



RBNZ Draft Interim Solvency Standard

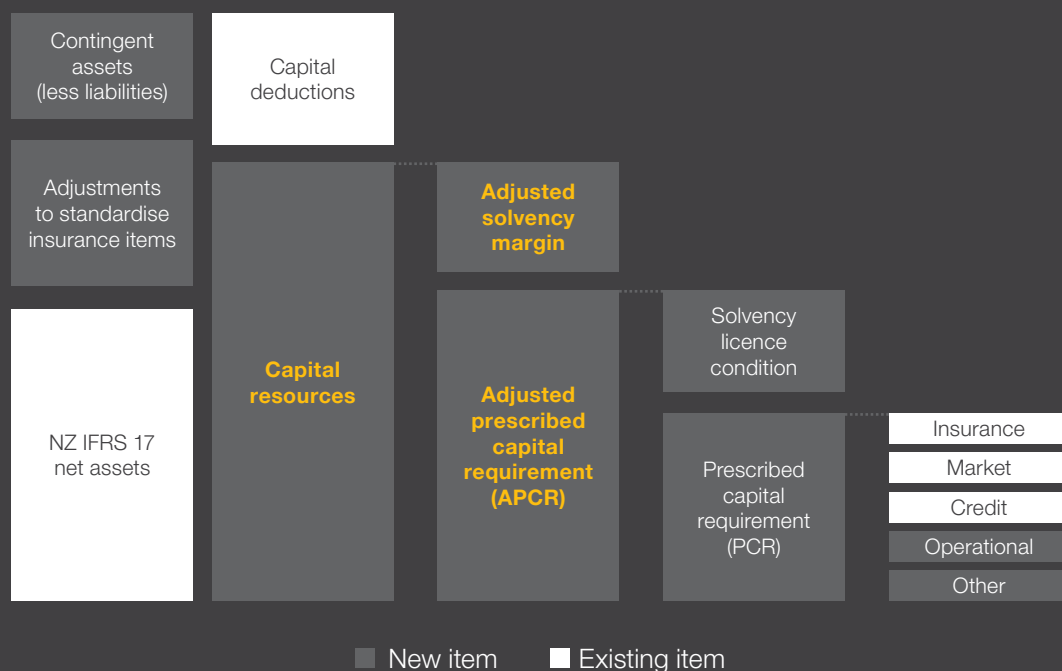
Initial thoughts and implications
for New Zealand insurers

Draft Interim Solvency Standard

The Reserve Bank of New Zealand (RBNZ) released a draft interim solvency standard (ISS) in July 2021 to apply from 1 January 2022. In October 2021, following initial feedback from insurers and industry bodies, RBNZ changed the implementation date to 1 January 2023. While not formally communicated yet, we understand that the intention of this implementation date is to align with reporting under NZ IFRS 17 *Insurance Contracts* (NZ IFRS 17), which is effective for reporting periods beginning on or after 1 January 2023.

Our high-level summary below, provides you with some of the key changes. 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**. Charges may 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 review. However, there are several potential capital impacts, some of which may be unintentional.
- Certain NZ IFRS 17 **insurance items are standardised** to better reflect an economic position. This is based on a **General Model measurement approach** and 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% in volume.
- There is a new 50% charge on reinsurance recoveries in dispute.
- Contingent assets and liabilities become part of capital and any **repayable amounts** as a result of financing reinsurance **become a deduction** from capital. There are possible unintentional impacts in the drafting of how this repayable amount is calculated in the likelihood test, potentially capturing standard pure risk reinsurance contracts as well as financing reinsurance.
- **New wind-up and business run-off charges apply** in certain circumstances.
- 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. Insurers operating between the AMCR and APCR will have heightened prudential supervision; resolution of the insurer applies below AMCR (also known as the “ladder of intervention”). Interest rate shocks allow for negative interest rates and base interest rates are prescribed.
- **Interest rate shocks** allow for negative interest rates and base interest rates are prescribed. The drafted interest rate charge is similar to the current interest rate risk charge from the Solvency Standard for Non-Life business, which may create unintended consequences for insurers with long-term contracts.
- Significantly more work will be required by Appointed Actuaries as part of the Insurance (Prudential Supervision) Act 2010 **Section 78 report** to reconcile NZ IFRS 17 to solvency information.

Practical implications

General model cash-flows

To standardise the balance sheet for the insurance items, a General Model approach to estimating (re)insurance liabilities is required

The Premium Allocation Approach (PAA) is not permitted, so if you are planning on using the PAA method under NZ IFRS 17 you will need to consider how you will produce the required information for solvency. For general insurers with short term business, this may be similar to the existing approach to estimating premium liabilities, but for other general and health insurers, constructing models with long-term projections of future cash flows may require a significant amount of additional effort.

Acquisition cash flows

Any assets established for insurance acquisition cash flows, that are allocated to future groups of contracts under NZ IFRS 17, are removed from the balance sheet

However, the contract boundary of the standardised insurance assets and liabilities is extended to allow for any future renewals, which will ensure that the future cash flows used to recover any previously incurred acquisition costs are part of the Capital Resources.

Product groupings

Product groups are explicitly specified, largely in line with the current RBNZ groupings for insurance risk (general insurers) or data returns (life insurers)

If contracts in an NZ IFRS 17 group have components spanning more than one product group, the group of insurance contracts does not need to be split across product groups for solvency purposes. It is simply allocated to the product group associated with the “main” benefit.

Risk adjustment

A 75% PoS risk adjustment is needed for the standardised insurance items, which may be based on a different contract boundary to that under NZ IFRS 17

This may present additional complexity for some insurers, particularly those that are adopting a cost of capital approach to calculating their risk adjustments. It also differs to the approach proposed by the Australian Prudential Regulation Authority (APRA) for life insurers whereby the capital requirements are based on best estimate liabilities only.



Items where further clarification may be required

Will the definition of a “**short-term contract**” capture all contracts that you expect to be “short-term”? To meet this definition, all claims must be reported within one year of the reporting date. There must be no acquisition costs allocated to future renewals and there cannot be any guaranteed renewability. The contract boundary for “short-term” contracts is adjusted to include all ultimate claim payments, which may be many years after the claim date (for example, Canterbury earthquake claims).

The **50% recovery risk charge on reinsurance recoverables** in dispute appears subjective, yet it could be very material post a large event. The interpretation of what is “in dispute” could lead to inconsistencies in interpretation amongst insurers.

A separate asset is required to be set up for **premiums receivable**, yet it would also be included in the NZ IFRS 17 assets or liabilities. Does this new requirement result in double-counting the value of premiums receivable? What about claims payable liabilities?

Interest rates are to be determined by reference to swap rates and the Treasury yield curve. The interest rate shock now incorporates the possibility of negative interest rates, varying from 1% to 1.75%. There is a lack of clarity on how to bridge from the swap rates to the Treasury yield curve and whether the new interest rate shocks apply to forward rates, spot rates or to the entire yield curve. This may lead to discontinuities in the yield curve applied or inconsistent application.

There are possible unintentional capital impacts in the drafting of some aspects, some of which could be very significant for the insurance industry. Of note are the drafting of the reinsurance likelihood testing and the interest rate risk charge, primarily affecting life insurers. The RBNZ has carried out a Quantitative Impact Assessment (QIA) with a small selection of insurers in conjunction with the consultation process. This is intended to understand any unexpected or undesirable effects and a summary of results should be released in the coming months.



Next steps

It will be important to work through the details as there may be additional changes that are relevant for your business. The RBNZ published the QIA template on its website in September 2021, so all insurers are able to use this template to estimate the impact of the proposed changes for their solvency position. While the RBNZ has changed the date of implementation of the ISS from 1 January 2022 to 1 January 2023, this date is still fast approaching and aspects of the standard may change with further consultation. It is important for insurers to consider potential capital impacts, communicate this to management and the board, then prepare to implement new calculation logic and processes as part of their NZ IFRS 17 project.

Potential capital impacts



For life insurers

Product groups for applying the Current Termination Value (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.

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 capital requirements.

There are possible unintentional capital impacts with how the repayable amount for reinsurance is calculated in the likelihood test, potentially capturing standard pure risk reinsurance contracts as well as financing reinsurance. The ISS prescribes 10% as the “highly unlikely” threshold probability for the reinsurer making a significant loss and the QIA instructions include a 10% allowance for reinsurer profit margins. This means that if it is less likely than 10% that the reinsurer could make significantly less than a

10% margin at risk-free interest rates, then a repayable amount may be needed. This may result in unintended increases in capital for treaties that are highly profitable for the reinsurer, but genuinely provide risk transfer.

For many insurers, there may be a (positive or negative) capital impact from adopting the prescribed interest rates. There may be additional capital required in a low interest rate environment with the revised interest rate shocks. However, more significantly, there are possible unintentional impacts for life insurers with the drafting of the interest rate risk charge as it applies to the standardised insurance liabilities, which could be assets for certain types of contracts. We estimate that this could add up to \$1.0 billion of capital to the entire life and health insurance industry based on how it has been originally drafted. The RBNZ is currently considering alternative wording to limit the interest rate shock to positive standardised insurance liabilities only, which should minimise this impact and is likely to be part of further consultations or industry discussions.



For all insurers

There will be an impact from the new capital charges for operational risk, distressed wind-up and business run-off. 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. There will also be an impact from the 50% charge on reinsurance recoveries that are in dispute, which is a significant increase from the 2-4% charges on reinsurance recoveries typically observed in practice.

The solvency ratio (calculated as Capital Resources divided by the PCR) may change for various reasons, even if your excess capital position does not. This may be due to the adjustment to a 75% PoS position made within the Capital Resources, the inclusion of licence conditions, or previous deductions moving to capital charges (for example, goodwill, deferred tax assets, equity investments in subsidiaries, etc). Solvency ratios may be even more distorted than under the current standard and will continue to be difficult to compare amongst life insurers. For example, a profitable life insurer will have a higher Capital Resources amount and would therefore end up with a lower solvency ratio than an unprofitable life insurer with all else being equal.



For general insurers

Due to the Capital Resources being based on a standardised balance sheet with 75% PoS premium liabilities, this may mean that any excess of your existing unearned premium reserve and your premium liabilities will increase your Capital Resources and Solvency Margin (the excess of Capital Resources over the PCR) compared to the existing solvency standard.

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



For health insurers

Health insurance contracts are viewed as long-term contracts due to their guaranteed renewable nature. For health insurers currently using NZ IFRS 4 Appendix D, this will result in additional costs to establish new models and it may have unintended capital impacts. 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. If adopted, it also means the issue in respect of the interest rate risk charge above for life insurers may also affect health insurers.

The prescribed solvency charges have reduced to 105% of best estimate medical expense claims and 101% of best estimate medical expense inflation. This is 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.

How we see it

The draft ISS has a few surprises in calculating the minimum level of capital, but other changes were largely expected. It provides some clarity on how the “ladder of intervention” will work in practice, with the hard minimum set at 80% of the prudential requirement. The impact on your capital position may be positive or negative, and will bring some practical challenges alongside NZ IFRS 17 implementation. Changes to watch are:

There will be an increase in capital requirements as a result of the new **operational risk capital charge**. Insurers and industry bodies have suggested that a diversification benefit is needed to offset this, but diversification is more likely to be introduced in Phase 2 of the review.

For profitable general insurers, **credit will be given to any excess of the unearned premium reserve over premium liabilities** within the Capital Resources. This will improve the Solvency Margin.

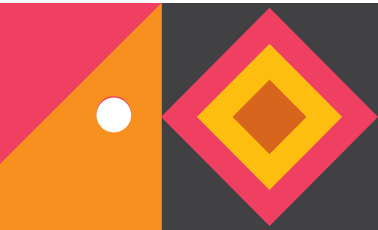
For **life insurers with health business**, capital requirements may reduce slightly with a reduction in the prescribed solvency assumptions for health. Standalone health insurers may also find that their capital requirements reduce if sufficient premium discretions are used in their long-term projections.

There may be significant increases in capital requirements for life insurers, in particular, if the currently drafted wording does not change for the reinsurance likelihood testing and interest rate risk charges.

Life insurers with granular product grouping under NZ IFRS 4 may find capital requirements reduce with prescribed **grouping that groups level and YRT lump sum risk together**.

Including the licence conditions within the Adjusted Solvency Margin will **improve transparency and reporting** of total capital requirements.

Building, or maintaining, **long-term projected cash flow models** for capital purposes will be required for all insurers with long-term contracts (health and some general insurers included).



Regardless of the impact, the release of this ISS signals the types of approaches needed for solvency and it will allow insurers to plan their NZ IFRS 17 projects with more confidence. With the requirement for a long-term projection model, it may have insurers questioning whether the costs of developing a PAA model are worth the benefits and it is important to understand these changes earlier to factor them into inflight projects.

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