

New Zealand Captive Insurance Association

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Submission to the Reserve Bank

Solvency Standards for Non Life Insurance

31 August 2009

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Reserve Bank of New Zealand & The New Zealand Society of Actuaries Solvency Standard for Non Life Insurance Consultation Paper

The Reserve Bank of New Zealand (RBNZ) and the New Zealand Society of Actuaries (NZSA) have releasing a draft Solvency Standard discussion paper and for discussion. The New Zealand Captive Insurance Association (NZCIA) is pleased to provide the commentary on the proposed Standard.

General Comment

The Solvency Standard, as prepared by the Reserve Bank of New Zealand and the New Zealand Society of Actuaries, is the Standard that is prepared for general insurers that provide insurance protection for consumers. The Reserve Bank needs to ensure that a general insurers providing insurance protection for consumers has sufficient assets and solvency to pay claims when they occur.

However captive insurers as the Reserve Bank has previously agreed with the NZCIA, provide a different form of insurance than that of general insurers. This form of insurance provides asset and balance sheet protection for corporate entities through the formation of a captive insurance company. The parent company and the captive have a better understanding of the specific risk that the captive is underwriting and price it accordingly in conjunction with reinsurance pricing.

The risk of the parent company can be successfully underwritten by a captive at a significantly reduced cost. This reduced cost will enhance the parent company's overall solvency. It is because of this risk understanding that a captive should not be judged by the same solvency standards as a general insurer.

In keeping with captive standards promulgated by the International Association of Insurance Supervisors (IAIS), the NZCIA believe that a captive should be held to a solvency standard of \$500,000. The NZCIA believe that this will enable New Zealand as a captive domicile to compete on a global basis for captive business and ensure that captive insurance companies have sufficient solvency to meet their claim obligations.

The NZCIA will now directly comment upon sections of the Solvency Standard as requested by the Reserve Bank.

1. Definition of Capital

The Reserve Bank question.

Comments are sought on the suitability of the definitions of Capital and Deductions from Capital and whether:

- (a) *The proposed approach will cause significant disruption to the existing business model of any insurer;*

NZCIA Comment:

The proposed definition of capital, in particular Section 23 Deductions from Capital, would cause significant disruption to the running of a captive insurance company in New Zealand.

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All recognised captive insurance domiciles that subscribe to the report set out by the IAIS, of which the Reserve Bank of New Zealand is a member, allow captive insurance companies to have equity investments and subordinated loans to members of the corporate group. Under the New Zealand Solvency Standard, this investment would be deducted from capital to calculate the actual solvency capital. The NZCIA believe that in keeping with good governance and the IAIS, captives should be exempt from Section 23(3) of the Solvency Standard.

- (b) *Other instruments should be recognised as capital for the purpose of the proposed Act;*

Captive domiciles recognise other instruments as capital. These instruments can be letters of credit from an investment grade bank with the beneficiary being the Commissioner of Insurance.

- (c) *If so, the nature of these instruments and the limits that should be applied and a process needed to approve and supervise use of alternative instruments.*

See (b) above.

2. Procedures for Compliance

NZCIA Comment

The NZCIA is in favour of the Procedures for Compliance.

3. Role of Appointed Actuary

(a) **Reserve Bank Question:**

Comment is sought on the detailed scope of the role of the appointed actuary, and whether the refer to appointed actuary situations are appropriate.

It is the responsibility of the appointed actuary is to audit certain items in their insurers financial statements such as technical insurance liabilities.

NZCIA Comment

In recognised captive domiciles, that are members of the IAIS, acknowledge that an actuary is required for review of specified insurance liabilities. In particular they require an actuarial evaluation of all long tail business that the captive insurer underwrites. Long tail business is described as “an insurance policy with a risk that may take between 2 to 10 years to close the policy.” These types of policies are generally defined Liability policies.

The NZCIA would be in favour of an actuary to review all Liability policies issued by captive insurance companies. We do not believe it is necessary to have an actuary appointed to provide an actuarial evaluation on other short tail business, ie. Property.

(b) **Reserve Bank Question:**

To prepare a “Financial Condition Report” for the insurer which includes analysis and commentary on the application of the Solvency Standard to the insurer.

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NZCIA Comment:

The NZCIA believe that the financial condition report to be prepared by the actuary to be an over-burdensome requirement on captive insurance companies and as such believe the captive should be exempt from this requirement. The audit of the financial statements and solvency return will provide adequate oversight of the captive operations.

4. Actuarial Assessment of Technical Liabilities

Comment is sought on the nature of the actuaries role in establishing or testing insurance liabilities and whether the draft Standard, including PS4 provides adequate guidance.

NZCIA Comment:

NZCIA is in favour of the actuaries role in establishing and testing insurance liabilities as they relate to known loss reserves, incurred but not reported reserves and incurred but not reported expenses. Accounting Standards NZIFRS4 provide adequately for the calculation of other insurance liabilities. The NZCIA believe that the actuary should be limited to commentary and establishment of outstanding claims reserves.

5. Scope of Financial Condition Report

Comment is sought on the most appropriate Scope of a Financial Report both for commercial and supervisory purposes. As well as comment on matters currently covered in the draft Solvency Standard, it would help to have comments on the Australian Financial Condition financial condition report as scoped by APRA.

NZCIA Comment

The NZCIA believe this section is an over-burdensome response on captive insurance companies. The cost involved in providing the information and having an actuary complete assessments (a) through (i) would create an uncompetitive situation for most captive insurance companies. The NZCIA believe that this Scope of Financial Condition report could be catalyst to drive New Zealand captive insurers from New Zealand.

6. Premium Adequacy & Deferred Acquisition Costs

Reserve Bank

Comments are sought on whether the proposed approach is adequate or whether more specific allowances need to be made in the Solvency Standard for insurance business, that has been or is expected to be loss making for the insurer.

The NZCIA believe that the Accounting Standard NZIFRS4 adequately covers this exposure.

7. Related Party Assets

Reserve Bank Question:

(a) *Practical examples where the approach would significant impact insurers' current business model.*

NZCIA Comment

Captive insurance companies regularly utilise equity investments and subordinated loans to members of the corporate group as part of their investment strategy. These loans are supported by signed, 24-hour demand notes and pay a commercial rate of interest.

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These loans are allowable in all recognised captive domiciles Singapore, Bermuda, Dublin, Vermont. The NZCIA believes that captive insurance companies should be exempt from this solvency requirement.

- (b) *Whether there are other circumstances which credit is appropriate for related parties.*

NZCIA Comment

A captive insurance company should be allowed to invest a substantial portion of its assets in line with an investment strategy approved by the Board of Directors with its parent or affiliated companies within the family group.

- (c) *Suitable prudential rules for applying credit in such situations.*

NZCIA Comment

A captive should be exempt from this solvency requirement.

8. Liquidity Risks

Reserve Bank Question:

Comments are sought on the most suitable approach for dealing with Liquidity Risks.

NZCIA Comment

The approach taken in the draft Standard is a simple and efficient one. It requires that 20% of total liabilities be available in liquid assets. All captive insurance companies operate a very secure investment strategy. Included in that strategy is the investment of assets in short term liquid investments including bank deposits, cash, loans to parent companies and loans to affiliated companies. The captive investment strategy would be compliant with the liquidity risk capital charge based upon our comment in 7 above.

9. Assets Readily Utilisable in New Zealand

Reserve Bank Question:

Comment is sought on whether the issue needs to be dealt with in Solvency Standard and whether there is a preferred alternative to that proposed.

The proposed approach recognises the issue of requiring the appointed actuary to include in the financial condition report an analysis of the risks concerning the ability to readily realise assets in the jurisdiction that they are required to meet policy holder claims.

The NZCIA would like to point out there is a potential under this section to allow assets to be hidden or deposited in foreign countries out of the jurisdiction of the Reserve Bank. As is the case in Australia, where APRA requires that all assets in Australia exceed liabilities in Australia, New Zealand may need to adopt this to protect its local policy holders.

10. Long Term Risks

Reserve Bank Question:

Comment is sought on whether this treatment is adequate.

Insurers with long term assets and / or liability risks may require additional risk charges at the discretion of an actuary. The NZCIA is in favour of this Section of the Solvency Standard.

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NZCIA would like to comment on Section 3 Minimum Solvency Capital of the proposed standard

Section 31 states "the minimum solvency capital is the sum of:

- Insurance Risk Capital Charge*
- Catastrophic Risk Capital Charge*
- Asset Risk Capital Charge*
- Reinsurance Recovery Risk Capital Charge*
- No Insurance Activity Capital Charge*

The minimum solvency capital is to be a minimum value of \$Y million.

NZCIA Comment

NZCIA believe that the minimum solvency capital for a captive insurance company should be set at \$500,000. This is in line with all recognised captive domiciles, Bermuda, Singapore, Dublin, Vermont, Luxembourg, Canada and various American States. Any greater minimum solvency capital requirements would make New Zealand uncompetitive in the captive world and cost New Zealand significant opportunities by way of increased tax revenues and economic activity.

The NZCIA will address each one of minimum solvency capital charges:

- Insurance Risk Capital Charge**
The calculation on the Insurance Risk Capital Charge including Underwriting Risk Capital Charge and run off risk factor, capital charges are acceptable to the NZCIA.
- Catastrophic Risk Capital Charge**
The concept of Catastrophic Risk Capital Charge is intended to reflect the exposure of the insurer's very large claims, including those arising from an event results in claims from more than one insurance contract such as an earthquake and storm.

Calculation:

For an insurer with significant property exposures, the largest single event is likely to be a natural catastrophe and the insurers catastrophic reinsurance programme will be a key deterrent in their cost. In this situation the risk capital charge is a net cost to the insurer of a catastrophic event occurring including any gap or shortfall in the reinsurance cover relative to a 1 in 250 year event and the cost of one reinstatement of all catastrophic reinsurance programme.

The Catastrophic Risk Capital Charge will cause considerable pain and financial burden on captive insurance companies.

All captive insurance companies are subsidiaries of corporations and only insure the risks of their parent, affiliates, subsidiaries and members of the corporate group. It has a better understanding of its risk profile that enables greater risk retention than traditional insurance companies.

For example, captive A is a subsidiary of a large multi-national New Zealand corporation. They are retaining \$10 million each and every for their Material Damage / Business Interruption insurance. (Commercial property). Under this section of the draft Solvency Act this captive would have to put up \$10 million in capital to meet the minimum standard as proposed by the Standard. This is excessive, does not recognise the unique understanding of the risk, nature of captive insurance companies and the insurance policies they underwrite.

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The NZCIA has polled every captive insurance company in New Zealand and with the Catastrophic Risk Capital Charge applied, every captive insurer would be insolvent.

The NZCIA believe that captives should be exempt from this catastrophic Risk Capital Charge and that a mandatory solvency requirement of \$500,000 should be applied. This solvency requirement is in line with all recognised captive domiciles.

– **Asset Risk Capital Charge**

Concept: Asset Risk Capital Charge is intended to reflect exposure of the insurer to losses of investment assets and other minor asset classes. It is intended for a credit risk and market risk in respect of relevant assets as asset concentration and liquidity risks.

Captive insurance companies have investment strategies prepared for by their managers and approved by the Board of Directors of the captive insurance company. In well managed captives investment strategies include cash, sovereign debt, bank deposits and inter-company investments.

In early years a significant number of captives will invest its assets through a secure loan agreement to its parent company. This loan agreement is secured by a 24 hour call and pays a market rate of interest.

Under the definitions of asset classes and capital factors as defined in Solvency Standard for Non Life insurance business, these types of assets would be inadmissible assets and be subject to a 100% capital charge.

The NZCIA believe that this capital charge is excessive, does not take into consideration the unique nature of a captive insurance company and the capital support received from its parent. The ability of the captive to invest its funds with its parent through a secure note is recognised in all major domiciles. The NZCIA believe that captive insurance companies should be exempt from the Asset Risk Capital Charge due to the nature of the risks they underwrite.

– **Asset Concentration Risk Charge**

The Asset Concentration Risk Charge with respect to each counter-party is the amount by which the insurer asset is exposed with the other counter-party less the applicable asset risk capital charge determined from table 2, exceeds the limit specified in table 3 with a minimum of nil.

The NZCIA believe that captive insurance companies should be exempt from this requirement due to the nature of the business they underwrite and their prudent investment strategies. Captive insurance companies are unique entities and they only underwrite risks of their parent, affiliates and subsidiaries and use those funds to the best interests of the total group. In its infancy most captive insurance companies will invest a significant portion of its assets back into the parent to ensure minimum opportunity cost and maximum benefit for the group as a whole. This risk charge will be detrimental to the growth of captive insurance companies and detrimental to their financial health.

– **Related Party Assets**

The NZCIA believes that captives should be exempt from the related Party assets definition and that captives should be allowed to invest their funds with their parent companies supported by a 24 hour demand notice with interest paid at market rates.

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- **Reinsurance Recovery Risk Capital Charge**
The Reinsurance Recovery Risk Capital Charge is intended to reflect exposure of the insurance and losses arising from failure to fully recover on reinsurance contracts, including losses due to reinsurance and expense. The NZCIA is in favour of this Reinsurance Recovery Capital Charge.
- **Non Insurance Activity Capital Charge**
Captive insurance companies very rarely conduct any activity which is not insurance related for its parent, affiliates and subsidiaries. As such we do not believe that this capital charge will impact the ability of a captive insurance company to continue to operate in a commercial environment.