RBNZ Interim Solvency Standard

Potential implications and considerations for New Zealand insurers

pwc

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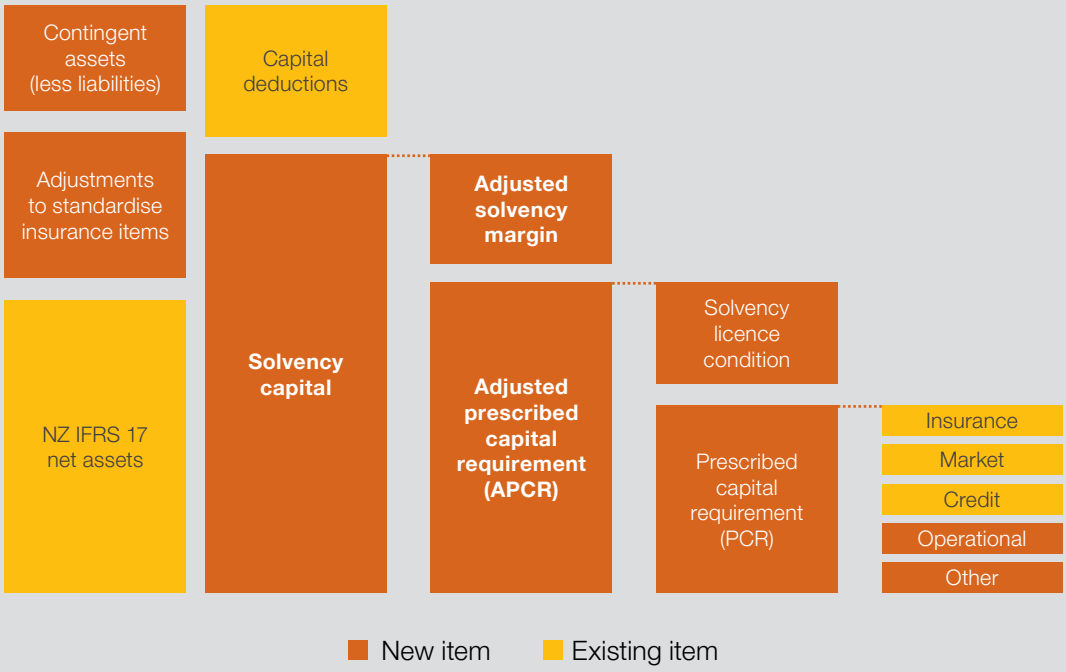
Interim Solvency Standard

On 3 October 2022, the Reserve Bank of New Zealand (RBNZ) released its final Interim Solvency Standard (ISS) following feedback on the previous review and draft versions.

The ISS comes into force from 1 January 2023 with solvency requirements applicable for each insurer (by way of a change to the conditions of their insurer licence) from the commencement date of their first reporting period under NZ IFRS 17. For example, if you have a 30 June balance date, the effective date of the ISS for solvency purposes is 1 July 2023. For the next annual solvency return, the RBNZ expects a 'dual return' to be prepared – that is, one return on the current solvency standard in the normal timeframes and one return on the ISS with a longer timeframe to submit (in a format yet to be finalised).

Our high-level summary below, provides you with some of the key changes relative to the current requirements. Insights into the impacts for life, general and health insurers are provided on the following pages.

Mapping solvency capital requirements to the NZ IFRS 17 balance sheet



Key changes that apply to all insurers

- There is only **one solvency standard**, however charges differ for “long-term” and “short-term” contracts.

- There is **no intended change** to the level of capital required - this will be considered in the next stage of the RBNZ’s solvency review. However, there are several potential capital impacts that we discuss further below, many of which are initially favourable for insurers.

- The terminology used in the standard is changed. The Prescribed Capital Requirement (PCR) is similar to the existing Minimum Solvency Capital (MSC). Solvency licence conditions are added to the PCR to calculate the new minimum **Adjusted Prescribed Capital Requirement** (APCR), as this gives better information to stakeholders of true capital requirements. An Adjusted Minimum Capital Requirement (AMCR) is 80% of APCR.

- In the long-term, insurers operating between the AMCR and APCR will have a heightened level of prudential supervision, while resolution of the insurer applies below AMCR (also known as the “**ladder of intervention**”). However, the AMCR lower level of solvency is not prescribed within the Insurance (Prudential Supervision) Act 2010, so there are legislation changes needed before the AMCR level has any legal meaning. This is not likely to happen until 2026 or 2027.

- Certain NZ IFRS 17 **insurance items are standardised** to better reflect an economic position compared to the NZ IFRS 17 balance sheet:

  - For insurance contracts that meet the “short-term insurance contracts” definition, there is an option to calculate the standardised insurance liability using a Premium Allocation Approach (PAA), with adjustment for premiums due but not received, Deferred Acquisition Cost (DAC) assets and profit margins (net of tax).

  - For all other contracts, the standardisation step is based on the General Measurement Model (GMM) approach, with an allowance for tax. This includes a risk adjustment at a 75% Probability of Sufficiency (PoS) but excludes the Contractual Service Margin (CSM). Contract boundaries are extended for guaranteed renewable business and the reinsurance boundaries are matched to the underlying contracts.

- There is a **new operational risk capital charge**, which is higher for insurers growing more than 20% per annum in volume. The new charge will be phased in over a three year period with the 3% charge not applicable until 2026 and beyond.

- Capital charges must be determined with an **allowance for the tax effects** expected under the prescribed solvency shocks. Any resulting deferred tax asset after wind-up is added to the distressed wind-up capital charge.

- There is a new charge on **reinsurance recoveries in dispute** (defined as recoveries subject to litigation, arbitration, unresolved disagreement or elapsed time since request of more than 180 days, or the payment is overdue by more than 365 days). A 50% charge applies to the difference between the value of the asset in the financial statements and the value agreed by the reinsurer.

- **Contingent assets** and liabilities become part of capital and any repayable amounts as a result of financing reinsurance become a deduction from capital.

- New **distressed wind-up and business run-off charges** apply in certain circumstances. Many of the deductions from capital in the previous standards are moved to be capital charges.

- Interest rate shocks **allow for negative interest rates** and base discount rates are prescribed, including a new definition of the long-term forward rate.

- The specified actuarial information for the purposes of section 77 of Insurance (Prudential Supervision) Act 2010 has been updated to reflect NZ IFRS 17. Appointed Actuary **Section 78 reports will need to be updated** to reflect these new requirements.

- There are **additional requirements** for Appointed Actuaries to comment on in the Financial Condition Report, including outsourcing arrangements, conduct issues and premium adequacy.

Changes that have been made since the ISS review version

There have been a number of items confirmed or updated in the final ISS relative to the draft review version previously published for consultation. These include:

- The definition of a “short-term” contract has been expanded to include travel insurance where claims are expected to be incurred within a 24 month period of commencement (otherwise all claims covered must be incurred within 12 months of commencement). This means that group life insurance contracts with three year repricing terms are unlikely to meet the definition of “short-term”.

- The long-term forward rate to be used for discounting has been redefined to be the average of the forward rates implied by the two longest-dated nominal bonds published on the RBNZ website at the solvency determination date and at dates three, six, nine and 12 months prior. Using an average over the prior year is expected to reduce the volatility that might otherwise occur. However, the bond information published on the RBNZ website only includes up to five and 10 year bonds, so the resulting yield curve could be significantly different from the risk-free yield curve used for NZ IFRS 17 purposes.

- In determining risk adjustments for non-financial risk, approximate methods may be used. Adjustments may also be needed if the shape of the distribution of outcomes results in a material change after applying the prescribed solvency assumptions.

- For participating business, the discount rates to be used have been confirmed as those used under NZ IFRS 17, provided they are consistent with the earning assumptions used to project bonuses. In addition, it has been made clear that "any component benefiting shareholders" should not be included in the standardised insurance items.

- The specified factors for short-term underwriting and claims run-off risk now incorporate allowance for life and health insurance meeting the definition of "short-term".

- For long-term health insurance business, the prescribed solvency assumptions have been revised to be more closely aligned to those applicable to short-term business.

- For life and health insurers, there is now an explicit requirement to determine catastrophe risk under a seismic event, calibrated to a 99.5% occurrence exceedance probability. This terminology may be new for such insurers, but essentially refers to a one in 200 year event.

- The seismic and pandemic catastrophe charges now incorporate the requirement to allow for one reinstatement of any applicable reinsurance cover, based on contractually agreed rates for reinstatement if available, otherwise current reinsurance market conditions.

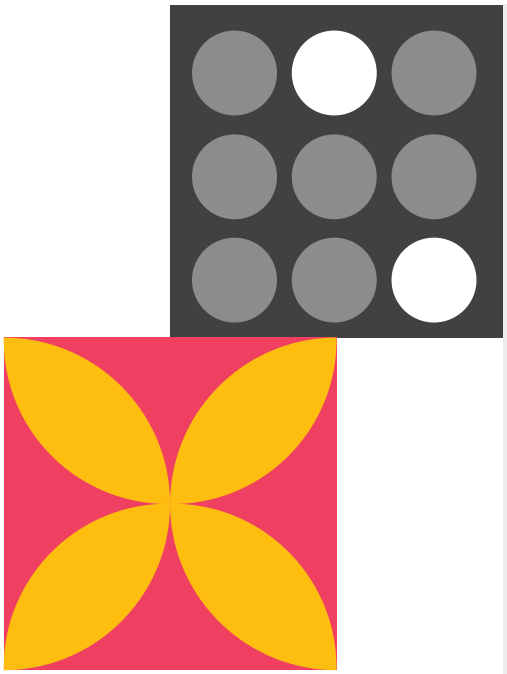
- The interest rate capital charge does not apply to any standardised liability for remaining coverage which is an asset. This means that the interest rate charge will apply to the standardised liability for incurred claims, regardless of whether the Current Termination Value (CTV) minimum applies for that product class, or to any product classes where the standardised liability for remaining coverage is a liability.

- The definition of NZ IFRS 17 insurance revenue used in the operational risk capital charge is now defined as premium revenue until two years of NZ IFRS 17 insurance revenue has been recorded.

- Paragraph 96 of the ISS has been added to exclude a credit risk capital charge where an item is subject to a market risk capital charge. Given that the interest rate charge is part of the market risk charge, it implies that there would be less credit risk capital charges in practice. However, we understand the intention is only to exclude a credit risk capital charge where there is another equity or property risk capital charge.

- Appendix 8 has been amended to make it clear that taxation "must" be applied in the calculation of the Prescribed Capital Requirement. "Wind-up" is now a defined term and this change could generate a solvency benefit for many insurers. See the key focus areas below.

Potential capital impacts



For all insurers

There will be an impact from the new capital charges for operational risk, distressed wind-up, business run-off and reinsurance disputes (if applicable). Not all changes will immediately impact the solvency margin. The impact of the operational risk capital charge will be phased in over three years, and some of the effects from the distressed wind-up charge may be offset within the solvency margin if the changes reflect what was previously a deduction from capital.

The adjusted solvency ratio (calculated as Solvency Capital divided by the APCR) may change significantly, even if your solvency margin (excess capital position) does not. This may be due to the standardisation adjustments made within Solvency Capital, the inclusion of licence conditions, or previous deductions from Capital moving to capital charges (for example, goodwill, deferred tax assets, equity investments in subsidiaries, etc). Solvency ratios will be even more difficult to compare, particularly amongst life insurers. For example, a profitable life insurer is expected to have a higher Solvency Capital amount and would therefore end up with a lower solvency ratio than an unprofitable life insurer with all else being equal. The RBNZ are expected to issue further commentary and guidance on the potential changes in solvency ratios. This will give some comfort to management and directors that this change does not mean the RBNZ views the capital positions of insurers to be weaker than under current standards.

For tax-paying licenced insurers, the clarification of how tax is expected to work under the new “wind-up” definition is likely to be a significant change for those insurers. We expect that many insurers will benefit significantly from thinking about this new wording and have provided further commentary on this below.

For life insurers

Product classes for applying the CTV minimum (i.e. the amount that would be payable on wind up) are explicitly defined. Level and yearly renewable term (YRT) lump sum risk business is grouped together, which reduces the risk of additional capital needed if level premium business is separated under NZ IFRS 17. Life insurers with granular product grouping under NZ IFRS 4 may find capital requirements are reduced with the new prescribed grouping.

Solvency liabilities are based on the standardised insurance balances, which include a 75% PoS risk adjustment. This may mean that solvency liabilities are more likely to exceed the CTV in borderline cases, which will give rise to additional capital requirements through the interest rate risk capital charge. There is also a second-order effect whereby the prescribed solvency assumptions are applied to the standardised liabilities including a risk adjustment, which may increase insurance risk capital charges.

Given the guaranteed renewable nature of life insurance, most businesses will be classified as “long term”. This includes group life businesses where there is usually a three year guarantee period and this may require new projection models along with associated changes in capital requirements.

There may be a (positive or negative) capital impact from adopting the prescribed interest rates. There may be additional capital required in a very low interest rate environment with the revised interest rate shocks, which will mean that fewer licence conditions will be needed to deal with the risks of very low (or negative) interest rates.

For general insurers

Due to the standardised balance sheet with 75% PoS premium liabilities, this will mean that any excess of your existing unearned premium reserve over and above your premium liabilities will increase your solvency capital and solvency margin compared to the existing solvency standard. This could be significant for profitable general insurers.

If contracts meet the definition of "short-term", then there is an option to use PAA as the base for the standardised liability for remaining coverage. Adjustments are required for premiums due but not yet received, DAC assets, and expected profit margins (net of tax and an implicit adjustment for non-financial risk). This approach may be optionally applied and is intended to give similar outcomes to the GMM approach, but the outcomes may not always be equivalent.

There is a requirement to include all expenses in the standardised insurance liabilities. This is a change to existing solvency requirements where only claims handling expenses and policy administration expenses were included in premium liabilities, and hence may increase capital requirements.

For any general insurers that included an allowance for a long-term risk characteristics charge, this charge has been removed for short-term insurance contracts now. This will reduce capital requirements and increase the solvency margin.

For health insurers

Unless health insurance contracts can be justified as not being guaranteed renewable, then health insurance contracts are likely to be viewed as long-term contracts. For health insurers currently using NZ IFRS 4 Appendix D, this will result in additional costs to establish new projection models. Solvency capital will heavily depend on future claims and premium inflation assumptions as well as the level of premium discretions, which places more onus on Appointed Actuaries.

The prescribed solvency charges have been set to 111% of best estimate incurred medical claims, 115% of best estimate future medical expense claims in the first year, then 105% of best estimate thereafter, together with a 1% per annum addition to the best estimate medical expense inflation rate. This is likely to be lower than the 130% of claims cost in the current Life Solvency Standard and may reduce capital requirements for those currently accounting for their health business using NZ IFRS 4 Appendix C. However, the prescribed claims inflation assumption is new and may result in capital increases for some insurers.

Standalone health insurers may also find that their capital requirements reduce if sufficient premium discretions are used in their long-term projections. Appendix 7 provides more guidance on the application of discretions with the intention to avoid using long-term premium increases to offset short-term losses prior to repricing taking effect.

Three areas to consider right now

We have identified three areas that we think all insurers should be considering right now. They are as follows:

1

Understand the impacts and consider engaging your auditor

It is important that all insurers understand the impact of the ISS for their business, not least because, as noted in the ISS, "Insurers have a responsibility to continuously maintain solvency margins in accordance with whatever conditions of licence and whichever solvency standards are currently applicable". Insurers will need to be confident that they are in compliance with the ISS from the date that it becomes applicable for them and start factoring these new requirements into solvency projections for any balance dates after October 2022. It is important that insurers have understood and communicated any impacts to management and the board. Insurers' boards may also request additional assurance procedures on the early solvency calculations to give additional comfort, so you may need to start engaging your auditor now to ensure you have enough time to obtain assurance on your first solvency return under the ISS.

2

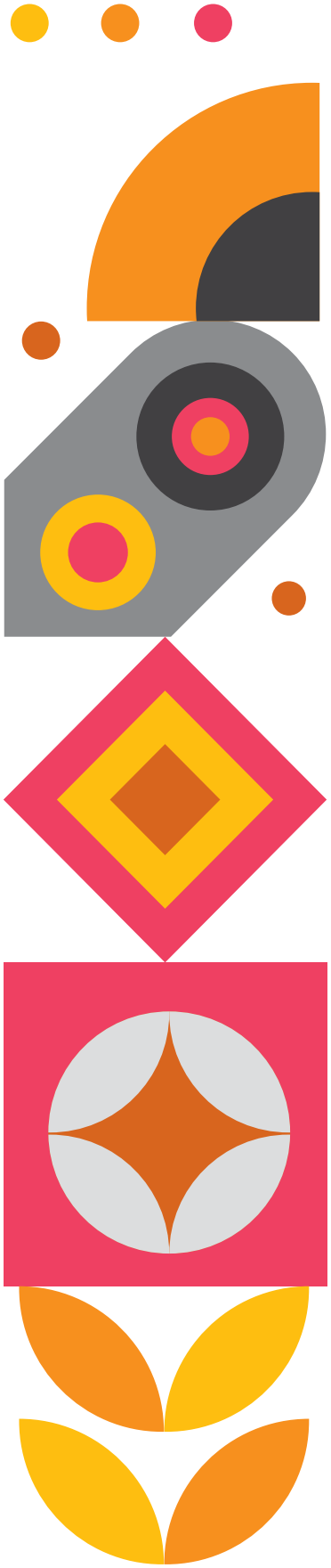
Work through your risk adjustments for both NZ IFRS 17 and solvency

Risk adjustments for non-financial risk under NZ IFRS 17 should represent the compensation the entity requires for bearing the non-financial risk. It is not expected to be a 75th percentile in many cases and will likely differ depending on the product, likely duration (short-tail vs long-tail) and insurer's own risk appetite or capital requirements. The risk adjustments will then need to be converted to a 75th percentile for solvency purposes, potentially with a different contract boundary for guaranteed renewable insurance. Further adjustments may need to be made if the distribution of outcomes changes after applying the prescribed solvency assumptions. All of this requires careful consideration and multiple methods are expected to be used in deriving risk adjustments. This will not necessarily be an easy task, and insurers should not underestimate the work required in its determination – particularly for life insurers where risk margins have not to date been a feature of financial reporting.

3

Don’t forget about tax

The requirements with regard to taxation will need to be carefully worked through to ensure charges can be determined both gross and net of tax, and any resultant deferred tax asset on wind-up determined. The new “wind-up” definition assumes that the entity is closed to new business with immediate effect and that within 12 months all contracts are run off or transferred, with final closure occurring one year after the solvency determination date. The implication of this is that any tax liability expected to be generated over that year until final closure, can be offset against any deferred tax assets on the balance sheet or arising from the prescribed solvency shocks. Considerations in this assessment are how long to project out tax for (12 months or less?), what an appropriate tax deduction for each capital charge is and the appropriateness of expense assumptions without any new business. Actuaries should be working with their tax experts to determine a sensible methodology and this is likely to generate a substantial solvency benefit for many insurers.



How PwC can help

The insurance industry is undergoing fundamental transformation as it comes up against the impact of new regulation with NZ IFRS 17 presenting the most significant change in financial reporting in 20 years. It's important to remain on top of emerging trends and impacts for both financial reporting and prudential supervisory changes, making the most of any opportunities to create more efficient processes for insurers.

Specifically, our Insurance teams can assist with:

- Providing assurance over or managing your financial, operational and reputational risks
- Providing assurance or managing your regulatory requirements and financing reporting
- Actuarial services including modelling, risk management and appointed actuary functions

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