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Dear Walter,

Definition for Investment-linked Contracts of Insurance

Thank you for the opportunity to comment on the proposed wording that you have developed for the definition of “investment-linked contract of insurance”, to be included in regulations under the Financial Advisers Act (the FAA). This definition will determine the insurance contracts that will be classed as Category 1 products.

We note that the approach you are proposing for the Financial Advisers regulations is to define investment linked contracts as “any contract of insurance except those contracts that are pure risk contracts of insurance”. For the reasons set out below, we believe that this approach introduces unnecessary complexity and introduces significant differences across legislation, in particular as between the FAA and the Insurance (Prudential Supervision) Act 2010. We understand that this may be an unintended consequence of the proposal.

We have recently made submissions to the Ministry of Justice (consultation on AML/CFT Regulations) and the Ministry of Economic Development (Securities Law Review) which both included recommendations regarding the definition of pure risk life insurance business. We recommended that a precise definition should be developed to distinguish between pure risk insurance contracts and those that have an investment component. Definitions should also be consistent across the Insurance (Prudential Supervision) Act 2010 (IPSA), the AML/CFT Act, the FAA and the Securities Act.

As the IPSA (at section 98) contains a definition of “investment linked contract,” ISI members are of the view that this definition should be applied to the FAA, AML/CFT Act and Securities Act if at all possible, or at the least should be referred to in any different definition so that any differences in approach are made clear.

Accordingly, we have proposed an alternative definition below that would be consistent with the definitions in the IPSA. This approach leads to legislative consistency and does away with the need to separately define pure risk insurance products.

Investment-linked Contract

Several concerns have been expressed with the proposed definition of "investment-linked contract of insurance". There is a view that the definitions are becoming circular, and increasingly complicated, requiring reference to category 1 products, category 2 products, and terms defined in regulations. This may be very difficult to implement in practice.

The term ‘Investment Linked’ is well known in the industry to represent those products sold which comprised unit linked ‘managed funds’ for long term savings and/or retirement funding along with optional term life insurance. The proposed definition of “investment-linked contract of insurance” does not automatically connect as also incorporating Whole of Life and Endowment Plans and therefore could be misleading without further explanation. It would have been preferable therefore if the FAA had avoided use of the term "investment-linked", but the last minute inclusion was made without industry consultation. Without further change to the FAA, there will be two definitions of "investment-linked" contracts in the market: a narrow one under the IPSA and a wide one under the FAA (the latter needed in order to encompass all insurance contracts with an investment component).

Pure Risk Life Insurance Policy

The definition of “pure risk life insurance policy” that you have proposed is reasonably consistent with the recommendation we made to the Finance and Expenditure Committee in response to the Departmental Report on the Financial Service Providers (Pre-Implementation Adjustments) Bill. However, for the reasons set out above it should not be necessary to separately define these products.

Other concerns with the proposed definition include:

1. The drafting in limb (a) “an amount exceeding the sum of the premiums” is unclear. On one interpretation, it can be read as requiring that, to be an eligible policy, any sum insured must exceed the premiums. In our view, the New Zealand law does not require that the sum insured exceed the premium in order for a contract to be a contract of insurance. This view is supported by the definition of "contract of insurance" in the IPSA.
2. An insurance bond of, say, a 5 year term with no early surrender value would fall within the definition. The insured contingencies under limb (a) are the continuance of human life for 5 years or sooner death (these are still uncertain events because even though the life insured will either survive for or die during the term, the timing of any sooner death is uncertain).
3. The reference to the insured contingency being “such as” the death etc of the life insured is imprecise. By implication the insured contingency must affect the life insured but that is not certain, especially given that the definition needs to exclude non-life pure risk contracts.
4. It is unclear whether the definition is intended to include so-called “money back” term policies, where the policyholder receives a refund of all or part of the premium paid if the

insured event does not happen during the term. On its face, the proposed definition would include such policies. In that case, limb (a) of the proposed definition perpetuates one problem with the current securities law definition of term life insurance policy - an arbitrary different treatment arises depending upon whether the term policy is or is not periodically renewable.

5. The references to "termination" arguably do not include surrender of a policy. That is because surrender of a life insurance policy is, at law, an assignment of the policy to the company liable under the policy (refer to the Life Insurance Act 1908). While an assignment to the company liable under the policy results in a legal merger of the obligations and benefits of the contract, thereby extinguishing the contract, the way in which the word "termination" is used in the proposed definition could be read as being limited to a positive act of termination by either party (e.g. cancellation). In a strict sense, "termination" arguably also does not include expiry of the policy due to performance (eg. maturity or payment of the sum insured). In our proposed definition below, we consider that the words in brackets in limb (c) help clarify that, for the purpose of the definition, "termination" is intended to include termination by reason of performance of the contract.

6. Because there is no definition of "contract of insurance" in the FAA (despite its use in the definitions of "category 1 product" and "category 2 product"), it is uncertain whether annuity contracts are to be investment-linked contracts. In our view, they should be (and that may be the intention) but the absence of a definition of "contract of insurance" leaves that uncertain.

7. The reference to "unused portion of risk premiums" is unclear. There is no temporal reference and the expression needlessly brings in the concept of "risk" premiums - for example, how should the policy fee component of a premium be characterised?

Alternative Definition

Our preference for an alternative definition is as follows:

investment-linked contract of insurance means a contract of insurance, other than a contract of insurance specified in paragraph (j) of the definition of category 2 product:

(a) that is a contract of insurance of the kind described in section 84 (1)(c), (e) or (f) of the Insurance (Prudential Supervision) Act 2010; or

(b) under which an amount is or may be payable upon a contingency dependent on the continuation of human life; or

(c) that may have a value on its surrender or termination (other than termination upon the happening of the insured contingency) greater than the value of any unexpired premium relating to a period after the date of surrender or termination.

The intention of paragraph (b) is solely to bring endowment policies into the definition.

We also recommend that the FAA itself should be amended to insert a definition of "contract of insurance" by cross reference to the IPSA.

In addition, further refinements will need to be made when the Securities Act is rewritten, to ensure that only the appropriate insurance policies with an investment component are classified as collective investment schemes under the new securities regime. The Ministry of Economic Development should not infer from this submission that all ISI members agree to all

"investment-linked contracts of insurance" being collective investment schemes under a revised securities regime.

We are happy to discuss these recommendations if that would be helpful. In view of the technicalities involved in these definitions we would appreciate the opportunity to review the wording before the regulations are finalised.

Yours sincerely

Deborah Keating
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