SOLVENCY STANDARD FOR NON-LIFE INSURANCE CONSULTATION DRAFT 29 APRIL 2011

Submission by the Insurance Council of New Zealand

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ICNZ Insurance Council of New Zealand

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1.0 Introduction

1.1 The Insurance Council of New Zealand

The Insurance Council of New Zealand (the Council) is the insurance representation body for fire and general insurance companies in New Zealand. The Council has 25 member companies and writes a substantial majority of New Zealander's general insurance business.

2.0 Overview

2.1 The Council is pleased to provide comments on the Draft Solvency Standard (the Standard) issued by the Reserve Bank in April.

2.2 Council members have been consulted and this submission reflects comments received from the members.

2.3 The Standard includes amendments that satisfactorily addressed one of the Council's earlier concerns by clarifying the application of Dual Solvency Standards, where an insurer has general and life insurance activities. The Standard also addresses concerns around Reserve Bank of New Zealand (RBNZ) approval, by removing the requirement for insurers to receive prior RBNZ approval for the payment of dividends and capital reductions. The Council sees this as a positive, pragmatic move.

2.4 However, the industry still has serious concerns about the Standard's proposed Catastrophe Risk Capital Charge, as well as some further general concerns which are outlined in clause 9.

3.0 Catastrophe Risk Capital Charge

3.1 Under the Standard, insurers are expected to have sufficient capital or reinsurance cover to meet their Probable Maximum Loss (PML) arising from:

- a one-in-one-thousand year earthquake economic loss where insurers have property exposures, or
- a one-in-two-fifty year economic loss from other catastrophe perils.

3.2 The Council's concern is that the one-in-one-thousand year event standard is an overly burdensome measure, which appears to have been set in an arbitrary manner. The requirement is too simplistic and too open to interpretation to be effective as a solvency catastrophe risk measure. The result of imposing this measure will be to increase the cost of insurance to all policyholders without any clear increase in policyholder protection.

3.3 One-in-one-thousand is an inappropriate standard given the experience from the Canterbury earthquake. Some companies that purchased reinsurance on the basis of their catastrophe modelling at the level of a one-in-one-thousand year event, had claims significantly in excess of their reinsurance levels, whereas others that had reinsurance levels well below the one-in-one-thousand year event, had losses well within their reinsurance levels. It is clear that to establish reinsurance levels solely by a measure of probability that an event will happen, is too simplistic and risks not achieving the regulatory objectives.

3.4 The requirement for reinsurance to cover a 1-in-1000 year event means that insurers are expected to cover the economic loss from a catastrophe that will occur only once every millennium. To put this in perspective, this means insurers would have needed to have sufficient reinsurance in place to cover the two largest catastrophes on record in the last 2,000 years. There are levels of loss that are not covered by insurance because they can't be measured and priced or they are too extreme, e.g. terrorism and war. For earthquake, in other parts of the world, cover is either not available or is too expensive. In Japan a Government scheme provides cover for up to 50% of the value of domestic properties and home owners have to purchase expensive top-up cover. In California 84% of domestic properties have no earthquake cover because of the large costs. Where earthquake cover is available, property owners have to absorb high excesses before cover commences. If high levels of reinsurance are required for New Zealand property insurers, this undesirable outcome may eventuate here in New Zealand. This will exacerbate the problems of non-insurance and under-insurance and leave the economy exposed to high levels of economic loss.

4.0 Finity Report

4.1 The Council asked Finity Consulting Pty Ltd to prepare a report on Minimum Acceptable Catastrophe Reinsurance to assist with its submission on the Standard. A copy is **attached** at Appendix 1.

4.2 The Finity Report highlights a number of compelling concerns with the one-in-one-thousand year event measure. These include:

4.2.1 **Dependence on catastrophe models** – insurers rely on catastrophe modelling to assist with establishing their reinsurance requirements. These models take into account the science (geophysics, geology, etc), property damage, technical insurance matters and insurance market data. While these models are highly complex, they are only ever a simplified version of reality that can produce approximate results based on the input submitted, in establishing insurers PML's. At the extreme end of probabilities the outputs of catastrophe models will be highly uncertain.

4.2.2 **Potential for model shopping** – a measure of one-in-one-thousand year event will result in reinsurance levels higher than most insurers would want to buy. As a result, insurers could potentially use less conservative models which would result in lower levels of reinsurance. We would regard this as an undesirable consequence.

4.2.3 **Higher reinsurance limits** – under the proposed one-in-one-thousand year earthquake risk reinsurance measure, insurers in New Zealand would be required to increase the amount of reinsurance they purchase. This is in spite of the fact that the vast majority of insurer's reinsurance programmes responded more than adequately to the Canterbury earthquakes, the largest disaster in New Zealand history.

4.2.4 **Increased reinsurance premiums –** requirements for increased levels of reinsurance in New Zealand will come at a high price for levels of risk that in reality, are seen to be extremely remote. If insurers are to maintain their positive margins, higher premium rates will be passed on to policyholders in the form of higher premiums.

4.2.5 **Stretched reinsurance capacity –** the large losses in Christchurch and Australia in the past twelve months, have focused reinsurance attention on the South Pacific. Reinsurers are facing extremely high costs for Australasian losses, which is likely to have an impact on reinsurance capacity here in New Zealand. Greater levels of reinsurance, as a result of the requirement to cover one-in-one-thousand year events, will result in issues of availability and affordability.

4.2.6 **Disadvantage to domestic insurers -** New Zealand indigenous insurers will be at a disadvantage against their international competitors if reinsurance requirements are set too high.

New Zealand's multi-national insurers tend to buy reinsurance under the umbrella of their parent companies and take advantage of economies of scale. If reinsurance requirements are set at much higher levels as is

proposed, this will exacerbate the competitive disadvantage of indigenous New Zealand insurers.

This will likely have the unintended consequence of encouraging insurers to set up office abroad.

4.3 Further information on the above points is contained in the Finity Report **attached** in Appendix 1.

5.0 Macro Economic Impacts

5.1 Additional reinsurance costs will be passed on to policyholders in their premiums. This could lead to customers not buying insurance, or reducing their cover. This will exacerbate the impact of under and non-insurance after a disaster, leaving the Government with a larger liability for reinstatement.

5.2 Increased reinsurance costs or reductions in capacity, could lead to insurers imposing high earthquake excesses for property as they do in Japan and California.

5.3 If insurers can't get satisfactory returns on investment in New Zealand because of a high costs regime they will move their capital to other jurisdictions where the requirements are not so onerous.

6.0 EQC

6.1 Currently the EQC covers the first $100,000 plus GST of property damage and $20,000 plus GST of contents damage. Government has indicated they will be reviewing EQC which could see them operating differently in the market. This will impact insurer's reinsurance costs and would need to be factored into the Solvency Standard when it occurs.

7.0 Regulatory Arbitrage

7.1 The proposed Catastrophe Risk Capital Charge at one-in-one-thousand years is vastly higher than other comparable international jurisdictions. The Council is concerned at the risk of regulatory arbitrage occurring as a result of overseas branches being able to rely on the solvency of their parent company in any of these overseas jurisdictions. (e.g., Australian companies require only one-in-two-fifty year's reinsurance cover for their Solvency Standard.) This places insurers who are incorporated in New Zealand at a significant disadvantage to overseas

branches and could encourage a move from an onshore incorporated entity to a New Zealand Branch structure. New Zealand indigenous insurers would not be in a position to do this and would be competitively compromised. The Council believes that the Solvency Standard would risk the creation of a non-level playing field.

8.0 Alternative Option

8.1 The Council believes the one-in-one-thousand proposal for reinsurance catastrophe cover is seriously flawed for all of the above reasons. As an alternative, insurers should be allowed to assess their reinsurance needs based on the PML for their individual company. For most companies this is typically the Wellington earthquake scenario; however some companies, because of their product mix and market niche, will identify other PML scenarios.

8.2 The Finity Report proposes that RBNZ develop a separate reinsurance guideline, which should require companies to identify their PML and be required to use agreed standard measures in modelling. This should result in less variation in interpretation of what the Solvency Standard actually requires. The Council submits that RBNZ should establish a separate guideline covering minimum acceptable reinsurance cover in accordance with the suggestions of the Finity report. This guideline can include technical detail on the determination of the PML and can cover other prudential requirements of the RBNZ regarding reinsurance.

8.3 This could be incorporated in the Solvency Standard under paragraph 59, which would read;

> "For a licensed insurer that has property and other exposure, the licensed insurers Probable Maximum Loss (PML), is the amount determined by the licensed insurer to the satisfaction of the RBNZ in accordance with any applicable guideline."

8.4 For licensed insurers who do not have property exposures, the reinsurance requirement could be the one-in-two-fifty year economic loss arising from other catastrophe perils, which is in line with other international jurisdictions.

9.0 Other Concerns

The Council's other concerns with the Standard are set out below:

9.1 Paragraph 31(vii) – Deductions from capital: It is not clear as to the kinds of assets this is intended to cover. It appears that such instruments as unlisted property trusts and unlisted shares may be captured. However we note that such assets attract an additional charge under Table 2 and as such should not need to be deducted from capital.

9.2 Paragraph 33 – we do not understand why sub-paragraph c) is limited to group solvency only. Nowhere in this paragraph is it specified what to do with a non-insurance subsidiary when reporting on a solo basis.

9.3 Paragraph 47 – Premium Liabilities Adjustment: This section refers to "unearned premium liability" and "unexpired risk liability", neither of which is defined. We suggest that the appropriate NZ Accounting Standard be used to define these.

9.4 Paragraphs 47 to 51 – the Premium Liabilities Adjustment is not subject to the factors in Table 1 and does not attract a tax deduction; the Outstanding Claims Liability Adjustment is subject to Table 1 and does attract a tax deduction. We submit that both adjustments should be subject to Table 1 and attract a tax deduction.

9.5 Further, the treatment of tax throughout the Standard is inconsistent, with some charges attracting tax relief and others not. We submit that all charges should attract tax relief to the extent that the insurer has sufficient deferred tax liabilities against which it could offset such relief.

9.6 Table 2 – we note that unrated New Zealand local authority debt attracts a higher charge than BBB rated securities. We submit that in terms of risk characteristics they are more similar to A rated securities.

9.7 Table 2 – subordinated debt receives a 15% or 40% charge, depending on the issuer's rating. Noting that subordinated debt is usually specifically rated itself, we question why the Standard does not apply a charge consistent with each subordinated debt issue's rating and limit the application of the current approach to unrated subordinated debt.

9.8 Paragraph 75 and Table 3 – the requirements are circular. Paragraph 75 states that the Asset Concentration Risk Charge is applied to exposures in excess of the limits specified in Table 3. Table 3 states that the limits are various percentages plus the charge. The charge should not be part of the limit.

9.9 Paragraph 31(i) – reference is made to Section 2.2; it should be 2.1.

9.10 Paragraph 79 – refers to paragraphs 84 and 89; it should be 85 and 90 respectively.

9.11 Paragraphs 89 and 90 – paragraph 90 requires that both an increase and decrease in interest rates be tested. However, paragraph 89 effectively limits this to an increase in interest rates as it only requires a fall in asset values to be considered.

9.12 Table 4 – we question why AAA rated reinsurers attract the same charge as AA rated reinsurers.

9.13 Paragraph 112 concerns recommended solvency ratios. We strongly believe insurers should not be required to disclose a comparison to a "recommended" solvency ratio. A standard "one size fits all ratio is too simplistic, and potentially misleading, as insurers are different sizes with different mixes of business with different capital requirements. Solvency ratios do not reflect scale risks, where smaller companies can have high solvency ratios but these don't reflect their full exposure to risk (e.g Western Pacific).

9.14 Paragraph 85 requires an insurer to apply an additional Asset Risk Capital Charge of 22% to the net open foreign exchange position in each currency other than NZD regardless of whether the position is long or short. It is appropriate to hold (at least) some equity in the same currency as the liabilities (to allow, for example, offsetting of potential losses). As such this charge is too onerous and consideration should be given to lowering the percentage charge.

10.0 Conclusion

10.1 The events in Christchurch have raised the issue of reinsurance requirements, however we note that for the vast majority of insurers, reinsurance cover was more than adequate for the Christchurch earthquakes and that insurers have also been able to purchase reinstatements after each significant earthquake event. At least one or two companies did not have sufficient reinsurance cover and we understand this to be because of a failure of catastrophe models rather than the level of cover.

10.2 To require all companies to raise reinsurance to the one-in-one-thousand level would be an excessive and unnecessary cost to New Zealand. The Council believes that the alternative outlined in the Finity Report in Appendix 1, is more realistic and more in line with the way insurers operate internationally.

10.3 The Council is happy to discuss these points further with the RBNZ and assist in developing the alternative reinsurance measure proposed.

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Appendix 1

Minimum Acceptable Catastrophe Reinsurance

A report prepared by Finity Consulting Pty Limited 2010