RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Non-technical summary

Insurance solvency standard: first consultation

What is the insurance solvency standard?

Insurance business involves promising to make payments to policyholders when something goes wrong (a home insurance policy for theft or natural disasters, a health insurance policy for sickness etc.). Insurance companies need to be sure they have enough funds to pay out to customers who make a claim. Since no-one knows the future, insurers can't be certain how much they will need, though they can use their experience of what has happened in the past for guidance.

Insurers use this knowledge of past experience, alongside information about their policyholders, to decide how much to charge for the cover they provide. They need to charge enough to make sure that they have enough funds to cover claims and expenses, while making an adequate profit so that they can continue operating. However, there is always some uncertainty about the amount of claims that will occur in the future (and what the assets they hold to cover the claims will be worth).

Because of this uncertainty, insurers should have some extra funds (usually described as 'solvency capital') so that, even if claims turn out to be higher than expected or investments fall in value, they will still have enough to be able to pay out what they have promised to policyholders.

Solvency standards are rules that the Reserve Bank produces, which set out how to calculate the minimum amount of capital insurers should hold. The solvency standards have been designed so that policyholders can be comfortable that, even if unexpected adverse outcomes occur, the insurance company has enough funds to meet its promises to policyholders.

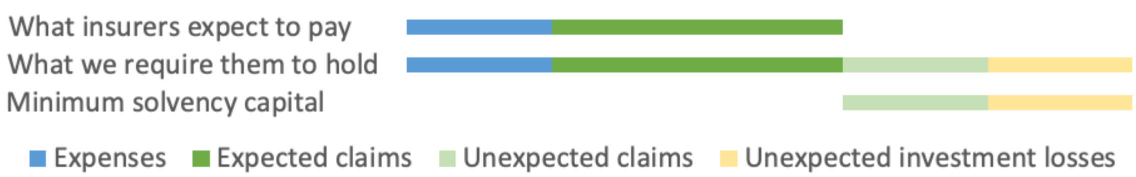
Why are we reviewing the solvency standard?

It is important that the Reserve Bank's insurance regulations are up to date. The current solvency standard has been in operation since 2014. Since that time, we have seen how the solvency standard is working with different insurers and have noticed some areas where it might be improved. Some of the international accounting rules are also about to change in ways that will affect how insurers monitor their financial position.

What is this consultation about?

The overall review of the solvency standard is planned to take three years.

This consultation looks at a series of technical issues concerning how insurance companies calculate their solvency capital requirements.



These issues need to be settled before we can look at more practical questions around how much capital insurers should hold. They are also more urgent as the new accounting rules come into effect in two years' time and we need to ensure that the solvency standards are ready for the new accounting rules. The rest of this summary lists the issues addressed in this consultation and we welcome your feedback on these issues.

Purpose and principles

The paper begins by suggesting that the solvency standard should begin with a purpose statement. It asks whether the following purpose statement is appropriate:

'The purpose of solvency capital is to ensure that, in adversity, an insurer's obligations to policy-holders will continue to be met as they fall due'.

New accounting rules are coming into force

When insurers calculate how much solvency capital they need, they draw on their accounts. Insurers' accounts are complicated because they need to include an estimate for what the insurer will eventually pay to its policyholders even though future payments are uncertain. Some of the new accounting rules are more suitable for telling investors how much profit or losses an insurer is making, and where, rather than for calculating how much solvency capital insurers should hold to withstand adverse outcomes. This part of the consultation asks to what extent the Reserve Bank will need to ask insurance companies to alter their accounts when calculating how much solvency capital to hold.

When does an insurance company need extra supervision? When is it in serious trouble?

The current rules set a single minimum amount of solvency capital that insurers should hold to be reasonably sure that they will be able to withstand adverse events. As soon as their solvency capital falls below that level, the rules allow the Reserve Bank to use its crisis powers to deal with the business. In practice, though, 'solvency' is not all-or-nothing. The consultation suggests the solvency standard should have two control levels: one that marks the boundary between insurers that are fine and those that might need some extra mointoring, and another, lower, one that marks the point when insurers are in crisis. It asks how the Reserve Bank should set those levels. Should it mostly use statistical models (for example, a 1-in-200 chance of the business failing in a year) or should it look at which previous (real life) crises the insurance company would have been able to withstand (for example the global financial crisis or the Canterbury earthquake sequence)?

Should we just worry about the safety of the whole company or should we also look at particular parts of the business?

The remainder of the paper asks questions about how to break down the analysis of how much capital an insurer needs. When is it enough to look at the capital held by the insurance company as a whole and when should we make sure there is enough capital to cover particular business (such as life insurance)? How much should insurers be able to set off losses in one area against profits in another, bearing in mind that insurance works by "pooling" a large number of policies?

What do you think?

If you would like to contribute to the discussion, we'd like to hear from you.

Please send your thoughts by 5pm, Thursday 18 February 2021 to insurancesolvency@rbnz.govt.nz

(This non-technical summary has been prepared to supplement the more formal consultation document. Please note that, where there is any ambiguity, the text of the formal consultation prevails over this summary.)