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Dear Richard,

Statutory Fund Regulations Consultation Paper

The Financial Services Council of NZ ("FSC"), previously the Investment Savings and Insurance Association, appreciates the opportunity to comment on the consultation paper issued by RBNZ on 19 December 2011 covering proposed statutory fund regulations.

In discussion with our member companies we have identified a number of issues which we believe need to be addressed before the regulations are released. In addition, we believe there are several issues which would be better dealt with in the Life Insurance Solvency Standard rather than in the regulations.

We have set out our comments using the same order as the consultation paper.

1. NOTICE OF ESTABLISHMENT OF A STATUTORY FUND

- Section 1 (a), (b) and (c) refer to 'classes of life insurance business', 'categories of life insurance business' and 'kinds of policies to be written by the life insurer'. It would assist insurers in their establishment notices if the words 'classes', 'categories' and 'kinds' could be clarified or defined.
- The references to financial arrangements in 1 (1) (d) and (e) need clarification
- It is not clear whether 1 (1) applies to existing business being transferred into a statutory fund as a result of the new legislation
- The 10 year period in 1 (1) (e) (ii) is unreasonable and should be limited to the 3 year solvency projection term. A 10 year projection is highly subjective and therefore any statement of accuracy by the appointed actuary is likely to be heavily qualified. There are considerable unknowns in such a lengthy period of projection, in particular new business sales will depend on changes to product, changes in the competitor landscape, changes in legislation and population demographics.
- Has RBNZ considered setting a prescribed form for 1 (1) (f)?

2. UNSECURED BORROWINGS OF A STATUTORY FUND

The definition of free assets in 2 (2) refers to the 'solvency margin'. We suggest this should be replaced by 'solvency requirement' (of the applicable Solvency Standard).

3. **INVESTMENT PERFORMANCE GUARANTEE**

Section 3 proposes a limit of 5% in relation to the investment performance guarantee attached to investment linked policies within a statutory fund. It is not clear to us the purpose of this limit, and why such guarantees should be limited if sufficient solvency reserves in relation to them are held.

The limit proposed appears to duplicate a similar test in the Australian regime. However there are some important points about the Australian regime that need to be considered:

- The Australian regime requires a separate statutory fund for investment-linked business in order to ensure that the assets supporting investment linked contracts cannot be called upon to meet any liabilities in respect of non-investment linked policies. The 5% limitation is placed on the cost of guarantees in relation to the total liabilities of the investment linked statutory fund.
- The purpose of the restriction is not to limit such guarantees, but to ensure substantial guarantees are not provided **from an investment linked statutory fund.** The *Life Insurance Act 1995, Circular to Life Insurance Companies, Administration No.B4 – Administration of Section 42 of the Life Insurance Act 1995, June 2007,* stated "It is not the purpose of section 42 to limit the ability of the company to offer products which provide more substantial guarantees. Rather it is to ensure that those guarantees, if offered, are not provided from an investment-linked fund. The guarantee benefit may be provided by another (generally a non investment-linked) statutory fund; this reinforces other requirements which impose on the industry the discipline of separately identifying and costing the guarantee component and disclosing this information to the policy owner and prospective policy owner."

Thus investment performance guarantees are not limited in Australia, just the portion that can be provided for within an investment linked statutory fund. Section 3 seems to have misunderstood the purpose of this clause as used within Australian regulations.

We submit that there should be no limitation on the amount of investment linked guarantees provided within a statutory fund. We can see no reason why guaranteed savings type products cannot be provided from a statutory fund. Indeed non-investment linked products with significant guarantees will be provided from the same statutory fund without restriction, including investment account policies and traditional whole of life and endowment type contracts. We submit that such guarantees and their potential impact on the security of policyholder funds would be best addressed within the solvency standards where appropriate solvency reserves could be stipulated to cover the potential consequences of the guarantees.

Notwithstanding the above, there are also several practical issues with the limit as proposed:

- The 5% threshold is to be complied with at all times. With the possibility of extreme market movements, absolute compliance could be difficult, unless no guaranteed business is provided at all. There would need to be specific provision for life insurers to be able to notify the RBNZ of any breach of the threshold and to come to an agreement with the RBNZ on how that breach will be addressed or rectified.

- It is possible that the total policy liabilities of the statutory fund on an NZ GAAP basis are negative, in which case the section is unworkable.

4. **NOTIFICATION OF INTERESTED PERSONS**

- The reference to section 111(3) does not appear to be correct- we suggest that this should be section 109.
- The wording of 4 (1) states that “a life insurer … must, within 20 working days …, give written notice … to the owner of every policy referable …”. Section 4 (2) (c) then states that

the notice must set out "the identifying details of each policy owner's policy that is referable…". Some redrafting of this section might be required as the intent would not be to send details of all policies referable to the fund to all policy owners.

5. **ALLOCATION OF PROFITS AND LOSSES AND CAPITAL PAYMENTS**

Interpretation

We understand the purpose of this section is to define participating and non-participating business and the formulas for accumulation of retained profits and shareholders or members capital.

Definition of non-participating business

We are concerned that the definition of non-participating benefit is too narrow, resulting in some products being erroneously classified as participating. These products do not currently distribute profits and losses in the manner required of participating business by the regulations. Examples cited by members were:

- investment account business where profits are not allocated via a "gate" (e.g. 80/20)
- Group schemes with experience refunds (sometimes referred to as "profit shares")
- Small blocks of legacy whole of life and endowment policies which are effectively run as investment account business, with a shareholder deduction of a fixed percentage charge (in the region of up to 1%) rather than as a proportionate share of policyholder distributions.

We note that the equivalent APRA Standard (LPS 600 released in July 2011) has a more extensive definition of non-participating business including a specific section defining non-participating investment account business as well as a transitional definition allowing some policies written before a specific time to qualify as non-participating.

As a minimum we think the "and" at the end of (1) (a) (ii) should be changed to an "or" as this would widen the definition.

In addition, we recommend that RBNZ include within these regulations a declaration as envisaged by part (b) of the definition of non-participating benefit, to specify those benefits discussed above, that should be treated as non-participating.

Incorrect reference

We believe the reference to section 111 in 5 (1) should be changed to reference section 112.

In section (3), in the definition of "b", the word "allocated" should be "distributed", and in the definition of "c", the word "distributed" should be "paid" and make reference to section 11(2).

6. **OBLIGATION TO ALLOCATE OPERATING PROFIT OR LOSS**

The wording of 6 (1) needs amendment so that operating loss is also limited to the period to which the statements relate.

7. **OPERATING PROFIT OR LOSS**

No comment.

8. **ALLOCATION OF OPERATING PROFIT OR LOSS**

No comment.

9. **BASIS OF ALLOCATION OF OPERATING PROFIT OR LOSS**

Allocation of losses

The nature of participating business is that policyholders should receive the same percentage of profits and losses. Hence the wording in (9) (1) (a) should be consistent with the wording in (9) (2) (a) and allow policyholders to receive more than of 80% of profits and losses if the constitution of the insurer allows. This would also be consistent with the equivalent APRA Standard (LPS 600).

In the second line of 9 (2) (a) “lower” should be replaced by “higher”.

10. **DISTRIBUTION OF RETAINED PROFITS**
    The references to ‘shareholders’ funds’ in this section need to be reviewed and made consistent with references to ‘shareholders’ capital’ in other sections. It is not clear whether “shareholders’ funds” and “shareholders’ capital” are essentially referring to the same thing or not.

11. **DISTRIBUTION OF SHAREHOLDERS’ OR MEMBERS’ CAPITAL**
    Again, there is some confusion regarding the term “shareholders’ funds” versus “shareholders’ capital”.

12. **PROHIBITED INVESTMENTS**
    The purpose of this regulation is not clear and it would be helpful for RBNZ to explain its intention.

    In the 3rd line of 12 (2) the words “is prohibited” need to be inserted following the brackets.

13. **PAYMENTS TO A STATUTORY FUND**
    - The proposed requirement for an establishment amount for the statutory fund to be calculated with reference to the commencement of the business is unreasonable and should be amended to the previous balance date. That would be consistent with the Australian requirements.
    - The paragraph referencing composite policies needs to be clarified such that it only applies subject to section 85 of the Act.

    Starting amounts
    Starting amounts are defined in accordance with the regulations; we presume they are effectively defined by section 13.

    Section 13 requires the starting amount to be consistent with an amount as if the Act had been in place from the commencement of the business. This requirement is impractical as some of the business will have been in-force for around 100 years and so will require the restatement of accounts back to that time. We also note that this requirement is not mentioned in the more detailed steps.

    The equivalent APRA Standard (LPS 600) defines starting amounts in terms of:

    - Audited financial statements;
    - Policy liabilities calculated in accordance with actuarial standards;
    - Appointed Actuary’s opinion as to reasonableness.

    We believe a definition linking starting amounts to these components would be appropriate and practical.

14. **RECORDING OF RESTRICTED INVESTMENTS**
    No comment.

15. **ASCERTAINMENT OF INCOME AND OUTGOINGS OF A STATUTORY FUND**
    It would be helpful if RBNZ could to clarify whether the final paragraph means a separate bank account will be needed for each statutory fund or whether it will be sufficient to separately identify funds within one account.

Deborah Keating
EXECUTIVE OFFICER