its solvency margin over the next three years, which should provide the Bank with comfort over future solvency breaches and take account of emerging profits over that time horizon. Our feeling is that to allow for these events but not for future profits is inconsistent and overly conservative.

Another approach might be to require a schedule with a brief description of all contingent liabilities, defined according to a common understanding, thus allowing the Bank to review the information and request further details or initiate discussion if the information gives the Bank concern.

In summary we believe that the proposed wording is too wide and will have unintended consequences. The proposed paragraph 95 would require the actuary to take account of a wide range of possibilities that are unlikely to occur. This will require a significant amount of work which we do not feel is warranted given the relative risks these 'remote possibilities' pose to an insurer.

With regard to paragraph 97 we suggest that a more appropriate way of dealing with the value of a contingent liability would be for it to be treated net of the value of any corresponding guarantees associated with it. For example an Insurer with a contingent liability that has taken out insurance against it (e.g. Indemnity cover), the wording of the paragraph implies that an Insurer would need to allow for the gross value of the potential liability whilst not being able to count the contingent asset (potential insurance proceeds). This is inconsistent with the approach for reinsurance where a reinsurance asset is able to be counted and incurs only a (relatively small) capital charge. We would like to understand the Bank's rationale for this as we believe that what is proposed is overly conservative.

Specific comments on Appendix 3

We have no specific comments and its content is reasonable.

Specific responses to Bank's posed questions

1. Do you agree that guarantees of shorter duration than the underlying asset should receive some recognition in calculating an insurer's Asset Risk Capital Charge?

We agree with that guarantees of a shorter duration than the underlying asset should receive partial recognition.

2. Do you have any comments on the proposed treatment of limited term guarantees?

We believe that the treatment of these guarantees is pragmatic and we see no immediate issue with this. Both the term period of 5 years and the definition of the maturity are reasonable.

3. What are your views on placing a limit on the amount that the Asset Risk Capital Charge can be reduced through the use of guarantees?

We believe that there should be no limit to the use of guarantees and that restricting the use of the guarantee appears to be rather arbitrary and extremely penal. The proposed treatment makes no allowance for the quality of the guarantees or the diversity of them (if more than one is used).

4. Do you have any comments on the proposed amendments to the Solvency Standards in the appendices?

See the above sections:

1. Specific comments on Appendix 1
2. Specific comments on Appendix 2
3. Specific comments on Appendix 3
