March 2021

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Review of Insurance Solvency Standards: Principles and Timeline Consultation

Feedback Statement

Current Information Available

Information about the review, including the Terms of Reference, is available on the Reserve Bank website at:

http://www.rbnz.govt.nz/regulation-and-supervision/insurers/consultations-and-policy-development-for-insurers/active-policy-development/solvency-standard-review

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Background

1. In October 2020, the Reserve Bank of New Zealand - Te Pūtea Matua announced the commencement of a review of the Insurance Solvency Standards ('the Review'), alongside a re-commencement of the Review of the Insurance (Prudential Supervision) Act 2010[1] (IPSA).

2. As part of this announcement, the Reserve Bank requested public submissions on the proposed timelines and the principles governing the Solvency Standard review. The principles governing the review of the capital adequacy framework for registered banks – known as 'the Capital Review'[2] were used as a starting point, with minor modifications to better suit them to the insurance sector. The proposed Insurance Solvency Standards review principles and timeline have been reproduced here for convenience.

#	Principle
1	We will have regard to international comparability, particularly LAGIC3, Solvency II4, the ICS5 and the ICPs6, with the caveat that principle number 2 will take precedence.
2	We take a substance over form approach and tailor our requirements to New Zealand. This principle will take precedence over international comparability.
3	Capital must readily absorb losses before losses are imposed on policyholders.
4	Capital requirements should be set in relation to risks that may impact insurer balance sheets.
5	Insurers should be subject to a single method of determining capital requirements and the use of judgement should be limited to the extent possible.
6	Capital requirements of New Zealand insurers should be conservative relative to those of international peers, reflecting the Reserve Bank's regulatory approach.
7	The solvency framework should be practical to administer and minimise unnecessary complexity and compliance costs.
8	The solvency framework should be transparent to enable effective market discipline.

Submissions received

3. Submissions from this round of consultation closed on 12 November 2020. The Reserve Bank received 14 submissions from stakeholders including insurers, industry and professional associations, and consulting firms. We appreciate all feedback provided. Individual redacted submissions will be available on the Reserve Bank's website unless confidentiality was requested.

4. Overall, there was general support for principles 1, 2, 3, 7 and 8. Submitters felt that principles 4, 5 and 6 required amendments or further clarification. Specific feedback will be discussed in the following sections.

[1] https://www.rbnz.govt.nz/news/2020/10/reserve-bank-relaunches-insurance-act-review

[2] https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Banks/Review-capital-adequacy-framework-for-registered-banks/capital-review-issues-paper-may2017.pdf?la=en&revision=7731184d-ef6e-4b87-b843-9e0337033f7c

[3] Australia's Life and General Insurance Capital framework.

[4] The European Union's insurance capital regime

[5] The Insurance Capital Standard to be applied by the International Association of Insurance Supervisors to Internationally Active Insurance Groups

[6] The Insurance Core Principles issued by the International Association of Insurance Supervisors.

Principle 1: International Comparability

5. In general, submitters supported this principle with the view that emphasising international comparability recognises the close relationship between New Zealand entities and overseas parents, as well as the importance of general support from international entities through funding and investment. In particular, a solvency framework that is too out of line relative to international standards could reduce access to funding and capital, and disadvantage the New Zealand insurance industry as a whole.

6. As part of this feedback, it was also noted that having regard to international frameworks is consistent with the objectives of IPSA to ‘promote the maintenance of a sound and efficient insurance sector’.

7. Submitters also noted that, aside from solvency levels, the Reserve Bank should consider other aspects of international frameworks including:

   - Broader risk and capital management frameworks, including potentially implementing regulatory controls other than solvency requirements, such as the ICAAP[7];
   - The degree of supervision at each level of solvency;
   - Different classes of business sold in different jurisdictions;
   - Differences in availability and quality of capital;
   - Implied probabilities of sufficiency in different jurisdictions;

8. Submitters emphasised the importance of considering planned or anticipated changes to international frameworks in response to the introduction of new accounting standards (IFRS 17).

9. There were a number of submitters who felt that this principle could benefit from greater clarity. In particular, the relationship to international comparators needed to be clarified, as not all aspects of all international jurisdictions will be relevant for the New Zealand environment. They also suggested that the principles could be restructured as this first principle is overriden explicitly by Principle 2 and implicitly by Principle 6.

10. The comments received were useful and constructive. In our development of an IFRS 17 solution we will continue to consider other jurisdictions’ responses to IFRS 17, and how they might apply to us. We will continue to consult with industry and other stakeholders throughout the IFRS 17 solution development process.

11. This principle will be redesignated as Principle 2, as it depends on the ‘Substance over Form’ principle.

Principle 2: Substance over form

12. There was general support for this principle, with submitters noting the importance of having a framework that is suitable for New Zealand, due to a number of characteristics that are unique to the domestic market.

13. Submitters emphasised the need for clarity about what the Reserve Bank saw as unique about the New Zealand environment and how that informed regulatory choices. They recommended that extensive consultation with industry be held to determine what these unique characteristics were and how they might be reflected in tailored solvency requirements.

14. Conversely, other submitters noted that it would be important to achieve consistency with the Australian framework, given the close relationship between some New Zealand insurers with their Australian counterparts.

[7] Internal Capital Adequacy Assessment Process

15. Some submitters recommended establishing at the outset whether a prescriptive or a more principles-based approach will be adopted. To the extent that regulation is principles-based, they requested that the principles be supplemented with clear guidance.

16. While we would like to adopt a more principles-based approach, in the past this has led to some confusion, so our default continues to be an outcomes-based approach with detailed guidance in order to achieve consistency across the industry. In developing a framework that is suitable for New Zealand, we will continue to engage with interested stakeholders.

17. This principle will be redesignated as Principle 1, as it is relied on by the 'International Comparability' principle.

Principle 3: Capital must readily absorb losses

18. Submitters generally supported this principle. However, they requested some clarifications.

19. Firstly, the wording of the principle is considered to not clearly reflect the existing difference between banks and insurers in the type of capital instruments that can count towards regulatory capital. Bank capital comprises Common Equity Tier 1 capital ('CET1'), Additional Tier 1 capital ('AT1') and Tier 2 capital ('T2'), each with varying levels of loss absorbency.[8] In contrast, insurance capital is defined in the solvency standards, and not explicitly categorised.

20. Secondly, most submitters commented that there was a difference between losses occurring in the normal course of running a business and extraordinary losses (for example during an insolvency or extreme event).

21. They noted that for a going concern, capital buffers may not be required to absorb day-to-day losses. For instance, premiums charged to policyholders are normally already priced to include an allowance for normal levels of claims and expenses. In the case of participating and non-guaranteed policies, excess losses may be passed on to policyholders in the form of reduced benefits or increased premiums. This concept of risk-sharing is pivotal in the management of insurance risk.

22. In an insolvency, submitters commented that the fundamental purpose of capital was to ensure that the insurer was still able to fully meet its obligations to policyholders.

23. Some submitters noted that the wording of the principle might ignore the risk-sharing aspect of insurance business, and implied that the Reserve Bank expected working losses to be supported by capital in the first instance rather than through other management actions. It was suggested that this principle be modified to focus instead on policyholder protection.

24. Other comments about this principle included the importance of keeping sustainability objectives in mind and continuing to allow for management discretions.

25. We acknowledge that some volatility in an insurer's business is expected and can be managed through margins in pricing and management actions. The IAIS[9] states that the purpose of regulatory capital is to ensure that the insurer is able to meet its obligations to policyholders in a range of adverse scenarios. Accordingly, we will modify the principle to promote the meeting of obligations rather than the absorption of losses.

[8] https://www.rbnz.govt.nz/regulation-and-supervision/banks/prudential-requirements/information-relating-to-the-capital-adequacy-framework-in-new-zealand

[9] International Association of Insurance Supervisors guidance paper on the structure of capital resources for solvency purposes, para 10. (2009)

Principle 4: Risks impacting the balance sheet

26. Most submitters considered that while the premise of this principle was not unreasonable, it could be further clarified.

27. There appeared to be general agreement amongst submitters that the principle should be amended to reflect the risks to meeting policyholder obligations, rather than focusing simply on the balance sheet.

28. Submitters cautioned that the balance sheet may not accurately capture all risks that could impede meeting obligations to policyholders. The balance sheet may include intangible assets that are simply accounting artefacts, but which may not be available to absorb losses if required.[10] The economic value of some assets and liabilities may also not be correctly captured on the balance sheet.[11]

29. In addition, submitters pointed out that there are other non-financial risks which are not on the balance sheet but may affect an insurer's ability to meet its obligations to policyholders (such as reputational risk and conduct risk). Submitters agreed that these risks could be material and should be captured in the capital requirements. However, some submitters expressed the view that while it would be important to allow for such risks, an overly prescriptive approach may not be suitable as circumstances may vary from one insurer to another. Instead, they recommend qualitative methods such as supervisory adjustments or licence conditions.

30. There were also comments regarding practicality and allowing for the effect of mitigating actions.

31. We agree that the accounting balance sheet may not provide a clear picture of the prudential risks faced by an insurer, and will adjust this principle to refer to the meeting of obligations. We do, however, measure solvency strength based on the balance sheet, making adjustments as needed to reflect an economic value (e.g. through deductions from capital).

32. We acknowledge that the current framework may not capture all risks (e.g. operational risk) and we will address these as part of the second stage of the review. At the same time, we acknowledge that it would be difficult to specify a fair charge for idiosyncratic risks. We will continue to engage with stakeholders throughout the review to reach an optimal solution.

33. This principle will be amended to focus on meeting policyholder obligations, rather than balance sheet risks.

Principle 5: Single method and limiting judgement

34. In general, most submitters disagreed with this principle and were of the view that it lacked clarity and could be interpreted in a number of ways.

35. Specifically, the terms 'single method' and 'limiting judgement' could be interpreted to mean that a single, prescribed methodology will apply to all insurers regardless of sector, business lines, or country of ownership. While there was support for consistency, submitters cautioned against using a single and overly prescriptive approach as it may not recognise the diversity of risks associated with different business operations. Such a method could also result in unintended consequences. They emphasised the importance of considering the wide range of risks and other factors that may impact an insurer's viability.

36. One submitter expressed support for this principle, but with qualifications around practicality and ensuring a level playing field. A number of submitters also noted that differences in solvency requirements should derive from differences in risk profiles, rather than from accounting judgements. Other matters raised by submitters included ensuring that a fair outcome is achieved for insurers as well as policyholders.

[10] E.g. Deferred Acquisition Costs

[11] Some long-term products may be valued as short-term products under IFRS 17

37. To ensure a solvency framework that is robust and flexible, submitters recommended clarifying the wording of the principle to reflect consistency or appropriateness instead.

38. We acknowledge that the term ‘single method’ has caused some confusion amongst submitters. We did not intend for this to mean that a single method would apply across all sectors and lines of business, or that we would prescribe all assumptions and methodologies, though we understand how the wordings of the principle could be interpreted in this way.

39. We acknowledge that by its nature, actuarial work requires a degree of judgement, and that it is not possible for the regulator to prescribe every single assumption, as such a method would be a blunt tool that does not reflect insurer-specific risks or experience.

40. What we were trying to achieve with this principle is consistency across the industry and fair and meaningful results. In our view, this means that similar business lines are valued using the same method, and that judgement should be limited with respect to assumptions that are not insurer-specific (e.g. the risk-free rate). Currently there is a lot of room for judgement in terms of product groupings and risk-free discount rates (for example), and we expect that this will be exacerbated by the introduction of IFRS 17. We do not want technical accounting judgements to lead to differences in solvency position for otherwise similar insurers.

41. Accordingly, the principle will be revised to promote consistency in methods and assumptions, rather than require use of a single method or limitation of judgement.

Principle 6: Conservative relative to international peers

42. Most submitters did not support this principle. Many interpreted it to mean that the Reserve Bank was intending to strengthen capital requirements further. It was noted that the 1:1000 non-life catastrophe risk capital charge was already conservative relative to international standards, and that further conservatism came with disadvantages, such as:

- Reducing investment and participation in the New Zealand market, which would in turn lead to reduced competition and innovation, ultimately disadvantaging policyholders.
- Affordability and/or availability issues - as shareholders require a particular level of return on capital, increases in capital requirements will be passed on to policyholders in the form of higher premiums and/or reduced cover.
- Putting local insurers at a (further) competitive disadvantange relative to their overseas-owned counterparts, who will have better access to capital.

43. Furthermore, submitters were of the view that increased conservatism contradicts the principles and objectives of IPSA. In particular, IPSA recognises the importance of maintaining the sustainability of the market, maintaining competition and minimising unnecessary compliance costs.

44. Some submitters remarked that if a conservative capital requirement was intended to complement the current ‘light touch’ supervisory approach, then it would be important to look at the future state of the Reserve Bank’s supervisory approach. In particular, in light of recommendations from 2016 FSAP[12], the Reserve Bank is increasing regulatory and supervisory resources and intensifying its monitoring activities.

45. Submitters argued that improvements in the quality of data and modelling in recent years enable better insights into an insurer’s risk. This, coupled with the the fact that some risks are not present in the New Zealand market, may not justify additional conservatism relative to international peers.

[12] The International Monetary Fund’s Financial Sector Assessment Programme

46. It was suggested that a statement based on risk appetite would be more appropriate. Submitters requested clarity around the Reserve Bank's risk appetite for insurer failure, noting that IPSA is not intended to be a zero-failure regime[13]. Capital requirements should then be determined based on what was considered appropriate for the Reserve Bank's risk appetite.

47. Some submitters considered that direct comparison with overseas jurisdictions may not be possible given differences in supervision approaches and risk appetite, as well as specific features of the individual markets. Submitters also asked which jurisdictions would be used in the comparison.

48. At this stage of the review we are not operating under the presumption that a general increase (or decrease) in capital requirements is needed. However, in some cases, changes in the capital requirements of individual insurers may be a consequence of the improvements we wish to consider.

49. As this is a review of the solvency standards, an overall change to capital requirements may be an outcome of this process. If this is the case, we will continue to engage with industry and other stakeholders to agree on an appropriate implementation timeline.

50. We acknowledge that IPSA is not intended to provide a zero-failure regime and that clarity is needed with regards to the Reserve Bank's risk appetite. The Reserve Bank's risk appetite is risk-based, which means that the more important an insurer is for the sector, the lower our appetite for risk. Given the small NZ insurance market and its specific risk profile, there is potential for a larger concentration of risks and lower capacity to absorb significant shocks. There is therefore a risk that that large-scale insurer failures may be followed by reduced availability of insurance coverage. Our *a priori* conclusion based on this is that our regulatory settings should be conservative relative to our international peers.

51. At the same time, we recognise the need to balance soundness with efficiency and sustainability of the sector.

52. Section 4 of the Structures Paper provides submitters with further opportunity to comment on the Reserve Bank's appetite with regard to insurer failure. We also acknowledge that risk appetite for insurer failure should to an extent reflect the risk appetite of the general public, so we will endeavour to engage with members of the general public as much as possible.

53. We will modify the principle to require the standard's risk appetite to reflect the New Zealand environment, with any conservatism to be expressed through that appetite.

Principle 7: Practicality

54. Submitters generally supported this principle, with some noting that avoiding undue compliance costs was one of the principles under IPSA.

55. However, submitters cautioned against the dangers of adopting an overly-blunt instrument in an attempt to minimise complexity. They noted that while simplicity and practicality were helpful considerations, they should not be the only deciding factor when specifying a framework. For instance, sustainability and competition are also important factors that need to be taken into account.

56. Submitters argued that one way of achieving a practical framework would be by leveraging the accounting balance sheet as much as possible.

57. In developing the new framework we will continue to engage with stakeholders to ensure a practical and efficient outcome.

[13] Section 4(d)i)

Principle 8: Transparency

58. Most submitters showed support for this principle, considering that transparency would be beneficial in ensuring a fair and consistent outcome across the industry. One submitter commented that transparency should come with full access to the Reserve Bank's decision-making processes.

59. Some noted that the current framework is opaque, with insurers in similar solvency positions having different credit ratings, without it being clear how this had come about.

60. Other submitters, while still supportive of transparency in relation to regulatory intervention, expressed the view that in some cases, too much transparency could actually jeopardise an insurer's solvency. They commented that a clear framework is needed to guide when transparency should or should not apply.

61. We will continue to engage with industry to develop clear rules and guideliens on transparency, and to minimse any unintended consequences.

Timeline

62. There were varying views on the suitability of the review timeline. Some submitters felt that the timeline was reasonable and that an early response to IFRS 17 was helpful in providing certainty. Others were concerned that they were not far enough ahead in the IFRS 17 implementation process and could not provide reliable numbers for the calibration exercise. Regardless of which of these views submitters took, most appeared to agree that due to the significant impact of IFRS 17, the review process must take into account IFRS 17 readiness.

63. A common theme across most responses was the need to allow for sufficient time, both for responding to the consultations (given many competing priorities) as well as for implementing any changes to the solvency standards. Some submitters recommended that a lighter touch interim standard be implemented in order to minimise the burden on industry, while others recommended minimal changes between the interim and final standards.

64. Other views expressed related to a desire to avoid dual reporting, and to a lack of clarity on how current issues would be addressed in the review process.

65. One submitter commented that the short time period between the principles consultation and the more substantive consultation meant that any feedback from the initial consultation would not be fully taken into account in the later consultations.

66. We acknowledge the strain on industry at the moment, through its COVID-19 response, IFRS 17 implementation, as well as various regulatory reforms. Our intention with the proposed timeline is to provide clarity for insurers in their IFRS 17 implementation, but we recognise that insurers are at varying stages of the implementation process.

67. At this stage we do not intend to make any significant modifications to our timeline, but we will continue to monitor the situation, including industry readiness. We also invite industry to keep us updated if any major changes arise that will mean the current timeline is no longer tenable.

68. Concerns expressed by insurers about their readiness to participate in a calibration exercise will be taken into acount in the design of the exercise. We also acknowledge that the interim standard is scheduled to be issued at the end of 2021, whereas some insurers will not be fully adopting IFRS 17 until 2024. We will consider how to implement the new standard(s) given varying IFRS 17 implementation dates.

Other comments

69. Submitters cautioned against directly adapting the principles governing the Bank Capital Review, citing a number of significant differences between the bank and insurance sectors.

70. It was also noted that the principles related more to the design of solvency standards, rather than to the review process itself. Some examples were given of principles that could govern a review process, including open-mindedness and engagement.

71. Other comments included:

    - Some submitters requested clarity on the transition process, both in terms of any reporting changes in general as well as if any increases in capital requirements are required.
    - We should continually interact with industry throughout the review process, and ensure that a representative range of risk profiles are included in the interactions.
    - We should look at risk and capital management processes as a whole, rather than limiting the review to just solvency levels.

72. Submitters also suggested a number of additional principles which revolved around the following themes: innovation, competitive neutrality, fairness, accessibility/availability of insurance and policyholder protection.

73. As many of these matters are already referred to in IPSA purposes and principles, we will add an additional principle that reinforces conformity of the review and its outcomes with the Act.

74. The comments seemed reasonable to us. Our reasoning for adopting the principles governing the Bank Capital Review as a starting point was to achieve broad consistency between Reserve Bank-regulated sectors. However, we acknowledge that there are a number of significant differences between the banking and insurance sectors that need to be taken into account.

75. In our view, the main difference between the two sectors relates to the systemic nature and interrelatedness of the banking sector. Insurers, on the other hand, are not subject to the same liquidity or 'run' risks or the criticality for payment services. They are important for sustaining business operations and effective savings and credit markets.

76. In undertaking the review, we will aim to achieve as much consistency as possible between Reserve Bank-regulated sectors, while taking into account characteristics that are unique to the insurance sector. As with other aspects of the review, we will engage with industry and other stakeholders extensively to identify any areas of differences and tailor the framework accordingly.

Revised principles

77. Based on the feedback received, we have revised the set of principles governing the solvency standard review as follows:

#	Change	Revised principle	Comments
1	Reordered (formerly #2) & changed	We take a substance over form approach and tailor our requirements to New Zealand. ~~This principle will take precedence over international comparability.~~	
2	Reordered (formerly #1) & changed	We will have regard to international comparability, particularly LAGIC, Solvency II, the ICS and the ICPs, **with the caveat that principle number 1 will take precedence.**	By looking at comparators, we can draw good ideas from each regime and benefit from international best practice. We would seek to align with the ICPs to the extent it makes sense in our context.
3	Changed	Capital must ~~readily absorb losses before losses are imposed on policyholders~~ **be of sufficient quality to enable insurers to meet obligations to policyholders in a range of adverse scenarios.**	The focus of principles 3 & 4 is on meeting *financial* obligations to policyholders, established by contract or otherwise.
4	Changed	**The quantum of** capital requirements should be set in relation to **material** risks that may impact the insurer's ~~balance sheet~~ **ability to meet its obligations to policyholders.**	We will decide which risks are material, having taken into account any feedback provided by respondents to consultation.
5	Changed	Insurers should be subject to ~~a single method of~~ **consistent** methods **and consistent assumptions** in determining capital requirements.~~ and the use of judgement should be limited to the extent possible.~~	We would expect identical insurers to use identical assumptions. In reality, however, insurers have different experience, underwriting standards etc., and this means that assumptions will not be identical (although should be consistently developed).
6	Changed	Capital requirements of New Zealand insurers should ~~be conservative relative to those of international peers, reflecting~~ **reflect a risk-based approach, taking into account the risks that are specific to New Zealand, the nature of the New Zealand market, and** the Reserve Bank's regulatory approach.	Notwithstanding our NZ focus, under a risk-based approach we would expect the treatment of any overseas business to reflect the risks specific to that business.
7	No change	The solvency framework should be practical to administer and minimise unnecessary complexity and compliance costs.	
8	No change	The solvency framework should be transparent to enable effective market discipline.	
9	New	**We will have regard to how the solvency requirements work together with other regulatory measures to meet IPSA's principles and purposes.**	

Have your say

78. Stakeholders are welcome to provide feedback and information to the Reserve Bank at any time. While no feedback is specifically sought on this summary paper, we would welcome your views at any point during the Review period,

79. Please use the email address insurancesolvency@rbnz.govt.nz to provide any further comments.

80. Further information about the Review can be found on our website:

    https://www.rbnz.govt.nz/regulation-and-supervision/insurers/consultations-and-policy-development-for-insurers/active-policy-development/review-of-the-insurance-solvency-standards