

**INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ
INC**

SUBMISSION
TO THE
RESERVE BANK
ON THE
DRAFT

SOLVENCY STANDARD FOR
LIFE INSURANCE BUSINESS

29 October 2010



I.S.I

INVESTMENT SAVINGS AND INSURANCE ASSOCIATION OF N.Z. INC.

1 Introduction

The Investment Savings and Insurance Association ("ISI") is the industry association representing the companies which issue or manage life insurance, superannuation and managed funds.

ISI members are also the leading providers of KiwiSaver funds and all six default providers are members of ISI.

As there are 15 ISI members that offer life insurance products, as well as 5 reinsurance companies, ISI is well-placed to provide views on the consultation draft of the Solvency Standard for Life Insurance Business issued on 23 August 2010 ("the draft standard") by the Reserve Bank of New Zealand ("the Bank").

A list of ISI members is given at the end of this submission.

2 Overview

Our initial analysis suggests that the draft standard will lead to an increase in the capital required above what we believe is a relatively conservative approach at present resulting from the current solvency standard of the NZSA, PS5.01 *Solvency Reserving for Life Insurance Business* (PS5.01).

This would appear to be unduly conservative and will have consequences such as:

- Further price pressure (on top of recent tax changes and a general belief that life insurance cover is too expensive)
- Reduction in return on capital
- Higher barriers for new entrants
- Consequent issues for both demand and supply, leading to greater underinsurance and erosion of a service which is in the public interest.

We support the solvency concept broadly, and in particular its role in promoting trust and confidence, however over capitalisation will drive poor outcomes for all stakeholders which we believe is ultimately damaging for the industry.

3 General Comments

3.1 Philosophy

It would be useful in forming a view and commenting on the draft standard if the Bank could articulate the philosophy behind the solvency requirement. We would expect the purpose of the solvency requirement to be related to the protection of policyholders' interest under a range of potential adverse conditions. The draft standard is not clear in this respect. For example, there is confusion regarding profitability versus solvency in paragraph 52 (we make further comment on this in section 4.7 below).

3.2 Practical Implications

Given the short timeframe in which this submission has had to be prepared, members are still working through the practical implications of the draft standard, including completion of the Quantitative Impact Study (QIS) released by the Bank.

However it is our view that the amount of capital required under the draft standard will increase across the industry, due to higher prescribed capital charges together with a potentially more granular product level and the \$5m minimum.

In general we do not believe that a significantly increased capital requirement for New Zealand life insurers is warranted or justifiable.

We will be in a position to provide further comment regarding the level of capital required under the draft standard once members have worked through the QIS.

3.3 Minimum Solvency Requirement

The draft standard should set out the minimum solvency capital that the Reserve Bank believes is appropriate.

However paragraph 127 requires that an insurer disclose a comparison of its Solvency Ratio with any recommended solvency ratio guideline published by the Bank. This implies that the minimum solvency capital set out by this draft standard may not be the minimum that the Bank believes is appropriate.

Taken together with paragraph 101, paragraph 127 is also somewhat disconcerting in that effectively the Bank has the ability to vary the requirements individually and collectively making the standard difficult to follow.

Should the Bank believe the minimum solvency capital is inappropriate, we believe that the Bank should look to revise the solvency standard rather than use a crude ratio to increase capital across the industry.

We note also that the requirement for insurers to be solvent at all times and to consider their projected solvency over a three year period, will mean that an

insurer will automatically require a buffer over the minimum level set out in the draft standard.

Any further minimum set in terms of a ratio will only serve as an extra required layer of capital. In our view, the Bank would need to be able to articulate the rationale for any extra capital requirement that results.

We recommend that paragraph 101 specify the circumstances the Bank expects would lead to an increased minimum requirement.

3.4 New Zealand Society of Actuaries Professional Standards

There are several references within the draft standard to the New Zealand Society of Actuaries (NZSA) Professional Standard No.3 (PS3) and NZSA professional standards in general (paragraph 145).

Inclusion of such references effectively gives those standards the weight of law. However the NZSA standards have not been drafted on that basis and we believe that it is inappropriate therefore to use them in this manner.

Further comment is provided below. In addition, we understand that the NZSA have made comment in this respect.

3.5 Accountability

There are several places in the draft standard where a particular calculation is specifically required to be calculated by the appointed actuary (eg. paragraph 67.c.iv.) and others where specific Board approval is required (eg. paragraph 67.d.iii). It is unclear why these items in particular are singled out in such a way.

We recommend that there be someone singularly responsible, whether the appointed actuary, the Board, the CFO or CEO, for the overall solvency calculation.

4 Detailed Comments

4.1 Application of the Standard

Statutory Funds

Under the Insurance (Prudential Supervision) Act (“the Act”), life insurance business is required to be ring-fenced in a separate statutory fund. The purpose of the statutory fund is to safeguard the interests of the policyholders whose policies are included in the statutory fund from other business interests of the insurer, including non-life insurance business.

In our view, each statutory fund should be required to meet the solvency capital requirement in its own right, excepting in respect of the overall minimum capital

requirement of \$5m. The rationale for the statutory fund, being to safeguard policyholders' interests, is not achieved if this is not the case.

Paragraph 38 of the draft standard allows for capital to be attributed to the statutory fund and that the capital thus attributed is then effectively included in the solvency calculation for the statutory fund. The statutory fund itself would not actually need to have assets greater than its liabilities, if there were sufficient free assets available outside of the statutory fund. This is not satisfactory and is inconsistent with the rationale for having statutory funds. Even if capital is attributed to the statutory fund, that capital is still potentially at risk from non-life insurance or non-insurance business outside of the statutory fund, which could threaten the financial security of the business within the statutory fund.

We recommend that the statutory fund be required to meet the solvency requirement in its own right, excepting for the overall minimum \$5m requirement which we believe is appropriate only at the total entity level.

Interaction between life and non-life standards

Many existing life insurers have blocks of business which are managed as part of their life insurance portfolio, but which are deemed to be non-life insurance business under the Act and hence would sit outside the statutory fund, for example health insurance.

Under the draft standard, such an insurer would be subject to a minimum capital requirement of \$8m; \$5m in respect of its life business within the statutory funds and \$3m in respect of its non-life business.

We question the rationale for the requirement for a separate \$3m minimum capital requirement for the non-life business specifically, in addition to the \$5m required for life insurance.

The risks taken on by a life insurer are many and varied. The capital requirement set out in the draft standard is designed to reflect these. We do not believe that there are any particular unique risks inherent in the non-life business outside of the life statutory funds that warrant an additional capital requirement by way of an extra \$3m minimum.

In addition, we understand that there are some life insurers with very small amounts of business which fall outside of the statutory fund. Requiring an extra \$3m of capital in such cases would be excessive.

We recommend that the minimum capital requirement for a life insurer be limited to \$5m in respect of all of its business.

4.2 Definitions

Paragraph 10 states that terms defined in the Act have the same meaning in the draft standard and are shown in bold. It is noted that terms other than those defined in the Act are also shown in bold.

For ease of reference, **we recommend** that the definitions be put in alphabetical order.

Estimated Liability

The use of the term “Estimated Liability” is confusing throughout the draft standard. It is used in different contexts in different places. In some cases, it appears to be akin to the Best Estimate Liability calculated for financial reporting purposes, but this is not always the case. For Participating policies, the Best Estimate Liability under PS3 would not include allowance for future bonuses and therefore in that case the Estimated Liability would not be equal to the Best Estimate Liability as calculated under PS3.

“Estimated Liability” is also used in paragraph 55 in terms of a recalculation of the Estimated Liability but using the solvency assumption set.

We refer to our comments in section 3.3 regarding reference to PS3. In addition, the definition of “Estimated Liability” refers to it being calculated in accordance with PS3. However there is no amount called “Estimated Liability” in PS3.

We recommend that different names are used for different amounts within the draft standard so that it is clear what is required.

We recommend that the draft standard either refer to specific amounts calculated for financial reporting purposes under NZ IFRS accounting standards, or sets out the basis for calculation fully.

Policy Liability

Similar comments as for “Estimated Liability” apply to the definition of “Policy Liability” in terms of its multiple use throughout the draft standard and the reference to PS3.

Paragraph 25 defines the policy liability to included allowance for future profit for non-participating business, but to exclude allowance for future profits for participating business. This is inconsistent with financial reporting requirements.

A further issue arises in relation to the definition of “policy liability” in that, resulting from recent changes to the life insurance taxation regime, many life insurers are now calculating policy liabilities for financial reporting purposes without allowance for tax, with an explicit deferred tax liability then being held on the balance sheet. This will need to be taken into account in the calculations within the draft standard.

Again, **we recommend** that different names are used for different amounts within the draft standard so that it is clear what is required, and that the draft standard either refer to specific amounts calculated for financial reporting purposes under NZ IFRS accounting standards, or sets out the basis for calculation fully.

We recommend that the draft standard be amended to reflect the possible calculation of the policy liability for financial reporting purposes on a gross of tax basis.

4.3 Associated Product Groups

Paragraph 28 sets out the principles of Associated Profit Groups (APGs) while paragraph 29 contains examples “which should not be regarded as being in the same associated product groups”.

It is important that the principles relating to APGs are clear. Currently, for financial reporting purposes, the life insurance industry uses Related Product Groups (RPGs) as required under NZ IFRS 4. We believe that the draft standard should look to lock in the same product groupings. This would provide consistency with financial reporting and be more practical for insurers.

The APGs effectively set the granularity at which the Current Termination Value (CTV) and financial reporting policy liability minimums are enforced.

A more granular product grouping together with the application of the CTV minimum at that level will result in increases in capital. As noted in section 2, we are concerned regarding the increase in capital that the draft standard appears to result in and the resulting consequence for the life insurance industry.

We recommend that the product groupings used in the draft standard be set to be the same as those used for financial reporting purposes under NZ IFRS 4.

Riders

It is unclear what is meant by “rider benefit”. Many life insurance entities only maintain one policy under which is grouped various benefits such as trauma, TPD, life, health and disability income. There is not necessarily any one base cover any more. One policy could have “coverages” providing benefits of each of the types a – f in the examples.

Many savings type contracts, eg. investment linked, may have insurance benefits attached, but for which a separate, identifiable premium is charged. In such cases, the contract should be unbundled into its separate components and treated as such.

Thus there is a clear contradiction between the requirement to have riders in the same product group as the base policy and the examples given.

Given this **we recommend** that the reference to rider benefits be removed.

Examples

The examples have been stated (at Bank stakeholder meetings) to be examples only and do not override the principles. However we find the examples distract from the principles.

Particularly we make comment regarding example d, which would require the separation into different product groups of contracts with substantially different commission terms or new business expenses. With respect to ongoing solvency, initial commission and new business expenses are irrelevant. What matters is the ability of the contracts to generate positive future cashflow.

In addition, insurers are unlikely to have sufficient information on past years new business to achieve such a split with respect to existing business.

We recommend that paragraph 29 is removed. In our view the application of APGs in line with the principles stated should be sufficient.

4.4 Capital

The draft standard only allows preference shares to be included as capital if they are fully paid-up perpetual non-cumulative preference shares that meet certain specified criteria.

In comparison, under banking regulations, registered New Zealand banks are able to hold some other types of preference shares as Tier 2 capital.

We do not believe there is any reason for life insurers to be treated any more onerously from a capital perspective than registered banks. **We therefore recommend** that the same rules apply to life insurers as to banks with regard to the admissibility of preference shares as capital.

4.5 Deductions from Capital***Future income tax benefits***

PS 5.01 allows future income tax benefits to be admissible for solvency purposes to the extent that it does not exceed the value of any income tax benefit that would accrue and be realised on ceasing to write new business.

We recommend that future income tax benefits should be admissible for solvency purposes to the extent that benefits could be reasonably realised under the shock scenarios presented.

Deferred Acquisition Costs

Some life insurers will have Deferred Acquisition Cost (DAC) assets on their balance sheet which relate to either non-life insurance business or non-insurance business. The inadmissibility of such DAC assets for life insurers is inconsistent with their treatment under the non-life solvency standard.

Under the financial reporting standards, DAC in relation to life insurance contracts is not explicitly shown on the balance sheet. Any explicit DAC on the balance sheet will relate to either non-life insurance business or non-insurance business. In these circumstances, there would not appear to be any justification for a difference in treatment between the life and non-life standards.

We recommend that DAC be admissible for life insurers to the extent that it relates to non-life insurance or non-insurance business, subject to the same liability adequacy test as in the non-life solvency standard.

Deferred Income Reserve

Some life insurers with DAC assets that would not be admissible under paragraph 37, also have on their balance sheets explicit Deferred Income Reserves (DIR). These reserves will be released to profit over time.

In many cases, the DIR and DAC asset are related to the same product line but for financial reporting purposes are required to be shown separately on the balance sheet. If it was not for this requirement, the two would be netted off and only the net figure shown.

We therefore recommend that the DAC asset for life insurers only be Deduction from Capital under paragraph 37 to the extent that it exceeds any related Deferred Income Reserve.

4.6 Dividend Payments

Section 52(1) of the Companies Act 1993 states that

“The board of a company that is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the solvency test may, subject to [section 53](#) of this Act and the constitution of the company, authorise a distribution by the company at a time, and of an amount, and to any shareholders it thinks fit.”

Many of our members believe that such a test should also be sufficient with respect to life insurers.

There are many actions that a board can take that have financial implication for the entity, including the payment of dividends. In all of these cases the board and management will need to take into account the implication of that action for the solvency of the company, including the impact on future solvency. We do not believe that there is any rationale for treating dividends any differently.

We recommend that paragraphs 45 and 46 are reviewed with this in mind.

4.7 Insurance Risk Capital Charge

Calculation

We note our previous comments regarding reference to PS3.

The calculation of the Insurance Risk Capital Charge is reliant on a recalculation of the financial reporting policy liability on more adverse solvency assumptions. Given expected changes to the calculation of insurance contract liabilities for financial reporting purposes (as per the recently released exposure draft by the International Accounting Standards Board), it would be useful if the draft solvency standard could stand on its own.

There is no need for a recalculation of the financial reporting profit margins. The key calculations are the calculation of the Estimated Liability using the Prescribed Solvency Assumption and then comparison to the CTV. An overall comparison to the financial reporting policy liability is only relevant to ensure that the resulting capital charge is appropriate to the calculation of capital. This would be the same regardless of the basis of the policy liability calculation.

We recommend that the Insurance Risk Capital Charge calculation be revised such that it does not require a recalculation of profit margins and the Policy Liability (as defined).

Further **we recommend** that the financial reporting policy liability minimum be applied at the statutory fund level. Carrying out this minimum at the product group level introduces a further level of conservatism above the requirement to hold the CTV.

The draft standard should be focused on solvency rather than profitability. What matters from a solvency perspective is the ability to generate future positive cashflow which is measured by the Estimated Liability.

We note also our earlier comments regarding the fact many life insurers now calculate policy liabilities on a gross of tax basis. This needs to be taken into account in the calculation of the Insurance Risk Capital Charge.

Health Insurance

Paragraph 57 of the draft standard directs that the insurance risk capital charge for health insurance be calculated in accordance with the non-life solvency standard.

There are a number of life insurers that sell health insurance within the same legal entity as life insurance business. In these circumstances, health insurance is usually valued for financial reporting purposes under the same accounting standard as life insurance (NZ IFRS 4 Appendix C), not valued as general insurance under NZ IFRS 4 Appendix D.

The items referred to in the non-life standard (eg. premium liabilities) will not therefore be part of the liability held in the financial statements for these contracts. As such it will not be possible to calculate the Insurance Risk Capital Charge for these contracts.

We recommend that the Insurance Risk Capital Charge for health insurance be included specifically as another benefit type in Appendix A.

We note that any health insurance which is treated as non-life by the life insurer can be covered under the non-life solvency standard upon application of paragraphs 3 and 4.

4.8 Catastrophe Risk Capital Charge

The calculation of the catastrophe risk capital charge appears to be taken directly from the non-life solvency standard and does not appear to properly assess the risk from a life insurance perspective. The charge of two times the maximum exposure is completely unrelated to any catastrophe risk that the entity might be exposed to.

In addition, relating the catastrophe charge to the cost of the catastrophe reinsurance program encourages insurers to take out minimal catastrophe cover which is not in the interests of policyholders.

We recommend that the catastrophe risk capital charge be reconsidered from a life insurance point of view so that it is appropriate to the exposure to risk.

Pandemic Risk

Many insurers do not consider a pandemic to be a catastrophe risk and in many cases it is not covered under existing catastrophe reinsurance cover.

Pandemic risk is an insurance risk and we are generally of the opinion that it is much better covered under the Insurance Risk Capital Charge, potentially as an additional mortality margin.

We therefore recommend that the reference to pandemics in paragraph 62 be removed.

4.9 Resilience Capital Charge

Calculation Principles

We have several comments regarding the calculation principles set out in paragraph 67.

- The term CCPL is not used anywhere else other than in 67.c.
- Under 67.c.ii, the CCPL should reflect the effect of the same asset shocks on the liabilities, rather than being the same magnitude as the asset shocks.

- The specific requirement in 67.c.iv for the CCPL to be calculated by the appointed actuary seems out of place. We do not understand why the CCPL in particular be singled out to be calculated by the appointed actuary.
- It is unclear why under 67.d.iii., changes to the hypothecated assets or liability portfolios need to be approved by the Board, when other methodology does not.
- It is unclear why under 67.d.v. it should specifically be the appointed actuary's responsibility to ensure that all of the criteria are satisfied for hypothecation, particularly after Board approval is presumably already been given.
- Paragraph 67.e. states that the Resilience Capital Charge must be calculated without any deferred tax or other taxation benefit. We are of the opinion that this does not appropriately allow for the reality of an asset shock (and consequent liability movement) in that in the normal course of events there would potentially be a consequent impact on deferred tax and other taxation benefits.

We therefore recommend that paragraph 67.e be deleted.

Credit, Equity and Property Risk

Paragraph 75 states that there is no CEP Capital Charge for the interest rate or foreign currency position arising from derivative transactions. We are unclear as to why this should be the case.

In table 2, we do not understand the rationale for the difference in treatment of AA rated fixed interest under and over one year's duration.

There are several references to off balance sheet exposures – paragraphs 67.a., 77, 78 and Table 2 item 9. In some of these it is clear that reference is to off balance sheet exposures that represent contingent liabilities, but that is not the case with all references (eg Table 2 item 9).

We recommend that the Bank clarify the treatment of off balance sheet exposures.

Table 2 has reference to unpaid premiums in items 5, 8 and 13. Distinction needs to be made where unpaid premiums are fully secured by the surrender value on the underlying policy. In such cases we are of the opinion that such premium assets should be fully admissible and receive no capital charge on them.

We recommend that Table 2 be amended to allow unpaid premiums that are fully secured by the underlying policies to have zero capital charge.

Interest Rate Risk

We believe the interest rate downward shock should be subject to a minimum level (for example, under PS 5.01 it is limited to 20% of the mid-swap rate) so

that there is no possibility it becoming negative in extreme conditions. Further, the price changes implied on bonds at lower interest rates are greater and hence major yield movements are less likely.

It is unclear what the phrase “either for the purpose of preparing financial statements or for internal risk management purposes” at the end of paragraph 85 is trying to achieve.

We note that in paragraph 86, the net revaluation impact only refers to a decrease in the value of assets and liabilities. This is inconsistent with paragraph 87 which then refers to both a yield upshock and downshock.

4.10 Asset Concentration Risk Charge

Paragraph 92 and Table 3 are confusing and somewhat circular. The 2nd column in the table appears to include both the limit and the charge.

We recommend that Table 3 be restructured to make clearly set out what the Asset Concentration Risk Charge is.

4.11 Reinsurance Risk Capital Charge

The calculation of the reinsurance risk capital charge appears to be taken directly from the non-life solvency standard and contains references (eg. to POS of 75%) that are not applicable for a life insurer.

To the extent that reinsurance arrangements are with a reinsurer who is also bound by this draft standard and hence also holds a specified amount of capital, we do not believe there should be any requirement to hold a reinsurance risk capital charge.

We recommend that the Reinsurance Risk Capital Charge for life insurance business be revised, taking into account the above comments

4.12 Discretions

Paragraph 105 indicates that any discretions must be approved by the Board. Together with hypothecation of assets and liabilities (paragraph 67) these seem to be the only components of the solvency calculation that must be approved by the Board.

We do not understand the rationale for the particular need for approval by the Board of discretions used. As paragraph 106 goes on to state, application of discretions will be a matter of professional judgment, as will the calculation of other components that impact the solvency calculation but for which Board approval is not required.

We recommend that the Bank review the specific clauses in the draft standard with regard to approval by the Board, with a view to ensuring that this is appropriate and consistent.

We note that paragraphs 112 and 114 regarding inflation linked increases to expense charges are inconsistent. **We recommend** this is reviewed.

4.13 Obligations of a Licensed Insurer

Section 5 sets out the obligations of a licensed insurer as prescribed by the Act. We do not believe they need to be restated in the solvency standard.

4.14 **Obligation of an Appointed Actuary**

Section 6 appears to have been copied directly from the non-life solvency standard and includes reference to items that are not appropriate to life insurers.

We therefore recommend that Section 6 be revised such that it is appropriate to life insurers.

The reference to PS 3, in paragraph 136, we believe gives an inappropriate weight of law to PS3. With respect to a life insurer, figures for the financial statements are required to be calculated in accordance NZ IFRS 4 Appendix C and where any inconsistencies arise, PS 3 is secondary to NZ IFRS 4.

We recommend that the reference in paragraph 136 to PS 3 be changed to NZ IFRS 4.

Paragraph 142 sets out what the Bank to consider relevant issues in considering tax. Paragraph 142(c) appears to be inconsistent with the Deductions from Capital requirement to exclude all deferred tax assets or future tax benefits.

We recommend that paragraph 142 be rewritten to state only that the solvency calculations should have appropriate regard to tax.

List of ISI Members

ISI MEMBERS

AIA New Zealand
AMP Financial Services
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AXA New Zealand
BNZ Life Insurances
CIGNA Life Insurance NZ Ltd
Dorchester Life
Equitable Group
Fidelity Life Assurance Co Ltd
FNZ Limited
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
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