25 June 2008

David Williams
Senior Adviser
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Reserve Bank of New Zealand
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Dear David,

Review of Financial Products and Providers
Prudential Regulation of Insurance May 2008 Consultation Paper

The Investment Savings and Insurance Association of NZ Inc ("ISI") appreciates the opportunity to comment on the Consultation Paper *Prudential Regulation of Insurance.*

ISI recognises the need for change in the prudential regulation of the NZ insurance industry and we have previously commented on discussion documents released by the Law Commission in 2004 and the Review of Financial Products and Providers in 2006.

We also had the opportunity for several meetings with Reserve Bank officials following the announcement that the Reserve Bank would become the prudential regulator for New Zealand and before the release of the Cabinet paper in December 2007. The purpose of those meetings was to discuss specific matters that required further consideration and are now covered in the May 2008 Consultation Paper.

Throughout the consultation process, ISI has maintained a consistent position in support of improved prudential regulation. We continue to agree that changes to the regulatory environment are necessary to ensure a sound and efficient financial services system which has the confidence and respect of the New Zealand public. We note the intention and efforts to date to achieve this with a relatively light handed approach to supervision and regulation.

We applaud the fact that the Reserve Bank has consulted with the Australian Prudential Regulation Authority ("APRA") and intends to work closely with them to achieve an efficient home/host supervisory approach for Australian owned insurers who operate in the New Zealand market, helping to achieve wider trans-Tasman harmonisation and mutual recognition objectives.

The local incorporation of branches of foreign insurers is, however, one issue on which the membership of ISI does not have a unanimous view and we must acknowledge that some of our members consider that local incorporation is necessary for adequate policyholder protection.

The membership of ISI encompasses a range of business models and members do not always hold the same views on particular issues. Individual members of ISI will make submissions on points of particular importance to their own businesses.

The key points of this submission are:

- We support separation of insurance business lines, subject to the definition of 'life insurance'.
- Some but not all members agree that for the branches of foreign insurers, who are fully compliant with their home country regulator's prudential requirements, the Reserve Bank should have discretion to accept compliance with those requirements in place of compliance with its own requirements.
- We support an approach to distress and statutory management similar to that already existing in the Reserve Bank of New Zealand Act.
- We agree that actuarial standards should be promulgated for connected party exposures.
- We agree to the limitation on non-insurance activities, subject to the definition of 'insurance' and grandfathering of existing business.

Our responses to the specific questions in the Consultation Paper are as follows.

Separation of insurance business lines

How important do you think it is to eliminate the risk of contagion between different types of insurance within the same licensed insurer?

We support the intention of the Reserve Bank to reduce the risk of detriment to one business line when the financial strength of an insurer is undermined by problems within another business line, but this requires a clear distinction between life insurance (personal) and general (property) insurance. Different types of life insurance also have significantly different risk profiles (e.g. life insurance with an investment component and pure death risk) and it is the job of the actuary to manage the risks of each business line separately and in relation to each other.

We acknowledge that such a separation of business is IAIS best practice but also note that Reserve Bank supervision of banks accords different weightings to riskier types of assets for the purpose of determining capital adequacy but does not require separation of different lines of bank business. However, we agree that the proposals appear sensible and the establishment of criteria relating to actuarial standards, foreign policyholder preference and regulatory supervision correctly concentrates assessment on risk, as it relates to the New Zealand policyholder.

For the purposes of eliminating the potential risk of contagion between different types of insurance within the same licensed insurer, do you agree that legal separation of life insurance, using a statutory fund is appropriate? (This is the preferred alternative (number 4) described.) Please indicate your support, together with any reasons, or articulate any concerns you may have, including any potential costs and implications. Any comments on the existing degree of legal separation of insurance business lines within insurers will be helpful.

We agree with Alternative 4, that life insurance should be held in a separate statutory fund within the licensed insurer. This requires a clear delineation of what can be classified as life insurance and it is essential that the definition should not be too narrow. Industry practice is for products such as TPD, trauma and income protection to be provided in conjunction with life insurance and business models would be disrupted if that were no longer possible.

We would support following the Australian Life Insurance Act 1995 which includes TPD, trauma and income protection as ‘continuous disability policies’ within the definition of a life policy.

Do you have any comments regarding the more detailed provisions of the preferred alternative (number 4), including the additional rules which will constitute the statutory fund, the test of significance, the domicile of the statutory fund, having more than one statutory fund or the possibility of a grandfathering arrangement for existing fund structures?

We agree that the Reserve Bank needs to have discretion to grandfather existing arrangements that do not meet the test of significance for co-mingling. There would be significant compliance costs involved in separating out the arrangements for existing business.

We are also concerned to maintain the ability to write some general insurance benefits within life insurance statutory funds. These are benefits such as accidental death covers, injury/dismemberment benefits, or benefits payable on redundancy or bankruptcy for example. Some of these may be captured within the definition of life insurance which is critical, as noted above.

There will always, however, be some risks that sit neatly with life insurance benefits but outside any usual definition of life insurance. The test of significance in the Consultation Document limits the liabilities in respect of those risks to 5% of the statutory fund capital. Our view is that 5% is too low as the risk relates to miss-estimation of the liability.

We propose that a 5% significance test is too conservative and that a test of general insurance policyholder liabilities being less than 20% of the capital of the life insurance statutory fund would be more commercially appropriate.

With regard to the domicile of statutory funds, we note that two of our member companies have their life insurance business in statutory funds that combine New Zealand and Australian funds. That arrangement has the approval of APRA and we recommend that it should be acceptable to the Reserve Bank as well on the basis that there is no insolvency priority in favour of Australian policyholders. The New Zealand Law Commission, in its discussion paper on life insurance (Preliminary Paper 53), considered the issue and also concluded that there is nothing in Australian life insurance legislation to justify insolvency priority for Australian policyholders.

Do you consider that the legal separation of health insurance into its own statutory fund is necessary; or do you consider it appropriate that there is no such requirement for health insurance?

We do not consider that legal separation of health insurance is necessary. Health insurance can fit comfortably with either life or general insurance and actuaries are able to manage the risks of the different lines of business. We would support insurers having discretion to include health insurance in the statutory fund of a life insurer, or to treat it as general insurance.

Treatment of Branches of Foreign Insurers

Do you agree with the first preferred alternative that foreign-owned branches must obtain and publish a financial strength rating which takes into account any home country policyholder preference arrangements and other legal issues which disadvantage New Zealand policyholders in any way, together with disclosure of the implications of the policyholder preference or other arrangements? In addition, that the Reserve Bank retains the right to require local incorporation if circumstances arise which prejudice the position of New Zealand policyholders? If not, please articulate any concerns you may have.

We note that the aim of the Reserve Bank is to ensure adequate prudential supervision of all insurers, including branches of foreign insurers where the assets and liabilities of the branch are subject to home country laws and powers. The treatment of assets backing New Zealand liabilities in the event of cross-border insolvency is a particular concern and the regulatory objective is to ensure that New Zealand policyholders are not unduly disadvantaged by the corporate form of their insurer.

In its submissions to the Law Commission and the Review of Financial Products and Providers ISI supported local incorporation for branches of foreign insurers, with an exemption for existing life insurance companies meeting certain criteria.

As noted earlier, this is an area in which the membership of ISI does not have a unanimous view. Consequently, individual companies will make their individual positions clear in their own submissions to the Reserve Bank.

In previous submissions ISI has expressed reservations about reliance on financial strength ratings:

- ratings have relevance to prospective policyholders but provide little benefit to existing policyholders who may find it difficult to shift insurer because of worsening health status

- reliance on ratings also puts undue responsibility on policyholders to understand their implications
- policyholders are better protected by prudential supervision and compliance with actuarial standards
- ratings provide a snapshot picture of the business at the time the ratings assessment is done, which may be a considerable time before the rating is relied on by the prospective policyholder.

We have previously recommended that, if a requirement for financial strength ratings is introduced, it should apply to insurers of any size. Small insurers are more likely to have more concentrated risk, lower absolute levels of reserves and less ability to withstand fraud and we do not consider that smaller size should afford insurers exemptions from or different treatment in respect of prudential requirements.

That would be the basis for ISI agreeing to a requirement that foreign-owned branches must obtain and publish, and distribute to prospective policyholders, a financial strength rating that takes into account any home country preferences and any other legal arrangements that may affect New Zealand policyholders.

We support the Reserve Bank retaining the right to require local incorporation of existing foreign-owned branches if circumstances change to the extent that it is required for policyholder protection. The Reserve Bank should also have the discretion to decline the granting of a licence to a new insurer where significant risk in the legal and accounting framework of the home country jurisdiction has been identified.

We also recommend that reinsurance companies should be exempt from the requirement for local incorporation. There are no domestic reinsurers and requiring an off shore reinsurance company to incorporate in New Zealand will only limit the number of reinsurers available to New Zealand insurers.

The implications of the proposed changes for branches of foreign insurers are significant. For large companies, certainty of requirements will be very important and we seek clarification of the proposals in respect of the granting of exemptions - expected process, timing, conditions that may be imposed on a license, etc.

In order to carve out New Zealand policyholders from Australian policyholders the insurer would need to seek approval from the Australian Federal Court to approve a scheme of arrangement, which is an expensive and complex process. In addition, the New Zealand Companies Act requirements would include approval of the scheme of arrangement by the High Court.

Managing smaller statutory funds can be expected to be less efficient, leading to greater costs and higher risk for New Zealand policyholders, which is contrary to the Reserve Bank's objectives. As well as higher ongoing costs and reserving requirements, there would be a loss of the significant protections and benefits available through participation in APRA-supervised Australian life funds which pose no obvious risk or detriment to New Zealand policyholder security. This is an area that individual ISI members will cover in more detail in their own submissions.

The prudential regulation requirements and ongoing supervision by APRA are significant and we believe that New Zealand should be able to rely on APRA in many respects. We are very interested in understanding the intended extent of recognition of APRA's requirements and supervision.

Approval of a foreign jurisdiction by the Reserve Bank should take into account special economic relationships with the home country particularly the CER relationship with Australia and the further development of a single economic market.

Do you agree with the other preferred alternative that foreign-owned branches may be required to incorporate in New Zealand? If not, please articulate any concerns you may have.

ISI does not support Alternative 5. We would strongly object to the size of an insurer triggering the requirement to locally incorporate, in the absence of other factors which detrimentally affect New Zealand policyholders such as home country policyholder preference. The size of an insurer should not be an over-riding criterion. Smaller insurers often pose a greater level of risk than large foreign insurers. Given the objectives of the initiatives, assessment should be based on risk to New Zealand policyholders and the risk of small insurance providers being unable to meet commitments to New Zealand policyholders may indeed be greater than that of a large established insurer.

The Consultation Paper acknowledges that the costs of transferring assets and liabilities to a New Zealand subsidiary could be substantial. Those costs would need to be met by New Zealand policyholders and the security of New Zealand policyholders would also be detrimentally affected by the risk concentration of a smaller insurance pool.

An additional point to consider is that further costs affect the business case for even a large branch operation continuing in the New Zealand market. The cost of continuing to operate in New Zealand and the substantial, one-off costs of local incorporation would need to be assessed against other international opportunities for foreign insurers.

If there is a local incorporation requirement, should it relate to size, or some other measure of risk to New Zealand policyholders?

We strongly disagree that a local incorporation requirement should be related to the size of the insurer. A requirement by the Reserve Bank for large foreign insurers to locally incorporate could weaken the position of New Zealand policyholders rather than protect them. There should be no requirement for foreign insurers to locally incorporate unless the potential risk to New Zealand policyholders is sufficiently large to justify the costs and far reaching consequences. As a minimum, the requirement to locally incorporate should only be invoked in circumstances where home country policyholder preference exists to the detriment of New Zealand policyholders in the event of insolvency. We strongly believe size is not an adequate measure of risk, the assessment of which should be based in fact as it relates to classes of policyholders.

We agree that the Reserve Bank should have discretion to exempt existing foreign-owned insurers from incorporating locally if they meet all the Bank's criteria for operation as a branch. We envisage that the key criteria would be the robustness of prudential supervision in the foreign jurisdiction and the relationship between regulators.

Distress management of insurers

Do you agree that these are appropriate goals of a distress management framework?

Yes, we agree that they are appropriate, although perhaps 63A should refer to firms in significant financial distress rather than 'inefficient' firms.

Which goals do you think are relevant to insurance?

All except 63F are relevant to insurance, although 63F could be relevant in the event of the collapse of a large funds management subsidiary of an insurer.

We also recommend the inclusion of an additional goal:

> *Avoiding significant damage to the insurance sector and the consequential flow on to the financial system.*

This goal recognises the impact that the failure of an insurer can have on confidence in the insurance sector and the financial system.

Do you have any comment on the description of the insolvency framework above and its applicability to insurers?

The options in the insolvency framework described apply generally to all companies and will be relevant when an insurance company is in financial distress.

Are there any other issues that are peculiar to the insolvency of an insurer and should be accounted for in a new prudential supervision regime?

Issues that are particularly relevant for life insurers are the operation of statutory funds and the valuation of policyholder liabilities.

Do you agree with the costs and benefits of statutory management?

We acknowledge the costs and benefits set out in the Consultation Paper but consider that the Insurance Prudential Supervision Act would set out the powers and responsibilities of the Reserve Bank which could include a requirement to consult all parties and provide some certainty to creditors.

Do you agree that statutory management should be an option available to the Reserve Bank?

ISI would support a statutory management regime modelled on the Reserve Bank of New Zealand Act, with the criteria set out in an Insurance Prudential Supervision Act. The approach to statutory management in the Reserve Bank of New Zealand Act is a good model.

Do you agree with the threshold for statutory management described above?

We agree that the threshold should be equivalent to CIMA and the criteria set out in paragraph 96 are appropriate.

What powers and discretions do you think should be available to the statutory manager? And what other features should be part of a statutory management regime (eg is an advisory committee necessary?)

ISI supports the Reserve Bank having an escalating series of possible interventions to be applied, when justified, to an insurer in financial distress. We agree with the concept of modifying the statutory management regime modelled on the Reserve Bank Act to accommodate the objectives of the Insurance Prudential Supervision regime. It is essential that the Reserve Bank has the opportunity to initiate resolution options and to participate in them. While these powers may be necessary, the criteria for when these may be triggered need to be clearly defined, including detail regarding the level of penalties which may be imposed. Schemes of Arrangement can be a viable alternative providing the potential for savings in administration costs associated with run-off.

Do you agree with the approach recommended above?

We agree that the status quo needs to be modified in light of the new prudential supervision regime. The Reserve Bank needs to have adequate discretionary powers to take an escalating series of possible interventions. Those interventions may include close oversight and review of management decisions, agreeing to the transfer of business to another insurer or, in extreme cases, initiating liquidation.

We cannot see any strong reason not to apply the overall approach to distress and statutory management in the Reserve Bank of New Zealand Act when considering insurance companies.

Do you agree that the modifications to existing insolvency proceedings are appropriate as a whole?

Yes.

Do you have any comment on particular proposals?

No.

Do you consider that any modifications for the rules of set-off are appropriate for the insurance context?

We don't have any recommendations for modifications of the rules for set-off for the insurance context but we note that the value of set-offs will need to be determined actuarially.

Connected party exposures

Do you agree with the preferred alternative of utilising connected party exposure requirements within New Zealand actuarial standards, where those requirements are developed and agreed with the Reserve Bank?

We agree with the proposal for the Reserve Bank to work with the New Zealand Society of Actuaries to agree appropriate standards for the treatment of connected party exposures in order to limit the risk of an insurer's financial position being undermined by connected party exposures. There is already a requirement for disclosure of connected party exposures in normal reporting.

We consider that actuarial standards, formulated around capital adequacy and solvency calculations, provide a robust mechanism with which to limit connected party exposures within de minimis tolerances, while providing the flexibility to implement a timely response to evolving market conditions.

Where a bank is a connected party of an insurance company the standards should not require the insurance company to treat transactions with that bank any more stringently than transactions with another, unconnected, bank – within overall limits of exposure.

While the Reserve Bank should work with the Society of Actuaries to draft the standards they must be given legislative standing.

Non-insurance activities

Do you agree with the preferred option that, subject to an appropriate exemption limit, licensed insurers should not conduct business activity other than insurance? If not, please outline any concerns you may have and/or your preferred approach.

We agree with the proposal to prohibit insurers from conducting material non-insurance activities, which could change the risk profile of an insurer, in conjunction with insurance activities.

This proposal will require the definition of insurance and the materiality limits (to be defined within the Insurance Prudential Supervision Act) to take into account that existing life insurance business in New Zealand includes policies that are essentially investment only, either capital assured or unitised (or investment linked).

Although modern investment products are now provided through vehicles outside life insurance companies, the definition of 'life insurance' must not exclude those investment policies that have been issued as life insurance products for decades with no apparent problem. We note that those policies are included within the definition of 'life policy' in the Australian Life Insurance Act 1995.

We would appreciate clarification of what will be considered to be 'insurance-related'. We assume that the life insurance business will be separated in the statutory fund and that the limit on non-insurance activities only extends to the legal entity providing insurance, not to related companies or entities in the group. Our recommendation is that the suggested 2.5%

limit should not apply to a business held in a subsidiary, such as a brokerage or a property business.

Do you agree that the proposed exemption limit for non-insurance activities of 2.5% of gross premium income is appropriate? If not, please suggest an alternative exemption limit.

Depending on the definition and the provisions for existing investment business, the exemption limit may need to be higher to allow for the management of existing business.

Amalgamations and transfers

Do you agree with the proposal that the Reserve Bank must approve amalgamations, purchases, sales, transfers and other corporate transactions ("corporate transactions") performed by a licensed insurer? If not, please outline any concerns you may have and/or your preferred approach.

We agree that, in order to preserve the integrity of policyholders' interests, the Reserve Bank should be required to approve all material changes to the ownership or governance of an insurer, such as amalgamations and transfers, which could materially change the exercise of control over policyholders' liabilities or other major corporate transactions that may materially adversely change the risk level exposures of policyholders.

We would appreciate clarification of whether this proposal is intended to be in place of or additional to other existing regulatory requirements in place for these transactions.

In order to facilitate the timely consideration of such corporate activities and to ensure that commercial opportunities are not forgone due to an overly arduous and protracted appraisal process, guidelines should be agreed with the insurance industry and published with respect to the focus, notification requirements and timeframes for a Reserve Bank review.

Do you agree that the Reserve Bank should be notified of but not be required to approve small corporate transactions defined as those less than the higher of NZ$10million or 10% of the total balance sheet size of either party to the intended corporate transaction?

We recommend that all such corporate transactions should be required to be approved by the Reserve Bank. Policyholder protection is paramount, even in a small fund.

Confidentiality of information

Do you agree that the lack of a comprehensive confidentiality provision in respect of insurance prudential information is likely to limit the amount of information supplied by insurers or their appointed representatives to the Reserve Bank?

Yes. We agree that a component of the information sought by the Reserve Bank will be of a commercially confidential nature, particularly with regard to proposed corporate transactions. Lack of confidentiality may result in insurers limiting the information to the minimum requirement which would not support an open and constructive relationship between the supervisor and insurance companies.

Do you agree with the proposal that prudential information about licensed insurers which is not publicly disclosed, as part of disclosure requirements, should be confidential and not subject to the provisions of the Official Information Act?

Yes. We recommend that, except with regard to information which is publicly disclosed, information supplied for prudential purposes should remain confidential and not be subject to the provisions of the Official Information Act.

Additional considerations

Have the problem(s) been defined correctly? Are there any other related problem(s)?

We agree that the problems have been defined and addressed appropriately and we have not identified any other related problems.

We do have two recommendations to make in conclusion:

- The role of actuary is not defined in statute and we recommend that it is defined in the Insurance Prudential Supervision Act
- Consideration of compliance costs and the ultimate impact on policyholders must be a top priority.

Have all of the feasible alternatives (and sub-alternatives) been correctly identified? Do you consider that there are other alternatives (and/or sub-alternatives) that should be considered? If so, please identify the benefits and potential risks of each of these additional alternatives. Where a preferred alternative is put forward, do the benefits justify the costs?

Yes

What are the nature (e.g. taxation implications) and quantum of the costs (both transitional and ongoing operational) relating to each of these new alternatives? In particular, if you believe that the potential cost of the preferred alternative, or any other alternative, will be passed on to policyholders, please comment on the extent, likelihood and process by which this transfer will occur.

n/a

Yours sincerely,

Vance Arkinstall
CHIEF EXECUTIVE