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Deloitte Issues Paper: The New Zealand Life Insurance Sector

Key Insights, Trends, Analyses and supplementary commentary on the RBNZ Bulletin (Vol. 83, No. 1.)

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About

Deloitte Limited (as trustee for the Deloitte Trading Trust) was commissioned to produce this Issues Paper by Partners Life in advance of an expected review of capital requirements and solvency standards for the life insurance sector by the RBNZ.

Our intention is that this Issues Paper and the independent research and analysis Deloitte has conducted for it will promote further discussion and analysis to support key decisions that will help shape the direction and future of the New Zealand Life Insurance industry.

Given its New Zealand expertise and the global perspective of its board, Partners Life is conscious of the unique nature and complexity of the New Zealand life insurance market and the need for this to be taken into account in any regulatory changes. As such and as part of its desire to constructively contribute to the work programme the RBNZ has underway, Partners Life commissioned Deloitte to undertake this research.

The RBNZ Bulletin published in January 2020 aimed to provide insight into the current state of the Life Insurance sector in New Zealand. This Issues Paper further discusses the observations made by the RBNZ and their implications. In particular, Deloitte has focussed on the profitability and capital requirements of the Life Insurance sector, given the proposed upcoming review of the Solvency Standard.

The Issues Paper purposefully does not set out a recommended approach or preferred outcome from the review. Rather it attempts to highlight some of the key considerations and challenges that Deloitte believes need to be considered in regards to capital adequacy and solvency standards for the sector.

Partners Life Limited remains independent of the analysis and interpretation of data and information presented in this Issues Paper.

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Executive summary

Each Life Insurance sector is unique, shaped by characteristics specific to the country in which it exists. In this context, the New Zealand Life Insurance industry has a number of features that differentiate it from other countries. As a result, it can be very difficult to compare sector efficiency, profitability and capital adequacy with other countries based only on high level metrics.

The New Zealand Life Insurance landscape

A unique feature of the New Zealand Life Insurance industry is that it exists alongside the Accident Compensation Corporation (ACC)[1] , KiwiSaver[2] and NZ Super[3], which provide cover under circumstances which would normally require insurance in other countries. As a result, it has been shaped by the perceived needs and demands of the local population.

According to ACC's 2019 Annual Report, paid weekly compensation benefits were approximately NZ$1.3b for the year. Had this been insured by the life insurance industry, this would add close to NZ$2b to the gross premium income based on a 60% claims ratio. This is set against insurance industry gross insurance premiums in 2019 of $2.7b.

Adjusting for ACC would nearly double the Life Insurance penetration for New Zealand.

The community has a high awareness of the existence of support through ACC, KiwiSaver and NZ Super. We observe that as a result, there is some complacency in New Zealand with the perception that support will be provided by the Government, leading to a degree of underinsurance.

Profitability

The characteristics of the Life Insurance sector mean that common measures of performance can be distorted, making it difficult to compare profitability in New Zealand with overseas markets.

[1] The Accident Compensation Corporation (ACC) is a New Zealand Crown entity that provides cover in the event of an accidental injury or death.

[2] KiwiSaver is a voluntary retirement savings scheme.

[3] New Zealand Superannuation ("NZ Super") provides universal superannuation for people over the age of 65.

Claims ratio

Life Insurance markets which are dominated by risk-only products tend to exhibit lower claim ratios when compared with life insurance markets where insurers sell a significant amount of savings-type products. The RBNZ references EIOPA statistics, where the majority of the market is dominated by savings or investment-type products.

The Financial Services Council (FSC) statistics for the year to 31 March 2020 indicate that the gross claims ratio for New Zealand's traditional business was approximately 312%.

This highlights that the structure of these products naturally results in higher claims ratios.

Expense ratio

The size of the New Zealand economy is small relative to other countries. As a result, even if fixed costs were consistent across other countries, the number of policies supporting these costs is significantly less. That is, there is a lack of scale in New Zealand that exists in overseas markets.

The expense ratio is largely driven by the size and structure of the New Zealand market, rather than primarily due to inefficiencies inherent in operations of New Zealand Life Insurers.

Commission ratio

Comparisons of commission ratios across markets need to account for the different distribution models. A significant portion of life insurance in Australia is distributed through mandated default insurance under group schemes attached to Superannuation. The dominance of Adviser distribution and a much smaller proportion of group schemes in New Zealand therefore naturally leads to a higher commission ratio in whole-of-sector comparisons.

The distribution channel can distort the commission ratio which can lead to incorrect conclusions around relative efficiency.

There have been suggestions in New Zealand that commission provides the wrong incentives and therefore should be banned. However, this assumes an appetite for consumers to pay directly for advice and opens the potential for many experienced Advisers to leave the market. This could significantly reduce access to insurance advice for customers and has the potential to further exacerbate the underinsurance issue in New Zealand, particularly given that the Adviser channel dominates the market.

A comprehensive review of Adviser commissions was undertaken by the FMA and RBNZ in 2019. As a result of the review, the Government recently announced a new financial conduct regime to address Insurer conduct and gaps in the current regulatory regime. Life insurers are currently implementing changes in response to this, with these changes expected to address the issues identified and thus satisfy the requirements of both the FMA and RBNZ.

Capital adequacy

Prudential supervision enhances the soundness and efficiency of the financial system.

The RBNZ notes that "the aggregate solvency ratio of life insurers in New Zealand is low relative to many European countries and Australia". However, it is difficult to draw any conclusions regarding the relative risk of failure of New Zealand insurers from this given that:

- Insurers are subject to different minimum solvency requirements in other countries and therefore the base for the solvency ratio differs;
- capital and accounting frameworks vary between countries;
- insurers in New Zealand may be the subsidiary of a foreign parent that prefers to retain surplus capital in its home country; and
- some insurers view New Zealand's minimum solvency requirements as more conservative than those in other countries.

These limitations mean it is difficult to conclude from solvency ratios alone that New Zealand's life insurers are financially weaker than overseas insurers.

For example, because of peculiarities in the applicable accounting standard, NZ IFRS 4, and the RBNZ solvency standard, the impact of changes in economic conditions on life insurers is different in New Zealand than elsewhere.

As interest rates have fallen to historically low levels, this has brought about the unusual combination of higher returns on equity for insurers and lower solvency ratios.

We reviewed the publicly available solvency information for the top 9 life insurance businesses that are regulated by the Reserve Bank. The total Actual Solvency Capital (ASC) is NZ$2.1b and the aggregate Minimum Solvency Capital (MSC) is NZ$1.6b. It is estimated that approximately NZ$1b of 'intangible' policy liability assets are included in both the ASC and MSC. Adjusting for this, which would be more consistent with APRA's framework, **the aggregate solvency ratio in New Zealand would be closer to 190%. This is more comparable with the solvency ratios of other countries.**

Insurers purchase reinsurance as a form of risk management. Reinsurance can protect an insurer against adverse losses and, in doing so, it functions as a substitute for surplus capital that an insurer may otherwise choose to hold. However, Life Insurers in New Zealand strongly rely on reinsurance for a number of reasons other than as an alternative for holding solvency capital, driven by the product offerings and the size of the local economy.

The degree of reinsurance that can be held to reduce capital requirements is limited. If a life insurer has significant exposure to a single reinsurer, the Solvency Standard requires additional capital to be held to mitigate the risk of the reinsurer defaulting. The level of additional capital will also vary depending on the credit rating (and therefore implied stability) of the reinsurer.

It is difficult to say whether capital held by a New Zealand insurer provides a more robust risk management mechanism than transfer of risk to a global reinsurer.

Given the size and scale of most global reinsurers, it may be that there is less risk with using a large global reinsurer given their access to capital instruments, compared with increasing local capital holdings.

With the upcoming review of the current Solvency Standard, a view on the adequacy of current levels needs to be undertaken, not based on comparisons with overseas markets but based on the needs of the New Zealand market. It is key that a balance is struck between providing stability and confidence in the sector without imposing a strain on the industry through unnecessarily high capital requirements, discouraging investment in growth and innovation to provide better levels of insurance coverage for the community.

The use of additional reinsurance could support this balance. Although reinsurance does result in a reduction in capital requirements, the merits of transferring a greater proportion of risk to a global partner (rather than additional capital holdings) needs to be considered.

The key is identifying the best mix of capital holdings and reinsurance for a more diversified approach to risk management, allowing New Zealand companies to take advantage of the size and scale of global reinsurers whilst easing the capital strain locally, to potentially free up capital for further investment into the local market.

The New Zealand Life Insurance landscape

The New Zealand Life Insurance industry exists alongside ACC, KiwiSaver and NZ Super, which provide cover under circumstances which would normally require insurance in other countries. As a result, it has been shaped by the perceived needs and demands of the local population.

The Accident Compensation Corporation (ACC) provides cover in the event of an accidental injury or death. The ACC scheme covers medical expenses, partial replacement of lost income, modifications to home and vehicles if required as a result of a person's injury, and a survivor's benefit for fatal accidents.

As ACC is a public scheme, there is no compulsory insurance often seen in other markets such as motor insurance and workers compensation insurance (IMF). Surveys[4,5] suggest that there is a tendency for New Zealanders to regard ACC as adequate for disability cover and that they lack awareness that incapacity due to illness, which is statistically more likely, is excluded.

KiwiSaver is a voluntary retirement savings scheme with contributions made from a person's salary or wages. Both KiwiSaver contributions and investment earnings are taxable. However, there is a government contribution for KiwiSaver that would not apply for savings-type products.

This leads to a preference to invest directly in KiwiSaver as a vehicle for retirement savings, rather than an alternative savings-type product.

Although KiwiSaver is intended to be a retirement savings scheme, it provides some flexibility by allowing individuals to withdraw savings to assist in purchasing a first home or when facing a financial hardship.

New Zealand Superannuation ("NZ Super") provides universal superannuation for people over the age of 65. NZ Super reduces the exposure to financial hardship at older ages. Many other countries do not have this type of scheme in place.

With the availability of support through ACC, KiwiSaver and NZ Super, coupled with a strong public health care system, there is some complacency observed in New Zealand where there is the belief that support will be provided by the Government, resulting in a degree of underinsurance.

Insurance penetration

The penetration rate is used as an indicator of whether a population is adequately insured. It is calculated as the ratio of gross premiums to GDP and is used by the RBNZ as a measure for comparison of life insurance sectors across different countries.

In the case of a unique market such as New Zealand, this measure is not readily comparable with other markets. New Zealand's relatively low penetration rate can be primarily attributed to the discontinuation many years ago of bundled insurance and savings products and the existence of ACC, which provides financial benefits in the case of an accidental death. In other countries, this would typically be included in a life insurance policy. According to ACC's 2019 Annual Report[6], paid weekly compensation benefits were approximately NZ$1.3b for the year. Had this been insured by the life insurance industry, this would add close to NZ$2b to the gross premium income based on a 60% claims ratio.

[4] Financial Services Council (2011) – Exploring Underinsurance within New Zealand. Retrieved from http://media.nzherald.co.nz/webcontent/document/pdf/20138/insurance.pdf.

[5] Financial Services Council (2020) – Gambling on Life: The Problem of Underinsurance. Retrieved from https://www.fsc.org.nz/site/fsc1/Gambling%20on%20Life%20-%20The%20Problem%20of%20Underinsurance%20-%20Financial%20Services%20Council%20-%20January%202020.pdf.

[6] ACC (2019) – Annual Report 2019. Retrieved from https://www.acc.co.nz/assets/corporate-documents/acc8053-annual-report-2019.pdf

This is set against insurance industry gross insurance premiums in 2019 of $2.7b[7].

Adjusting for ACC would therefore nearly double the life insurance penetration rate.

New Zealand is also disadvantaged under a penetration measure because a typical savings portfolio includes KiwiSaver, residential property and other direct investments that sit outside the life insurance industry. KiwiSaver is a retirement savings scheme, but participation is voluntary and the contribution rates are much lower (so the insurance opportunity is limited).

Market concentration

The total size of the Life Insurance market, based on in force annual premium income as at 31 March 2020, is $2.7b[8]. As shown in the chart below, the market is somewhat concentrated, with the three largest insurers accounting for 60% of the market. All three of these insurers are branches or subsidiaries of overseas insurers.

Recent market consolidations include Cigna and Onepath, as well as AIA New Zealand and Sovereign Assurance. There is the potential for further consolidation in the market, with a few key reasons including:

- A number of NZ insurers are owned by Australian institutions and have already sold or are reviewing ownership of their life insurance business in New Zealand; and
- the increased burden of compliance with the new accounting standard IFRS 17, to be implemented by 1 Jan 2023, which introduces additional implementation costs and significant operational impacts.

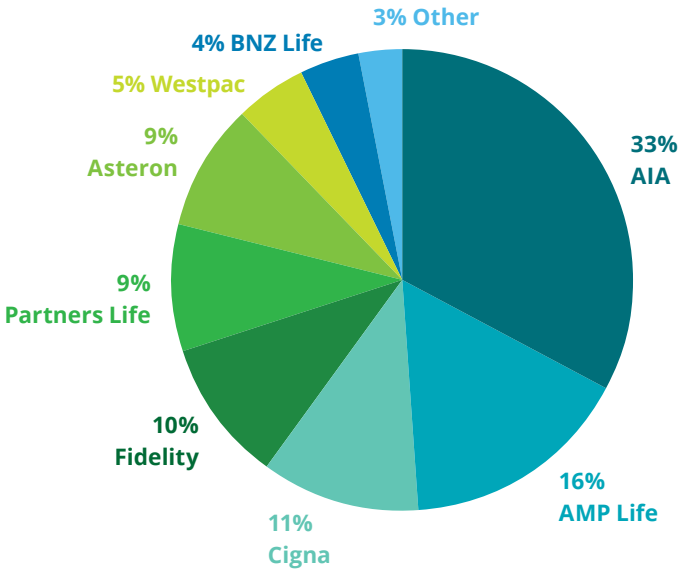
Product mix

Life insurance products sold in New Zealand are quite different from much of the rest of the world. New Zealand life insurers primarily offer risk-only products with cheaper, yearly renewable premiums which increase step-wise with age. In comparison, life insurers in many overseas markets offer combined savings and insurance products such as whole of life and universal life and use a level premium structure.

Bundled savings products were previously available in New Zealand but were mostly discontinued in the 1970/80s. This was partly due to the public's preference for cheaper coverage such as yearly renewable term policies, which do not include a savings mechanism and therefore cost less.

The three largest insurers are **60%** of the market, and the five largest insurers are almost **80%** of the market.

Figure 1. Level of market concentration based on gross premium incomes (2019)



[7] Financial Services Council (2019) – Spotlight on Insurance: Annual Snapshot as at 31 December 2019. Retrieved from https://www.fsc.org.nz/site/fsc1/Financial%20Services%20Council%20Insurance%20%20DEC%202019.pdf.

[8] Financial Services Council (2020) – Spotlight on Insurance: Annual Snapshot as at 31 March 2020. Retrieved from https://www.fsc.org.nz/site/fsc1/Insurance%20%20Spotlight%20March%202020%20-%20Financial%20Services%20Council.pdf.

More generally, the low levels of return offered by savings-type products combined with a lack of tax incentives for retirement savings investments have led to a low level of demand. The introduction of KiwiSaver and easier access to managed funds have also had an impact on the demand for traditional savings products, as consumers prefer to invest with investment specialists and turn to life insurers for the insurance coverage alone.

Distribution channels

A small proportion of life insurance in New Zealand is sold directly (~7%), or through bancassurers (29%). Both channels tend to offer products that are:

- Simpler than those offered through an Adviser channel; or
- have relatively low sums insured to reflect the limited underwriting usually associated with products offered through these channels.

The majority of business is sold via Advisers, who play a central role in the New Zealand life insurance market, selling almost two thirds of new policies[9].

The Adviser market is made up of approximately 7,000 Registered Financial Advisers (RFAs) who can give personalised advice on life insurance, but not on products with an investment component such as KiwiSaver, bonds, shares, managed investment products and derivatives. There are approximately 1,800 Authorised Financial Advisers (AFAs) who can provide advice on most types of financial products, including investment planning services.

The Life Insurer pays a commission to the Adviser as a fee for the time spent undertaking the following tasks on behalf of the customer:

- Finding appropriate consumers who need advice (known as lead generation);
- getting to know the client's personal circumstances (known as fact-finding);
- analysing their need for insurance (known as needs analysis);
- recommending a solution to those needs (known as providing personalised advice);
- selecting a product provider;
- supporting application completion and submission to the insurer;
- assisting the customer through the underwriting process;
- explaining sub-standard underwriting terms to customers, and potentially reviewing recommendations based on those terms; and
- supporting the customer with ongoing advice and updating of his or her life insurance cover as their needs change over their lifetime.

The role of the Adviser is to help address the more complex needs of the customer, reflecting a more comprehensive view of their insurance needs, above and beyond the typical bancassurance cover which tends to be linked to a mortgage and does not necessarily provide holistic coverage.

[9] Melville Jessup Weaver (2015) – Review of Retail Life Insurance Advice – An Opportunity for a New Beginning. Retrieved from https://mjw.co.nz/wp-content/uploads/2015/11/MJW-Independent-Report-Final-November-2015_pwd.pdf

Profitability

The RBNZ compares the profitability of life insurers in New Zealand to those in other OECD countries. However, care needs to be taken to ensure key metrics are compared on a like-for-like basis to avoid drawing incorrect conclusions.

Key measures of profitability

In support of the RBNZ's observation that life insurers in New Zealand are more profitable than their peers in many developed OECD countries, the RBNZ compares key measures such as claims ratios, expense ratios and commission ratios. We provide below a discussion of these measures.

Claims ratio

The gross claims ratio is the percentage of gross premium income which goes towards paying claims. It is calculated by dividing an insurer's claims expense by its gross premium income for a given year. The RBNZ Bulletin notes that New Zealand life insurers' aggregate gross claims ratio is 58%, compared to the OECD average of 79%. Based on the EIOPA statistics referenced by the RBNZ, the simple average of the gross claims ratio is 80%. However, the EIOPA claims payments include surrender and maturity payments.

The Financial Services Council (FSC) statistics for the year to 31 March 2020 indicate that the gross claims ratio for New Zealand's traditional business was approximately 312%.

It should be noted that in New Zealand, the traditional books of business are in run-off and have been closed to new business for a number of years. These traditional products are structured such that they include both a savings and insurance component, principally with a level premium, with the intention of 'repaying' any accumulated savings back to the policyholder in the future reflected as surrender or maturity payments. Over time, this savings component will increase in value relative to the annual premium.

Given this, the gross claims ratio is likely to continually increase over time. This highlights that the structure of these products naturally results in higher claims ratios. In the European market, these types of products account for approximately 70% of gross written premium[10], so one would expect that the gross claims ratio would be higher than in New Zealand, which primarily sells yearly renewable term (YRT) products.

The implication is that the difference in claims ratios across different countries may be partly due to the mix of products offered.

Finally, what constitutes a "low" claims ratio is a matter of opinion. Life insurers need a margin in premiums to cover the risk associated with the uncertainty in the timing and size of claims. A gross loss ratio of close to 100% would not be reasonable based on the products in the New Zealand market as it indicates a life insurer is not sustainable. In the long run, an unprofitable insurer is worse for New Zealand than one that makes an appropriate risk-adjusted return.

Expense ratio

The expense ratio is the percentage of gross premium income which goes towards paying operating expenses. It is calculated by dividing an insurer's operating expense by its gross premium income. The RBNZ Bulletin notes that expense ratios in New Zealand are high relative to other countries and suggests that the New Zealand market is less efficient.

There are a number of reasons for the relatively high expense ratio:

- The size of the New Zealand economy is small relative to other countries. As a result, even if fixed costs were consistent across other countries, the number of policies supporting these costs is significantly less. That is, there is a lack of scale in New Zealand that exists in overseas markets; and

[10] EIOPA (2019) – European Insurance Overview 2019 – Solo Undertakings. Retrieved from https://www.eiopa.europa.eu/sites/default/files/publications/reports/european-insurance-overview-2019-eiopa.pdf.

- complex products and legacy issues also drive up expenses. As Life Insurers transition to better managed new business we may see high operating expenses as they administer policies on multiple systems (legacy vs new). However, the expectation would be that over time, policies will be transitioned to updated systems, seeing a reduction in overall operating costs and the potential for lower premiums as a result.

This implies that **the expense ratio may well be driven by the size and structure of the New Zealand market, rather than inefficiencies**. Moreover, the characteristics of the New Zealand market means it is difficult to utilise off-the-shelf solutions available overseas without significant modification for such solutions to be fit for purpose locally. Hence, although further investment could be made by life insurers to automate and streamline processes to potentially reduce operating expenses, the cost of the investment may outweigh the benefits, given the small size of the New Zealand market.

... the expense ratio may well be driven by the size and structure of the New Zealand market, rather than inefficiencies.

Commission ratio

The RBNZ refers to the 2019 Life Insurer Conduct and Culture review by the FMA and RBNZ, which commented that New Zealand Life Insurers have high commission ratios relative to those overseas. They stated that high commission ratios result in high premiums for Life Insurance. The FMA and RBNZ also found that incentives and conduct of Life Insurance Advisers promote replacement activity and create risks of sales volumes being prioritised over policyholders' interests. In addition to monetary commissions, soft commissions were said to be prevalent in the Life Insurance sector which may add to the cost of premiums. Soft commissions are usually rewards for meeting sales targets and accounted for about 1% of gross premiums, which is not a significant proportion of gross premiums.

RBNZ indicated that these factors lead to poor value-for-money products and that high commission ratios could also act as a barrier to new entrants to compete with existing insurers' payment of upfront commission to Advisers.

The Government recently announced a new financial conduct regime in response to Insurer conduct and gaps in the current regulatory regime. The FMA will regulate the new regime under the Financial Markets Conduct Act 2013.

Life insurers are currently implementing changes in response to this, with these changes expected to address the issues identified and thus satisfy the requirements of both the FMA and RBNZ.

It is difficult to draw the conclusion that high commission ratios indicate a less efficient insurance sector without considering the dominant distribution channel of the local market driven by the local customer. As discussed above, Advisers are the main distributor of Life Insurance in New Zealand.

For example, a relevant comparison is with the Australian life insurance sector, which exhibits a product mix most consistent with that observed in New Zealand. However, a significant portion of life insurance in Australia is distributed through mandated default insurance under group schemes attached to Superannuation (where there is no commission payable):

Portion of business sold through each channel

Country	Commission Ratio (%)	Adviser Channel	Group Super Schemes	Other
New Zealand	19.0	64%		36%
Australia	9.2	31%	63%	6%

Source: RBNZ Bulletin[11], Life Insurer Conduct and Culture Report[12], APRA Claims and Disputes[13]

[11] RBNZ (2020) – An Overview of the Life Insurance Sector in New Zealand, Vol. 83, No.1, January 2020. Retrieved from https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/2020/rbb2020-83-01.pdf?revision=ae2e8917-076f-45ec-9d48-b65135bb74d5.

[12] Financial Markets Authority and RBNZ (2019) – Life Insurer Conduct and Culture. Retrieved from https://www.fma.govt.nz/assets/Reports/Life-Insurer-Conduct-and-Culture-2019.pdf.

[13] APRA (2019) – Statistics: Life Insurance Claims and Disputes Statistics, June 2018. Retrieved from https://www.apra.gov.au/sites/default/files/life_insurance_claims_and_disputes_statistics_june_2018.pdf

The dominance of Adviser distribution and a much smaller proportion of group schemes in New Zealand therefore naturally lead to a higher commission ratio in whole of sector comparisons.

The results above suggest that the **commission ratios can be significantly distorted based on the industry structure and distribution channel** and is therefore not a straightforward basis for comparing the efficiency of sectors across different countries.

Economic impacts

While changes in interest rates are outside of an insurer's control, they can have an impact on profitability. Under NZ IFRS 4, most life insurance companies carry a negative policy liability (that is, an asset) on their balance sheet for individual risk products. As interest rates fall, this value becomes more negative and the resulting movement in the liability would be reflected as a profit for the period. This would result in an increase in return on equity.

It is important to distinguish between profits from changes in economic conditions and underwriting profits, which are based on providing insurance coverage. IFRS 4 requirements in other countries are different to New Zealand (except for Australia, where the accounting standard is essentially the same) and a decrease in interest does not result in the same improvement in return on equity. In Australia, the increase in the return on equity due to changes in asset values has been largely offset by poor claims experience[14].

Underinsurance

The RBNZ suggests several reasons for the level of underinsurance:

- High cost of insurance relative to the expected benefit;
- low discretionary household income to spend on insurance;
- a lack of trust in insurance providers;
- misinformation or lack of information; and
- a reliance on the Government (primarily ACC).

These reasons highlight the need for educating New Zealanders on the importance of Life Insurance. While a number of these are not in the control of the Life Insurer, the Bulletin does suggest that improving premium affordability will assist in the levels of underinsurance. There is a suggestion that the high cost of insurance relative to the expected benefit arises as a result of inefficiencies in the sector, as indicated by the observed expense ratios, commission ratios and profitability being high in comparison to other countries.

In particular, high commission rates have been the recent target with the intention of reducing the cost of insurance and addressing the issue of underinsurance. However, a key role that Advisers play is to ensure that their customers understand the value of Life Insurance and purchase the appropriate products for their needs, which fulfills the educational gap identified by the RBNZ.

Commission is paid to Advisers to cover their costs of servicing their customers and providing this education. There have been suggestions that commissions provide the wrong incentives and so, they should be banned. However, this assumes an appetite for consumers to pay directly for advice and opens the potential for many experienced Advisers to leave the market. This could significantly reduce access to insurance advice for customers and has the potential to further exacerbate the underinsurance issue in New Zealand, particularly given that the Adviser channel dominates the market.

A ban on commissions could significantly reduce access to insurance advice for customers and has the potential to further exacerbate the underinsurance issue in New Zealand.

[14] The DII industry has collectively lost $2.5 billion through this product offering over the past five years, with no signs of improvement. https://www.apra.gov.au/news-and-publications/apra-demands-life-insurers-improve-sustainability-of-individual-disability

Capital adequacy

Life insurers are required to hold capital to ensure that their obligations to policyholders can be met in the event of an adverse shock or major loss.

Since the introduction of the RBNZ Solvency Standard in 2011, life insurers have generally complied with the minimum capital requirements, and in some cases held significant capital buffers above the minimum requirement.

Over time, life insurers have refined their internal capital management policies by setting optimal capital levels that balance regulatory requirements, risk management and commercial considerations. In some instances, insurers have made productive use of their surplus capital to support business growth.

The RBNZ notes that there will be a review of the current Solvency Standard and is considering the case for solvency buffers, with the aim of improving resilience in the sector. This review may have, in part, been driven by the recent collapse of CBL, which was a credit surety and financial risk provider rather than a life insurer. However, a question should be raised as to whether the collapse was solely due to inadequacies in the Solvency Standard itself, particularly given that New Zealand's solvency requirements are considered by some as being more conservative than other jurisdictions.

It is also worth noting that the current Solvency Standard has been calibrated to set capital requirements to withstand a 1 in 200 event. In comparison, the Banking sector has only recently had capital requirements increased to sufficient levels to cover a 1 in 200 event (previously a 1 in 100 event). Given this, it may be implied that a 1 in 200 event is sufficient for setting capital requirements for a stable financial services sector.

Considerations for new levels of capital, especially for life insurers, should be driven by actuarial findings and detailed study of the current market. In particular, a view on the adequacy of current levels needs to be undertaken, not based on comparisons with overseas markets but based on the needs of the New Zealand market. A balance must be struck between providing stability and confidence in the sector without imposing a strain on the industry through unnecessarily high capital requirements, discouraging investment in growth and innovation. In addition, requiring life insurers to hold further capital will likely lead to an increase in life insurance premiums. This will reduce the affordability of life insurance and could lead to a further decline in the level of insurance in New Zealand.

Recent events that have shaped the perception of insurance in New Zealand include the Global Financial Crisis and the 2010/11 Canterbury earthquakes. While it is prudent to account for these events when developing views on Solvency Capital, there is a risk (and bias) to overweight past event considerations in the decision-making process. Similarly, any strengthening of capital in response to Covid-19 risks needs to take into consideration impacts that insurers may have already allowed for, such as lower projected interest rates and adjustments to non-economic assumptions.

A balance must be struck between providing stability and confidence in the sector without imposing a strain on the industry through unnecessarily high capital requirements.

Capital requirements

Prudential supervision enhances the soundness and efficiency of the financial system. The most compelling reasons for regulating financial institutions are to provide a base level of assurance to consumers and to prevent the failure of one institution from affecting the wider economy. Capital adequacy and liquidity requirements are key elements of the RBNZ's approach towards prudential supervision. Insurers are subject to minimum capital requirements.

The objective of a minimum capital requirement is to provide assurance that an insurer can withstand larger than expected losses. In addition, the requirement ensures that shareholders have a reasonable amount of "skin in the game" and are therefore incentivised to ensure their business is well-run and does not take on undue risk.

Solvency ratios for Life Insurers in New Zealand

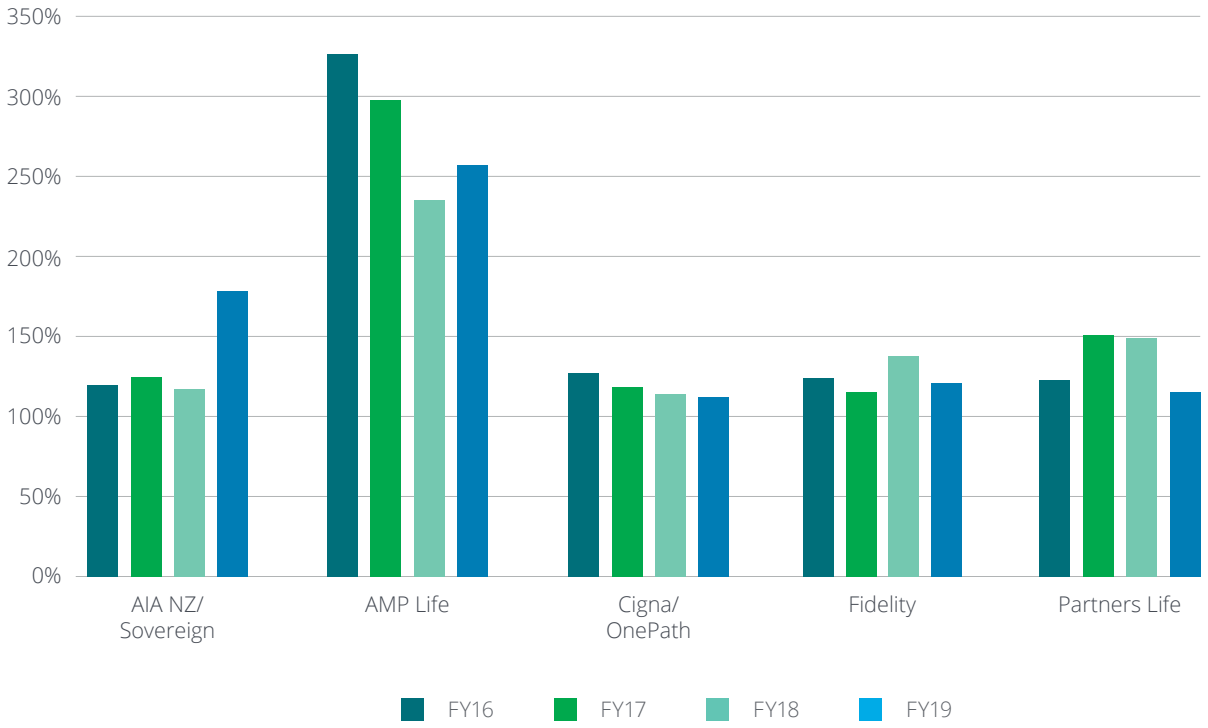
In general, a higher solvency ratio indicates an insurer's greater financial strength and ability to withstand larger than expected losses. Insurers establish their own level of 'buffer' capital beyond the minimum requirement of the Solvency Standard, which takes into account management and commercial considerations. With governance and oversight from their Boards, insurers manage capital levels to ensure that:

- The company continues to to meet the requirements of the Solvency Standard and expects to do so in future;
- the approach to capital is in line with the company's risk appetite;
- the interests of policyholders and creditors are protected; and
- shareholder value is created.
- Life insurers typically elect to maintain a level of 'buffer' capital in excess of the minimum requirement.

Solvency ratios will vary from year to year to reflect the dynamics of balancing commercial interests and capital risk management. If an insurer determines that its solvency ratio is at risk of dropping below the required level, it will carry out actions necessary to mitigate this risk. Corrective actions may include initiating a capital raise, decreasing the volume of new business written, reducing expenses and restricting distribution payments amongst other actions.

The graph below shows recent solvency trends in the five largest life insurers in New Zealand.

Figure 2. Solvency Ratios for Major Life Insurance Companies[15]



[15] AMP Life applies APRA's Capital framework.

Solvency ratios over the period varied by company depending on internal "target capital" decisions. The main drivers impacting solvency ratios include:

- Capital requirements from a parent company. This is highlighted in Figure 2., with AMP Life's capital calculated using the APRA framework, in line with the requirements of their Australian parent company. As a result, their solvency ratio appears significantly higher than other New Zealand companies due to the different capital framework applied;
- growth in business volumes consuming capital;
- reductions in interest rates, causing the negative policy liabilities to grow;
- strategic capital injections in response to capital forecasting and planning (generally observed through step change increases in Solvency ratio); and
- Each company's individual risk appetite with regards to setting their solvency margin above the minimum capital requirements.

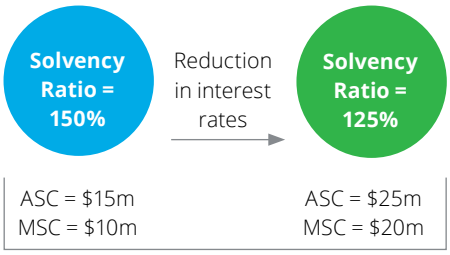
Impact of interest rate movement

Insurers often use operating profits to build up their capital reserves. This means that high returns on equity are not typically associated with low solvency ratios. However, the two are linked because of peculiarities in the applicable accounting standard, NZ IFRS 4, and the RBNZ solvency standard. These requirements are unique to New Zealand as IFRS 4 is not a globally consistent accounting standard and the solvency standard closely follows NZ IFRS 4.

Under the RBNZ solvency standard, the starting point is an insurer's NZ IFRS 4 net assets, with deductions made from capital to derive the Actual Solvency Capital (ASC). The minimum regulatory requirement is known as the Minimum Solvency Capital (MSC). The solvency ratio is simply the ASC divided by the MSC.

As discussed previously, when interest rates decrease the net asset balance is bigger, which increases the ASC. Any asset related to policy liabilities is, effectively, intangible, so it is added to the MSC as well. Lower interest rates therefore increase the ASC and the MSC by similar amounts.

Figure 3. Example of interest rate impact on solvency ratios



Difference between ASC and MSC remains at $5m

If we consider the following: Figure 3. Illustrates that whilst a dollar margin may be maintained, the solvency ratio is reduced.

Therefore, for life insurers in New Zealand, decreases in interest rates have resulted in higher returns on equity and lower solvency ratios. With the exception of Australia, other countries would not see the same improvement in return on equity when interest rates fall as their IFRS 4 requirements are very different. Australia has similar IFRS 4 requirements to New Zealand, but differences in the regulatory capital framework prescribed by APRA ensure the solvency ratio is less sensitive to movements in interest rates.

Different treatment of 'intangible' policy liability assets

Based on publicly available information, the top nine life insurance businesses that are regulated by the Reserve Bank have been considered from a solvency perspective. The total ASC is NZ$2.1b and the aggregate MSC is NZ$1.6b. It is estimated that approximately NZ$1b of 'intangible' policy liability assets are included in both the ASC and MSC. Adjusting for this, which would be more consistent with APRA's framework, **the aggregate solvency ratio in New Zealand would be closer to 190%. This is more comparable with the solvency ratios of other countries. Thus, New Zealand's regulatory regime makes it very difficult to compare solvency ratios between domestic insurers and those based overseas.** The RBNZ Bulletin includes a graph showing aggregate solvency ratios for life insurers in New Zealand, Australia and several European countries but itself warns against making a direct comparison.

Reasons why it is difficult to draw conclusions from comparing Solvency ratios include:

- Overseas insurers are subject to different minimum solvency requirements;
- capital frameworks vary between countries;
- insurers in New Zealand may be the subsidiary of a foreign parent that prefers to retain surplus capital in its home country; and
- some insurers view New Zealand's solvency requirements as more conservative than those in other countries.

These limitations mean it is difficult to conclude from solvency ratios alone that New Zealand's life insurers are financially weaker than overseas insurers.

Reinsurance

Insurers purchase reinsurance as a form of risk management. Reinsurance can protect an insurer against adverse losses and, in doing so, it functions as a substitute for surplus capital that an insurer may otherwise choose to hold.

Life insurers in New Zealand strongly rely on reinsurance for a number of reasons:

- as a risk management mechanism to:
  - mitigate their exposure to one-off large claims; and
  - reduce volatility in cashflows to support business planning;
- provide global experience and knowledge to support growth and innovation; and
- to provide pricing and administration support.

The RBNZ bulletin highlights that New Zealand insurers make greater use of reinsurance compared with their international peers. This is due to their relatively small size and the types of products offered. Moreover, the bulletin notes that there has been a greater use of reinsurance as an alternative to holding solvency capital.

This may raise concern with New Zealand Life Insurers reducing their required capital holdings through reinsurance and increasing the exposure of the sector to the risk of default of the reinsurers. However, the degree of reinsurance that can be held to reduce capital requirements is limited. If a life insurer has significant exposure to a single reinsurer, the Solvency Standard requires additional capital to be held to mitigate the risk of the reinsurer defaulting. The level of additional capital required will also vary depending on the credit rating (and therefore implied stability) of the reinsurer.

Furthermore, it is not obvious that capital held by a New Zealand insurer provides a more robust risk management mechanism than transfer of risk to a global reinsurer. Given the size and scale of most global reinsurers, it may be that there is less risk with using a large global reinsurer given their access to capital instruments, compared with increasing local capital holdings.

The use of reinsurance needs to be further analysed. Although additional reinsurance does result in a reduction in capital requirements, the merits of transferring more of the risk to a global partner (rather than additional capital holdings) needs to be considered. The key is identifying the best mix of capital holdings and reinsurance for a more diversified approach to risk management, allowing New Zealand companies to take advantage of the size and scale of global reinsurers and easing the capital strain locally, to potentially free up capital for further investment into the local market.

The key is identifying the best mix of capital holdings and reinsurance for a more diversified approach to risk management...

Conclusion

The New Zealand Life Insurance industry is unique in that it exists alongside ACC and KiwiSaver, which provide cover under circumstances which would normally require insurance in other countries. As a result, features of the sector make it difficult to compare efficiency, profitability and capital adequacy based only on high-level metrics.

As demonstrated, the product mix and distribution channel can distort ratios commonly used to compare sectors for other industries. Given this, it is difficult to conclude whether one country's insurance sector is more or less efficient, or profitable, than another.

The local capital framework, the interplay with local accounting standards and the capital strategy of local insurers all play a part in shaping a metric such as the Solvency Ratio. As a result, an unadjusted Solvency Ratio cannot be applied as an indicator of relative financial stability to overseas insurers.

With the upcoming review of the current Solvency Standard, considerations for new levels of capital, especially for life insurers, should be driven by actuarial findings and detailed study of the current market. In particular, given the current Solvency Standard for Life Insurers is calibrated to the same probability of sufficiency as the new Banking requirements, the implication may be that current levels are already sufficient for a stable financial services sector. Or, is there an argument that the Life Insurance industry needs to be more robust than the Banking Sector?

A view on the adequacy of current levels needs to be taken, not based on comparisons with overseas markets but based on the needs of the New Zealand market. A balance must be struck between providing stability and confidence in the sector without imposing a strain on the industry through unnecessarily high capital requirements, discouraging investment in growth and innovation.

The use of additional reinsurance could support this balance. Although reinsurance does result in a reduction in capital requirements, the merits of transferring a greater proportion of risk to a global partner (rather than additional capital holdings) needs to be considered.

The key is identifying the best mix of capital holdings and reinsurance for a more diversified approach to risk management, allowing New Zealand companies to take advantage of the size and scale of global reinsurers whilst easing the capital strain locally, to potentially free up capital for further investment into the local market.

A balance must be struck between providing stability and confidence in the sector without imposing a strain on the industry through unnecessarily high capital requirements, discouraging investment in growth and innovation.

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