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Weather the Storm: The Latest Insurance Solvency Capital Updates across Asia Pacific

Volume 1: Market Updates on Insurance Solvency Capital Developments

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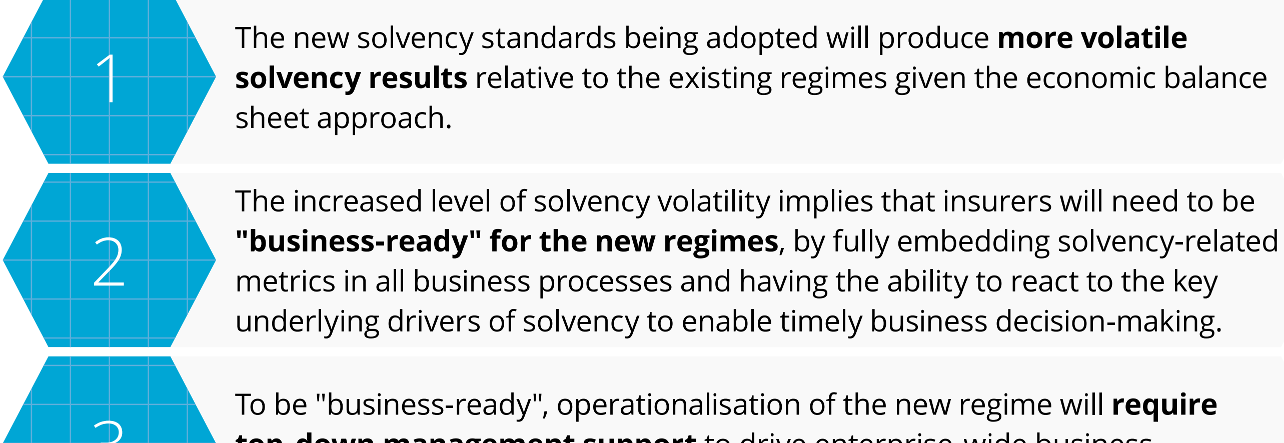
Executive Summary

Insurance markets in Asia Pacific are going through an era of rapid change in their regulatory solvency regimes, albeit at a different pace across the region. In the past few years, markets including Australia, Chinese Mainland and Singapore have transitioned into a new solvency regime which is akin to Solvency II. Other markets including Hong Kong SAR, Japan, Korea, Malaysia, New Zealand and Thailand are embarking on their journey to a new solvency regime.

Despite the different levels of progress, these regulatory changes all have a far-reaching impact on the level of capital held by the insurance industry and is a topic of focus by a myriad of stakeholders including regulators, investors, credit rating agencies and the general public.

This evolution of regulatory solvency regime has resulted in a number of key themes:



This article is the first volume of the series **Weather the Storm: The Latest Insurance Solvency Capital Updates across Asia Pacific** which provides an update on the solvency regime developments in each of the insurance markets in Asia Pacific and Deloitte's observations on the market trends under formation.

Volume 2 of this series will zoom in for a discussion around the operationalisation of a new solvency regime and key success factors for the implementation of the Pillar 2 Qualitative Requirements under a three-pillar solvency regime.

Market Updates on Insurance Solvency Capital Developments

Insurance markets in Asia Pacific are going through an era of rapid change in their regulatory solvency regimes, albeit at a different pace across the region. In this section, we go round the region and provide an update on the solvency regime developments in each of the insurance markets in Asia Pacific and Deloitte's observations on the market trends under formation.

Australia

Overview of Capital Requirements

The Australian Prudential Regulation Authority ("APRA") defines Australia's current capital framework for life and general insurers in a series of prudential standards. This framework is referred to as the Life and General Insurance Capital Standards ("LAGIC") and has been in place since 1 January 2013. A project is currently underway to harmonise the capital requirements for private health insurers with the LAGIC framework – see details below.

LAGIC is a risk-based solvency standard based on the regulatory balance sheet, derived from the financial reporting balance sheet with adjustments including to intangible assets and liabilities. Capital shocks are applied to the regulatory balance sheet to derive capital charges for each risk. These capital charges are aggregated to allow for diversification between risks and the result is the Prescribed Capital Amount ("PCA"). The PCA is intended to reflect a capital requirement that is calibrated to a 1 in 200-year event in a 1-year time horizon. APRA can also apply a supervisory adjustment if required – notably, many life insurers and reinsurers are currently subject to a supervisory adjustment reflecting APRA's view of the risks inherent in individual disability income products.

The capital shocks are prescribed for all risks except the insurance risk charge where insurers are required to derive shocks that are calibrated to their own businesses. Insurers[1] currently can also use an internal capital model to derive the PCA; this is not widely used by life insurers due to the calibrations required for market risk and the requirement to derive insurance risk shocks which, in effect, mimics a partial internal model. General insurers have also found it difficult to get approval and, since APRA has limited the capital benefit that could be gained through an internal model, few insurers have sought approval. We know of only one general insurance company in Australia who currently uses an approved internal model for regulatory capital (noting that all companies tend to use their own models to derive their Target Surplus and for the ICAAP).

The LAGIC framework has several parallels to Solvency II in Europe, including incorporating disclosure and reporting requirements such as the Internal Capital Adequacy Assessment Process ("ICAAP") (which is akin to the ORSA under Solvency II).

1. see https://www.apra.gov.au/round-three-%E2%80%93-response-paper-and-draft-standards-integrating-aasb-17-into-capital-and-reporting

APRA Developments

The impact of IFRS 17

APRA is currently undertaking a number of developments to the LAGIC framework, largely to align the requirements with AASB 17 (the Australian adoption of IFRS 17) and also to harmonise the private health insurance capital requirements with IFRS 17 and LAGIC.

Australian insurers will need to adopt IFRS 17 for financial reporting periods beginning on or after 1 January 2023 (i.e. in line with international adoption of this standard). IFRS 17 will be implemented as AASB 17 which will replace both of the current Australian accounting standards for life and general insurers. The assets and liabilities used to derive the regulatory balance sheet in the LAGIC framework is underpinned by the underlying accounting standards and, with no changes, regulatory report would diverge from financial reporting.

APRA has committed to revising LAGIC both to replace references to the current accounting standards and to allow for the impact of the change to IFRS 17. The updated LAGIC framework is to be effective from 1 July 2023.

APRA has consulted with the industry on these changes and undertook a targeted Quantitative Impact Study ("QIS") involving 13 insurance companies across life, general and private health insurance – informal feedback was provided to participants. APRA is undertaking an industry wide QIS which will be due in March 2022.

APRA has also undertaken two "readiness" surveys (in 2019 and in Q2 2021) which were intended to gain insights into insurer's IFRS 17 implementation plans and progress. APRA has stated that, whilst progress has been made between the two surveys, there remains a significant amount of work to be done to implement IFRS 17; the related LAGIC updates will also require work, notably because the timelines for implementation are not fully aligned

Climate Change – Prudential Practice Guide

APRA has also issued its Prudential Practice Guide on the impact of Climate Change on Financial Risks. APRA consulted on a draft practice guide in April 2021 and issued the final version of the Prudential Practice Guide "CPG 229 Climate Change Financial Risks" on 26 November 2021[2]. Practice guides are not regulatory standards but do provide APRA's views of good practices in respect of key areas, in this case, the impact of climate risk on insurers. CPG 229 is intended to assist insurers to comply with the requirements of APRA's risk management and governance standards and, to quote CPG229, "to outline prudent practices in relation to climate change financial risk management".

Private Health Insurance ("PHI")

Capital requirements for PHI funds are currently defined in terms of prudent liability calculations and an allowance for operational risks. APRA considers that the current framework for PHI funds is less robust than that applied to life and general insurers and that it does not fully reflect the risks faced by PHI funds. The capital requirements for PHI funds are thus being reviewed to align with LAGIC (especially for risks that are similar across industries e.g. asset risk) and to align with IFRS 17 (as discussed above).

The new requirements will also apply to the entire business rather than the health benefits fund on its own. The proposed changes have been tested as part of the targeted QIS with feedback being provided to APRA by participants – further consultation is planned for 2021 with the updated PHI capital requirements to be finalised in 2022 and effective in 2023 (i.e. following the same timelines as for life and general insurers).

2. See https://www.apra.gov.au/consultation-on-draft-prudential-practice-guide-on-climate-change-financial-risks

Chinese Mainland

Overview

Chinese Mainland implemented a new solvency regime known as China Risk Oriented Solvency System (C-ROSS) in 2016. The C-ROSS is a standard formula approach where the prescribed shock factors are applied to determine the amount of solvency capital required. The framework is similar to many new solvency regimes with three pillars focusing on quantitative, qualitative and disclosure requirements.

The China Banking and Insurance Regulatory Commission (CBIRC) commenced its amendment plan on C-ROSS beginning September 2017. The C-ROSS amendment working group identified 20 amendments to the solvency standard, with the insurance industry performing field tests on the proposed amendments in February 2020, July 2020 and June 2021. The final standard was issued in December 2021 with the first reporting date of 31 March 2022. The amended standard will be known as C-ROSS Phase II.

Key Amendments under C-ROSS Phase II

Limit amounts of unearned profits recognized as core capital to improve the quality of available capital

The concept of unearned profits of insurance contracts currently exist under China GAAP reserving but not under C-ROSS reserving. In the existing regime, all unearned profits are currently recognized as Tier 1 core capital under C-ROSS. To enhance the quality of core capital, it is expected that insurers will be required to classify insurance contracts into various groups based on the remaining policy period. A different limit exists on the various groups of insurance contracts on the amount of unearned profits that can be recognized as core capital and ancillary capital. In aggregate, the amount of unearned profits recognized in core capital cannot be more than 35% of the core capital. Amount in excess of the limit on core capital and ancillary capital will be treated as insurance liability.

Change in valuation basis of investment real estate and owner-occupied property from fair value to historical cost

Despite a certain degree of cooling-off experienced in recent months in the real estate market in Chinese Mainland, since 2015, real estate market value has been on a sharp upward trend in the Tier 1 cities. To address the concern of potential inflation and volatility between reporting periods in the amount of available capital, a proposed amendment under C-ROSS Phase II is for the value of investment real estate and owner-occupied property to be valued at historical cost rather than fair value for solvency purposes. Field test results showed that this change in valuation basis would have a significant impact on some insurers' solvency position, depending on the proportion of real estate held in the asset portfolio.

Encourage better asset-liability management practices through changes in the interest rate risk capital methodology

Under the current C-ROSS regime, only assets classified as Fair Value through P&L ("FVPL") and Fair Value through OCI ("FVOCI") with an explicit contract term are included in the interest rate risk computation. Under the current rules assets not measured at fair value, i.e. measured at Amortised Costs ("AC") are excluded from the interest rate risk capital computation reduced the offsetting effect against liabilities. Under C-ROSS Phase II, all assets sensitive to interest rate movements will be included in the interest rate risk capital computation rather than strictly based on the accounting classification of assets. Consideration of all interest rate sensitive assets in the interest rate risk capital computation is in line with the approach in other risk-based capital regimes. Based on the field test results, this change is expected to reduce interest rate risk capital by up to 40%. This is expected to encourage insurers having a higher proportion of AC assets to provide more stable long-term cash flows for better asset-liability management.

Look-through approach on fund management products
There has been great concern on the lack of transparency in the assets managed by third-party fund managers in the form of trust plan, asset backed securities and bank financial management products. The existing regime simply requires a look-through view on the underlying assets in these fund management products. The new rules will be stricter on the look-through requirement and place a more conservative capital charge factor up to 60% of products that insurers cannot manage to look through.

Revised capital charge factors
Quite a few risk factors have been re-calibrated. Most notably, higher risk factors are expected to be placed on non-standardised assets containing multi-layer structures, financing credit insurance. Previously P&C insurers with larger business volume enjoy lower capital charge factors on their insurance risks, which provides them even more advantage against smaller scale insurers. This mechanism will be removed. Capital savings up to 10% on insurance risks are provided to supported segments, i.e. agricultural P&C and Insurtech companies.

Clearer guidance on recognition of reinsurance treaties in available capital and required capital
Guidance on the recognition of reinsurance treaties in available capital and required capital under the current C-ROSS regime is often deemed an ambiguous area. Under C-ROSS Phase II, it is expected that whether a reinsurance arrangement can be recognized in available capital and required capital calculations will depend on assessments of its termination clause, coverage period, existence of real risk and asset transfer, amongst other criteria.

Greater emphasis on Pillar 2 ERM
Whilst the emphasis of C-ROSS Phase I had been on building up a quantitative framework, it is expected that CBIRC will place a greater emphasis on Pillar 2 qualitative assessment under C-ROSS Phase II. It is expected that insurers will be required to incorporate risk management into business operations through strengthening asset-liability management, performing forward-looking capital planning to steer capital management and allocation, and building up a suite of key risk indicators for early risk detection.

Recovery and Resolution Planning (RRP)
In addition to the upcoming changes to the C-ROSS regime, CBIRC published a regulation related to recovery and resolution planning for the banking and insurance industry in June 2021. This regulation targets the "too-big-to-fail" entities, i.e. Insurance groups or companies with consolidated assets of more than RMB 200 billion are required to submit a recovery and resolution plan to CBIRC and update the plan annually after submission. The RRP in the insurance industry is aligned with the framework of RRP for banks and investment firms, but will also make use of stress testing and liquidity testing results under C-ROSS to some degree. The entities in scope are required to provide their recovery plans under extreme scenarios and to demonstrate the effectiveness of their recovery measures.

Hong Kong SAR

Overview

The current Hong Kong regulatory solvency regime will be replaced by a three pillar Risk-based Capital framework ("HKRBC"). This new regime will result in significant changes and impacts that Hong Kong insurers have not seen in decades.

The industry's regulator, the Hong Kong Insurance Authority ("HKIA") published its first consultation paper on the development of the HKRBC framework for the insurance industry in Hong Kong back in late 2014. HKIA subsequently conducted three rounds of Quantitative Impact Study ("QIS") during 2017-2019 to collect data, understand potential impacts to the industry and facilitate refinements to the framework.

While the expected go-live date for Pillar 1 is 2024, Pillar 2 became effective from 1 January 2020 with the release of HKIA's Guideline 21 ("GL21") – Guideline on Enterprise Risk Management. By mid-2021 insurers would have submitted their first Own Risk and Solvency Assessment ("ORSA") report to HKIA for its financial year ending on or after 31 December 2020.

In 2021, the HKIA has been consulting the industry on Pillar 3 requirements and development of a more robust mechanism for the operation and management of participating ("par") business, the latter could impact the HKRBC framework.

- For par fund management, in October 2021, the HKIA shared highlights of the par fund survey with participants and made proposals on fund structure, par fund balance sheet, long-term adjustment application criteria and the timeline for different proposed requirements. The HKIA will continue to work on other par fund areas (e.g. asset transfers, dividend mechanism, enhanced governance and disclosures etc.) in the coming months.
- For Pillar 3, the scope of consultation covered the regulatory reporting architecture under HKRBC i.e. regulatory returns and instructions. Legislative proposals on regulatory returns will follow in 2022. And finally, public disclosure (a key source of information for policyholders) requirements are currently being developed by the HKIA.

Impacts for Insurers

Pillar 1 – Quantitative requirements

- The HKRBC framework will bring significant impact to the solvency positions of Hong Kong insurers.
- The Pillar 1 requirements means much higher complexity and increased effort with regard to data, systems and reporting processes. Many insurers are facing implementation and operational challenges in preparing for HKRBC.
- For example, improving the quality of data (asset data, policy data and economic and financial data), technology used, and analytical capability will be just one amongst many challenges under HKRBC.
- While the industry is naturally at different stages of preparedness, there could also be considerable work to develop/enhance actuarial models to produce the HKRBC balance sheet. Any model development/ enhancement should consider synergies and consistency with other reporting bases such as IFRS17, Embedded Value etc.

Pillar 2 – Qualitative requirements

- The introduction of Pillar 2 (ERM framework and ORSA) requires insurers to re-think and enhance risk management and governance framework, business strategy, and operation.
- Some key areas for insurers to consider are: Identification and assessment of risks including emerging risks such as climate change, risk measurement against risk appetite, stress and scenario testing (including reverse stress testing) and mitigation actions.
- Enhanced management of risk will also likely bring additional benefits to shareholders through improved decision-making around strategic issues.
- First submission of the ORSA report by Hong Kong insurers in 2021 are likely be far from perfect. We expect the HKIA will likely provide feedback on these initial submissions to ensure the ORSA report is concise, proportionate and clearly articulates how the risk management processes are embedded in the running of the company.

Pillar 3 – Disclosure and transparency

Meeting the Pillar 3 regulatory reporting requirements could involve implementing new reporting systems and insurers requiring additional resources. Further resource demands could follow once the public disclosure requirements are developed by the HKIA.

Japan

For more than 10 years, the Financial Services Agency, Japan ("JFSA") has been considering an economic value-based solvency regime. The first move was in 2007 where a study group established by the JFSA recommended that discussions on the introduction of the economic value-based solvency regime be accelerated to promote further enhancement of the ERM framework in the Japanese market. Under the current regime, the solvency margin ratio ("SMR") is based on accounting balance sheets with liabilities valued using locked-in assumptions. The SMR relies on a simple factor-based risk assessment and hence has limited room for insurers to exercise discretion. For example, interest rate/duration mismatch risk cannot be appropriately recognized even though many life insurers have sold significant amounts of ultra-long-term contracts with a fixed assumed interest rate.

In 2010, the JFSA conducted the first field test for all insurers to calculate economic value-based insurance liabilities, etc. After that, field tests were conducted in 2014, 2016, and 2018 respectively, and have been performed annually thereafter. The specifications of the field tests have been consistent with the IAIS Insurance Capital Standard ("ICS") field test since 2016.

In May 2019, the JFSA established a study group to discuss future direction towards the development of a new, economic value-based solvency regime. The framework is similar to Solvency II with three pillars focusing on quantitative, qualitative and disclosure requirements. In June 2020, the group released a report recommending the implementation of the new regime in April 2025.

Under Pillar 1, either a standardised or internal model will be allowed. The standardised model for the new regime (solo/consolidated) will be based on the ICS, of which specifications will provisionally be decided in 2022. The JFSA is considering how the ICS specifications should be adjusted to the Japanese context. Some examples of potential adjustments include the following:

- Granularity level of the life/non-life insurance risk
- Treatment of group internal reinsurance and equities in subsidiaries (only for solo basis)
- Specifications / Guidelines for the validation report on insurance liability (not covered by the ICS)

In addition, internal models will be used for regulatory purposes, of which a pre-approval process will start from 2022 prioritizing natural disaster models followed by other insurance risk and investment risk models.

Based on the field testing results since 2016, the economic value-based solvency ratio ("ESR") of life insurance companies has been on a recovery trend (rising from an average of 104% in 2016 to 187% in 2020). This is due to the continued rise in local and global stock markets over the past few years and an improvement in calculation methods, as well as the shift from savings-type products that have become less attractive under the current low interest rate environment to highly profitable protection-type products such as medical and cancer insurance. As an asset management strategy, it is also an option to reduce interest rate risk by purchasing ultra-long-term bonds for duration matching. However, if investment income is relatively fixed in the current low interest rate environment, medium- to long-term profitability will deteriorate, so each company is weighing up the risk reduction vs return benefits. From the viewpoint of ERM, a balance among capital, risk, and return needs to be considered.

Regarding Pillar 2 supervision, the JFSA has been encouraging insurers to enhance the economic value-based ERM for more than 5 years. In 2021, the legal status of the field testing was clarified by the JFSA with a view to facilitating a gradual and smooth transition to the new regime. Compared with the previous field tests, it is necessary to improve model governance systems to ensure the reliability and comparability of the calculation results, though the required contents are not expected to be changed.

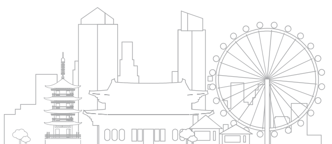
With the legal status of the field test being clarified, insurance companies with a low ESR will not be required to recover the ESR in a short term, but will need to present a direction of travel towards 2025. However, as mentioned above, many insurance companies in Japan have been raising capital and changing their product

portfolios little by little for about five years in response to the upcoming new solvency regime. Therefore, it is considered that few insurance companies will need an early recovery of the ESR within the next few years before the introduction of the new regulation.

Other developments related to the new solvency regime include the following:

- An Actuarial Report will be required in some form under Pillar 1.
- Some of the Pillar 2 monitoring metrics and figures rather than the ESR will be revised to be economic value-based.
- Overview of the Pillar 3 disclosure will be decided in 2022 and be considered further in detail going forward.
- The accounting standards will be reviewed over the medium to long term, in addition to the review of the solvency regime.

Korea



From January 2023, the current International Financial Reporting System 4 (IFRS4) will be replaced by IFRS17, published by the International Accounting Standards Board (IASB). At the same time as IFRS17 is implemented, Korean-Insurance Capital Standard ("K-ICS") will also be implemented. For this, insurers have to correspond to these changed accounting standards (both IFRS17 and K-ICS) by updating their IT systems, modifying actuarial methodologies, and changing financial accounting.

In July 2018, the Financial Service Committee of Korea (FSC) announced the new local statutory solvency regime, Korean-Insurance Capital Standard 1.0 ("K-ICS 1.0"), based on Insurance Capital Standards (ICS) and conducted the first Quantitative Impact Study for all insurers ("QIS 1"). It will replace the current Risk Based Capital ("RBC") regime which has been in place since April 2011 as Pillar 1 Quantitative Requirements of the solvency regime.

After the announcement of K-ICS 1.0, there have been three batches of amendments and QIS exercises; K-ICS 2.0 and QIS 2 in 2019, K-ICS 3.0 and QIS3 in 2020, and K-ICS 4.0 and QIS 4 in 2021. The amendments were mainly to provide more a relief in the insurance liabilities. Examples of such amendments include changing the risk margin from a 5% cost-of-capital method to a 85th percentile confidence level approach and a recalibration of the long-term ultimate forward rate on a yearly basis.

The following highlights the key changes proposed under the new regime:

- Market Value of Insurance Liabilities: Under the K-ICS valuation methodology, insurance liabilities will be calculated based on market value, not historical cost basis as in the old RBC regime which inflated insurance liabilities.
- Full fair value of assets and liabilities: K-ICS will evaluate assets and liabilities, including debt securities, loan receivables, real estate, insurance and other financial liabilities on a fair value basis. This represents a change from the current cost basis of some assets and debts.
- Required Capital: The required capital under K-ICS consists of 5 categories (Life and Long-term Insurance Risk, General Insurance Risk, Market Risk including Interest Rate Risk, Credit Risk, and Operational Risk). Under the standard formula, each risk is assessed with various shock scenarios and risk factors calibrated to a 99.5th percentile confidence level (compared to 99th percentile under current RBC regime). Internal models are allowed upon approval by the FSC.

Under the new regime, most insurers in Korea are expected to face a significant decrease in their solvency ratio even below the minimum requirements. Additionally, more capital would be required to cover capital volatility due to fair-value valuation of assets and liabilities. Each insurer is planning to set a few capital strategies on their asset and liability portfolio as follows:

- Increase in available capital: Issue of hybrid bonds and subordinated bonds, no shareholder dividend policy up to 2023, investment in derivatives (e.g. bond forwards to reduce asset / liability duration mismatch) and high-yield alternatives instead of long-term bonds to raise investment income.
- Decrease in required capital: Lower portion of risky assets such as public equities and real estate.
- Co-insurance: Reduction of risks and required capitals by sharing them with re-insurers as FSC amended regulation to allow co-insurance in 2019.
- Implementation of ALM system: Implementation or update of ALM system to project insurers' capital position more sophisticatedly in the future as well as to set up strategies for asset allocation and liability portfolio management.

With respect to Pillar 2 Qualitative Requirements of the solvency regime, the FSC launched the Risk Assessment and Application System ("RASS") in 2007 and Own Risk and Solvency Assessment ("ORSA") in 2017. These will remain intact going forward.

New Zealand

A New Solvency Standard is on the Horizon

Last July the Reserve Bank of New Zealand (RBNZ) released an Exposure draft of its Interim Solvency Standard. The interim standard is planned to take effect in 2023 and will be in force until a final Solvency Standard supersedes it following an amendment to the Insurance Prudential Supervision Act (2010) in 2024. Along with the draft standard, RBNZ issued an explanatory note that provides useful context and invites comments on the draft.

The draft interim standard is a single document intended to replace five solvency standards that currently exist. It has been drafted to reflect the revised insurance accounting standard, IFRS17, and to embody the review principles that were shared with the industry in late 2020.

This exposure draft completes stage one of a three-year review, and RBNZ has targeted recalibration as a primary task for stage 2 of the review. Below are some key points that may be of concern to actuaries and the wider insurance industry.

Implementation date aligning with IFRS17 timeline

The consultation closed on 1 October 2021 and RBNZ aims to publish a final interim standard by 1 October 2022. The draft standard requires use of some IFRS17 elements. An implementation date of 1 January 2022 was proposed initially. However, given the tight timeframe and the feedback received from insurers around early adoption of IFRS 17, the date of implementation of the Interim Solvency Standard has been amended to 1 January 2023. This date aligns with the implementation date of IFRS 17. Doing so will also give RBNZ time to address concerns raised in the consultation.

Calculation

Standardised insurance liabilities and assets shall be determined in accordance with IFRS17. While the draft interim standard notes that the premium allocation approach is not permitted, RBNZ has said that it expects General Insurers will be able to use current calculations to determine liabilities.

A quantitative impact assessment was carried out with selected insurers in September 2021. The template for this is expected to form the basis for the Insurer Solvency Return once the standard has been implemented.

Increase in Capital Requirement

An explanatory note issued by RBNZ indicates that the draft standard “is not primarily designed to alter capital requirements but will have some implications for capital”. However, in the same note, the expected impacts on insurers all appear at least neutral or will require an increase in capital (for example the new operational risk charge of at least 3% of Gross Written Premium). As offsetting reductions (such as a diversification allowance) are not incorporated within the draft interim standard, a higher level of capital may be required until stage 2 of the Solvency review is completed.

Health Insurance measured as a long term risk

Short term insurance contracts are now defined under the standard, with one of the criteria being that the contract does not include a guarantee of future insurability. Currently, Health Insurance is measured as a short term contract under the "Non-life" standard by Health Insurers and a long term contract under the "Life" standard by Life Insurers that also offer health cover. Regardless of its Capital impact, this change will create a significant implementation challenge, with new projection models being required.

Inclusion of risk adjustment for Long Term insurance and calibration

Liabilities will include a risk adjustment at the 75th percentile (90th percentile for businesses in run off). The long-term insurance risk Solvency Liability requires prescribed adverse adjustments to be applied on top of the risk adjustment. As the prescribed assumptions have not been weakened from existing Life Insurance assumptions (except for Health, which is now explicitly listed), this will result in a higher overall stress on Best Estimates than the current standard.

Interest Rate Charge

This is now applied to the unstressed Insurance

liabilities, which are likely to be interest rate sensitive for long term risks. The current standard tests the impact of interest rates on the Insurance Risk Capital Charge, which for many product groups results in no interest rate sensitivity where the Current Termination Value over-ride applies. This change will alter the impact of any Asset-Liability matching currently applied to capital requirements. RBNZ has received much feedback concerning the interest rate charge and plans to address the concerns soon.

Reinsurance Likelihood test

There is new guidance that "highly unlikely" means a probability of less than 10%. This may result in many (or perhaps most) commercial reinsurance arrangements failing the risk transfer test (i.e. a 10% probability of loss over the lifetime of the treaty, at a risk free rate).

Financial Condition Report (FCR) requirements for Actuaries

There are a number of new items included in the requirements of a Financial Condition Report (FCR). NZ Society of Actuaries professional standards already require Appointed Actuaries to assess Premium Adequacy in the FCR, and Material Conduct risks would be identified as part of the "Material Risks". Outsourcing arrangements may also be covered under Operational Risk if material for the insurer. The financial projection requirements are now more explicit and at a higher level of detail than is currently required under the existing Solvency Standards or actuarial professional standards.

Southeast Asia (SEA) Region

The SEA region covers a number of countries including Brunei, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand and Vietnam. We have seen different levels of progress in the evolution of solvency regimes and business practices in the SEA region which can be broadly divided into two categories:

- **Markets on a New Solvency Regime** such as Singapore which adopted a new solvency regime in 2020.
- **Markets transforming to a New Solvency Regime** such as Malaysia and Thailand which are going through a major change in the solvency regime developed based upon the Insurance Capital Standard ("ICS"), together with considerations of developments under IFRS 17. Brunei is currently conducting a field testing of the new RBC framework. The framework is expected to be finalised once the regulator has considered the field testing outcome. For Philippines, the RBC framework was introduced to the insurance industry in 2020. Due to the impacts brought by COVID-19, some has been some degree of temporary relief in the net worth requirements.

We provide a further update on the latest developments in these SEA markets in the section below.

Singapore

Singapore completed their transition to a new solvency framework commonly known as RBC 2 on 1 January 2020. The new framework has brought changes in the valuation of liabilities, assessment of capital requirements and recognition of available capital. Since the first RBC2 consultation in 2014, Singapore insurers have actively participated in the development of the RBC2 framework. As a result, insurers were generally well-prepared for the adoption of the new framework.

With RBC2, we have seen a shift in product mix in the market, with a new focus on products with less guarantees. There has also been a focus on reinsurance re-optimization and asset liability management as well as a constant search for good quality assets to back up long duration liabilities.

Malaysia

On 30 June 2021, Bank Negara Malaysia ("BNM") issued a discussion paper ("DP") on the Risk-Based Capital ("RBC") framework. This DP outlines proposals to enhance the design of the RBC framework for all insurers and takaful operators ("ITOs"). To facilitate this process, all ITOs are invited to provide feedback on the DP by 30 September 2021. BNM expects to finalise the new RBC framework with parallel run ending in 2023.

The proposed changes are intended to align Malaysia's solvency framework with ICS and also to incorporate the new requirements under IFRS 17, for instance, future RBC required capital and available capital calculations are expected to take into account IFRS 17 requirements such as deferred profit recognition pattern on CSM, illiquidity premium added on top of the yield curve, etc.

The proposed changes are expected to have an impact across the full spectrum of the insurance industry, covering both life and general insurance businesses as well as takaful operators. The proposed changes are expected to place greater demands on an ITO's ability to model their risks appropriately which will affect the level of capital requirements. Given the degree and nature of the imminent changes, ITOs should also consider an industry-wide effort as the scope of changes are expected to affect everyone (almost equally) across the industry.

The DP focuses on four main areas:

- Recognition of loss absorbing capacity of management actions in the determination of available capital. For example, an ITO's discretion on future participating bonus payouts and medical product pricing, a Takaful operator's discretion on takaful surplus distribution etc.
- Risk calibration to set the appropriate capital charges to meet the specified target risk level
- Improvement in the comprehensiveness of risk components for required capital determination
- Standardisation of Capital Adequacy Ratio ("CAR") formula across all ITOs

Thailand

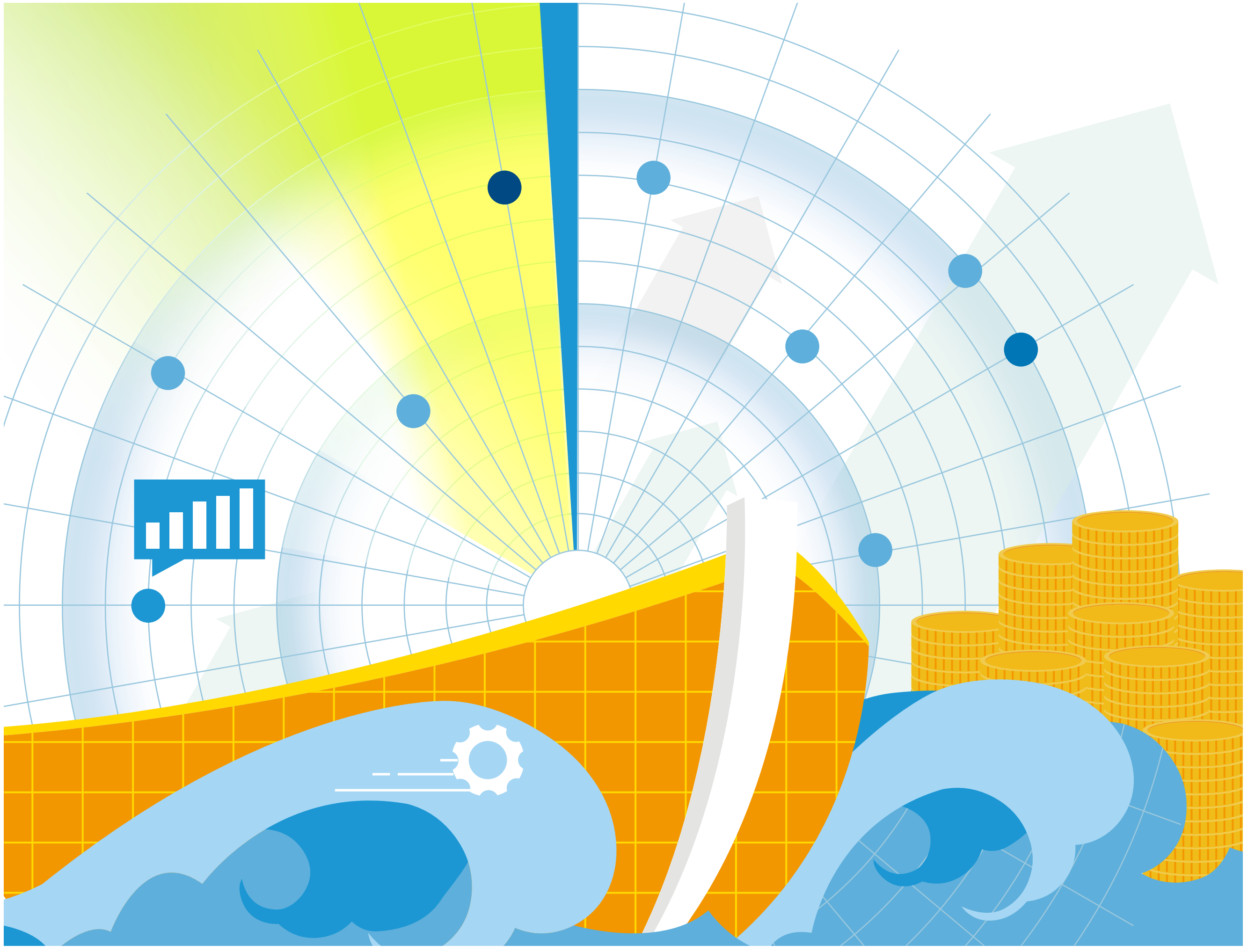
The Office of the Insurance Commission's ("OIC") Board approved a revision of its risk-based capital ("RBC") calculations in late August 2020, and has been effective since 31 December 2020, followed by a review process. The revisions mainly cover two areas:

- Allow equity hedging effect to be included in the RBC calculation
- Reduce the diversification benefit between asset risk and insurance risk from 75% down to 25%, using Solvency II as reference

OIC will continue monitoring the CAR movement following the change in the RBC calculations and will commence on a review process. The OIC is currently working with the industry to gauge the impact of IFRS 9 and IFRS 17 as part of its development of the second generation of the RBC framework commonly known as RBC 2. A key feature of RBC 2 is an uplift in the risk level of required capital; translates into a 99.5% confidence internal over a one-year horizon. The OIC will initiate an industry quantitative impact study on the proposed RBC 2 framework and will set the new framework based on the industry results and insurers' feedback. It is expected that RBC 2 will be implemented two years after the IFRS 17 effective date.

Other Markets

For the other markets such as Cambodia, Indonesia, Laos and Vietnam, given most of the players in these markets are multinational insurers, the insurers are still subject to their home country group supervision which are more stringent than the local solvency regimes. These countries are most likely going to stay with a factor-based local solvency regime in the near term. For example, in Cambodia and Laos, the solvency margin is a factor of the premium size. In Vietnam the solvency margin is a factor of the premium for non-life while a factor of liabilities for life insurers.



Taiwan (China)

The current Taiwan Risk-Based Capital ("RBC") regime has been in place for the past 20 years. For increased alignment with international regulatory supervision standards, the Taiwan Insurance Bureau has announced a plan to adopt a new solvency regime in 2026, the same year in which the new IFRS 17 accounting standard will come into effect. The new solvency regime will be based upon the Insurance Capital Standard ("ICS").

Compared to the existing RBC regime, ICS presents three key changes to the insurance industry:

- Solvency measurement will move away from a historical-value balance sheet approach to an economic balance sheet approach, providing a current view of the solvency position of an insurer
- The calculation of required capital will move away from a factor-based approach to a stress-based approach to better capture the "tail-risk"
- Requirements on assets qualifying as admissible capital for solvency purposes will be stricter than the current requirements

Two Quantitative Impact Studies ("QIS") have been carried out by the insurance industry, in 2020 and 2021 respectively. The studies were performed following the 2020 ICS technical specifications, with additional testing on methodology and parameters prescribed by the Insurance Bureau to gauge the financial impact on the insurance industry and individual insurers. It is expected that the insurance industry will enter into a 3-year parallel run period starting from 2022, where ICS solvency results will be reported annually together with the current RBC results. Given the QIS results general showed a weakening in the solvency position for insurers across the industry, it is expected that insurers will take business actions during the 3-year period to better prepare for transition to the new basis. 2025 will be a transition year where the insurance industry will review and fine-tune the production process of ICS, getting ready for go-live in 2026.

The Taiwan insurance industry has been focusing on IFRS 17 implementation in the past two years and most insurers are now well-placed with a concrete plan for system and data implementation for the next two years. Necessary investments on financial reporting systems such as an IFRS 17 calculation engine (sometimes known as IFRS 17 sub-ledger) and a data platform for hosting the financial reporting data are mostly in place. We expect increased attention on ICS implementation from the insurance industry starting from 2022, where insurers will likely perform an operational impact study to set out an ICS implementation plan and to maximise the benefits from the significant investment and work performed to date on IFRS 17 implementation.

From a business point of view, the simultaneous adoption of ICS and IFRS 17 is accelerating developments in asset-liability management ("ALM") as the new solvency and accounting regimes highlight some inherent issues faced by insurers across the industry, of which the most prominent one is the duration and currency mismatch in assets and liabilities. Insurers are aware of the greater solvency position volatility brought by this mismatch under ICS. We have seen movements, starting with the larger life insurance players, who are beginning to revamp their ALM approach, re-define their KPIs by aligning their strategic objectives with ICS and IFRS 17, revisit strategies around products, investments, in-force management, enterprise risk management and financial management in light of the new solvency regime. We expect the impact of the strategic realignment to be manifested gradually in the next few years, as insurers use a new lens to look at their business outcomes and exercise more conscious balancing of profitability, capital efficiency and financial stability.

Whilst a major change is expected on Pillar 1 of the solvency regime in the years to come, the current Pillar 2 framework is expected to remain intact in the foreseeable future. The Taiwan market first adopted a requirement for Own Risk and Self-Assessment (ORSA) in 2016, developed based upon Insurance Core Principle (ICP) 16 Enterprise Risk Management for Solvency Purposes published by the International Association of Insurance Supervisors ("IAIS"). Since then, insurers have been submitting their ORSA report to the Insurance Bureau annually to provide an overview of their financial resilience and enterprise risk management outcomes. As of the time of writing, there is not yet a clear plan for the development of the Pillar 3 disclosure framework.

Conclusion

All insurance markets in Asia Pacific are going through an evolution of their regulatory solvency regime, albeit at a different pace across the region. The evolution is driven by the aspiration to align with international capital standards such as ICS and Solvency II to strengthen the financial soundness and resilience of the insurance industry.

In Volume 2 of this series, we will discuss the challenges and solutions to the operationalisation of a new solvency regime and the key success factors for the implementation of the Pillar 2 Qualitative Requirements under a three-pillar solvency regime.

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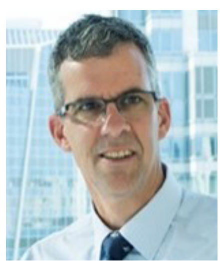

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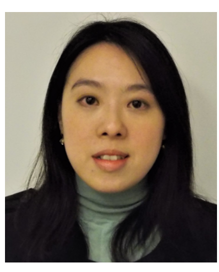

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