Solvency Standard for Non-life Insurance Business 2014

Prudential Supervision Department

Issued: December 2014 (incorporating amendments to November 2018)
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1. Introduction

1.1. Authority

1. This solvency standard is made under section 55 of the Insurance (Prudential Supervision) Act 2010 (“the Act”).

1.2. Previous Versions

2. The table below shows the previous versions of this solvency standard that have been issued.

<table>
<thead>
<tr>
<th>Issue Date</th>
<th>Amendment Date</th>
<th>Title</th>
<th>Revoked from</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>15 May 2012</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>17 December 2014</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1.3. Commencement

3. This solvency standard comes into force on 1 January 2015, except:

   (a) From the reporting period that begins on or after 1 January 2019:\footnote{1}
      i. paragraph 28A commences;
      ii. paragraph 62A commences;
      iii. right-of-use assets arising from leases with a related party recognised under NZ IFRS 16 Leases are excluded from exposure class 14 of Table 2, the Asset Concentration Risk Charge set out in paragraph 72, and from Table 3.

   (b) Paragraph 100 applies from 1 January 2019.\footnote{1}

1.4. Application

4. This solvency standard applies (in accordance with this Section) to every licensed insurer that carries on non-life insurance business in New Zealand subject to:

   (a) an overseas insurer is not required to comply with this solvency standard or a part of this solvency standard to the extent it has been granted an exemption under section 59(1) of the Act; and

   (b) for all other licensed insurers carrying on non-life insurance business in New Zealand, this solvency standard applies only if the licensed insurer is

\footnote{1}{Until these times, the previous wording continues to apply.}
required by a condition of licence to maintain a Solvency Margin in accordance with this solvency standard.

5. Subject to paragraph 6, to the extent that a licensed insurer subject to this solvency standard carries on non-life insurance business all of the provisions of this solvency standard will apply to that licensed insurer in respect of its non-life insurance business, consistent with the licensed insurer's conditions of licence.

6. To the extent that a licensed insurer subject to this solvency standard carries on business that is subject to the requirements of another solvency standard, as specified in its conditions of licence or in that other solvency standard, that business will not be subject to this solvency standard.

7. Where a licensed insurer subject to this solvency standard carries on health insurance business that is accounted for as non-life insurance business in the financial statements or group financial statements of the licensed insurer, such health insurance business must also be dealt with in accordance with this solvency standard.

8. Where a licensed insurer is required to maintain a Solvency Margin under its conditions of licence in respect of more than one solvency standard, and/or is required to calculate and report solvency under more than one solvency standard, the calculations and reporting must be done separately in respect of the business subject to each solvency standard.

1.5. General Provisions

General

9. Any Solvency Margin required to be calculated in accordance with this solvency standard must be prepared on the basis of any appropriate NZ GAAP financial statements that are available to the licensed insurer unless this solvency standard specifies otherwise. If no appropriate NZ GAAP financial statements are available for this purpose, then the Alternative Financial Information used in order to calculate any required Solvency Margin must be prepared in accordance with NZ GAAP.

10. The appointed actuary of the licensed insurer must be responsible to the board of the licensed insurer for performing or reviewing all aspects of the Solvency Margin calculations to ensure the calculations are complete and accurate. Under the Act, the licensed insurer is responsible for compliance with all conditions of licence, including a condition to maintain a Solvency Margin, and is responsible for compliance with the reporting and disclosure requirements of the solvency standard.

11. All assets and liabilities of the licensed insurer must be considered in calculating the required Solvency Margin, except where a condition of licence limits the Solvency Margin requirements to a specified pool of assets and liabilities.

2 For example, consistent with the requirements of NZ IFRS 4 Appendix D.
Minimum Amount of Capital: Fixed Capital Amount

12. Subject to paragraphs 13 and 14, a licensed insurer subject to this solvency standard must maintain a Fixed Capital Amount of 3 million New Zealand dollars.

13. Where a licensed insurer meets the requirements for the exemptions for small insurers set out in regulations 9 to 13 of the Insurance (Prudential Supervision) Regulations 2010, the Fixed Capital Amount is zero New Zealand dollars.

14. Where a licensed insurer is subject to more than one solvency standard the Fixed Capital Amount is the largest of the Fixed Capital Amounts applying to the licensed insurer.

15. The Aggregate Minimum Solvency Capital is subject to a minimum of the Fixed Capital Amount that the licensed insurer must maintain.

Related Party Exposures

16. A related party is defined in section 6 of the Act. An asset or Contingent Liability that represents an exposure to a related party may be treated as if it were not a related party exposure for the purpose of paragraph 24(c), Table 2 or paragraph 66(b) if:

   (a) the obligation arises as the result of an exposure to a bank that is a related party of the licensed insurer and that bank is subject to prudential regulation and supervision by the Reserve Bank or its international equivalents; or

   (b) the asset is a related party trade credit, that does not in substance represent permanent funding, that is provided on not more than 90 day terms in the ordinary course of business on an arm’s length commercial basis and where payment is not overdue.

Solo and Group Solvency Reporting Requirements

17. Where a licensed insurer has a subsidiary or subsidiaries that are themselves licensed insurers, then the solvency standard must firstly be applied to, and reported on a solo basis, for each licensed insurer.

18. In addition, where a licensed insurer has insurance subsidiaries, within or outside New Zealand, that are themselves prudentially regulated as an insurer or licensed insurer within or outside New Zealand, (or, in jurisdictions where licensing is not required, an insurer), such subsidiaries must be consolidated with the licensed insurer. This consolidation will constitute the insurance group for the purpose of calculating and reporting group solvency in accordance with the requirements of this solvency standard.

19. Where a licensed insurer has subsidiaries that are not insurance subsidiaries then, for the purposes of calculating the solvency of the New Zealand solo licensed insurer and the insurance group, such subsidiaries should be treated as related
party equity investments, subordinated loans or other obligations in accordance with the provisions of this solvency standard.

1.6. Simplifying Assumptions or Methodologies contained in Solvency Calculations

20. This solvency standard represents minimum requirements for calculating a licensed insurer’s Solvency Margin. Accordingly, if any simplifying assumptions are made or simplifying methodologies are used in calculating the licensed insurer’s Solvency Margin, the appointed actuary must:

(a) ensure that such simplifying assumptions or methodologies result in a more conservative assessment of the licensed insurer’s Solvency Margin, or do not Materially alter the result, compared to the case without the simplification; and

(b) within the Financial Condition Report, disclose such simplifying assumptions or methodologies and justify them on the grounds of Materiality or on the grounds that they provide a more conservative outcome than would be the case without the simplification.

1.7. Definitions

21. Unless stated otherwise, terms defined in the Act have the same meaning in this solvency standard. Terms defined below are capitalised when used in this solvency standard.


Actual Solvency Capital means Capital minus Deductions from Capital.

Aggregate Actual Solvency Capital means the sum of the Actual Solvency Capital determined for each individual Solvency Margin required to be maintained by the licensed insurer.

Aggregate Minimum Solvency Capital means the sum of the Minimum Solvency Capital determined for each individual Solvency Margin required to be maintained by the licensed insurer.

Alternative Financial Information means any financial information other than NZ GAAP financial statements used to calculate a Solvency Margin.

Annual Solvency Return means a report in a form prescribed by the Reserve Bank and required under paragraph 98.

Asset Concentration Risk Charge is the amount calculated in accordance with Subsection 3.3(c).

Asset Risk Capital Charge is the amount calculated in accordance with Section 3.3.

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3 Terms defined in the Act are generally indicated in bold, a failure to indicate a term in bold does not imply the definition differs from the Act.
Capital means the amount calculated in accordance with paragraph 22 or the equivalent section of any other applicable solvency standard, as the context requires.

Catastrophe Risk Capital Charge is the amount calculated in accordance with Section 3.2.

Collective Investment Vehicle means a managed investment fund and includes, for example, unit trusts and group investment funds.

Contingent Liabilities has the meaning given in paragraph 64.

Counterparty Grade means the grade assigned to an asset or to the counterparty to an asset or obligation of the licensed insurer determined under Section 3.7.

Deductions from Capital means the amount calculated in accordance with paragraph 24 or the equivalent section of any other applicable solvency standard, as the context requires.

Direct Credit Substitute means an exposure that has a risk of loss to the licensed insurer that is equivalent to a direct extension of credit by the licensed insurer and includes, for example, letters of credit, guarantees and similar covenants.

Derivatives Capital Charge is the amount calculated in accordance with Subsection 3.3(b).

Downshock means the reduction in interest rates set out in column 3 of Table 4 for the purposes of the Interest Rate Capital Charge.


Exposure Class is the class of exposure described in column 1 of Table 2 and defined in column 2 of Table 2.

Extreme Event means one or more events, including, for example, earthquake, flood or storm, that results in unexpected large or extreme losses as a result of claims on more than one insurance contract.

Extreme Event Exposure means the total of all insurance losses that the licensed insurer will incur as a result of an Extreme Event, calculated in accordance with Section 3.2.

Financial Condition Report means a report required under paragraph 103.

Financial Institution means a financial institution as defined in section 2(1) of the Reserve Bank of New Zealand Act 1989.
**Fixed Capital Amount** is the minimum amount of the Aggregate Minimum Solvency Capital that a **licensed insurer** must hold and maintain and is the amount referred to in sections 19(1)(f), 21(2)(b) and (c), and 56(a)(i) of the Act.

**Foreign Currency Risk Capital Charge** is the amount calculated in accordance with Section 3.4.

**General Requirements for Capital Instruments** are the requirements set out in Section 2.4 that a capital instrument must meet in order to be included within a licensed insurer’s Capital.

**Half-yearly Solvency Return** means a report in a form prescribed by the Reserve Bank and required under paragraph 99.

**Insurance Risk Capital Charge** is the amount calculated in accordance with Section 3.1.

**Interest Rate Capital Charge** is the amount calculated in accordance with Section 3.5.

**Local Authority** means a local authority as defined in section 5(1) of the Local Government Act 2002.

**Material and materiality** have the meaning set out in Appendix A.

**Minimum Solvency Capital** means the amount calculated in accordance with Section 3 or the equivalent section of any other applicable **solvency standard**, as the context requires.

**Net Outstanding Claims Liability** means all unpaid claims and claims handling expenses, net of **reinsurance** and other recoveries and excluding any Government charges imposed such as levies, duties and taxes, relating to claims incurred prior to the end of the reporting period, determined in accordance with NZ GAAP as it relates to insurance contracts.

**Non-insurance Activity** means any business activity undertaken for third party customers that does not involve the bearing of risk under a **contract of insurance**. For example, Non-insurance Activity includes insurance broking, **premium** funding, claims management services and risk management or any other consultancy activities.

**NZ GAAP** means New Zealand **generally accepted accounting practice**.

**NZ IAS 37** means the New Zealand equivalent to International Accounting Standard 37.

Outstanding Claim Liability Adjustment is the amount required under paragraph 37 and calculated in accordance with paragraphs 39 and 40.

Preliminary Solvency Margin is the Solvency Margin determined prior to the Deduction from Capital specified under subparagraph 24(k) for the purposes of Section 2.6.

Premium Liabilities means the present value of the expected future cash flows relating to all future claims arising from the rights and obligations under the licensed insurer’s existing contracts of insurance that have not yet expired during the assessment period. The assessment period is the period during which, in the opinion of the appointed actuary, premiums and benefits cannot in practice be adjusted to reflect adverse changes in risk. This period may be until expiry, or next contract renewal or some other date, and may differ from any period used for accounting purposes.

(a) the value of the Premium Liabilities must include an amount in respect of the expenses that the licensed insurer expects to incur in administering and settling the relevant claims and allow for expected premium refunds;

(b) in respect of Premium Liabilities for which reinsurance has not yet been purchased, allowance must be made for this reinsurance;

(c) Premium Liabilities are to be determined on a prospective basis, net of expected reinsurance recoveries and non-reinsurance recoveries;

(d) the value of Premium Liabilities may exclude any Government charges imposed such as levies, duties and taxes; and

(e) Premium Liabilities are to include a risk margin intended to provide a 75% probability of sufficiency, and are to be assessed by the appointed actuary.

Premium Liabilities Adjustment is the amount calculated in accordance with paragraph 36.

Reinsurance Recovery Risk Capital Charge is the amount calculated in accordance with Section 3.6.

Resilience Capital Factor means the factor specified in column 3 of Table 2 in relation to an Exposure Class.

Risk Weighted Exposure is the amount calculated in accordance with paragraph 62(b).

Risk Weighted Exposures Charge is the amount calculated in accordance with Subsection 3.3(a).

Run-off Risk Capital Charge is the amount calculated in accordance with paragraph 35.
Run-off Risk Capital Factor is the factor set out in column 3 of Table 1 for the class of insurance business set out in column 1 of Table 1.

Solvency Margin is the excess of Actual Solvency Capital over Minimum Solvency Capital expressed in New Zealand dollars.

Solvency Ratio is the Actual Solvency Capital divided by the Minimum Solvency Capital, expressed as a decimal or a percentage.

Solvency Unexpired Risk means the difference between Premium Liabilities and the amount of unearned premium in respect of the same assessment period, with a minimum of zero.


Underwriting Risk Capital Charge is the amount calculated in accordance with paragraph 34.

Underwriting Risk Capital Factor is the factor set out in column 2 of Table 1 for the class of insurance business set out in column 1 of Table 1.

Upshock means the increase in interest rates set out in column 2 of Table 4 for the purposes of the Interest Rate Capital Charge.
2. Actual Solvency Capital

2.1. Capital

22. Capital is the total value of the following items:

(a) issued and fully or partly paid-up ordinary shares, that meet the General Requirements for Capital Instruments (Section 2.4) and the qualifying criteria for ordinary shares set out in Appendix C (Subpart C.1);

(b) issued and fully or partly paid-up perpetual non-cumulative instruments that meet the General Requirements for Capital Instruments (Section 2.4) and the qualifying criteria for perpetual instruments set out in Appendix C (Subpart C.2). Perpetual instruments may not constitute more than 50% of Capital for a licensed insurer that is a mutual insurer and 25% for all other licensed insurers;

(c) Credit Union Securities that meet the General Requirements for Capital Instruments (Section 2.4) and the qualifying criteria for Credit Union Securities set out in Appendix C (Subpart C.3);

(d) revenue and other reserves, including the following, but not including reserves that are held aside or otherwise committed on account of any assessed likelihood of loss:

i. reserves arising from a revaluation of tangible fixed assets, including owner occupied property;

ii. foreign currency translation reserves;

iii. reserves arising from the revaluation of investments; and

iv. other reserves that are created or increased by appropriations of retained earnings net of tax and dividends payable;

(e) retained earnings; and

(f) non-controlling interests.

23. In the case of a licensed insurer that is a mutual insurer constituted in New Zealand, Capital may be referred to as ‘Reserves’ or ‘Members Funds’ or such other term by which it is described in the financial statements or Alternative Financial Information of the mutual insurer.
2.2. Deductions from Capital

24. Deductions from Capital is the total value of the following items:

(a) intangible assets, including goodwill, as determined in accordance with Section 2.5;

(b) deferred tax assets;

(c) equity investments in, and subordinated loans to, related parties;

(d) equity investments in, and subordinated loans to, other Financial Institutions or holding companies of other Financial Institutions (whether held directly or indirectly) that are classified as Counterparty Grade 1, 2 or 3, to the extent that the total of such equity investments or subordinated loans exceeds 15% of Actual Solvency Capital, calculated excluding this subparagraph;

(e) equity investments in, and subordinated loans to, other Financial Institutions or holding companies of other Financial Institutions (whether held directly or indirectly) that are classified as Counterparty Grade 4 or 5;

(f) unrealised gains and losses on liabilities designated at fair value through profit and loss that arise from changes in the licensed insurer's own credit risk;

(g) any fair value gain that relates to a financial instrument for which:

i. fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by processes from observable current market transactions in the same instrument; or

ii. fair value is not based on observable market data; or

iii. fair value is based on prices in a market that is not active;

(h) any surplus, net of any associated deferred tax liabilities, in any defined benefit superannuation fund sponsored by the licensed insurer (or another group entity) as employer;

(i) allowance for any dividend that has been declared or repayment of Capital made prior to finalisation of the Solvency Margin calculations but which has not been reflected in the financial statements or Alternative Financial Information,

(j) any deferred acquisition costs in excess of the limit in Section 2.7; and

(k) any portion of the licensed insurer's Preliminary Solvency Margin relating to its overseas branches, not freely available to meet losses of the licensed insurer outside those branches. Refer to Section 2.6 for how this is determined.
25. To the extent that an asset is a Deduction from Capital, it is not included in the Asset Risk Capital Charge, Foreign Currency Risk Capital Charge or the Interest Rate Risk Capital Charge.

2.3. Overall Characteristics of Capital Instruments

26. To ensure every capital instrument included within a licensed insurer’s Capital is of high quality, each capital instrument must meet the following overall characteristics. The capital instrument must:

(a) provide a permanent and unrestricted commitment of funds (“Permanence”);  
(b) be freely available to absorb losses (“Loss absorption”);  
(c) not impose any unavoidable servicing charge against earnings (“Servicing charge”);  
(d) rank behind the claims of policyholders and other creditors in the event of a winding-up of the licensed insurer (“Ranking on winding-up”); and  
(e) have other features or treatments appropriate to the capital instrument (“Other appropriate features”).

The above overall characteristics of high quality capital instruments are further articulated into relevant qualifying criteria that each type of capital instrument must meet as set out in Appendix C.

2.4. General Requirements for Capital Instruments

27. Each capital instrument included within a licensed insurer’s Capital must meet the following General Requirements for Capital Instruments:

(a) it must, in its entirety, meet the qualifying criteria for the appropriate constituent of Capital as set out in Appendix C;  
(b) it must, irrespective of its name, satisfy the substance as well as the legal form of the qualifying criteria for the appropriate capital instrument;  
(c) it must not contain any terms, covenants or restrictions that could:
   i. hinder the recapitalisation of the licensed insurer; or
   ii. inhibit the sound and prudent management of the licensed insurer; or
   iii. restrict the Reserve Bank’s or a statutory manager’s ability to use its powers under the Act in respect of the resolution of any actual or potential issues relating to the solvency or any other prudential matter experienced by the licensed insurer; and
(d) if a capital instrument does not meet the qualifying criteria for the appropriate capital instrument set out in Appendix C, then it cannot be included within Capital.

2.5. Intangible Asset Deductions

28. The Deduction from Capital for intangible assets comprises the value of the following to the extent that they form part of the assets of a licensed insurer as measured under NZ GAAP and are recognised in the financial statements or Alternative Financial Information of the licensed insurer:

(a) goodwill;

(b) capitalised computer software costs to the extent that they exceed the known resale value of that software (if the resale value is not known then it should be taken as nil);

(c) any other asset defined as an intangible asset under NZ GAAP.

28A. A right-of-use asset arising from a lease contract accounted for under NZ IFRS 16 Leases where the underlying asset is tangible shall not be deducted from capital. Where the underlying asset is intangible the deduction from capital is determined as:

$$100\% \times (\text{Value of the right-of-use asset} - \text{value of the corresponding lease liability})$$

with a minimum of zero.

2.6. Overseas Branch Deductions

29. Where a licensed insurer has one or more overseas branches it must calculate a Preliminary Solvency Margin for the entity as a whole, incorporating any branch assets and liabilities into the calculation. If any portion of this Preliminary Solvency Margin is not freely available to meet losses of the licensed insurer outside its branches, then this amount must be treated as a Deduction from Capital under subparagraph 24(k). Such an amount may arise due to restrictions on the use of branch assets in the jurisdiction in which the branch operates, or because of local capital requirements relating to the branch, or for some other reason.

2.7. Deferred Acquisition Costs

30. Any amount of deferred acquisition costs in excess of the limit specified in this paragraph is a Deduction from Capital. The limit is the amount that can be supported after applying a liability adequacy test that:

(a) incorporates a risk margin to achieve a probability of sufficiency of at least 75%; and

(b) does not defer acquisition costs beyond the current insurance contract period; and

(c) is otherwise in accordance with NZ IFRS 4.
3. Minimum Solvency Capital

31. Minimum Solvency Capital is the sum of the:

- Insurance Risk Capital Charge (Section 3.1);
- Catastrophe Risk Capital Charge (Section 3.2);
- Asset Risk Capital Charge (Section 3.3), comprising the:
  - Risk Weighted Exposures Charge (Subsection 3.3(a));
  - Derivatives Capital Charge (Subsection 3.3(b)); and
  - Asset Concentration Risk Charge (Subsection 3.3(c));
- Foreign Currency Risk Capital Charge (Section 3.4);
- Interest Rate Capital Charge (Section 3.5); and
- Reinsurance Recovery Risk Capital Charge (Section 3.6).

3.1. Insurance Risk Capital Charge

32. The Insurance Risk Capital Charge is the total of the Underwriting Risk Capital Charge and the Run-off Risk Capital Charge.

*Concept*

33. The Underwriting Risk Capital Charge reflects the risk to the licensed insurer of writing unprofitable insurance business. The Run-off Risk Capital Charge reflects the risk to the licensed insurer of inadequate provision being made for outstanding claim liabilities, and includes any adjustment to the valuation of liabilities to bring them to a common basis.

*Calculation*

34. The Underwriting Risk Capital Charge is calculated by multiplying the Premium Liabilities of the licensed insurer at the calculation date by the Underwriting Risk Capital Factors in Table 1, and then adding the Premium Liabilities Adjustment set out in paragraph 36 (if any). The calculation is to be made by class of insurance business and summed across all classes.

35. The Run-off Risk Capital Charge is calculated by multiplying the Net Outstanding Claims Liability of the licensed insurer at the calculation date by the Run-off Risk Capital Factors in Table 1 and then adding the Outstanding Claim Liability Adjustment (if any). The calculation is to be made by class of insurance business and summed across all classes. This paragraph is subject to paragraphs 37 to 40.
Table 1 – Insurance Risk Capital Factors

<table>
<thead>
<tr>
<th>Class of Insurance Business</th>
<th>Underwriting Risk Capital Factor</th>
<th>Run-off Risk Capital Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic property</td>
<td>14%</td>
<td>9%</td>
</tr>
<tr>
<td>Private motor</td>
<td>14%</td>
<td>9%</td>
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<tr>
<td>Commercial property</td>
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<td>11%</td>
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<tr>
<td>Commercial motor</td>
<td>14%</td>
<td>9%</td>
</tr>
<tr>
<td>Liability classes</td>
<td>22%</td>
<td>15%</td>
</tr>
<tr>
<td>Marine</td>
<td>16%</td>
<td>11%</td>
</tr>
<tr>
<td>Health &amp; Personal Accident</td>
<td>16%</td>
<td>11%</td>
</tr>
<tr>
<td>Travel</td>
<td>14%</td>
<td>9%</td>
</tr>
<tr>
<td>Other</td>
<td>16%</td>
<td>11%</td>
</tr>
</tbody>
</table>

**Premium Liabilities Adjustment**

36. The Premium Liabilities Adjustment is required if the licensed insurer’s unearned premium liability plus unexpired risk liability is less than the Premium Liabilities. The Premium Liabilities Adjustment is equal to the difference between the Solvency Unexpired Risk and the unexpired risk liability in the licensed insurer’s financial statements or Alternative Financial Information, with a minimum of zero.

**Outstanding Claim Liability Adjustment**

37. The Outstanding Claim Liability Adjustment is required if the licensed insurer has established its Net Outstanding Claims Liability with a risk margin different to that required to achieve a 75% probability of sufficiency (POS) provision.

38. Section 5.1 specifies that the appointed actuary must assess the provision for outstanding claims and the corresponding recovery asset.

39. If, in the opinion of the appointed actuary, the licensed insurer’s Net Outstanding Claims Liability is less than the 75% POS provision, then, for the purposes of paragraph 35, the Run-off Risk Capital Factors in Table 1 must be applied to the 75% POS provision rather than the amount in the licensed insurer’s financial statements or Alternative Financial Information. The Outstanding Claim Liability Adjustment is an addition to the Run-Off Risk Capital Charge equal to the 75% POS provision less the licensed insurer’s provision after adjustment for tax.

40. If, in the opinion of the appointed actuary, the licensed insurer’s Net Outstanding Claims Liability is greater than the 75% POS provision, then, for the purposes of paragraph 35, the licensed insurer may apply the Run-off Risk Capital Factors in Table 1 to the 75% POS provision rather than the amount in the licensed insurer’s financial statements or Alternative Financial Information and apply an Outstanding Claim Liability Adjustment (being a deduction from the Run-off Risk Capital Charge) equal to the licensed insurer’s provision less the 75% POS provision after adjustment for tax.
**Insurance Business with Long Term Risk Characteristics**

41. Most non-life insurance business comprises short term contracts (up to one year) with no long term guarantees or contractual commitments. There can, however, be products that have features like guaranteed renewability, return of premiums and other features that create longer term commitments and risks for the licensed insurer. There are also products such as single premium consumer credit and lenders mortgage insurance that cover risks over a period much longer than one year and thus create long term risk for the licensed insurer.

42. If a licensed insurer issues a significant volume of contracts with features that may produce significant risk for the licensed insurer for more than one year, then the licensed insurer must seek and adopt the advice of its appointed actuary on:

   (a) an appropriate basis for setting provisions for unexpired risk (including unearned premiums) and outstanding claims; and

   (b) whether an additional capital charge is appropriate in light of the risks to the licensed insurer and, if so, what is a suitable basis for calculating that capital charge.

43. The appointed actuary must, in giving the relevant advice, consider the significance of the risks and the Materiality of the business, and may judge that no adjustments are needed.

44. The appointed actuary must consider whether the Solvency Standard for Life Insurance Business provides additional guidance as to the appropriate treatment of contracts with long term risk and, if appropriate, seek to achieve reasonable consistency with that solvency standard.

3.2. Catastrophe Risk Capital Charge

**Concept**

45. The Catastrophe Risk Capital Charge for non-life insurers is intended to protect the licensed insurer’s solvency position from the potential exposure of the licensed insurer to Extreme Events.

**Calculation**

46. The calculation of the Catastrophe Risk Capital Charge is based on the licensed insurer’s potential future losses. The calculation of the Extreme Event Exposure must include all exposures under any contract of insurance issued by the licensed insurer that could arise as a result of an Extreme Event.

47. The licensed insurer’s Extreme Event Exposure is the greater of the following:

   (a) the projected insurance losses incurred by the licensed insurer in respect of a major earthquake event affecting Wellington (defined as everywhere within
a 50 kilometre radius from the Beehive), calibrated to a minimum loss return period as detailed in paragraph 48; or

(b) the projected insurance losses incurred by the licensed insurer in respect of a major earthquake affecting any place other than Wellington (as defined above), calibrated to a minimum loss return period as detailed in paragraph 48; or

(c) the projected insurance losses incurred by the licensed insurer in respect of a non-earthquake Extreme Event occurring anywhere within New Zealand or elsewhere, calibrated to a minimum loss return period of 1 in 250 years.

48. Subject to paragraph 49, the projected insurance losses referred to in paragraph 47 are calibrated as follows:

(a) for financial reporting periods commencing before 8 September 2015, the greater of the maximum amount of catastrophe reinsurance (expressed in New Zealand dollars) held by the licensed insurer before the date of granting a full licence under Subpart 1 of Part 2 of the Act, or an amount equivalent to the licensed insurer’s calculation of a 1 in 500 years loss return period;

(b) for financial reporting periods commencing on or after 8 September 2015: the greater of the maximum amount of catastrophe reinsurance (expressed in New Zealand dollars) held by the licensed insurer before 8 September 2015, or an amount equivalent to the licensed insurer’s projected insurance losses calibrated to a specified loss return period of 1 in 750 years; and

(c) for financial reporting periods commencing on or after 8 September 2016: the greater of the maximum amount of catastrophe reinsurance (expressed in New Zealand dollars) held by the licensed insurer before 8 September 2015, or an amount equivalent to the licensed insurer’s projected insurance losses calibrated to a specified loss return period of 1 in 1000 years.

49. If the amount of catastrophe reinsurance (expressed in New Zealand dollars) held by a licensed insurer before the date of granting a full licence under Subpart 1 of Part 2 of the Act is greater than the licensed insurer’s projected insurance losses calibrated to a loss return period of 1 in 1000 years then the licensed insurer may (but is not obliged to) reduce its catastrophe reinsurance to a level equal to the licensed insurer’s calculation of projected insurance losses calibrated to a loss return period of 1 in 1000 years.

50. In assessing whether the licensed insurer must report to the Reserve Bank under Section 24 of the Act, the licensed insurer must use the return period that will be applicable to the licensed insurer at the date of the forward assessment of solvency.

51. The Catastrophe Risk Capital Charge is the net cost (after reinsurance recoverable amounts) to the licensed insurer of the Extreme Event Exposure, including any gap or shortfall in the reinsurance cover, plus the cost (if any) of one reinstatement of the full catastrophe reinsurance programme.
52. For a licensed insurer that does not have an exposure to an Extreme Event, and does not have other per risk exposures greater than the licensed insurer’s net retention, the Catastrophe Risk Capital Charge is two times the largest per risk retention of the licensed insurer plus the cost (if any) of one reinstatement of the reinsurance programme.

53. The largest per risk retention is the cost to the licensed insurer of the largest individual claim to which it could reasonably be exposed under policies issued, net of reinsurance recoveries and including the cost (if any) of one reinstatement of the appropriate reinsurance. If the licensed insurer issues policies that do not have a maximum sum insured, or are not protected by excess of loss reinsurance, then the licensed insurer must seek the advice of its appointed actuary as to a reasonable approximation for the largest per risk retention.

Actuarial Review

54. The appointed actuary of the licensed insurer must review the basis on which the Catastrophe Risk Capital Charge has been calculated. In carrying out this review, the appointed actuary must consider all relevant factors. If the appointed actuary has any concerns with respect to the Catastrophe Risk Capital Charge, the appointed actuary must report them to the licensed insurer’s board as soon as reasonably possible and report those matters to the Reserve Bank along with the licensed insurer’s solvency calculation.

55. If the appointed actuary is of the opinion that the Extreme Event Exposure of the licensed insurer or other form of catastrophe risk (in the case of non-property exposure) is not adequately reflected in the Catastrophe Risk Capital Charge, the appointed actuary must recommend an alternative method of calculation for determining the Catastrophe Risk Capital Charge for the licensed insurer. Any alternative method of calculation must be agreed by the Reserve Bank. The licensed insurer must use that alternative method.

3.3. Asset Risk Capital Charge

Concept

56. The Asset Risk Capital Charge reflects the exposure of the licensed insurer to losses on investment assets and financial risks to the licensed insurer arising from other exposures. It also reflects the risks to the licensed insurer from having large exposures to a single counterparty.

Calculation

57. The Asset Risk Capital Charge is the sum of the:

(a) Risk Weighted Exposures Charge (Subsection 3.3(a));
(b) Derivatives Capital Charge (Subsection 3.3(b)); and
(c) Asset Concentration Risk Charge (Subsection 3.3(c)).
58. If the **licensed insurer** holds investments in a professionally managed Collective Investment Vehicle or in a subsidiary that is primarily used to hold investments for the **licensed insurer**, then the **licensed insurer** must ‘look through’ the investment vehicle or subsidiary to the underlying investments that represent the assets attributable to the **licensed insurer**. The **licensed insurer** must take account of any special conditions (such as guarantees or redemption restrictions) that the investment vehicle or subsidiary may provide.

59. For the purposes of paragraph 58, a **licensed insurer** must only ‘look through’ the investment vehicle or subsidiary if it is satisfied with the quality and reliability of the information about the underlying investments. If the **licensed insurer** is not satisfied with the quality and reliability of the information about the underlying investments or, if the ‘look through’ approach is unable to be applied, then the requirements of this **solvency standard** shall be applied to the investment vehicle or subsidiary.

60. An amount that is included in the Reinsurance Recovery Risk Capital Charge as a reinsurance (or coinsurance) recovery asset is not included in any element of the Asset Risk Capital Charge.

### Table 2 – Exposure Classes and Resilience Capital Factors

*Unless otherwise provided, in applying Table 2 the Counterparty Grade should be determined by reference to the issue rating from Table 5.1 or 5.2 if possible. If no such rating is available, the Counterparty Grade may be determined by reference an issuer rating from Table 6.*

<table>
<thead>
<tr>
<th>Exposure Class</th>
<th>Definition</th>
<th>Resilience Capital Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Cash and Sovereign Debt</td>
<td>Notes and coin Cash at bank on call Debt or other obligations issued by or guaranteed irrevocably by the New Zealand government or a government or supra-national agency with a Counterparty Grade 1</td>
<td>0.5%</td>
</tr>
<tr>
<td>2 AA rated fixed interest &lt; 1 year</td>
<td>Any debt obligation (excluding subordinated debt) maturing or redeemable in less than one year with Counterparty Grade 1 or 2 Cash management trusts with Counterparty Grade 1 or 2</td>
<td>1%</td>
</tr>
<tr>
<td>3 AA rated fixed interest ≥ 1 year</td>
<td>Any debt obligation (excluding subordinated debt) maturing or redeemable in one year or more with Counterparty Grade 1 or 2</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>Description</td>
<td>Details</td>
</tr>
<tr>
<td>---</td>
<td>-----------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>4</td>
<td>A rated fixed interest</td>
<td>Any debt obligation (excluding subordinated debt) with Counterparty Grade 3 Cash management trusts with Counterparty Grade 3</td>
</tr>
<tr>
<td>5</td>
<td>Unpaid premiums &lt; 6 months past due</td>
<td>Unpaid <em>premiums</em> (including premium funding receivables) that are not yet due or are less than six months past the contractual due date for payment to the licensed insurer.</td>
</tr>
<tr>
<td>6</td>
<td>Deferred acquisition costs</td>
<td>Deferred acquisition costs below the limit determined in accordance with Section 2.7</td>
</tr>
<tr>
<td>7</td>
<td>BBB rated fixed interest</td>
<td>Any debt obligation (excluding subordinated debt) or cash management trust with Counterparty Grade 4 Credit provided to a related party on not more than 90 day terms in the ordinary course of business on an arm’s length commercial basis and where payment is not overdue</td>
</tr>
<tr>
<td>8</td>
<td>Unrated Local Authority Debt, and Third Party Claims Recoveries</td>
<td>Any debt obligation with a Local Authority that is unrated Claim recoveries collectable from third parties (excluding reinsurance recoveries or coinsurance recoveries from the EQC)</td>
</tr>
<tr>
<td>9</td>
<td>Other fixed interest and short term unpaid premiums</td>
<td>Any debt obligation or cash management trust that has a Counterparty Grade 5 or is unrated Subordinated debt of a counterparty with Counterparty Grade 1, 2 or 3 Unpaid <em>premiums</em> (including premium funding receivables) that are more than six months but less than twelve months past the contractual due date for payment to the licensed insurer</td>
</tr>
<tr>
<td>10</td>
<td>Other Contingent Liabilities not covered elsewhere</td>
<td>Other Contingent Liabilities not dealt with elsewhere</td>
</tr>
<tr>
<td>11</td>
<td>Listed equity &amp; trusts, and property, plant and equipment</td>
<td>Equities listed on a recognised stock exchange Listed trusts (unless paragraph 58 applies) Listed property trusts Direct property holdings Owner occupied property Property, plant and equipment</td>
</tr>
<tr>
<td>Table 1.</td>
<td>Description</td>
<td>Risk Weighting</td>
</tr>
<tr>
<td>---------</td>
<td>-------------</td>
<td>---------------</td>
</tr>
<tr>
<td>12 Unlisted equity, unlisted trusts</td>
<td>Unlisted equities Unlisted trusts (unless paragraph 58 applies)</td>
<td>35%</td>
</tr>
<tr>
<td>13 Other On Balance Sheet Assets not covered elsewhere</td>
<td>Any other on balance sheet asset not described in this table, including assets associated with Non-insurance Activities that are not dealt with elsewhere, but not including reinsurance assets covered under Section 3.6 and not including any coinsurance amounts recoverable from EQC</td>
<td>40%</td>
</tr>
<tr>
<td>14 Assets incurring a full Capital Charge (if this row applies it must be used even if another row of this table could apply)</td>
<td>Loans to directors or associated parties of the licensed insurer Unsecured loans to employees or agents of the licensed insurer in excess of $1,000 Assets under a fixed or floating charge Obligations of a related party (except as provided in Exposure Class 7 and right-of-use assets under NZ IFRS 16 Leases where the lease is entered into on prudent commercial terms on an arm’s length basis) Unpaid premiums (including premium funding receivables) that are twelve months or more past the contractual due date for payment to the licensed insurer</td>
<td>100%</td>
</tr>
</tbody>
</table>

### 3.3. (a) Risk Weighted Exposures Charge

61. To the extent that this solvency standard applies to a licensed insurer, all of the licensed insurer’s assets (unless paragraph 25 applies) and Contingent Liabilities (as described below) are included in the Risk Weighted Exposures Charge.

62. The Risk Weighted Exposures Charge is calculated as follows:

- (a) each of the licensed insurer’s assets and Contingent Liabilities is assigned to the relevant Exposure Class (see Section 3.7 to determine the Counterparty Grade);

- (b) the absolute value of each asset and Contingent Liability is multiplied by the relevant Resilience Capital Factor, for each asset and Contingent Liability this is the Risk Weighted Exposure;

- (c) the Risk Weighted Exposures Charge is the sum of the values of the Risk Weighted Exposures.
62A. Right-of-use assets arising from the application of NZ IFRS 16 Leases are excluded from the calculation in paragraph 62. The Risk Weighted Exposures Charge under paragraph 62 is increased in respect of right-of-use assets and corresponding lease liabilities recognised under NZ IFRS 16 Leases by:

\[ 100\% \times (\text{value of the right-of-use asset} - \text{value of the corresponding lease liability}) \]

subject to a minimum of zero.

63. In calculating the Risk Weighted Exposures Charge, assets that have been guaranteed may be treated in accordance with Appendix B, in which case all the requirements of Appendix B apply. For the avoidance of doubt, if a guarantee does not meet the requirements of paragraph 3 of Appendix B it must not be used to reduce the Risk Weighted Exposures Charge.

64. Except as set out in this paragraph, Contingent Liabilities must be included in the calculation of the Risk Weighted Exposures Charge. In this solvency standard, Contingent Liabilities means: contingent liabilities as defined by NZ IAS 37 and Direct Credit Substitutes, to the extent that the Direct Credit Substitute has not been fully recognised on the balance sheet. Contingent liabilities that do not meet the test for disclosure under NZ IAS 37 are not required to be included in the Risk Weighted Exposures Charge, unless the appointed actuary is of the view that the undisclosed contingent liability has the potential to pose a material risk to the ability of the licensed insurer to maintain the required Solvency Margin now or in the future.

65. All Contingent Liabilities must be quantified assuming the Contingent Liability were to be paid (i.e. that the contingent event has occurred). If the potential value of the Contingent Liability is certain, then that amount must be used. If the value of the Contingent Liability is uncertain or a range of outcomes is possible, the value must be estimated at a prudent amount\(^4\) and noted as such, with the basis of the estimation clearly described in the licensed insurer’s Financial Condition Report. If the Contingent Liability can only become a liability on a certain date in the future, a present value estimate may be used. In all other cases it must be assumed that the amount is immediately payable.

66. The appropriate Exposure Class for a Contingent Liability is determined as follows:

(a) for a Direct Credit Substitute or other contingent liabilities where the licensed insurer bears credit risk, the Exposure Class is determined by assigning the Contingent Liability to column 2 of Table 2, where the appropriate Counterparty Grade is the issuer rating of the party to whom the licensed insurer is exposed;

(b) despite (a), for all Contingent Liabilities that give rise to an exposure to a related party the Exposure Class is 14 “Assets incurring a full Capital Charge”; and

\(^4\) As guidance, prudent amount means more than the best estimate of the potential amount but is not necessarily the largest potential value.
(c) for other types of Contingent Liability, or where there is no Exposure Class that appropriately reflects the risks inherent in the exposure, the Exposure Class shall be 10 “Other Contingent Liabilities not covered elsewhere”.

Illustrative Examples

1) A licensed insurer provides a guarantee to Acme Bank in respect of a loan to ABC Limited, an A rated institution. The licensed insurer is exposed to ABC Limited. The exposure is in respect of a debt obligation of an A rated institution hence the Exposure Class is 4.

2) The licensed insurer provides a letter of credit to XYZ Limited, a related party of the licensed insurer. The Exposure Class is 14.

3.3. (b) Derivatives Capital Charge

67. The Derivatives Capital Charge is the total of the amounts calculated in accordance with paragraphs 68 to 71.

68. For equity and bond derivatives, the amount is calculated by multiplying the asset or liability net position by the relevant Resilience Capital Factor in column 3 of Table 2.

69. For options, the amount is the delta weighted position i.e. face value multiplied by delta factor. The delta factor is that implied after the application of the appropriate equity or bond Resilience Capital Factor in column 3 of Table 2, the shock in foreign currency exchange rates specified in paragraph 81 and the shock in interest rates specified in Table 4.

70. For mark-to-market gains on any derivatives, the amount is calculated by multiplying the mark-to-market gain by the appropriate Resilience Capital Factor in column 3 of Table 2.

71. The interest rate or foreign currency position arising from derivative transactions is not to be included when calculating the Derivatives Capital Charge.

3.3. (c) Asset Concentration Risk Charge

72. In order to determine the Asset Concentration Risk Charge, the licensed insurer must first calculate the total value of its exposures to any single entity or group of related entities (counterparty). For the purposes of the Asset Concentration Risk Charge the exposures must include assets (excluding right-of-use assets arising from lease contracts recognised under NZ IFRS 16 Leases), Contingent Liabilities included in the Risk Weighted Exposures Charge and the gross balance sheet asset in respect of derivatives with that counterparty (“asset derivative position”) or, where there is a legally binding netting agreement with that counterparty, the net asset derivative position with that counterparty.

73. Where an asset is guaranteed and the requirements of paragraph 3 of Appendix B are met, then the licensed insurer may substitute the guarantor for the direct counterparty in respect of the guaranteed portion of the asset for the purposes of the Asset Concentration Risk Charge. The guarantor may be substituted to the full value
of the guarantee whether or not paragraphs 7 and 8 of Appendix B apply. Where the **licensed insurer** has ‘looked through’ a Collective Investment Vehicle or subsidiary in accordance with paragraph 58, the same look through basis must be used in calculating the Asset Concentration Risk Charge.

74. The Asset Concentration Risk Charge for each counterparty applies to the **licensed insurer’s** total exposure to each counterparty that exceeds the limits specified in column 2 of Table 3. This is the excess. An excess is calculated for each obligation category in Table 3.

75. The Asset Concentration Risk Charge in respect of each counterparty is calculated as the sum of the products of the excess for each obligation category and the applicable Resilience Capital Factor determined from Table 2, except for obligation category 4 in Table 3 “Any other asset or counterparty exposure” for which the multiplier will be twice the applicable Resilience Capital Factor determined from Table 2.

76. If more than one Resilience Capital Factor applies in respect of exposures to a counterparty in a given obligation category, the excess must be apportioned to each relevant Resilience Capital Factor based on the proportion of total exposures to that counterparty in that obligation category subject to each Resilience Capital Factor under Table 2. The relevant Resilience Capital Factor (which must be twice the Resilience Capital Factor for obligation category “Any other asset or counterparty exposure”) is then applied to each portion of the excess and the sum of the products constitutes the Asset Concentration Risk Charge for that counterparty in that obligation category.

77. The Asset Concentration Risk Charge may be reduced, if, in respect of a particular asset or Contingent Liability the Risk Weighted Exposures Charge plus the Asset Concentration Risk Charge, prior to adjustment, exceeds 100% of the value of the asset or Contingent Liability used for the Risk Weighted Exposures Charge calculation. The Asset Concentration Risk Charge that applies in respect of a given asset or Contingent Liability is determined on the basis of the apportionment set out in paragraph 76.

78. The Asset Concentration Risk Charge is the total for the **licensed insurer** across all relevant counterparties.

79. For **licensed insurers** with total assets less than 10 million New Zealand dollars the following exposures do not need to be included in the calculation of the Asset Concentration Risk Charge: bank bills issued by or deposits (including term deposits and cash on call) with a registered New Zealand bank.
### Table 3 – Asset Concentration Risk Limits

| Obligation Category | Limit (% of total assets of the Life Fund excluding:  
|                     | • any *reinsurance* recovery assets;  
<table>
<thead>
<tr>
<th></th>
<th>• any right-of-use assets arising from lease contracts recognised under NZ IFRS 16 <em>Leases</em>)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Issued by the New Zealand government or by a national government or supra-national agency of Counterparty Grade 1</td>
<td>100%</td>
</tr>
<tr>
<td>2. Issued by a New Zealand Local Authority or State-Owned Enterprise</td>
<td>50% (or $5m if greater)</td>
</tr>
<tr>
<td>3. Bank bills issued by or deposits (including term deposits and cash on call) with a specific New Zealand registered bank</td>
<td>25% (or $5m if greater)</td>
</tr>
<tr>
<td>4. Any other asset or counterparty exposure</td>
<td>10% (or $2m if greater)</td>
</tr>
</tbody>
</table>
Example of calculation under paragraphs 76 and 77

An insurer has only two assets and these assets are with a single counterparty that is not a bank or a government entity.

Asset 1 is valued at $200m and is subject to a fixed charge and so is subject to a Resilience Capital Factor of 100% for the purposes of the Risk Weighted Exposures Charge.

Asset 2 is valued at $300m and is subject to a Resilience Capital Factor of 2% for the purposes of the Risk Weighted Exposures Charge.

The total asset base is $500m.

The excess of the limits specified in Table 3 is the amount greater than 10% of the insurer’s asset base, this is $450m.

In order to determine the Asset Risk Concentration Charge the excess is apportioned based on the relative value of the total assets subject to each Resilience Capital Factor.

40% ($200m/$500m) of the excess ($180m) is subject to a Resilience Capital Factor of 2 x 100%

60% ($300m/$500m) of the excess ($270m) is subject to a Resilience Capital Factor of 2 x 2%

The Asset Risk Concentration Charge prior to adjustment is:

$180m x 200% + $270m x 4% = $370.8m

$180m of the asset base is however subject to a total Capital Charge of 300%. The Asset Concentration Charge may be reduced by $360m to reduce the total Risk Weighted Exposures Charge and Asset Concentration Charge to 100% for the relevant asset.

3.4. Foreign Currency Risk Capital Charge

Concept

80. In applying this solvency standard a licensed insurer must consider the degree of mismatching between assets and liabilities in terms of foreign currency risk.

Calculation

81. The Foreign Currency Risk Capital Charge is calculated by multiplying the net open foreign exchange position in each currency other than New Zealand dollars, regardless of whether the position is long or short, by 22% and taking the sum of those amounts.
82. The net open foreign exchange position is the absolute value of the value of assets less the value of liabilities (taking into account applicable derivative positions and including any Contingent Liabilities) that are denominated in the relevant currency.

83. Where an asset of a licensed insurer is denominated in a foreign currency and has been guaranteed, the underlying asset is included in the net open foreign exchange position, but the guarantee is not.

84. Where a New Zealand dollar asset of a licensed insurer is:

(a) subject to a guarantee that is denominated in a foreign currency; and

(b) that guarantee is limited to a particular foreign currency value;

then the amount of the guarantee recognised in the calculation of the Risk Weighted Exposures Charge must be included in the calculation of the net open foreign exchange position for the relevant foreign currency (guarantees denominated in a foreign currency that do not limit the New Zealand dollar amount guaranteed, either because the amount of the guarantee is unlimited or because the guarantee is hedged, do not need to be included in the net open foreign exchange position).

3.5. Interest Rate Capital Charge

Concept

85. In applying this solvency standard a licensed insurer must consider the degree of mismatching between assets and liabilities in terms of interest rate risk.

Calculation

86. The Interest Rate Capital Charge is calculated by reference to fixed interest-bearing assets and fixed interest-bearing liabilities. For the purposes of determining the Interest Rate Capital Charge:

(a) fixed interest-bearing assets are those assets and derivative positions bearing a fixed interest rate for a period of time (re-set period) beyond the balance date at which the solvency calculation is performed. Fixed interest-bearing assets must be included in the calculation regardless of the existence of any guarantee in relation to such assets;

(b) fixed interest-bearing liabilities are insurance liabilities and derivative positions and any other liabilities, including fixed interest-bearing Contingent Liabilities, where the economic value depends upon discounting actual or expected cash flows for the time value of money; in other words those liabilities where the value depends implicitly or explicitly on interest rate assumptions; and

(c) insurance liabilities are Premium Liabilities and the Net Outstanding Claims Liability at a minimum 75% probability of sufficiency, as advised by the appointed actuary.
87. The Interest Rate Capital Charge is calculated by separately revaluing the licensed insurer’s fixed interest-bearing assets and fixed interest-bearing liabilities under each of an Upshock and a Downshock movement in all nominal and real interest rates as set out in Table 4, applied to all fixed interest-bearing assets and liabilities.

<table>
<thead>
<tr>
<th>Table 4 Upshock and Downshock Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upshock (gross of tax)</td>
</tr>
<tr>
<td>-------------------------</td>
</tr>
<tr>
<td>Nominal Interest Rate Instruments</td>
</tr>
<tr>
<td>Real Interest Rate Instruments</td>
</tr>
</tbody>
</table>

88. The interest rate used for the revaluation under the Downshock movement in interest rates is limited to a minimum of 0.

89. For each of the Upshock and Downshock the net revaluation impact is calculated. The net revaluation impact is the change in the value of assets less the change in the value of liabilities resulting from the Upshock or Downshock (summed over both the nominal and real interest rate instruments). The Interest Rate Capital Charge is equal to whichever of the net revaluation impact under either of the Upshock or Downshock has the largest adverse impact on the licensed insurer’s Solvency Margin.

3.6. Reinsurance Recovery Risk Capital Charge

Concept

90. The Reinsurance Recovery Risk Capital Charge reflects the exposure of a licensed insurer to losses arising from failure to fully recover on reinsurance contracts, including losses due to reinsurer failure and contract dispute.

Calculation

91. The Reinsurance Recovery Risk Capital Charge is the sum across all reinsurers of the reinsurance recovery asset in respect of each reinsurer multiplied by the Reinsurance Risk Capital Factor determined by reference to the relevant reinsurer Counterparty Grade in Table 6.

92. For the purposes of the Reinsurance Recovery Risk Capital Charge, the reinsurance recovery asset is the sum of the value of the following assets on the licensed insurer’s balance sheet:

(a) reinsurance recoverable in respect of outstanding claims as included in the 75% POS provision used within the Insurance Risk Capital Charge calculations;
(b) deferred **reinsurance** expense (less any unearned exchange commission); 

(c) amounts due from reinsurers in respect of paid claims; and 

(d) amounts due from coinsurers, including EQC, in respect of recovery of claims amounts previously paid by the **licensed insurer** in respect of the co insurer’s share of the loss.

The **reinsurance** recovery asset does not include recoveries that are not **reinsurance** (e.g. salvage and subrogation). Where arrangements with a reinsurer involve both liability and asset components, these may be taken as a single net exposure to the extent they are subject to a legally enforceable right of offset.

### 3.7. Determining Counterparty Grades

93. Some of the capital charges in this **solvency standard** depend upon the Counterparty Grade of reinsurers, other counterparties or the issue rating of an asset. The Counterparty Grade is determined with reference to:

(a) the credit rating of the asset in respect of investment assets (issue ratings) or, in some cases, the rating of the counterparty (issuer rating);

(b) the **insurer financial strength rating** in respect of **reinsurance** recovery assets;

issued by recognised rating agencies.

94. Because rating agencies do not always agree it is necessary to have a consistent method of determining which Counterparty Grade to use. Each **licensed insurer** must adopt a policy that states the rating agency that it will use as a first preference and other agencies (in order of preference) that it will use if the preferred agency does not publish ratings for a particular counterparty or asset.

95. The Counterparty Grades are determined by reference to Table 5.1 or Table 5.2 in respect of investment assets and by reference to Table 6 in respect of **reinsurance** assets and in respect of issuer ratings.

96. Where an asset does not have a public rating, but the issuer has a public rating, the rating of the issuer, determined by reference to Table 6, may be used.
Table 5.1 Short Term Ratings – normally for assets with terms of 12 months or less

<table>
<thead>
<tr>
<th>Counterparty Grade</th>
<th>Standard &amp; Poor’s</th>
<th>Moody’s</th>
<th>Fitch</th>
<th>AM Best</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A1+</td>
<td>F1+</td>
<td>AMB-1+</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>A1</td>
<td>F1</td>
<td>AMB-1</td>
<td></td>
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<td>3</td>
<td>A2</td>
<td>P2</td>
<td>F2</td>
<td>AMB-2</td>
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<td>4</td>
<td>A3</td>
<td>P3</td>
<td>F3</td>
<td>AMB-3</td>
</tr>
<tr>
<td>5</td>
<td>Other</td>
<td>Other</td>
<td>Other</td>
<td>Other</td>
</tr>
</tbody>
</table>

Table 5.2 Long Term Ratings – normally for assets with terms of over 12 months

<table>
<thead>
<tr>
<th>Counterparty Grade</th>
<th>Standard &amp; Poor’s</th>
<th>Moody’s</th>
<th>Fitch</th>
<th>AM Best</th>
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<tbody>
<tr>
<td>1</td>
<td>AAA</td>
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<td>BBB</td>
<td>Baa2</td>
<td>BBB</td>
<td>bbb</td>
</tr>
<tr>
<td></td>
<td>BBB-</td>
<td>Baa3</td>
<td>BBB-</td>
<td>bbb-</td>
</tr>
<tr>
<td>5</td>
<td>Below or unrated</td>
<td>Below or unrated</td>
<td>Below or unrated</td>
<td>Below or unrated</td>
</tr>
</tbody>
</table>
### Table 6 Reinsurer or Issuer Counterparty Grades

<table>
<thead>
<tr>
<th>Counterparty Grade</th>
<th>S&amp;P/Fitch</th>
<th>AM Best</th>
<th>Moody’s</th>
<th>Reinsurance Risk Capital Factor</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>AAA</td>
<td>A++</td>
<td>Aaa</td>
<td>2%</td>
</tr>
<tr>
<td>2</td>
<td>AA+</td>
<td>A+</td>
<td>Aa1</td>
<td>2%</td>
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<tr>
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<td></td>
</tr>
<tr>
<td></td>
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<td></td>
<td>Aa3</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>A+</td>
<td>A A-</td>
<td>A1</td>
<td>4%</td>
</tr>
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<td></td>
<td>A</td>
<td></td>
<td>A2</td>
<td></td>
</tr>
<tr>
<td></td>
<td>A-</td>
<td></td>
<td>A3</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>BBB+</td>
<td>B++ B+</td>
<td>Baa1</td>
<td>10%, up to a 20% proportion of the total reinsurance recovery asset, and 20% above that limit</td>
</tr>
<tr>
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<td>BBB</td>
<td></td>
<td>Baa2</td>
<td></td>
</tr>
<tr>
<td></td>
<td>BBB-</td>
<td></td>
<td>Baa3</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Below/unrated</td>
<td>Below/unrated</td>
<td>Below/unrated</td>
<td>20%, up to a 10% proportion of the total reinsurance recovery asset, and 40% above that limit</td>
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4. Obligations of the Licensed Insurer

4.1. Reporting to the Reserve Bank

97. Section 56(d) of the Act allows the Reserve Bank to include within a **solvency standard** requirements relating to reports about the financial condition or solvency of a **licensed insurer**. Section 56(g) of the Act allows the Reserve Bank to include within a **solvency standard** requirements relating to the disclosure of information relating to the financial condition or solvency of the **licensed insurer**.

4.2. Licensed Insurer must provide Solvency Returns to the Reserve Bank

98. A **licensed insurer** must provide an Annual Solvency Return and the accompanying information set out in (a) to (e) to the Reserve Bank. The Annual Solvency Return and accompanying information must be supplied within the timeframe required under section 81(1) of the Act for the provision of **financial statements** or **group financial statements** to the Reserve Bank. If the **licensed insurer** is exempt from section 81(1) of the Act, the Annual Solvency Return and accompanying information must be supplied within the timeframe specified in regulation 12(c) of the Insurance (Prudential Supervision) Regulations 2010 for the provision of financial information. The Annual Solvency Return must be in the form specified by the Reserve Bank and be accompanied by:

- (a) a certification by two **directors** of the **licensed insurer** (or in the case of an **overseas insurer**, its **New Zealand chief executive officer**) in the form specified by the Reserve Bank;

- (b) a copy of the audited **financial statements** or **group financial statements** of the **licensed insurer** or where Alternative Financial Information has been used, a copy of that information;

- (c) a report by the auditor of the **licensed insurer** on the audit of the Annual Solvency Return;

- (d) a **Financial Condition Report** prepared by the **appointed actuary** of the **licensed insurer**; and

- (e) a report from the **appointed actuary** that meets the requirements of section 78 of the Act.

99. A **licensed insurer** must provide a Half-yearly Solvency Return to the Reserve Bank. The Half-yearly Solvency Return must be supplied within the timeframe required under section 81(2) of the Act for the provision of interim financial information. If the **licensed insurer** is exempt from section 81(2) of the Act, the Half-yearly Solvency Return and accompanying information must be supplied within 4 months of the date that is 6 months after the end of the **licensed insurer’s** financial year. The Half-yearly Solvency Return must be in the form specified by the Reserve Bank and must be accompanied by a certification by two **directors** of the **licensed insurer** (or in the case of an **overseas insurer**, its **New Zealand chief executive officer**) in the form specified by the Reserve Bank.
4.3. Audit of Annual Solvency Return

100. A licensed insurer must engage its auditor to undertake a reasonable assurance audit of the Annual Solvency Return and must do everything necessary to allow the auditor to undertake this function.\(^5\) The audit may exclude the Catastrophe Risk Capital Charge and 4 year forward looking projections required in the Annual Solvency Return.

101. The auditor’s report on the Annual Solvency Return must address the matters prescribed in this solvency standard and must be signed by the auditor.

102. The Reserve Bank may, at its discretion, require independent review of the audit and auditor’s report.

4.4. Financial Condition Report by the Appointed Actuary

103. A licensed insurer must engage its appointed actuary to prepare a Financial Condition Report for the licensed insurer and must do everything necessary to enable the appointed actuary to undertake this function.

4.5. Disclosure of Solvency Calculations

104. A licensed insurer must disclose the information set out in paragraphs 107 and 108 in its financial statements or group financial statements. This disclosure must be as at the balance date to which the financial statements or group financial statements relate along with a comparative for the immediately preceding financial year.

105. For an overseas insurer subject to this solvency standard, the disclosure under paragraph 104 need only be made within the financial statements or group financial statements prepared for the New Zealand Branch.

106. A licensed insurer must disclose the information set out in paragraphs 107 and 108 on its website (if any). This disclosure must be updated within 10 working days following the required date for submission of each of the Annual and Half-yearly Solvency Returns to the Reserve Bank to reflect the information in those returns.

107. The information, based on the solo solvency calculations of the licensed insurer, is the:

(a) Actual Solvency Capital;
(b) Minimum Solvency Capital;
(c) Solvency Margin;

\(^5\) Reasonable assurance in the context of the audit requirements of the annual solvency return, is defined in section 12 of the International Standard on Assurance Engagements (New Zealand) 3000, issued by the External Reporting Board in July 2014.
(d) Solvency Ratio.

108. The information, in respect of the aggregate Solvency Margin requirements of the licensed insurer, is the:

(a) Aggregate Actual Solvency Capital;

(b) Aggregate Minimum Solvency Capital, adjusted to take account of the Fixed Capital requirement;

(c) Aggregate Solvency Margin, being the Aggregate Actual Solvency Capital less the Aggregate Minimum Solvency Capital; and

(d) The Aggregate Solvency Ratio, being the ratio of the Aggregate Actual Solvency Capital to Aggregate Minimum Solvency Capital.

4.6. Advice to the Reserve Bank on likely failure to maintain Solvency Margin

109. Section 24 of the Act requires that, if a licensed insurer has reasonable grounds to believe that a failure to maintain a Solvency Margin is likely to occur at any time within the next three years, the licensed insurer must report the likely failure to the Reserve Bank as soon as is reasonably practicable.

110. In order to determine if the licensed insurer is likely to maintain the required Solvency Margin over the three year assessment period, and whether a reporting obligation arises, the licensed insurer must:

(a) consider a forward looking assessment of its compliance with the solvency standard in addition to the calculations at the most recent balance date. This forward looking assessment should extend for at least three years from the licensed insurer’s last annual or half year balance date and take into account known aspects of the licensed insurers business plan, its enterprise risk management practices and the external environment; and

(b) put in place procedures, including reporting to the appointed actuary, that allow for the identification and escalation of circumstances that may give rise to a reporting obligation under section 24.
5. Obligations of the Appointed Actuary

5.1. Financial Statements

111. Section 77 of the Act requires that the licensed insurer ensure that actuarial information contained in, or used in the preparation of, the financial statements or group financial statements is reviewed by the appointed actuary. Section 77(4)(c) allows the Reserve Bank to specify, within a solvency standard, information that is actuarial information in addition to that specified in the Act. The specified actuarial information is the information in subparagraphs 111(a) – (e) and the information specified in paragraph 115:

(a) the Premium Liabilities as defined in this solvency standard;
(b) the Net Outstanding Claims Liability as defined in this solvency standard;
(c) the reinsurance and any other recovery asset(s) relevant to the Reinsurance Recovery Risk Capital Charge;
(d) any deferred acquisition cost or deferred fee revenue relevant to the Premium Liabilities; and
(e) any other information deemed by the appointed actuary to warrant actuarial review for the purpose of profit or solvency reporting.

112. If it is the licensed insurer's established policy to seek the advice of the appointed actuary in respect of part or all of this actuarial information and to always adopt that advice in its financial statements or group financial statements, then the advice from the appointed actuary to the licensed insurer satisfies the review requirements.

113. In other circumstances the appointed actuary must undertake whatever additional work is necessary in order to complete the review.

114. In completing the review the appointed actuary may need to utilise the skills and experience of other experts in accordance with paragraph 126.

115. The appointed actuary's review must cover the following actuarial information:

(a) net outstanding claims calculated in accordance with NZ IFRS 4 including:
   i. central estimate of expected claims and recoveries;
   ii. discounting at a risk free rate;
   iii. allowance for claim handling expenses; and
   iv. a risk margin intended to provide the specified probability of sufficiency;
(b) application of the liability adequacy test; and
the level of deferred acquisition cost in the financial statements or Alternative Financial Information after the application of the liability adequacy test as detailed in Section 2.7.

116. Any adjustments arising as a result of the review of the appointed actuary must be incorporated into the solvency calculations.

117. The appointed actuary must use professional judgement to determine the extent of work required regarding the liability adequacy test, considering the nature and size of the licensed insurer's business and the Materiality of the risks involved. A full assessment would include comparison of:

(a) the relevant accounting provisions (uneearned premium, deferred acquisition cost, deferred reinsurance expense, deferred reinsurance commissions, unexpired risk and the like); and

(b) the actuarial estimate of net Premium Liabilities comprising:
   i. determination of the appropriate assessment period for Premium Liabilities;
   ii. central estimate of expected claims and recoveries;
   iii. discounting at a risk free rate;
   iv. allowance for policy administration and claim handling expenses;
   v. allowance for the cost of any future reinsurance (i.e. that has not yet been purchased) required to cover unexpired risks; and
   vi. a risk margin intended to provide a 75% POS (or such higher percentage that may have been used).

118. Any adjustments arising as a result of this assessment must be incorporated into the Premium Liability Adjustment.

119. The results of the appointed actuary's review must be documented in a report that meets the requirements of section 78 of the Act.

5.2. Solvency Calculations and Reporting

120. The appointed actuary must calculate or review all aspects of the Solvency Margin calculations. The results of the calculation or review must be documented in the Financial Condition Report.

121. The appointed actuary must include specific comment in the Financial Condition Report on: the basis for determining the Catastrophe Risk Capital Charge, the adjustment of various items for taxation and any other Material issues arising from Sections 2 and 3.
122. In preparing the Financial Condition Report, the appointed actuary must make due enquiries in order to determine whether the licensed insurer is exposed to any Contingent Liabilities that have not been disclosed in the licensed insurer's financial statements. The appointed actuary may rely on paragraph 126 in identifying such Contingent Liabilities.

123. In considering the appropriate adjustment for tax the relevant considerations include:

(a) the fact that the items subject to adjustment are usually revenue items whereas the solvency standard is based on comparison of balance sheet items;

(b) the appropriate adjustment will normally be to reduce the relevant amount by the applicable company tax rate;

(c) if the overall impact of tax adjustments would be to create a greater deferred tax asset then a corresponding adjustment to the Deductions from Capital should be made; and

(d) whether any particular features of the tax laws or the taxation status of the licensed insurer need to be taken into account.

124. All numeric capital factors, the Upshock and Downshock and shock to foreign currency exchange rates used within the capital charge calculations are stated gross of taxation (that is, before any allowance for taxation).

5.3. Financial Condition Report

125. The Financial Condition Report prepared by the appointed actuary must:

(a) identify and describe the Material risks (of which it is reasonable to expect the appointed actuary to be aware) facing the licensed insurer, that in the appointed actuary's opinion pose a threat to the licensed insurer's ability to maintain the required Solvency Margin now or in the future, and where practicable quantify such risks;

(b) comment on the steps taken or proposed to be taken by the licensed insurer to address the risks identified in (a);

(c) identify and describe any Contingent Liabilities, identified in accordance with paragraph 122, that have not been disclosed in the financial statements, comment on the potential size and probability of occurrence of those Contingent Liabilities and the level of uncertainty around these estimates, and describe any steps taken by the licensed insurer to manage the risk associated with those Contingent Liabilities;

(d) explain any differences between Capital and the value of net assets in the licensed insurer's financial statements;
(e) comment on whether, in the appointed actuary's opinion, the outstanding claims provision established by the licensed insurer is substantially different from that which would be determined in accordance with NZ IFRS 4 and with a risk margin required to achieve the specified POS, and if so on the relevant figures by class of insurance business;

(f) advise the licensed insurer on the appropriate treatment, for solvency purposes, of any insurance business with long term risk characteristics or any product, activity or insurance business with risk characteristics not adequately covered by this solvency standard;

(g) advise the licensed insurer, if relevant, on the approximate impact on the Asset Risk Capital Charge over the course of the year and at the date of calculation of the Solvency Margin;

(h) comment on the risks involved with mismatching of assets and liabilities and how such mismatch has been accounted for in any relevant capital charge;

(i) detail all assumptions used in the calculation of the Solvency Margin, and:
   i. identify those assumptions to which the licensed insurer's Solvency Margin is most sensitive ("key sensitivities") and quantify the impact on the Solvency Margin of those key sensitivities;
   ii. disclose and justify any simplifying assumptions or methodologies (see Section 1.6) used in the calculation of the Solvency Margin; and
   iii. detail the basis for the estimation of the value of any Contingent Liability included in the Risk Weighted Exposures charge, where such estimate is made;

(j) advise the licensed insurer on whether, in the appointed actuary's opinion, the licensed insurer needs to consider reporting to the Reserve Bank under section 24 of the Act, taking account of the licensed insurer's forward looking assessment of the Solvency Margin and the appointed actuary's assessment of the licensed insurer's business plans, its enterprise risk management practices and the external environment.

126. The appointed actuary may need to deal with issues that are not within the skills and experience of the appointed actuary. In this situation the appointed actuary will need to utilise the skills and experience of others and may rely on other relevant experts, provided that reliance is appropriate and adequate disclosure is included on the nature of that reliance.

5.4. New Zealand Society of Actuaries' Professional Standards

127. The appointed actuary must ensure that all actuarial work carried out for the purposes of, or supporting, this solvency standard is carried out in accordance with the New Zealand Society of Actuaries' Professional Standards.

Standard Ends
Appendix A: Materiality

1. All calculations required in relation to this **solvency standard** are subject to the following Materiality requirements.

2. Particular values or components are considered Material to the overall result of a calculation when their misstatement or omission would cause that result to be misleading to the users of the information.

3. Materiality tests assess the significance of the particular value or component by relating it to the amount of the overall result to which it contributes.

4. The base amount for Materiality purposes is the Solvency Margin.

5. The **appointed actuary** must consider Materiality relative to the amount of both:
   
   (a) the major individual components of the calculation; and
   
   (b) the overall cumulative effect of those individual components.

6. Values or components generating variations in amounts of 10% or more of the Solvency Margin must be presumed Material, while those generating variations in amounts of 5% or less of the Solvency Margin may be presumed immaterial. The Materiality of values or components generating variations between 5% and 10% will be a matter for professional judgement.

7. In applying the Materiality standards described in paragraphs 4 to 6 above:
   
   (a) it is appropriate to use as the base amount for Materiality purposes a rolling average of the Solvency Margin provided that the average so derived is a function of not less than three and not more than five years experience and reflects the current and anticipated future experience; and
   
   (b) it is appropriate, as the Solvency Margin approaches zero, for alternative key indicators to be used in establishing Materiality.

8. Materiality applies to all aspects of the determination and covers the acceptability of grouped data, modelled projections and approximate valuation methods.
Appendix B: Guarantees

1. The portion of an asset covered by a guarantee that meets the requirements of paragraph 3 of this Appendix may be assigned the Resilience Capital Factor that would be applicable were the guarantor the principal counterparty, plus an Additional Capital Factor of 2%. In determining the Resilience Capital Factor for a guaranteed asset the Counterparty Grade in Table 2 should be interpreted as an issuer rating of the guarantor (determined by reference to Table 6). The portion of an asset considered to be covered by a guarantee is that portion of the asset equal to the value of the guarantee calculated in accordance with paragraphs 4 to 9 of this Appendix. Any portion of the asset in excess of the value of the guarantee must be assigned the Resilience Capital Factor applicable absent the guarantee.

2. For the purposes of this Appendix the following definitions apply:

   *Beneficiary* in respect of a guarantee means the **licensed insurer** who benefits from the guarantee;

   *Maturity in respect of a guarantee* includes a maturity date and any date on which the guarantor has the capacity to terminate, otherwise end or increase the effective cost of the guarantee;

   *Maturity in respect of the underlying asset* means the longest possible remaining time that the asset may remain an asset of the **licensed insurer** (irrespective of any potential rights to call);

   *Principal counterparty* means the counterparty to the transaction with the **licensed insurer** that gave rise to the underlying asset;

   *Residual maturity* means the time remaining until maturity. For a demand loan the residual maturity of the loan shall be deemed to be 3 years and the residual maturity of a guarantee of a demand loan shall be deemed to be the initial maturity.

3. The guarantee must:

   (a) be provided by a guarantor with an issuer Counterparty Grade (or for governments, the long-term foreign currency credit rating) of 1, 2 or 3 (refer Table 6); and

   (b) be provided by a party that is not a parent entity of the **licensed insurer** and is not a *related party* of the **licensed insurer**; and

   (c) be legally enforceable, clearly documented in writing and, if exercised, represent a direct claim on the guarantor that may be pursued without legal action being taken against the principal counterparty; and

   (d) be explicitly referenced to a specific asset or pool of assets; and

   (e) cover all types of payments the principal counterparty is required to make under the documentation (including interest); and
(f) be irrevocable by the guarantor prior to maturity (that is the guarantor may not have the right to unilaterally terminate the guarantee prior to any specified date on which the guarantee will mature or may otherwise terminate); and

(g) be unconditional (there must be no conditions that need to be fulfilled prior to the guarantor being liable on default of the principal counterparty).

4. Where an asset, or pool of assets, of a licensed insurer is subject to more than one guarantee, but those guarantees are limited to the extent of common collateral, the guarantees may only be recognised up to the value of that collateral.

5. For the purposes of paragraph 1, the value of a maturity matched guarantee is the guaranteed amount. A maturity matched guarantee exists when the residual maturity of the guarantee is the same or greater than the residual maturity of the underlying asset. A guarantee of a demand loan where the initial maturity of the guarantee is 3 years or greater shall be considered to be a maturity matched guarantee.

6. For the purposes of paragraph 1, the value of a maturity mismatched guarantee must be calculated in accordance with paragraphs 7 to 9. A maturity mismatched guarantee exists if the residual maturity of the guarantee is less than the residual maturity of the underlying asset.

7. Except as provided in the next sentence, the value of a maturity mismatched guarantee where the residual maturity of the guarantee is equal to or less than 12 months is 0. Where a maturity mismatched guarantee of residual maturity equal to 12 months provides that it will be renewed automatically unless a notice of termination is given, and the licensed insurer has no reason to believe that the guarantee will not be renewed, the guarantee may be recognised in the 12 months prior to renewal provided that the value of the guarantee is calculated in accordance with the formula in paragraph 8 and the residual maturity of the guarantee is considered to be 6 months for the entirety of that 12 months for the purposes of that formula.

8. Subject to paragraph 7, if a guarantee is maturity mismatched, the value of the guarantee for the purposes of paragraph 1 must be adjusted in accordance with the following formula:

$$\text{Value of guarantee} = \text{guarantee amount} \times \frac{\min(T, \text{residual maturity guarantee})}{\min(5, \text{residual maturity asset})}$$

Where residual maturity is measured in years or part thereof and “T” is the lesser of 5 and the residual maturity of the asset.

9. Where there is a single guarantee, limited in sum, that applies to a pool of assets where the residual maturity of the assets in the pool differ, the licensed insurer must assume that the guarantee applies to the asset with the longest residual maturity first for the purposes of paragraph 8.
Appendix C: Qualifying criteria for capital instruments

1. To be included within a licensed insurer’s Capital, each capital instrument must meet the following qualifying criteria for that instrument.

C.1 Ordinary shares: qualifying criteria

Permanence

2. The principal amount of the ordinary shares must be perpetual (i.e. there is no maturity date) and cannot be repaid outside of liquidation (i.e. the ordinary shares are not redeemable as defined in section 68 of the Companies Act 1993) setting aside discretionary acquisitions permitted by section 58 of the Companies Act 1993.

3. Neither the licensed insurer nor any related party of the licensed insurer may do anything to create an expectation at issuance that the ordinary shares will be repaid or cancelled, and the contractual terms of the ordinary shares (wherever set out) must not contain any feature that may give rise to such an expectation.

4. The ordinary shares can only be included within Capital to the extent the ordinary shares are paid-up and the paid-up amount has been irrevocably received by the licensed insurer.

Loss absorption

5. After retained earnings and revenue and other reserves, the issued ordinary shares must incur the first and proportionately greatest share of any losses as they occur in all circumstances, including on a going concern basis and upon wind-up of the licensed insurer.

Servicing charge

6. Distributions must meet the following requirements:

(a) the level of distributions may not be linked in any way to the amount paid at issuance and may not be subject to a contractual cap (except for restrictions imposed by the Companies Act or this solvency standard);

(b) there must be no circumstances under which the distributions are obligatory and in all circumstances the licensed insurer must be able to waive any distribution;

(c) any waived distributions must be non-cumulative (i.e. waived distributions cannot be required to be made up by the licensed insurer at a later date and bonus payments to compensate for unpaid distributions are prohibited);

(d) non-payment of distributions must not be an event constituting default of the licensed insurer or any related party of the licensed insurer;
(e) distributions may only be paid by the licensed insurer after all other legal and contractual obligations have been met, such as payment obligations on more senior capital instruments and debt having been made. This means that the ordinary shares must not have any preferential or predetermined rights to distributions of capital or income; and

(f) the licensed insurer must not be required to make any distribution if it would result in the licensed insurer breaching the Solvency Margin requirements of the conditions of licence of the licensed insurer.

**Ranking on winding-up**

7. The ordinary shares must represent the most subordinated claim in the event of liquidation of the licensed insurer.

8. Ordinary shareholders are entitled to a claim on the residual assets of the licensed insurer that is proportional with their share of issued capital, after all senior claims have been repaid in liquidation (i.e. the claim is variable and unlimited and not fixed or capped).

9. The paid-up amount, or any future payments related to the ordinary shares, must not be secured nor covered by a guarantee of the licensed insurer or any related party of the licensed insurer or be subject to any other arrangement that legally or economically enhances the seniority of the holder’s claim. The ordinary shares must not be subject to netting or offset claims on behalf of the holder of the ordinary shares.

10. The paid-up amount must be classified as equity.

**Other appropriate features**

11. The ordinary shares must be directly issued by the licensed insurer and neither the licensed insurer nor any related party of the licensed insurer over which the licensed insurer exercises control or significant influence can have purchased the ordinary shares nor directly or indirectly funded their purchase.

12. Holders of the ordinary shares must have full voting rights arising from the ownership of the shares.

13. The amount of ordinary shares must be clearly and separately disclosed within the licensed insurer’s financial statements or Alternative Financial Information.

**C.2 Perpetual instruments (“Perpetuals”): qualifying criteria**

**Permanence**

14. The principal amount of the Perpetuals must be perpetual (i.e. there is no maturity date).

15. Neither the licensed insurer nor any related party of the licensed insurer may do anything to create an expectation at issuance that the Perpetuals will be repaid or
cancelled (except as provided for in paragraph 17 of this Appendix), and the contractual terms of the Perpetuals (wherever set out) must not contain any feature that may give rise to such an expectation.

16. The Perpetuals can only be included within Capital to the extent the Perpetuals are paid-up and the paid-up amount has been irrevocably received by the licensed insurer.

17. The Perpetuals may only be callable or redeemable (as defined in section 68 of the Companies Act 1993) at the initiative of the licensed insurer and only after a minimum of five years from the date on which the licensed insurer irrevocably receives the proceeds of payment for the Perpetuals, except that a Perpetual instrument may provide for a call within the first five years of issuance as a result of a tax or regulatory event. An event will not meet the definition of a tax or regulatory event if it is an event that the licensed insurer was in a position to anticipate at the time of the issue of the instrument or if the event is minor or insignificant.

**Loss absorption**

18. The Perpetuals must have the potential to absorb losses on a going concern basis, for example through cancellation of distributions, and upon wind-up of the licensed insurer.

**Servicing charge**

19. Distributions must meet the following requirements:

   (a) the licensed insurer must have full discretion at all times to cancel distributions on the Perpetuals. Any waived distributions must be non-cumulative (i.e. waived distributions cannot be required to be made up by the licensed insurer at a later date and bonus payments to compensate for unpaid distributions are prohibited);

   (b) cancellation of distributions must not be an event constituting default of the licensed insurer or any related party of the licensed insurer. Holders of the Perpetuals must have no right to apply for the liquidation or voluntary administration of the licensed insurer or any related party of the licensed insurer or appoint a receiver of the property of the licensed insurer or any related party of the licensed insurer on the grounds that the licensed insurer fails to make, or may become unable to make, a distribution on the Perpetuals;

   (c) cancellation of distributions must not impose restrictions on the licensed insurer, or any related party of the licensed insurer, except in relation to:

      A. the acquisition, repurchase or redemption of ordinary shares, Perpetuals or other instruments; or

      B. dividend stopper arrangements that stop distributions on ordinary shares, other Perpetuals or other instruments;
(d) the licensed insurer must have full access to cancelled distributions to meet obligations as they fall due;

(e) the Perpetuals must not have a credit sensitive distribution feature, such as a distribution that is reset periodically based in whole or in part on the credit standing of the licensed insurer or any related party of the licensed insurer;

(f) the Perpetuals must not contain any step-ups or incentives to redeem. This requires that the terms of the Perpetuals must provide for the distribution rate to be fixed for the entire term of the instrument and must not provide for the rate to be altered or reviewed except for the following:

A. a distribution may be cancelled, in whole or in part; and

B. where there is a variable rate and where the formula for setting the rate is fixed at the outset. For example, it would be acceptable to specify the distribution rate as a fixed margin above a recognised market benchmark such as the bank bill rate;

C. conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread will not in itself be viewed as an incentive to redeem. However the licensed insurer or any related party of the licensed insurer must not do anything that creates an expectation that the call will be exercised. A change in the margin will be considered to be an incentive to redeem; and

(g) the licensed insurer must not be required to make any distribution if it would result in the licensed insurer being insolvent (as defined by the Companies Act 1993) or breaching the Solvency Margin requirements of the conditions of licence of the licensed insurer.

Ranking on winding-up

20. The Perpetuals must represent the most subordinated claim after ordinary shares in the event of liquidation of the licensed insurer.

21. The paid-up amount of the Perpetuals, or any future payments related to the Perpetuals, must not be secured nor covered by a guarantee of the licensed insurer or any related party of the licensed insurer or subject to any other arrangement that legally or economically enhances the seniority of the holder’s claim. The Perpetuals must not be subject to netting or offset claims on behalf of the holder of the Perpetuals.

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6 Perpetuals may utilise a broad index as a reference rate for the calculation of distributions, provided that the index does not exhibit any significant correlation with the licensed insurer’s credit rating.

7 Conversion from a fixed rate to a floating rate that is calculated as a benchmark rate plus a margin, will be considered an incentive to redeem if there is an increase in the margin relative to that implied for the fixed rate.
**Other appropriate features**

22. The Perpetuals must be directly issued by the **licensed insurer** and neither the **licensed insurer** nor any related party of the **licensed insurer** over which the **licensed insurer** exercises control or significant influence can have purchased the Perpetuals nor directly or indirectly funded their purchase. Except that the **licensed insurer** may issue a perpetual instrument to a Special Purpose Vehicle ("SPV") in conjunction with a Perpetuals capital instrument issued by the SPV to third party investors at the same time. The Perpetuals capital instrument issued by the SPV to third party investors will qualify as Capital provided that the following criteria are fully satisfied:

(a) the perpetual instrument issued by the **licensed insurer** to the SPV must meet the qualifying criteria for classification as Perpetuals (except that it may be purchased by a related party SPV);

(b) the Perpetuals capital instrument issued by the SPV to third party investors would, if issued by the **licensed insurer**, meet the qualifying criteria for classification as Perpetuals;

(c) the terms and conditions of the perpetual instrument issued by the **licensed insurer** to the SPV must match, in all material respects, the terms and conditions of the Perpetuals capital instrument issued at the same time by the SPV to third party investors;

(d) the proceeds from the issue of the Perpetuals capital instrument issued by the SPV to third party investors must be immediately and directly invested in the Perpetuals capital instrument issued to the SPV by the **licensed insurer** and be available, without limitation to, the **licensed insurer**; and

(e) the SPV must be controlled by the **licensed insurer**.

23. The amount of the Perpetuals must be clearly and separately disclosed within the **licensed insurer's financial statements** or Alternative Financial Information.

**C.3 Credit Union Securities: qualifying criteria**

24. Credit Union Securities ("Securities") are a capital instrument that may only be issued by credit unions under the Friendly Societies and Credit Union Act 1982.

**Permanence**

25. The principal amount of the Securities must be perpetual (i.e. there is no maturity date) and cannot be repaid outside of liquidation.

26. The Securities can only be included within Capital to the extent the Securities are paid-up and the paid-up amount has been irrevocably received by the **licensed insurer**.
**Loss absorption**

27. After retained earnings and revenue and other reserves, the Securities must incur the first and proportionately greatest share of any losses as they occur in all circumstances, including on a going concern basis and upon wind-up of the licensed insurer.

28. The Securities must be issued in accordance with the requirements and provisions of the Friendly Societies and Credit Unions Act 1982.

**Servicing charge**

29. Distributions must meet the following requirements:

   (a) the level of distributions may not be linked in any way to the amount paid at issuance and may not be subject to a contractual cap (except to meet the requirements of this solvency standard or any other laws);

   (b) there must be no circumstances under which the distributions are obligatory and in all circumstances the licensed insurer must be able to waive any distribution;

   (c) any waived distributions must be non-cumulative (i.e. waived distributions cannot be required to be made up by the licensed insurer at a later date and bonus payments to compensate for unpaid distributions are prohibited);

   (d) non-payment of distributions must not be an event constituting default of the licensed insurer or any related party of the licensed insurer;

   (e) distributions may only be paid by the licensed insurer after all other legal and contractual obligations have been met, such as payment obligations on more senior capital instruments and debt having been made. This means that the Securities must not have any preferential or predetermined rights to distributions of capital or income; and

   (f) the licensed insurer must not be required to make any distribution if it would result in the licensed insurer being insolvent or breaching the Solvency Margin requirements of the conditions of licence of the licensed insurer.

**Ranking on winding-up**

30. The Securities must represent the most subordinated claim in the event of liquidation of the licensed insurer.

31. The paid-up amount, or any future payments related to the Securities, must not be secured nor covered by a guarantee of the licensed insurer or any related party of the licensed insurer or be subject to any other arrangement that legally or economically enhances the seniority of the holder’s claim. The Securities must not be subject to netting or offset claims on behalf of the holder of the Securities.
32. The paid-up amount must be classified as equity.

**Other appropriate features**

33. The Securities must be directly issued by the licensed insurer and neither the licensed insurer nor any related party of the licensed insurer over which the licensed insurer exercises control or significant influence can have purchased the Securities nor directly or indirectly funded their purchase.

34. The amount of the Securities must be clearly and separately disclosed within the licensed insurer's financial statements or Alternative Financial Information.