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Reserve Bank of New Zealand
Financial System Policy and Analysis Department

Dear Sir/Madam,

ICNZ submission on Review of Insurance Solvency Standards: Structure and IFRS 17

Thank you for the opportunity to submit on the review of Insurance Solvency Standards: Structure and IFRS 17 consultation document November 2020.

By way of background, ICNZ's members are general insurers that insure about 95 percent of the New Zealand general insurance market, including about a trillion dollars' worth of New Zealand assets and liabilities. ICNZ members provide insurance products ranging from those usually purchased by individuals (such as home and contents, travel and motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability, business interruption, professional indemnity, commercial property and directors and officers insurance).

Please contact John Lucas (john@icnz.org.nz) if you have any questions on our submission or require further information.

This submission has two parts:

- overarching comments, and
- responses to individual questions.

1. Overarching comments

The purpose of the first stage of the Reserve Bank's review of Insurance Solvency Standards is to address structural changes to the standards including allowance for changes to accounting standards under IFRS17.

While detailed responses to each of the questions posed by the Reserve Bank within the consultation document are set out below, there are two proposed structural changes that we consider warrant particular emphasis, namely:

- the approach to adjusting solvency calculations for IFRS17 (Question O), and
- the proposal to implement a 'ladder of intervention' framework (Question Y).

In relation to IFRS17, the Reserve Bank has proposed several alternative options for addressing the change in accounting standards. The ICNZ and its members believe the key considerations when determining the most appropriate option are:

- Ensuring the solvency calculations are consistent and comparable across insurers by limiting use of judgement and any impacts of alternative valuation methods under IFRS17.
- Where possible, improving alignment with international solvency/capital standards to facilitate comparability between New Zealand and overseas insurers' capital positions and accordingly more clearly demonstrating the strength of the New Zealand insurance market.
- Striking an appropriate balance between ensuring solvency calculations accurately reflect the risks borne by each insurer and simplicity of calculation.

- General insurers are comfortable with the way the current Solvency Standards operates and considers that it is important to have separate standards for life, health and general insurers.
- The absence of a requirement to maintain a buffer above the MCR opens up the risk for some insurers to operate close to the MCR with no room for error.
- As noted, the treatment of health insurance should be specified more clearly.
- With these considerations in mind, ICNZ supports Option 3 (GAAP with adjustments). Within option 3, we believe the RBNZ should seek a balance between ensuring equivalent treatment for comparable risks, while not unnecessarily introducing complexity by requiring a liability valuation method for regulatory purposes that fundamentally differs from IFRS 17. Please note that not all members support this position. Those that do not will come back to you separately on this matter.

Another key structural change the Reserve Bank is considering as part of the first phase of the solvency standard review is the introduction of a 'ladder of intervention' framework.

We are supportive of a ladder framework with clear trigger points and a range of actions available to ensure that the MSC is unlikely breached in most operating scenarios.

Responses to individual questions

2. Purpose statement

A. Would a purpose statement be a useful addition to the solvency standards? Why or why not?

An explicit purpose statement would be useful to communicate the reasons why capital should be held at the levels prescribed and the importance of doing so. It could also guide the RBNZ's changes to solvency standards and provide better context to users that are new to the standards and industry.

To add real value to the solvency standard the purpose statement should set out more than just a descriptive explanation of what a solvency standard is, outlining the specific purpose of the solvency standard(s) and the settings within it, consistent with the intended risk appetite and regulatory approach. While achieving all this will be challenging, there is a risk that an overly simplified purpose statement creates more issues than it solves.

A purpose statement would also assist and support:

- Consultation on proposed changes to solvency standards, with a purpose statement guiding people to those options that achieve the stated objectives the best way.
- The application by firms of appropriate judgement in interpreting and applying solvency requirements.

Also see comments in response to questions B and EE below.

B. Please comment on the utility of the purpose statement ("The purpose of capital is to ensure that, in adversity, an insurer's obligations to policy-holders will continue to be met as they fall due.") and suggest improvements, if any.

While the proposed statement is good as a starting point, in our view it is not sufficiently linked to the regulatory requirement and does not include specification of the level of adversity. We also note that access to capital is required for other reasons (such as to support ongoing business growth and development and provide access to capital).

The proposed statement should also include:

- An additional sentence highlighting that solvency is a key measure for reporting to shareholders, employees, creditors. Reference should also be made to how the monitoring of capital protects, in broader terms, the livelihood of the community and health of the economy.

- A calibration objective specific to the purposes of capital required by the solvency standard and regulation. In a number of places, the consultation document notes that the current solvency standard is calibrated to a 99.5% probability of sufficiency over 1 year. This calibration is not currently set out in solvency standards and in places the calibration is currently aimed at a higher probability of sufficiency (such as in the case of natural hazard risks within the non-life solvency standard).

We are concerned that that an overly simplified purpose statement risks saying nothing in substance or being inconsistent with what the standard does. . Instead of a single statement a more multifaceted purpose statement that reflects the various dimensions of a solvency standard could be more appropriate, for example:

- to reduce the risk that an insurer would be unable to meet claims made by policyholders.
- to reduce the losses suffered by policyholders if an insurer is unable to meet all claims fully.
- to set levels of capital below which the regulator would conduct more vigorous oversight, and
- to promote confidence in the financial stability of the insurance sector.

The use of the word 'ensure' is, if applied literally, inconsistent with elements of the consultation document (e.g., Question C) and the operation of what is not a 'no-failure' regime and international comparators. While an unqualified purpose statement is simpler and sounds good, it is not practical or reflective of the regulatory approach being undertaken and other words such as 'safeguard' may be more appropriate.

Some international examples of relevance in this regard include:

- IAIS ICPs 2019 on which the purpose statement is based uses the word 'ensure'. However, the context is subtly different and the ICPs recognise this expectation is not absolute or certain.
- IAIS "*An insurance company is solvent if it is able to fulfil its obligations under all contracts under all reasonably foreseeable circumstances*" – paragraph 3 of 'Principles on Capital Adequacy and Solvency – 2002'.
- APRA, Prudential Standard GPS 110: "*The Board must ensure that the general insurer or Level 2 insurance group maintains an adequate level and quality of capital commensurate with the scale, nature and complexity of its business and risk profile, such that it is able to meet its obligations under a wide range of circumstances*".

In general terms, we refer to equivalent statements from other jurisdictions (e.g. APRA GPS 100, paragraph 25, APRA GPS 110 Capital Adequacy, paragraph 30, EU Directive 2009/138/EC (Solvency II) Article 101, paragraphs 2 and 3, and IAIS ICS V2.0 Level 1 document, paragraph 93) that are more closely linked to regulation and which set out a level of adversity (e.g. a 99.5 per cent confidence level), which could be drawn upon.

C. How likely should the fulfilment of obligations by an insurer be (recognising that certainty is an impossibility, and that there is a trade-off with efficiency and competition)?

We interpret that this is as a 'regulators' view with reference to consistency with international standards.

The solvency standard and solvency ratio targets are in place to ensure an insurer can carry on as a going concern, with the intention of fulfilling its obligations to policyholders.

In determining how likely the fulfilment of obligations by an insurer should be, the RBNZ should seek international comparability. As Appendix 1 of the consultation paper details, many jurisdictions seek minimum capital levels aligned in a 1-in-200 year level of sufficiency. The RBNZ should consider if there is sufficiently strong rationale for a level that is more prudent than this, noting the impact this has in term of stifling competition in the New Zealand market and negatively impacting the affordability of insurance.

We consider that a 99.5% VAR over a 1-year horizon or equivalent is an appropriate criterion to be applied in general, noting that there may be circumstances for some individual risks where a higher level may be considered more appropriate (e.g. for earthquake risk as seen in New Zealand and Canada).

Although there are arguments to use different measures of risk, a VaR specified level over a 1-year time frame has been applied in other major jurisdictions of relevance to New Zealand, as shown in the examples included in our response to question B above. This approach supports the RBNZ's goal of international comparability.

We suggest that capital is based on:

- BAU risks (applying to everyone) – capital and reinsurance related to a risk appetite of 1:200
- Concentration risk related to natural disaster such as storms etc., noting this could be more material for smaller property insurers, – a mixture of capital and reinsurance related to a risk appetite of 1:200.
- Geological risk (systemic risk) – which can only be mitigated by a prescribed reinsurance requirement (quantity and quality).

Please note that an insurer falling below its minimum solvency requirement is different to it not fulfilling obligations to policyholders.

D. Should the solvency risks be assumed to crystallise immediately, in the short-term (say one year) or over the long-term?

We consider that a long-term view of solvency risks is more appropriate and reflective of reality.

As was observed with the earthquakes and in relation to the CBL collapse, claims reserves take some time to materialise or not as the case may be. Provided good risk and governance frameworks are in place, taking a long-term view and managing to this, is to the benefit of customers, regulators, shareholders and the Government. Large events may take several years to run-off, at which point the insurer may be able to trade out of a tight situation to the benefit of all parties.

The long-term period that we believe would be reasonable today would be 2 to 5 years for a significant event such as an earthquake. The Canterbury Earthquakes took longer, however that was due to many complications that have now been resolved for future large catastrophe events.

Given that there can be some uncertainty within longer period forecasts, we recognise that it may not always be clear whether a longer period would provide absolute clarity. However, this should not prevent insurers looking further than one-year to aid their own capital management and considerations to ensure that the one-year capital horizon remains healthy.

Please note that some members may support the short-term position and come back to you separately on this matter.

Additionally, solvency risks are ongoing, so the settings of capital requirements should take into account the life of insurance assets/liabilities and any mismatches as well as the diversification of risk. This will also depend on the underlying attribute of the solvency related risk.

For completeness, please note that:

- Different solvency triggers within a ladder of intervention framework may have different objectives (for example, a point of minimum viability may be referenced to a best estimate wind up basis).
- Before any potential solvency issue could arise, insurers may have access to retained capital, reinsurance (either in advance of an event or in respect of adverse development of incurred claims), and the ability to obtain further capital in response to adverse events.
- Adverse events may occur over time or may result from a specific limited duration impact (e.g. an earthquake). The ability of an insurer to meet its ongoing obligations to policyholders may

require a broader assessment than a balance sheet approach based on the solvency measure alone. This should be considered in the development of a ladder of intervention framework and in any supervisory actions triggered by solvency levels.

- The ICAAP framework allows longer-term risks to be factored into the solvency risk.

3. Principles

E. Should a “total balance sheet approach” be adopted for solvency calculations?

In principle, as a starting point, we consider that the required level of capital is best measured by considering the total balance sheet and the economic impact of a specified stress event over the requisite timeframe. That said, the immateriality of second order effects, and the inability of insurers to identify and measure these impacts sufficiently robustly, may not justify the additional complexity associated with a total balance sheet approach. We would expect that a material assessment may need to be applied to reflect the firm’s expectations on second order impacts (e.g. of policyholder behaviour).

Accordingly, a framework that identifies the key material first order impacts and allows for diversification, within an appropriate risk management framework, including an internal ladder of intervention, may be the most appropriate approach to take.

While a total balance sheet is a more robust measure, it also adds complexity and ideally would be reliant on guidance from the RBNZ.

F. Do you think there are insurers that are “sectorally-important”? If so, what would be the advantages and disadvantages of imposing higher capital requirements on them, relative to those that are considered not sectorally-important? Please provide your reasons.

We do not consider that the potentially difficult task of identifying relevant sectors and “sectorally-important” insurers, and applying additional capital requirements to them, would be appropriate or necessarily increase the ability of the insurer or the sector to survive a major insurance event.

Additionally, it is worth noting that:

- Large insurers in New Zealand have demonstrated their ability to be resilient if allowed to manage issues that arise for themselves, for example the Canterbury and Kaikōura earthquakes and COVID-19 (including the Australian Business Interruption cover issue).
- Imposing higher capital requirements on “sectorally-important” larger insurers would distort the competitiveness of the market, resulting in non-competitive pricing for the policyholder. A larger general insurer will already have a larger absolute minimum capital requirement and this should not be ‘loaded’ with an extra ‘minimum capital requirement’.
- The measures such as size, based on balance sheet aggregate measures (premiums, assets, total liabilities), or market share, may not appropriately capture the impact an insurer’s failure may have on the relevant sector or sectors as a whole, or reflect the resilience of that insurer to insurance events. For example, a large multi-line insurer may hold significant market shares in some sub-sectors of the market whilst not being a significant player in other sub-sectors of the market. A large multi-line insurer may, for example, be more diversified in its risks and be able to withstand adverse events when supported by appropriate reinsurance and risk management frameworks than a smaller less diversified insurer.
- The RBNZ’s risk-based approach to supervision already ensures greater monitoring and scrutiny of large insurers.

It is more important to focus on systemic risks from the insurance sector as a whole. The biggest risk to most non-life insurers in New Zealand is from natural disasters (primarily earthquakes). Realistically this is a reinsurance rather than a capital issue.

We suggest that the RBNZ risk-based approach to supervision should balance solvency and other risk factors (such as an appropriate governance and risk framework).

Consistent with the approach advocated for above, it is important to note that, from an international perspective, no other jurisdiction really has different standards for "sectorally-important" insurers. While the IAIS developed a focus on 'systemically important insurers' following the GFC, it explicitly pulled back from this approach in 2018¹, moving towards an activity-based approach to systemic risks in place of an entity-based approach. The change recognised that, in respect of the financial system, systemic risk related to insurance may arise from common exposures, the degree firms are interconnected to each other and the wider economy and other factors, rather than the purely individual firm's size or market share. We understand the 2016 G-SII framework will cease from 2020. Insurers in New Zealand are not expected to be strongly interconnected in the sense that the failure of one insurer would lead to the stress or failure of another directly. New Zealand insurers also generally do not have a strong role in the investment markets in that there are limited savings and retirement products offered by the market as a whole and insurer's investments are aimed at supporting insurance liabilities.

4. Industry sectors

G. Please comment on how effectively existing solvency standards address particular sectors and subsectors of the industry.

Overall, we consider that the existing standards address different individual sectors satisfactorily and are reasonably effective. That said:

- The absence of a requirement to maintain a buffer above the MCR opens up the risk for some insurers to operate close to the MCR buffer with no room for error.
- As noted, the treatment of health insurance should be specified more clearly or treated separately as outlined in our answer to question H below.
- The use of license conditions to first apply solvency requirements and to impose supervisory adjustments is also not ideal. It would be preferable for IPSA to require all relevant insurers to comply automatically with the applicable solvency standards and then permit RBNZ to impose supervisory adjustments, as necessary.

While there is an opportunity to reduce duplication and unnecessary differences in requirements (e.g. asset risk charge factors), and consolidate documentation, we consider that separate standards for life and non-life remain appropriate and are preferable to the implementation of a consolidated single solvency standard. Also see our response to questions H and I below in this regard.

Some of the challenges presented by different standards (e.g. the complexity of the application of IFRS17 and Solvency II) could be resolved by, in addition to drafting the standards, establishing a dedicated solvency standard for health insurance businesses.

H. Should health insurance have its own specific solvency standard?

Yes, we consider that health insurance should have its own specific solvency standard.

As banks, life, non-life and health insurers have different capital requirements, they should have separate and specific solvency standards in our view.

As outlined directly above, we consider that there should be a single standard for health insurance businesses rather than current arrangement under which, as noted in the consultation document, either a non-life or life approach applies to them. This standard should cater for longer term risks and health insurance specific stress scenarios/ prudential margins, calibrated to reflect risks specific to health insurance.

¹ <https://www.spglobal.com/marketintelligence/en/news-insights/trending/t564hucsvgbedqlian5h9a2>

A single solvency standard for health insurance business would avoid the need for the non-life standard to consider health insurance specific considerations which may lead to unintended consequences.

I. Please discuss your preferences with respect to how the standards should apply to industry sectors, with reference to the specified options.

As earlier indicated our preference is to maintain separate standards for life and non-life (option 1). This is because:

- Sector specific standards better capture the industry specific risks and allow the development of better “fit for purpose” solvency standards including reflecting differences in the duration of policy liabilities and the long-term solvency requirements applicable.
- A single solvency standard, while potentially reducing inconsistency, has a significant risk of creating complexity (and even worse, confusion) as the framework seeks a ‘one size that fits all’ approach.
- Having appropriately tailored solvency requirements for each sector is much more important than making it a little easier to update them through consolidation of the standards into one.
- Each sector (e.g. general insurance, life and health) is a multi-billion dollar sector in its own right and so it is appropriate to have separate standards.

Having separate solvency standards also has the advantage in that, if a change is required with regard to a particular sector, other sectors can be unaffected.

Notwithstanding the above, sector differentiated standards should be developed using the same overarching principles (e.g. capital should be set based on a 99.5% probability of sufficiency for each sector). Also, where risks and the requirements are the same between sectors, these requirements should be aligned as much as possible.

Our second preference would be option 3. Option 2 is not appropriate. Having a single framework would be too complex and difficult to implement, particularly given how long IFRS 17 is already taking. In addition to the reasons outlined above, there are significant differences in product and investment strategies etc (statutory funds) and one standard is likely to lead to unintended consequences and unnecessary complexity. Also, as earlier alluded to, the concentration risk for the different sectors is completely different.

5. Statutory and other funds

J. Please comment on how effectively existing solvency standards address statutory and other funds.

Our view is that non-life firms should not have a statutory fund requirement. Doing so would increase complexity and regulatory burden while not providing any meaningful increase in security for policyholders. Statutory funds are much more appropriate for insurers with long tail classes where investment returns are fundamental to the pricing of the insurance product. This contrasts with short tail general insurance classes where investments are more liquid and there is a more transaction cashflow.

K. Should solvency standards applied to statutory funds apply a floor to assets based on the provisions of Sections 82-119?

As we represent general insurers, we do not consider that it is appropriate for us to comment on this life insurance sector specific issue.

L. Please discuss your preferences with respect to how the standards should apply to statutory and other funds, with reference to the specified options.

We support option 1 (status quo). We strongly oppose Option 2 on the basis that, as earlier eluded to, statutory funds are not required or appropriate for general insurance. See our answer to question J in this regard.

As outlined above, we understand that statutory fund requirements will be reviewed within the IPSA Review.

6. Consolidation

M. In your view, is the current treatment of insurance and non-insurance subsidiaries in the solvency standards appropriate?

The current treatment of consolidating insurance subsidiaries is appropriate.

With regard to non-insurance subsidiaries however, we support a more sophisticated approach being taken, looking at whether or not there is any potential impact to the solvency position of the licensed entity (positive or negative). A flat 100% capital charge is totally inappropriate in our view.

It can also be unclear which solvency margin (either entity or consolidated, with any other insurer subsidiary in a group) drives regulatory actions and which margin is required to be disclosed.

N. If your answer to the previous question was “No”, what do you feel would be a better treatment of insurance and non-insurance subsidiaries?

If the non-insurance subsidiary poses no particular/unique risk, then in our view a more appropriate treatment would be to simply 'look through' to the underlying balance sheet and apply 'vanilla' capital charges. The requirement in IPSA to report a 'solo' and also a 'consolidated' set of financial statements could provide the basis for such a 'look-through'.

7. Insurance liabilities and other technical provisions

O. In the context of solvency requirements, which of the specified options do you consider to be the most appropriate for New Zealand?

Please note that not all members support the position outlined below. Those that do not will come back to you separately on this matter.

We agree with the RBNZ that options 1 and 2 (status quo, and IFRS 17 without adjustments) are unlikely to be realistic in practice. Option 1 is unattractive as most insurers would not wish to continue with parallel reporting under IFRS 4 once they have transitioned to IFRS 17. Option 2 may also be unsuitable for solvency purposes if insurers apply judgement in the application of IFRS 17 resulting in different asset and liability valuations for the same risk profile, for example, in the calibration of the risk adjustment for non-financial risk.

We agree with the RBNZ that option 4 (full regulatory balance sheet) is likely to be more burdensome for small insurers than the other options, while also making it harder to reconcile with financial statements prepared under NZ GAAP and the solvency position, so do not favour this approach.

As a consequence, we prefer option 3 (GAAP with adjustments). Within option 3, we believe the RBNZ should seek a balance between ensuring equivalent treatment for comparable risks, while not

unnecessarily introducing complexity by requiring a liability valuation method for regulatory purposes that fundamentally differs from IFRS 17.

Given many insurers are already well advanced with their projects to implement IFRS 17, we are concerned that the RBNZ may select an approach that requires significant rework of solutions and systems at a late stage of the implementation path. For example, a majority of our members are expecting to utilise the premium allocation approach available under IFRS 17, and if the RBNZ were to specify that all insurers must use the general model, or a significantly different non-IFRS 17 liability valuation method, this would necessitate a significant change in approach those insurers took.

On the other hand, there may be a range of ways to enhance comparability between insurers while having a less burdensome impact, as they would less fundamentally change an insurer's approach to IFRS 17. These may include, as examples:

- specifying parameters (such as to the confidence level that the risk adjustment for non-financial risk must provide),
- building in other adjustment mechanisms (equivalent to the existing mechanisms in the non-life solvency standard which ensure that a risk margin is incorporated so that liabilities have a 75% probability of sufficiency), or
- being prescriptive about the choices an insurer must make when there are options that are available under IFRS 17 (for example, as to whether an insurer applying the PAA should discount cash flows that are expected to be paid or received in one year or less from the date the claims are incurred).

As the RBNZ has identified in Appendix 2 of the consultation paper, the situation is perhaps different for life insurers than non-life insurers. Accordingly, a different approach may be required for life versus non-life portfolios, for example, option 3c may be more suitable for life insurers, whereas option 3a or 3b may be more suitable for non-life insurers.

8. Other (non-technical) items

P. How do insurers currently treat non-technical insurance assets and liabilities on the balance sheet? Are all assets currently designated as backing insurance liabilities, and hence valued using the fair value approach? Are there any items (other than technical provisions) on the balance sheet that insurers are not currently measured using fair value?

Insurers currently treat non-technical insurance assets and liabilities on the balance sheet as follows:

- Non-technical insurance assets and liabilities are treated on a historical cost basis, except for financial assets which are treated on a fair value basis.
- Outstanding claims and related reinsurance recoveries are discounted to present value using a risk-free rate.

Many New Zealand insurers apply NZ IFRS 4 and NZ IFRS 9 with assets being managed in portfolios that either back insurance liabilities or are shareholder's funds. Assets backing insurance liabilities are, as required, valued at fair value through profit and loss. Remaining assets are assessed under NZ IFRS 9 and valued at fair value through profit or loss or amortised cost. Assets recognised at amortised cost include cash, cash equivalents, trade and other receivables, loans including policyholder loans and related party receivables. We note that IAIS ICP 14 recognises that an amortised cost may be an appropriate economic valuation method, along with at least annual impairment testing (see ICP 14 paragraph 14.5.12 – 14.5.15).

We understand there will be no change to the recognition and measurement of all other/non-technical balances as all other IFRS must continue to be applied on a consistent basis. As outlined above, some assets are typically valued using a fair value approach, but this is because of the application of other IFRS (e.g. IFRS 9 where insurers may have adopted the 'fair value through profit & loss' approach pertaining to investments/financial assets).

Q. How, if at all, is the treatment in (P) likely to change after transition to IFRS 17 (and IFRS 9)?

The treatment in (P) will not change after transition to IFRS 17 (and IFRS 9). IFRS 17 aims to achieve fair value. Accordingly, the current treatment on most financial statement line items will only change where a historical cost basis is used for non-technical insurance assets and liabilities.

R. Is fair value a reasonable approach to value non-technical assets and liabilities? Would an adjustment to bring all assets and liabilities on the balance sheet to fair value for solvency purposes be appropriate?

An adjustment to bring all assets and liabilities on the balance sheet to fair value for solvency purposes would not be appropriate in our view.

For consistency with the NZ IFRS 4 treatment, where assets are held to back insurance liabilities and there are options available under GAAP to fair value assets (such as for financial assets and investment properties), we consider it reasonable to continue to hold those assets and fair value. If the insurer chooses not to hold those assets at fair value in their financial statements, then an adjustment to bring them to fair value for solvency purposes could be appropriate. We do not believe that other assets / liabilities (e.g. intangibles, taxes, leases, , property, plant and equipment) should be fair valued, where this is not an option available under GAAP.

S. Is it necessary to have visibility of insurance receivables, and hence the associated credit risk, from a solvency perspective? If not, how do we ensure that any material credit risk is properly reflected in the solvency standards?

We consider that it is necessary to have visibility of insurance receivables from a solvency perspective. Credit risk exists in respect to receivables and should be recognised for solvency purposes where material. Receivable balances (including premiums,² and to a greater extent reinsurance) on the balance sheet can be a material amount and accordingly may have a significant impact on solvency if there is a risk of non-collection.

From a solvency perspective, in general terms it is appropriate to have visibility of the different types of insurance receivables, due to the different risk profiles they have. For example, reinsurer receivables would be subject to insurance regulation by the RBNZ, or an equivalent regulator, whereas receivables from an insurance broker or agent would not be. Given the different risk they present, in our view solvency standards should apply to different credit risk charges based on whether a counter-party is insurance regulated or not.

We would expect that insurers will continue to maintain systems to monitor receivables and amounts payable.

T. How do insurers currently measure insurance receivables and payables (premium and reinsurance recovery receivables, claims payable)?

Generally, receivables and payables are measured as the present value of expected future receipts, a similar basis as the liability for outstanding claims. A provision for impairment is made when there is objective evidence that the entity is unable to collect all the amounts due under the original terms. This provision is the difference between the amount due and the present value of the estimated cashflows.

² We acknowledge that premium receivable may have relatively low credit risk. in conjunction with the ability to lapse the contract for non- payment, outstanding premiums may be recovered from any claims payment to be made.

U. How are insurers looking at implementing the changes relating to insurance receivables and payables resulting from IFRS 17 from a systems perspective? Are major system changes to collate the receivables/payables system with the valuation system being considered, or will separate systems be maintained, with a high-level adjustment being applied to incorporate the receivables/payables into the measurement of insurance contracts?

While insurers are still working through the system change implications of IFRS 17, we believe there will be a variety of approaches. Accordingly, insurers will likely provide comment on this question individually.

V. If the measurement of insurance receivables under IFRS 4 currently includes an allowance for impairment, how will insurers change the basis to determine the impairment related to insurance receivables after transition to IFRS 17?

While insurers are still working through the system change implications of IFRS 4, we believe there will be a variety of approaches. Accordingly, insurers will likely provide comment on this question individually.

9. Tax

W. How are the tax items on the balance sheet likely to be impacted by IFRS 17 (and IFRS 9)?

To date there have been no information as to the impact of IFRS17 on tax items. However, for general insurers we do not expect the treatment of tax items on the balance sheet under IFRS 17 to be materially different to current treatment.

We agree that the primary impact on tax items are expected to be deferred tax balances associated with the differences between reinsurance contract assets and liability values on the balance sheet and the corresponding amounts required for taxation purposes.

Under IFRS 17 the expenses identified as acquisition costs and the extent to which they are deferred for accounting purposes will change. However, we expect that the deferred taxation balances will remain consistent with the assets and liabilities they relate to (e.g. deferred acquisition costs and the associated deferred tax assets) will change in value consistently.

X. Will there be any flow on impacts of tax impacts on other insurance and non-insurance items on the balance sheet?

As outlined in response to question W above, we assume that there are no material changes to income tax law as a result of IFRS 17. However, we cannot be certain of this until the tax implications have been fully worked through. Specifically, there could be impacts on the deferred tax assets and liabilities, which insurers are awaiting guidance from IRD on. Depending on insurers' decisions on how to treat deferred acquisition costs, there could also be an increase in deferred tax asset or liabilities.

We do not anticipate that changes to income tax law is required as a result of IFRS 17 outside of any necessary changes to maintain the status quo. Insurance and reinsurance assets and liabilities under IFRS 17 are determined on a gross of income tax basis (i.e. the fulfilment of cashflows is used to assess the insurance assets and liabilities do not include income tax).

10. Options for operating the ladder of intervention

Y. Should we implement a ladder of intervention approach to solvency?

We believe that there is no single set of trigger points that would be appropriate for all insurers in all circumstances and that the best approach is for the individual insurer to develop trigger points based on probability of sufficiency parameters. However, such a framework may be complex for the regulator to oversee, and may be difficult for some smaller insurers to implement. Accordingly, we are supportive of a ladder of intervention approach that provides clear trigger points and a range of actions available. We believe this will facilitate more graduated and proportional responses by the RBNZ to any deterioration in an insurer's capital adequacy.

Generic industry wide trigger points based on solvency ratios, while easier to apply and understand, will not adequately reflect the risk profile of each individual insurer and are likely to disadvantage insurers who underwrite a range of business and benefit from a greater degree of diversification.

Irrespective of the approach taken to setting trigger points, RBNZ actions at a trigger point should not be mandatory. RBNZ should have the ability to take certain actions at a trigger point but should also have flexibility to consider the individual circumstances of the insurer to determine whether the actions are necessary or appropriate

In general terms, we agree with approach shown in the 'illustrative' diagram on page 30 that the lower rung of the ladder should be lower than the current MSC. It should not be necessary to hold large buffers on top of PCR, especially if a robust reinsurance programme is in place.

Z. At what point should the insurer's operations be considered to be no longer be viable?

There is unlikely to be a single measure that would be sufficient to adequately indicate an insurer is unviable and that could apply across all insurers in all circumstances. A breach of regulatory solvency is not a clear indication of viability as there are often restorative actions that can be undertaken at this stage. For example, following a large event the reinsurance recovery capital charges may be significant and result in a solvency ratio below 1.0, but this situation can reverse once these amounts are received.

Similarly, it is possible that current solvency is sufficient, but business circumstances suggest that over a relatively short time a non-recoverable position will be reached. The solvency standard manages this effectively through the solvency projections and continuous reporting requirements. Accordingly, insurers need to determine the minimum levels based on the business' size and complexity. The regulator requires sufficient powers to investigate situations that arise on their merits, including an evaluation of the insurers recovery plan and to take directive action where appropriate.

AA. Conversely, what point in an insurer's solvency level triggers the need to start increasing the intensity of supervisory intervention from BAU supervision?

The answer to this question may depend on the type of trigger framework that is adopted.

If the trigger framework is based on individual insurer developed trigger points (potentially as part of an ICAAP), the breach of these trigger points could require RBNZ notification and be a signal for the RBNZ to consider increased supervision.

Alternatively, if generic industry wide triggers points based on solvency ratios are adopted, the appropriate trigger point should be a modest capital conservation buffer applied on top of the MSC, with initial interventions applied restricting the insurers ability to reduce their capital, through dividends or other reductions in capital, the further into the buffer the insurer is operating. This approach is similar to the banking framework.

BB. Should we adopt an ICAAP/ORSA-type approach alongside the solvency requirements? If so, are either of these frameworks a good starting point for New Zealand?

We see merit in adopting a simplified ICAAP approach alongside the solvency requirements. Many larger insurers already have a requirement for an ICAAP through APRA supervision, so this framework is preferred over ORSA, which would result in some duplication of effort. However, prescribing a particular framework will place a larger compliance burden on the smaller insurers, who currently consider their capital management using different frameworks.

A simplified ICAAP approach would complement the insurer's risk management framework, ensure insurers have appropriate trigger points in consideration of its risk profile and risk appetite, and outline actions that could be taken to restore capital if required.

CC. Are any of the above measures (solvency ratio, assets/stressed liabilities, probability of failure) more or less appropriate to calculate and assess an insurer's solvency position, from the point of view of implementing an effective ladder of intervention framework? If not, what measures do you consider would be more appropriate for this purpose?

As noted in Y above, there is no single assessment measure that is appropriate for all insurers in all circumstances and accordingly the best approach is for the individual insurer to develop trigger points based on probability of sufficiency parameters. However, such a framework may be complex for regulators to oversee and may be difficult for some smaller insurers to implement. Accordingly, we are supportive of a ladder of intervention approach that provides clear trigger points and a range of actions available. We believe this will facilitate more graduated and proportional responses by the RBNZ to any deterioration in the insurer's capital adequacy.

11. Other considerations

DD. What approach would strike the right balance between clarity and discretion when setting out supervisory responses at different levels of the ladder of intervention?

As noted in Y and CC above, the best approach is a ladder with trigger points based on probability of sufficiency parameters stipulated by the regulator. Irrespective of the approach taken to setting trigger points, RBNZ actions at a trigger point should not be mandatory. RBNZ should have the ability to take certain actions at a trigger point but also the flexibility to consider the individual circumstances of the insurer to determine whether such actions are necessary or appropriate.

EE. What should our risk appetite be in relation to insurer failure?

We consider that the risk appetite should be consistent with the calibration of the solvency requirements. The calibration of the solvency standards minimum requirements (e.g. 99.5% VAR) should be consistent with the regulator's view (as a proxy for that of the wider community) on the acceptable level of insurance failure having regard to insurer's voluntary additional capital targets.

The RBNZ should also seek international comparability in setting the risk appetite. As Appendix 1 of the consultation document details, many jurisdictions seek minimum capital levels aligned to a 1-in-200 year level of sufficiency. The RBNZ must consider if there is a sufficiently strong rationale for a level that is more prudent than this, noting that as outlined above this risks stifling competition in the New Zealand market and impacts the affordability of insurance.

Please also see comments made in respect of question C above.

We also agree that it is necessary to balance soundness and efficiency. Regard must also be had to the nature of the New Zealand market and the exposure to natural events such as large earthquakes.

Other factors that we believe should be considered in considering risk appetite include:

- The importance of a relatively simple regulatory framework, both to reduce costs of the RBNZ and insurer, and to improve the transparency and understandability of the regulatory framework with policyholders.
- The highly concentrated nature of New Zealand's insurance market, particularly in the general insurance market, which means that the failure of a single insurance company could have a significant impact on the economy as a whole.
- The different characteristics of insured parties, so that the risk appetite could be higher for insurers who do not provide insurance directly to consumers – either because they insure only commercial customers, or because they provide insurance to consumers only via intermediated channels. In these situations, the policyholder, or their agent, is likely to be more sophisticated and therefore can better appreciate the risk of the insurer failing.

12. Solvency calculations (deductions v charges)

FF. Would you be comfortable with handling some deductions from capital through the Resilience Risk Capital Charge? Why or why not?

Whether a deduction or 100% capital charge is applied the resulting solvency margin is the same, however the Solvency Ratio differs depending on the approach. While the solvency ratio has some limitations, we recognise that it is a simple metric that is used to confirm capital sufficiency by regulators, industry commentators and policyholders. It is therefore important that efforts are made to have consistent results within each insurance sector (and preferably across sectors).

The MSC is a regulatory capital buffer above what is required for economic solvency and therefore implies the insurer is a going concern. On a going concern basis items that are currently considered a 100% deduction from capital would have some value and would be better treated as a partial (less than 100%) capital deduction.

As many insurers express target capital holdings as a multiple of the MSC, increasing the MSC would cause insurers to reassess what multiples are appropriate for internal capital targets.

When an asset is expected to have nil recognition for solvency purposes, that is a 100% capital charge we consider it would be best to retain these as deductions from capital. This avoids grossing up both actual capital and minimum capital required. This also avoids the situation where a requirement to maintain a solvency margin greater than the minimum requirement (110% of the MSC for example), suggests that the insurer is required to have capital to the value of 110% of the asset, when the most the insurer could be at risk for is 100%.

We consider that it would be preferable for adjustments aimed at restating the IFRS balance sheet to a common base for the solvency balance sheet (for example to restate IFRS17 insurance liabilities to a 75th percentile) to be retained within the solvency balance sheet's assets or liabilities, and therefore flow through to Actual Solvency Capital, rather than as an adjustment to the capital charges. Another example would be under IFRS17 there will be a variety of treatments for acquisition expenses, under PAA there is an option to expense them immediately. For solvency purposes it would be appropriate to have a consistent approach by altering the capital position.

GG. Do you believe that some value should be allowed for certain deductible items at higher levels on the ladder of intervention? Is it appropriate to assume a 'going-concern' valuation at these levels?

It should be assumed that each insurer is a going concern provided they meet the MSC requirements. The MSC is a recognised regulatory capital buffer and as such capital exceeds the amount that would trigger an external audit going-concern qualification and / or a IPSA section 24 projected going-concern issue. The point where the insurer moves from going concern to a run-off assessment for solvency purposes is therefore somewhat below the MSC, but likely higher than the threshold that might be applied for financial reporting purposes. In principle, this approach is consistent with the

actual expected operation of the insurer and reflects its economic risks at this level. Under this approach some deductible items may be more appropriately treated as an asset with a capital charge, rather than as a partial deduction from capital.

Caution should be applied if a capital charge or a partial deduction is to be recognised at a higher rung of the ladder (when solvency is strong), but a higher charge or greater deduction taken when solvency is weak. This will magnify the impact and any regulatory response needs to be proportionate to the actual change in circumstance.

13. Solvency calculations (supervisory adjustments)

HH. Is it appropriate for us to adjust insurer solvency calculations?

We consider that it is appropriate for the RBNZ to adjust insurer solvency calculations from specified requirements in limited, rare, and exceptional circumstances to protect the interests of the policyholders, provided there is accountability, transparency and clarity over the reasons for the adjustment.

The role and purpose of this adjustment should be clear and should be prescribed in advance, for example, in relation to very rapid premium growth or for new entrants. Additionally, the requirement to state trigger points where those adjustments have been made would need to be removed. We also note the following in this respect:

- The proposal suggests that RBNZ may apply both a supervisory adjustment and apply the existing requirement mandating an additional solvency margin by way of condition of licence (expressed as a ratio, dollar amount or otherwise). We do not consider that both requirements are necessary. If both are retained, the circumstances under which they are applied should be clearly spelled out in the relevant guidance.
- We consider that such adjustments should not be disclosed separately, i.e. the minimum capital requirement is increased from the amount otherwise determined under the standards but the amount of that increase and the reasons for it are not disclosed separately.

II. Does the list in paragraph 140 cover all circumstances where solvency calculations should be adjusted?

The circumstances in paragraph 140 are very broad and should cover most of the circumstances for when solvency should be adjusted.

JJ. Do you support introducing supervisory adjustments as an integral part of the determination of capital requirements?

We support the introduction of supervisory adjustments as an integral part of determining capital requirements. However, further consultation with the insurance industry is required detailing the proposed circumstances where supervisory adjustments may be imposed and what are the available opportunities/actions for removing them, provided there is accountability, transparency and clarity over the reasons and a way to challenge them. The role and purpose of such adjustments should be clear and could be prescribed in advance. For example, in relation to very rapid premium growth of, for new entrants etc.

It will be helpful for the insurer to know when the supervisory adjustments are no longer required and can be removed.

It will be important for any disclosure by the regulator of any supervisory adjustment requirements to be cognisant of commercial sensitivity by avoiding any public announcements.

Where a supervisory adjustment has been applied, we consider that this should form part of the insurers MSC as appropriate and accordingly be appropriately reflected in an insurer's published solvency margin and ratios. Under the current IPSA and solvency standards, a requirement to hold an

additional solvency margin, whilst publishing margins and ratios determined relative to the solvency standard minimum requirement, can be misleading.

KK. Are there other forms (other than fixed amounts, ratios and valuation instructions) that the supervisory adjustments could take?

We consider that there are other forms that supervisory adjustments could take and it may not be necessary to limit the form such adjustments could take. Other forms can be used such as an additional amount expressed as a ratio of the otherwise determined solvency requirement. This would depend on the reason for the supervisory adjustment. In some cases, a fixed dollar approach may be appropriate, whereas in other cases an increase of the minimum required solvency ratio may make sense.

14. Hierarchy of risks and diversification

LL. Should New Zealand adopt a more structured risk hierarchy? Why or why not?

We do not consider that New Zealand should adopt a more structured risk hierarchy. This would add complexity where the BAU risk will be driven by a lack of governance/risk frameworks and systemic risk by earthquake type events. We consider that the approach should instead focus on the appropriateness of the reinsurance programme given the criticality of this to general insurance in New Zealand.

Additionally, it would be helpful to clearly set out the nature and range of risks that the solvency standard intends to capture, and perhaps areas where solvency standard do not capture a risk that an insurer should have regard to when establishing its target capital levels. Operational risk may be an example of such a risk. There is no explicit capital required in respect of operational risk within the current solvency standard. However, an insurer may wish to have regard to operational risks in establishing its target capital levels.

Adding a more structured risk hierarchy will add complexity without commensurate benefit.

MM. Is it necessary to introduce risk charges for risks currently not hypothesised in solvency standards, for example operational risk? Why or why not?

While there may be some merit in introducing this (e.g. in respect of operational risk) conceptually, given the complexity, we query how this could meaningfully work in practice.

NN. Should solvency standards allow for a diversification benefit of some form? Is the Solvency II approach to relating risks appropriate for New Zealand conditions?

We consider that solvency standards should allow for a diversification benefit with parameters (e.g. correlations) adjusted to New Zealand conditions. It is unlikely all the risks will impact the insurer at the same time, so a diversification benefit would provide a more realistic solvency requirement, it may be difficult to apply this in a way that is consistent across all insurers.

Our view is that Solvency II approach appears relatively complex to determine and to calibrate and that a simpler approach may be appropriate for the New Zealand market. We consider that the approach taken by APRA is reasonable and suggest alignment with Australia is more appropriate given the majority of investment comes from Australian. A materially different approach would increase complexity.

Details of the APRA Diversification Benefits and calculation formula are set out in appendix 1.

15. Life insurance risk capital charge restructure

OO. Should the deduction for policy and other liabilities be moved inside the Life IRCC?

We have not answered this question as it is not relevant to general insurers.

16. Grouping of policies

PP. Are any of the following grouping options (Insurer, statutory fund, IFRS 17 portfolio, regulatory groupings, IFRS 17 groups, individual policy) appropriate for solvency purposes?

For general insurers the regulatory grouping for solvency purposes currently aligns closely with the classes of business used for financial reporting and industry data collection. The regulatory groupings for data collection have been more granular, but again are products or groupings commonly used across the general insurance industry. This has had significant administrative advantages for insurers.

Not all of our members have finalised their IFRS 17 portfolios yet and there is not consensus as to whether these will be materially different from the current classes of business.

Even if IFRS 17 portfolios deviate from the current classes of business, these will remain in common usage across the industry. Accordingly, our members preference is that these regulatory groupings continue to align with the classes of business.

If the regulator intends to introduce new groupings the industry request that consultation is undertaken urgently so that insurers can develop the appropriate reporting in conjunction with IFRS 17 systems changes.

QQ. Are there any other grouping approaches that you consider would be appropriate for solvency purposes?

Groupings for solvency purposes need to be at a sufficiently granular level that they recognise the differences in risk associated with different types of business (e.g. liability versus domestic buildings), but not so granular as to make the administration unduly complicated (e.g. individual contract ~~contact~~).

Separating different classes of business does not allow for the diversification benefits of writing different lines of business. This needs to be considered in the calibration of the solvency charges.

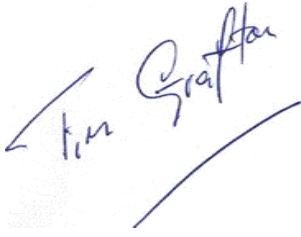
RR. What are your views on our preferred option of specifying regulatory groupings for solvency purposes? What basis do you think should be used to form the regulatory groupings?

For general insurers defined regulatory grouping aligned with the current class of business structure, as applies at present, should be continued. This involves a broad categorisation of contracts into groupings with similar risk characteristics.

Conclusion

Thank you again for the opportunity to submit on this matter. If you have any questions, please contact our Insurance Manager by emailing john@icnz.org.nz.

Yours sincerely,

Handwritten signature of Tim Grafton in black ink, featuring a stylized 'T' and 'G'.

Tim Grafton
Chief Executive

Handwritten signature of John Lucas in black ink, consisting of several sweeping, parallel lines.

John Lucas
Insurance Manager

Appendix 1

APRA diversification benefits

APRA allows for two types of diversification:

- Diversification between the Asset Risk Charge and the sum of the Insurance Risk charge and Insurance Concentration Risk Charge.
- Diversification within the Asset Risk Charge between the different asset shocks (real interest rates, inflation, currency, equity, property, and credit spread).

The first of these is relatively straight forward and easy to calculate and is all insurers should be able to produce easily. The second, while fundamentally the same, is a bit more computationally involved simply because it is applying across six different asset risk shocks (with several of the shocks having both up and down shocks).

The extracts below are from the General Insurance Standards, but the Life Insurance Standards include similar diversification benefits.

Diversification between Asset Risk and Insurance Risk - Extract from APRA GPS 110: Capital Adequacy

Aggregation benefit

31. *The aggregation benefit makes an explicit allowance for diversification between asset risk and the sum of insurance risk and insurance concentration risk in the calculation of the prescribed capital amount.*

32. *The aggregation benefit formula is:*

$$\text{Aggregation benefit} = (A+I) - \sqrt{(A^2 + I^2 + 2 \times \text{correlation} \times A \times I)}$$

where:

(a) 'A' is the Asset Risk Charge;

(b) 'I' is the sum of the Insurance Risk Charge and Insurance Concentration Risk Charge; and

(c) 'correlation' is:

(i) 20 per cent for all insurers except lenders mortgage insurers;

(ii) 50 per cent for lenders mortgage insurers; or

(iii) the weighted average of the factors in sub-paragraphs (i) and (ii) for Level 2 insurance groups. The weighting of the factors must be by the size of the insurance risk charges for the non-lenders mortgage insurance and lenders mortgage insurance business, respectively.

33. *The Asset Concentration Risk Charge and the Operational Risk Charge are not included in the calculation of the aggregation benefit.*

The same approach is outlined for Life Insurance in LPS 110.

In addition to this APRA also allows for diversification within the Asset Risk Charge between the different asset shocks it applies (real interest rates, inflation, currency, equity, and property). While taking the same approach the calculation for the asset risk diversification is a bit more complicated, simply because it is applying across six different asset risk shocks (with several of the shocks having both up and down shocks).

Diversification within Asset Risk - Extract from APRA GPS 114: Capital Adequacy: Asset Risk Charge

Aggregation formula

77. The aggregated risk charge component is calculated as:

$$A_{\text{default}} + \sqrt{\sum_{x,y} \text{Max}(0, \text{Corr}_{x,y} \cdot A_x \cdot A_y \cdot \text{sign}(x) \cdot \text{sign}(y))}$$

where

- (a) A_x is the risk charge component for asset risk stress x ;
- (b) A_y is the risk charge component for asset risk stress y ;
- (c) $\sum_{x,y}$ is the sum over all combinations of asset risk stresses, excluding the default stress;
- (d) $\text{Corr}_{x,y}$ is the correlation between asset risk stresses x and y ;
- (e) $\text{sign}(x)$ is 1 for the equity, property, and credit spreads stresses. For the real interest rates and expected inflation stresses, $\text{sign}(x)$ is 1 if the stress is a decrease in rates, otherwise it is -1. For the currency stress, $\text{sign}(x)$ is 1 if the stress is a depreciation of the Australian dollar against foreign currencies, otherwise it is -1; and
- (f) $\text{sign}(y)$ is defined in the same way as $\text{sign}(x)$.

78. The correlation matrix is:

Table 5: Asset Risk Charge correlation matrix

| | RIR | INF | CUR | EQY | PROP | CSP |
|-------------|------------|------------|------------|------------|-------------|------------|
| RIR | 1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| INF | 0.2 | 1 | 0.2 | 0.4 | 0.4 | 0.2 |
| CUR | 0.2 | 0.2 | 1 | 0.6 | 0.2 | 0.4 |
| EQY | 0.2 | 0.4 | 0.6 | 1 | 0.4 | 0.8 |
| PROP | 0.2 | 0.4 | 0.2 | 0.4 | 1 | 0.4 |
| CSP | 0.2 | 0.2 | 0.4 | 0.8 | 0.4 | 1 |

79. The real interest rates, expected inflation and currency stresses apply in two directions. The aggregation needs to be performed twice for each of these stresses if both stresses produce a non-zero risk charge component, with the larger of the aggregates chosen. If two of the bidirectional stresses have a nonzero risk charge component for stresses in both directions, the aggregation will need to be performed four times — once for each combination of stresses. If all three of the bidirectional stresses have a non-zero risk charge component for stresses in both directions, the aggregation will need to be performed eight times.

