

# **Navigating Uncharted Waters?**

**Prudential Regulation for the New Zealand Insurance Sector**

**A presentation to the**

**New Zealand Insurance Law Association Conference 2010**

**Christchurch Town Hall, 5 August 2010**

**Richard Dean**

**Manager, Insurance Policy**

**Reserve Bank of New Zealand**

In September 2007 the Hon Justice Bruce (now Sir Bruce) Robertson addressed the Joint Australian and New Zealand Insurance Law Association conference on the “connections between the New Zealand and Australian insurance industries and their impact on reform in New Zealand”. His address considered a number of issues such as the need for reform of insurance law in New Zealand, the influence of overseas regulation (particularly that of our nearest neighbour Australia), and of harmonisation of any New Zealand approach with overseas insurance regulatory models. His conclusion clearly acknowledged that the prime consideration in any New Zealand insurance regulatory approach must be the best interests of New Zealanders.

We are now almost three years further advanced down the New Zealand insurance regulatory track so it is timely to take stock of what actually has been achieved in that space, and consider the derivation of the policy positions taken during that time, in bringing New Zealand into line with established international regulatory standards and reasonable international expectations. It is also worth noting that during this three year period the world has endured, and largely survived, the worst financial crisis since the 1930s Depression, with impacts felt across all aspects of financial services and in all regions of the globe. Events such as this inevitably leave an imprint in the regulatory arena – the art is in recognising such circumstances via an appropriate level of response rather than an unnecessary over-reaction.

My focus will be on the Insurance (Prudential Supervision) Bill, the development of which I am charged with heading for the Reserve Bank. I will not be commenting directly on other existing and developing legislation that is targeted more at matters of market conduct.

The Bill will be a bold step into comparatively unknown territory (at least in this country) for industry, policyholders and regulator alike. New Zealand has never had legislated prudential regulation of its insurance sector before, and now it's about to get it. But it's not exactly a case of sailing blindly away from shore – the course toward this brand-new regulatory regime has been well considered and carefully charted, and the regulatory model has been developed on some very solid relevant precedent approaches.

### **Why introduce new prudential regulation at all?**

Going right back to the earliest considerations – at least in this current round - of an improved prudential regulatory model for the New Zealand insurance industry, that is in the work done by the Law Commission in producing its 2004 report on Life Insurance, and the government's Review of Financial Products and Providers which commenced in 2005, many in the industry were very quick to point out, and the Reserve Bank itself has also stated over time, that the New Zealand insurance industry is not an industry in distress. The most recent real failure of a New Zealand insurer was AC&L back in 1989. So if things aren't broken, why fix them? The answer to this lies in the often-quoted mantra that appears on investment prospectuses: "Past performance is no guarantee of future outcomes". The mere fact that there have been so few insurance failures in New Zealand in recent times is no guarantee that such events will never occur in the future. Again, it is worth noting recent international experience to remind ourselves of just what could happen. In Australia the HIH failure sent shock waves through the market and was a watershed event that led to significant regulatory change in that country. There have been a number of insurer failures in the United Kingdom and in Asia. The Insurance (Prudential Supervision) Bill is intended to ensure that the industry collectively and its insurers individually, and where required the Reserve Bank as regulator, will be as well positioned as possible to manage such distress should such situations arise in New Zealand in the future. There is a clear, and as a result of recent events a significantly increased, public expectation that the financial services industry including insurers will be well regulated and required to perform to appropriate standards.

### **So what is the nature of current New Zealand insurance legislation and regulation?**

Current insurance legislation has been developed over a long period of time, generally out of context with other insurance-targeted enactments and in an entirely different time context. The outcome provides a somewhat disjointed, inconsistent and frequently out of date approach to the treatment of similar issues between companies.

A very limited range of prudential-flavoured insurance legislation currently exists through the following Acts, which are all to be repealed either wholly or in large part:

- The Life Insurance Act 1908, with its requirements including that life insurers produce annual financial statements and actuarial reports, and a limited statutory funds requirement.

- The Insurance Companies' Deposits Act 1953, that requires insurers to hold a deposit with the Public Trust of up to \$500,000 which is intended to provide some policyholder protection in the event of insurer failure.
- The Insurance Companies (Ratings and Inspections) Act 1994, that requires property and casualty insurers to have a rating of claims-paying ability and empowers the Ministry of Economic Development to inspect insurers solely in relation to their ability to pay claims.
- The Mutual Insurance Act 1955, which provides for insurers to incorporate as mutual organisations, but no longer has any effect.

In addition, there are a variety of non-legislated insurance sector voluntary codes, including:

- Solvency standards for life insurers from the New Zealand Society of Actuaries and solvency standards for health insurers from the Health Funds Association of New Zealand.
- The Insurance Council's Fair Insurance Code: a code of conduct covering standards for the fire and general insurance membership of the Insurance Council.
- The Insurance and Savings Ombudsman: a dispute resolution service for customers of participating companies.

For insurers incorporated overseas and with a presence in New Zealand, prudential supervision is generally conducted by the insurer's home-country regulator. For example, a branch of an Australian insurer is subject to the regulations and supervision of the Australian Prudential Regulation Authority – APRA.

### **The case for reform**

The outcome from this combination of legislation, voluntary codes and overseas supervision, is:

- Despite common issues, different rules apply to different insurers in relation to important matters such as:
  - financial reporting
  - credit rating coverage
  - measuring solvency
  - distress management
  - policyholder protection

- In respect of many insurers the absence of credit rating requirements and inadequate financial reporting requirements mean it is unnecessarily difficult for policyholders, financial market participants or government agencies to gauge an insurer's financial soundness.
- Many features of the legislation are well out of date. For example: the requirement to hold a deposit of up to \$500,000 with the Public Trust is unrealistically low as security for policyholder losses, and no statutory deposit regime of any type is an effective substitute for a properly calibrated solvency model; the schedules to the Life Insurance Act require details of investments in, among other things, "British Government Securities", "Indian and Colonial Government Securities", "Railway and other debentures", and the Mutual Insurance Act no longer has any applicability because it offers a corporate form that no longer has any attraction for insurers.
- The current arrangements lack any real "teeth", particularly in relation to such matters as supervising compliance with statutory funds, monitoring the solvency position of an insurer and direct regulatory involvement in distress management.

The enactment of the new legislation will bring together all the prudential concepts under one cohesive model and remove inconsistent legislative application within and between different insurance sectors. It will bring New Zealand into line with established international benchmarks and expectations regarding its financial services sector.

Note that a number of the requirements contained in legislation to be repealed will be carried forward into the new Bill.

### **What is the Reserve Bank seeking to achieve via Prudential Regulation?**

The fundamental focus of any insurance prudential regulatory regime is policyholder confidence. Every provision and compliance requirement in the Bill can be tied back to that common genesis. At the bottom line it's about creating an environment where, other things being equal, insurance companies are unlikely to fail but, if they do fail, their exit from the market can be efficiently handled so that the policyholder position is protected to the utmost extent possible.

(Note that the legislation is not a guarantee against the possibility of individual insurer failure. Individual insurance companies are not considered to be systemically important in this country and the failure of an individual insurer, while causing a degree of inconvenience at the policyholder and industry level, would not threaten the financial system.)

The stated key purposes of the Bill are promoting the maintenance of a sound and efficient insurance sector and promoting public confidence in that sector. The Bill will achieve this through the establishment of a framework for the prudential regulation of insurers, including the licensing of insurers, imposing prudential requirements on insurers, providing

for supervision by the Reserve Bank of insurers' compliance with the requirements in the Bill, and conferring certain powers on the Reserve Bank to act in respect of insurers in financial distress or other difficulties.

The Bill focuses on the licensing and prudential regulation of insurers carrying on insurance business in New Zealand. It does not offer New Zealand licensing to insurers that do not carry on, or propose to carry on, insurance business in New Zealand or that do not have New Zealand policyholders.

The intention of the legislative regime is to deliver effective regulation and supervision of insurers (the key insurance sector responsibilities with which the Government has charged the Reserve Bank) via an efficient mode of delivery. Unlike some of our offshore colleague insurance regulators, the Reserve Bank will not have vast armies of personnel on strength to deliver this brave new regulatory world. The Reserve Bank staffing model for insurance supervision is much more modest, so the delivery model will therefore differ significantly from, for example, the APRA or FSA precedents. It will adopt a comparatively light touch regulatory approach that will enable a largely self-administering approach for compliant insurers. The Bill contains a strong emphasis on director and senior officer obligations and accountability, and also has a degree of reliance on external input sources such as ratings agencies and actuaries. The model will be one of a risk-based supervisory approach based largely on a principles-based regulatory model, albeit that the approach to statutory fund rules and solvency standards necessarily carry a clear rule-based flavour.

The prudential supervision requirements and distress management tools written into the Bill are comprehensive and intended to enable the Reserve Bank to effectively deal with situations where insurers do get themselves into distress.

Compliance costs are not expected to be high for compliant insurers, however it is acknowledged that there will be implementation costs on all insurers associated with the new regulatory requirements. A generous and intentional transitional period of up to three years will mitigate this cost.

### **Alignment with international regulatory models and trends**

There is a certain undeniable reality about New Zealand and its influence in the wider world. That is, because of its lack of size and therefore comparative lack of importance in the financial world, New Zealand will almost never be driving the international market or setting the international agenda. This country is basically a price-taker rather than a price-maker. This is particularly the case when it comes to the design of regulation that has the potential for an international interface. Insurance is, by its nature, an international service. The New Zealand insurance industry has countless international connections and, in fact, a significant reliance on international support. So for obvious reasons it makes sense for any New Zealand insurance regulatory model to be generally aligned to the regulatory markets of the

rest of the world with which it interacts. Choosing a different course from the rest of the world and pursuing an approach that isolates New Zealand from international cooperation and support would not be of any value to the industry, its policyholders, or the country in general.

However, there are also advantages in being the last bus stop on the run. In arriving late to the insurance prudential regulatory table, New Zealand has been able to draw upon, and unashamedly has drawn upon, and learned from relevant offshore regulatory models in the design of a suitable model for New Zealand. Models currently in place with APRA, FSA in the UK, OSFI in Canada, and a number of other regulators have been studied and assessed for their applicability to New Zealand. The extensive principles and guidance of the International Association of Insurance Supervisors have also provided much useful input toward the final outcome of the New Zealand regulatory model. On-site assessment of these relevant models has also proven beneficial.

But there is far more to producing an appropriate and workable regulatory model for New Zealand than simply gathering “best of breed” samples from round the world and cobbling them together as the new approach. To do so could potentially cause serious damage to the New Zealand market, or at least mire it down in a morass of compliance requirements where the relevant and appropriate is heavily outweighed by the irrelevant, the inapplicable or the unnecessary.

For any insurance regulatory model to work in New Zealand it must be compiled with the realities, the idiosyncrasies, the unique factors of the New Zealand industry in mind. Just some of the more important considerations include:

- Total population only equal to that of a small international city (Melbourne)
- More than 150 entities currently have insurance deposits paid
- Range of corporate forms for insurers (locally incorporated, branches of overseas insurers, mutuals, friendly societies, etc)
- Some comparatively large by New Zealand standards, some very small
- All very small by worldwide standards
- Strong dependence on overseas support (reinsurance, branches)
- Unbundled distribution model, but legacy portfolios of bundled products

So the art in putting together appropriate insurance prudential legislation for the New Zealand market is in balancing the many contributing, and in some cases competing, requirements, expectations, needs and desires of a range of significant interest groups, at both a local and an international level.

## **Consultation – the critical element**

The most effective way to ascertain and understand these competing priorities is to get out of the office and talk to the stakeholders. Given that the environment being created is new to the market (as it is to the regulator) it has been necessary to be in close touch with the constituency in order to bring them along with the Reserve Bank in the development of the legislation. The intention has been, and will remain, to both seek as well as listen to stakeholder input as the new legislation takes shape. Right from the time the Bill started to take its earliest solid form the Reserve Bank has been out consulting stakeholders, making presentations at group seminars, working with industry associations, presenting at conferences, and constantly encouraging contact and feedback from the market. In so doing the Reserve Bank has been able, in the main, to minimise surprises for the industry and has thereby created a position of general industry support for the legislation.

That is not to say that every stakeholder request / demand / expectation has been accepted, or that the answer will always be yes. That expectation has always been actively addressed by the Reserve Bank in all stakeholder discussions by clearly differentiating between consultation and consensus; the Reserve Bank is, after all, in the position of regulator and therefore the one that must make the decisions for recommendations to Parliament. However, the major value in consultation is that all stakeholders have early awareness of what to expect in the new regulatory world, and in general industry has appreciated this early awareness and the opportunity of engagement in the process. In turn, the Reserve Bank has greatly benefited from the advice given by industry, especially on matters of a highly-technical nature.

## **Industry divergence on certain policy considerations**

Given the diverse nature of the New Zealand insurance industry it is not surprising that a degree of divergence appeared in respect of certain policy considerations. Examples of this were:

- Local incorporation requirement versus allowing branches of overseas insurers
- Home/host regulatory recognition and the extent of its application
- Should New Zealand solvency standards mirror APRA requirements?
- Should the Bill license overseas insurers that do not carry on insurance business in New Zealand?
- The requirement for a financial strength rating from an approved rating agency
- The requirement for an appointed actuary
- Exemptions or other relief for small insurers

- Definition of “carrying on business in New Zealand”
- The statutory fund requirement

In reaching a policy position on each of these issues the Reserve Bank has been guided first by the underlying principle of policyholder confidence, then by a range of issues including an assessment of the current market position, established international practice from relevant precedent regulators, considerations regarding international support of the market, proportionality of regulatory response, and effective as well as efficient regulation.

**The Select Committee Review: Consultation enshrined in democracy:**

The Finance and Expenditure Committee received almost 60 submissions on the Bill from interested parties, of which 31 were presented in person to the committee. Not surprisingly the majority of submissions related (either directly or indirectly) to the areas of divergence that had already been identified. The Committee’s review of the Bill and submissions received was very thorough and resulted in considerable further input being sought from the Reserve Bank in relation to certain issues. At the conclusion of its deliberations the Committee unanimously reported back to Parliament in general support of the Bill, noting a number of useful recommendations for change which have been incorporated into the Second Reading version of the Bill.

**Pre-enactment review: Does the Bill deliver on initial goals?**

**1. Firstly, has the Bill delivered on the recommendations of the Law Commission report?**

The Law Commission Report on Life Insurance recommended the establishment of a prudential supervisor for insurers to monitor solvency and fill a consumer protection role.

- This has been achieved, although the Reserve Bank is the appointed prudential regulator rather than a policyholder agent as recommended by the Law Commission.
- The Reserve Bank as prudential regulator has been granted wider powers than envisaged by NZLC including a clear focus on public policy objectives

**2. Secondly, has the Bill accomplished the in-principle goals set for the development of the New Zealand prudential regulatory model in the Review of Financial Products and Providers?**

The Review of Financial Products and Providers intended (inter alia) to:

- Remove unnecessary costs on business and make the regulatory regime more flexible in some areas
  - The Bill has sought to avoid unnecessary costs
- Make regulation more transparent and effective

- The Bill is highly transparent and the Reserve Bank considers it will be effective in achieving its intentions
- Ensure that where it imposes costs on business that they be proportionate to the risks posed, and do not impose unnecessary burdens on business
  - The Bill delivers a comparatively low-cost, low-interference model of regulation.
- Lead to regulatory design which is responsive to business, based on sound analysis and actually achieves our objective of encouraging investment in New Zealand's financial markets by promoting a sound and efficient financial system in which the public has confidence
  - The Bill has, as one of its stated purposes, the promotion of a sound and efficient financial system in which the public has confidence
- Achieve these goals more effectively through consulting with business and consumer groups early in the process on both the problem identification and regulatory development
  - Significant consultation has been undertaken, and remains ongoing, across a wide sphere in the development of the Bill

**3. And, finally, has the development of the Bill charted a successful course through unfamiliar waters to not only reach where it is today, but to continue the regulatory voyage into the future?**

The Reserve Bank is satisfied that the primary underlying purpose of prudential regulation – that of ensuring the confidence of New Zealand policyholders – will be achieved via the Insurance (Prudential Supervision) Bill in a manner that is both effective and appropriate. The Bill has received generally favourable review from key industry stakeholders as well as a range of industry observers and contributors. The extent of necessary alignment to established international principles, whilst retaining the necessary relevance and appropriateness to the specific nature of the New Zealand market, has also gained approval.

But whilst this is the view of the Reserve Bank, it is acknowledged that the public, the industry, and a broad array of other domestic and international observers will be the real judges based on future outcomes. One thing is for certain – the Reserve Bank will continue to very carefully chart its course forward, emphasising its established consultative and collaborative approach, in the ongoing development of the regulatory regime.

The Bill is due for enactment before the end of this year, and then commences a planned transitional path to compliance which must be achieved across the industry within a three year timeframe. There are interesting and exciting times ahead!