



O F N E W Z E A L A N D  
T E P Ū T E A M A T U A

## Response to submissions: Solvency Standard Reissue 2014

The following provides the Reserve Bank's response to the main points raised in submissions on the Exposure Draft of the Solvency Standards released in September 2014.

### **Quality of capital: Perpetual debt**

Four submitters considered that perpetual non-cumulative debt instruments should be allowable capital for insurers as they are economically equivalent to perpetual non-cumulative preference shares. The Reserve Bank agrees and has made this change to the solvency standards.

### **Contingent liabilities**

Several submitters expressed concerns in relation to the requirements in respect of contingent liabilities. Concerns were expressed as to:

- the set of contingencies against which capital must be held;
- how much capital must be held against contingent liabilities; and
- the role of the actuary in identifying contingent liabilities.

The Reserve Bank has reconsidered the requirements in respect of contingent liabilities. In order to give more certainty as to the set of contingencies against which capital must be held, contingent liabilities have been defined as: contingent liabilities as defined under NZ IAS 37 and Direct Credit Substitutes (to the extent that they are not fully recognised on the balance sheet). Given the definition is referenced back to IAS 37, we do not consider it necessary to include a statement that any amounts included on the balance sheet are not contingent liabilities. We also do not consider it necessary to exclude potential repayable amounts from the definition of contingent liability. If an amount is a contingent liability under GAAP it should be treated as such for the solvency standards.

Where an insurer is exposed to a contingent liability but the probability of that contingent liability crystallizing is remote, and it is hence not disclosed, the insurer can exclude that amount from the risk weighted exposures charge. However the appointed actuary is expected to make enquiries as to whether any such undisclosed contingent liabilities exist and if so report on these contingent liabilities in the Financial Condition Report. There are a number of approaches the actuary could take to show evidence of due enquiry, including keeping a risk register with input from relevant officers or by requiring directors to attest as to whether or not they are aware of any undisclosed contingent liabilities.

In terms of the valuation of contingent liabilities, the Reserve Bank expects the value for the purposes of the solvency standard to be greater than the best estimate. The valuation should be undertaken on the basis that the contingent event has occurred (i.e. the probability of occurrence is 1). If the potential value of the contingent liability is certain, this amount

should be used. In other cases a prudent value should be used. The actual amount of capital held against a contingent liability will depend on the relevant resilience capital factor.

## **Reinsurance**

### *Stress testing*

It was submitted that stress testing of reinsurance agreements should be repeated if there were significant changes to assumptions or to the mix and size of business. We agree with this point and have made this change the standards.

Two submitters considered that for existing business stress testing should be able to be carried out using the assumptions and business in-force at the current date. We agree with this comment, provided that the results of the stress test would not be materially different from the case had the stress test been carried out from inception.

Two submitters considered it was not clear that future projected new business is included in the stress testing. Appendix E (and relevant references) has been clarified such that stress testing is to apply to all business in force and to future projected business. Stress testing should be based on a realistic portfolio of policies that will be reinsured under the agreement, such that the level of risk transfer under the agreement can be tested.

It was submitted that a reinsurance agreement should not be stress tested if the solvency reinsurance balance is less than 0 (i.e. a net asset). Although in this case the likelihood test could not give rise to a repayable amount, the Reserve Bank intends that stress testing still be undertaken in this case. This is because the Reserve Bank considers that the stress testing requirements are also a risk management tool and it is important for insurers to understand the sensitivity of their reinsurance agreements. Following the last consultation the Reserve Bank allowed that immaterial agreements need not be stress tested.

### *Specified event test*

It was submitted that the specified event test should exclude increases in reinsurance premium in the case where the increase is limited to the circumstances that the insurer can increase premiums as well, or there is a reasonable price limit on the increase. It is not intended that such a scenario is caught by the specified event test. This has been clarified in the standard.

One submitter considered that paragraph 11(a) of appendix E should refer to proportionate amounts. The Reserve Bank does not agree with this submission. Amounts are excluded from the specified event test where the amount due to the reinsurer is broadly equivalent to the amount that the insurer will receive. A larger but proportionate amount is not excluded as the insurer will not have recouped a similar amount.

The Reserve Bank has clarified that the exception to the specified event test for contractual damages refers to damages for loss as determined by a court of law, or similar forum (such as through arbitration).

It was submitted that in relation to the exception to the specified event test for fraud, the exception should apply to fraud at any time during the duration of the contract, rather than being restricted to "at or before the time the reinsurance agreement is entered into". The Reserve Bank does not agree with this point. An amount pre-specified in the contract as payable for fraud at any time during the contract will not necessarily bear any relation to the actual loss.

It was submitted that un-remediated material default should be an allowable termination clause under paragraph 11. The Reserve Bank has allowed this exception, provided that the amount payable is limited to the loss of future profits for the reinsurer (as assessed by an independent third party).

One submitter did not consider that (former) clause 11(d)B(iv) should be restricted to losses of future profits. The Reserve Bank does not agree with this statement. A clause in the reinsurance contract that requires repayment of past amounts creates a potential obligation on the insurer and should be recognised in solvency calculations.

#### *Recognition of the benefits of reinsurance*

It was queried if the reference to an insolvency event in paragraph 41 referred to Companies Act insolvency or a breach of an insurer's solvency margin requirements. A reinsurance contract with any unilateral right for the reinsurer to cancel in relation to existing business in the event of any pre-specified solvency event in relation to the insurer is not recognised as a benefit under the standard. This applies whether the insolvency event is defined as insolvency under the Companies Act or breach of the solvency margin.

#### *Transition period*

Some submitters considered that the transition period of 1 year for new business and 4 years for existing business should apply to the requirements as to when reinsurance may be recognised as a benefit. The Reserve Bank accepts this and has made the change.

### **Health Business**

Some submitters noted that the application of the standard to Health Insurance Business required that health business be dealt with as part of the life fund outside of the statutory fund of the insurer. Section 85 of the Insurance Prudential Supervision Act (IPSA) requires a composite contract, including life and non-life business, to be accounted for as life business if the non-life component represents less than 25% of the premium. In this case the non-life component will be accounted for within the statutory fund.

The Reserve Bank has amended paragraph 7 to clarify that health insurance business that is treated as life insurance under section 85 will be accounted for within the statutory fund to which it refers.

### **Foreign Currency Risk Charge**

It was submitted that paragraph 84 of the Non-Life Standard (paragraph 81 of the Life Standard) was unclear as to the treatment of New Zealand denominated guarantees.

Paragraph 84 only applies where a guarantee is denominated in a foreign currency. Hence, there is no foreign currency risk charge in relation to the guarantee if the guarantee is to be paid in New Zealand dollars (NZD). Further a hedge that is intended to be settled in NZD should be considered to be a NZD asset. Therefore a NZD guarantee of a hedge to be paid in NZD will not be subject to a foreign exchange charge as both the asset and guarantee are denominated in NZD. The wording of this paragraph has been clarified in the standard.

### **Reinsurance Related party exclusion**

Some submitters noted that paragraph 104 of the current Non-Life Standard provides that a reinsurance asset held with a related party is not considered to be a related party asset for the purposes of determining deductions from capital and for the purposes of the Asset Risk

Capital Charge. These assets are instead subject to the Reinsurance Recovery Risk Capital Charge (RRRCC). This exclusion has not been carried over to paragraph 16 of the revised standard.

However paragraph 60 of the revised standard provides that any amount included in the RRRCC as a reinsurance recovery asset is not included in any element of the Asset Risk Capital Charge. In effect, these assets are subject to a charge under the RRRCC and are not subject to the Asset Risk Capital Charge. This means they are not subject to the related party charge in row 14 of Table 2 and are not included in the Asset Concentration Risk Charge. This applies to all reinsurance assets included in the RRRCC, including related party reinsurance receivables that are to be paid in more than 90 days.

The Reserve Bank considers it unlikely that the reinsurance assets would be in the form of equity or subordinated loans to related parties and hence do not consider the exclusion relevant to the deductions from capital; if there were such assets a deduction would result in the appropriate capital treatment.

The Reserve Bank therefore considers the exclusion for reinsurance assets from the related party definition is unnecessary.

### **Captive related party exclusion**

Some submitters commented that the provision in paragraph 104 of the current Non-Life Standard, that provides that an asset is not considered to be a related party asset if the primary party is a captive insurer and the related party is the parent of the captive, has been removed. This provision applies where the captive holds asset in the parent (i.e. the parent is the related party of the captive). This provision does not apply to entities under the Non-Life standard as these entities are not captive insurers. This provision has been maintained in the Captive Standard.

### **Reinsurer Counterparty Grade**

One submitter noted that in Table 6 of the Non-life Standard the AA category of reinsurer had not been included. This rating grade has been made explicit and the format of Table 6 made consistent with Table 5 (Table 4 and 5 of the Life Standard). This submitter queried whether a reinsurance receivable asset is subject to Table 2 or Table 6. As discussed above all assets included in the RRRCC are excluded from the Asset Risk Capital Charge and hence subject to the risk factors in Table 6.

### **Reinsurance Recovery Risk Charge: Coinsurance**

Some submitters considered it unclear when coinsurance is included in RRRCC. It has been clarified that coinsurance is only included in the RRRCC where there is an amount due from the coinsurer because the insurer has previously paid the coinsurers portion of the loss.

### **Certification**

It was noted that 99(a) and 100 of the Non-Life Standard (127,128 of the Life Standard) have been amended to refer to a certification by two directors. This is not a change in policy or substance, but has been made to provide consistency with the language in IPSA.

### **Catastrophe Risk Capital charge**

Several submitters commented on the calibration of the Catastrophe Risk Capital Charge. This is not within the scope of the solvency standard reissue.

**Derivatives**

One submitter considered that the Reserve Bank should review derivatives as a priority. We agree that this is a reasonable priority and expect to issue a consultation paper on the treatment of derivatives in the solvency standard next year.

**Disclosure**

Several submitters submitted in favour of the disclosure requirements. However one submitter considered it could encourage a race to the bottom in terms of capital held, given pressures to maintain low premiums.

The Reserve Bank considers that disclosure is important to provide market discipline. For entities with large solvency margins it provides an opportunity to inform their policy holders as to their business model and risk tolerance. There is no change to the disclosure requirements.

**Time frame for submission of financial statements**

One submitter considered that the timeframe for submission of financial statements would put undue pressure on small insurers. Several submitters commented that the shorter timeframe would not cause any problems.

The reduction in the timeframe retains alignment with other legislation. The Reserve Bank does not intend to change this requirement.

**Hybrid instruments**

One submitter considered that the treatment of hybrid instruments under Table 2 (Non-Life) was unclear. These instruments should be treated according to the accounting classification of the principal amount on the issuer's balance sheet.

**Definition of acquisition costs and maintenance costs**

One submitter considered that these definitions should refer to IFRS. The definition is taken from NZSA PS3. The Reserve Bank is not intending to change this definition.

**Related party exemptions**

One party considered that the related party exemption should be extended so that credit union deposits with NZACU are not considered to be related party assets. This issue is not within the scope of the solvency standard reissue.

**Extreme Event Exposures**

One submitter did not consider that the Catastrophe Risk Capital Charge appropriately provided for business restructuring. It has been clarified that the Catastrophe Risk Capital Charge only applies to an insurer's potential future losses.

**Administrative Issues**

One entity queried why paragraph 2 refers to previous versions. Solvency standards are disallowable instruments. The Regulations Review Committee requires that previous

versions be listed in the standard to improve transparency. The standard only references previous versions (i.e. issued standards) and not amendments.

Paragraph 97 of the Non-life Standard (108 Life) has been deleted as it is unnecessary in the solvency standard.

One entity requested that a table of contents be provided. This has been done in the Life and Non-life Standards.

### **Tax**

A number of submitters noted the clarification of numerical capital factors as gross of tax. The December 2014 Standards include clarification that numerical capital factors are stated gross of tax within the Solvency Standards. This change is based on the December 2012 consultation on the quality of capital and regulatory treatment of financial reinsurance. The Reserve Bank notes that there is no intended change in policy in regards to taxation treatment under the December 2014 Standards. The current Standards allow for appropriate adjustments to be made for taxation effects of the capital calculations in certain areas (for example paragraph 60, 61, 102, 139 and 140 of the Solvency Standard for Non Life Insurance Business; and section 4.3 of the Solvency Standard for Life Insurance Business). These have been retained.

### **Ongoing work**

Some submitters commented that the amount of consultation currently being undertaken is difficult to resource. Submitters requested further forward guidance on the Reserve Bank's intended policy considerations. The Reserve Bank intends to provide a new initiative table on its website similar to that on the banking website and will seek to use the industry news letter to keep industry up-to-date.

### **Regulatory Impact Statement**

A regulatory impact statement on the changes to the solvency standards was issued 16 September 2014. This is available on the Reserve Bank website. In the view of the Reserve Bank the changes discussed in this response to submission have the overall effect of reducing the cost of regulation, compared to the consultation drafts. Hence a further regulatory impact statement is not provided.