The Act passes, and the Transition begins...

The Insurance (Prudential Supervision) Act 2010 was quietly passed on 7th September 2010, a few days after the devastating earthquake in Christchurch. Having moved largely from the consultation period to implementation phase, we think it is worthwhile revisiting the core reasons for the development of the Act.

Whilst the Act has passed, another consultation draft of the non-life insurance solvency standard has been released. We highlight 6 key points and provide our thoughts on the potential impacts on insurers.
Use these quick links below to dip into items of interest.

- **Catastrophe Risk Capital charge** – further protection required for earthquake risk
- **Overseas Insurers** – some decisions to make
- **Premium Liability** – wording changed introducing “assessment period”
- **Composite Insurers** – minimum capital applied to each line of business
- **Deferred Acquisition Costs** – provision for allowance clarified
- **Treatment of Dividends and Capital Reductions** – bank permission required in some cases.

### Insurance (Prudential Supervision) Act 2010

The purposes of the Act are to promote:

- the maintenance of a sound and efficient insurance sector, and
- public confidence in the insurance sector.

These purposes are achieved by:

- establishing a system for licensing insurers
- imposing prudential requirements on insurers
- providing for the Reserve Bank to supervise compliance with those requirements
- conferring certain powers on the Bank to act in respect of insurers in financial distress or other difficulties.

In achieving the purposes of the act, the Bank must take into account 10 principles. These include:

- the importance of insurance to members of the public in terms of their personal or business risk management
- recognising that it is not the purpose of the Act to eliminate all risk of insurer failure
- the desirability of consistency in the treatment of similar institutions
- the need to maintain competition within the insurance sector
- the need to avoid unnecessary compliance costs.

The Act is well placed to largely achieve the stated purposes, although much of the detailed implementation will come via regulations and guidelines that have not been published yet - so we need to wait and see what eventuates.

Given one of the principles is to maintain competition officials have attempted to negotiate a path that balances the interests of international insurers with an appropriate domestic prudential regime. Of necessity this has resulted in some compromise.
Non-Life Insurer Solvency Standard

For most non-life insurers the draft solvency standard appears to have been accepted without too many issues. The structure and content is similar to APRA and the use of IFRS accounts as the starting point helps to keep the calculation process relatively simple. There is some complexity for insurers with liabilities of any length as a result of the Interest Rate Risk Capital charge, but the required calculations are not overly complex.

The draft standard for captives is consistent with the non-life insurance standard, although the minimum capital required is reduced from $3 million to $1 million. The minimum capital for life insurers is $5 million. It is likely, but not confirmed, that composite insurers will be subject to a combined minimum of $8 million. (see below)

A revised standard (consultation draft) for non-life insurers was recently published, dated 20 October 2010. Key points from this revised draft and our thoughts on implications are below.

Draft Solvency Standard dated 20 Oct 2010

Overall Comments

We agree with much of what the Bank has done in developing the regulatory regime - going from nothing to a full regime is not a simple task and on the whole we think it has been done well.

The phased transition period included in the Act is logical, but as always, uncertainty can be difficult to deal with. Until all regulations are in place and the Bank has had the opportunity to talk to insurers about individual transition plans, there remain unanswered questions. In particular a number of insurers are unclear about when the Bank will talk to them and what the nature of these discussions will be.

The Bank has confirmed that Australia and the United Kingdom will be “prescribed jurisdictions” so on application branches in New Zealand will be granted reporting exemptions under Section 59 of the Act. As a result we expect the most “comfortable” at the moment are the branches of Australian incorporated insurers:

- they are currently reporting under the APRA regime with an Appointed Actuary, Financial Condition Report, Fit and Proper Policy, and Risk management framework.
- there is consistency in accounting standards between New Zealand and Australia.

As a result reporting to the Bank in New Zealand should not be onerous. The degree of consistency in approach with the United Kingdom is less clear. For other insurers, particularly branches of non-exempt jurisdictions, the reporting requirements and level of compliance will require significant preparation, often relying on the parent to complete the work required.
Catastrophe Risk Capital Charge (paragraphs 57 - 61)

This is the biggest change in this draft of the standard. The risk charge now depends on the nature of the insurer’s risk exposure.

<table>
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<tr>
<th>Insurer</th>
<th>Catastrophe Risk Capital Charge</th>
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<tbody>
<tr>
<td>No Property Exposure OR no risk greater than reinsured catastrophe retention</td>
<td>2 times largest risk retention, plus cost of one reinstatement</td>
</tr>
<tr>
<td>With Property Exposure AND NO Earthquake risk</td>
<td>Net cost of catastrophe including any gap relative to 1 in 250 year event, plus cost of one reinstatement</td>
</tr>
<tr>
<td>With Property Exposure AND Earthquake risk</td>
<td>Net cost of catastrophe including any gap relative to 1 in 1000 year event, plus cost of one reinstatement</td>
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In addition, the actuary is required to consider the accumulation of exposures across multiple policies, and if the terms of the standard above don’t adequately reflect the exposure to catastrophe events, then the actuary must recommend an appropriate alternative.

Commentary:
- Recent events in Christchurch are a timely reminder of the uncertainties insurers face and the approach taken in this aspect of the standard is reasonable.
- The requirements may not greatly impact the industry with those insurers exposed to earthquake risk typically already purchasing reinsurance to cover a Wellington event, which is broadly in line with a 1 in 1000 year return. For those that don’t purchase to this level we assume the Bank is confident that reinsurance capacity is available, and that it will continue to be in the future for all insurers.
- But why codify current practice? If the Bank is satisfied that most insurers currently purchase at the 1 in 1000 year level and this is achieved in the absence of any regulation, we’re not convinced that the introduction of a regulatory capital requirement at 1 in 250 years will set a de facto minimum level and change this.
In contrast to the Bank’s approach, APRA appears to be moving towards a 1 in 200 year requirement. This is not as inconsistent as it might first appear, as the risk profiles of large events in the two countries are very different. The costs of low frequency, high severity events in New Zealand are proportionately higher given the nature of the seismic and volcanic risk in New Zealand. This difference may be represented as follows:

**Figure 1 – Example Catastrophe Risk Profile NZ and Australia**

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<thead>
<tr>
<th></th>
<th>Australia</th>
<th>NZ</th>
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**Compulsory Reinsurance Introduced**

Our greatest concern regarding the changes proposed for the Catastrophe Risk Capital Charge relates to the wording of paragraph 57. While this paragraph is headed “Concept”, it appears to require insurers to purchase reinsurance cover at least to the level of losses generated by a 1 in 1000 year earthquake event and 1 in 250 year event for other risks. The introduction of a requirement to purchase a stated level of reinsurance cover is a significant change of approach taking responsibility away from Board and management.

At a practical level, we’re not sure how this requirement would be applied by a licensed insurer who is a reinsurer.

In our view paragraph 57 should refer to the concept that an insurer’s reinsurance and capital must be sufficient to provide cover in the event the specified levels of loss occur, leaving the insurer responsible for how this is achieved.
Overseas Insurers (paragraphs 35 and 36)

There is no change in approach to branches, although the Bank has advised that they will shortly publish the first list of exempt (“prescribed”) jurisdictions - Australia and the United Kingdom.

The requirements for non-exempt regimes are to effectively provide reporting to the Bank of the overseas parent’s entire position on the New Zealand solvency basis. All branches will report their parent company results to the RBNZ, presumably including the Financial Condition Report.

The RBNZ has adopted this approach attempting to balance the interests of local and overseas insurers. But does the concession for overseas insurers provide much, other than for branches of Australian companies?

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Given regular reporting will be done from overseas for many non-exempt branches, we believe the risk of non-compliance will be relatively high. The penalties for not complying and the reputational damage that may cause, especially with the home jurisdiction regulator, are potentially significant.

As a result we expect a number of branches (other than Australian and possibly UK), will consider incorporating locally in New Zealand or restructuring as branches of Australian insurers.

We are also unclear how this approach provides protection for New Zealand policyholders and promotes public confidence in the insurance sector. The Bank views the New Zealand branch of an overseas insurer as being “indivisible” from the parent.

Do overseas insurers (and regulators) view this arrangement in the same way?

If not, what will this mean for policyholders in New Zealand?

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Cost of
- complying with NZ and home jurisdictions
- risk of not complying with NZ requirements from abroad

Cost of
- incorporating locally in New Zealand
- capitalising the New Zealand subsidiary

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Premium Liability (paragraph 21)

Premium Liabilities have now been defined as “the present value of the expected future cash flows relating to all future claims arising from rights and obligations under the licensed insurer’s existing policies that have not yet expired during the assessment period”. The assessment period is the period until benefits or premiums can be adjusted to reflect adverse changes in risk. This may be at expiry, the next policy renewal or some other date.

Commentary:
- This change is driven by longer term or open ended policies such as health insurance. The particular concern is that the insurer allows for contracts where premium revenue may not have been recognized in the unearned premium liability and where there is an ongoing obligation for claims.
- While the wording is not clear, we understand it is the intention that insurers will allow for future premium receipts during the assessment period (i.e. those not included within unearned premium) as well as future claim payments.
- The approach is similar to the concepts used in the Liability Adequacy Test of NZ IFRS 4.

Composite Insurers (paragraph 4)

If a licensed insurer underwrites both life and non-life insurance, they are subject to both solvency standards and must apply the relevant standard to each line of business separately.

Commentary:
- We are not sure that this approach works in the current version unless the insurer is able to completely split its balance sheet, including capital, between the lines of business.
- More significant is the requirement for each line of business to meet the minimum level of Minimum Solvency Capital - $3 million for non-life and $5 million for life business.
- The rationale for requiring each line of business within a single insurer to be subject to separate levels however escapes us, particularly given the exemption for life insurers who write health insurance and can report it under the life insurance standard.

We suggest that the bank amends this requirement such that the insurer determines the solvency margin for each line of business ignoring the $3 million or $5 million minimum, and then apply the greater of these (i.e. $5 million) when determining the overall Solvency Margin for the total insurer. In our view the minimum test should be applied at the entity level, rather than “fund” or line of business level.
Deferred Acquisition Costs (various paragraphs)

Commentary:
- Provisions relating to the allowance for DAC have been tidied up. As expected DAC is allowable to the extent that it is supported by the Liability Adequacy Test. Any amount not supported is deducted from capital.

Treatment of Dividends and Capital Reductions (paragraph 38)

Paragraph 38 requires insurers to notify the Bank if they propose payment of a dividend that is more than the earnings in respect of the period to which the dividend relates. The Bank may decline to approve such transactions.

This is not a new provision.

Commentary:
- Similar to the introduction of compulsory reinsurance in paragraph 57, this requirement is inconsistent with the principles underlying much of the regulatory regime the Bank is implementing.
- With respect to dividend payments other safeguards already exist including:
  - Under the Companies Act, Directors must ensure that the company is solvent before a proposed dividend is paid and that it will continue to be solvent after payment is made.
  - The standard’s requirement for maintenance of a solvency margin is ongoing and includes a continuous forward looking 3 year view.
- Given both of these requirements we do not believe Bank approval of dividend payments is necessary.
- We would also note that in many instances movement in capital requirements may be different to reported profits. It is quite possible for insurers (life insurers in particular) to report profits while at the same time reporting a declining Solvency Margin. In these circumstances the insurer could pay a dividend without notifying the Bank.
- As these provisions are repeated in the life insurer solvency standard they do not achieve the desired outcome.

We recommend these provisions be removed as the terms of the Companies Act, together with the continuous and forward looking solvency test of the standard are sufficient.
What’s next?

Now that the Act has passed what are the next steps?

- All insurers must complete the “Insurer Notice of Intention to Carry On Business of Insurance in New Zealand” form and submit it to the Reserve Bank by 5 January 2011. The form is available from the Reserve Bank’s website.
- In coming months the Bank will publish supporting regulations, guidelines and standards. Insurers should assess how the Act, standards and regulations will impact on them.
- During the first quarter of 2011 the Bank will be consulting with each insurer and developing individual transition plans with them. These plans will be formalised as conditions to provisional licenses.
- We expect the Bank will consult widely on standards as they are developed, so ensuring consultation drafts are reviewed and submissions made to the Bank is important. This will require commitment from insurers to free up staff to allow time for thorough analysis.
- By March 2012 insurers will need to be in a position to apply for a licence under sections 17 and 18 of the Act.

Contacts

If you have questions or points you would like to discuss please contact us.

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Insurers who are faced with options and decisions should be in a position to discuss these with the Bank as part of the transition planning discussions in early 2011.

We’re ready to assist insurers with developing responses, considering strategic options and planning, and with preparation of licence applications.