Financial Services Council
growing and protecting the wealth of New Zealanders

Financial Services Council of New Zealand
Level 12, City Chambers
Cnr. Johnston & Featherston Streets
PO Box 1514, Wellington 6140
New Zealand
Ph: +64 4 473 8730
Fax: +64 4 471 1881
Email: fsc@fsc.org.nz
www.fsc.org.nz
www.yourwealth.org.nz

28 February 2013

Ian Woolford
Manager, Financial Policy
Prudential Supervision Department
Reserve Bank of New Zealand

Ian.woolford@rbnz.govt.nz

Dear Ian,

Insurance Solvency Standards Consultation Paper

The Financial Services Council ("FSC") appreciates the opportunity to comment on your consultation paper *Insurance solvency standards: the quality of capital and regulatory treatment of financial reinsurance.*

Individual members of the FSC will make their own company-specific submissions. Our response is based on discussion with members but is more in the nature of general comments from an industry perspective.

We have set out our response in the same order as the consultation paper.

Part 1 The Quality of Capital

While we recognise the need to ensure capital on the balance sheet is available to meet claims, restrictions on the type of capital does limit options to raise funds.

Q1 Do you agree with definition of capital for solvency purposes?

FSC disagrees with the definition. We agree that actual solvency capital must be permanent and available without encumbrance to absorb large unexpected losses. However, some debt instruments could meet these tests, but would be excluded because of form rather than substance. The definition could usefully be broadened or improved to cover these items.

In some circumstances, it can be more tax-efficient for investors to receive an interest coupon rather than a dividend. For example, many life insurers are currently unable to attach imputation credits to post-tax earnings from which dividends are paid. It is more efficient to pay interest from pre-tax profits. In both cases, the investor has to pay tax on the income received but in case of shares the company and investor both incur tax.

The key test is whether the instrument acts like equity in absorbing losses: it cannot be redeemed; interest payments are discretionary; and non-payment does not trigger any rights over future income.

Although a permanent instrument cannot have redemption rights, it may be acceptable to have conversion rights (into ordinary shares), or voting rights (alongside ordinary shares) as a protection for this class of investor vis-à-vis ordinary shareholders (after a coupon is not paid).

Allowing more flexibility in the form of financial instruments facilitates greater innovation in New Zealand. The ability to use capital in a more efficient way ultimately benefits policyholders.

Q2 Do you agree with overall characteristics of high quality capital?
FSC agrees with the criteria set out in part 20. We support a strong insurance sector with adequate capital to provide protection to policyholders during bad times as well as good.

Q3 Do you agree with the general requirements for capital instruments?
FSC agrees with principles-based criteria that look through to the substance rather than legal form of any capital instrument. We agree with the requirements regarding permanence, loss absorption, servicing charge and ranking on wind up.

These requirements support a financially strong insurance sector and public confidence in the pooling mechanism of insurance. A functioning insurance sector alleviates the potential financial impact of random events that can be catastrophic for an individual or small firm. Risk transfer through insurance provides peace of mind for entrepreneurs whose creativity and determination are essential for economic growth.

Q4 Do you agree with specific requirements?
FSC does not disagree with any of the qualifying criteria set out in the consultation paper.

Q5 Are the proposed criteria appropriate for licensed insurers to manage their current and future capital requirements?
FSC believes that the Reserve Bank should have the discretionary power to examine and, if appropriate, approve any capital instrument that meets the general requirements.

Part 2 Regulatory Treatment of Financial Reinsurance

Q1 Do you agree/disagree with the Reserve Bank's concerns regarding the current lack of constraints on the solvency benefits arising from financial reinsurance arrangements?
We agree with the position put forward by the Reserve Bank. As a general rule it is preferable for the industry to have certainty on the interpretation and treatment of arrangements.

Q2 Do you agree/disagree that these concerns should be addressed?
We agree that the concerns should be addressed, subject to the details of proposals for implementation.

Q3 Are the two policy options presented in this paper appropriate ways of dealing with the issues?
We understand that there are differing views among the membership but, of the options proposed, we consider that option 2 is the more appropriate and would support the proposed allowance with a cap of 15% of total capital.

Although not directly related to financial reinsurance, we do note that other regulations sometimes allow a relatively small fixed percentage of some items of potential debate to count as capital; for example, we understand that APRA standards allow for 20% subordinated debt to count for solvency purposes.

Q4 What are the advantages and disadvantages of the two options?
Both options will increase the difficulty for new entrants coming into the market but option 2 will have a lesser impact.

Q5 Are there any other options that the Reserve Bank should consider?
No comment on this question.

Q6 For insurers: How would your company be affected by the two options presented here?
We will leave it to individual insurers to respond to this question.

Q7 What is your current use of financial reinsurance arrangements and what were the reasons for entering into those arrangements?
We will leave it to individual insurers to respond to this question.

Q8 Are there any technical or implementation issues? If so, what are they and how could they be addressed?
We note that the insurer's CEO, CRO and appointed actuary would be required to attest to the accuracy of the information provided. Clear definitions will be necessary for that purpose.

We support the proposal that the Reserve Bank verify the nature of the arrangement and recommend a process for insurers to obtain an opinion for the bank on the acceptability of their arrangements at the outset.

Q9 Are there any other possible indicators of financial reinsurance, apart from those outlined within the introduction to this part of the consultation paper?
No comment on this question.

Part 3 Other revisions to solvency standards

We do not have any comments on this section.

Yours sincerely,

Deborah Keating
EXECUTIVE OFFICER