

# Reserve Bank of New Zealand and New Zealand Society of Actuaries

## Solvency Standard For Non-life Insurance Business

### *Important Notice:*

*This draft “Solvency Standard For Non-Life Insurance Business” has been written in the anticipation that the proposed Insurance (Prudential Supervision) Act – currently in the draft Bill form – will be passed by Parliament in due course.*

*References to “the Proposed Act” throughout this document refer to the Insurance (Prudential Supervision) Bill currently in circulation for public consultation. This Proposed Act has not yet been introduced to or passed into law by Parliament and therefore remains subject to amendment.*

*To the extent that there are changes to the Proposed Act the draft “Solvency Standard For Non-Life Insurance Business” may require corresponding alteration.*

*If for any reason the Proposed Act is not passed into law it is anticipated that the draft “Solvency Standard For Non-Life Insurance Business” will have relevance as industry guidance and its value is therefore not solely dependent on passage of the Proposed Act.*

### 1. Introduction

#### 1.1. Authority

1. This **solvency standard** is made under Section 50 of the Insurance (Prudential Supervision) Bill (“the Proposed Act”).
2. Once approved by the **Bank**, this **solvency standard** becomes a regulation under the Proposed Act (refer Section 50(4)).

#### 1.2. Application

3. This **solvency standard** applies to every **licensed insurer** under the Proposed Act, except for a **life insurer**.

4. Section 5 of the standard applies to the actuary appointed by the relevant **licensed insurer** in accordance with the Proposed Act (refer Section 74).

### 1.3. Previous Versions

5. None

### 1.4. Effective Date

6. This **solvency standard** is effective from the date of commencement of Sub-part 2 of Part 2 of the Proposed Act.

### 1.5. Definitions

7. **The Proposed Act** means the Insurance (Prudential Supervision) Bill. Terms defined in the Proposed Act have the same meaning in this standard and are shown in **bold type**.
8. **Actual Solvency Capital** of an insurer means the excess of the value of its assets over the value of its liabilities determined in accordance with Section 2 of this **solvency standard**.
9. **Minimum Solvency Capital** for an insurer means the amount determined in accordance with Section 3 of this standard and is referred to in the Proposed Act as the **solvency margin**).
10. **Appointed actuary** means the actuary appointed by the insurer in accordance with Section 74 of the Proposed Act
11. **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.
12. **NZ GAAP** means New Zealand Generally Accepted Accounting Practice, and includes standards and pronouncements of the NZ Financial Reporting Standards Board<sup>1</sup>
13. **Net Written Premium** means written premium for a financial period for direct and inwards reinsurance business less outwards reinsurance business, determined as per section 4.2 of Appendix D of NZ IFRS 4 Insurance Contracts (noting there is no deduction for commission or brokerage)

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<sup>1</sup> Refer to the website of the NZ Institute of Chartered Accountants for details – [www.nzica.com](http://www.nzica.com)

14. **Collective investment vehicle** means a managed investment fund including but not limited to unit trusts and group investment funds
15. **Non-insurance activity** means a business that is distinctly different from the business of insurance and that is undertaken for third party customers. It includes insurance broking and premium funding but does not include direct insurance sales or claims management activities.

## 1.6. Requirements of the Proposed Act

16. Section 57 of the Proposed Act requires that a **licensed insurer** must, at all times, maintain a **solvency margin** as defined in the **solvency standard**. Under this standard, the **solvency margin** is defined as the excess of Actual Solvency Capital over Minimum Solvency Capital and an insurer must maintain Actual Solvency Capital in excess of the amount required to maintain this margin.
17. Sections 58 and 59 of the Proposed Act require attestation by a **licensed insurer** to the **Bank** relating to compliance with the **solvency standard**.
18. Section 60 of the Proposed Act requires a **licensed insurer** to report to the **Bank** regarding any likely future failure to comply with the **solvency standard**.
19. Section 74 of the Proposed Act requires each **licensed insurer** to appoint an actuary. Section 75 requires the insurer to have its appointed actuary assess certain items in the **financial statements**. Section 78 requires the insurer to obtain a financial condition report from its appointed actuary.
20. Compliance with the **solvency standard** (Section 57 of the Proposed Act) is a continuous obligation. As a minimum a **licensed insurer** must undertake calculations as required under this 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**.

## 2. Actual Solvency Capital

21. **Actual Solvency Capital** is defined as the total of **Capital** minus **Deductions from Capital**.

22. **Capital** is defined as the following items:

- (i) issued and fully 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;
- (ii) fully paid up perpetual non-cumulative preference shares, that are not redeemable within the meaning of section 68 of the Companies Act 1993 and are not repayable or redeemable at the option of the holder, but only if those shares meet the following requirements:
  - (a) dividends on the shares are able to be waived if the financial condition of the insurer would not support payment of those dividends (for example, if no dividends are being paid on ordinary shares);
  - (b) dividends that are waived in accordance with paragraph (a) do not cumulate; and
  - (c) the shares are not subject to any arrangement for resetting the dividend margin.

Perpetual non-cumulative preference shares may not constitute more than 50% of capital for a mutual insurer and 25% for all other insurers.

- (iii) revenue and other reserves, which includes capital redemption reserves, other reserves that are created or increased by appropriations of retained earnings (other than current accounting period retained earnings), share premium reserves arising from the issue of ordinary shares and each of the following reserves that are reflected in the statement of financial position:
  - (a) reserves arising from a revaluation of tangible fixed assets, including owner occupied property and cumulative fair value gains on investment property;
  - (b) foreign currency translation reserves;
  - (c) reserves arising from the revaluation of investments;

This does not include reserves that are earmarked on account of any assessed likelihood of loss.

- (iv) retained earnings; and
- (v) minority interests.

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

- (i) goodwill and other intangible assets;
- (ii) future tax benefits;
- (iii) equity investments in, and subordinated loans to related parties;
- (iv) equity investments and subordinated debt (whether held directly or indirectly) issued by other financial institutions;
- (v) cumulative gains and losses on a cash flow hedge that—
  - (a) has been recognised directly in equity; and
  - (b) is not against an available-for-sale item on which fair value gains and losses are recognised directly in equity;
- (vi) unrealised gains and losses on liabilities designated at fair value through profit and loss that arise from changes in an institutions own credit risk;
- (vii) any fair value gain that relates to a financial instrument for which a fair value cannot be reliably calculated;
- (viii) any surplus net of any associated deferred tax liabilities, in any defined benefit superannuation fund sponsored by the 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.

24. The NZ GAAP **financial statements** to be used for the purpose of the **solvency standard** are the entity accounts of the **licensed insurer**. Where a licensed insurer has subsidiaries, they must be consolidated with the licensed insurer for the purpose of preparing the solvency calculations.

25. The Equity of the insurer is treated as Actual Solvency Capital to the extent that it is of a permanent nature and freely available to meet

losses. If a capital instrument forms part of the Equity but may not be 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 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 insurer must follow that advice.

26. In the case of a mutual insurer incorporated in New Zealand, Equity may be referred to as 'Reserves' or 'Members Funds'.
27. In the case of an **overseas insurer**, the relevant accounts are those prepared in respect of the New Zealand Branch of the insurer (as if it were a New Zealand Corporation), with the Equity being the excess of assets over liabilities of the Branch; this Equity may be referred to as 'Head Office Balance' or similar.

## **2.1. Treatment of Dividends and Capital Reductions**

28. This paragraph applies to any dividends that are declared in respect of the current financial period, or which are declared in respect of the preceding financial period but prior to completion of the solvency return, and which in total are no greater than the earnings in respect of the relevant period. Otherwise the next paragraph applies. Under this paragraph an insurer may declare and pay such dividends in the normal course of business provided that any dividends declared but unpaid do not form part of the Actual Solvency Capital of the insurer.
29. If an insurer proposes to pay dividends to which the previous paragraph does not apply or to materially reduce its capital in another way, it must first seek and receive advice from its appointed actuary about the implications for future compliance with the Solvency Standards. The insurer must advise the Bank at least 10 working days before such dividends become irrevocably payable and include a copy of its actuarial advice.

## **2.2. Intangible Asset Deductions**

30. The Intangible Asset Deductions comprise the following amounts to the extent that they form part of the assets of the insurer according to NZ GAAP:
  - (a) Goodwill measured in accordance with NZ IFRS 3 *Business Combinations*, NZ IAS 28 *Investments in Associates* and NZ IFRS 31 *Interests in Joint Ventures*

- (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)
- (c) Any other intangible asset to which NZ IAS 38 *Intangible Assets* 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).

### 3. Minimum Solvency Capital

31. The Minimum Solvency Capital is the sum of the:

- Insurance risk capital charge
- Catastrophe risk capital charge
- Asset risk capital charge
- Reinsurance recovery risk capital charge
- Non-insurance activity capital charge.

The Minimum Solvency Capital is subject to a minimum value of \$y million<sup>2</sup> (or refer to a table if the minimum varies by category of insurer).

#### 3.1. Insurance Risk Capital Charge

The Insurance Risk Capital Charge is the total of the Underwriting Risk Capital Charge and the Run-off Risk Capital Charge.

##### **Concept**

- 32. The Underwriting Risk Capital Charge is intended to reflect the risk to the insurer of writing unprofitable insurance business. To some extent this charge is also intended to reflect the exposure of the insurer to operational risk, although it is not a substitute for adequate management of operational risk.
- 33. The Run-off Risk Capital Charge is intended to reflect the risk to the insurer of inadequate provision being made for outstanding claim liabilities, and includes any adjustment to the valuation of liabilities to bring them to a common basis.

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<sup>2</sup> The minimum value to be applied is still under consideration by the Bank and the Government

### **Calculation**

34. The Underwriting Risk Capital Charge is determined by multiplying the Net Written Premium of the insurer during the twelve months prior to the calculation date by the Underwriting Risk Capital Factor in Table 1. The calculation is to be made by class of insurance business and summed across all classes. Note that the capital charge does not deal directly with rapid growth of an insurer; this issue is addressed in section 4.7<sup>3</sup>.
35. The Run-off Risk Capital Charge is determined by multiplying the Net Outstanding Claim Provision of the insurer at the calculation date by the Run-off Risk Capital Factor in Table 1 and then adding the Outstanding Claim Liability Adjustment (if any). The calculation is to be made by class of insurance business<sup>4</sup> and summed across all classes.

**Table 1 – Insurance Risk Capital Factors**

<b>Class of Insurance Business</b>	<b>Underwriting Risk Capital Factor</b>	<b>Run-off Risk Capital Factor</b>
Domestic property	7%	9%
Private motor	7%	9%
Commercial property	8%	11%
Commercial motor	7%	9%
Liability classes	11%	15%
Marine	8%	11%
Health and Personal Accident	8%	11%
Travel	7%	9%
Other	8%	11%

### **Outstanding Claim Liability Adjustment**

36. The Outstanding Claim Liability Adjustment is required if the insurer has established its net outstanding claims provision with a risk margin materially different to that required to achieve a 75% probability of sufficiency ('75% POS provision').
37. Section 5.1 of this standard specifies that the appointed actuary must assess the provision for outstanding claims and the corresponding recovery asset.

<sup>3</sup> Specific comment is sought in the Discussion Paper

<sup>4</sup> The classes are adapted from those used for statistical collection by the Insurance Council of New Zealand; refer to the Council if assistance is required in determining the appropriate class

38. If, in the opinion of the appointed actuary, the insurer's net outstanding claims provision is materially less than the 75% POS provision, then the Run-off Risk Capital Factors in Table 1 must be applied to the amount advised by the appointed actuary rather than the amount in the insurer's accounts and the Outstanding Claim Liability Adjustment is an addition to the risk charge equal to the 75% POS provision less the insurer's provision after adjustment for tax.
39. If, in the opinion of the appointed actuary, the insurer's net outstanding claims provision is materially greater than the 75% POS provision, then the insurer may, if it chooses, apply the Run-off Risk Capital Factors in Table 1 to the amount advised by the appointed actuary rather than the amount in the insurer's accounts and adopt an Outstanding Claim Liability Adjustment (being a deduction from the risk charge) equal to the insurer's provision less the 75% POS provision after adjustment for tax.

### ***Insurance Business with Long Term Risk Characteristics***

40. Most non-life insurance comprises short term contracts (mostly 12 months) 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 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 insurer.
41. If an insurer issues a material volume of contracts with features that may produce significant risk for the insurer for more than one year, including continuous disability insurance (refer Section 6(2) of the Proposed Act), then the 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 insurer and, if so, a suitable basis for calculating that risk charge.
42. If an insurer defers acquisition costs (DAC) over a period longer than the current contract period, this represents a long term risk. An appropriate response, subject to the appointed actuary's advice, would be to create an additional capital charge equal to the difference between the DAC as accounted and what the DAC would be if it was spread over the current contract period (adjusted for tax).

43. 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.
44. 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 standards.

### **3.2. Catastrophe Risk Capital Charge**

#### ***Concept***

45. The Catastrophe Risk Capital Charge is intended to reflect the exposure of the insurer to very large claims, including those arising from an event that results in claims on more than one insurance contract, such as an earthquake or storm.

#### ***Calculation***

46. For an insurer with significant property exposures, the largest single event is likely to be a natural catastrophe and the insurer's catastrophe reinsurance program will be the key determinant of the net cost. In this situation the Catastrophe Risk Capital Charge is the net cost to the insurer of a catastrophe event including any gap or shortfall in the reinsurance cover relative to a one in 250 year event and the cost (if any) of one reinstatement of the full catastrophe reinsurance program.
47. For an insurer without significant property exposures, or with other per risk exposures greater than the insurer's catastrophe retention, the Catastrophe Risk Capital Charge is two times the largest per risk retention of the insurer.
48. The largest per risk retention is the cost to the insurer of the largest individual claim to which it could reasonably be exposed under policies issued, net of reinsurance recoveries and including the cost of reinstatements. If the insurer issues policies that do not have a maximum sum insured, or are not protected by excess of loss reinsurance, then the insurer may need to seek the advice of its appointed actuary as to a reasonable approximation for the largest per risk retention.
49. The appointed actuary of the insurer must review the basis of the Catastrophe Risk Capital Charge. If the appointed actuary is of the opinion that the exposure of the insurer to catastrophe risk, including the

accumulation of exposures across multiple policies, is not adequately reflected in the Catastrophe Risk Capital Charge, the appointed actuary must recommend an alternative method of determining the Catastrophe Risk Capital Charge for the insurer, and the insurer must use that alternative method.

### **3.3. Asset Risk Capital Charge**

#### ***Concept***

50. The Asset Risk Capital Charge is intended to reflect the exposure of the insurer to losses on investment assets, and some other minor asset classes. It is intended to reflect credit risk and market 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 insurer must first assign each of its assets to the relevant Asset Class as per the definitions in Table 2. The counterparty grade must be determined in accordance with Section 3.6.
52. If the insurer holds investments in a professionally managed collective investment vehicle such as a unit trust, then the insurer must 'look through' the investment vehicle to the nature of the underlying investments that represent the share of the assets attributable to the insurer.
53. If the insurer has a subsidiary entity that is primarily used to hold investments for the insurer, then it must 'look through' the subsidiary entity to the nature of the underlying investments. In order for this paragraph to be applicable, the insurer or the insurer's group of companies must own 100% of the shares and have effective day-to-day control over the activities of the investment subsidiary entity.
54. In applying the 'look through' approach in the preceding two paragraphs, the insurer must only 'look through' if it is satisfied with the quality and reliability of the information about the underlying investments. The insurer must also take account of any special conditions (such as guarantees or redemption restrictions) that the investment vehicle may provide.
55. The Asset Risk Capital Charge is the total of the asset values in each Asset Class multiplied by the relevant Asset Risk Capital Factor from Table 3 plus the Asset Concentration Risk Charge (if any) and the Liquidity Risk Capital Charge (if any).

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

<b>Asset Class</b>	<b>Definition</b>	<b>Asset Risk Capital Factor</b>
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 fixed interest < 1 yr	Any debt obligation (excluding subordinated debt) maturing or redeemable in less than one year with a counterparty rating of Grade 1 or 2 Cash management trusts with a counterparty rating of Grade 1 or 2	1%
3 AA fixed interest > 1 yr	Any debt obligation (excluding subordinated debt) maturing or redeemable in one year or more with a counterparty rating of Grade 1 or 2	2%
4 A fixed interest	Any debt obligation (excluding subordinated debt) with a counterparty rating of Grade 3 Cash management trusts with a counterparty rating of Grade 3	4%
5 Unpaid premiums < 3 mths	Unpaid premiums that are not yet due or are less than three months past the contractual due date for payment to the insurer	4%
6 BBB fixed interest	Any debt obligation (excluding subordinated debt) with a counterparty rating of Grade 4 Cash management trusts with a counterparty rating of Grade 4	6%
7 Other fixed interest	Any debt obligation with a counterparty rating of Grade 5 or unrated Cash management trusts with a counterparty rating of Grade 5 or unrated Subordinated debt of a counterparty with a rating of Grade 1 or 2 Unpaid premiums that are more than three months but less than six months past the contractual due date for payment to the insurer	15%
8 Listed equity & trusts	Equities listed on a recognized stock exchange Listed trusts (unless the look	30%

	through provisions require them to be included in another asset class) Listed property trusts	
9 Unlisted equity, property, any other assets	Unlisted equities Direct property holdings Owner-occupied property Property, plant and equipment Unlisted trusts (unless the look through provisions require them to be included in another asset class) Any other asset not described in the table	<b>40%</b>
10 Inadmissible assets	Loans to directors of the insurer or of associated parties Unsecured loans to employees or agents of the insurer in excess of \$1,000 Assets under a fixed or floating charge Obligations of a related party (unless the related party is a bank or the obligation is a reinsurance recoverable) <sup>5</sup> Equity holdings in subsidiary companies (unless the subsidiary is an investment entity company that is looked through) Unpaid premiums that are six months or more past the contractual due date for payment to the insurer	<b>100%</b>

### ***Asset Concentration Risk Charge***

56. In order to determine the Asset Concentration Risk Charge, the insurer must first calculate the total value of its assets that represent obligations of one entity or group of related entities (counterparty). The Asset Concentration Risk Charge in respect of each counterparty is the amount by which the insurer's asset exposure to that counterparty, less the applicable Asset Risk Capital Charge(s) determined from Table 2, exceeds the limits specified in Table 3, with a minimum of nil. The Asset Concentration Risk Charge is the total for the insurer across all relevant counterparties.

<sup>5</sup> In the Discussion paper specific comment is sought on the treatment of related party assets

**Table 3 – Asset Concentration Risk Limits**

Nature of Obligation	Limit (% of total assets of the 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 government or State Owned Enterprise	50% (or \$5m if greater)
Secured by bank bills or deposits with a New Zealand Bank	25% (or \$5m if greater)
Any other asset or counterparty exposure	10% (or \$2m if greater).

***Liquidity Risk Capital Charge<sup>6</sup>***

57. The Liquidity Risk Capital Charge is intended to encourage insurers to properly manage liquidity risk, and it may be nil. The amount is determined as 20% of the total liabilities of the insurer less the amount of assets held in cash or assets that are readily realisable within 2 working days without material loss of value, with a minimum of zero.

***Treatment of Derivatives<sup>7</sup>***

58. Derivative instruments (including futures, options, forwards, swaps and other similar contracts) may change the investment risk profile of an insurer and may, in some circumstances, expose the insurer to large risk positions with no or very small outlay.
59. In determining the Asset Risk Capital Charge the insurer must apply the relevant risk charges to its effective exposures assuming that each derivative is replaced by its underlying security and must also include allowance for counterparty risk relating to derivatives.
60. An insurer must seek and obtain the advice of its appointed actuary about how to treat derivatives under the solvency standard before entering into derivative contracts. If an insurer buys or sells derivatives during the course of a financial year then the appointed actuary's Financial Condition Report in respect of that year must outline the use of derivatives throughout the year and the approximate impact on the Asset Risk Capital Charge over the course of the year.

<sup>6</sup> Alternatives are discussed and specific comments sought in the Discussion paper

<sup>7</sup> Specific comment is sought in the Discussion paper on the treatment of derivatives

### ***Off Balance Sheet Exposures***

61. An 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. An insurer must allow for any off balance sheet exposures, whether they represent contingent assets or contingent liabilities, as if they were asset exposures when calculating its Asset Risk Capital Charge.
62. If it is not clear which Asset Class is relevant to the exposure then the risk charge shall be 40% of the face value of the exposure.

### ***Asset/Liability Mismatch***

63. In applying the solvency standard an insurer must consider the degree of mismatching between assets and liabilities (in terms of duration and currency).
64. In the case of currency mismatch, an additional Asset Risk Capital Charge (at a level to be determined) 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 total of the assets and liabilities and applicable derivative positions that are denominated in the relevant currency.
65. In the case of duration mismatch the appointed actuary must comment in the financial condition report on the risks involved with mismatching. Where duration mismatch is beyond 1 year there will be an additional rule-based Capital Charge applied (on a basis to be determined).

### ***Related Party Assets***

66. A related party is defined in the Proposed Act (refer Section 6) and the definition is significantly broader than the definition of associated person that would generally be applicable for accounting consolidation.
67. Notwithstanding this definition an asset is not regarded as a related party asset for the purpose of determining the Asset Risk Capital Charge 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 amount is not material and the transaction that created the asset has been entered into at arm's length in the normal course

of business (e.g. unpaid premiums on insurance policies bought by directors).

### **3.4. Reinsurance Recovery Risk Capital Charge**

#### ***Concept***

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

#### ***Calculation***

69. In order to determine the Reinsurance Recovery Risk Capital Charge, the 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, 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).
70. 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 5. The reinsurer counterparty grade must be determined in accordance with Section 3.6.

### **3.5. Non-insurance Activity Capital Charge<sup>8</sup>**

71. The Non-insurance Activity Capital Charge is intended to reflect the exposure of the insurer to losses arising from business activities that are not part of the insurance business, including those undertaken by the insurer itself and by subsidiary companies of the insurer.
72. If the insurer itself (not a subsidiary company) engages in material activities that are not in the nature of insurance business, then it is required to make a separate actuarial assessment of the assets and liabilities relating to the non-insurance business or businesses. It must also make an assessment of the level of capital customary in the

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<sup>8</sup> Specific comment is sought in the Discussion paper on this issue

relevant business for sound and prudent operations (the 'non-insurance activity capital requirement').

73. The Non-insurance Activity Capital Charge is the sum of the non-insurance activity capital requirement and the liabilities in respect of the non-insurance business less the assets in respect of the non-insurance business. The Non-insurance Activity Capital Charge may not be less than zero.
74. If a subsidiary company of the insurer engages in material non-insurance activities a Non-insurance Activity Capital Charge is required only if the subsidiary is undercapitalised for the business undertaken, in which case the charge is the amount recommended by the insurer's appointed actuary.

### **3.6. Determining Counterparty Grades**

75. Some of the capital charges in this 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.
76. Each 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. An 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.
77. The counterparty grades are determined from Table 5.

**Table 5 – Counterparty Grades**

<b>S&amp;P/Fitch</b>	<b>AM Best</b>	<b>Moody's</b>	<b>Counterparty Grade</b>	<b>Risk factor</b>
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 proportionate threshold, and higher above that limit (to be finalised)
Below or unrated	Below or unrated	Below or unrated	5	20% up to a proportionate threshold, and higher above that limit (to be finalised)

### **3.7. Special Circumstances**

78. 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 standard are appropriate for the risk profile of that insurer. The requirement may take the form of an additional percentage on one or more capital charges, an alternative form of calculation or any other form considered appropriate by the Bank.
79. Once notified in writing by the Bank of such a requirement, the insurer and its appointed actuary must apply the solvency standard in accordance with any amendment required by the Bank.

## 4. Obligations of the Insurer

### 4.1. Appointment of an Actuary

80. Each licensed insurer<sup>9</sup> must appoint an actuary, as required by Section 74 of the Proposed Act.
81. The suitability of an individual actuary for the role is the responsibility of the insurer and must be dealt with in its fit and proper policy.
82. The actuary must be a Fellow of the New Zealand Society of Actuaries, whether or not the actuary is a New Zealand or an overseas actuary.

### 4.2. Annual Returns to the Bank

83. The Proposed Act requires that the licensed insurer must provide an annual solvency return to the Bank within three months after the end of the 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 insurer (or in the case of a **overseas insurer**, its New Zealand Chief Executive Officer) in the form specified in regulations; and
  - (b) A copy of the audited **financial statements** of the insurer; and
  - (c) A report by the auditor of the insurer on the audit of the solvency return; and
  - (d) A financial condition report prepared by the appointed actuary of the insurer.

### 4.3. Half-yearly Return to the Bank

84. The Proposed Act requires that the licensed insurer must provide a half-yearly solvency return to the Bank within three months of the date six months after the end of the 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 insurer (or in the case of a an overseas insurer, its New Zealand Chief Executive Officer) in the form specified in regulations.

### 4.4. Audit of Annual Solvency Return

85. An 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.

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<sup>9</sup> If the insurer is a Friendly Society the appointed actuary for the purposes of this Act may be the same or a different actuary as that appointed under the Friendly Societies Act

86. 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**

87. An insurer must engage its appointed actuary to prepare a financial condition report for the insurer and must do everything necessary to allow the appointed actuary to undertake this function.

#### **4.6. Disclosure of Solvency Calculations**

88. An insurer must disclose in its annual report and on its website (if any) the following items from its most recent annual solvency return:

- (a) Actual Solvency Capital
- (b) Minimum Solvency Capital
- (c) Solvency Ratio, being (a) divided by (b).

89. Following submission of its half-yearly solvency return to the Bank, an insurer must update the disclosure on its website (if any) to show the figures from that half-yearly return.

#### **4.7. Advice to the Bank on likely breach**

90. Section 60 of the Proposed Act requires a licensed insurer to report the matter to the Bank if the insurer 'knows, or could reasonably be expected to know, that the insurer is likely to fail to maintain a solvency margin at any future time'.
91. In order to comply with this Section an 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.
92. The forward looking assessment must extend at least twelve months from the relevant balance date and must take into account known aspects of the insurer's business plan.
93. Because Section 60 of the Proposed Act applies continuously, not just once a year, an 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 60. Those procedures must include timely advice to the insurer's appointed actuary.

## 5. Obligations of the appointed actuary

<This section may need additional material in relation to the professional obligations of the appointed actuary..>

### 5.1. Financial Statements

94. Section 75 of the Proposed Act requires an assessment by the insurer's appointed actuary of specified information in the financial statements. The specified information for the purpose of this standard is:
- (a) The provision for outstanding claims
  - (b) The reinsurance and other recovery asset relevant to outstanding claims
  - (c) The application of the Liability Adequacy Test and any consequent write-down of deferred acquisition costs or additional provision for unexpired risk.
95. If it is the 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 accounts, then the advice from the appointed actuary to the insurer satisfies the requirements of this standard.
96. In other circumstances, for example if the 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 standard.
97. The investigation of the appointed actuary must be done in accordance with the NZSA's Professional Standard Number 4.
98. 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
    - ▶ a risk margin intended to provide a 75% probability of sufficiency
  - ▶ Application of the Liability Adequacy Test.
99. 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 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
  - 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
  - a risk margin intended to provide a 75% probability of sufficiency.

100. The results of the appointed actuary's assessment must be documented in a report that meets the requirements of Section 76 of the Proposed Act. The report may be part of the financial condition report or may be a separate report.

## **5.2. Solvency Calculations**

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

102. The appointed actuary's review must include specific comment on the basis for determining the Catastrophe Risk Capital Charge, the adjustment of various items for tax and any other material issues arising from Sections 2 and 3 of this standard.

103. 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 capital 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 significantly greater deferred tax asset which cannot be offset against a deferred tax liability, then a corresponding adjustment to the Intangible Asset Deductions should be considered

- Whether any particular features of the tax laws or the taxation status of the insurer need to be taken into account.

### 5.3. Financial Condition Report<sup>10</sup>

104. The appointed actuary must prepare a financial condition report<sup>11</sup> in accordance with Section 78 of the Proposed Act. In the Financial Condition report the appointed actuary must, inter alia:

- (a) identify and describe the risks facing the insurer that, in the appointed actuary's opinion, pose the greatest threat to the insurer's ability to meet the solvency standard now and in the future
- (b) comment on the steps taken or proposed to be taken by the insurer to address the risks identified in (a)
- (c) advise on whether the 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) advise the insurer on whether, in the appointed actuary's opinion, the outstanding claim provision established by the insurer is materially different from that which would be determined in accordance with Appendix D of 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 insurer on the appropriate treatment of any insurance business with long term risk characteristics
- (f) advise, 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
- (h) advise the insurer on whether, in the appointed actuary's opinion, the insurer needs to consider reporting to the **Bank** under Section 60 of the Proposed Act, taking account of the insurer's forward looking assessment of the solvency standard and the appointed

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<sup>10</sup> In the Discussion paper specific comment is sought on the overall scope of the financial condition report; this section currently includes only those aspects directly relevant to the solvency standard

<sup>11</sup> If the insurer is a Friendly Society the relevant information may be included in the financial condition report required under the Friendly Societies Act

actuary's assessment of the insurer's business plans, its enterprise risk management practices and the external environment.

105. The appointed actuary may need to deal with issues that are not within the relevant skills and experience of the actuary. In this situation the 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.

**Standard Ends**