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By email: ian.woolford@rbnz.govt.nz

Dear Ian,

INSURANCE SOLVENCY STANDARDS - THE QUALITY OF CAPITAL AND REGULATORY TREATMENT OF FINANCIAL REINSURANCE

The Insurance Council of New Zealand ("the Insurance Council") appreciates the opportunity to comment on the Reserve Bank's Consultation Paper on Insurance Solvency Standards. The matters discussed in the Paper are of significant interest to our members.

1. Insurance Council of New Zealand

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.

The Insurance Council plays an active role in representing the insurance industry. Our members are licensed under the Insurance (Prudential Supervision) Act 2010 and are 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. Part One - The Quality of Capital

2.1. Do you agree/disagree with the definition of capital for solvency purposes?

These comments on capital are prefaced by the reminder that capital is not free. The providers of capital seek a satisfactory return and the greater the quality and quantity of capital required, the greater the cost. This cost must ultimately be borne by policy holders. The regulator must balance the need for policyholder protection with the need for affordable insurance products.

Specific Concerns

Paragraph 16 of the consultation document on Reserves is unclear. The categories a – d in this paragraph need to be explained and examples given to better outline what is intended. The devil is obviously going to be in the detail of this, but it is too difficult to comment at this stage without greater clarity. Can the bank give more direction on this?

Paragraph 17, we are uncertain why there should be these sub limits on non-cumulative preference shares. These seem no less robust than ordinary capital.

Paragraph 22(e)(i); what is meant by "any related party"? Can the bank provide some more detail on this?

Paragraph 22(e)(iii); this is very vague. We would appreciate clarification as to which circumstances this clause is intended to capture. It would be helpful to get some examples of circumstances in which the Reserve Bank would foresee this clause being relevant. Otherwise, this clause appears to be a catch-all type provision which would provide little certainty to insurers going forward.

Paragraph 28, we seek some clarity about whether share buy-backs are permitted. Is this seen as a "distributable item"?

Paragraphs 36 and 37; the words "contractual or any other arrangement" are too wide and vague. Can the Bank provide some explanation or guidelines that would make compliance easier?

Our member companies currently have fairly straightforward capital structures. Accordingly, the Reserve Bank's definition of capital for solvency purposes seems appropriate in the current context. However, if member's capital structures were required to change going forward, because of economic conditions or prevailing international trends for example, then it would be important to ensure the Reserve Bank's proposed definition was in line with other similar standards in similar jurisdictions.

It is important for the definition of capital for solvency purposes to be kept in line with similar definitions under accounting standards and also APRA standards in Australia. The original intention when the Solvency Standard was first developed was to tie the solvency calculations to NZ GAAP so solvency returns could be aligned as closely as possible with published financial statements. This was in order to minimise the workload and compliance in preparing the return. Recent evidence suggests the Bank has departed from that thinking and solvency is becoming more complex. Increased regulatory complexity ultimately impacts on the affordability of insurance.

In order to gain a greater understanding of the issues we ask that the Bank maps the difference between the proposals in this document and the requirements of IFRS.

2.2. Do you agree/disagree with the overall characteristics of high quality capital?

Again, due to our members' relatively straightforward capital structure this definition seems appropriate in the current context. However, it is important to make sure the Reserve Bank's proposed definition is in line with standards in similar jurisdictions. Too restrictive regulation will inhibit innovation and restrict improvements and efficiencies in capital structure, ultimately impacting on affordability of insurance.

2.3. Do you agree/disagree with the general requirements for capital instruments?

Again, due to our members' relatively straightforward capital structure this definition seems appropriate in the current context. However, it is important to make sure the Reserve Bank's proposed definition is in line with other similar standards in similar jurisdictions.

2.4. Do you agree/disagree with the qualifying criteria for capital instruments, for:

2.4.1. Ordinary shares

2.4.2. Reserves

2.4.3. Perpetual non-cumulative preference shares

2.4.4. Credit Union Securities

Our members will make comments on this in their individual submissions.

2.5. Are the proposed qualifying criteria for capital instruments appropriate for licensed insurers to manage their current and future capital requirements?

Our members will make comments on this in their individual submissions.

3. Part Two - Regulatory Treatment of Financial Reinsurance

3.1. Do you agree/disagree with the Reserve Bank's concerns regarding the current lack of constraints on the solvency benefits arising from financial reinsurance arrangements?

We agree with some of the Reserve Bank's noted concerns and it would add some clarity and certainty for members to have some existing guidelines to utilise in this area going forward.

However, it is important to note that financial reinsurance has the potential to be an effective capital mechanism for insurance companies in that it can support start-up business and can also help insurers in stress-situations, such as following a catastrophic disaster. Accordingly, while our members currently do not utilise this type of capital structure, some parent companies do and it is possible New Zealand subsidiaries may need to, or wish to, going forward. This prescriptive approach to financial reinsurance in the consultation document sets in stone rules around issues which the industry is currently not involved in. It would be better to have a more principled approach for the regulator to be able to evaluate future proposals against after reviewing these on a case by case basis.

An additional complexity is that member's reinsurance arrangements are often made at group level, which for many is in Australia. There is the potential for conflict if the New Zealand and Australia approaches to financial reinsurance differ greatly.

3.2. Do you agree/disagree that these concerns should be addressed?

Our members agree that these concerns should be addressed, but we do not necessarily agree with the policy proposals outlined by the Reserve Bank.

3.3. Are the two policy options presented in this paper appropriate ways of dealing with the issues?

Both options are very prescriptive and are out of line with current requirements under APRA.

As noted above, financial reinsurance can be a very effective capital mechanism in that it supports start-up business and can also help insurers in stress-situations such as following a catastrophic disaster. For that reason, it is very important that Option 1 is not elected.

It would make far more sense for the Reserve Bank to follow the APRA requirement for insurers to submit potential financial reinsurance contracts and have them assessed on a case-by-case basis – a slight variation on Option 2.

These financial reinsurance arrangements are not frequently utilised in New Zealand and so the Reserve Bank would not need to invest significant resources in terms of assessing such applications on a similar basis to APRA.

3.4. What are the advantages and disadvantages of the two options?

The advantage of adopting the second option (with slight variation to accommodate APRA requirements) is that it allows for a more pragmatic solution to the problem. This option would provide sufficient flexibility for insurers to be able to utilise these structures as well as appropriate certainty for the Reserve Bank going forward. Option 1 is overly prescriptive and would restrict insurers from utilising this type of capital structure.

3.5. Are there any other options that the Reserve Bank should consider?

The Reserve Bank should closely look at the requirements under APRA and use them as a guideline for developing an appropriate standard for New Zealand.

3.6. For insurers: How would your company be affected by the two options presented here?

Our members will make comments on this in their individual submissions.

3.7. What is your current use of financial reinsurance arrangements and what were the reasons for entering into those arrangements?

Our members will make comments on this in their individual submissions.

3.8. Are there any technical or implementation issues? If so, what are they and how could they be addressed?

N/A Our members will make comments on this in their individual submissions.

3.9. Are there any other possible indicators of financial reinsurance, apart from those outlined within the introduction to this part of the consultation paper?

N/A Our members will make comments on this in their individual submissions.

4. Part Three - Other Revisions to Solvency Standards

4.1. Do you agree/disagree with the proposed other revisions to the Reserve Bank's solvency standards set out above?

Proposed Revision No. 3:
The proposed solvency treatment of overseas branches seems onerous. There will potentially be a diluting effect on the solvency ratio of a company with overseas branches where the overseas branch is well capitalised. The overall reported solvency ratio of the insurer is diminished because of the presence of an overseas branch as the overseas branch capital is only counted as a reported ratio of 100% even though it might be higher. (This might be due to a portion of the overseas branch's margin not being freely available or where there are also local requirements or restrictions involved or for some other reason).

The other suggestions under Part 3 seem to make sense.

4.2. Are there any technical or implementation issues? If so, what are they and how could they be addressed?

Not as far as we are aware.

5. Conclusion

Thank you again for the opportunity to provide input on the Consultation Paper. We would appreciate the opportunity to discuss our submission in more depth with you. Please contact Terry Jordan on (04) 472 5230, or at terry@icnz.org.nz, to discuss.

Yours sincerely

Terry Jordan
Operations Manager