

Reserve Bank of New Zealand

Solvency Standard For Captive Insurers Transacting Non-life Insurance Business

1. Introduction

1.1. Authority

1. This **solvency standard** is made under Section 55 of the Insurance (Prudential Supervision) Act 2010 (“the Act”).
2. Once approved by the **Bank**, this **solvency standard** becomes a regulation under the Act (refer Section 233(1)).

1.2. Licensed Insurer may be both a captive insurer and an insurer that is not a captive insurer, and may be subject to more than one solvency standard

3. A licensed insurer may be a captive insurer as well as an insurer that is not a captive insurer. To the extent that the insurer carries on non-life insurance business in New Zealand that is captive insurance it will be considered a captive insurer, and all the provisions of this solvency standard will apply to that insurer in respect of the captive business. Similarly, to the extent that an insurer carries on insurance business in New Zealand that is not captive insurance business, or is otherwise not covered by this solvency standard, it will be subject to the requirements of the solvency standard or standards appropriate to other business it carries on.
4. Except as provided for in paragraph 5 below, where a **licensed insurer** is subject to more than one **solvency standard** the requirements of each **solvency standard** will apply separately as appropriate to each class of business carried on by the **licensed insurer**, and the overall requirement on the **licensed insurer** will be the aggregate of the requirements of each **solvency standard** to which the **licensed insurer** is subject.
5. Where a licensed insurer is subject to more than one solvency standard the Minimum Capital Requirement applicable to the licensed insurer (refer paragraph 41 of this solvency standard) will be the higher, or highest, of the Minimum Capital Requirement (or in the case of a licensed insurer that is a life insurer, the Fixed Capital Requirement) amounts within the applicable solvency standards. The requirements shall not be cumulative.

1.3. Application

6. This **solvency standard** applies to, and only to, every **licensed insurer** that is a **captive insurer**, as defined in the Act, that transacts non-life insurance business. To the extent that the provisions of this **solvency standard** conflict with the provisions of any other **solvency standard** issued by the **Bank** under Section 55 of the Act that may apply to a **captive insurer** that transacts non-life insurance business, then the provisions of this **solvency standard** will prevail in respect of that **captive insurer**.
7. Section 5 of this **solvency standard** applies to the **actuary** appointed by the **licensed insurer** in accordance with Section 76 of the Act.

1.4. Previous Versions

8. None.

1.5. Effective Date

9. This **solvency standard** is effective from the date of commencement of Subpart 2 of Part 2 of the Act.

1.6. Definitions

10. The **Act** means the Insurance (Prudential Supervision) Act 2010. Terms defined in the Act have the same meaning in this **solvency standard** and are shown in **bold type**.
11. **Actual Solvency Capital** of a **licensed insurer** means the total of Capital minus Deductions from Capital determined in accordance with Section 2 of this **solvency standard**.
12. **Appointed actuary** means the **actuary** appointed by the **licensed insurer** in accordance with Section 76 of the Act.
13. **Collective investment** vehicle means a managed investment fund including but not limited to unit trusts and group investment funds.
14. **Financial Institution** means a financial institution as defined in the Reserve Bank of New Zealand Act 1989.
15. **Local Authority** has the same meaning as in Section 5(1) of the Local Government Act 2002.

16. **Material** means important or essential in the opinion of the **appointed actuary**. For this purpose 'material' does not have the same meaning as in NZ GAAP.
17. **Minimum Solvency Capital** for a **licensed insurer** means the amount determined in accordance with Section 3 of this **solvency standard**.
18. **Net Outstanding Claims Liability** means all unpaid claims and claims handling expenses, net of **reinsurance** and other recoveries and excluding any Government charges imposed such as levies, duties and taxes, relating to claims incurred prior to the end of the reporting period, determined in accordance with NZ GAAP as it relates to insurance contracts.
19. **Non-insurance activity** means any fee-generating business activity undertaken for third party customers that does not involve the acceptance of risk under a **contract of insurance**. For example, non-insurance activity includes insurance broking, premium funding, claims management services and risk management consultancy activities.
20. **NZ GAAP** means New Zealand Generally Accepted Accounting Practice. For the purposes of this regulation, **financial statements** will be deemed to comply with generally accepted accounting practice only if those statements comply with:
- a. applicable financial reporting standards; and
 - b. in relation to matters for which no provision is made in applicable financial reporting standards and that are not subject to any applicable rule of law, accounting policies that:
 - i. are appropriate to the circumstances of the reporting entity; and
 - ii. have authoritative support within the accounting profession in New Zealand.
21. **Premium Liabilities** means the present value of the expected future cash flows relating to all future claims arising from the 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 during which, in the opinion of the **appointed actuary**, premiums and benefits cannot in practice be adjusted to reflect adverse changes in risk. This period may be until expiry, or next

policy renewal or some other date, and may differ from any period used for accounting purposes.

- a. The value of the premium liabilities must include an amount in respect of the expenses that the **licensed insurer** expects to incur in administering and settling the relevant claims and allow for expected premium refunds.
 - b. In respect of premium liabilities for which **reinsurance** has not yet been purchased, allowance must be made for this **reinsurance**.
 - c. Premium liabilities are to be determined on a prospective basis, net of expected **reinsurance** recoveries and non-**reinsurance** recoveries.
 - d. The value of premium liabilities must exclude any Government charges imposed such as levies, duties and taxes.
 - e. Premium Liabilities are to include a risk margin intended to provide a 75% probability of sufficiency, and are to be assessed by the **appointed actuary**.
22. **Solvency margin** is defined as the excess of Actual Solvency Capital over Minimum Solvency Capital, and may be expressed as a dollar amount, or a proportion, or a ratio, or a percentage.
23. **State-Owned Enterprise** means an organisation named in Schedule 1 or Schedule 2 of the State-Owned Enterprises Act 1986.

1.7. Requirements of the Act

24. Section 21(2)(b) of the Act requires that a **licensed insurer** must, at all times, maintain a solvency margin as defined in the **solvency standard**. The solvency margin must always be greater than zero, and a **licensed insurer** must maintain Actual Solvency Capital in excess of the amount required to maintain this solvency margin.
25. Sections 21(2)(f) and (g) of the Act require attestation by a **licensed insurer** to the **Bank** relating to compliance with any conditions of licence, which includes any that may relate to a **solvency standard**.
26. Section 24 of the Act requires that, if a **licensed insurer** has reasonable grounds to believe that a failure to maintain a solvency margin is likely to occur at any time within the next 3 years, the

licensed insurer must report the likely failure to the **Bank** as soon as is reasonably practicable.

27. Section 76 of the Act requires each **licensed insurer** to appoint an **actuary**. Section 77 requires the **licensed insurer** to have its **appointed actuary** review certain items in the **financial statements**. Section 56(d) sets out requirements regarding the preparation of a financial condition report.

28. Compliance with the **solvency standard** (Section 21(2)(b) of the Act) is a continuous obligation. As a minimum a **licensed insurer** must undertake calculations as required under this **solvency standard** twice each year – as at its financial year end and as at six months after its financial year end – and report those calculations to the **Bank**.

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2. Actual Solvency Capital

29. Actual Solvency Capital is defined as the total of Capital (as per paragraph 30) minus Deductions from Capital (as per paragraph 31).

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30. Capital is defined as the following items:

- (i) issued and fully or partly paid-up ordinary shares, that have full voting rights, have no preferential or predetermined rights to distributions of capital or income and are not redeemable within the meaning of Section 68 of the Companies Act 1993. (*Partly paid-up shares qualify as Capital only to the extent the shares have been paid*);
- (ii) fully paid-up perpetual non-cumulative preference shares may be included in Capital if they meet the following requirements:
 - (a) the payment of dividends on shares is able to be withheld if the financial condition of the **licensed insurer** would not support payment of those dividends; and
 - (b) dividends that are withheld in accordance with sub-paragraph (a) are not cumulative; and
 - (c) the dividend rate for the shares must be set:
 - i. as a fixed percentage rate; or
 - ii. as a fixed margin above a benchmark floating rate (e.g. a bank bill rate); and
 - (d) the shares are not:
 - i. subject to any arrangement for resetting the dividend rate; or
 - ii. redeemable within the meaning of Section 68 of the Companies Act 1993; or
 - iii. repayable or redeemable at the option of the holder.

Perpetual non-cumulative preference shares without full voting rights may not constitute more than 50% of Capital for a **licensed insurer** that is a mutual insurer and 25% for all other **licensed insurers**.

- (iii) revenue and other reserves, including the following, but not including reserves that are held aside or otherwise committed on account of any assessed likelihood of loss:
 - (a) capital redemption reserves;
 - (b) other reserves that are created or increased by appropriations of retained earnings net of tax and dividends payable;
 - (c) share premium reserves arising from the issue of ordinary shares;
 - (d) each of the following types of reserves that are reflected in the statement of financial position:
 - i. reserves arising from a revaluation of tangible fixed assets, including owner-occupied property;
 - ii. foreign currency translation reserves;
 - iii. reserves arising from the revaluation of investments;
- (iv) retained earnings; and
- (v) non-controlling interests.

31. Deductions from Capital is defined as the sum of the value of the following items:

- (i) goodwill and other intangible assets as determined in accordance with Section 2.2 of this **solvency standard**;
- (ii) future tax benefits, or recognised deferred tax assets;
- (iii) equity investments in, and subordinated loans to, related parties (but see paragraph 77);
- (iv) equity investments in, and subordinated loans to, other financial institutions or holding companies of other financial institutions (whether held directly or indirectly) that are classified as Counterparty Grade 1 or 2 or 3 as per Table 4, to the extent that the total of such equity investments or subordinated loans exceeds 15% of Actual Solvency Capital;
- (v) equity investments in, and subordinated loans to other financial institutions or holding companies of other financial institutions (whether held directly or indirectly) that are classified as Counterparty Grade 4 or Counterparty Grade 5 as per Table 4;
- (vi) unrealised gains and losses on liabilities designated at fair value through profit and loss that arise from changes in the **licensed insurer's** own credit risk;
- (vii) any fair value gain that relates to a financial instrument for which:
 - a. fair value is determined in whole or in part using a valuation technique based on assumptions that are not supported by processes from observable current market transactions in the same instrument; or
 - b. fair value is not based on observable market data; or
 - c. fair value is based on prices in a market that is not active;
- (viii) any surplus, net of any associated deferred tax liabilities, in any defined benefit superannuation fund sponsored by the licensed insurer (or another group entity) as employer;
- (ix) allowance for any dividend that has been declared or repayment of capital made prior to preparation of the solvency calculations but which has not been reflected in the accounts, and
- (x) any deferred acquisition costs in excess of the amount determined in accordance with Section 2.2 of this **solvency standard**.

32. The NZ GAAP **financial statements** to be used for the purpose of this **solvency standard** are, in the first instance, the entity accounts of the **licensed insurer**.

33. Solo and Group Solvency Reporting Requirements:

(a) Where a **licensed insurer** has a subsidiary or subsidiaries that are themselves **licensed insurers** then the **solvency standard** must firstly be applied to, and reported on a solo basis for, each **licensed insurer**.

(b) In addition, where a **licensed insurer** has subsidiaries that are themselves a **licensed insurer**, such subsidiaries must be consolidated with the **licensed insurer** for the purpose of calculating and reporting group solvency in accordance with the requirements of this **solvency standard**.

(c) Where a **licensed insurer** has subsidiaries that are non-insurance subsidiaries, then for the purposes of calculating group solvency only, such non-insurance subsidiaries should be treated as **related party** equity investments, subordinated loans or other obligations in accordance with the provisions of this **solvency standard**.

(d) The **Bank** may require a group to exclude from its Actual Solvency Capital any component which the **Bank** has reasonable grounds to believe does not genuinely contribute to the financial strength of the group.

34. The Capital of the **licensed insurer** is intended to represent capital instruments that are of a permanent nature and freely available to meet losses. If a capital instrument is not of a permanent nature and freely available to meet losses, then the **appointed actuary** must give advice in the Financial Condition Report in accordance with Section 5 of this **solvency standard**. If the **appointed actuary** recommends that part or all of the value of a capital instrument should be excluded from the Actual Solvency Capital, then the **licensed insurer** must follow that advice.

35. In the case of a **licensed insurer** that is a mutual insurer incorporated in New Zealand, Capital may be referred to as 'Reserves' or 'Members Funds'.

36. An **overseas insurer** that operates a branch in New Zealand, that has been granted an exemption under Section 59 of the Act, will be required to calculate and report the solvency position of the parent

company calculated in accordance with the regulatory requirements of the home jurisdiction of the parent company. In addition, the **Bank** may require the **overseas insurer** to report solvency in respect of the New Zealand Branch of the **overseas insurer** (as if it were a New Zealand Corporation), prepared in accordance with the requirements of this **solvency standard**. Within this calculation all or part of the Capital of the Branch may be reported as 'Head Office Balance' or similar.

37. An **overseas insurer** that operates a branch in New Zealand, that has NOT been granted an exemption under Section 59 of the Act, will be required to calculate and report solvency of the parent company calculated in accordance with the requirements of this **solvency standard**. In addition the **Bank** may require the **overseas insurer** to report the solvency position in respect of the New Zealand Branch of the **overseas insurer** (as if it were a New Zealand Corporation), prepared in accordance with the requirements of this **solvency standard**. Within this calculation all or part of the Capital of the Branch may be reported as 'Head Office Balance' or similar.

2.1. Intangible Asset Deductions

38. The Intangible Asset Deductions comprise the following amounts to the extent that they form part of the assets of the **licensed insurer** according to NZ GAAP:

- (a) Goodwill measured in accordance with NZ GAAP, to the extent that this has not otherwise been deducted;
- (b) Capitalised computer software costs to the extent that they exceed the known resale value of that software (if the resale value is not known then it should be taken as nil); and
- (c) Any other intangible asset to which NZ GAAP applies (note that deferred acquisition costs are measured according to NZ IFRS 4 *Insurance Contracts* and so are not an intangible asset deduction for this purpose).

2.2. Deferred Acquisition Costs

39. The amount of deferred acquisition costs that may be included in Actual Solvency Capital is limited to the amount that can be supported after applying a Liability Adequacy Test which:

- (a) incorporates a risk margin to achieve a probability of sufficiency of at least 75%; and
- (b) does not defer acquisition costs beyond the current insurance contract period; and

- (c) is otherwise in accordance with NZ IFRS 4; and
- (d) is signed off by the **appointed actuary** in accordance with the Professional Standards of the New Zealand Society of Actuaries.

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3. Minimum Solvency Capital

40. The Minimum Solvency Capital is the sum of all components of the:

- Insurance risk capital charge (refer Section 3.1 below)
- Asset risk capital charge (refer Section 3.2 below)
- Foreign currency risk capital charge (refer paragraph 70 below)
- Interest rate capital charge (refer paragraphs 71-75 below)
- Reinsurance recovery risk capital charge (refer Section 3.3 below)

41. The Minimum Solvency Capital applicable to the licensed insurer for the purposes of this solvency standard will be subject to a minimum required amount of \$1 million. If the Minimum Solvency Capital calculated as per the previous paragraph is less than \$1 million then the licensed insurer must increase its Minimum Solvency Capital to this amount.

3.1. Insurance Risk Capital Charge

Concept

42. The Insurance Risk Capital Charge is intended to recognize and reflect:

- a. the risk to the **licensed insurer** of writing unprofitable insurance business;
- b. the exposure of the **licensed insurer** to operational risk, (although it is not a substitute for adequate management of operational risk);
- c. the risk to the licensed insurer of inadequate provision being made for outstanding claim liabilities

Calculation

43. The Insurance Risk Capital Charge is an amount equal to 20% of the largest foreseeable per event retention of the **licensed insurer** plus the cost of one reinstatement of the relevant **reinsurance** programme if any.

44. The largest foreseeable per event retention is the cost to the **licensed insurer** of the largest individual claim or series of claims, relating to a single event, to which it could reasonably be exposed under policies issued, net of **reinsurance** recoveries.

45. If the **licensed insurer** issues policies that do not have a maximum sum insured, or are not protected by excess of loss **reinsurance**, then the **licensed insurer** may need to seek the advice of its **appointed actuary** as to a reasonable approximation for the largest foreseeable per event retention.

Insurance Business with Long Term Risk Characteristics

46. Most non-life insurance comprises short term contracts (up to one year) with no long term guarantees or contractual commitments. There can, however, be products that have features like guaranteed renewability, return of premiums and other features that create longer term commitments and risks for the **licensed insurer**. There are also products such as single premium consumer credit and lenders mortgage insurance that cover risks over a period much longer than one year and thus create long term risk for the **licensed insurer**.
47. If a **licensed insurer** issues a material volume of contracts with features that may produce significant risk for the **licensed insurer** for more than one year then the **licensed insurer** must seek and adopt the advice of its **appointed actuary** on:
- (a) An appropriate basis for setting provisions for unexpired risk (including unearned premiums) and outstanding claims
 - (b) Whether an additional capital risk charge is appropriate in light of the risks to the **licensed insurer** and, if so, what is a suitable basis for calculating that risk charge.
48. The **appointed actuary** must, in giving the relevant advice, consider the significance of the risks and the materiality of the business, and may judge that no adjustments are needed.
49. The **appointed actuary** must consider whether the life insurance **solvency standards** in force from time to time give additional guidance as to appropriate treatment of contracts with long term risk and, if appropriate, seek to achieve reasonable consistency with the life insurance **solvency standards**.

3.2. Asset Risk Capital Charge

Concept

50. The Asset Risk Capital Charge is intended to reflect the exposure of the **licensed insurer** to losses on investment assets, and some other minor asset classes. It is intended to reflect credit risk in respect of the relevant assets, as well as asset concentration and liquidity risks.

Calculation

51. In order to determine the Asset Risk Capital Charge, the **licensed insurer** must first assign each of its investment assets to the relevant Asset Class as per the definitions in Table 2. The counterparty grade must be determined in accordance with Section 3.4 of this **solvency standard**.
52. If the **licensed insurer** holds investments in a professionally managed collective investment vehicle such as a unit trust, then the **licensed insurer** must 'look through' the investment vehicle to the nature of the underlying investments that represent the share of the assets attributable to the **licensed insurer**. Similarly, if the **licensed insurer** has a subsidiary entity that is primarily used to hold investments for the **licensed insurer**, then it must 'look through' the subsidiary entity to the nature of the underlying investments.
53. In applying the 'look through' approach in the preceding paragraph, the **licensed insurer** must only 'look through' if it is satisfied with the quality and reliability of the information about the underlying investments. The **licensed insurer** must also take account of any special conditions (such as guarantees or redemption restrictions) that the investment vehicle may provide.
54. Assets that have been explicitly, unconditionally and irrevocably guaranteed for their remaining term to maturity by a guarantor with a counterparty rating (or for governments, the long-term foreign currency credit rating) in Grades 1, 2 or 3 (refer Table 4) may be assigned the Asset Risk Capital Factor that would be applicable to the guarantor. Guarantees provided to a **licensed insurer** by its own parent entity or by any **related party** are not eligible for this treatment.
55. The Asset Risk Capital Charge is the total of the asset values in each Asset Class (to the extent that the asset values have not been excluded from, or reduced in, the determination of Actual Solvency Capital in Section 2 herein) multiplied by the relevant Asset Risk Capital Factor from Table 2 plus the Asset Concentration Risk Charge (if any).
56. Any asset that is a Deduction from Capital under Section 2 of this **solvency standard** will not be subject to an Asset Risk Capital Charge.

Table 2 – Definition of Asset Classes, and Asset Risk Capital Factors

Asset Class	Definition	Asset Risk Capital Factor
1 Cash and Sovereign Debt	Notes and coin Cash at bank on call Debt issued by or guaranteed irrevocably by the New Zealand government or a government or supra-national agency with a Grade 1 counterparty rating	0.5%
2 AA rated fixed interest < 1 yr (excluding related party transactions)	Any debt obligation (excluding subordinated debt) maturing or redeemable in less than one year with counterparty rating of Grade 1 or 2 Cash management trusts with counterparty rating Grade 1 or 2	1%
3 AA rated fixed interest > 1 yr (excluding related party transactions)	Any debt obligation (excluding subordinated debt) maturing or redeemable in one year or more with counterparty rating of Grade 1 or 2	2%
4 A rated fixed interest (excluding related party transactions)	Any debt obligation (excluding subordinated debt) with counterparty rating of Grade 3 Cash management trusts with counterparty rating of Grade 3	4%
5 Unpaid premiums < 6 months	Unpaid premiums that are not yet due or are less than six months past the contractual due date for payment to the licensed insurer	4%
6 Deferred Acquisition Costs	Deferred Acquisition Costs that are determined in accordance with Section 2.2 of this standard	5%
7 BBB rated fixed interest (excluding related party transactions)	Any debt obligation (excluding subordinated debt) with counterparty rating of Grade 4 Cash management trusts with counterparty rating of Grade 4	6%
8 Unrated Local Authority Debt, and Third Party Claims Recoveries	Any debt obligation with a New Zealand local authority that is unrated Claim recoveries collectable from Third Parties (excluding reinsurance recoveries)	8%

<p>9 Other fixed interest and short term unpaid premiums (excluding related party transactions)</p>	<p>Any debt obligation with counterparty rating of Grade 5 or unrated Cash management trusts with counterparty rating of Grade 5 or unrated Subordinated debt of a counterparty with rating of Grade 1 or 2 or 3 Unpaid premiums that are more than six months but less than twelve months past the contractual due date for payment to the licensed insurer</p>	<p>15%</p>
<p>10 Related Party transactions between captive insurer and its parent owner</p>	<p>Any debt obligation or other balance of any nature between a captive insurer and its parent owner</p>	<p>15%</p>
<p>11 Off Balance Sheet Exposures not covered elsewhere</p>	<p>Off balance sheet exposures and contingent liabilities not dealt with elsewhere</p>	<p>20%</p>
<p>12 Listed equity & trusts, and property, plant and equipment</p>	<p>Equities listed on a recognized stock exchange Listed trusts (unless the look through provisions require them to be included in another asset class) Listed property trusts Direct property holdings Owner occupied property Property, plant and equipment</p>	<p>25%</p>
<p>13 Unlisted equity, unlisted trusts</p>	<p>Unlisted equities Unlisted trusts (unless the look through provisions require them to be included in another asset class)</p>	<p>35%</p>
<p>14 Any Other Assets (not described elsewhere)</p>	<p>Any other asset not described in the table, including assets associated with non-insurance activities that are not dealt with elsewhere, but not including reinsurance assets covered under Section 3.3</p>	<p>40%</p>
<p>15 Assets incurring a full Capital Charge</p>	<p>Loans to directors of the licensed insurer or of associated parties Unsecured loans to employees or agents of the licensed insurer in excess of \$1,000</p>	<p>100%</p>

	<p>Assets under a fixed or floating charge Unpaid premiums that are twelve months or more past the contractual due date for payment to the licensed insurer</p>	
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Asset Concentration Risk Charge

57. In order to determine the Asset Concentration Risk Charge, the **licensed insurer** must first calculate the total value of its assets that represent obligations of one entity (counterparty) or group of related entities, (to the extent that the asset values have not been excluded from, or reduced in, the determination of Actual Solvency Capital in Section 2).
58. The Asset Concentration Risk Charge for each counterparty is a separate charge in addition to the Asset Risk Capital Charge **calculated in accordance with paragraph 55, and applies only to the licensed insurer's** total asset exposure to each counterparty that exceeds the limits specified in Table 3.
59. The Asset Concentration Risk Charge in respect of each counterparty is calculated as the product of the **licensed insurer's** total assets with that counterparty in excess of the limits specified in Table 3, and the applicable Asset Risk Capital Factors determined from Table 2, except for the obligation category "Any other asset or counterparty exposure" for which the multiplier will be two times the applicable Asset Risk Capital Factor determined from Table 2.
60. For **licensed insurers** with total assets less than NZ \$10 million there is no Asset Concentration Risk Charge for obligations secured by bank bills or deposits with a registered New Zealand bank.
61. The Asset Concentration Risk Charge is the total for the **licensed insurer** across all relevant counterparties.

Table 3 – Asset Concentration Risk Limits

Nature of Obligation	Limit (% of total assets of the licensed insurer)
Guaranteed by the New Zealand government or by a national government or supra-national agency of rating grade 1	100%
Guaranteed by a New Zealand local authority or State-Owned Enterprise	50% (or \$5m if greater) and an additional risk weight as per Table 2 for anything in excess
Exposures to the parent owner of the captive insurer	66% (or \$5m if greater) and an additional risk weight as per Table 2 for anything in excess
Secured by bank bills or deposits with a New Zealand Bank	25% (or \$5m if greater) and an additional risk weight as per Table 2 for anything in excess
Any other asset or counterparty exposure (except for reinsurance recoverable assets dealt with elsewhere)	10% (or \$2m if greater) and an additional double risk weight for anything in excess

Treatment of Derivatives

62. Derivative instruments (including futures, options, forwards, swaps and other similar contracts) may change the investment risk profile of a **licensed insurer** and may, in some circumstances, expose the **licensed insurer** to large risk positions with no or very small outlay.
63. There is no Asset Risk Capital Charge for the interest rate or foreign currency position arising from derivative transactions.
64. For equity and bond derivatives, the appropriate Asset Risk Capital Charge is calculated by multiplying the net position by the appropriate equity or bond Asset Risk Capital Factor within Table 2. For equity and bond options the position to be used is the delta weighted position (face value multiplied by delta). The delta factor is that implied after the application of the appropriate equity or bond Asset Risk Capital Factor within Table 2, the shock in foreign currency exchange rates specified in paragraph 70 and the shock in interest rates specified in paragraph 75.
65. Mark-to-market gains on any derivatives will attract an Asset Risk Capital Charge calculated by multiplying the mark-to-market gain by the appropriate Asset Risk Capital Factor within Table 2.

66. If a **licensed insurer** buys or sells derivatives during the course of a financial year or the **licensed insurer** has an existing derivative position or positions then the **appointed actuary's** Financial Condition Report in respect of that year must describe the use of derivatives throughout the year, the **licensed insurer's** derivative position or positions and the approximate impact on the Asset Risk Capital Charge over the course of the year and at the date of calculation of the solvency margin. The **actuary** may seek the input of the Chief Financial Officer in this matter.

Off Balance Sheet Exposures

67. A **licensed insurer** can be exposed to various investment risks through transactions or dealings other than those reflected on its balance sheet, for example by issuing guarantees or letters of credit. A **licensed insurer** must allow for the amount of any such off balance sheet exposures that represent contingent liabilities as if they were assets when calculating its Asset Risk Capital Charge. All known contingent liabilities must be included when calculating the Asset Risk Capital Charge, whether or not the contingent liability or liabilities are disclosed within the NZ GAAP **financial statements** of the **licensed insurer**.

68. If it is not clear which Asset Class is relevant to the exposure then the Asset Risk Capital Factor shall be 20% of the face value of the exposure.

Foreign Currency and Interest Rate Risks

69. In applying the **solvency standard** a **licensed insurer** must consider the degree of mismatching between assets and liabilities in terms of foreign currency and interest rate risks.

Foreign Currency Risk

70. In the case of a currency position, an additional Asset Risk Capital Charge of 22% must be applied to the net open foreign exchange position in each currency other than NZD, regardless of whether the position is long or short. The net open foreign currency position is the absolute difference (ignoring any negative sign in the outcome) between any assets and liabilities (taking into account applicable derivative positions) that are denominated in the relevant currency.

Interest Rate Risk

71. An Interest Rate Capital Charge is calculated by reference to fixed interest-bearing assets and fixed interest-bearing liabilities. For the purposes of determining the Interest Rate Capital Charge:
- (a) Fixed interest bearing assets are those assets and derivative positions bearing a fixed interest rate for a period of time (re-set period) beyond the balance date at which the solvency calculation is performed; and
 - (b) Fixed interest-bearing liabilities are insurance liabilities and derivative positions and any other liabilities where the economic value depends upon discounting actual or expected cash flows; in other words those liabilities where the value depends implicitly or explicitly on interest rate assumptions; and
 - (c) Insurance liabilities are unearned premium liabilities plus unexpired risk liability plus net outstanding claims provision at a minimum 75% probability of sufficiency, as advised by the **appointed actuary**.
72. The Interest Rate Capital Charge is calculated by separately re-valuing both the **licensed insurer's** fixed interest-bearing assets and fixed interest-bearing liabilities and by then calculating the net impact of the revaluation on fixed interest-bearing assets and fixed interest-bearing liabilities ("net revaluation impact").
73. The revaluation of fixed interest-bearing assets and fixed interest-bearing liabilities must be performed using a 175 basis point change in all interest rates used to value or discount the **licensed insurer's** fixed interest-bearing assets and fixed interest-bearing liabilities at the balance date at which the solvency calculation is performed, either for the purpose of preparing **financial statements** or for internal risk management purposes.
74. The net revaluation impact for any revaluation of assets and liabilities is the decrease in the value of assets less the decrease in the value of liabilities resulting from the re-valuation, with a minimum of zero.
75. The net revaluation impact should be calculated for both a 175 basis point increase ("upshock impact") and 175 basis point decrease ("downshock impact") in all interest rates, across all fixed interest-bearing assets and fixed interest-bearing liabilities, where the downshock impact is limited to the absolute size of the interest rates prior to the decrease. The upshock impact and downshock impact are both gross of tax. The Interest Rate Capital Charge is the greater of the adverse upshock impact and the adverse downshock impact.

Related Party Assets

76. A **related party** is defined in Section 6 of the Act and the definition is significantly broader than the definition of associated person that would generally be applicable for accounting consolidation.

77. Notwithstanding this definition an asset is not regarded as a **related party** asset for the purpose of determining the Deductions From Capital in accordance with paragraph 31 (iii) if:

- (a) The **related party** is a bank subject to prudential regulation by the **Bank** or its international equivalents; or
- (b) The asset is a **reinsurance** asset in which case the reinsurance recovery risk capital charge applies; or
- (c) The primary party is a **Captive Insurer** (as defined in the Act) and the **related party** is the parent owner of the **Captive Insurer**; or
- (d) The asset is a **related party** trade credit, that does not in substance represent permanent funding, that is provided on not more than 90 day terms in the ordinary course of business on an arm's length commercial basis and where payment is not overdue.

3.3. Reinsurance Recovery Risk Capital Charge

Concept

78. The Reinsurance Recovery Risk Capital Charge is intended to reflect the exposure of the **licensed insurer** to losses arising from failure to fully recover on **reinsurance** contracts, including losses due to reinsurer failure and contract dispute.

Calculation

79. In order to determine the Reinsurance Recovery Risk Capital Charge, the **licensed insurer** must first determine the amount due from each reinsurer in respect of the total **reinsurance** recovery asset on its balance sheet. The total **reinsurance** recovery asset is the sum of the **reinsurance** recoverable in respect of outstanding claims established to a 75% Probability of sufficiency, the deferred **reinsurance** expense (less any unearned exchange commission) and amounts due from reinsurers in respect of paid claims. It should not include recoveries other than from **reinsurance** (e.g. salvage and subrogation).

80. The Reinsurance Recovery Risk Capital Charge is the sum across all reinsurers of the **reinsurance** recovery asset in respect of each reinsurer multiplied by the Reinsurance Risk Capital Factor determined from Table 4. The reinsurer counterparty grade must be determined in accordance with Section 3.4.

3.4. Determining Counterparty Grades

81. Some of the capital charges in this **solvency standard** depend upon the counterparty grade of reinsurers and asset counterparties. The counterparty grade is determined based on ratings issued by recognised rating agencies. Because rating agencies do not always agree it is necessary to have a consistent method of determining which rating to use.

82. Each **licensed insurer** must adopt a policy that states the rating agency that it will use as a first preference and other agencies (in order of preference) that it will use if the preferred agency does not publish ratings for a particular counterparty. A **licensed insurer** must notify the **Bank** as soon as practicable if it changes its counterparty grading policy and explain the nature of and reasons for the change.

83. The counterparty grades are determined from Table 4.

Table 4 – Counterparty Grades

S&P/Fitch	AM Best	Moody's	Counterparty Grade	Reinsurance Risk Capital Factor
AAA	A++	Aaa	1	2%
AA- to AA+	A+	Aa3 to Aa1	2	2%
A- to A+	A- A	A3 to A1	3	4%
BBB- to BBB+	B+ B++	Baa3 to Baa1	4	10%, up to a 20% proportion of the total reinsurance recovery asset, and 20% above that limit
Below unrated or	Below unrated or	Below unrated or	5	20%, up to a 10% proportion of the total reinsurance recovery asset, and 40% above that limit

3.5. Special Circumstances

84. The **Bank** may require an amendment to the Minimum Solvency Capital for a particular **licensed insurer** if it is not satisfied that the methods and capital charges specified in this **solvency standard** are appropriate for the risk profile of, or other matters relating to, that **licensed insurer**. The requirement may take the form of an additional percentage on one or more capital charges, alternative calculation methods, alternative parameters or assumptions, or any other form considered appropriate by the **Bank**.

85. Once notified in writing by the **Bank** of such a requirement, the **licensed insurer** and its **appointed actuary** must apply the **solvency standard** in accordance with any amendment required by the **Bank**.

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4. Obligations of the Licensed insurer

4.1. Appointment of an Actuary

86. Each **licensed insurer** must appoint an **actuary**, as required by Section 76 of the Act.
87. The suitability of an individual **actuary** for the role is the responsibility of the **licensed insurer** and must be dealt with in its fit and proper policy.
88. The **actuary** must be a Fellow of the New Zealand Society of Actuaries, or hold an equivalent professional qualification approved by notice to the **licensed insurer** from the **Bank**.

4.2. Licensed insurer must provide Solvency Returns to the Bank:

89. The **Act** requires at Section 56(d) that the **licensed insurer** must provide reports relating to the solvency of the **licensed insurer**. Section 56(d) also authorises the Bank to specify the frequency with which such reports must be provided to the Bank.

4.3. Frequency of Solvency Returns to the Bank

90. The **licensed insurer** must provide an annual solvency return to the **Bank** within five months and twenty days after the end of the **licensed insurer's** financial year. The annual solvency return must be in the form specified in regulations and be accompanied by:
- (a) An attestation by two directors of the **licensed insurer** (or in the case of an **overseas insurer**, its New Zealand Chief Executive Officer) in the form specified in regulations;
 - (b) A copy of the audited **financial statements** of the **licensed insurer**;
 - (c) A report by the auditor of the **licensed insurer** on the audit of the solvency return; and
 - (d) A financial condition report prepared by the **appointed actuary** of the **licensed insurer**.
91. The **licensed insurer** must provide a half-yearly solvency return to the **Bank** within five months of the date six months after the end of the **licensed insurer's** financial year. The half-yearly solvency return must be in the form specified in regulations and must be

accompanied by an attestation by two directors of the **licensed insurer** (or in the case of an **overseas insurer**, its New Zealand Chief Executive Officer) in the form specified in regulations.

92. The Bank may, at its discretion, require the licensed insurer to provide the Bank with solvency returns on a more frequent basis, and in such format and subject to such verification or attestation as it may require.

4.4. Audit of Annual Solvency Return

93. A **licensed insurer** must engage its auditor to undertake an audit of the annual solvency return and must do everything necessary to allow the auditor to undertake this function.

94. The auditor's report on the solvency return must include the information prescribed in regulations and must be signed by the auditor, either in the auditor's own name or the name of the auditor's firm.

4.5. Report by the Appointed Actuary

95. A **licensed insurer** must engage its **appointed actuary** to prepare a financial condition report for the **licensed insurer** and must do everything necessary to enable the **appointed actuary** to undertake this function.

4.6. Disclosure of Solvency Calculations

96. A **licensed insurer** must disclose in its annual **financial statements** (required under the Financial Reporting Act 1993) and on its website (if any) the **licensed insurer's** current Solvency Ratio, being the ratio of Actual Solvency Capital divided by Minimum Solvency Capital from its most recent annual solvency return. The **licensed insurer** will also be required to include in such disclosure a comparison of its Solvency Ratio with any current recommended solvency ratio guideline published by the **Bank**.

97. Following submission of its half-yearly solvency return to the **Bank**, a **licensed insurer** must update the disclosure on its website (if any) to reflect the solvency position from that half-yearly return.

4.7. Advice to the Bank on likely breach

98. Section 24 of the Act requires that, if a **licensed insurer** has reasonable grounds to believe that a failure to maintain a solvency

margin is likely to occur at any time within the next 3 years, the **licensed insurer** must report the likely failure to the **Bank** as soon as is reasonably practicable.

99. In order to comply with Section 24 of the Act a **licensed insurer** will need to consider a forward looking assessment of its compliance with the **solvency standard** in addition to the calculations at the most recent balance date.
100. The forward looking assessment must extend at least thirty-six months from the current date and must take into account known aspects of the **licensed insurer's** business plan.
101. Because Section 24 of the Act applies continuously, not just once a year, a **licensed insurer** will need to be satisfied that it has adequate procedures in place to identify and escalate circumstances that may give rise to a reporting obligation under Section 24. Those procedures must include timely advice to the **licensed insurer's appointed actuary**.

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5. Obligations of the appointed actuary

5.1. Financial Statements

102. Section 77 of the Act requires an assessment by the **licensed insurer's appointed actuary** of specified information in the **financial statements**. The specified information for the purpose of this **solvency standard** is:

- (a) The provision for outstanding claims;
- (b) The **reinsurance** and other recovery asset relevant to outstanding claims; and
- (c) The application of the Liability Adequacy Test and any consequent write-down of deferred acquisition costs and additional provision for unexpired risk, if any.

103. If it is the **licensed insurer's** established policy to seek the advice of the **appointed actuary** in respect of part or all of this information and to always adopt that advice in its **financial statements**, then the advice from the **appointed actuary** to the **licensed insurer** satisfies the requirements of this **solvency standard**.

104. In other circumstances, for example if the **licensed insurer** establishes the relevant provisions without actuarial advice, then the **appointed actuary** must undertake whatever additional work is necessary in order to form an opinion for this **solvency standard**.

105. The investigation of the **appointed actuary** must be done in accordance with the New Zealand Society of Actuaries' ("NZSA") Professional Standard Number 4.

106. The **appointed actuary's** assessment must cover:

- Net outstanding claims as per NZ IFRS 4, including:
 - central estimate of expected claims and recoveries;
 - discounting at a risk free rate;
 - allowance for claim handling expenses; and
 - a risk margin intended to provide a 75% probability of sufficiency;
- Application of the Liability Adequacy Test; and

- The level of deferred acquisition cost in the financial statements after the application of the Liability Adequacy Test as detailed in paragraph 39.

107. The **appointed actuary** must use professional judgement to determine the extent of work required regarding the Liability Adequacy Test, considering the nature and size of the **licensed insurer's** business and the materiality of the risks involved. A full assessment would include comparison of:

- the relevant accounting provisions (unearned premium, DAC, deferred **reinsurance** expense, deferred **reinsurance** commissions, unexpired risk and the like); and
- the actuarial estimate of net premium liabilities comprising:
 - determination of the appropriate period for premium liabilities
 - central estimate of expected claims and recoveries;
 - discounting at a risk free rate;
 - allowance for policy administration and claim handling expenses;
 - allowance for the cost of any future **reinsurance** (i.e. that has not yet been purchased) required to cover unexpired risks; and
 - a risk margin intended to provide a 75% probability of sufficiency (or such higher percentage that may have been used).

108. The results of the **appointed actuary's** assessment must be documented in a report that meets the requirements of Section 78 of the Act. The report may be part of the financial condition report or may be a separate report.

5.2. Solvency Calculations

109. The **appointed actuary** must review the **licensed insurer's** calculations of Actual Solvency Capital and Minimum Solvency Capital in accordance with this **solvency standard**. The results of the review must be documented in the financial condition report.

110. The **appointed actuary's** review must include specific comment on the basis for determining the adjustment of various items for tax and

any other material issues arising from Sections 2 and 3 of this **solvency standard**.

111. In considering the appropriate adjustment for tax the relevant considerations include:

- The fact that the items subject to adjustment are usually revenue items whereas the **solvency standard** is based on comparison of balance sheet items;
- The appropriate adjustment will normally be to reduce the relevant amount by the applicable company tax rate;
- If the overall impact of tax adjustments would be to create a greater deferred tax asset then a corresponding adjustment to the Deductions from Capital should be considered; and
- Whether any particular features of the tax laws or the taxation status of the **licensed insurer** need to be taken into account.

5.3. Financial Condition Report

112. The **appointed actuary** must prepare a Financial Condition Report in accordance with Section 56(d) of the Act. In the Financial Condition report the **appointed actuary** must, inter alia:

- (a) identify and describe the material risks (of which it is reasonable to expect the **appointed actuary** to be aware) facing the **licensed insurer** that, in the **appointed actuary's** opinion, pose a threat to the **licensed insurer's** ability to meet the **solvency standard** now and in the future, and where practicable quantify such risks;
- (b) comment on the steps taken or proposed to be taken by the **licensed insurer** to address the risks identified in (a);
- (c) comment on whether the **licensed insurer** has issued any instruments that form part of Actual Solvency Capital but that may not be both of a permanent nature and freely available to meet losses, and if so on the implications for future compliance with the **solvency standard**;
- (d) comment on whether, in the **appointed actuary's** opinion, the outstanding claim provision established by the **licensed insurer** is materially different from that which would be determined in accordance with NZ IFRS 4 and with a risk

margin required to achieve a 75% probability of sufficiency, and if so on the relevant figures by class of insurance business;

- (e) **advise the licensed insurer on the appropriate** treatment of any insurance business with long term risk characteristics;
- (f) advise the **licensed insurer**, if relevant, on the treatment of derivatives and the approximate impact on the Asset Risk Capital Charge over the course of the year;
- (g) comment on the risks involved with mismatching of assets and liabilities and any relevant capital charge; and
- (h) advise the **licensed insurer** on whether, in the **appointed actuary's** opinion, the **licensed insurer** needs to consider reporting to the **Bank** under Section 24 of the Act, taking account of the **licensed insurer's** forward looking assessment of the **solvency standard** and the **appointed actuary's** assessment of the **licensed insurer's** business plans, its enterprise risk management practices and the external environment.

113. The **appointed actuary** may need to deal with issues that are not within the relevant skills and experience of the **appointed actuary**. In this situation the **appointed actuary** will need to utilise the skills and experience of others and may rely on other relevant experts provided adequate disclosure is included on the nature of that reliance.

5.4. **New Zealand Society of Actuaries' Professional Standards**

114. The **appointed actuary** must ensure that all actuarial work carried out for the purposes of, or supporting, this **solvency standard** is carried out in accordance with the New Zealand Society of Actuaries' Professional Standards

Standard Ends