Addendum to the Regulatory Impact Statement – Interim Solvency Standard

12 December 2024

Reserve Bank of New Zealand
Te Pūtea Matua

Contents

Glossary

GMM	NZ IFRS 17 General Measurement Model
IAIS	International Association of Insurance Supervisors
ICPs	IAIS Insurance Core Principles
In-force Standard	Interim Solvency Standard 2023 after the First Amendment
IPSA	Insurance (Prudential Supervision) Act 2010
NZ IFRS 17	The incoming financial reporting standard for insurance contracts, issued by the External Reporting Board for application in New Zealand
PAA	The NZ IFRS 17 Premium Allocation Approach
Reserve Bank	Reserve Bank of New Zealand
RIS	Regulatory Impact Statement - Interim Solvency Standard 2023, published in October 2022
The First Amendment	Interim Solvency Standard Amendment Standard 2023
The Second Amendment	Interim Solvency Standard Amendment Standard 2024
The Standard	Interim Solvency Standard 2023 (all versions)
The Solvency Review	The review of the insurance solvency standards by the Reserve Bank
UWRCC	Underwriting risk capital charge

Introduction

Context

1. The Reserve Bank of New Zealand (**Reserve Bank**) is the prudential regulator and supervisor of the insurance sector in New Zealand under the Insurance (Prudential Supervision) Act 2010 (**IPSA**). As part of its regulatory role, the Reserve Bank issues solvency standards under the IPSA[1] which are applied to insurers via conditions of licence.

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

3. In October 2020, we announced the start of a review of our insurance solvency standards (**Solvency Review**) alongside a review of the IPSA.[2] The first stage of the Solvency Review, which addressed structural changes and other issues that required immediate attention (including the introduction of NZ IFRS 17, the new accounting standard for insurance contracts), resulted in the introduction of the Interim Solvency Standard 2023 (the **Standard**). The Standard came into force on 1 January 2023. We also published a Regulatory Impact Statement (**RIS**) which described the policy process we followed and the likely impacts of the policy.

4. The Standard was amended in June 2023 to address certain minor matters[3] (the **First Amendment**).

5. The Reserve Bank subsequently became aware of issues in the operation of the Standard, partly due to differing interpretations of NZ IFRS17 and the Standard itself.[4] Some of these issues are documented in letters received from the Insurance Council of New Zealand and the New Zealand Society of Actuaries (NZSA). Other issues have arisen from discussion with individual insurers and from the observations of Reserve Bank staff.

6. On 27 September 2023, we released a consultation paper discussing how we might address errors and ambiguity and proposing a Second Amendment of the Interim Solvency Standard. Owing to the depth of feedback and the complexity of the Standard, we decided to commission an external review which concluded in June 2024. We also consulted on a revised exposure draft of the second amendment between 6 August and 17 September 2024. We received a lot of valuable stakeholder feedback in both of our consultations and through the external review and have taken a lot of this feedback on board.

7. This Addendum to the RIS updates the impact statement to account for changes contained in the Second Amendment consultations, subsequent feedback and final decisions on the Second Amendment. The addendum is complementary to the RIS and should be read together with that document. It is structured largely following the RIS and focuses on highlighting only changes to that RIS as a result of the Second Amendment. It does not reprise assessments in the RIS that remain unchanged, nor cover the full detail of the changes proposed in the

1 Section 55 of the IPSA.
2 See more information about the IPSA Review here: 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
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.

Second Amendment consultation paper. Readers who are interested in the latter should refer to the consultation documentation and feedback statements on the Reserve Bank's website.

8. The Second Amendment does not replace the Stage 2 work on the Standard described in the RIS.

Problem Definition

9. The RIS laid out the problem the Standard was aiming to address in a number of areas, including:
    - The changing accounting basis underlying relevant standards.
    - Sub-optimal structure and application of prior standards.
    - Shortcomings pointed out in regulatory reviews.
    - Increased focus on compliance with ICPs.
10. However, the initial version of the Standard had a number of technical issues, relating to, for example:
    - The inadmissibility of deferred reinsurance expense assets.
    - The under-specification of the underwriting risk and credit risk capital charges.
    - Misalignment between valuation methods.

Policy Options

Options

11. The preferred option described in the RIS was to introduce the Standard. Similarly, the option being considered here is whether or not to introduce the Second Amendment to the Standard.
12. The Second Amendment proposals aim to correct some issues with the in-force Standard and reduce ambiguity for matters that fall within the scope of Stage 1 of the Review. The proposals consulted on in the Second Amendment consultation paper were presented as a list of changes to clauses. In many cases these were accepted, rejected or adjusted, or deferred to Stage 2 of the Review, depending on stakeholder feedback and their fit with the objectives (measurement criteria) laid out in the RIS.

Costs and Benefits

13. The second amendment of the ISS does not introduce new policy or require an increase in capital requirements beyond what was intended when the ISS was first issued. Instead, this amendment aims to restore the original policy intent of the ISS. Therefore, the costs and benefits of the Standard remain largely as described in the RIS. The impacts on capital requirements and solvency margins are set out in the summary table on page 18 of the RIS. In summary, our assessment was that changes in measured solvency levels following the introduction of the Interim Solvency Standard could mainly be absorbed by insurers within

their current surplus capital. Our Quantitative Impact Assessment found that solvency margins were likely to increase for general insurers but fall for health and life insurers.

14. However, because the in-force version of the standard did not fully implement the policy intent, the Second Amendment will have an impact relative to the in-force version of the standard. In aggregate, the changes in the second amendment will increase the amount of capital some insurers must hold relative to the in-force Standard. This is to be expected given the amendment is addressing issues which unintentionally allowed insurers to hold too little capital. However, in practice, we expect that insurers have maintained capital at levels appropriate to the original intent of the standard and will not have to raise more capital to respond to this amendment.

15. In aggregate, we expect the benefits of issuing the second amendment to outweigh the costs:

    - The main costs of issuing the second amendment are some administrative and compliance costs – both for industry and Reserve Bank. We expect these costs to be relatively small, and somewhat offset by the changes we have made to improve the clarity of the Standard.

    - The main benefits of issuing the second amendment are to address weaknesses in the in-force standard and ensure that our effective appetite for insurer failure is restored to the level originally intended. This is a significant benefit – as a failure to restore the solvency standard would undermine our supervision of insurers and our ability to satisfy the purposes of IPSA.

Impact of the Second Amendment relative to the in-force Standard on insurer's solvency margins

16. We expect insurers have maintained their capital positions in expectation of the issuance of the second amendment and the restoration of the policy intent of the ISS. Nevertheless, the Second Amendment includes a number of improvements to the Standard that will have an impact on the determination of an insurer's solvency margins – which is the insurer's free capital above regulatory requirements.

17. This section summarises the impact of the second amendment, relative to the in-force standard, on solvency margins – given solvency margins an important metric used by the Reserve Bank and market participants. The most significant include:

    - Re-basing the underwriting risk capital charge (UWRCC) to fully reflect pricing risks.

    - Insurers being allowed to fully recognise deferred reinsurance expense assets (DREA).

    - Reinstating credit risk capital charges on interest-sensitive assets (CROISA).

    - Changes to 'contract boundaries' which govern the insurance cashflows valued (CB).

18. The impact of these changes on each insurer's solvency margin will depend on a range of idiosyncratic factors, for example:

    - The proportion of premiums payable modally rather than annually.

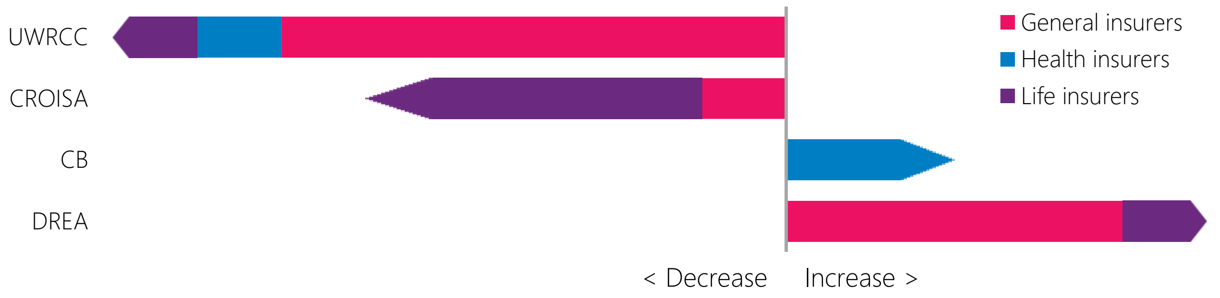
    - Whether reinsurance has been contracted for business not yet written.

- The degree of an insurer's exposure to debt securities.
- The profitability of an insurer's long-term insurance business

19. We were not able to do a more detailed quantitative analysis of the impacts of the second amendment owing to limitations in the data we collect and the impact on data quality resulting from the transition to NZ IFRS 17. We elected not to undertake a full quantitative impact assessment as part of the second amendment, because we undertook two rounds of impact assessments as part of the original ISS development; since the second amendment is aimed at restoring the policy intent of the original ISS, we do not consider that the benefits of undertaking further quantitative impact assessments would outweigh the costs on industry.

20. In the graphic below, we have provided an illustrative view of the likely aggregate impacts on solvency margins across the sector, relative to the in-force Standard. We have also summarised how the second amendment that will increase and decrease solvency margins relative to the in-force Standard in the tables below.

Expected change in solvency margin from each source (illustrative):



Factors that will decrease solvency margins relative to the in-force Standard

Affected groups	Likely impact	Evidence certainty
Life insurers	We expect a moderate decrease in solvency margins due to capital-charging of interest-sensitive bonds.	Good
General insurers	Significant decrease in solvency margins due to re-basing of underwriting risk capital charge.	Good

Factors that will increase solvency margins relative to the in-force Standard

Affected groups	Likely impact	Evidence certainty
General Insurers	We expect a moderate increase in solvency margins due to the admissibility of deferred reinsurance expense assets.	Good
Health insurers	We expect a moderate increase in solvency margins from moving to a long-term valuation approach and being able to recognise future profits as capital.	Moderate

Issues consulted on

Major issues consulted on

21. We briefly outline how we addressed the most significant issues that we consulted on as part of the Second Amendment. For more detail, please refer to the published submissions, and our Feedback Statement.

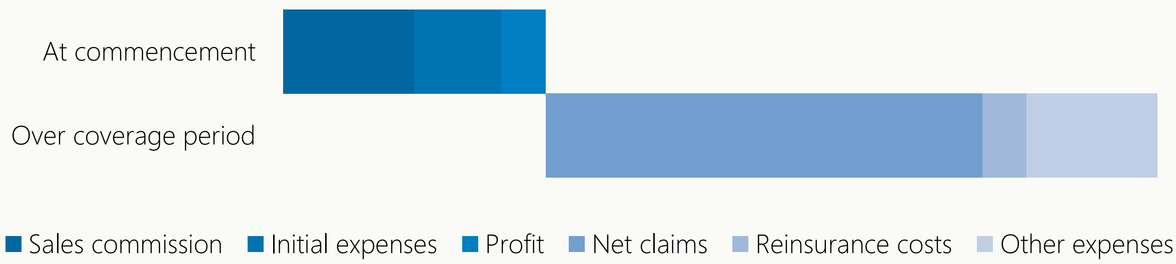
Underwriting risk capital charge

22. The UWRCC requires capital to be held against the risk of under-pricing of short-term insurance products. It is determined by applying a factor to a base amount.

23. In previous versions of the standard, the base amount was drawn from IFRS financial statements, however NZ IFRS 17's treatments meant this base (and hence the UWRCC) was too small for some insurance contracts. We have changed the base to elements that directly contribute to pricing risk to restore the charge to the intended level.

24. General insurers and other insurers with short term business will experience a decrease in solvency margins relative to the in-force Standard.

Utilisation of insurance premium;
Expenses over the remaining coverage period are sources of underwriting risk

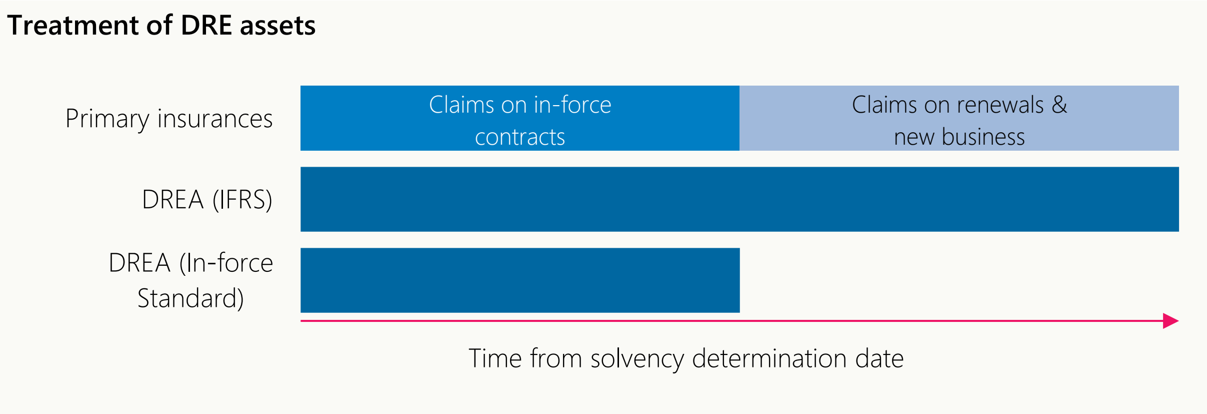


Deferred reinsurance expense assets

25. General insurers typically buy reinsurance in advance to cover their reinsurance needs in a calendar year. These needs include not just reinsurance of in-force insurance contracts, but also renewals and new business during the year.

26. A DREA is established to offset the payment of reinsurance premiums so there is no immediate loss from contracting reinsurance (and to recognise the value to the direct insurer of the claims to be paid by the reinsurer). However, the in-force Standard may be interpreted in such a way that reinsurance premiums paid in respect of renewals and new business are excluded from Solvency Capital.

27. We've made a change which will allow all DREA to contribute to Solvency Capital. This will increase solvency margins relative to the in-force standard and mostly affect general insurers.



Credit risk on interest-sensitive assets

28. In the in-force version of the Standard, credit risk charges on bonds that are subject to an interest rate risk capital charge were inadvertently excluded. In the Second Amendment we reinstated credit risk charges on interest-sensitive assets (CROISA).

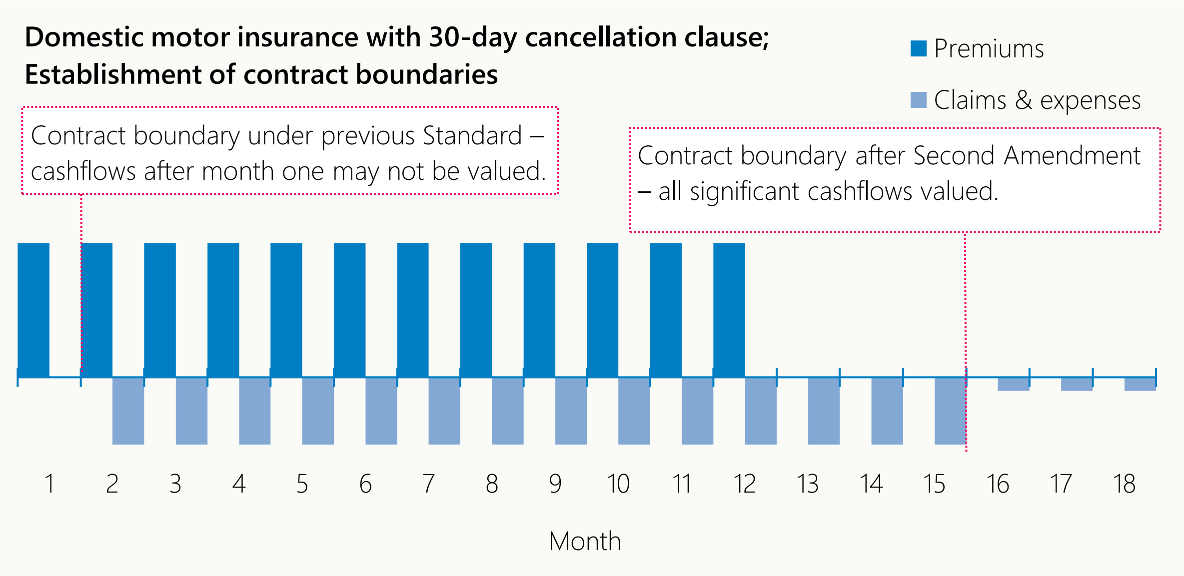
29. This change restores the original intent but may result in a decrease in solvency margins relative to the in-force Standard for insurers holding such assets. However, as this change is to correct an inadvertent increase in solvency margins, we expect that insurers have maintained capital at appropriate levels. We do not expect that insurers will have to raise more capital to respond to this amendment. This change will mainly affect life insurers as they hold the largest bond portfolios.

Contract boundaries

30. Insurance contracts are often valued using discounted cash-flow methods, with a contract boundary (CB) setting a limit beyond which cash-flows shouldn't be included.

31. The In-force Standard sets a boundary at the point the insurer is released from risk, and for some insurance contracts, this can be as early as 14 days after inception. It is, however, common for insurance contracts to continue after such risk-release points and further cashflows should be included in an economic valuation. In the Second Amendment we removed wording establishing contract boundaries on risk-release events, in order to support an economic valuation.

32. This change will result in an increase in solvency margins where business is profitable beyond the risk-release point.



Other changes

33. We have made a number of changes to enhance the consistency between the modified GMM (paragraph 28) and the modified PAA (paragraph 29) valuation methods, as well as clarifying tax treatments. For example, we have introduced a modification in paragraph 29, requiring adjustment of the modified PAA result where it differs significantly from that produced by the modified GMM method. The impacts of these changes will depend on insurers' interpretations of the in-force standard.

34. Other changes to the Standard are expected to have a lower impact or are primarily clarifications to the text to improve consistency between methods or reduce ambiguity. Please refer to our feedback statement for further detail about these changes.

Delivering the preferred options

Implementation

35. An amendment to the Standard is secondary legislation and will need to follow presentation and publication requirements as set out in the Legislation Act 2019 and section 233 of the IPSA. This includes presentation of the Amendment Standard by the Minister of Finance to the House of Representatives, notification in the NZ Gazette, and publication on the Reserve Bank website. The intention is that the amended Standard will be effective for all insurers on 1 March 2025.

36. We expect insurers to report in accordance with the in-force Standard until the Second Amendment of the ISS is effective. We have earlier released guidance to note that we are comfortable for insurers to disclose, alongside the mandatory solvency disclosures, additional solvency figures calculated as if the second amendment of the ISS was already in effect. Please see more details relating to this disclosure on our website.

Monitoring and evaluation

Impact on reporting

37. There may be a change in some insurers' solvency margins and ratios once the Standard is amended. There may also be a period of time (depending on balance dates) where there is an inconsistency between solvency ratios published by insurers on their websites and their ratios post-amendment.

38. The Reserve Bank will start to receive data returns, prepared in accordance with the amended standard, at the end of May (in respect of 31 March 2025 balance dates). These returns will enable us to 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.

39. We will be undertaking a second stage of the review of the solvency standard, which will include a full recalibration of methods and parameters in the standard. We will be in close contact with insurers and industry associations throughout the policy process and conduct further quantitative impact assessments. Insurers will have the opportunity to inform us of any difficulties they are having with the standard and we will try to address these in Stage 2 of the Review.

Consultation

Consultation cycles

40. Consultation on the proposals for the Second Amendment ran from 27 September to 8 November 2023. This represented an extension of the process outlined in the RIS that took place from 2020 to 2022. After taking stakeholder feedback on board and undertaking an external review, we held a second consultation on the revised exposure draft from 6 August to 17 September 2024.

Scope of the Second Amendment of the Standard

41. The scope of Stage 1 of the Solvency Review includes the transition to NZ IFRS 17 and certain structural changes to the solvency regime. The two rounds of consultation on the Second Amendment sought feedback aimed at correcting errors and improving the operation of the Standard within this scope. We also sought feedback on the drafting of the Standard and of an accompanying guide. Stage 2 issues, including new methodologies and parameterisation, were out of scope for this consultation.

Review

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.