Review of Insurance Solvency Standards.

Public feedback statement on the second amendment of the Interim Solvency Standard 2023

6 August 2024

Reserve Bank of New Zealand
Te Pūtea Matua

Current Information Available

Information about the review, is available on the Reserve Bank website at: Review of the Insurance Solvency Standards - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)

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Glossary

AA	Appointed Actuary
Charge, Capital Charge	A capital charge contributing to the Prescribed Capital Requirement
CEP Capital charge	Credit, Equity and Property Risk Capital Charge
CTV	Current Termination Value
CRCC	Credit Risk Capital Charge
CSM	Contractual Service Margin
DAC	Deferred Acquisition Cost
Discussion Draft	The 2023 consultation document
Draft Amendment Standard	Consultation draft of second amendment of the Interim Solvency Standard (published 27 September 2023)
DRE	Deferred reinsurance expense
DTA	Deferred Tax Assets
Exposure Draft	Version of Second Amendment currently being consulted on
FCR	Financial Condition Report
First Amendment	Interim Solvency Standard Amendment Standard 2023
GMM	General Measurement Model
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles, issued by the IAIS
ICS	Insurance Capital Standard, issued by the IAIS
In-force Standard	Interim Solvency Standard incorporating the first amendment
IPSA	The Insurance (Prudential Supervision) Act 2010
IRRCC	Interest Rate Risk Capital Charge
LAGIC	Australia's capital requirements for insurers

LIC	NZ IFRS 17 Liability for Incurred Claims
Life Standard	Solvency Standard for Life Insurance Business 2014
LRC	NZ IFRS 17 Liability for Remaining Coverage
LTIRCC	Long Term Insurance Risk Capital Charge
MCR	Minimum Capital Requirement
MGMM	Modified General Measurement Model
MPAA	Modified Premium Allocation Approach
MRCC	Market Risk Capital Charge
Non-life Standard	Solvency Standard for Non-life Insurance Business 2014
NZ IFRS	New Zealand-adapted International Financial Reporting Standards
NZ IFRS 4	Accounting for Insurance Contracts (old standard)
NZ IFRS 17	Accounting for Insurance Contracts (new standard)
NZSA	New Zealand Society of Actuaries
Original ISS	Interim Solvency Standard 2023 before amendments
PAA	Premium Allocation Approach (an NZ IFRS 17 valuation approach)
PCR	Prescribed Capital Requirement
Reserve Bank	Reserve Bank of New Zealand
RIS	Regulatory Impact Statement
Second Amendment	Interim Solvency Standard Amendment Standard 2024
SLIC	Standardised liability for incurred claims
SLRC	Standardised liability for remaining coverage
Solvency Review	The review of the solvency standards
Stage 1	The review of the structure of the solvency regime and the handling of NZ IFRS 17
Stage 2	The full review of methods and parameters in the standard
Standard/ISS	Interim Solvency Standard 2023
UWRCC	Underwriting Risk Capital Charge
VFPM	Value of Future Profit Margins, an artificial liability established to smooth profits under NZ IFRS 4.

Contents

Introduction 1

Responses to consultation questions 3

External review 3

Next Steps 3

Solvency capital 4

Contract boundaries 4

Modified PAA valuation 7

Deferred reinsurance expense assets 11

Embedded obligations test for financial reinsurance 12

Consistency between valuation methods 13

Contingent items 14

Capital requirements 15

Re-basing of the Underwriting risk capital charge 15

Run-off term 17

Taxation expense and the PCR 17

Run-off triggers 19

Credit risk on interest-sensitive assets 19

Capital charge for reinsurance disputes 20

Double counting of discretions 21

Prescribed assumptions for long-term non-life contracts 21

Seismic risk - 168-hour grace period 22

Reporting requirements 23

Disclosure of annual solvency return 23

Use of adjusted solvency capital for website disclosure 23

Conduct and outsourcing requirements in the FCR 24

Other issues 25

Intangibles and solvency ratios 25

Transfer of guidance to a separate document 27

Introducing IPSA-related definitions for classes of insurance 28

Apportionment of repayable amounts 28

Early adoption of amendment standard 29

Minor issues raised 29

Wording and definitions 31

Have Your Say 34

Introduction

1. The *Reserve Bank* is the prudential regulator and supervisor of the insurance sector in New Zealand, under *IPSA*. As part of its regulatory role, the *Reserve Bank* issues solvency standards under *IPSA*[1] which are applied to insurers via conditions of licence.

2. Solvency standards impose minimum capital requirements on insurers. The purpose is to increase the likelihood of insurers being able to meet their obligations to policyholders over the coming year.

3. The *Reserve Bank* initiated the *Solvency Review* on 1 October 2020. As noted in paragraph 2 of the launch paper, the *Solvency Review* was required due to:

   i. the introduction of a new accounting standard for insurance contracts (*NZ IFRS 17*);

   ii. the need to respond to recommendations received from several other reviews[2] conducted over the preceding five years; and

   iii. the need to embed supervisory experience gained since the commencement of IPSA.

4. The *Reserve Bank* issued the *Original ISS* in September 2022. The standard took effect on 1 January 2023.The standard was amended in June 2023 to address certain minor matters (the *First Amendment*).[3]

5. The *Reserve Bank* subsequently became aware of issues in the operation of the *Standard*, partly due to differing interpretations of *NZ IFRS 17* and the *Standard* itself.[4] Some of these issues were documented in letters received from the Insurance Council of New Zealand and the New Zealand Society of Actuaries (*NZSA*). Other issues were highlighted in discussion with individual insurers and from the observations of *Reserve Bank* staff.

6. The new accounting standard for insurance contracts, *NZ IFRS 17*, has been effective since 1 January 2021 (with early adoption permitted). It only became mandatory for all insurers from the start of the financial year, commencing on or after 1 January 2023.

7. Over time, as knowledge of *NZ IFRS 17* has grown, it has become evident (from our own work and the detailed analysis and feedback from some respondents) that there are a number of different interpretations of components of *NZ IFRS 17* and the *Standard*. It can therefore be challenging to write a standard that provides complete clarity in all situations.

8. The second amendment will address many issues in the current version of the *Standard*, but some areas may remain where insurers can exercise their own judgement in interpretation. We expect insurers to rely on expert advice and seek guidance from the *Reserve Bank* where necessary. While the *Second Amendment* addresses significant issues with the current standard, some matters will be addressed in *Stage 2* of the *Solvency Review*.

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1 Section 55 of IPSA.

2 The Trowbridge-Scholtens Review of the Supervision of CBL, the IMF's Financial Sector Assessment, the Appointed Actuary Thematic Review and the FMA/RBNZ Review of Conduct and Culture.

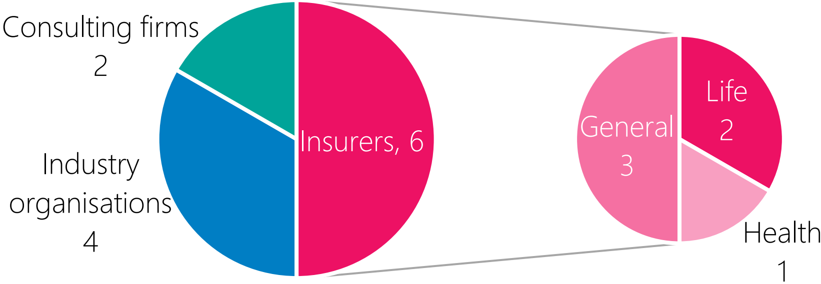
3 This included providing for the certification of interim solvency standards by management, rather than the directors, of the insurer, as well as addressing minor errors.

4 The issues are documented in the consultation paper to which this feedback statement responds.

9. The *Reserve Bank* proposed to amend the *Standard* to address these issues. We published consultation documents on 27 September 2023, including a *Discussion Draft* of an amendment standard. This *Second Amendment* is designed to address all remaining issues that are within the scope of *Stage 1* of the *Solvency Review*.

10. Consultation closed on 8 November 2023. As well as the written submissions, we received verbal feedback through bilateral meetings and webinars. Owing to the depth of stakeholder feedback received during the consultation on proposals for the *Second Amendment*, and given the importance and complexity of the standard, we also commissioned an external review of the standard. The external review concluded in June.

11. We received a number of written submissions in response to our consultation, which are broken down by type of entity below:



12. We thank all of those who have taken the time to prepare submissions or to discuss with us the content of the consultation. Your feedback has been very valuable and we have taken the time to review it in depth. A good deal of the material submitted is reflected in the revised standards and guide.

13. This feedback statement discusses each of the questions in the consultation paper. For some topics we have provided a grouped response where feedback is related or of a similar nature e.g. for the valuation paragraphs. We have considered all feedback provided by stakeholders and summarised major themes emerging from the submissions.

14. We acknowledge, however, that much of the feedback received relates to specific situations faced by individual insurers; and we have considered these situations carefully. Where we have not been able to adjust the standard to accommodate a situation, we have provided an explanation for the reason in this feedback statement.

15. We also acknowledge that, owing to the technical nature of some of the feedback, there is a risk that we may have misunderstood or misinterpreted some of the feedback. We have tried to minimise this risk through discussions with stakeholders.

16. We have decided to hold a further consultation on the *Exposure Draft* of the standard to give stakeholders an opportunity to review the changes we've made on the back of stakeholder feedback. The consultation on the *Exposure Draft* will run from 6 August to 17 September. A draft standard and guidance document is published alongside this feedback statement.

Responses to consultation questions

17. This feedback statement is structured into 5 sections:

    i. Solvency capital

    ii. Capital requirements

    iii. Reporting requirements

    iv. Other issues

    v. Wording and definitions

18. While we have not commented on external review findings at a detailed level, the conclusions have also been informed by that review.

External review

19. The Reserve Bank commissioned PFS Consulting to undertake an external review of our proposed changes to the *ISS*. This review was focused on the proposed changes to the *Standard* set out in the consultation and the *Reserve Bank's* subsequent changes to respond to stakeholder feedback.

20. PFS Consulting raised a range of issues which the *Reserve Bank* have subsequently addressed. PFS Consulting concluded that, to the best of their knowledge, each of the proposed changes to the *Standard* set out in the consultation or in response to stakeholder feedback would be very likely to achieve its intended outcomes and objectives and would be unlikely to result in significant gaps or errors, or significant unintended consequences.

21. The external review did not include the guidance document. However, PFS Consulting suggested some areas where additional guidance would be beneficial, and the *Reserve Bank* has added further guidance in those places.

Next Steps

22. Following the *Exposure Draft* consultation, we will consider the feedback received and finalise the *Standard*. We anticipate publishing an amendment standard in mid-December 2024, with the changes to take effect from 1 March 2025. The consolidated version of the *Standard* (incorporating all amendments) will also be made available.

23. An addendum to the *RIS* will be published alongside the finalised amendment. While the *Second Amendment* is intended to restore the impact that the *Standard* was intended to have, we acknowledge that the impact on some stakeholders may be significant and this will be addressed in the addendum to the *RIS*.

Solvency capital

Contract boundaries

Introduction

24. Insurance contracts are often valued using discounted cash-flow methods. The contract boundary sets a limit beyond which possible cash-flows should not be valued.

25. ICP 14.4 says that insurance contracts should be held at their economic value (that is, realistic and neither conservative nor optimistic). This implies that the contract boundary should be far enough in the future to encompass a wide range of possible paths for the contract. ICP 14.8.3 however, says that a contract boundary is established at the point where an insurer can cancel or re-underwrite an insurance contract.

Summary of issue with In-force Standard

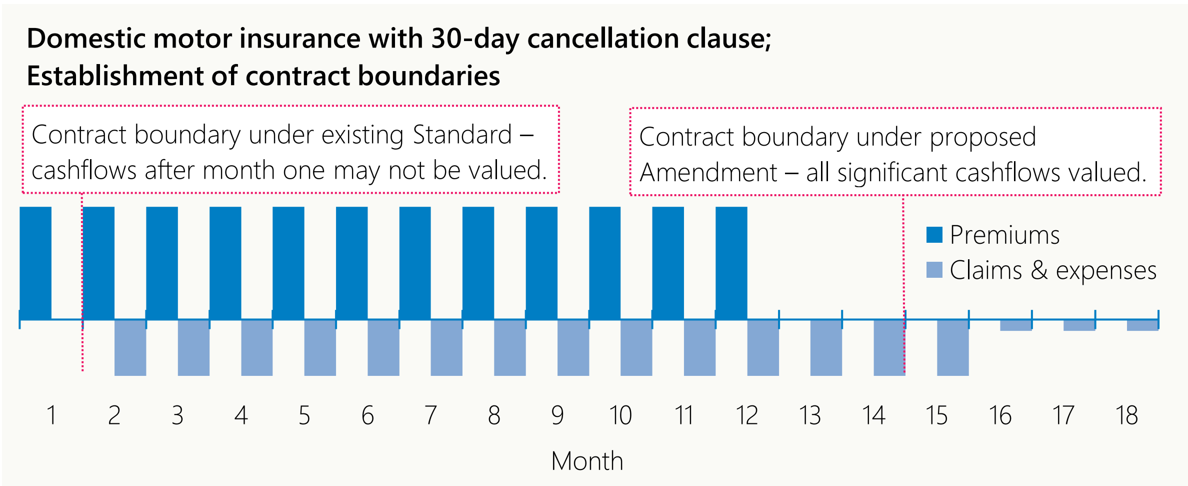
26. Many insurers have the contractual right to cancel policies after 14 days. Under the current wording – based on ICP 14.8.3 – this establishes a contract boundary so short that there may be minimal cashflows to value and insurance items will have a negligible standardised value.

27. However, as noted above, ICP 14.4 requires an economic valuation of the insurance contract. On an economic basis the value of the contract would be established based on a range of futures, most of which will extend beyond the cancellation point.

Proposed change consulted on

28. In the consultation, we proposed removing the wording in the *Standard* that relates the contract boundary to the insurer's right to terminate, re-price or re-underwrite an individual contract. This would allow contract boundaries to fall at the end of the term over which benefits may be paid in normal circumstances and ensure that cancellation clauses don't undermine the economic valuation approach. The impact of this issue may be zero to significant, depending on profitability and interpretation, and may affect life insurers, health insurers and some general insurers.

29. The diagram below shows the monthly cashflows (in blue) under a certain motor insurance policy, and where the contract boundaries could fall under different wordings of the standard.



Stakeholder feedback to consultation proposal

Renewability and insurability

30. **Stakeholder feedback:** Some respondents were concerned about the 'guaranteed renewability feature' in sub-paragraph 28(v) of the *Standard*. They contend that this will extend the contract boundary for many health insurance policies indefinitely. They suggest that 'guarantee of future insurability', which is used in the definition of short-term insurance contracts, would be more appropriate.

31. **RBNZ response***:* We have not made a change to the text of the standard as we think that insurability and renewability are slightly different concepts. The former could give the right to continue, increase or effect new insurance on pre-defined terms, while the latter gives the right to continue insurance on terms which are set for a class of insurance contracts from time to time. The fact that a contract is renewable does not, in itself, make a contract long-term (particularly if each year's cashflows are self-contained). We have included a definition of 'guaranteed renewability' to provide more clarity and will re-visit this issue in *Stage 2*.

Interplay with coverage period

32. **Stakeholder feedback:** Several respondents raised a concern that the proposed change to define the contract boundary will not necessarily achieve the required clarity for all contracts without also defining the 'coverage period' in the *Standard*, owing to differences in interpretation by industry.

33. **RBNZ response:** We agree with this feedback. *NZ IFRS 17* relates the definitions of contract boundary and coverage period in a way that may not be helpful for the purposes of the *Standard*. Therefore, we have defined the coverage period in the *Standard* so that it does not depend on the *NZ IFRS 17* contract boundary.

34. **Stakeholder feedback:** Some respondents noted that the coverage period may not be the same as the end of the benefit term, creating inconsistencies between standardised values and the short-term underwriting risk capital charge.

35. **RBNZ response:** While we acknowledge there are inconsistencies between the way things are handled for solvency capital and the way they are handled for the *PCR*; we believe this is necessary because of the different purposes of the two measures – setting economic value and establishing capital against shocks. We therefore propose no change to the wording in the standard.

36. **Stakeholder feedback:** A respondent noted that one interpretation under *NZ IFRS 17* is that the coverage period terminates prior to the end of the benefit term where the insurer has the unilateral right to terminate the policy. Under this interpretation, the proposed amendment to paragraph 30 of the *Standard* does not achieve the desired effect and may continue to understate capital requirements for contracts with cancellation clauses.

37. **RBNZ response:** We have made the definitions of coverage period, benefit term and contract boundary independent of *NZ IFRS 17*, so risk-release considerations should no longer come into play.

38. **Stakeholder feedback:** The respondent further recommended that the contract boundary definition for short-term contracts be modified to include an 'assessment period' definition'[5] (as per the previous *Non-Life Standard*). This would give additional discretion to the appointed actuary so that they can align the length of the risk period with the intended principles of the solvency standard and hold more appropriate levels of capital.

39. **RBNZ response:** We agree that using the assessment period could head off some extreme interpretations of the contract boundary. However, the suggested measure would reduce consistency and would need adaptation to support the economic valuation of solvency capital, as the assessment period is bounded by the point at which the insurer is released from risk. We therefore propose no change to the proposal to remove the risk-release wording.

40. **Stakeholder feedback:** One respondent noted that insurers may be establishing *NZ IFRS 17* 'pre-recognition liabilities' where risk-release events are shortening the *NZ IFRS 17* contract boundary and premium has already been collected in respect of cover after the boundary. They were concerned that these items may not be derecognised in the determination of solvency capital and there may be double counting as a result.

41. **RBNZ response:** Paragraph 25 of the standard removes all NZ IFRS insurance items and replaces them with standardised items, so double counting shouldn't arise.

Consistency between modified GMM and modified PAA valuation methods

42. **Stakeholder feedback:** Some respondents noted that changes applied to paragraph 28 of the *In-force Standard* should also be applied to paragraph 30.

43. **RBNZ response:** We agree that we need to restructure paragraphs 26 to 31 of the *Standard* (broadly as proposed by the *NZSA*) to gain greater consistency between the *MGMM* and *MPAA* methods. Please see "Consistency between valuation methods" for further discussion on consistency between the *MPAA* and *MGMM* methods.

Included claims

44. **Stakeholder feedback:** A respondent argued that the use of 'benefit term' in paragraph 28(v) of the *In-force Standard* extends beyond the boundary and will capture all payments, including premiums, expenses and claims, after the contract boundary rather than only benefits. They recommend amending the text to clarify that only claims incurred prior to the contract boundary are included.

45. **RBNZ response:** As the contract boundary is defined as being 'the end of the benefit term', there is no situation in which cash-flows after the boundary can be taken into account. However, the concern may be that premium and expense cash-flows after the coverage period (rather than the contract boundary) need to be valued. We do not believe this is the case as such cash-flows will not relate to the current *ISS* contract (as defined by paragraph 26 of the *Standard*). We therefore propose no change to the proposal.

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5 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

Finalised position on contract boundaries in Exposure Draft

Renewability and insurability: we have included a definition of 'guaranteed renewability' to provide more clarity.

Interplay with coverage period: we acknowledge that there is some concern that not defining the 'coverage period' may result in inconsistent outcomes. We have explicitly defined coverage period in the amendment so that it does not depend on the *NZ IFRS 17* contract boundary.

Consistency between MGMM and MPAA valuation methods: we have restructured paragraphs 26 to 31 to gain greater consistency between the *MGMM* and *MPAA* methods.

Included claims: we continue to set the contract boundary for determining standardised liabilities independent of risk release considerations, as economic valuation demands the consideration of multiple possible futures.

Modified PAA valuation

Introduction

46. The default method for valuing insurance contracts under *NZ IFRS 17* is the *GMM*. This is a prospective, probability weighted discounted cash-flow valuation.

47. For short-term insurance contracts, *NZ IFRS 17* allows an alternative valuation method to be used, at the option of the insurer. Under this approach, known as the *PAA*, the liability is established based on retrospective information, including the premiums that have been paid and the proportion of the coverage period that has expired. Results determined under the *PAA* are supposed to be good approximations to those that would have been determined using the *GMM*.

48. The default method for valuing insurance contracts under the *ISS* – call it *MGMM* – is a modified form of the *NZ IFRS 17 GMM*, with the modifications designed to elicit the economic value of the contract.

49. The *ISS* also allows a modified form of the *NZ IFRS 17 PAA* approach, the *MPAA*, to be used in valuing short-term contracts. The modifications in this case are designed to promote broad consistency with both economic value and the value that would have been produced by the *MGMM* method.

Summary of issues with In-force Standard

i. Tax adjustments: It is not clear whether tax items are included in the *MPAA* valuation.

ii. Acquisition expense: References to *DAC* assets are confusing.

iii. Risk adjustment granularity: *MGMM* and *MPAA* risk adjustments are different for short-term insurance contracts, even though the economic substance is the same.

Proposed change consulted on

i. **Tax adjustments:** Changing the wording of paragraph 30 of the In-force Standard to "The NZ IFRS 17 Premium Allocation Approach may optionally be used to standardise liabilities for remaining coverage (and related tax items) under short-term insurance contracts, by applying the following modifications:"

ii. **Acquisition expense:** Remove reference to *DAC* assets and change paragraph 30(ii) of the *In-force Standard* to simply read that "IFRS17.59(a) must not be applied".

iii. **Risk adjustment granularity:** Modification of sub-paragraph 30(iii) of the *In-force Standard*, by removing the reference to performing calculations at the product class level and including wording to reflect that the risk adjustment may be determined across all business valued under this paragraph.

50. The impact of this proposal is moderate and variable, depending on interpretation and premium mode, and affects mainly general insurers.

Stakeholder feedback to consultation proposal

Reinsurance

51. **Stakeholder feedback:** One respondent submitted that paragraph 30 of the *In-force Standard* should be explicit regarding the allowance for reinsurance to ensure consistency with paragraph 28.

52. **RBNZ response:** We agree with this. The (re-numbered) paragraph 29 in the *Exposure Draft* sets out the specific assumptions for the *MPAA* method, with sub-paragraphs (iii) and (iv) describing the treatment of reinsurance.

Tax adjustments

53. **Stakeholder feedback:** One submitter questioned whether there may be some inconsistency in the tax treatment of the standardised liability between the *MPAA* (paragraph 30 in the *In-force Standard*) and *MGMM* (paragraph 28 in the *In-force Standard*) methods. The *NZSA* proposed that the tax effect of standardisation be regulated by a separate paragraph, to follow paragraphs dealing with the standardisation of the gross of tax items.

54. **RBNZ response:** This seems to make sense as tax cashflows cannot be estimated until the gross cashflows are known. In the *Exposure Draft* we have established a new paragraph 31, which describes a tax treatment common to both the *MPAA* and *MGMM* methods. We have dealt with the tax adjustments separately, in a subsequent paragraph and have defined relevant tax items more tightly. We have also extended wording to incorporate current tax items.

55. **Stakeholder feedback:** Respondents also submitted that the full netting of the standardised liability may have some unintended consequences for related capital charges, particularly the Claims Run-off Risk Capital charge which will be applied to a net of tax standardised liability. They note that this is also inconsistent with Appendix 8 which outlines that a gross amount of capital charge should be accounted for.

56. **RBNZ response:** We are comfortable with tax effects being taken into account in both the determination of standardised liabilities and (on an incremental basis) capital charges. We will not make any change now, but will consider this point further when we recalibrate the charge in *Stage 2* of the *Solvency Review*.

Acquisition expense

57. **Stakeholder feedback:** Some respondents noted that they were unsure what outcome is expected from the proposed change to sub-paragraph 30(ii) of the *Draft Amendment Standard*.

58. **RBNZ response:** We confirm that the intention is to remove perceived ambiguity related to the wording in the *Standard* and require the deduction of acquisition costs within the *MPAA* liability (whether or not paragraph 59(a) of *NZ IFRS 17* applies). We have further modified the wording to this end. Ultimately we want a good approximation to the economic value of the liability, and consistency across insurers.

59. **Stakeholder feedback:** Does the *Reserve Bank* intend to apply capital charges to the notional acquisition cost asset created under the *MPAA* method?

60. **RBNZ response:** No, this is an integral part of the insurance liability, not a standalone item subject to capital charges.

Risk adjustment granularity

61. **Stakeholder feedback:** Respondents noted that paragraph 28(iv) of the *In-force Standard* relating to the adjustment for non-financial risk should be amended for short-term insurances.

62. **RBNZ response:** We agree with this in respect of the *MGMM* method. The distinction for risk adjustment granularity should be based on whether a contract is short-term or long-term, not by its valuation method (*MPAA*/*MGMM*). In respect of the *MPAA* method, we have decided to no longer require the inclusion of risk adjustments or the deduction of profit margins, as these partially offset and are relatively minor elements of the liability.

63. **Stakeholder feedback:** Some respondents suggested that the risk adjustment should be determined across all business in the statutory fund or at company level. They submitted that diversification between product classes should be allowed for both short-and-long-term business. They further submitted that, if a long-term insurer is sold or wound up, it is not likely to be sold at product class level, but by other subdivisions, such as distribution channel.

64. **RBNZ response:** We note that allowing risk adjustments for long-term business to be set at the company level would weaken capital requirements. The reason the *Standard* treats short-term and long-term business differently is that the risk adjustment is designed to ensure there are sufficient funds available to resolve an insurer. We expect short-term business to be run-off in resolution while long-term business is expected to be sold in blocks. We have assumed that the product classes are equivalent to 'minimum saleable blocks', although we do of course recognise that in practice the business could be broken up in a different way. Accordingly, we have not changed the approach in the *Exposure Draft*.

65. **Stakeholder feedback:** A respondent raised the situation of insurers that have both long- and short-term contracts within one product class, and suggested these issues be considered more carefully in *Stage 2* of the *Solvency Review*.

66. **RBNZ response:** Yes, we will consider this in *Stage 2*. In the interim, we suggest that insurers notionally divide the product class into short and long-term partitions for the purpose of determining the risk adjustment. The risk adjustment for the business in the long-term partition will be determined at the level of that partition, while the risk adjustment for business in the short-term partition can be diversified across the insurer.

Premium receivables

67. **Stakeholder feedback:** A respondent asked whether paragraph 30(i) of the *Draft Amendment Standard* (now renumbered paragraph 27(vi) in the *Exposure Draft*) sets up a chargeable premium debtors account.

68. **RBNZ response:** Not directly. 'Unpaid premiums' and 'Premiums not yet due' are now explicitly defined in paragraph 17 in the *Exposure Draft*, and these quantities are subject to a variety of credit risk charges based on security and aging. This is similar to the treatment of *NZ IFRS 4* premium receivables under the 2014 standards.

69. **Stakeholder feedback:** A respondent noted that, given that the *UWRCC* in paragraph 56 of the *In-force Standard* is no longer based on the standardised liability, there is no longer a need to adjust the standardised liability under the *MPAA* method for premiums receivable. They suggested that removing this adjustment will help achieve consistency with the *MGMM* method.

70. **RBNZ response:** We haven't removed the adjustment under the *MPAA* method for premiums receivable because, even though the receivable adjustment is not required for the purposes of the *UWRCC* or for determining Solvency Capital, it is still required to place an economic value on the liability.

Finalised position on MPAA valuation in Exposure Draft

Reinsurance adjustments: we have allowed for reinsurance premium pre-payments and post-payments in the *MPAA* valuation.

Risk adjustments: these are no longer required under *MPAA* valuations.

Risk adjustment granularity: the adjustment for non-financial risk for short-term insurances, can now be set at the company level where the *GMM* valuation method is used.

Acquisition expense: we have provided clearer wording in the *Exposure Draft* about how acquisition costs are to be treated in the *MPAA* method.

Premium receivables: 'Unpaid premiums' and 'premiums not yet due' have been defined in paragraph 17 to facilitate their inclusion in the base for the 'other credit risk capital charge'. Receivables set up under paragraph 27(vi) are not explicitly charged.

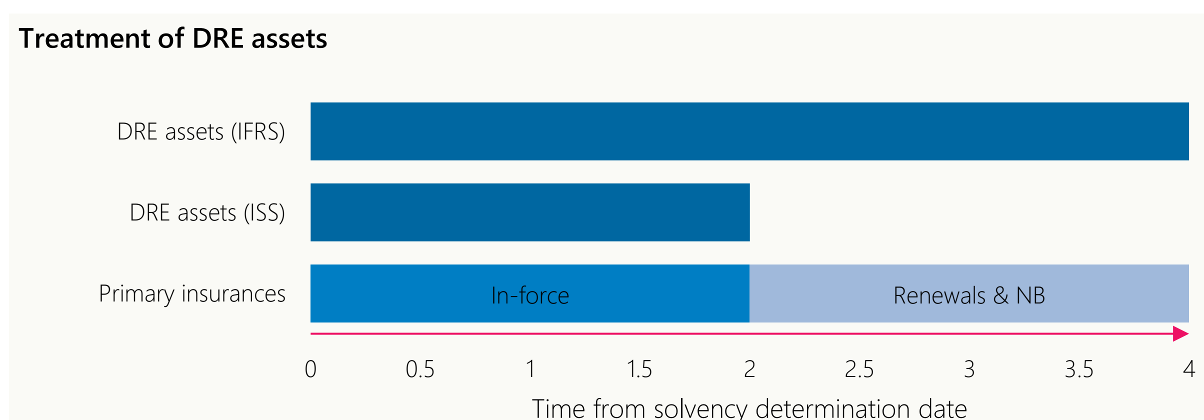
Deferred reinsurance expense assets

Introduction

71. General insurers typically buy reinsurance in advance to cover all of their reinsurance needs in a calendar year. These needs include not just reinsurance of currently in-force insurance contracts, but also renewals and new business (NB) during the year. A *DRE* asset is established to offset the payment of reinsurance premiums so there is no immediate loss from contracting reinsurance.

72. The diagram below shows which cash-flows contribute to the *DRE* insurance item on both the IFRS and *ISS* bases. The former includes reinsurance of future sales and renewals, while the latter limits reinsurance cashflows to those that support in-force primary business.

Treatment of DRE assets



Summary of issue with In-force Standard

73. The *ISS* replaces *NZ IFRS 17* insurance items (including *DRE* assets) with its own insurance items. *ISS* insurance items only relate to in-force insurance contracts, however, and on some interpretations a component of the *DRE* asset is excluded from Solvency Capital. This is theoretically incorrect, as the reinsurance premium paid in respect of renewals and new business does, in fact, create economic value for the insurer.

Proposed change consulted on

74. Solvency Capital should include value generated by reinsurance premiums paid.

75. We proposed adding a phrase to the end of paragraph 22(i) of the *In-force Standard* to make our intention explicit, which is to specifically exclude from the definition of "insurance items" any cash-flows related to reinsurance of future primary contracts. The proposal allows *DRE* assets in respect of future renewals and NB to contribute to Solvency Capital as a non-insurance item. This change results in a moderate increase in Solvency Capital, mainly affecting general insurers.

Stakeholder feedback to consultation proposal

76. **Stakeholder feedback:** One respondent asked for clarification of the intent behind the addition of the wording, '…excluding cash-flows relating to outwards reinsurance of primary insurance that is not valued under paragraphs 28-31' to the *In-force Standard*.

77. **RBNZ response:** The intention of this wording was to clarify that the part of *DRE* assets relating to future primary contracts does not get standardised or capital-charged. In the *Exposure Draft*, the wording has been changed to "Outwards reinsurance or retrocession cash-flows beyond the contract boundary of associated primary insurance or inwards reinsurance contracts". This is because the earlier wording could have given the impression that primary insurance contracts were being tested for exclusion, rather than certain reinsurance or retrocession cash-flows.

78. **Stakeholder feedback:** A respondent also observed that there is now a charge on deferred reinsurance assets and expected portfolio reinsurance recoveries in the standardised liability for remaining coverage, and that there is potential for double counting as a result. They suggest changing paragraph 101(i)(f) of the *In-force Standard* to "any outwards reinsurance component of the standardised liability for remaining coverage in respect of portfolio reinsurance, where this is an asset to the solvency entity and the risk is not captured by other charges."

79. **BNZ response:** While we have not made the suggested change, we do acknowledge the potential for double-counting. Therefore, we have added a phrase to sub-paragraph 101(i)(f) in the *Exposure Draft*, "other than a deferred *reinsurance* expense asset included in sub-paragraph (c)". We have also added a paragraph to the guidance to made it clear that the part of the *DRE* asset relating to future primary contracts does not get standardised or subjected to insurance risk capital charges.

Finalised position on DRE assets in Exposure Draft

We have made our intention regarding the treatment of *DRE* assets explicit, by specifically excluding from the definition of "insurance items" any cash-flows related to reinsurance beyond the primary insurance contract boundary. Additionally, we have clarified in the *Exposure Draft* and in the guidance document that the part of the *DRE* asset relating to future primary contracts does not get standardised or double-counted in insurance risk capital charges.

Embedded obligations test for financial reinsurance

Introduction

80. Financial reinsurance can be a hidden form of debt financing. It's important that the *ISS* is able to identify such arrangements and ensure they are properly accounted for in Solvency Capital. The *ISS* uses three tests to determine the nature of a reinsurance arrangement:

    - The likelihood test – is there a significant transfer of risk to the reinsurer?;
    - The specified event test – is there an event that would trigger a repayment?; and
    - The embedded obligations test – is part of the reinsurance arrangement effectively a debt instrument?

Issue with In-force Standard

81. We have identified some ambiguity in the embedded obligations test in Appendix 2, paragraph 27 of the *In-force Standard*, in respect of references to "amounts".

Proposed change consulted on

82. We suggested some wording in the *Draft Amendment Standard* that clarifies which "amounts" are being referred to. We also proposed to discuss the test in the Guide to provide further clarity.

Stakeholder feedback

83. **Stakeholder feedback:** One respondent requested clarity on the difference between the three tests.

84. **RBNZ response:** Under the embedded obligations test, repayments are programmed rather than triggered by an event (as per the specified event test). The likelihood test ascertains the degree of risk that the reinsurer is exposed to, rather than whether something akin to a loan repayment is expected.

Finalised position on the embedded obligations test for financial reinsurance in Exposure Draft

We have not made any further changes to the *Standard* arising from this feedback.

Consistency between valuation methods

Introduction

85. The *Standard* has specific valuation approaches for the *MGMM*, *MPAA* and accumulation methods.

Proposed change consulted on

86. This is not a topic we consulted on, but we did receive some feedback.

Stakeholder feedback

87. **Stakeholder feedback:** Some respondents noted that the changes made to paragraph 30 of the *Draft Amendment Standard* in respect of premiums due have not been reflected in paragraph 28, meaning the methods are still not fully aligned. They submit that these changes are necessary to ensure that the *MPAA* and *MGMM* methods give materially the same solvency outcomes for similar contracts.

88. **RBNZ response:** We broadly agree with this proposal. We note that this issue is tightly related to the *MPAA* valuation issues that we did consult on. Paragraph 27 of the *Exposure Draft* now contains assumptions and settings common to both methods, while paragraph 28 describes the *MGMM* method and paragraph 29, the *MPAA* method.

Finalised position on consistency between valuation methods in Exposure Draft

We agree that paragraphs 28 and 30, which standardise the value of insurance items need to be more consistent. We have restructured paragraphs 26-31 to draw out areas of commonality between the methods.

Contingent items

Introduction

89. Contingent assets and liabilities are included in solvency capital at their economic value. They are subsequently stressed as part of the *PCR* calculation. These items can, however, be difficult to value.

Proposed change consulted on

90. This is not a topic we consulted on, but we did receive some feedback.

Stakeholder feedback

91. **Stakeholder feedback:** One respondent noted that they find the treatment of contingent liabilities unclear in the *Standard*. They note that it is unclear whether paragraph 44 of the *In-force Standard* applies to direct credit substitutes only, or to all contingent liabilities and ask that it be clarified.

92. **RBNZ response:** Our intention was for paragraphs 42 and 43 to determine which direct credit substitutes paragraph 44 applies to – those that have not been recognised in financial statements and whose fair value has not been disclosed in the notes to the financial statements. We have clarified in the guidance to paragraph 42 that the disclosure referred to is in the notes to the financial statements.

93. **Stakeholder feedback:** A respondent noted that contingent items are, by their nature, uncertain in terms of the amount and/or timing and that it is unclear how a value distribution can be derived. They also note that the capital charge refers to contingent assets and liabilities. Given that contingent assets are valued at 99.5th percentile, it would simplify matters considerably to exclude contingent assets. Otherwise, it will be necessary to consider all contingent assets and assess the 99.5th percentile to prove value is immaterial.

94. **RBNZ response:** We agree with this point. While the method we consulted on is theoretically correct, we acknowledge that it would be very difficult to use. Therefore, we have adjusted the *Exposure Draft* so that, where estimation of percentiles is not feasible, 'Likely Maximum Exposure' and Zero are now used as the stressed values for contingent liabilities and assets respectively in paragraph 112.

Finalised position on contingent items in Exposure Draft

We have clarified in the guidance to paragraph 42 that the disclosure referred to is in the notes to the financial statements.

'Likely Maximum Exposure' and Zero can now be used as the stressed values for contingent liabilities and assets respectively in paragraph 112, where estimation of value is not feasible.

Capital requirements

Re-basing of the Underwriting risk capital charge

Introduction

95. The *UWRCC* sets capital aside against the risk that premiums collected for short-term insurance business are insufficient to pay future claims and expenses. It is specified as a percentage – which varies by product class – of a base amount. The base amount is the *SLRC*.

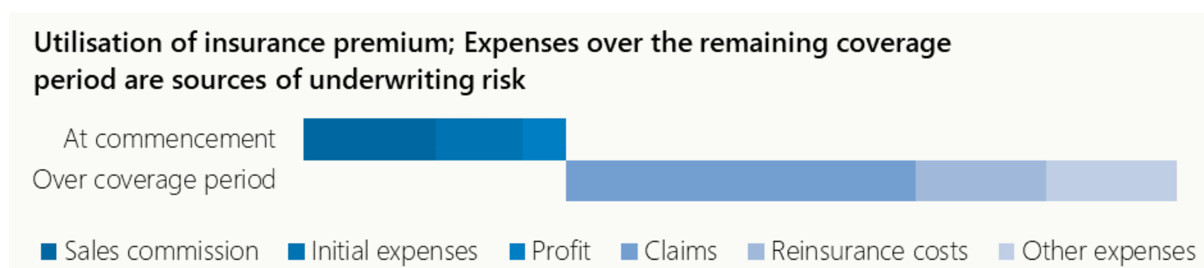
Summary of issue with In-force Standard

96. In the *ISS* the charge was established as a percentage of the *SLRC*, in the belief that this was a good proxy for the magnitude of the risk. However, an outcome of using a *modified NZ IFRS 17* valuation method is that *SLRCs* for insurance contracts with premiums payable more frequently than annually are too small to adequately reflect the underwriting risk.

Proposed change consulted on

97. In our *Discussion Draft*, we proposed using expected claims during the remaining coverage period as the base for the charge to broadly restore capital levels to what they were under the previous *Non-Life Standard*. This would significantly increase the *PCR* across the sector, and mainly affect general insurers.

98. The diagram below shows which expenses are incurred at commencement and which are incurred over the coverage period as risk expires.



Stakeholder feedback to consultation proposal

99. **Stakeholder feedback:** One respondent noted that an allowance for risk adjustment is needed.

100. **RBNZ response:** We agree that the base for this charge should be at economic value and hence include a risk adjustment. In sub-paragraph 56(iv) of the *Exposure Draft* we have explicitly included such an adjustment, equal to that determined under sub-paragraph 27(iv).

101. **Stakeholder feedback:** Some respondents noted that basing the *UWRCC* on claims and claims handling expenses alone ignores critical elements of risk in the pricing basis. Some proposed including other sources of pricing risk (reinsurance, expenses, taxation etc), in the calculation base, while others suggested that reverting to 'premium liabilities' as in the old *Non-life Standard* would help ensure that all critical elements of risk are captured.

102. **RBNZ response:** We considered a number of options to address this issue. These options are set out in the table below.

Potential Calculation Base	Advantages	Disadvantages
Standardised liability (as per amended standard)	• Minimal change in Standard • Changes to paras 27 - 29 will make the measure more robust	• Still some risk of not properly capturing the underwriting risk.
Expected claims (as proposed in the consultation paper)	• As specified in consultation paper, simple	• Doesn't fully capture the risk; understates the charge
[Preferred basis]: Expected claims, reinsurance costs, expenses & risk adjustment	• Accurately targets underwriting risk	• New measure

103. We agree with stakeholder feedback that the claims measure proposed in the consultation paper doesn't fully capture all sources of underwriting risk. We have therefore extended the measure proposed to include expenses and reinsurance costs (third option in the table above).

104. **Stakeholder feedback:** It was suggested that allowance be made for the possibility of re-pricing or changes in benefits prior to the end of the coverage period.

105. **RBNZ response:** As this charge only relates to short-term liabilities, and as re-pricing etc. is generally not instantaneous, we won't be changing this treatment at this time.

Finalised position on the UWRCC in Exposure Draft

- We have made the allowance for risk adjustment clearer by explicitly including it as an element of the *UWRCC* base.
- We have extended the measure proposed in the *Discussion Draft* to include other sources of underwriting risk – expected claims, reinsurance costs and expenses – in the base for the *UWRCC*.

Run-off term

Introduction

106. The run-off term is the period during which the licensed insurer is deemed to be sub-scale and incapable of supporting its expenses. During the run-off term, part of the expenses of the insurer will need to be funded out of capital.

Summary of issue with In-force Standard

107. The run-off term commences when actual expenses fall below $1m (in 2023 dollars). It is possible that actual expenses may never fall below $1m and yet the insurer needs funding support because the business is generating insufficient expense loadings.

Proposed change consulted on

108. Updating sub-paragraph 126(i)(b) of the *In-force Standard* to reflect that the charge be based off loadings released. This should ensure the run-off term is sufficiently long in the charge calculation. This proposal will result in a moderate increase in *PCR* and affect insurers in run-off.

Stakeholder feedback to consultation proposal

109. **Stakeholder feedback:** A respondent noted that, while they agree with the proposal, they questioned whether the sub-paragraph should be adjusted to reflect actual inflation from January 2024. They also suggested that we specify what index will be applied when allowing for inflation.

110. **RBNZ response:** We agree that it should be clarified that the inflation adjustment is on the $1 million figure, which was established in 2023 dollars. We do not think it necessary to specify the index, as the definition of expected inflation refers to the CPI.

Finalised position on the run-off term in Exposure Draft

The initial proposal stands and is supplemented by wording to the effect that the base date for inflation adjustment is 1 January 2023, and that, for clarity, the adjustment applies to both monetary amounts mentioned in the paragraph.

Taxation expense and the PCR

Introduction

111. The taxation calculations to be performed are specific to the application of this solvency standard and should affect the capital charge calculations made. The results may differ from taxation calculations prepared for other purposes.

Summary of issue with In-force Standard

112. The *In-force Standard* has no specific definition for taxation expense.

Proposed change consulted on

113. Replacing the definition of "taxation" in paragraph 28(iii)(c) in the *In-force Standard* with "taxation expense", being "tax paid plus the increase in taxation liabilities over the period". This change aimed to ensure tax effects are handled in line with the philosophy of the regime – i.e. that capital charges should be calibrated to the actual losses the insurer would suffer under prescribed stresses. This change would have a moderate to variable impact, depending on interpretation, and may affect all insurers.

Stakeholder feedback to consultation proposal

114. **Stakeholder feedback:** Some respondents noted that taxation expense could be negative. One respondent asked for clarity regarding whether "taxation expense" captured all tax paid, not only taxation in relation to timing differences. They also proposed adding 'Taxation Expense' as a separate line in the marked-up copy of definitions.

115. **RBNZ response:** We agree with this feedback. A separate definition now incorporates tax paid, tax credits and movements in tax liabilities, implicitly allowing for negatives, in the *Exposure Draft*.

116. **Stakeholder feedback:** One respondent noted that they consider the threshold of ''beyond doubt" as per Appendix 8 is too strict. They believe that the threshold should be aligned to the "probable" threshold in NZ IAS 12. The respondent also notes that they consider item 2(2)(c) in Appendix 8 on "wind-up" should not have to be considered.

117. **RBNZ response:** We agree with relaxing the probability criterion slightly and have used the phrase 'highly likely' in the *Exposure Draft*. However, we have not excluded the wind-up paradigm from consideration, due to the current nature of the *Standard* (that is, a document needing to encompass both going concern and wind-up paradigms).

118. **Stakeholder feedback:** A respondent noted that the tax treatment under the *Standard* is complex and will lead to a saw-tooth pattern in the solvency margin as the tax liability increases and decreases. The issue arises because final net *DTAs* get charged off. When an insurer makes a tax payment, the net *DTA* grows and so does the charge-off. The solvency margin decreases discretely.

119. **RBNZ response:** We acknowledge these concerns and will revisit this issue in *Stage 2* of the *Solvency Review* when we consider going-concern and wind-up solvency paradigms.

Finalised position on taxation expense and the PCR in Exposure Draft

- We have provided clarity about what is intended by 'tax paid over the period'.
- We have made changes to the definition of tax expense to allow for negatives, tax paid, tax credits and movement in tax liabilities.
- We have changed the phrase "beyond doubt" to "highly likely" in Appendix 8. We have also required tax assets to be recoverable within a five-year period.

Run-off triggers

Introduction

120. Paragraph 17 of the *ISS* includes a definition that sets out three criteria for determining if a solvency entity is in run-off. One of these is that: "the Reserve Bank has issued a direction to the licensed insurer in respect of the solvency entity to cease selling all new insurance contracts".

Summary of issue with In-force Standard

121. Not all triggers for run-off are included in the current wording. The wording fails to cover the case where the *Reserve Bank* uses a condition of licence to stop or restrict the insurer's sales of new business.

Proposed change consulted on

122. To expand the criteria for run-off to recognise that the *Reserve Bank* may, under *IPSA*, issue a direction to the insurer, or impose a condition of licence upon the insurer which prohibits or significantly restricts the issuance of new insurance contracts. We expect the impact to be minor, affecting mostly life insurers.

Stakeholder feedback to consultation proposal

123. **Stakeholder feedback:** A respondent noted that this amendment may restrict the ability to sell new business. They suggest that, rather than imposing a run-off capital charge, the standard should impose a minimum solvency margin licence condition. They suggest that leaving the requirement unchanged would allow more flexibility.

124. **RBNZ response:** For insurers in run-off, we would always want a mechanism to help preserve sufficient capital as new capital is very unlikely to be forthcoming when a business enters this stage. It is best if this is done systematically (through the *Standard*) rather than through individual licence conditions. We propose no further change to the *Exposure Draft*.

Finalised position on run-off triggers in Exposure Draft

We have not made any further change relative to what we consulted on.

Credit risk on interest-sensitive assets

Introduction

125. The old solvency standards combined elements of credit and market risk in a single capital charge (the *CEP charge*). In the *ISS* we split this into separate charges. As we didn't want to double count, we excluded assets from the *CRCC* if they had been subject to the *MRCC*.

Summary of issue with In-force Standard

126. One element of market risk that wasn't included in the *CEP charge* was interest rate risk. In the old standards, this allowed – correctly – interest-sensitive assets such as bonds to be

subject to both the *IRRCC* and the *CRCC*. In the *ISS*, credit risk charges on bonds subject to the *IRRCC* were inadvertently excluded.

Proposed change consulted on

127. Rather than exempting from the *CRCC* all assets subject to the *MRCC*, we proposed, in the *Discussion Draft*, to exempt only those subject to the property and equity risk components of the *MRCC* (the 'E' and the 'P' in CEP). The change will raise capital requirements and mainly affect life insurers as they have the largest bond portfolios.

Stakeholder feedback to consultation proposal

128. There was general agreement with the proposal and no negative responses.

Finalised position on credit risk on interest-sensitive assets in Exposure Draft

The wording in the *Exposure Draft* is unchanged relative to what was proposed during consultation. Only assets subject to property and equity risk components of the *MRCC* are exempted from the *CRCC*.

Capital charge for reinsurance disputes

Introduction

129. The calculation of the capital charge for reinsurance disputes calls for the value of the asset in the licensed insurer's financial statements to be compared to the value of the asset reported by the reinsurer.

Summary of issue with In-force Standard

130. The value of the asset has already been standardised in the Solvency Capital measure, so it is inappropriate to establish a capital charge based on the difference to the NZ IFRS value.

Proposed change consulted on

131. We updated paragraph 104 in the *Draft Amendment Standard* so that the charge compares the standardised value of the asset to the reinsurer's valuation. This change will affect insurers in dispute with their reinsurers.

Stakeholder feedback to consultation proposal

132. Feedback largely agreed with our proposals (or was absent).

Finalised position on capital charges for reinsurance disputes in Exposure Draft

As per our proposal in the *Discussion Draft*, we have updated paragraph 104 so that the charge compares the standardised value of the asset to the reinsurer's valuation.

Double counting of discretions

Introduction

133. The *Standard* allows insurers to use the same Appendix 7 discretion for multiple capital charges. This allowance supports the risk diversification approach we are considering introducing in the final solvency standard.

Summary of issue with In-force Standard

134. Theoretically the application of discretions could make the *LTIRCC* negative. However, there is no explicit requirement in the *Standard* for capital charges to be positive.

Proposed change consulted on

135. In the *Discussion Draft* we proposed that each capital charge should be subject to a floor of zero. This would provide some protection against over-use of discretions. The impact of this proposal is minimal as it is highly unlikely that a negative charge will arise.

Stakeholder feedback to consultation proposal

136. Feedback largely agreed with our proposals (or was absent).

Finalised position on double counting of discretions in Exposure Draft

As per our proposal in the *Discussion Draft*, we have updated the *Standard* to reflect that each capital charge should be subject to a floor of zero.

Prescribed assumptions for long-term non-life contracts

Introduction

137. Prescribed assumptions support the calculation of the Solvency Liability under the *LTIRCC*. They are designed to describe the adverse circumstances in which insurers of long-term business are required to be able to meet their obligations to policyholders.

Summary of issue with In-force Standard

138. Appendix 5 shows prescribed solvency assumptions for non-life claims as numbers only. These assumptions should only apply to general insurance business (as health insurance has its own assumptions). They should also refer to the use of factors in the underwriting and claims run-off risk capital charges, applying these as an increase in long-term claim assumptions.

Proposed change consulted on

139. We consulted on limiting these assumptions to general insurance, correctly identifying the source of the capital factors and stating that they are to be applied to long-term claim assumptions and liabilities. We expect the impact of this proposal to be minimal as we believe insurers have been interpreting the charge correctly. This issue would mostly affect general insurers.

Stakeholder feedback to consultation proposal

140. Feedback largely agreed with our proposals (or was absent).

Finalised position on prescribed assumptions for long-term non-life contracts in Exposure Draft

As per our proposal in the *Discussion Draft*, we have limited these assumptions to general insurance, correctly identifying the source of the capital factors and stating that they are to be applied to long-term claim assumptions and liabilities.

Seismic risk - 168-hour grace period

Introduction

141. In normal circumstances, the seismic risk component of the Catastrophe Risk Capital Charge includes the net losses from a prescribed event, plus the cost of reinstating reinsurance cover after such an event. In the week immediately after an event, however, we waive the requirement to provide for reinstatement cost, to give the insurer a chance to renew their contractual arrangements for reinstatement with a reinsurer.

Summary of issue with In-force Standard

142. Some insurers have told us that 168 hours is insufficient to restore the reinstatement provisions.

Proposed change consulted on

143. In the consultation paper we proposed no change to the 168-hour grace period at this time, but we noted that we intend to consider this grace period as part of *Stage 2* of the *Solvency Review*.

Stakeholder feedback

144. **Stakeholder feedback:** One respondent recommended linking the requirement to the 'hours clause' in the relevant reinsurance treaty, or 336 hours if not stated, given the level of uncertainty associated with the initial estimates of costs of seismic events.

145. **RBNZ response:** We will consider this as part of *Stage 2* of the *Solvency Review*.

Finalised position on seismic risk - 168-hour grace period in Exposure Draft

We will consider this proposal as part of *Stage 2* of the *Solvency Review* when we re-visit the catastrophe charge.

Reporting requirements

Disclosure of annual solvency return

Introduction

146. A licensed insurer must provide to the *Reserve Bank* an annual solvency return in respect of the solvency entity, and the accompanying information set out in paragraph 136(i) to (v) of the *In-force Standard* (in respect of the licensed insurer).

Summary of issue with In-force Standard

147. The *Standard* currently requires website disclosure of both annual and interim return data. In respect of the annual balance date this can create confusion as both audited annual returns and one of the unaudited interim returns relate to the same date.

Proposed change consulted on

148. We proposed removing the requirement for insurers to publish annual solvency return figures on their websites. We expect the impact to be minor, affecting all insurers.

Stakeholder feedback to consultation proposal

149. **Stakeholder feedback:** One respondent noted that, for a short period of time, the results in insurers' Annual Financial Statements will not align with the results for the same period on the insurer's website.

150. **RBNZ response:** We agree with this observation and propose that we require some explanatory wording on insurer's websites to clarify that the solvency figures on the insurer's website are based on unaudited information and may differ from those disclosed in audited financial statements. We have suggested in guidance that insurers note on their websites the possibility of differences arising between the audited annual information in financial statements and the unaudited quarterly information displayed on their websites.

Finalised position on disclosure of annual solvency return in Exposure Draft

The initial proposal stands; however, we have clarified in the guidance document that insurers should include a note on their websites about the possible differences.

Use of adjusted solvency capital for website disclosure

Introduction

151. The *Standard* requires the publication of 'adjusted' solvency information instead of the standard measures used in the old standards. This is because the *Reserve Bank* considers that solvency licence conditions reflect specific risks or balance sheet weaknesses that the *ISS* itself does not handle appropriately. These weaknesses or additional risks are an integral part of the insurer's profile and should be reflected in published solvency measures.

Proposed change consulted on

152. This is not a topic we consulted on, but we did receive some feedback.

Stakeholder feedback

153. **Stakeholder feedback:** One respondent noted that it is confusing to require the adjusted solvency capital and adjusted items to be disclosed on websites when there may be no adjustment. They propose different terminology be used for public disclosure.

154. **RBNZ response***:* As we keep licence conditions confidential, we cannot differentiate terminology between insurers that have conditions and those that don't. Therefore, while we acknowledge that the terminology isn't perfect (as it implies adjustment where there may be none), changing this terminology now would trigger a wave of license condition and notice-rewriting. This is best left for *Stage 2* of the *Solvency Review*, as we will need to create some new terminology then in any case.

Finalised position on adjusted solvency capital for website disclosure in Exposure Draft

We have not made any changes to the standard to address this issue but will revisit this question in *Stage 2* of the *Solvency Review*.

Conduct and outsourcing requirements in the FCR

Introduction

155. When we first issued the *ISS*, we introduced a requirement for the *AA* to comment in the *FCR* on conduct and outsourcing risks. We made it clear that the actuary was able to rely on the output of other professionals for this purpose. This requirement was in response to the findings of several recent reviews of the *Reserve Bank's* approach to supervision.

Proposed change consulted on

156. This is not a topic we consulted on, but we did receive some feedback.

Stakeholder feedback

157. **Stakeholder feedback:** One respondent noted that it is not appropriate for *AAs* to be required by paragraph 161(xi) and (xii) of the *In-force Standard* to comment on topics such as outsourcing and conduct in the *FCR*. They note that this requirement dilutes the power of the *FCR*, which should be at a high level, commenting on the risks in the company. They think that, instead, the *Reserve Bank* should seek this information through section 121 notices.

158. **RBNZ response:** We note that *IPSA* is currently under review,[6] and that it is currently proposed that *IPSA* be amended to empower standards addressing governance, risk management and related issues. Such standards may be a more appropriate measure to

6 See: rbnz.govt.nz/regulation-and-supervision/oversight-of-insurers/how-we-regulate-and-supervise-insurers/our-policy-work-for-insurer-oversight/review-of-insurance-prudential-supervision-act-2010

address outsourcing and conduct matters. Accordingly, we intend to defer consideration of this issue for the moment.

Finalised position on conduct and outsourcing requirements in the FCR in Exposure Draft

We will defer consideration of this matter and it will be part of any further *IPSA* review and amendment work.

Other issues

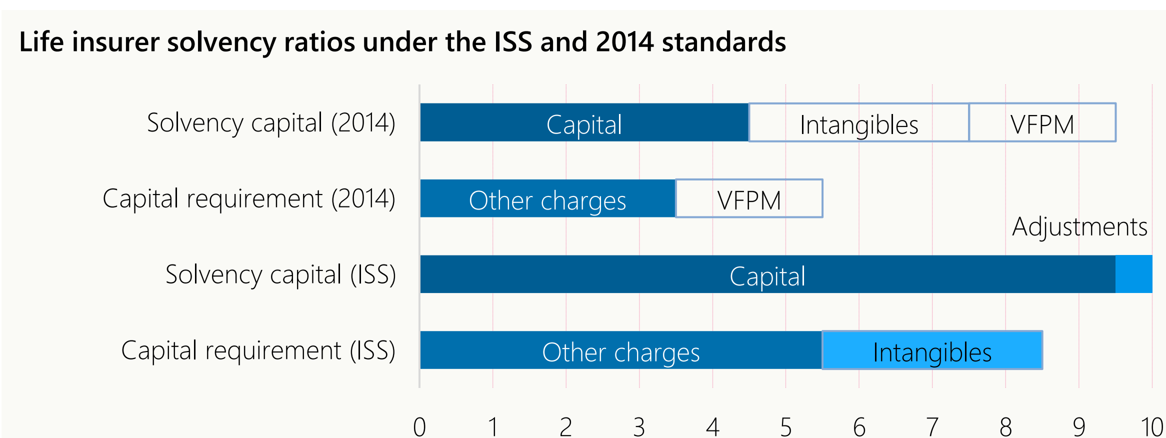
Intangibles and solvency ratios

Introduction

159. The old standards established a conservative valuation for Solvency Capital, by deducting intangible assets and incorporating an artificial profit margin liability (*VFPM*) for life insurance.

160. In the *ISS*, no profit margin liability is deducted. Intangible assets are allowed to contribute to solvency capital at their economic value, but also contribute to the *PCR* as they are expected to lose value under solvency stresses. Solvency ratios have fallen as a result of these changes.

Life insurer solvency ratios under the ISS and 2014 standards



161. In the graphic we show the impact of intangibles on solvency ratios for an example company. Transparent boxes indicate deductions. The solvency ratio under the old standards is 129% (4.5/3.5), while the ratio under the *ISS* is 118% (10/8.5), while the margin remains at 2. The change in solvency ratio arises from setting Solvency Capital to its economic value and allowing the *PCR* to reflect all risks to value.

Summary of issue with In-force Standard

162. Intangible assets are difficult to value and the value showing in the financial statements may not be appropriate.

Proposed change consulted on

163. We proposed allowing the *AA* to write down certain intangibles to economic value by introducing a new sub-paragraph 38(iv) which deducts any amount that, *in the opinion of the Appointed Actuary*, is in excess of the economic value of items covered by the Distressed Wind-up Charge. This change is expected to have a minor impact and may affect all insurers.

Stakeholder feedback to consultation proposal

Actuarial valuation of intangibles

164. **Stakeholder feedback:** Many respondents interpreted the wording of 38(iv) of the *Draft Amendment Standard* to mean that it is mandatory for the *AA* to value intangibles and make an adjustment to Solvency Capital. Many raised the concern that the *AA* would not necessarily have the expertise, or that methods may not exist, to determine economic value for some of the items listed in this paragraph. Some also suggest that the wording and intended outcome is not clear, for example with respect to the amount to be capital-charged under paragraph 113.

165. **RBNZ response:** We acknowledge this feedback. Our intention is for the adjustment to be optional and for the remaining intangible assets after adjustment to be capital charged under paragraph 113. Therefore, we have re-worded para 38(iv) in the *Exposure Draft* to make it clear that we are providing the *AA* the opportunity to re-value intangibles, not obliging them to override the value in the accounts.

166. **Stakeholder feedback:** Some respondents agreed with the proposal but questioned whether the adjustment should be seen as a deduction from capital or be considered as part of the standardisation of assets.

167. **RBNZ response:** Our intention is for the adjustment to be seen as a standardisation of value rather than a deduction from capital. We have moved subparagraph 38(iv) to paragraph 37 in the *Exposure Draft* to support this.

General concerns about treatment of intangibles

168. **Stakeholder feedback:** Some respondents do not agree with our approach to the treatment of intangibles in general. They suggest that the treatment of intangibles as an addition to the distressed wind-up capital charge is not consistent with an economic basis of valuation or with *IAIS* developments. They recommend that, instead, intangibles should be treated as a deduction from capital, arguing that such assets will not be available in wind-up. Some also noted that the use of a distressed wind-up capital charge is contrary to a 'going concern' basis and out of line with comparable jurisdictions.

169. **RBNZ response:** While we understand this perspective, our view is that intangibles do have economic value. For example, brands may be sold, and *DTAs* can be offset against current taxation. We do, however, agree that under the *In-force Standard* an insurer's solvency ratio will decrease when an intangible is written off, and that this is counter-intuitive. These issues will be addressed as part of *Stage 2* of the *Solvency Review* when we may look at the *PCR* and *MCR* as going concern and wind-up concepts respectively.

170. **Stakeholder feedback:** Both the *ICS* and *LAGIC* deduct intangibles from capital. However, Solvency II takes a similar approach to the *Standard*, having an 'intangible risk capital charge' (but also having stricter criteria than the *Standard* for admitting value into Own Funds in the first place).

171. **RBNZ response:** We acknowledge that, until we properly establish the *MCR*, we necessarily have to combine – somewhat inelegantly – going concern and wind-up concepts in Solvency Capital and the *PCR*.

Handling of negative liabilities

172. **Stakeholder feedback:** One respondent questioned whether using an approach similar to Solvency II is appropriate for New Zealand without adjustment. They note that more profitable insurers may now have lower solvency ratios than less profitable insurers because the solvency ratio is diluted by the charging off of negative liabilities.

173. **RBNZ response:** This issue has always existed in our solvency standards – negative liabilities boost Solvency Capital while *CTV* minimums boost the *PCR*. This has the effect of making Australian and New Zealand life insurers appear weaker (in ratio terms) than European life insurers (where most insurance liabilities are positive). It is, however, theoretically correct in that future profits from YRT policies do have economic value. The effect used to be masked under the *Life Standard* by the presence of an artificial liability for future profit margins (similar to the *CSM* under IFRS 17). In *Stage 2* the situation will be addressed when we look in detail at the difference between going concern and wind-up paradigms.

Finalised position on intangibles and the solvency ratio in Exposure Draft

Actuarial valuation of intangibles:

- We have re-worded para 38(iv) to make it clear that we are simply providing the *AA* the opportunity to re-value intangibles, not obliging them to override the value in the accounts.
- We have also moved subparagraph 38(iv) to paragraph 37 so that it is seen as a standardisation of value rather than a deduction from capital.
- The appropriate role of going concern and wind-up valuations for solvency purposes will be revisited in *Stage 2* of the *Solvency Review*.

Transfer of guidance to a separate document

Introduction

174. Guidance boxes are currently contained within the *In-force Standard*.

Proposed change consulted on

175. We proposed moving all guidance to a separate document and augmenting it with new explanatory material. This change will improve clarity and align better with international practice.

Stakeholder feedback to consultation proposal

176. There was general agreement with the proposal and no negative responses.

> **Finalised position on the transfer of guidance to a separate document**
>
> As per our proposal in the *Discussion Draft*, guidance has been expanded with new explanatory material and is now contained in a separate document. We've also added more guidance since the version consulted on last year, including based on feedback from our external reviewer, to try and provide additional clarity.

Introducing IPSA-related definitions for classes of insurance

Introduction

177. The *ISS* draws on *IPSA* definitions of life insurance and health insurance.

Summary of issue with In-force Standard

178. The definitions are somewhat obscure and there is no *IPSA* definition of general insurance.

Proposed change consulted on

179. We proposed defining these terms directly in the *ISS*, by reference to appropriate *IPSA* paragraphs. We expect the impact of this proposal to be minimal, but to potentially affect all insurers.

Stakeholder feedback to consultation proposal

180. Feedback largely agreed with our proposals (or was absent).

> **Finalised position on subsector definitions in Exposure Draft**
>
> As per our proposal in the *Discussion Draft*, we have defined these terms directly in the *Exposure Draft*.

Apportionment of repayable amounts

Introduction

181. In clause 29 of Appendix 2, the *In-force Standard* requires that a sound and principled basis be used in apportioning any repayable amount to the appropriate product classes, if such apportionment is necessary, in determining the repayable amount adjustment.

Summary of issue with In-force Standard

182. This paragraph is carried over from the previous *Life Standard*, which required the repayable amount to be added to the insurance risk capital charge for each related product group. Since the *ISS* requires that insurers deduct the repayable amount (in aggregate) from capital, this clause is no longer required.

Proposed change consulted on

183. We proposed in the *Discussion Draft* to remove clause 29 in Appendix 2.

Stakeholder feedback to consultation proposal

184. We did not receive any feedback on this proposal.

Finalised position on apportionment of repayable amounts in Exposure Draft

As per our proposal in the *Discussion Draft*, we have removed clause 29 in Appendix 2.

Early adoption of amendment standard

185. We had earlier planned for the *Second Amendment* to be effective for all insurers from 1 June 2024. Multiple stakeholders advised that they would prefer to adopt the *Standard* earlier than the 1 June as this would allow entities with 31 March balance dates to disclose a more robust solvency calculation and help avoid communication challenges associated with delaying the effective date. Some noted that the XRB allowed early adoption when *NZ IFRS 17* was introduced.

186. We acknowledge the impact that the issues with the *In-force Standard* have had for insurers, particularly those reporting on it. Unfortunately, we could not accommodate early adoption because the law requires that entities meet the in-force version of the standard. We also made a decision to commission an external review, which extended the period of time where insurers faced this challenge. However, we are committed to running a robust process which delivers a version of the *ISS* which resolves issues, returns the *Standard* to its original intent and - in the long-term - creates less disruption for entities. External review will help us accomplish these aims and provide confidence in the new *Exposure Draft*.

Finalised position on early adoption of amendment standard

The *Reserve Bank* expects to issue the *Second Amendment* in December and for the standard to be effective for all insurers from 1 March 2025.

Minor issues raised

187. **Stakeholder feedback:** A stakeholder raised a question about Appendix 2 – Financial Reinsurance, which contains tests for assessing whether a repayable amount exists, as well as methods for valuing the repayable amount. In the *Discussion Draft* we made no proposal to amend the *Standard* in this area.

188. **RBNZ response:** Clause 20(v)(a) of Appendix 2 of the *In-force Standard* allows terminations of reinsurance treaties where the termination value is the “arms-length commercial value of the portfolio” to be excluded from the definition of specified events. In fact, some treaties preclude such a payment, resulting in greater risk for the reinsurer. In order to provide more flexibility in deal structuring, we have changed the wording in Appendix 2 subclause 20(v)(a) in the *Exposure Draft* from “based on the arm’s-length commercial value” to “an amount no greater than arm’s length commercial value”.

189. **Consultation proposal:** In the *Discussion Draft* we proposed that the *Standard* explicitly state that contracts valued using *GMM* must be subject to the *LTIRCC*, not the *UWRCC*.

190. **RBNZ response:** On reflection we have retained the approach of subjecting long-term insurance contracts to the *LTIRCC* and short-term insurance contracts to the *UWRCC* in the *Exposure Draft*. This is because the *UWRCC* is not, in any case, based on the *MPAA SLRC*.

191. **Stakeholder feedback:** One respondent noted that paragraph 58(i) of the *In-force Standard* should state that the assumptions are set in Appendix 5.

192. **RBNZ response:** We agree that we should add this for clarity. We have inserted wording in paragraph 58(i) of the *Exposure Draft* to state that the prescribed solvency assumptions are set in Appendix 5.

193. **Stakeholder feedback:** A respondent requested that we add a definition for the term 'one-off expenses'.

194. **RBNZ response:** This term was used in the May 2022 draft "Review Version" of the *Standard* but has not been used in issued versions of the *Standard*. We therefore propose no change.

195. **Stakeholder feedback:** One respondent noted that paragraph 28(iii)(d) of the *In-force Standard* requires the inclusion of a share of non-attributable expenses to be included in fulfilment cashflows as part of the standardisation of insurance items, but that there are no wording changes proposed regarding the determination and allocation of these expenses. They noted that the guidance does provide some background but think it should more explicitly state that ongoing non-attributable expenses relating to the fulfilment of existing insurance contracts within the contract boundary are to be taken into account.

196. **RBNZ response:** We acknowledge this feedback and have made changes in the *Exposure Draft* in response. The wording now refers to "A share of all *maintenance costs* and *investment management costs*", both of which are defined terms.

197. **Stakeholder feedback:** The respondent also notes that the requirement to include a share of non-attributable expenses in standardised insurance items has only been included in paragraph 28 of the *In-force Standard* and not in paragraph 30 and should be applied to both paragraphs to ensure equivalence between the methods.

198. **RBNZ response:** We don't think it makes sense to include 'non-attributable expenses' in the *MPAA* method as this method is retrospective and based on premiums, not projections of cash-flows. We have, however, inserted the phrase "inside the contract boundary" into the guidance on non-attributable expenses under the *MGMM* method, to provide a little more clarity.

199. **Stakeholder feedback:** Paragraph 157 refers to NZ IFRS financial statements, so the guide entry shouldn't make reference to a risk margin determined at a 75% probability of sufficiency.

200. **RBNZ response:** We agree; the guide now simply refers to "an adjustment for non-financial risk".

201. **Stakeholder feedback:** The RBNZ should create a regulatory balance sheet with short-term insurance liabilities at 75% probability of sufficiency.

202. **RBNZ Response:** We consulted on the interface between the solvency regime and NZ IFRS in late 2020, with the outcome that we decided to continue using the NZ IFRS balance sheet as a starting point for solvency calculations.

Updates to minor issues in Exposure Draft

Financial reinsurance: We have changed the wording in Appendix 2 subclause 20(v)(a) from "based on the arm's-length commercial value" to "an amount no greater than arm's length commercial value".

Prescribed solvency assumptions: We have inserted wording in paragraph 58(i) of the *Exposure Draft* to state that the prescribed solvency assumptions are set in Appendix 5.

Non-attributable expenses: The phrase "inside the contract boundary" has been inserted into the guidance on non-attributable expenses in paragraph 28(ii)(c) of the *Exposure Draft*.

Wording and definitions

203. **Stakeholder feedback:** We have received feedback that the wording in the table in paragraph 107 "assets under a fixed or floating charge" in the *In-force Standard* is outdated and needs to change to align with changes in NZ insolvency law.

204. **RBNZ response:** We acknowledge this point, and in response have changed the wording in paragraph 107 in the *Exposure Draft* from 'Assets under a fixed or floating charge' to…'Assets under a charge, where charge is as defined in section 3 of the Insolvency Act 2006'.

205. **Stakeholder feedback:** One respondent notes that, while paragraph 28(ix) of the *In-force Standard* provides direction on how to treat premium receivables and payables, it is silent on other debts and creditors. They further note that under *NZ IFRS 17*, the attributable portion of these "other liabilities" comprises part of insurance assets and liabilities, specifically in the *LIC*. They suggest a number of ways to account for "other liabilities" and note there are differing views within the industry about how this should be done and would encourage explicit guidance or instruction to be added.

206. **RBNZ response:** We think that this concern is already addressed in the *Standard*, because the *Standard* does include a definition of 'insurance items.' An item which meets the definition will be included in insurance items, standardised under paragraphs 26-31, and potentially become part of the base for the Claims Run-off Capital Charge or the *LTIRCC*. If it doesn't meet the definition, it will flow into Solvency Capital at its IFRS value and won't be subject to any insurance risk capital charges. Therefore, we have not made the suggested changes.

207. **Stakeholder feedback:** One respondent suggested that the definition of 'insurance revenue' implies that insurers must have two years of *NZ IFRS 17* reporting, or otherwise use an *NZ IFRS 4* concept. The respondent would like more clarity on the appropriate application.

208. **RBNZ response:** The definition of 'insurance revenue' has been modified in the *Exposure Draft* such that only determination on an *NZ IFRS 17* basis is required, not production of financial statements.

209. **Stakeholder feedback:** A respondent noted that no changes were reflected in paragraph 49 of the tracked changes version of *Draft Amendment Standard*.

210. **RBNZ response:** The change we refer to relates to the formula, which has changed from $PCR = Max\ (FCA, \sum CCi\ i\ )$ to $PCR = Max\ (FCA, \sum Max(CCi\ , 0)\ i\ )$.

211. **Stakeholder feedback:** One respondent suggested changing the wording in clause 5 of Appendix 5 in the *In-force Standard* from "Increase claims incidence assumptions by the percentage prescribed in paragraph 57" to "Increase the expected future claim payment assumptions by the percentage prescribed in paragraph 57."

212. **RBNZ response:** We agree, as the claims contributing to the *LIC* have already been incurred, and have updated the text. In the *Exposure Draft* the prescribed stress is simply to increase the *SLIC* by the paragraph 57 percentage.

213. **Stakeholder feedback:** Some respondents noted that the tables in paragraphs 56 and 57 of the *In-force Standard* which set out applicable factors for each product class do not fully encompass all possible general insurance product classes set out in the definitions. They note that a 'credit' product class should be included alongside the 'other personal lines' and 'personal accident' classes.

214. **RBNZ response:** We agree that all classes should be covered. We have therefore included the credit product class in the tables in the *Exposure Draft*.

215. **Stakeholder feedback:** One respondent suggested that life insurance should be split out in paragraph 57 (and presumably in paragraph 56 as well).

216. **RBNZ response:** We do not agree with this suggestion, as there are forms of life insurance that are short-term and therefore subject to these paragraphs.

217. **Stakeholder feedback:** A respondent noted that guidance in paragraph 6 of the *In-force Standard* implies that solo and group bases need to be considered even where there are only non-regulated subsidiaries.

218. **RBNZ response:** We have inserted 'where applicable' in the revised guidance to clarify that consolidation on a group basis is not required where there are only non-regulated subsidiaries.

219. **Stakeholder feedback:** One respondent suggested the definitions relating to long-term and short-term contracts could be removed, and that the *Standard* could simply refer to general, life and health solvency requirements throughout.

220. **RBNZ response:** This issue was addressed in the July 2021 consultation on the first exposure draft of the *Original ISS*, and is not within the scope of the current amendment. We don't think there should be a difference in treatment based solely on the object insured, be that future income, a property, a liability etc. Differences in treatment should reflect the structure of insurance contracts.

221. **Stakeholder feedback:** It was suggested that the standard avoid terminology used by *NZ IFRS 17*, to avoid confusion.

222. **RBNZ response:** Terminology such as 'contract boundary', 'coverage period' etc. is found in other accountings standards and solvency regimes around the world, and it would be confusing not to use it. We have, however, taken care to define quantities in the standard where they are intended to have a different meaning to *NZ IFRS 17*.

223. **Stakeholder feedback:** The standard should clarify whether the definition of wind-up refers to actual or deemed wind-up.

224. **RBNZ response:** The definition was introduced to provide clarity about the meaning of wind-up for Appendix 8, and is therefore 'deemed'.

Finalised position on wording and definitions in Exposure Draft

We have changed the wording in paragraph 107 to 'Assets under a charge, where charge is as defined in section 3 of the Insolvency Act 2006'.

We have changed the definition of "insurance revenue" to reflect that two years of insurance revenue measures are determined, rather than that financial statements have to be produced.

We have changed the prescribed assumption for long-term non-life insurance *SLICs* to simply apply the factor in paragraph 57.

We have included the credit product class in the tables in paragraphs 56 and 57.

We have updated paragraph 6 of the guidance document to clarify that solo and group bases need not be considered where there are only non-regulated subsidiaries.

Have Your Say

Stakeholders are welcome to provide feedback and information to the *Reserve Bank* on the second amendment by 17 September 2024. Please make your submission on the *Exposure Draft* via Citizen Space.

You are welcome to contact us at any time on general matters via our email address insurancesolvency@rbnz.govt.nz. Further information about the *Solvency Review* can be found on our website: rbnz.govt.nz/have-your-say/2020/review-of-the-insurance-solvency-standards