INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

SUBMISSION

TO THE

FINANCE AND EXPENDITURE SELECT COMMITTEE

ON THE

INSURANCE (PRUDENTIAL SUPERVISION) BILL

10 February 2010

INVESTMENT SAVINGS AND INSURANCE ASSOCIATION OF N.Z. INC.

1.0 Introduction

1.1 The Investment Savings and Insurance Association ("ISI") is the industry association representing the companies which issue or manage life insurance, superannuation and managed funds.

1.2 As there are 15 ISI members that offer life insurance products, as well as 5 reinsurance companies, ISI is well-placed to provide views on the Insurance (Prudential Supervision) Bill ("the Bill").

1.3 A list of ISI members is given at the end of this submission.

1.4 We request the opportunity to appear before the Select Committee in support of this submission.

2.0 Key Recommendations

2.1 The key recommendations of this submission, subject to the proviso in paragraph 3.2, are:

- In respect of branches of foreign insurers, the Bank should be given wider powers of exemption to apply where it is satisfied that home regulation is at least as robust as in New Zealand
- The definition of life insurance business for the purpose of the statutory fund rules should be amended to allow inclusion of health insurance and of other non-life business where the amount held is within an acceptable limit
- The threshold for composite policies should be applied to *classes* of insurance contracts
- The 5% limit in relation to investment performance guarantees attached to investment linked policies within a statutory fund should be amended to allow for the possibility of a temporary breach in exceptional circumstances
- The interim financial statements required under the Bill should be prepared in accordance with any dispensations in respect of overseas companies available under the Financial Reporting Act for registered financial statements.
- The proposed process for transfers and amalgamations of insurers should be in place of rather than as well as the Companies Act process
- The Bill should allow commercially sensitive information to remain confidential
- We note the extent of detail that will be covered by regulations under clause 229, particularly in respect of allowing overseas insurers to operate in New Zealand and the allocation of the income and capital of a statutory fund between shareholders and policyholders. The successful implementation of the new regime will depend to a great extent on the content of the regulations

and we strongly recommend that the industry be given the opportunity to comment.

3.0 General Comments

3.1 ISI supports the introduction of a robust prudential supervision regime, with the proviso that it should be appropriate for the size and shape of the industry in New Zealand. ISI generally supports the Bill and commends the Reserve Bank of New Zealand ("the Bank") and the Ministry of Economic Development for the consultation undertaken before and during the drafting of the Bill, including the opportunity to comment on a draft in June 2009.

This submission deals only with specific aspects of the Bill that we consider still need amendment in order to improve its workability and better achieve its objectives.

3.2 The concerns of our member companies vary on some points. In particular, ISI members do not have a unanimous view on the recommendations regarding branches of foreign insurers or the inclusion of health insurance in the life insurance statutory fund. The recommendations on these items in this submission represent reasonably widely held industry views. Separate submissions from individual members of ISI will address issues of particular concern to those companies.

3.3 Generally, the industry's main concerns arise where the Bill will lead to an increase in compliance costs for insurance companies (which inevitably will be passed on to policyholders) without a corresponding increase in policyholder protection. These concerns arise particularly in connection with:

- The definition of life insurance business for the purpose of the statutory fund rules
- The 5% limit in relation to investment performance guarantees attached to investment linked policies within a statutory fund
- The proposed process for transfers and amalgamations which should be in place of rather than as well as the Companies Act process
- The rules relating to interim financial statements

3.4 We welcome the inclusion of Clause 52 which requires the Bank to publish its policies in relation to how it acts or proposes to act.

4.0 Detailed Comments

4.1 Exemptions for Overseas Insurers

The Bill allows the Bank to grant exemptions in relation to:

- fit and proper requirements for overseas insurers depending on the Bank's satisfaction with home jurisdiction requirements (clause 36); and
- providing an exemption from compliance with a solvency standard (clause 60); and
- compliance with statutory fund requirements (clause 117)

where it is satisfied with the law and regulatory requirements, and the nature and extent of prudential supervision, in an overseas insurer's home jurisdiction.

ISI members with just under a quarter of the New Zealand life insurance market sell life insurance through branch operations, particularly of Australian resident life insurers. Those members consider that the efficiency and effective operation of the New Zealand life insurance market will be promoted by allowing branch operations to be aligned (on a case by case basis) with appropriate prudential requirements of the home jurisdiction.

We recommend amendment of the Bill to give the Bank broader exemption power so that it can develop exemptions that recognise the prudential supervision provided in other jurisdictions and reduce the potential for duplication of reporting requirements and conflict in regulatory interventions. The practicality of a broad exemption power with the ability to exempt any person from any aspect of the Bill and the flexibility to allow financial statements prepared in other jurisdictions is already demonstrated in the Securities Act context. We believe the considerations are not significantly different here and recommend amendment of the Bill to enable a similar approach to be taken. Any exemptions should only be given where the security to New Zealand policyholders provided by overseas supervision is of a similar level to that provided under the Act.

We would also support a facility for the Bank to seek memoranda of understandings with foreign prudential regulators with a view to co-operating with them in regulating in a coordinated way insurance companies which operate on a global basis.

We recommend that the Bill should allow for "mutual recognition" of insurance prudential supervision in other jurisdictions.

4.2 Statutory Funds

4.2.1 Life Insurance Business

Clause 85 relates only to composite policies. However, a life insurer may also hold a small book of non-life insurance business and the Bill currently will require the insurer to account for its non-life insurance business outside of its life insurance statutory fund.

This is likely to impose additional systems and accounting related costs on life insurers that will inevitably be passed on to policyholders. Where the proportion of non-life insurance business is small any additional policyholder safety or financial reporting advantages created by statutory funds are outweighed by the costs of dealing separately with the non-life insurance business.

This concern is particularly acute in relation to health insurance. Health insurance is closely aligned to life insurance (more so than to general insurance) and a number of life insurers also write health insurance. Many of the risk attributes and underwriting and claims processes are similar and a life insurer should be able to include its health business within its statutory fund(s). It would be counter-productive and would cause increased costs with no material additional benefit to policyholders, to require a life insurer that also sells health insurance to isolate the health portfolio from its statutory fund.

In addition, the Bank should have the power to deem other non-life insurance business of a life insurer to be life insurance business, solely for the purpose of Part 2, Subpart 3, where the Bank is satisfied that the proportion of the insurer's total insurance business represented by the non-life insurance is not material and the interests of all policyholders attributable either to the life or non-life insurance business are not likely to be materially adversely affected.

We note that the Bank is the Regulator for both life insurance and general (non-life) insurance. There is no good policy reason why the inclusion of an acceptable level of non-life insurance into a statutory fund should cause any issues. Any perceived weakening of the policyholders' security that might arise could be addressed by the requirements of the solvency standard rather than by arbitrary exclusion.

We therefore **recommend** that:

- Clause 84(1) be amended by the addition of the following paragraph:

  (f) for the purpose of subpart 3 of Part 2, a contract for health insurance under which a life insurer is liable as an insurer.

- Clause 85(4) be amended by addition of the expression "and section 85A".

- A new clause 85A be added as follows:

  85A Power of Bank to deem business to be life insurance business
  Where the Bank is satisfied that -
  (a) The proportion of the total insurance business carried on by a life insurer that is non life insurance business is not material; and
  (b) The interests of any policyholder are not likely to be materially adversely affected,

- the Bank may deem the non-life insurance business of the life insurer to be life insurance business for the purposes of this subpart.

4.2.2 Composite Policies

As explained above, health insurance is closely aligned to life insurance (more so than to general insurance) and a number of life insurers have small but material books of health insurance. It is common to write composite life insurance policies that include health insurance benefits. One problem that will be encountered with these policies is that the proportion of the premium attributable to health insurance frequently fluctuates significantly over the life of the policy. Influencing factors include:

- the rate of health services inflation relative to inflation generally; and
- policyholders changing the benefits on their policies over the policy lifecycle, e.g. as family members are added and removed. These circumstances also exist to varying degrees in relation to other types of composite policies, e.g. combined life and redundancy insurance policies.

The requirement that a policy **must** be treated as a non-life policy if less than 25% of the premium relates to life insurance, and **must** be treated as a life policy if less than 25% of premium relates to non-life insurance, creates a situation where it is possible that policies around these thresholds may need to be transferred in and out of statutory funds in the course of their life cycle. This could impose a significant and continuous burden on the insurer under the requirements imposed by section 109 of the Bill (and on the Bank if section 107 applies).

We therefore recommend that the test in clause 85(2) should apply to *classes* of insurance contracts, rather than individual insurance contracts. A class of insurance contract should be defined by reference to the type of insurance benefits provided under the contract.

4.2.3 *Investment Guarantee*

Clause 97 applies where, in accordance with clause 97(1)(a), the business of the statutory fund "consists of" the provision of investment- linked benefits. Given the use of the expression "any of the policies" in clause 97(1)(b) and clause 82(1), we understand the intention to be that a statutory fund may comprise both investment-linked contracts and other policies. That is appropriate. However, the expression "consists of" could be taken to indicate that investment- linked contracts must be referable to a separate statutory fund.

We recommend that the expression "consists of" in clause 97(1)(a) be replaced with the expression "includes".

Clause 97 sets a limit of 5% in relation to the investment performance guarantee factor of a statutory fund and requires this 5% threshold to be complied with *at all times.* The possibility of extreme movements in investment markets makes it difficult to ensure absolute compliance at all times, unless no guaranteed business

is provided at all. The Bank should have scope to allow a short term breach in extreme circumstances.

We recommend the addition of a specific provision in the Bill for life insurers to be able to notify the Bank of any breach of the 5% threshold and to come to an agreement with the Bank on how that breach will be addressed or rectified.

4.2.4 Initial balance of a statutory fund

On the establishment of a statutory fund when the Act comes into force, it is not clear what provision covers the establishment of the initial balances in the statutory fund. We expect that the Bank would need to be satisfied with how initial balances are determined and that regulations may be needed to cover this.

We recommend that the application of clause 109 be extended to include when a policy first becomes referable to a statutory fund.

4.2.5 Application of a statutory fund on wind-up

Under clause 114(4) there is no guidance on how liabilities are to be distributed where there are insufficient funds to meet liabilities.

We recommend amendment of clause 114 to include provisions dealing with allocation of funds where they are insufficient to meet liabilities. These provisions need to be consistent with conditions where there are surplus funds – i.e. sections 114(4)(c) and (d).

4.2.6 Policies referable to a statutory fund

The current wording of clause 90(3) result in a policy referable to 2 or more statutory funds that does not apportion benefits or premiums being ineffective. This could leave the policyholder uninsured.

We recommend that where this error is discovered, clause 90(4) should require a policy document to be endorsed and premiums and investment earnings allocated to the appropriate statutory fund.

4.3 Investment of Statutory Funds

Clause 98 restricts related party transactions other than investing in registered Bank deposits. There is no policy basis to exclude from the carve out from registered bank deposits those cash PIEs offered by a related party where the underlying investments comprise deposits with a registered bank. Similarly there is no policy basis to exclude foreign exchange hedges transacted with a related party registered bank.

We recommend that clause 98(5) and 99 should be amended accordingly.

The definition of ‘associated person’ (section 9) should only apply to companies and should not capture investment funds such as unit trusts, group investment funds and superannuation schemes. It is not uncommon for statutory funds to be

invested in such investment funds of a fund management company that is a part of same group as the insurance company, and such investment funds could come within the 'associated person' restriction of section 98(2)(c). Given the protection afforded to the statutory fund as an investor in such investment funds (by the governing trust deed and securities legislation), it should not be necessary for the Bank to approve such investments.

If approval is to be required, it needs to be granted on a class basis to avoid cumbersome, case-by-case approval for the reasonable investment transactions outlined above that are common in the industry.

We recommend that such investments should not require the Bank's approval. If such approval is required, we recommend an amendment of clause 98(2)(c) to make the possibility of granting general approval clear.

4.4 Transfers and amalgamations

We welcome the provisions of clauses 42 to 51 that provide for the Bank to consider transfers and amalgamations. There is, however, uncertainty over whether the process in the Bill will be an alternative to the current process under the Companies Act or in addition to it. Clause 49 implies the process under the Bill is cumulative.

Clause 46 of the Bill gives the Bank the ability to take into account a potentially broad range of matters in approving transfers and amalgamations and this regime is sufficient, for both transitional and ongoing use, to enable a licensed insurer to rearrange its business in New Zealand with the approval of the Bank alone.

We recommend that the process for transfers and amalgamations should be instead of rather than as well as the Companies Act procedure and that the Bill should be amended to make that clear.

4.5 Financial statements

We recommend amendment of clause 81 to provide that interim financial statements and interim group financial statements should be prepared on the same basis as the financial statements and group financial statements referred to in clause 81(1). This will allow those interim financial statements to be prepared in accordance with any variations allowed under sections 11(3) and 14(5) of the Financial Reporting Act. The Bank should not be able, by regulations under clause 81(3)(b), to abrogate the benefit of those provisions of the FRA.

We recommend deletion of clause 81(3)(a) which requires interim financial statements to be audited if required by the regulations. We note that any such requirement would be over and above current financial reporting requirements and would impose an unnecessary burden to business.

4.6 Insurance concepts and definitions

"Meaning of carrying on insurance business in New Zealand":

The definition in clause 8(1) will not catch an insurer that is incorporated or established in New Zealand but is liable only under contracts entered into outside New Zealand with non residents. We submit that there are strong policy reasons to ensure that such insurers are appropriately regulated in order to protect New Zealand's international reputation. It is wholly undesirable that insurers incorporated or established in New Zealand can escape regulation in New Zealand merely because they insure only overseas policyholders.

We recommend that the definition be amended by deleting paragraphs (b) and (c) and adding a new paragraph (b) as follows:

> *(b) is liable as an insurer under a contract of insurance entered into in New Zealand or elsewhere.*

Meaning of "life policy"

Clauses 84 (1)(d)(ii) and (iii) refer to the disability or condition or disease of the policyholder. We believe that the intention was to refer to conditions of the insured person not the policyholder.

We recommend that in clauses (ii) and (iii) the word "policyholder" should be replaced with the words "insured person".

4.7 Breaches and Penalties

We recommend that the Bill or the regulations should include provisions for warnings, notices, orders or directives to be given to licensed insurers who may be in breach of a requirement, including opportunities to rectify any breaches.

As it stands, in many instances breaches of the legislation are an offence resulting in a liability to pay a fine.

4.8 Financial Strength Ratings

An amendment is required in respect of financial strength rating downgrades and the requirement of clause 69 of the Bill that insurers must notify policyholders if their financial strength ratings are downgraded.

At present, under the Insurance Companies (Ratings and Inspections) Act 1994, an insurer's rating must be disclosed in writing to policyholders prior to entering into or renewing a contract of insurance. If a rating is subsequently downgraded, an insurer must give "public notice" of the downgrade in the form of public notices and in the New Zealand Gazette.

The requirements of clause 69 as drafted are unduly onerous and will create new, significant costs to business. We believe that the present requirement under the Insurance Companies (Ratings and Inspections) Act 1994 to give public notice of

a downgrade will suffice to ensure that policyholders are aware of their insurer's financial strength rating.

We recommend that clause 69 be deleted and replaced with the current provisions of the Insurance Companies (Ratings and Inspections) Act 1994 requiring insurers to give public notice of a downgrade in financial strength rating.

4. 9 Confidentiality

In order to ensure full and frank disclosure of material information by the industry to the regulator, the industry needs to be confident that sensitive commercial information will be kept confidential.

A component of the information sought by the Bank will be of a commercially confidential nature, particularly with regard to reports of the appointed actuary and 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 Bank and insurance companies.

We recommend that the provisions of clause 133 be revised to ensure 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.

List of ISI Members

ISI MEMBERS

AIA New Zealand
AMP Financial Services
Asteron Life Ltd
AXA New Zealand
BNZ Investments and Insurance
CIGNA Life Insurance NZ Ltd
Dorchester Life
Equitable Group
Fidelity Life Assurance Co Ltd
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
ING New Zealand Ltd
Kiwibank Ltd
Medical Assurance Society NZ Ltd
Mercer
Munich Reinsurance Co of Australasia Ltd
Public Trust
RGA Reinsurance Co. of Australia Ltd
Sovereign Ltd
Southsure Assurance
Swiss Re Life & Health Australia Ltd
TOWER New Zealand
Westpac/ BT Funds Management Ltd

Associate Members

Bell Gully
BNP Paribas
Bravura Solutions
Burrowes & Co
Chapman Tripp
Davies Financial & Actuarial Ltd
Deloitte
DLA Phillips Fox
Ernst & Young
InvestmentLink (New Zealand) Ltd
KPMG
Kensington Swan
Melville Jessup Weaver
Minter Ellison Rudd Watts
Morningstar Research Ltd
PricewaterhouseCoopers
Russell McVeagh
Simpson Grierson