

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

**SUBMISSION
TO THE
RESERVE BANK
ON THE
DRAFT
SOLVENCY STANDARD FOR
LIFE INSURANCE BUSINESS**

27 May 2011



I·S·I

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

1 Introduction

- 1.1 The Investment Savings and Insurance Association ("ISI") is the industry association representing the companies which issue or manage life insurance, superannuation and managed funds.
- 1.2 ISI has 15 members that offer life insurance products, as well as 5 reinsurance company members, which puts us in a strong position to give an industry view on the second consultation draft of the Solvency Standard for Life Insurance Business which was released by the Reserve Bank ("the Bank") on 18 April 2011.
- 1.3 In total ISI has 23 members and 18 associate members who collectively manage over \$60 billion in collective investments on behalf of 1.3 million New Zealanders. ISI members are also the leading providers of KiwiSaver funds and include the KiwiSaver default providers.
- 1.4 A list of members appears at the end of this submission.

2. General Comments

- 2.1 We have appreciated the willingness of the Bank to consult on the draft Life Insurance Solvency Standard and we are pleased to see that a large number of the recommendations we made in our submission on the first draft of the Standard have been accepted by the Bank.
- 2.2 Overall we would expect the latest draft to produce capital requirements for insurers closer to the current actuarial standard. It was our understanding that this was the broad intention of the Bank at the outset of the process and so it seems that aim is closer to being achieved. However, it is likely that most insurers are still materially distant from this point and we submit that further work needs to take place to ensure that this gap is closed.
- 2.3 In particular, we are pleased to note that the provisions for "Associated Product Groups" have been omitted from the second draft. This will alleviate a significant financial and practical burden on life insurers in New Zealand. Alignment with the IFRS financial reporting requirements and professional actuarial standards is a far more practical approach.
- 2.4 Other clarifications in relation to deferred acquisition costs, taxation treatment and recalculation of profit margins are also welcomed by the industry. There are, however, a few concerns remaining for insurers in the second consultation draft with one being the retention at paragraph 131 of the reference to "any current recommended solvency guideline published by the Bank". This is unfortunate as it creates ongoing uncertainty around the actual level of the Bank's solvency requirements.

Other remaining concerns are outlined below.

3. Specific Comments

3.1 Catastrophe Risk Capital Charge

It is imperative for the longevity of the industry that life insurers are able to withstand a significant catastrophic event. A comprehensive study published in 2007 by Swiss Re predicted that a “1-in-200 year severity pandemic would give rise to excess mortality of between 1 and 1.5 deaths per 1000 lives within an insurance portfolio.”¹ Therefore, we believe the requirement for insurers to withstand a 1 per 1000 excess mortality event is not only reasonable, but necessary to provide adequate long-term peace of mind to New Zealand policyholders.

However, we do have concerns around the lack of diversification and a lack of clarity of particular aspects of the Catastrophe Risk Capital Charge calculation. These concerns could lead to unnecessary increases in capital and inconsistencies in the measurement of Catastrophe Risk. Specifically, our concerns are:

- Catastrophe risk is largely uncorrelated with long-term insurance risk and asset-liability mismatch risk. Holding capital in respect of catastrophe risk *on top of* capital for insurance and asset risk could over-state the capital needed to remain solvent with a 99.5% probability. We believe many insurers would already be able to withstand a 1-in-200 year catastrophe and an appropriate allowance for diversification between risk types (or alternative modification) is required to avoid significant increases in capital across the industry.
- Paragraph 60 requires insurers to hold a non-prescriptive amount of capital for other catastrophes. This will result in a lack of clarity and will be open to a number of different interpretations. It is also extremely unlikely that a major catastrophe would occur in the same year as a pandemic, so holding capital for both types of catastrophe is very conservative.
- Paragraph 60 also requires insurers to consider other risk concentrations; however, any material insurance risk concentrations that pose a threat to the future solvency would be discussed in the Financial Condition Report as per paragraph 144; therefore, it is not necessary to include risk concentrations in the Catastrophe Risk Capital Charge.
- It is unclear whether the Catastrophe Risk Capital Charge calculation permits an insurer to take account of reserves being released. We believe it would be appropriate for an insurer to recognise the release of reserves from participating, unit-linked and annuity business in the event of a catastrophe.
- The intention of the “cost of one reinstatement of the full catastrophe reinsurance contract” is unclear. Retentions and coverage conditions would vary widely on catastrophe reinsurance and this would significantly affect the cost. Holding capital for the cost of reinsurance may ultimately discourage

¹ For further details on the Swiss Re paper, refer to this website:
http://www.swissre.com/media/news_releases/new_focus_report__swiss_re_estimates_level_of_excess_deaths_in_life_insurance_portfolios_due_to_a_pandemic_mortality_shock.html

comprehensive catastrophe reinsurance, which is disadvantageous to the industry.

We recommend that the Catastrophe Risk Capital Charge should be changed to:

- A provision for a prescribed 0.5 per 1000 increase in mortality rates over the following year for a pandemic or a natural disaster, whichever is greater after allowance for catastrophe reinsurance; plus
- A requirement for the Appointed Actuary to increase the Catastrophe Risk Capital Charge, if required, to ensure the Minimum Solvency Capital is enough to withstand a more significant catastrophe (eg 1.5 per 1000 increase in mortality rates over one year) and still meet minimal liabilities within each Life Fund; and
- Permit an insurer to recognise the release of reserves in the Catastrophe Risk Capital Charge calculation where it is appropriate to do so; and
- Remove paragraph 60 and the requirement for the insurer to hold capital for the “cost of one reinstatement of the full catastrophe reinsurance contract”.

3.2 The Solvency Margin

The Solvency Margin calculation could make comparisons unfair. The Solvency Margin, expressed as a ratio, is the Actual Solvency Capital divided by the minimum solvency requirement. For risk business, the minimum solvency requirement is predominantly made up of a negative policy liability. So if the Bank recommends a solvency margin ratio of, say, 110%, this will mean the insurer is recommended to hold 10% more than the CTV as well as 10% of the absolute value of the negative policy liabilities. Other lines of business with positive policy liabilities would not have this issue, so any comparisons between insurers would not be fair if their mix of business was different.

To explain this issue further, consider the following example for a risk portfolio (ignoring Other Liabilities and non-insurance risk charges):

Policy liability (PL)	-100m
Insurance Risk Capital Charge = CTV	+10m
Minimum Solvency Capital (MSC)	+110m (= CTV – PL)
Recommended capital level	+121m (= MSC x 110%)

Effectively 10m of the recommended capital level is held in respect of the recommended margin on the negative policy liability.

We recommend that the Actual Capital and Minimum Solvency Capital are reduced by an amount equal to the sum of any negative policy liabilities (calculated at RPG level) prior to the solvency margin being calculated.

3.3 Obligations of a Licensed Insurer

As noted above and in our submission on the first draft of the Solvency Standard, we believe the retention at paragraph 131 of the reference to “any current recommended solvency ratio guideline published by the Bank” is unfortunate as it creates ongoing uncertainty around the actual level of the Bank’s solvency requirements.

3.4 Tax

The Best Estimate Liability (paragraph 14), Policy Liability (paragraph 27) and Solvency Liability (paragraph 55) are all to be calculated 'net of tax'. Currently for financial reporting purposes, many life insurance companies in New Zealand calculate pure risk policy liabilities gross of tax and then hold a separate Deferred Tax Liability on the balance sheet. These reserve calculations do not need to take into account the transitional adjustment for grand-parented policies under the new life insurance tax regime, particularly where this is only applicable for the next few years to 30 June 2015.

To include with company projection systems, the coding of the transitional adjustment (with all its inherent complexities) would be costly to implement. Given that it is only really an issue for the next just over four years and would only serve to reduce the Best Estimate Liability, Policy Liability and Solvency Liability, **we recommend** that allowance should be made to calculate these three items on a gross of tax basis with allowance for a corresponding Deferred Tax Liability. There should be scope to recalculate the deferred tax liability to meet the requirements of the solvency standard if appropriate.

The requirement in Paragraph 121a for the amount of taxation to be clearly identified is not practical for either the Insurance Risk Capital Charge or the Resilience Risk Capital Charge, where tax components are effectively embedded in the Solvency Liability.

The tax position must be assessed assuming a “wind up” scenario, which is inconsistent with the “going concern” nature of the rest of the standard. Indeed the standard does not imply a “wind up” scenario at all given the 3 year horizon for meeting the minimum solvency capital.

3.5 Comments on the Reinsurance Recovery Risk Capital Charge

We question the need for such a charge if the reinsurers are regulated by the Bank and propose that the reinsurance recovery risk capital charge in paragraph 99 should apply only for those reinsurers not regulated either by the Bank or by regulators “approved” by the Bank.

Furthermore, this requirement does not allow for the fact that a reinsurer could increase premium rates in the future.

We propose alternatively that the Reinsurance Recovery Risk Capital Charge should have an allowance for the credit risk of reinsurers involved in reinsuring catastrophe risk. This is likely to be the most important component of reinsurance recovery risk and a new paragraph should be added requiring capital to be held in respect of catastrophe reinsurance recovery risk.

Under paragraph 98, the Reinsurance Recovery Risk Capital Charge must allow for any implicit reinsurance asset within the Solvency Liabilities. If this requirement is retained in its current form (noting our comments above) it would be theoretically more correct if it was based on the Insurance Risk Capital Charge, rather than the Solvency Liability. This would be consistent with the approach to the Resilience Risk calculation (which uses the Insurance Risk Capital Charge). This approach would take account of the CTV

minimum used in calculating the Insurance Risk Capital Charge; however we believe this is appropriate.

We also note that there would be practical problems with splitting out future liabilities by an individual reinsurer (paragraph 96). Individual products can be reinsured by more than one reinsurer, yet an insurer's valuation is done at product level (not reinsurer level). We submit that this requirement should be removed.

3.6 Consumer credit business no longer in statutory fund

A new requirement in the solvency standard is that consumer credit insurance business cannot be in a life statutory fund (paragraph 4). We are unclear why this is the case, given that it is an insurance risk contingent on death or disability of a human life. Addition of such requirements also presents difficulties for insurers trying to establish their statutory funds in the licensing phase. **We recommend** that consumer credit business should be permitted to be in a statutory fund.

3.7 Health Insurance

It should be acknowledged that health insurance business written within a life insurance company will be subject to different capital requirements than health insurance business written within a non-life insurance company. While it would require some analysis to confirm, it is expected that the life insurance capital requirements will generally be higher. The Bank should be aware that this may lead to insurers structuring their companies to take advantage of this capital difference; which could in turn lead to a more complicated regulatory process. The Bank should be neutral to this situation and should allow insurers to choose the appropriate solvency requirements (i.e. either life or non-life) they wish to apply to their health insurance business.

3.8 Reference to NZSA standards is inappropriate

The reference to NZSA professional standards is inappropriate as it gives the professional standards the weight of law.

3.9 Asset risks

While we support the general approach we believe that the percentage may need review and refinement vis-à-vis other regulators. Currently the draft allows no credit for investment diversification at all. This could drive investment to sovereign bonds which may not be appropriate for asset-liability matching and management purposes.

The Asset Risk Capital Factors in Table 2 should be consistent with the draft non-life solvency standard unless there is a good reason not to be. Specifically, the non-life AA rated fixed interest charges distinguish between <1 year and >1 year; whereas the life standard does not. We believe the life standard is the correct one and the non-life should be updated.

3.10 Foreign Exchange Shock

An additional capital charge of 22% of any net open foreign exchange position is extreme, particularly given the lack of any diversification benefit. The use of foreign currency investments may be an appropriate investment particularly given the long

term nature of some insurance product offerings and the small investment market in New Zealand. An onerous capital charge does not facilitate good investment decisions.

We recommend that the FX capital charge needs to take into account the overall position of the company and in particular the diversification of its investment portfolio. **We further recommend** that a charge of 22% is overly conservative and does not take into account the long term nature of many of these investments.

3.11 Interest Rate Down Shock

Under the current NZSA professional standard, the interest rate down shock is limited to 20% of the mid-swap rate. The proposed Bank standard is only limited to a floor of zero in terms of the resulting interest rate used. When interest rates are low, this level of down shock is particularly extreme in terms of the impact it has on the value of the underlying assets and liabilities. **We recommend** that the interest rate down shock should be limited by reference to the absolute value of the interest rate prior to the shock being applied.

3.12 Interpretation/Definitions/Referencing

The standard should state clearly the basic background scenario that the Bank is envisaging, that is whether it is in the context of an entity that is closed to new business and now in run-off, or a going concern, and all assumptions and discretions should be made on this basis.

The definition of "Other Liabilities" in paragraph 26 is "...liabilities that are not Policy Liabilities". In general, there is no indication of how these should be valued. We expect that in most cases they should be calculated at the same value as in the NZ GAAP financial statements except if further guidance is given elsewhere within the solvency standard. This needs to be clarified.

The definition of Solvency Margin in paragraph 30 should be restricted to a ratio (not a dollar amount) as otherwise it conflicts with paragraph 131. With that restriction, paragraph 34 also needs to change to make the Solvency Margin not less than 1.

The reference to entity accounts in paragraph 44 should be clarified to show that "entity accounts" refers to the "Parent Accounts" not the "Group Accounts".

There are some referencing errors which should be fixed:

- Paragraph 66e should refer to section 3.3 not 5.2
- Appendix A, section 8 should refer to 3.3, not 6.3;
- In Table 2, references to Asset Class 16 should be to Asset Class 14;
- Paragraph 98 should refer to paragraph 55, not paragraph 61

List of ISI Members

AIA NZ
AMP Financial Services/AXA New Zealand
Asteron Life Ltd
BNZ Investments and Insurance
CIGNA Life Insurance NZ Ltd
Dorchester Life
Fidelity Life Assurance Co Ltd
FNZ
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
Kiwibank Ltd
Medical Assurance Society NZ Ltd
Mercer
Munich Reinsurance Co of Australasia Ltd
OnePath
Pinnacle Life
Public Trust
RGA Reinsurance Co. of Australia Ltd
Sovereign Ltd
Southsure Assurance
Swiss Re Life & Health Australia Ltd
TOWER New Zealand
Westpac/ BT Funds Management Ltd

Associate Members

Bell Gully
BNP Paribas
Bravura Solutions
Burrowes & Co
Chapman Tripp
Davies Financial & Actuarial Ltd
Deloitte
DLA Phillips Fox
Ernst & Young
InvestmentLink (New Zealand) Ltd
KPMG
Kensington Swan
Melville Jessup Weaver
Minter Ellison Rudd Watts
Morningstar Research Ltd
PricewaterhouseCoopers
Russell McVeagh
Simpson Grierson