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MEDIA BACKGROUNDER

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ISI ANNUAL GENERAL MEETING
INDUSTRY OVERVIEW AND STRATEGIC REPOSITIONING

The following paper provides background information for a media session that will be run by ISI CEO Peter Neilson on Monday, 10 October. This session will take place immediately following the 2011 ISI Annual General Meeting where members will be asked to vote on a proposed new strategic direction for the Association.

This paper is in four parts:

1. Overview of the Proposed Strategic Direction;
2. Foundation Projects;
3. 2010/11 Managed Funds Industry Overview; and,
4. 2010/11 Life Insurance Industry Overview.

1. OVERVIEW OF THE PROPOSED STRATEGIC DIRECTION

ISI has successfully represented the investment, savings and life insurance industries since 1996 and has been a staunch advocate on behalf of the wider financial services industry. It was influential in the creation of the KiwiSaver scheme, it was an initiator of regulatory changes to ensure the industry was seen to be more open in its reporting, and it advocated for more consistent tax treatment.

More recently, ISI has held up well in a period when a tsunami of regulatory changes arrived. Unfortunately the increased pace of regulatory reform has meant that a thinly resourced industry organisation inevitably became reactive as it attempted to cope with the large volume of regulatory change.

Since his arrival in May, new ISI CEO Peter Neilson has spent time engaging with every ISI Member to measure the level of satisfaction with the Association's overall performance and where it is felt better value could be delivered to Members.

Members value the work ISI does with industry submissions, providing industry statistics and opportunities for networking and sharing industry information.

However, the almost universal aspiration of Members was for an effective industry organisation that would work across the broader financial services industry and be listened to by politicians and their advisers.

The fact is that the environment within which New Zealand's financial services companies operate has changed and the industry organisations representing the various sectors need to evolve to reflect this:

- In the past, separate industry organisations developed because different sectors of the financial services industry were subject to distinctly different legislative and tax regimes – this is largely no longer the case;
- Current regulatory policy aims to standardise rules as much as possible across the broader financial services industry; and,

- The fragmented representation of the (relatively small) financial services industry in New Zealand has meant no one industry organisation has achieved sufficient scale to be truly effective, particularly in the development of evidence-based policy initiatives that speak from a perspective of what is best for New Zealand and the industry.

A strategy session with the ISI Board in June challenged ISI to become a more authoritative, outward looking body. A key question was: should ISI look to be an industry self-regulator, or a source of information and ideas that helps to shape the industry and promotes "best practice" for the benefit of NZ Inc?

There are severe limits in ISI trying to be an industry self-regulator when not every player belongs to the Association. And, as a voluntary organisation, any Member who does not agree with any self-regulated proposal can simply leave to avoid them.

That is why ISI's future lies in contributing to the much wider debate about the financial services industry and the value it can add to the New Zealand economy. This means developing sound arguments based on detailed research and analysis, where individual self-interest is put aside for the greater good.

Being an effective financial services industry organisation requires the ability to:

- Speak with authority on behalf of the long term interests of New Zealanders as well as the interests of the industry;
- Work collaboratively across the broader financial services industry, giving a stronger industry voice through a coalition of interests, as well as achieving economies through shared resources;
- Be recognised by officials and politicians as an essential organisation to consult;
- Develop well-researched policy positions for New Zealand rather than ad hoc recommendations based only on Members' immediate or short-term interests; and,
- Influence policies that build net wealth for and protect the lives and assets of New Zealanders based on:
    - Evidence-based policy advocacy leading to effective and practical solutions;
    - Capacity to identify viable solutions before the decision-makers are aware there is a problem to fix;
    - Ability to demonstrate wide coalitions of support for what it advocates;
    - Membership by almost all licensed entities including a wide cross section of the best performing organisations across the sector; and,
    - Promotion of best practice in the industry and the leadership shown by its members.

As a result, ISI is seeking a mandate from its Members to reposition the organisation as the Financial Services Council ("FSC") with a focus on:

- Helping New Zealanders to build and protect their net wealth;
- Having a "NZ Inc." focus through a separate and independent "Net Worth New Zealand" brand, built on evidence based policy development;
- Promoting best practice in the industry by developing best practice guidelines and encouraging the regulators to make them a requirement for the whole sector; and,

- Developing an inclusive, financial services industry wide definition (including support services) to broaden the scope of representation and to increase the influence of the organisation.

Discussions are underway with other financial services industry organisations to gauge the support for the development of a pan financial sector organisation with sufficient size and weight to deliver the outcomes Members want. A number of these organisations have indicated an interest in pursuing this opportunity.

It is expected that this process will take time but the objective is to have this complete by the end of 2012.

2. FOUNDATION PROJECTS

In order to transform itself into an organisation with a broad "NZ Inc." focus, there are a number of Foundation Projects planned for the next 12-18 months that will provide the necessary information and analysis required to develop sound strategic policy positions:

- **Insurance Gap**: this project is already underway and will help to identify whether New Zealand suffers from an under-insurance problem and, if so, the extent of the "insurance gap" and the economic impact on New Zealand as a result. It will also identify and propose solutions to help bridge this gap;

- **Future of Long Term Savings and KiwiSaver**: this project will provide a clear understanding of the economic issues facing New Zealand from an aging population, and the impact this is expected to have on the country's current "pay as you go" superannuation structure. The project will also outline its views on how a sustainable, long term solution can be developed.

- **Future of Regulation**: this project will be a pan sector initiative that will look at the new regulatory regime within New Zealand, the consequences of this regulation, and what alternatives may exist to address the concerns the regime was introduced to resolve. This project will be conducted in association with other sector organisations and is likely to be added to the 2011/12 work programme.

3. 2010/11 MANAGED FUNDS INDUSTRY OVERVIEW

Unlisted retail investment funds under management (FUM) by New Zealand fund managers increased 22% from $23.1 billion at 30 June 2010 to $28.3 billion at 30 June 2011*. ISI members managed 91% ($25.9 billion) of the total $28.3 billion.

** Source: Morningstar Research Retail Managed Investments Market Share Report, June Quarter 2011.*
Note: Morningstar has revised the 2010 statistics since the publication of last year's ISI Annual Review.

The amount in different product categories was:

	Total FUM ($ millions)	Annual % change
PIE Investment Trusts	$12,654.3	+11.9%
Investment Trusts	$1,148.2	+24.7%
Superannuation: PIE	$3,379.9	+62.7%
Superannuation: Non-PIE	$1,766.0	-14.0%

KiwiSaver	$8,559.3	+47.3%
Group Investment Funds	$124.0	-40.8%
Insurance Bonds	$654.7	-9.1%
All Products	**$28,286.4**	**+22.4%**

Source: Morningstar Research Retail Managed Investments Market Share Report, June Quarter 2011

Note: Morningstar has revised the 2010 statistics since the publication of last year's ISI Annual Review.

The increase of 22% in FUM ($5.128bn) in the year to 30 June 2011 was due to continued strong growth in KiwiSaver and other superannuation PIEs, as well as in PIE and non-PIE investment trusts.

The ongoing trend of large falls in FUM in the other three product categories (insurance bonds, non-PIE superannuation, and group investment funds) continued.

Net fund flows of $2.15bn throughout the year contributed to the overall result, although fund flows were practically flat (0.3%) in the final quarter to 30 June 2011. The largest positive net fund flows recorded for the year were in: KiwiSaver ($2.58bn) and PIE Unit Trusts ($333m), suggesting that improved investment returns from recovering markets was also a significant contributor to the overall result.

As in previous years, the largest inflows for the year ($2.34bn) have been into Multi-sector funds, which is likely a reflection of the growth in KiwiSaver and the fact most New Zealanders invest in default multi-sector funds. A possible concern may be that too many New Zealanders are defaulting into funds that are more conservative than they possibly should be.

Sector-specific funds to perform well were: cash ($157m), trans-Tasman equities ($75m), NZ fixed interest ($67m) and NZ equities ($48m).

The largest negative funds flows were recorded in sector-specific funds such as: mortgage-backed (-$254m), property (-$115m) and international equities (-$166m).

The Reserve Bank series is slightly different from the Morningstar data in that it includes wholesale funds and "other funds", including funds managed on behalf of charities and not-for-profit organisations. The Reserve Bank data shows an increase of $4.8 billion or 7.7% in total managed fund assets for the year (from $62.7 billion to $67.4 billion). However, as was the case in 2010, managed fund assets increased for the first 3 quarters of the year and then declined in the final quarter (albeit it slightly at -0.7%) from the high point that had been reached in the March quarter.

As indicated in the following table, KiwiSaver is the product type with the greatest increase (63%).

	Managed Fund Assets ($ millions)	Annual % change
Unit Trusts and GIFs	$13,401	-0.5%
Life Insurance	$5,843	-0.3%
Superannuation: KiwiSaver	$9,440	+63.0%
Superannuation: Other	$19,425	+6.1%
Other Funds	$19,341	+0.7%
Total	**$67,448**	**7.7%**

Source: Reserve Bank Table C15 Managed Fund Assets, by Product Category

Note: The Reserve Bank has revised the 2010 statistics since the publication of last year's ISI Annual Review.

Regulatory Reform

The aftermath of the Global Financial Crisis (GFC) has seen a surge in regulatory activity to address the twin concerns of: a) the public with the future of some financial institutions, and b) the taxpayer through Government bearing the cost of cleaning up after financial collapses.

The 25 year attempt at making light-handed regulation based on disclosure of credit ratings, supported by industry self-regulatory activity, has given way to prudential supervision, requirements to increase core capital and greater day by day influence of regulators on finance sector business decision making.

Underpinned by the licensing of financial institutions, agents and directors, it will be interesting to see whether this new regime out-performs the old. Industry participants' face increased costs from additional compliance activity and the requirement to hold greater levels of capital that does not deliver increased income.

We have to hope that these additional costs will be more than offset by additional benefits from fewer collapses in the future and consumers more often purchasing products they need and understand.

The Future of KiwiSaver

Seeking cross-party support for a sustainable retirement incomes policy is one of ISI's four core strategic pillars.

The May 2011 Budget demonstrated once again that the long term future of KiwiSaver must have cross-party support if it is to gain the trust and confidence of New Zealanders. Polling commissioned by ISI immediately after the Budget found significant public concern exists over what is seen as constant tinkering with the Scheme.

The opportunity therefore exists to undertake a full review of KiwiSaver and look at ways to create cross-party support for a sustainable long term savings and KiwiSaver platform that will deliver the required retirement outcomes that New Zealanders, and New Zealand, need.

ISI believes such a review should be driven by the industry with wider community involvement. Work is currently underway to establish a research project aimed at identifying the key issues facing KiwiSaver and the best way to ensure the Scheme can proceed with certainty.

4. 2010/11 LIFE INSURANCE INDUSTRY OVERVIEW

The current "Risk" market in New Zealand is (as at 30 June 2011) worth around $1.83bn in total in-force premiums, up 22.9% in the last 3 years (despite this period coinciding with weak economic conditions), and 6.4% in the twelve months to 30 June 2011.

However the total benefit count (i.e. the number of insurance benefits held by policyholders) reported by ISI members has grown at a far slower rate over the same period, up 12.6% (to 3.474m) in the last three years and only 1.4% in the twelve months ended 30 June 2011.

Even growth categories such as Trauma and Guaranteed Acceptance products have experienced slower growth in benefit counts over the last twelve months (up 8.4% and 5.6% respectively) than in-force premium growth (up 19.3% and 14.9% respectively).

This indicates that market growth is only slightly influenced by real new business being written, and that the bulk of the growth has been due to organic factors such as premium increases from annual age or inflation adjustments, and possibly increases to existing cover.

Feedback from ISI members also indicates that premium rates for Term Life have been reducing over recent years with an improvement in mortality rates, while premium rates for products such as Trauma and Replacement Income have been increasing due to a combination of extended coverage (e.g. more conditions being covered) and increased morbidity rates.

In early 2010 an increase in the rate of tax on life insurance products lead to many industry participants increasing premium rates.

This change also created a one-off drive by many advisers to shift existing clients from stepped to level premiums prior to the new rates taking effect. As a result a number of companies reported significant numbers of existing clients moving from stepped to level premium contracts. While these level premium products will generate higher premiums initially, over time they will become lower cost (for clients) than stepped premiums. This means in-force premium growth may slow even further.

Economic conditions over the last 2-3 years have also had an impact on insurance growth rates with cancellation rates rising, although the impact hasn't been as bad as anticipated. Anecdotal evidence suggests that this "better than expected" result may be due to a combination of:

- advisers (and companies) making an extra effort to preserve existing business (and revenue streams);
- investment-focused advisers switching their focus back to insurance products (i.e. the level of insurance sold is correlated to the number of advisers selling it); and,
- people with existing insurance cover feeling vulnerable in a recession (especially with asset values falling and increased employment uncertainty) and therefore retaining or even increasing their cover.

Companies are reporting that these factors have seen the level of cancellations level off over the last two years. However, there is also some suggestion that there may be a lag (possibly of up to 3 years) before the impact of the recession is felt by the insurance industry, so there may still be some after-effects to be felt by the industry.

As mentioned previously, the growth in in-force premiums appears to be only slightly influenced by true new business sales, with the bulk of the growth appearing to have been due to organic factors such as premium increases due to age or inflation adjustments, and possibly increases or additions to existing cover.

Amongst the core mainstream "Risk" products (i.e. term life, replacement income, and trauma) the level of industry churn appears to be significant given the high level of discontinuances compared to new sales.

Over the last 3-4 years true new sales have remained relatively flat across all three product categories and negative for the year ended 31 March 2011, although although this trend was reversed with robust sales in the June 2011 quarter.

While term life new sales tend to exceed discontinuances, the gap is often narrow. The issue of policy churn needs to be discussed (and addressed) as an industry if the gap between new sales and discontinuances is to widen and the country's "insurance gap" narrowed.

Trauma, one of the fastest growing product categories (and soon expected to become the second largest category), has a much healthier gap between the level of new sales and discontinuances, although even this gap is beginning to close.

However, the biggest concern for the industry should be with the replacement income category where the gap between new sales and discontinuances is practically nil. In fact, since 1 January 2010 the level of discontinuances has exceeded new business sales. Again, the level of product penetration appears to be low relative to the population, and the industry needs to discuss and understand (and then address) the issues that is driving this high level of product discontinuance.

Christchurch Earthquake and Under-insurance

In total, ISI members received and paid out on 84 individual life insurance claims as a result of the 22 February earthquake, worth a combined $16.5m and representing an average payment of $196,429 per claim (as at 30 June 2011).

This represents an insurance rate of around 46% of the total 181 deaths, although the true rate is expected to be closer to 60% once the number is adjusted to remove those victims who either had no need for cover (e.g. children and retired people) or who may not have been covered under a New Zealand life insurance policy (e.g. tourists, international students, etc).

As well as death claims, in the period to 30 June 2011 the industry also paid $395,000 in redundancy claims and $104,000 in income protection claims as a direct result of the Christchurch earthquake.

In comparison to the industry, data obtained from ACC confirmed that the Agency had, as at 28 May 2011, paid around $1.1m in death claims, with $609,000 in funeral grants (129 claims at $4,700 each) and $509,000 in survivor grants (70 claims at $7,300 each).

ACC had also processed 296 accidental injury claims that resulted in lost income, worth a total of $1.05m at an average of $3,564 per claim.

The level of claims resulting from the terrible events in Christchurch provides a rare snapshot of the issue of under-insurance in New Zealand, not only in terms of the actual number of lives insured, but also the level of cover insured. The average payment of $196,429 was about four times the average annual income, and may not have even covered the outstanding mortgage in many instances.

Following the Christchurch earthquakes, insurance companies and brokers both report increased interest from the insured in understanding what is or isn't covered in their policy.

For many of the insured, insurance is seen a 'grudge' purchase that involves giving up something real, a premium, for an unlikely future event that might result in a claim. For many the 'peace of mind' of having coverage is not sufficient to offset the feeling that they didn't get something back in the absence of a claim.

ISI has commissioned independent research (currently underway) to estimate the scale of under-insurance and what can be done about it.

Reinsurance

Reinsurance premiums often firm as the perception of risk increases after major losses are recorded.

Following the Christchurch earthquake, the Japanese earthquake and the floods in Australia, it is likely that sentiment has increased that catastrophe risk is now greater in this region. It is therefore likely that premium rates will firm and some capacity limits for specific risks or exposures will emerge.

Reinforcing this trend will be the requirement for insurers and other financial institutions to increase their core capital to be more resilient in a future financial downturn. With decreased leverage reinsurers will be unable to underwrite the same amount of risk without increasing the capital they hold.

Substantial losses of capital to meet the highest levels of single event claims in decades will constrain the capacity of the reinsurance markets and reinsurers will be seeking higher premiums to cover their expected increased cost of capital.

Industry Churn

While some categories of life cover have shown quite strong growth in recent years, many traditional lines such as Term Life have struggled to keep pace with inflation.

A combination of relatively high (by international standards) up front commissions appear to have incentivised 'churn' of existing business where the total volume of cover does not increase but the provider is switched.

There can be good reason for a new life policy to be written, such as a lower premium or better coverage.

However, under the new legal requirements for advisers to act in the best interests of customers, we can expect increased disclosure and explicit assurances being provided by advisers to customers that their new policy better meets their requirements, and that they have been advised of any changes in coverage that may reduce benefits to them as claimants.

ISI will be developing best practice guidelines to ensure insurance policyholders are able to ask the questions required to evaluate the offerings presented to them by advisers or through other sales channels.

Existing Conditions and Utmost Good Faith Contracts

In the last year there has been some media coverage of the issues surrounding disclosure of mental health issues.

While insurers cannot decline coverage on the basis of mental health issues they can charge to reflect risk and apply stand down periods where appropriate.

ISI has consistently encouraged applicants to undertake full disclosure to prevent later problems with claims if pre-existing conditions are not declared.

The rapidly reducing cost of genetic testing will mean that more and more members of the public will know of genetic predisposition to some conditions that will need to be declared if they are known when coverage is initially sought.

Regulatory Reform

The current Government has announced that, should it be re-elected, it will examine proposals to open workers compensation insurance (currently provided by ACC) to competition. The proposals are quite modest and conservative in that they envisage ACC remaining as a Government owned competitor without being subject to paying a dividend or tax to the Crown or having the capital it would require if privately owned under the existing prudential requirement for capital.

However there are no current plans to review or open up to competition the motor vehicle account (which is currently very much under-funded) and the medical misadventure account, now called “treatment injury” (which is not funded at all).

If the Government accepts the logic of its arguments for opening up worker compensation insurance to competition then at some point in the future these accounts will also be opened up to competition.

If that is to happen, levies for these areas will need to rise considerably to reflect the underlying risks before competition is allowed.