Regulatory Impact Statement – Interim Solvency Standard

Financial Policy

1 October 2022

Reserve Bank of New Zealand
Te Pūtea Matua

Contents

Glossary 2
Executive summary 3
Problem definition 5
Context 5
What are solvency standards for? 5
Existing solvency standards 6
Interaction with other regulations 6
The problem 7
Objectives 10
Policy options 10
Measurement criteria 10
Options 11
Assessment of options against measurement criteria 12
Preferred option – the Interim Standard 13
Delivering the preferred options 19
Implementation 19
Monitoring and evaluation 19
Consultation 20
Consultation cycles 20
Modes of consultation 20
Stakeholder feedback 20
Appendices 22
Appendix 1 – In-force solvency standards as at 1 August 2022 22
Appendix 2 – Detailed assessment of the Interim Solvency Standard 23
Appendix 3 – Quality Assurance 28

Glossary

APRA	The Australian Prudential Regulation Authority
Companies Act	The Companies Act 1993
FMCA	The Financial Markets Conduct Act 2013
IAIS	International Association of Insurance Supervisors
ICP	The IAIS' Insurance Core Principles
IPSA, the Act	The Insurance (Prudential Supervision) Act 2010
LAGIC	Life and General Insurance Capital (APRA's solvency framework)
NZ GAAP	New Zealand Generally Accepted Accounting Practice
NZ IAS	New Zealand accounting standards issued by the External Reporting Board
NZ IFRS	New Zealand financial reporting standards issued by the External Reporting Board
NZ IFRS 4	The current financial reporting standard for insurance contracts
NZ IFRS 17	The incoming financial reporting standard for insurance contracts
RBNZA	The Reserve Bank of New Zealand Act 2021
Remit	The Financial Policy Remit under the RBNZA
Reserve Bank	The Reserve Bank of New Zealand
Solvency II	The European Union's regulatory framework governing insurance capital
The Review	The review of the insurance solvency standards by the Reserve Bank

Executive summary

Introduction

Solvency standards impose minimum capital requirements on insurers that increase the likelihood of insurers being able to meet their obligations to policyholders over the coming year. There are currently five solvency standards on issue; two of these are primary standards, governing life and nonlife insurance business respectively, while three others are secondary standards responding to specific situations.

Problem definition

Our standards need review because:

1. The accounting basis underlying them is changing. NZ IFRS 4 insurance liabilities are a major input to the solvency standards; however, NZ IFRS 4 is being replaced with NZ IFRS 17, which provides a radically different basis. Capital measures determined using the current solvency standards but with NZ IFRS 17 inputs will be difficult to determine and produce values that do not align with our objectives.

2. Their structure and application are sub-optimal. There are inconsistencies between sub-sectors and among insurers. IPSA explicitly supports application of the standards to insurers and statutory funds only, not to non-statutory 'life funds'.

3. Recent regulatory reviews have pointed out shortcomings.

4. We wish to become more highly compliant with the Insurance Core Principles, which provide an internationally accepted standard of best practice. These include requirements to have a graduated approach to solvency and to have insurers undertake an assessment of their own risks.

Policy options

Three policy options are explored:

1. Continuing with the status quo. This option is sub-optimal because it will not address the problem as defined in the previous section.

2. Issuing an 'Interim Solvency Standard'. This is the preferred option, as it will address the impending introduction of NZ IFRS 17, and address many of the other issues identified with the existing standards. Furthermore, it can be accomplished within the timeframe available.

3. Develop a 'Final Solvency Standard' that will comprehensively address issues with the existing standards. This option is not preferred because there is insufficient time to implement it. We do, however, intend to produce such a document in coming years.

Delivering the preferred options

The Interim Solvency Standard will come into force from 1 January 2023 and be applied to each licensed insurer from the first day of their annual reporting period commencing in 2023.

The impacts of the standard will be monitored through the solvency returns the Reserve Bank receives from insurers, and any lessons factored into a second stage of the Solvency Standards Review.

Consultation

The Reserve Bank has undertaken several consultation cycles in the formulation of the Interim Solvency Standard. These included the establishment of principles for the Review, the formulation of a theoretical framework, the exposure of a draft standard and the publication of a more refined version.

There has been consultation through varying modes – bilateral meetings, webinars, written submissions, working groups etc. - and with a variety of parties. These included insurers, industry organisations, professional associations, consulting firms, catastrophe modellers and the public.

Financial policy remit statement

Under section 49 of the RBNZA, the Board of the Reserve Bank is required to have regard to the Financial Policy Remit ('the 'remit') when issuing prudential standards. In this section we explain how we have had regard to the remit in designing the Interim Solvency Standard, to allow the Board to meet its obligation.

The remit sets out the 'Government's desired outcomes for the financial system':

> *'It is desirable to have a financial system that is strong, efficient and inclusive, with a low incidence of failure of entities regulated by the Reserve Bank.*
>
> *Within the appetite of a low incidence of failure, a competitive financial system should be encouraged so as to best ensure ongoing financial efficiency and inclusion. In this respect, the Reserve Bank should have regard to the benefits of:*
>
> - *imposing regulatory and supervisory costs that are proportionate to the expected risks and benefits to the financial system and society;*
> - *encouraging new investment and financial innovation that raise the productive potential of the economy; and*
> - *encouraging the allocation of financial resources in a way that maximises the sustainable long-term growth of the New Zealand economy.*
>
> *If a regulated entity does fail, the Reserve Bank is expected to manage the failure in a manner that minimises the costs of failure and disruption to the broader economy, and prioritises protections for vulnerable consumers, depositors and public funds.'*

The Interim Solvency Standard sets a low appetite for insurer failure (one in two hundred years) and imposes costs on industry that are proportionate to risks and benefits. It encourages the sustainable growth of the economy by promoting a sound insurance sector and securing its role as a catalyst for economic activity. Failed entities are expected to retain sufficient assets that their business can be resolved with minimal detriment to consumers.

The remit also asks the Reserve Bank to have regard to government policy in relation to housing affordability, climate change, financial inclusion, and cyber resilience.

- The solvency standard already has provision for insurers to reflect short-term climate risk in their liability estimates (for example, in terms of likely flood risk for property portfolios). Our supervisors can seek assurance from insurers that their risk calculations reflect what we know about the climate change that has already taken place. The solvency calculation is less useful for encouraging longer-term thinking about climate change risk and risk mitigation. However, stage 2 of the Solvency Standards Review (leading up to the publication of a Final Solvency Standard) will include the design of a compulsory process for insurers to consider and document their own assessment of the adequacy of their capital in the light of a wide range of risks that they face, including longer-term climate risks.
- The Interim Solvency Standard establishes an operational risk capital charge. This is to make insurers more resilient by providing a capital buffer against operational risk events, including cyber risk events. In stage 2 of the Solvency Standards Review, the design of this charge will be improved such that it is sensitive to the risk environments of each insurer, providing insurer management with an incentive to mitigate and reduce cyber risk.
- Housing affordability is difficult to influence directly through a solvency standard. That said, in stage 2 of the Solvency Standards Review, we will be revisiting the parameters (including capital factors for property assets and mortgage loans) in the Interim Solvency Standard to ensure that they align with our risk appetite and do not unduly deter investment in the housing sector.
- Financial inclusion is also difficult to influence through a solvency standard, however we do not believe there is anything in the standard that would unduly restrict an insurer from taking a more inclusive approach to the marketing of its services.

Problem definition

Context

What are solvency standards for?

The Reserve Bank uses a combination of measures to increase the likelihood that licensed insurers will, in adversity, be able to meet their obligations to policyholders. These measures include risk management programmes, insurer board oversight, and Reserve Bank supervisory activity and solvency standards.

The particular role of solvency standards is to define a minimum amount of capital that a licensed insurer must hold, providing a buffer against adverse risk events. In this way, solvency standards support the purposes of the Act - to promote the maintenance of a sound and efficient insurance sector and to promote public confidence in the insurance sector (see section 3(1) of the Act).

The presence of capital in excess of regulatory requirements does not, however, guarantee that a licensed insurer will never fail, and members of the public remain responsible for their own decisions relating to insurance (as documented in section 4(d)(ii) of the Act).

The question of whether solvency standards represent an appropriate regulatory response was addressed in a regulatory impact statement issued in 2012, in conjunction with the launch of the original set of solvency standards. This statement accepts that question as settled, and instead looks at the impact of changes relative to the status quo.

Existing solvency standards

Initially, one standard was issued for life insurance business, and another for non-life insurance. These primary standards were adapted from Australian standards prevailing at the time (but since replaced with the LAGIC[1] framework). These documents have been modified from time to time, most recently to deal with the introduction of NZ IFRS 16 – Leases.

Over the years, other standards have been introduced in recognition of special situations. These include insurers in run-off, insurers offering variable annuities and captive insurers. These secondary standards modify the two primary standards to make them suitable for use in the special situation.

All these standards use the NZ GAAP[2] statement of financial position as a starting point for capital measurement. Notably, NZ GAAP currently incorporates NZ IFRS 4 – Insurance Contracts. NZ IFRS 4 is a principles-based standard that includes methods for valuation of insurance contracts that are specific to New Zealand and Australia.

Standards applicable to non-life business apply to the licensed insurer only, while standards applicable to life insurance business generally apply to the licensed insurer, each statutory fund and each 'life fund' outside of the statutory funds.

The standards are used to determine the 'solvency margin' defined in the Act. They also describe the reporting (on solvency and other matters) that each licensed insurer is required to produce.

A full list of in-force standards as at 1 August 2022 is provided in Appendix 1.

Interaction with other regulations

IPSA and the interim solvency standard's compliance with statutory requirements

The solvency standards are secondary legislation authorised under IPSA. IPSA's purpose is to promote the maintenance of a sound and efficient insurance sector and promote public confidence in the insurance sector.

A central prudential requirement under IPSA is that insurers hold sufficient capital (section 19(1)(f) and maintain an appropriate 'solvency margin' (section 21(b)) (including solvency margins for any statutory funds, in the case of life insurers (section 21(c)). Some of the statutory powers contained in IPSA (such as the power to issue directions or to recommend an insurer is placed in liquidation) are also triggered by an insurer's failure to maintain a solvency margin or likely failure to maintain a solvency margin.

The solvency standard sets out how 'sufficient capital' and the 'solvency margin' are to be calculated by each insurer (and some related reporting requirements). IPSA section 55 empowers the Reserve Bank to issue solvency standards and section 56 sets out the scope of those standards. We have ensured that all the elements of the interim solvency standard fall within the scope set out in section 56.

[1] Life And General Insurance Capital
[2] New Zealand Generally Accepted Accounting Practice – a combination of International Financial Reporting Standards with customary New Zealand accounting practice.

The standards apply to most licensed insurers. However, overseas insurers may be exempt from the solvency standard where they are subject to solvency controls and supervision of solvency in their home jurisdiction that is at least as satisfactory as those achieved by the New Zealand solvency standard (IPSA section 59). (Insurers from some jurisdictions are also declared exempt in regulations, empowered by IPSA section 238).

Companies Act 1993

'Solvency' in IPSA is different from the solvency test in the Companies Act, although there is a relationship between the two. Under the Companies Act, a company satisfies the solvency test if

1. the company is able to pay its debts as they become due in the normal course of business; and
2. the value of the company's assets is greater than the value of its liabilities, including contingent liabilities.

The minimum amount of capital required to be held under a solvency standard could be thought of as a buffer to ensure that, after a severe risk event, an insurer is still solvent under the Companies Act (even if it no longer maintains the solvency margin required by IPSA)

NZ IFRS and the Financial Markets Conduct Act 2013

The Interim Solvency Standard builds on insurers' financial balance sheets to determine solvency requirements. Relying on the New Zealand accounting rules where possible reduces compliance costs for insurers and reduces the number of detailed definitions that need to be included in the Interim Solvency Standard.

Under the FMCA, the financial reporting of licensed insurers is required to adhere to the accounting standards (NZ IAS and NZ IFRS) issued by the External Reporting Board. This act also sets deadlines for such reporting to be lodged with the Registrar of Financial Services Providers.

As explained elsewhere in this Regulatory Impact Statement, NZ IFRS 17 (Insurance Contracts) is in the process of replacing NZ IFRS 4, and NZ IFRS 9 (Financial Instruments) is being introduced concurrently. The solvency standards refer to other accounting standards as well, for example NZ IAS 1 and NZ IAS 37.

The problem

Regulatory stewardship

As the author of the solvency standards and the prudential regulator of the insurance industry, it is incumbent on the Reserve Bank to ensure that the solvency standards remain fit for purpose, incorporating emerging best practice and adapting to changes in the external environment.

In recent years, several internal and external reviews have alerted us to potential shortcomings in the standards:

- In 2016-17, the International Monetary Fund conducted a review of New Zealand's financial system. When looking at our insurance sector, they benchmarked our regulation against the Insurance Core Principles published by the International Association of Insurance Supervisors. There were several areas relating to our solvency regime where New Zealand was found to be less than fully compliant:

  - Lack of guidance on discount rates used for valuation of long-term liabilities
  - Lack of a requirement for insurers to assess their own risks
  - Use of a single solvency control level, making early intervention harder
  - Opacity in the use of solvency margin licence conditions
- In May 2019, John Trowbridge and Mary Scholtens QC published their report into the Reserve Bank's supervision of CBL Insurance Ltd, placed into liquidation in November 2018. The Reserve Bank has committed to implementing all the recommendations in this report. The report found the following in respect of the solvency standards:
  - There is insufficient detail regarding allocation of assets to classes, and no power for the Reserve Bank to over-rule insurer allocations.
  - There needs to be a graduated approach to determining capital adequacy.
  - Insurers should prepare and provide detailed 3-year solvency projections.
- A thematic review of the role of the Appointed Actuary found that the Reserve Bank needs to be clearer in its expectations.
- A review of insurer conduct and culture, conducted jointly by the Financial Markets Authority and the Reserve Bank, recommended that insurers report regularly on their progress in improving their culture and promoting good conduct towards customers.
- An external technical review of our proposed approach to solvency regulation was commissioned by the Reserve Bank in 2021. This review recommended, among other things, that we consider insurers' own risk and capital processes as an integral part of the regime.

Alongside these recommendations, our own experience from over a decade of supervising insurers has also provided lessons with respect to the content and form of the solvency standards.

NZ IFRS 17

NZ IFRS 17 is a new accounting standard for insurance contracts, replacing NZ IFRS 4. While it has already been in force for some time, it has mandatory application from 1 January 2023. It is designed to provide a consistent basis for performance reporting internationally, and its insurance valuation methodology has been developed to support this objective. For example, the main valuation method is designed to spread profit recognition over the term of the insurance contract.

However, due to distortions such as profit spreading, NZ IFRS 17 insurance valuations can under-estimate capital and are not necessarily appropriate as a base for solvency calculations. The basis for valuing insurance liabilities for the measurement of solvency capital should recognise the economic value of an insurance contract, as the aim of solvency regimes is to ensure that obligations to policyholders can be fulfilled in adversity.

Continued use of existing solvency standards under NZ IFRS 17 would result in our existing standards no longer working effectively and failing to provide a clear picture of insurer solvency.

Structural issues

In addition to issues generated by the reviews mentioned above, or by the introduction of NZ IFRS 17, several other structural issues have been noted with our existing solvency standards. These include:

- The use of separate primary standards for life insurance and non-life insurance has led to unwarranted inconsistencies between the two, for example:
    - Reinsurance quality requirements applying only to life insurance business
    - Reinsurance documentation requirements applying only to life insurance business
    - Long-term non-life business being valued as if it is short-term
    - Differences in capital factors for the same type of asset
    - Health insurance being classified as long or short-term at insurer discretion
- The use of secondary standards that rely on a primary standard has created some definitional discontinuities and opacity regarding capital requirements.
- The existing life insurance standard provides for solvency requirements to be applied to non-statutory 'life funds', however the Act only clearly mandates application to licensed insurers and their statutory funds.
- The existing standards do not allow for the degree of risk diversification inherent in insurers' business models. This is important as diversification reduces the overall quantum of risk borne by an entity. Risk hierarchies in the existing standards are not supportive of a diversification calculation.

Definition

Summing up the previous paragraphs, the solvency standards require review because

1. the accounting basis underlying them is changing;
2. their structure and application are sub-optimal;
3. Recent regulatory reviews have pointed out shortcomings; and
4. we wish to become more compliant with the Insurance Core Principles

While addressing items 2-4 above is less urgent, item 1 carries an immovable deadline.

Objectives

The problem definition in the previous section points to some of the objectives for the new standard:

- It should work well with NZ IFRS 17, re-using values where possible and revising them where necessary.
- It should align more closely with best practice (as indicated by the Insurance Core Principles)
- It should address the findings of recent regulatory reviews
- It should adhere to the set of principles that were consulted on at the outset of the review.
- In general, standards should support the purposes and principles of IPSA (section 3 and section 4).

Additionally, there are some statutory requirements that need to be complied with when a new solvency standard is introduced:

- The Reserve Bank is required to undertake appropriate consultation (IPSA section 235) and consider whether the standard imposes 'unreasonable' requirements for overseas branches relative to New Zealand incorporated entities or vice versa (IPSA section 55(4))
- When issuing a solvency standard the Board of the Reserve Bank must have regard to the Financial Policy Remit, issued by the Minister of Finance (Reserve Bank of New Zealand Act 2021 section 49(1)(d)

Policy options

Measurement criteria

We will assess the standard against a range of criteria, as follows:

- Does it interface well with NZ IFRS 17?
- Does it implement best practice, as codified by the Insurance Core Principles?
- Does it incorporate the recommendations of recent regulatory reviews?
- Does it abide by the principles established at the commencement of the Solvency Standards Review?
- Has the Reserve Bank had regard to the Financial Policy Remit in the development of the standard?
- Does the standard support the purposes and principles of IPSA?

Detailed assessment criteria are supplied in Appendix 2.

Options

Status quo

The existing solvency standards were first introduced in 2012, and comprehensively updated in 2014. There have been several developments since this time, which favour review of the existing standards as well as their subsequent amendment. The existing standards are authorised by section 55 of IPSA, which allows the Reserve Bank to issue solvency standards that establish the minimum amount of capital required to be held by insurers.

The Reserve Bank currently has several solvency standards on issue with the primary ones being the Solvency Standard for Life Insurance Business 2014 and the Solvency Standard for Non-Life Insurance Business 2014. These solvency standards build off an IFRS 4 balance sheet and specifically look at capital on a financial / performance reporting basis.

Actual solvency capital is a conservative measure determined by deducting from IFRS capital any assets that may suffer devaluation in a wind-up paradigm (for example, goodwill and deferred tax assets). Minimum solvency capital is determined by considering adverse events (other than operational risk) that may change the values of insurance liabilities and investment assets.

Interim standard

In recent years, there have been various reviews containing recommendations for the regulation of solvency in New Zealand. There have also been developments internationally (including Europe's introduction of Solvency II). The Reserve Bank has taken a 'first principles' approach to the development of the Interim Solvency Standard. This has been guided by core principles 14 (Valuation) and 17 (Capital Adequacy) of the IAIS. We have also considered comparator solvency regimes such as Australia and the European Union.

In relation to the measurement of capital, we noted that accounting standards sometimes deviate from realism (for example, because they focus on measuring performance rather than position). In line with IAIS core principle 14, however, the Reserve Bank has taken the view that solvency capital is best measured on an objective, realistic and economic basis that will deliver more consistency across insurers. The Interim Solvency Standard thus begins with an NZ IFRS balance sheet but then adjusts it to a 'Standardised' balance sheet.

The prescribed capital requirement is then determined by taking the 'Standardised' (economic) balance sheet and applying certain 'stresses' on assets and liabilities to get to a 'Stressed' balance sheet. The standardised balance sheet is stressed in line with the standard's risk appetite and the difference in the stressed and standardised scenarios is represented in the risk capital charges.

We have also made changes to the reporting required under the Interim Solvency Standard:

- The Financial Condition report is required to specifically comment on conduct and outsourcing risk.
- Reporting on some redundant reinsurance scenarios has been removed.
- 'Half-yearly' solvency reporting obligations have been changed to 'interim' reporting obligations to allow for other frequencies.

Fully developed standard

Another option would be to further develop the Interim Solvency Standard to include several elements that are not yet fully reflected.

ICP 17 prescribes what is known as a 'total balance sheet approach' to the determination of the prescribed capital requirement. Under such an approach, solvency shocks (for example, a pandemic, falls in asset values or a cyber-attack) are applied to every item on the balance sheet rather than just the primary item that may be affected. This enables capture of interactions between asset and liability values as well as capture of secondary effects (for example, higher lapses triggered by weak economic conditions). The Interim Solvency Standard has some elements of the total balance sheet approach, but the treatment is partial.

The methods used to determine capital charges under the Interim Solvency Standard have been largely adopted from earlier standards and do not necessarily represent best practice internationally. A fully developed standard would include methods updated to reflect emerging practice around the world.

Similarly, the parameters used in the Interim Solvency Standard have been brought in from the existing standards and the earlier documents they were based on. We do not have full confidence that they align with the 1-in-200 risk criterion that is our target for most charges. Under this option, the misalignment would be addressed.

While the Interim Solvency Standard has multiple solvency control levels, the lower level 'minimum capital requirement' has not yet been calibrated to the level at which we believe an insurer should be placed in resolution. A fully developed standard would address this deficiency.

A further weakness of the Interim Solvency Standard is that it does not provide a benefit to insurers that have diverse risks. Capital charges are simply added and correlations between risk events are not considered. This results in undiversified insurers being treated too leniently, a situation which a fully developed standard would address.

A fully developed standard of this nature is what we are aiming to deliver at the end of stage 2 of the Solvency Standards Review, however it requires significant additional work and consultation, and cannot be put in place in time for the introduction of NZ IFRS 17.

Assessment of options against measurement criteria

The following sections describe how the measurement framework and reporting options perform against the measurement criteria at a high level. A detailed assessment of the *preferred* options against the measurement criteria is supplied in Appendix 2.

Objective	Status Quo	Interim Standard	Fully developed
Support for NZ IFRS 17	The standards interface poorly, with unpredictable capital outcomes.	NZ IFRS 17 items and methods are used where possible, and the standards interface well.	Support would be unnecessary but dual accounting would be required.

Objective	Status Quo	Interim Standard	Fully developed
Closer compliance with ICPs / best practice	The current standards are only partially complaint with ICP 14 (valuation) and ICP 17 (capital adequacy)	The standard is compliant with ICP 14 and largely compliant with ICP 17.	A total balance sheet approach would be fully compliant with both ICPs.
Fulfilment of regulatory review recommendations	The existing standards do not incorporate any of the recommend-ations from the reviews.	The standard incorporates most of the recommendations (except the ladder of intervention and the own risk assessment)	This approach would address all of the recommendations (but would require deeper consultation and more time to implement).
Compliance with review principles	The current standards comply with most of the review principles, but not all (for example, 'substance over form', 'international comparability' and 'consistency'.	All the principles have informed development of the standard.	All the principles would inform development of this standard.
Promotion of Financial Policy Remit (For further detail, see the dedicated sections on the remit at page 4 above and Appendix 2 below)	The existing standards impact many matters raised in the remit.	We had regard to all aspects of the remit in preparing the standard. The standard impacts many matters raised in the remit.	We would have regard to all aspects of the remit in preparing the standard. This standard would impact most matters raised in the remit.
Compliance with the purposes & principles of IPSA	The existing standards support (or at least do not impede) the purposes and principles of IPSA.	The standard will more strongly support the purposes and principles of IPSA, for example 'soundness', 'disclosure' and 'distress management'.	This standard would most strongly support the purposes and principles of IPSA.

Preferred option – the Interim Standard

Rationale for choosing this option

We have chosen the option of implementing the Interim Solvency Standard as it was the most appropriate given the short timeframe and the impending implementation of the NZ IFRS 17 accounting standard. Insurers will be able to introduce this standard at the same time as NZ IFRS 17 and digest this change before moving on to other potential changes in the solvency regime. The Interim Solvency Standard also makes progress towards addressing other issues, such as alignment with ICPs and fulfilment of regulatory review recommendations

Maintaining the status quo in an NZ IFRS 17 environment would produce distortions and would not support supervisory objectives. It is therefore not a realistic option.

Implementing all the changes under the 'fully developed standard' would be desirable but is impossible given the time constraints related to NZ IFRS 17 and the need for an IPSA amendment in order to fully implement multiple solvency control levels.

Statutory compliance

The Interim Solvency Standard meets all the relevant statutory requirements for a solvency standard.

IPSA's statutory purposes and principles were considered throughout the policy process (see Appendix 2 for further detail).

While most of the development of the Interim Solvency Standard was conducted under the Reserve Bank Act 1989, the standard aligns well with the Financial Policy Remit issued under section 203 of the Reserve Bank of New Zealand Act 2021.

In particular, the new standard sets a low appetite for insurer failure (one in two hundred years) and imposes costs on industry that are proportionate to risks and benefits. It encourages the sustainable growth of the economy by promoting a sound insurance sector and securing its role as a catalyst for economic activity. Failed entities are expected to retain sufficient assets that their business can be resolved with minimal detriment to consumers. For a fuller assessment, see Appendix 2.

IPSA section 235 says that the Bank must not issue a solvency standard unless it has consulted with persons that will be substantially affected by the standard, those persons have had a reasonable opportunity to comment, and the Bank has considered their comments. We detail the consultation process that went into producing the standard in a separate section below.

In terms of compliance with section 235, we note that there were wide-ranging opportunities for stakeholder feedback. After each consultation round we considered feedback carefully and published a feedback statement, summarising the feedback and setting out a Reserve Bank response. We also made significant changes to the standard following feedback on the exposure draft.

IPSA section 55(4) requires the Reserve Bank to have regard to whether differences between the proposed solvency standards and relevant overseas standards affect any insurer 'in an unreasonable manner'. Insurers may experience differences depending on whether they are incorporated in New Zealand or some other jurisdiction and the relative application of solvency standards to those insurers.

Overseas insurers can decide whether to operate in New Zealand as branches of their home company (that is, with no separate legal personality in New Zealand) or as incorporated subsidiaries. Most overseas branches are currently exempt from New Zealand solvency requirements (under exemption powers authorised by IPSA section 59), so long as their home regulator's rules for solvency and supervision of solvency are 'at least as satisfactory' as those in New Zealand. Instead, they are subject to their home jurisdiction solvency rules. Section 55(4) was therefore motivated by fairness and competitiveness concerns.

It is not possible to ensure that there are no differences between the New Zealand solvency standard and those of the home jurisdictions of all branches, since the solvency requirements of overseas jurisdictions vary among themselves. The wording 'in an unreasonable manner' must therefore mean that the comparison is to be made in broad terms.

In developing the Interim Solvency Standard, we have had particular regard to solvency standards in Australia and Europe and to the International Association of Insurance Supervisors' Insurance Capital Standard. We have also considered standards in other jurisdictions that are the home jurisdiction of a current New Zealand branch. The solvency standard's 1-in-200 risk appetite is in line with international practice. The 1-in-1000 year risk appetite for seismic risk is more conservative than most other jurisdictions but, given its importance in the New Zealand economy, the difference is not 'unreasonable'.

Additionally, the Interim Solvency Standard makes relatively little difference to capital requirements (see the 'Marginal Benefits and Costs' section below). Where there are changes, these generally bring the solvency standard into closer alignment with international standards, for example by introducing an operational risk charge.

Marginal benefits and costs of the preferred option

Marginal costs of the preferred option, compared to taking no action

Affected Groups	Comment	Impact	Evidence certainty
All insurers	The measurement basis is changing to economic value. An operational risk charge is being gradually introduced. Some methodology is changing.	Solvency ratios are likely to decline (but financial strength is unaffected). There is likely to be a small decrease in solvency margins. Some increased compliance costs.	Good (Based on our QIA)
Life insurers	Risk adjustments are being included in liabilities to correct them to market value. Life insurers with health business are being brought onto the same basis as dedicated health insurers.	Solvency margins and ratios will decrease. Some insurers may seek injections of capital to restore their margins. Solvency margins and ratios will decrease. Some insurers may seek injections of capital to restore their margins.	Good
Reserve Bank		None	Good
Policyholders		Very low indirect costs passed on from insurers	Good

Affected Groups	Comment	Impact	Evidence certainty
Other market participants		None	Good

Marginal benefits of the preferred option compared to taking no action

Affected groups	Comment	Impact	Evidence certainty
Insurers	Advantages due to the impact of enhanced transparency on investor comfort. ISS will be compatible with new IFRS17 accounting rules	Low	Good
Reserve Bank		High (significant cost avoided), since failure to replace the solvency standard would undermine our supervision of insurers and our ability to satisfy the purposes of IPSA.	Good
Policyholders	Some greater assurance through increased requirements (operational risk charge, tighter reinsurance requirements and the like)	Low on average but potentially significant for some policyholders (if, for example, more supervisory and insurer scrutiny of reinsurance contracts prevented an insurer failure).	Good
Policyholders and other market participants		Greater transparency about insurer financial condition, allowing improved market discipline	Good

In the sections that follow, we will explore these impacts in more detail.

Impact on insurer capital requirements

We have run two quantitative impact assessments to gauge the likely financial effects of the Interim Solvency Standard:

1. July 2021, based on the exposure draft of the standard that was published in that month; and
2. May 2022, based on the version of the standard that was prepared for legal and technical review, and subsequently published.

For each assessment, we asked insurers to determine their solvency position based on both the current standard (using the existing Solvency Return) and the Interim Solvency Standard (using a new template designed for the purpose). Participation in the assessments was voluntary, however we still managed to achieve a reasonable spread among industry sub-sectors.

Participants were generally happy with the template provided, although the treatment of taxation led to some misunderstanding. This was because various approaches are effectively allowed under existing standards, while the Interim Solvency Standard requires insurers to determine capital charges net of tax effects.

Solvency Margins

The solvency margin is the amount by which solvency capital exceeds the prescribed capital requirement. Typically, insurers are required to have solvency margins greater than zero.

The results of the assessments show that life insurers have undergone the greatest movements in solvency margins.

1. The July 2021 assessment was performed based on an exposure draft that inadvertently double-counted an element of capital requirements; in the May 2022 version of the standard this effect had been removed.

2. Life insurance liabilities now include a risk adjustment; this has reduced solvency margins.

Solvency margins for the health and general insurance sub-sectors have been more stable.

Solvency Ratios

The solvency ratio is the solvency capital divided by the prescribed capital requirement. Unlike the solvency margin, the solvency ratio automatically scales to the size of the business and hence is a key (and comparable) measure of financial strength.

The table below provides solvency ratio information for insurers that participated in the July 2021 assessment.

Solvency ratios calculated using the Interim Solvency Standard are generally lower. Solvency capital is now determined on an economic basis without deduction of intangible items that have value on a going concern basis. These items are now added to the prescribed capital requirement, meaning that the numerator and denominator of the solvency ratio increase by the same amount, and the solvency ratio decreases.

For health insurers, this effect is especially acute. As well as the change in the treatment of deductions, some health insurers are also moving from a short-term to a long-term valuation basis, which further inflates both capital measures.

In general, the decline in solvency ratios simply indicates a change in basis, for example the replacement of deductions from capital with capital charges.. For life insurers, however, part of the decline is due to the introduction of risk adjustments. In any case these changes do not reflect a substantive deterioration in financial position.

Summary

Among the participants in the larger July 2021 exercise, we had the following overall results relative to the existing standards. (Note that these results are after adjustments to remove the capital charge double counting mentioned in the 'Solvency Margins' section above, and include the full operational risk charge.).

	General Insurers	Health Insurers	Life Insurers	Total
Increase in Capital Resources	$220m (+28%)	$126m (+21%)	$1,245m (+118%)	$1,591m (+65%)
Increase in Capital Requirements	$163m (+50%)	$141m (+81%)	$1,317m (+194%)	$1,621m (+151%)
Increase in Solvency Margin	$57m	-$15m	-$72m	-$30m

We are comfortable with the capital impacts observed, although recognise that there will need to be careful public communication with respect to the reductions in solvency ratios. Reserve Bank supervisors will also need to be aware of the changes so they can supervise effectively to the newly re-based ratios.

We think the changes in measured solvency levels can mainly be absorbed by insurers within their current surplus capital. Some insurers may decide to increase their capital level as needed to meet their own internal management buffers. We will monitor how they respond to the changes and use this information to inform the detailed review of the Standard in stage 2 of the Review.

Other stakeholder impacts

Other than the capital effects described in the previous section, the main impact on insurers is likely to relate to process complexity. In some areas, some insurers may be required to use more complex methods than those required under the existing standards, for example:

- Some non-life insurers currently use conservative (but simple) valuations of 'premium liabilities.' The Interim Solvency Standard ask insurers to move away from overly conservative valuation approaches, meaning that some insurers may have to adopt more complex methods.
- Some insurers with health business currently apply the non-life standard to health insurance, with the result that simpler approaches can be used. The Interim Solvency Standard may require some of this business to be viewed as long-term, and valued and capital-charged using projection methods.

Another impact on stakeholders is likely to relate to use of the new capital measures. Solvency ratios are likely to be lower than those under the existing standards, as both solvency capital and prescribed capital requirement will increase over their current analogues. Furthermore, a minimum capital requirement is being introduced for the first time. Reserve Bank supervisors, rating agency analysts and insurer capital managers will need to adapt their targets to the new standard and develop an understanding of the new measures.

The Reserve Bank should benefit from the greater transparency the new standard should bring, as

- a streamlined risk hierarchy will allow for better separation and understanding of individual risks; and
- new reporting obligations will provide more timely observations of solvency, more detailed projections and insight into conduct and outsourcing risks.

Policyholders may see moderate impacts in premium rates. This is because changes to the prescribed capital requirement may also change the insurer's cost of capital, and this may flow through to the pricing of insurance products. Policyholder security will be improved, however, through

- the imposition of reinsurance quality requirements on non-life insurers;
- the inclusion of an operational risk charge; and
- the use of risk-adjusted values for life insurance liabilities.

Delivering the preferred options

Implementation

The standard

The standard is largely self-implementing in that it is a set of rules that insurers need to follow. The main task for the Reserve Bank is to ensure that appropriate mechanisms are in place for insurers to submit their data returns, based on the new standard. This process is under way and systems will be in place before the standard comes into force.

We will also provide insurers with guidance on interpreting and applying the standard, including information on how it differs from the previous standards.

Application to insurers

The standard will apply to insurers from their first annual reporting date following 1st January 2023, which will vary between insurers.

Existing standards

The existing standards will remain in place for a transition period to ensure that insurers still reporting under NZ IFRS 4 will remain subject to solvency requirements. We expect to be able to rescind these standards in 2024.

Monitoring and evaluation

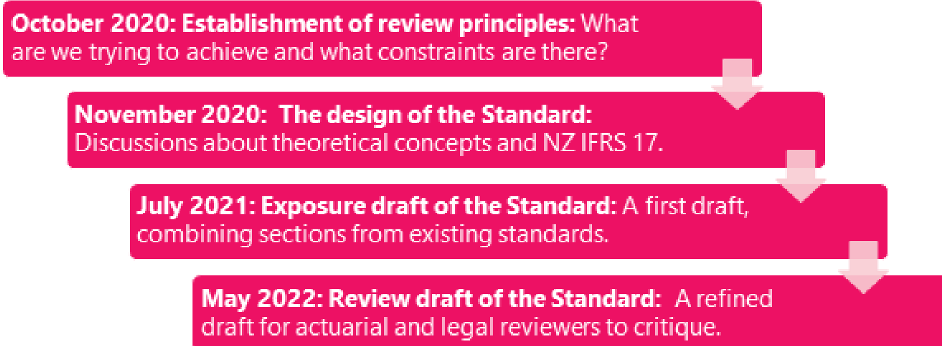
Insurers will provide us with solvency information through their regular solvency returns. These will enable us to further monitor changes in insurer capital (and the cost of that capital) as part of our regular supervision of the New Zealand insurance sector. Insurers will also be able to provide feedback on any issues they are having with the standard through their supervisors.

Once the Interim Solvency Standard is in place, we will be undertaking a second stage of review of the solvency standard, which will look particularly at how our capital charges operate and the degree to which they are calibrated to the risk appetite stated in the solvency standard. We will be in close contact with insurers and their industry associations throughout the policy process. We will conduct further quantitative impact assessments and insurers will be given opportunities to let us know about any difficulties they are having with using the standard.

Consultation

Consultation cycles

The process of developing the Interim Solvency Standard involved several consultation cycles.



These consultations enabled us to obtain stakeholder feedback throughout the policy development process. Each consultation provided opportunities for all stakeholders to have input (as detailed below). We collated and analysed the feedback given and produced a feedback statement for each of the first three consultations. This process has fulfilled our statutory requirements under section 235 of IPSA.

Modes of consultation

For each consultation, we released a formal consultation document, inviting submissions. Publication on the Reserve Bank's website was accompanied by a press release to alert stakeholders to the consultation. We also held a public webinar for each consultation.

We held many bilateral meetings with insurers and other market participants such as actuaries, rating agencies, and catastrophe modellers.

We held regular meetings with technical working groups of the two main insurance industry associations (the Insurance Council of New Zealand and the Financial Services Council) and the New Zealand Society of Actuaries throughout the policy process, enabling very granular engagement on specific technical issues.

We also held a series of public focus groups to gauge the New Zealand public's risk appetite for insurance failure at a high level.

Stakeholder feedback

Stakeholders are broadly comfortable with the overall structural changes, although some non-life insurers wished to retain something like the existing non-life standard due to its simplified approaches. There was general support for the way the standard addresses NZ IFRS 17 and the move to a more logical risk hierarchy.

When we published the first draft of the standard in July 2021, insurers quickly brought to our attention three issues of major import:

- That the initial planned implementation date of 1 January 2022 would be unworkable, both because the sector needed more preparation time and because it would require an NZ IFRS 17-optimised standard to work with NZ IFRS 4 for a year or so. We subsequently moved the implementation date to 1 January 2023.
- That there was some unintended doubling up between two of the capital charges for life insurers. The interest rate risk charge was subsequently modified to eliminate the additional charge.
- The 'cliff effect' that introduction of the operational risk capital charge would have (additional capital of around 3% of premium for most insurers). We subsequently modified the text such that the charge phases in over four years.

More recently, the Reserve Bank and industry working groups have been working through matters such as:

- definitions in the catastrophe insurance risk capital charge;
- the nature of the 'likelihood test' for financial reinsurance;
- consistency in the treatment of long and short-term health insurance business; and
- the impact of taxation.

Appendices

Appendix 1 – In-force solvency standards as at 1 August 2022

Title	Issued	Amended
Solvency Standard for Life Insurance Business 2014 (incorporating amendments to November 2018)	17 December 2014	23 November 2018
Solvency Standard for Non-life Insurance Business 2014 (incorporating amendments to November 2018)	17 December 2014	23 November 2018
Solvency Standard for Captive Insurers Transacting Non-life Insurance Business 2014	17 December 2014	
Solvency Standard for Non-life Insurance Business in Run-off 2014	17 December 2014	
Solvency Standard for Variable Annuity Business 2015	10 April 2015	

Appendix 2 – Detailed assessment of the Interim Solvency Standard

Support for IFRS 17

Topic	Description	Treatment in new standard
Re-use	The ability to re-use items from the IFRS balance sheet, and to re-use IFRS 17 methods, thus simplifying insurer reporting processes and reducing their cost.	The standard re-uses many NZ IFRS 17 items, for example assets valued under NZ IFRS 9. It also uses modified versions of NZ IFRS 17 valuation methods.
Effectiveness	The degree to which the interface between IFRS and the solvency standard allows for achievement of the objectives of the solvency standard.	Use of NZ IFRS accounts (including NZ IFRS 17) as a base for solvency calculations will not detract from meeting the objectives of the solvency standard.

Closer compliance with ICPs

Topic	Description	Treatment in new standard
Capital measures	ICP 14 requires economic valuation of balance sheet items, including compensation for risk. Insurance items should be valued on a probability-weighted discounted cash-flow basis.	The new standard has a strong focus on unbiased economic value and extends the use of risk adjustments to life insurance. It uses probability-weighted discounted cash-flow bases (or suitable approximations).
Prescribed capital	ICP 17 requires supervisors to establish capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention.	The standard provides for capital to be set aside to cover losses under severe stress (although this requires further calibration). The standard foreshadows a ladder of supervisory intervention, to be fully implemented once IPSA is amended.

Recent regulatory reviews

Topic	Description	Treatment in new standard
Discount rates	Guidance should be provided on discount rates used for valuation of long-term liabilities.	The new standard mainly requires the use of risk-free rates and identifies the Reserve Bank website as the source. An algorithm is supplied to determine discount rates for very long-dated cash-flows.
Own risk assessment	Insurers should be required to assess their own risks and manage their capital accordingly.	The new standard does not address this requirement, however a mandated 'risk and capital process' is planned as part of stage 2 of the Solvency Standards Review.
Ladder of intervention	There needs to be a graduated approach to determining capital adequacy, with multiple solvency control levels unlocking supervisory powers.	The new standard includes both 'prescribed' and 'minimum' capital requirements, however the latter can only be used as a supervisory guide until IPSA is amended.
Licence conditions	Solvency margin licence conditions should be established using a transparent process.	Stage 2 of the Solvency Standards Review will provide a framework for the establishment of 'supervisory adjustments' that are a formal part of the solvency margin calculation.
Asset classes	There is insufficient detail regarding allocation of assets to classes, and no power for the Reserve Bank to over-rule insurer allocations.	A new category has been added for tax assets, however the power to overrule insurer allocations may require an IPSA amendment.
Detailed projections	Insurers should prepare and provide detailed 3-year solvency projections.	The standard requires more detail to be provided in the Financial Condition Report, and solvency return templates will be amended to ensure full projections are provided.
Clear expectations	The Reserve Bank needs to be clearer in its expectations of Appointed Actuaries.	The standard makes it clear that Appointed Actuaries can rely on other experts in certain situations.
Conduct reporting	Insurers should report regularly on their progress in improving their culture and promoting good conduct towards customers	The standard requires that the Appointed Actuary report on the conduct environment in the Financial Condition Report.

Review principles

Topic	Description	Treatment in new standard
Substance over form	We take a substance over form approach and tailor our requirements to New Zealand.	The standard uses economic rather than book value and has adopted a prescriptive approach accessible to smaller insurers.
International comparability	We will have regard to international comparability, particularly LAGIC, Solvency II, the ICS and the ICPs, with the caveat that principle number 1 will take precedence.	The new standard has had regard to solvency regimes in Europe and Australia and seeks to improve compliance with the Insurance Core Principles of the International Association of Insurance Supervisors.
Quality of capital	Capital must be of sufficient quality to enable insurers to meet obligations to policyholders in a range of adverse scenarios.	Capital quality requirements and reinsurance quality requirements have been brought in from the current standards.
Quantity of capital	The quantum of capital requirements should be set in relation to material risks that may impact the insurer's balance sheet ability to meet its obligations to policyholders.	Minimum capital is established in proportion to the risks an insurer's business model presents, calibrated to an appetite for insurer failure of 0.5%. (note that there is more work to be done in this area).
Consistency	Insurers should be subject to consistent methods and consistent assumptions in determining capital requirements.	All insurers will be subject to the same standard and allowances for judgment have been restricted.
NZ-specific	Capital requirements of New Zealand insurers should reflect a risk-based approach, taking into account the risks that are specific to New Zealand, the nature of the New Zealand market, and the Reserve Bank's regulatory approach.	The standard is simpler than many overseas approaches, recognising the nature and scale of our insurance entities.
Efficiency	The solvency framework should be practical to administer and minimise unnecessary complexity and compliance costs.	We have sought to allow approximations where these ease the burden on insurers without undermining the aims of the Standard.
Transparency	The solvency framework should be transparent to enable effective market discipline.	There has been significant engagement with industry to ensure the Standard is well-understood.

Financial policy remit

Topic	Description	Treatment in new standard
Low appetite for failure	The Government desires a low incidence of failure of entities regulated by the Reserve Bank.	The standard aims for a one-in-two-hundred chance of failure in a calendar year.
Proportionate costs	Regulatory and supervisory costs should be proportionate to the expected risks and benefits to the financial system and society.	Capital charges in the standard are proportionate to the risks present on insurer balance sheets. Materiality is a function of an insurer's scale.
Investment & innovation	New investment and financial innovation that raise the productive potential of the economy should be encouraged.	The standard aligns with international approaches, does not require excessive capital levels and is easy to comply with.
Sustainable growth	Financial resources should be allocated in a way that maximises the sustainable long-term growth of the New Zealand economy	Capital charges in the standard are proportionate to the risks present on insurer balance sheets. A sound insurance industry acts as a catalyst for economic activity.
Minimised costs of failure	Failure of an entity is expected to be managed in a manner that minimises the costs of failure and disruption to the broader economy, and prioritises consumers and public funds.	The standard is designed in such a way that a solvency shock should not reduce the value of assets below the level necessary to allow the orderly resolution of the insurer.
Sustainable house prices	Improve affordability for first home buyers by supporting more sustainable house prices.	Housing assets and mortgage loans are assigned capital factors proportionate to the risk they contribute to insurers.
Climate change	The financial system should support community wellbeing and resilience as it responds to climate transition and increases in underlying risks.	The risk and capital process planned for stage 2 of the Solvency Standards Review will include the preparation of long-term climate change scenarios.
Financial inclusion	The Government wants to support access to financial services by rural communities, disabled persons, low-income individuals, and small businesses.	The standard has minimum capital levels that are relatively low by international standards. This supports the development of players able to serve niche markets.
Cyber resilience	The Government's aim is for New Zealand to be confident and secure in the digital world.	In stage 2 of the Solvency Standards Review, insurers will be asked to assess cyber risk as part of the process of determining the operational risk charge.

Purposes and principles of IPSA

Topic	Treatment in new standard
Purposes	
Soundness	The standard aims to ensure that insurers have sufficient capital to meet policyholder obligations in adversity.
Efficiency	The standard takes simpler approaches than some international comparators and make provision for the reasonable use of approximations.
Public confidence	The existence of solvency buffers will give the public more confidence that insurers will meet their obligations.
Principles	
The importance of insurance to members of the public in terms of their personal or business risk management.	The standard supports the undertaking of many forms of insurance.
The sustainability of the New Zealand insurance market.	The standard promotes sustainability by requiring capital to be held as a buffer against future adversity.
Dealing with insurers in distress in a manner that protects the interests of the public, the interests of policyholders, the financial system, and the NZ economy.	The standard is designed to facilitate the successful resolution of insurance businesses after a solvency shock, meeting obligations to policyholders and providing for the orderly wind-up of insurers.
The Act cannot eliminate all failure and members of the public are responsible for their own decisions.	The standard does not restrict the nature of risk that can be accepted by insurers.
The public should be provided with adequate information to make their own decisions.	The standard requires publication of solvency information and actuarial certification of certain information in financial statements.
Similar institutions should be treated consistently.	A single standard with common provisions will be applied to all non-exempt insurers.
Competition should be maintained.	The standard provides a fair and transparent basis for establishing regulatory capital.
Unnecessary compliance costs should be avoided.	The standard allows for cost reduction using approximations and simplifications.
Insurers should be soundly governed and exercise effective risk management.	The standard determines required capital based on risk, providing and incentive to insurers to understand, mitigate and/or reduce risk.

Appendix 3 – Quality Assurance

Quality Assurance	
Reviewing agency:	Reserve Bank
Panel assessment and comment	The regulatory impact statement for the Interim Solvency Standard has been reviewed by two Reserve Bank staff and, after reflecting feedback received, meets the quality assurance criteria.