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Dear Felicity

INSURANCE SOLVENCY STANDARDS: GUARANTEES AND OFF-BALANCE SHEET EXPOSURES

The Insurance Council of New Zealand ("the Insurance Council") appreciates the opportunity to provide comment on the proposals within the Reserve Bank's Consultation Paper regarding insurance solvency standards.

Our members have serious concern with the Consultation Paper as currently proposed. The proposals significantly limit the ability for insurers to recognise the benefit of guarantees as a valid form of risk mitigation for solvency purposes and also raise significant uncertainty for insurers with respect to off-balance sheet exposures.

1. **Insurance Council**

The Insurance Council is the industry representation body for fire and general insurance in New Zealand. The Council aims to assist members in key areas affecting their business through effective advocacy and communication.

The Council currently has 26 members who collectively write more than 95 percent of all fire and general insurance in New Zealand. Insurance Council members, both insurers and reinsurers, are a significant part of the New Zealand financial services system. Our members currently protect more than $0.5 trillion of New Zealanders' assets, including over $170 billion of home mortgages.

The Insurance Council plays an active role in representing the insurance industry. Our members are licensed under the Insurance (Prudential Supervision) Act 2010 and signatories to the Fair Insurance Code that requires insurers to act ethically. We also perform an important role in informing and educating consumers about key insurance issues and risks.

2. Consultation

When the Reserve Bank was in the initial stages of drafting the Solvency Standards it held public presentations with various industry bodies. These were extremely useful as it enabled the Reserve Bank to provide context around the intention of the wording within each Solvency Standard. We would strongly encourage the Bank to adopt a similar approach for this and subsequent material changes to the Standards.

3. Guarantees

We answer the following specific questions from the Consultation Paper.

1. Do you agree that guarantees of shorter duration than the underlying asset should receive some recognition in calculating an insurer's Asset Risk Capital Charge?

Yes.

2. Do you have any comments on the proposed treatment of limited term guarantees?

Yes, see answer to question 4.

3. What are your views on placing a limit on the amount that the Asset Risk Capital Charge can be reduced through the use of guarantees?

We believe there should be no limit on the use of guarantees. See comments under question 4.

4. Do you have any comments on the proposed amendments to the Solvency Standards in the appendices?

We have the following 3 significant issues with the proposed amendments in the appendices with respect to guarantees.

3.1. 15% Limit

Paragraph J in Appendix 1 proposes a limit on the amount of capital mitigation that may be obtained by way of guarantees, whereby an insurer's asset risk capital charge can be reduced only up to a maximum of 15% through the use of guarantees.

The Reserve Bank has not stated the basis or justification for arriving at this threshold. It does not appear reasonable nor reflect the inherent risk or any historical experience of guarantee defaults by suitably rated bank guarantors.

The credit risk on a guarantee from a suitably rated bank is the same as the credit risk on an ordinary investment with the same bank (e.g. term deposits) and therefore, we fail to understand why they are treated differently. The use of guarantees is a valid risk mitigation technique and we do not agree that the use of guarantees actually creates the perceived risks the RBNZ thinks it does.

The 15% limit proposal seems to be aimed at reducing exposures to any single counterparty. However, the solvency standards already account for this through the asset concentration risk charge which limits exposures to any single counterparty and captures guaranteed assets. Effectively this provision charges the insurer twice for utilising guarantees.

When compared to the actual cost of guarantees in the market, this proposal makes the use of guarantees as a valid and important form of risk mitigation uneconomical as the cost far outweighs the solvency benefits. There is a risk that these proposals will drive the wrong behaviour within the insurance industry.

Further, we are unable to find examples of other jurisdictions which apply a limitation on insurers for the asset risk capital charge.

We believe there should be no limit to the use of guarantees. If the Bank has concerns over particular contracts then in our view it would be better to raise that with the parties concerned rather than undermine guarantees for all market participants.

3.2. Restrictive Formula for Limited Term Guarantees

Paragraphs H and I in Appendix 1 propose a restrictive formula for calculating the portion of a limited term guarantee that may be recognised, based on the relative terms to maturity of the guarantee and the underlying asset.

Insurers will be required to undertake a separate calculation using this formula for both the asset risk capital charge and the asset concentration risk charge. This does not seem to have been taken into account or worked through by the Reserve Bank, as under the proposed formula the sum of these two charges could lead to a capital charge which exceeds 100% of the value of the underlying assets.

The sum of the asset risk capital charge and asset concentration risk charge should, as a matter of principle, not exceed 100% of the value of the underlying assets on the basis that the maximum possible loss that could be incurred is limited to the total value of the underlying assets. This occurs because there is no cap applied to the formula.

This effectively means insurers are encouraged not to use guarantees as a form of risk mitigation. This is despite the Reserve Bank's comments that, "*Guarantees of assets provide an important form of risk mitigation*." As noted above, these proposals run the significant risk of driving the wrong behaviour within the insurance industry.

The prescriptive formula proposed in the Consultation Paper should at least be capped to ensure that the sum of the asset risk capital charge and asset concentration risk charge do not exceed 100% of the value of the underlying assets.

3.3. Guarantees with more than one guarantor

Paragraph J in Appendix 1 proposes that where the licensed insurer has guarantees with more than one guarantor, and those guarantees would result in the 15% limit not being met, the guarantors with the higher quality counterparty rating must be used in the calculation of the AVG before those with a lower quality rating.

The example on page 10 highlights how these provisions actually act as a disincentive to use guarantees as a form of risk mitigation.

The insurer in that example has elected to protect its position with a number of guarantees. The concern arises when the value of the associated guarantees are omitted (e.g. by not recognising the guarantee on a2) in order to satisfy the calculation process.

The omission of a2 effectively undermines the whole purpose of obtaining guarantees from highly rated counterparties. Again, we believe there should be no limit to the use of guarantees.

4. Off-Balance Sheet Exposures

We answer the following specific question from the Consultation Paper.

4. Do you have any comments on the proposed amendments to the Solvency Standards in the appendices?

We have the following 3 primary concerns with proposed Appendix 2.

4.1. Uncertainty around wording

Section 95 in Appendix 2 proposes that contingent liabilities which have a remote possibility of a net outflow of resources over the next three years be included as off-balance sheet exposures and be subject to the asset risk and asset concentration risk charges as if they were assets.

The wording "*or which are able to be reasonably identified and give rise to a possibility, even if remote, of a net outflow of resources from the licensed insurer over the next 3 years"* is very open and could lead to unintended consequences.

It will significantly increase the level of complexity in solvency return calculations, requiring the actuary to take into account a wide range of possibilities that are unlikely to occur. This will require a significant amount of work which is not warranted given the relative risks these possibilities pose to an insurer.

If the Bank is looking to capture a specific item, such as lease commitments, then it should be transparent and explicitly state this. However, we reiterate that we do not support the inclusion of operating leases as off-balance sheet exposures and would appreciate confirmation of the Reserve Banks position on this particular matter.

Issue with wording "even if remote"

We note that the threshold has been set very low, as "*a possibility, even if remote*". Such a low threshold is significantly different to other jurisdictions such as Australia where remote matters, tax disputes or other legal disputes are not taken into account for risk charges. Australia's wording (APRA's GPS114) refers to financial instrument exposures (i.e. letters of credit, financial credit substitutes and surety bonds), as opposed to mere financial exposures (i.e. lease exposures and commercial warranties). The Reserve Bank's list of these kinds of potential exposures are too wide and, if anything, should be addressed by the insurer's management of operational risk and/or how the company is run by the independent board.

Further, In Australia, these exposures are only to be included in the asset risk charge to the extent that they affect the APRA-defined post-stress balance sheet position (in Australia, instead of applying factors to the value of assets and liabilities, companies are required to do 'stress tests', see what the impact on capital base is, and then report the change in capital base as the risk charge), and so will have less severe implications than the current RBNZ wording.

Members need clarification over the wording proposed by the Reserve Bank, particularly around the wording "*able to be reasonably identified*" and "*even if remote"*, as otherwise this provision will be impossible to comply with. This does not accord with the intention of the Reserve Bank, "*to increase certainty as to the intended application of the Standard*." The provision only exemplifies uncertainties.

Double counting of off-balance sheet exposures

In addition Section 95 of Appendix 2 does not make reference to the treatment of off-balance sheet exposures which may have already been accounted for through other charges. In particular we have in mind the guarantees and letters of credit that may be issued by or on behalf of insurers to claimants to support claims made against the insured. For example it is common practice in marine insurance to provide guarantees and letters of credit to claimants to secure the release of an insured's ship that has been involved in an accident (the security is provided to allow the ship to continue trading). As well, it is not uncommon for security to be provided to support appeals from decisions that may go against an insured. As the underlying liabilities of the claim which are being secured are already accounted for in other charges it is not efficient to charge the insurer twice for the same risk. Accordingly it makes sense to exclude from the off-balance sheet exposures those risks that are already provided for by other risk charges.

3 year solvency projection

Also, as paragraph 95 is concerned with the net outflow of resources over the next 3 years, we believe that the treatment of these contingent liabilities should not be treated within the solvency calculation with a capital charge, but instead be considered in the three year solvency projection.

4.2. Future Claims Disputes Payments

Section 96 in Appendix 2 proposes that a licensed insurer must include amounts for disputes in relation to unpaid claims in other off-balance sheet exposures.

We do not understand the rationale for this proposal. The liability for outstanding claims reserves in the balance sheet already includes allowances for disputes relating to unpaid claims. These allowances can be either implicit in the assumptions underpinning the valuation, or explicit in the case of large outstanding claims. Proper reserving practices would therefore mean that amounts relating to disputes on unpaid claims would already be factored in the outstanding claims valuation.

Given the Reserve Bank's strict requirements regarding the fitness and propriety of appointed actuaries, the default presumption should be that reserving practices of licensed insurers results in an outstanding claims valuation that already includes amounts for disputes relating to unpaid claims. Therefore, the proposals under section 96 are unnecessary and only add uncertainty.

4.3. Transition

We note that in paragraph 26 of the consultation paper there are transitional arrangements proposed for guarantees but no such arrangements for exposures. Given that both could have a material impact on insurers' solvency we feel that transitional arrangements should also be put in place for exposures. This would allow insurers to mitigate any potential adverse impact and assist in an orderly transition to the new Standards.

5. Conclusion

We would appreciate consideration of our above comments and will look forward to your response. Please contact Terry Jordan on (04) 472 5230, or at terry@icnz.org.nz, to discuss.

Yours sincerely

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