



26 March 2010

Richard Dean
Manager, Insurance Policy
Reserve Bank of New Zealand
2, The Terrace
P O Box 2498
Wellington

Dear Richard,

Solvency Standard For Non-life Insurance

The New Zealand Society of Actuaries (“the Society”) welcomes the opportunity to comment on the second draft solvency standard for non-life insurance. We have given specific commentary on the major issues and also provided some suggested wordings in the Appendix.

Consultation process

This is the second round of consultation on this standard and we have adopted a slightly different process from last time due to the shorter timeframe and the more detailed nature of the issues arising.

Representatives of the Society (the Non-Life Solvency Working Group) have had several very valuable discussions with the Reserve Bank. The draft standard has been circulated to Members of the Society and comments sought.

The members of the general insurance and health practice committees have reviewed a draft of this response, which has been approved by the Council of the New Zealand Society of Actuaries.

Support for standards

The New Zealand Society of Actuaries is supportive of mandatory solvency standards for insurers and for those standards to be issued by the Reserve Bank of New Zealand. The Society agrees with and supports the structure and principles of the standard. Most of this has already been discussed and submitted on.



Comments on the second draft Standard

Definition of Premium Liabilities (paragraph 16)

The definition of premium liabilities is unnecessarily complex for a concept that is interpreted adequately elsewhere.

The Society's suggestion is that this makes reference to the Liability Adequacy Test (LAT) wording in Section 9.1 of NZ IFRS4 Appendix D, where premium liabilities are described as; "The present value of the expected future cash flows relating to future claims arising from the rights and obligations under general insurance contracts, plus an additional risk margin"

Note that NZ IFRS4 does not define premium liabilities, but refers to them using the words above, so the solvency standard will need to use the same words as the accounting standard to avoid any doubt. Any additional guidance can be covered in NZSA Professional Standards, likely to be the revised PS4. It is important that the definition specifies that the premium liabilities relate to the period for which the risk has been accepted, rather than the period for which the risk has been paid for which is what is used in the accounts. Alternatively if the Bank wishes to retain the current approach we have provided some suggested wording amendments in the appendix to this letter.

Deferred Acquisition Costs (DAC) (Section 2)

The draft standard proposes to exclude Deferred Acquisition Costs (DAC) from capital. We understand that it is the Bank's view that the DAC asset may not always be recoverable or realisable, and therefore should be deducted from capital. The Society believes that the recoverability of DAC should be assessed, but we suggest that the following mechanism is more appropriate for making such an assessment.

The Society's view is that the appointed actuary should assess the adequacy of the provisions in the financial statements in respect of premium liabilities. These will be a combination of a number of elements including the DAC. Insurers are required under NZ IFRS to undertake a LAT. In making his/her assessment the actuary would be required to review only the LAT and make an adjustment for any shortcomings in the methodology and/or to achieve a 75% sufficiency level. There is already a requirement in the solvency standard for the actuary to review the LAT and the DAC (paragraphs 102 & 103).

The Society proposes that DAC should be included in capital and that there should be an additional requirement that the LAT must be made at 75% probability of sufficiency (POS). This could be by way of an adjustment to capital similar to the outstanding claims liability adjustment in the case where the LAT is stronger or weaker than the 75% POS. This will effectively exclude for solvency purposes any DAC that is not recoverable by raising a capital charge.

Where the revised LAT requires an additional unexpired risk liability, the suggested adjustment will go further by raising a capital charge of more than the DAC.



This proposed treatment would be consistent with the APRA approach which goes directly to Premium Liabilities and ignores the associated accounting provisions.

Asset Liability Mismatch (paragraphs 68 – 73)

The requirement for an asset charge in respect of the asset liability mismatch should not be required on all fixed interest assets. In addition this section does not mention derivatives, the presence of which can alter the effective duration of the fixed interest portfolio.

It is worth considering the underlying principles of the asset liability mismatch provision which are:

- Technical liabilities need to be matched by assets of similar duration.
- Only assets relating to policyholder obligations need to be considered
- Shareholder capital does not need to be matched

The Society's suggestion is that the asset liability mismatch is applied only to an asset amount equal to insurance liabilities. Insurance liabilities will need to be defined.

The duration of the assets backing the insurance liabilities may be determined from either a specific real portfolio or a hypothecated portfolio of fixed interest assets of equal value to the liabilities, or all fixed interest assets if there is insufficient to cover the amount of insurance liabilities.

The definition of the duration of both liabilities and fixed interest assets needs to be more specific, for example the discounted mean term. The standard should also specify that all interest related derivatives must be considered in determining the duration. The discounted mean term can be simply defined as the (percentage change in value) / (change in interest rate) for the portfolio of assets or liabilities using a small (0.01%) change in interest rate.

The Society notes that the 3% charge implies a price movement equivalent to a 3% change in yield. This is significantly higher than the current NZSA Life Insurance Solvency Standard figure of 1.75%.

It is worth noting that the Asset/Liability mismatch charge has been specified using a simplified method. This will be adequate for most NZ non-life insurers at the moment but will not be appropriate for life insurers or for any future long tail non-life insurance liabilities. If a revised approach is introduced for the latter situation, the methodology for applying the asset charges should also be reconsidered.

Treatment of Subsidiaries (paragraph 23 iii)

The solvency standard does not recognise the value of a licensed subsidiary in the licensed parent's financial statements.

A subsidiary that is a licensed insurer is subject to regulatory scrutiny and should therefore be a viable asset. For the purposes of this standard it would be appropriate to allow a licensed subsidiary as an asset but to add a capital charge for the asset. The appropriate capital charge



is that determined from the solvency standard applicable to that subsidiary insurer. This is equivalent to a full “look through” approach to licensed insurer subsidiaries.

The Society’s suggestion is that assets in respect of a licensed insurer subsidiary should not be deducted from capital. Rather, an additional capital charge should be determined from the application of the relevant solvency standard to the subsidiary as separately reported.

Asset Risk Charges (table 2)

Local Authority Fixed Interest. It is quite common for Local Authority stock to be unrated, in which case it incurs an asset charge of 15%. Such a charge is likely to result in all insurers selling Local Authority stock. The Society’s view is that the asset charge for such stock should be significantly less than 15%. We suggest 4% would be reasonable.

Financial Institutions (paragraph 23 iv)

There needs to be a definition of financial institutions to provide more clarity to Section 23 iv.

Derivatives (63 – 65)

It is not clear how derivatives used for hedging should be treated. The hedging of currency risk is appropriately dealt with in section 69. Derivatives used for hedging a particular asset or portfolio of assets reduce the risk and therefore should not attract an additional capital charge, in fact theoretically they should reduce the asset charge.

The Society’s suggestion is that these sections should deal explicitly with derivatives that are solely used for hedging and exempt these from further capital charge.

Catastrophe Risk Capital Charges (paragraph 50)

It is not clear under Paragraph 50, where an actuary reviews the basis of the catastrophe charge, whether the actuary should apply the 1-in-250-year event as a standard.

The Society suggests that Paragraph 50 is amended to include the 1-in-250-year event requirement.

Reinsurance Recovery Risk Capital Charge (paragraph 77)

The total amount recoverable must be split by reinsurer, including the amount for outstanding claims. In practice this might be difficult to achieve, particularly for outstanding claims.

The Society suggests that a pragmatic approach is allowed, for example by estimating an average capital charge first then applying this to the totals that cannot be separately identified.

Requirement for 2 solvency returns per year

Many smaller companies will not do a full assessment of insurance liabilities at half year. The solvency standard should allow for an estimated approach to be used for the actuary’s certification of the insurance liabilities at half year.



Forecast of Future Solvency

The actuary has to comment on the future solvency for a period of 2 years. The Society would like to know whether RBNZ envisages that this is to be done on a best estimate basis or a stress tested basis. The stress tested basis would require a significant extra level of capital and we would suggest that this is more appropriate to consider as part of the process of developing the solvency ratio guideline.

Solvency Ratio Guidelines

There has been no discussion of how these will be set. The Society would be happy to discuss this with the Bank at a later date.

Minor Drafting Issues and typos

- For consistency any reference to “this standard” should be changed to “this **solvency standard**”
- 60 - needs to have a maximum of 100%
- 74 - related party should be bold
- Table 4 - the heading of the last column should be “Reinsurance Risk Capital Factor”
- 87a – there is an extra a before an overseas insurer, same in 88
- 101 - NZSA is undefined
- 102 – the last bullet should refer to 103

Finally, the Society is willing to provide further comment on any aspect of the regulations and looks forward to being of assistance to the Reserve Bank in implementing the new standards.

Yours sincerely
for New Zealand Society of Actuaries (Inc)

Bernie Higgins
President

A handwritten signature in black ink, appearing to read 'Paul Rhodes', written in a cursive style.

Paul Rhodes
Council



Appendix – Suggested Wordings

16 Premium Liabilities

Premium Liabilities relates to all future claim payments arising from future events post the valuation date that will be insured under the insurer's existing policies that have not yet expired. For policies which have no fixed expiry date the calculation is in respect of the period during which premiums and benefits cannot practically be adjusted (which may be next renewal or another date). The value of the premium liabilities must include an amount in respect of the expenses that the insurer expects to incur in administering and settling the relevant claims and allow for expected premium refunds. In respect of premium liabilities for which reinsurance has not yet been purchased, allowance must be made for this reinsurance. Premium liabilities are to be determined on a prospective basis, net of expected reinsurance recoveries and non-reinsurance recoveries. The value of premium liabilities must exclude any Government charges imposed such as levies, duties and taxes. Any deferred acquisition cost asset is also excluded.

Premium Liability Adjustment

Concept

34. The Underwriting Risk Capital Charge is intended to reflect the risk to the insurer of writing unprofitable insurance business, and includes any adjustment to the valuation of liabilities to bring them to a Common Basis. To some extent this charge is also intended to reflect the exposure of the insurer to operational risk, although it is not a substitute for adequate management of operational risk.
35. The Run-off Risk Capital Charge is intended to reflect the risk to the insurer of inadequate provision being made for outstanding claim liabilities, and includes any adjustment to the valuation of liabilities to bring them to a Common Basis.
36. The Common Basis is a minimum 75% probability of sufficiency (POS) as assessed by the appointed actuary.

Calculation

37. The Underwriting Risk Capital Charge is determined by multiplying the Premium Liabilities of the insurer at the calculation date by the Underwriting Risk Capital Factors in Table 1 and then adding the Premium Liability Adjustment (if any). The calculation is to be made by class of insurance business and summed across all classes. The Run-off Risk Capital Charge is



determined by multiplying the Net Outstanding Claim Provision of the insurer at the calculation date by the Run-off Risk Capital Factor in Table 1 and then adding the Outstanding Claim Liability Adjustment (if any). The calculation is to be made by class of insurance business and summed across all classes.

Table 1 – Insurance Risk Capital Factors

Class of Insurance Business	Underwriting Risk Capital Factor	Run-off Risk Capital Factor
Domestic property	14%	9%
Private motor	14%	9%
Commercial property	16%	11%
Commercial motor	14%	9%
Liability classes	22%	15%
Marine	16%	11%
Health and Personal Accident	16%	11%
Travel	14%	9%
Other	16%	11%

Liability Adjustments

- 38. The Premium Liability Adjustment is required if the insurer’s Premium Liabilities on the balance sheet are materially different from those which would provide for claims, expenses and a risk margin required to achieve the Common Basis (ie 75% POS) for the required period. In some cases the Premium Liabilities and Liability Adequacy Test (LAT) recorded in the balance sheet may cover a different period from the solvency requirement (see paragraph 16).
- 39. The Outstanding Claim Liability Adjustment is required if the insurer has established its net outstanding claims provision with a risk margin materially different to that required to achieve the Common Basis (i.e. 75% POS).
- 40. Section 5.1 of this standard specifies that the appointed actuary must assess the provision for outstanding claims and the corresponding recovery asset as well as the LAT.
- 41. If, in the opinion of the appointed actuary, the insurer’s net outstanding claims provision is materially less than the 75% POS provision, then the Run-off Risk Capital Factors in Table 1 must be applied to the amount advised by the appointed actuary rather than the amount in the insurer’s accounts and the Outstanding Claim Liability Adjustment is an addition to the risk charge equal to the 75% POS provision less the insurer’s provision after adjustment for tax.



42. If, in the opinion of the appointed actuary, the insurer's net outstanding claims provision is materially greater than the 75% POS provision, then the insurer may, if it chooses, apply the Run-off Risk Capital Factors in Table 1 to the amount advised by the appointed actuary rather than the amount in the insurer's accounts and adopt an Outstanding Claim Liability Adjustment (being a deduction from the risk charge) equal to the insurer's provision less the 75% POS provision after adjustment for tax.
43. If, in the opinion of the appointed actuary, the insurer's *Premium Liability provision* is materially less than the *Common Basis* (i.e. 75% POS provision), then the *Underwriting* Risk Capital Factors in Table 1 must be applied to the amount advised by the appointed actuary rather than the amount in the insurer's accounts and the *Premium Liability Adjustment* is an addition to the risk charge equal to the 75% POS provision less the insurer's provision after adjustment for tax.
44. If, in the opinion of the appointed actuary, the insurer's *Premium Liability provision* is materially greater than the 75% POS provision, then the insurer may, if it chooses, apply the *Underwriting Risk* Capital Factors in Table 1 to the amount advised by the appointed actuary rather than the amount in the insurer's accounts and adopt a *Premium Liability Adjustment* (being a deduction from the risk charge) equal to the insurer's provision less the 75% POS provision after adjustment for tax.

Catastrophe Risk

3.2 Catastrophe Risk Capital Charge

Concept

46. The Catastrophe Risk Capital Charge is intended to reflect the exposure of the insurer to extreme adverse claims experience. This includes large individual claims, large aggregations of claims arising from an event that results in claims on more than one insurance contract (such as an earthquake or storm), as well as significant and rapid changes in claims levels due to other causes (e.g. legal or tax changes).

Calculation

47. For an insurer with significant property exposures, the largest single event is likely to be a natural catastrophe and the insurer's catastrophe reinsurance programme will be the key determinant of the net cost. In this situation the Catastrophe Risk Capital Charge is the net cost to the insurer of a catastrophe event including any gap or shortfall in the reinsurance cover relative to a one in 250 year event and the cost (if any) of one reinstatement of the full catastrophe reinsurance programme.



48. For an insurer with large per risk exposures that are not property or are in excess of the insurer's catastrophe retention, the Catastrophe Risk Capital Charge is two times the largest per risk retention of the insurer plus the cost of one reinstatement of the catastrophe reinsurance programme if applicable.
49. The largest per risk retention is the cost to the insurer of the largest individual claim to which it could reasonably be exposed under policies issued, net of reinsurance and any other recoveries and including the cost of one reinstatement of the full catastrophe reinsurance programme. If the insurer issues policies that do not have a maximum sum insured, or are not protected by excess of loss reinsurance, then the insurer may need to seek the advice of its appointed actuary as to a reasonable approximation for the largest per risk retention.
50. In all cases, the appointed actuary of the insurer must review the basis of the Catastrophe Risk Capital Charge. If the appointed actuary is of the opinion that the exposure of the insurer to a one in 250 year claims risk is not adequately reflected in the Catastrophe Risk Capital Charge, the appointed actuary must recommend an alternative method of determining the Catastrophe Risk Capital Charge for the insurer, and the insurer must use that alternative method. Aggregations of risk across multiple policies must be included in the assessment.