# Regulatory Impact Statement

# Prudential Regulation of Insurance

## Executive Summary

1. Cabinet approved the overall architecture of the insurance prudential supervision regime in December 2007. This included the objective of the regime, licensing conditions and monitoring powers for all insurers as well as certain distress management powers for the regulator.

2. Some additional requirements for the insurance prudential supervision framework are recommended, which are set out in the preceding Cabinet paper and described herein. These recommendations are consistent with the overall approach to the prudential regulation of insurers which intends to place significant reliance on strong self discipline coupled with appropriate statutory requirements and regulatory powers – in order to recognise potential risks which could undermine the government's objective. The additional requirements have the following main features:

**a. Separation of insurance business lines.**

- All life insurers operating in New Zealand will be required to establish at least one life insurance statutory fund to legally separate and better protect life insurance policyholder interests.

**b. Treatment of foreign owned branches.**

- Foreign-owned insurers can operate as branches in New Zealand, provided that all licensing, monitoring and other prudential requirements are met.

- New Zealand branches must obtain a financial strength rating from a rating agency approved by the Reserve Bank that takes into account any home country policyholder preference arrangements or other legal issues which could disadvantage New Zealand policyholders. Details of the rating requirement will be contained in regulations.

- Any home country policyholder preference must be clearly disclosed to the public in addition to the requirement to publish rating information.

- At licensing and on an ongoing basis, home country regulation and supervision of foreign-owned branches and home country legal and accounting practices must be of an acceptably high standard.

**c. Distress Management.**

In situations of insurer distress the Reserve Bank will utilise, as appropriate to the severity of each circumstance, a range of legal processes currently available to manage corporate distress. The following additional powers are recommended:

- *Statutory Management.* The scope and nature of statutory management powers under the proposed insurance prudential supervision legislation will be very similar to those applicable to banks under the Reserve Bank of New Zealand Act. The threshold for the application of statutory management will be set at an appropriately high level, and the agreement of the Minister will be required to place an insurer into statutory management.

- *Other distress management processes*. The Reserve Bank will have the power to apply to the Court to put a failing insurer into either voluntary administration or liquidation under the Companies Act if this is appropriate. The Bank will also have other rights in association with Companies Act distress proceedings, including attending court hearings, receiving reports, and being notified of any Companies Act distress proceedings that are initiated in order to make these proceedings more useful to the Reserve Bank's regulatory role.

**d. Connected party exposures.**

- The potential risks associated with an insurer lending to or investing in connected parties will be limited by disallowing connected party exposures, in excess of an agreed threshold, from inclusion in calculations of an insurer's solvency.

- All connected party exposures must be on arm's length terms and in the interests of the insurer and disclosure in director attestations that such exposures are on this basis will be required.

**e. Non-insurance activities.**

- Insurers will not be permitted to undertake any non-insurance business activities beyond a de minimis exemption level. This de-minimis exemption will only be granted on application to the Reserve Bank, which must be satisfied that the potential risks of the non-insurance activity are well managed and confined. Non-insurance exposures will be disallowed from inclusion in calculations of an insurer's solvency.

**f. Amalgamations and transfers.**

- To safeguard policyholders' interests the Reserve Bank must approve all corporate amalgamations, transfers, or other corporate transactions which change the ownership of policyholder liabilities.

**g. Confidentiality of information.**

- Prudential information in respect of insurers which is not otherwise publicly disclosed will be confidential and the proposed legislation will contain provisions restricting disclosure of such information by the Reserve Bank.

## Adequacy Statement

3. The Reserve Bank considers the level of regulatory impact analysis to be adequate given the magnitude of the proposal.

## Objectives

4. In arriving at the proposals within this paper the Reserve Bank has had regard to the statutory objective of the insurance prudential supervision regime, which is "to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence". Underlying this overall statutory objective are the following approaches and objectives:

- Effective risk identification, transparency and management: A risk-based approach to supervision and regulation of insurers will be taken, so that potential risks are identified and transparent to policyholders and other stakeholders within the insurance sector, effectively identified and managed by insurers and effectively regulated by the Reserve Bank. This approach will place significant reliance on strong corporate self discipline, director responsibility and published financial statements.

- Cost effective and competitively neutral regulation and supervision: Subject to meeting the proposed supervisory objective, prudential requirements and monitoring will be applied on a competitively neutral basis that is relatively non-intrusive in nature, to minimise compliance costs and unnecessary regulatory intervention.

- Effective regulatory involvement in distress management: The Reserve Bank will have direct involvement in processes that seek to achieve timely and orderly resolution of situations of insurer distress in order to minimise potential losses to policyholders and disruption to the wider insurance sector.

## Additional Prudential Requirements

5. The additional necessary requirements for the insurance prudential supervision framework are set out below including a description of the reasons for the preferred approach, potential impacts (benefits, costs and risks) and a summary of alternative options considered.

**Legal Separation Of Insurance Business Lines Within Insurers**

### Status Quo and Problem

6. Currently, Section 15 of the Life Insurance Act 1908 requires a New Zealand or an overseas incorporated life insurer operating in New Zealand to maintain a separate fund for assets relating to its life business. New Zealand industry practice is that separate companies or branches typically exist for life, general and health insurance whilst some products combine elements of life and health insurance.

7. If life and general insurance business co-exists within the same legal entity then contagion from one segment of the business has the potential to undermine the assets available to cover commitments in the other. Although this problem is most likely to manifest where short-term general insurance commitments undermine assets required to service long-term liabilities associated with life insurance, there is also the potential for contagion from outside the specific business segments to undermine funds required to cover insurance liabilities. Inadequate separation of assets required to support general and life insurance commitments can also expose insurance policyholders to losses if asset values decline.

### Alternative Options

8. The other alternatives considered in this area are as follows:

- maintaining the status quo, i.e. placing reliance on the existing legislation and on existing business and accounting separation, without imposing any additional separation requirements;

- making clear accounting separation a formal requirement; and

- requiring life insurance to be booked into a separate body corporate, but without a separate statutory fund.

**Benefits of alternatives**

- The major benefit of the alternatives is that they are likely to be lower cost for some insurers than the preferred option.

**Costs of alternatives**

- The alternatives do not adequately protect life policyholder funds from external contagion and therefore place the policyholder position at risk, without the policyholder being aware of this. They also fall short of international guidance and practice.

9. The alternatives are not preferred because they fail to meet the objective of effective risk identification, transparency and management, and this failure outweighs any benefits related to the lower cost they represent to insurers.

**Preferred Option**

10. The preferred alternative and recommendation is a requirement that all life insurers must operate at least one life insurance statutory fund. A statutory fund is, in effect, a fund established in the records of a life insurer that separates life insurance assets and policyholder liabilities from other company funds and any other statutory funds. There are detailed statutory rules governing the operation of the statutory fund, most importantly that the assets of that statutory fund may only be used to meet the liabilities of that statutory fund.

11. Due to the much shorter-term nature of general and health insurance liabilities, there will be no specific requirement for a statutory fund (or other) separation requirements for general insurance or health insurance products, although an insurer can establish such funds for general insurance and health products if they wish.

12. Life insurance statutory funds can include general insurance policyholder liabilities of no more than 5% of the capital of the life insurance statutory fund. Greater amounts of general insurance must be separated out.

13. The life insurance statutory fund of a New Zealand-incorporated entity must be managed in New Zealand and be under New Zealand regulatory supervision. For foreign insurers operating in New Zealand as branches, the life insurance statutory fund need not be based in New Zealand, but the Reserve Bank will have the right to require that the statutory fund is operated by a New Zealand-incorporated insurer where there are concerns about either the robustness of home country supervision or regulation or the adequacy of legal or accounting practices.

14. Exemptions from this requirement are considered to be not justified but insurers will be given sufficient lead time to implement this requirement.

**Benefits of preferred option**

15. The key benefits of the preferred option, relative to the status quo, are that:

- this solution better protects life policyholders as it achieves legally robust separation of life funds from other insurance funds;

- it aligns with internationally-accepted practice regarding separation of funds; and

- it represents a key component in the prudential soundness of the insurance sector and will promote policyholder confidence in dealing with insurers.

**Costs and risks of preferred option**

The costs and risks of the preferred option are that:

- this approach imposes some additional compliance costs on industry, including legal and actuarial costs, but the advantages to policyholders of protecting life funds over the long term justify these costs (which are not expected to be excessive). To minimise the potential compliance costs of this requirement, whilst still reasonably limiting the risks in this regard, life insurance statutory funds may include general insurance policyholder liabilities of no more than 5% of the capital of the life insurance statutory fund. Greater amounts of general insurance must be separated out from the statutory fund; and

- the requirements may place some constraints on insurers' business operations.

16. It is considered that the benefits of the preferred option outweigh these costs.

**<u>Treatment of foreign owned branches</u>**

**Status Quo and Problem**

17. Currently there are a small number of major Australian and American life and general insurers, plus some smaller foreign life and general insurers, operating in New Zealand as branches.

18. New Zealand policyholders have the potential to be disadvantaged, in the event of an insurer failure, by home-country supervisory regimes and insolvency laws controlling the responses of foreign-owned insurers operating in New Zealand.

19. One example of home country legal requirements which could disadvantage New Zealand policyholders in the event of the insolvency of an insurer is the existence of policyholder preference provisions within the home country. Such provisions exist in Australian general insurance legislation which provides that assets of general insurers in Australia must first be available to meet policyholder liabilities in Australia. As New Zealand policyholders of an Australian branch do not have a claim on Australian assets until all Australian liabilities are met, this potentially limits the assets available to support New Zealand policyholders' claims.

**Alternative Options**

20. The other alternatives considered in this area are as follows:

- Maintaining the status quo, with foreign owned branches having no measures that take account of the insolvency laws of the parent jurisdiction, although the Reserve Bank would have discretion to refuse to license an entity where the overall supervisory, legal or accounting framework applying in the home jurisdiction presented a significant risk to New Zealand policyholders;

- a requirement for foreign-owned branches to maintain assets within New Zealand either equal to or greater than New Zealand policyholder liabilities. This could be modelled on the Australian law and the Reserve Bank would supervise this requirement to ensure the required level of assets was maintained;
- including local policyholder preference provisions for insurance within New Zealand legislation; and
- requiring local incorporation of a New Zealand based branch where home country policyholder preference disadvantages New Zealand policyholders. Local incorporation could be applied either to all such branches or branches above a certain size.

**Benefits of alternatives**

- The status quo would be low cost for insurers;
- maintaining assets in New Zealand would ensure that sufficient assets are always available to meet the claims of New Zealand policyholders;
- local policyholder preference provisions for insurance within New Zealand legislation would be effective in protecting the position of New Zealand policyholders;
- local incorporation of branches would ensure that assets are available for New Zealand policyholders and are not at risk of being remitted to the foreign parent, and in cross border insolvencies local incorporation helps to ensure that offshore assets will be remitted to New Zealand; and
- local incorporation does not depend on the assessment of the implications of home country policyholder preference provisions by the market.

**Costs of alternatives**

- The status quo does not meet the transparency objective as policyholders would be unaware of the existence of home country policyholder preference provisions that could disadvantage them;
- maintaining assets in New Zealand does not meet the cost effective objective as it will be a relatively complex and costly approach which may include changes to insurers' asset portfolios;
- establishing local policyholder preference provisions for insurance within New Zealand legislation could be contrary to international financial commitments;
- local incorporation of branches does not meet the cost effective or competitive neutrality objectives as it is likely to be expensive and complex and may deter insurers from entering the market, thereby reducing competition and consumer choice; and
- a locally incorporated insurer will be smaller and typically have lower financial strength than a larger company of which it was previously a part.

21. The above alternatives are not preferred because they fail to meet the objectives of effective risk identification, transparency, and cost effective and competitively neutral regulation and supervision. It is considered that sufficient disclosure (which will occur under the preferred option below) and the Reserve Bank's other prudential requirements will provide adequate protection for policyholders in this area.

**Preferred Option**

22. Foreign-owned insurers can operate as branches in New Zealand, provided that all licensing, monitoring and other prudential requirements are met.

23. New Zealand branches of foreign insurers must obtain a financial strength rating from a rating agency approved by the Reserve Bank that takes into account any home country policyholder preference arrangements or other legal issues which would disadvantage New Zealand policyholders. Detail of the ratings requirement will be contained in regulations.

24. New Zealand branches of foreign insurers will be required to disclose any applicable home country policyholder preference or other such issues affecting New Zealand policyholders to the public in a form and manner to be prescribed by the Reserve Bank.

25. Branch operations of foreign insurers from jurisdictions where either home country regulation and supervision or the legal or accounting framework are not of an acceptably high standard will not be allowed. If any of these matters is unacceptable to the Reserve Bank, at licensing or on an ongoing basis, local incorporation in New Zealand of the foreign-owned branch may be required.

**Benefits of preferred option**

26. The key benefits of the preferred option, relative to the status quo, are that:

- Ratings provide a relatively simple metric summarising, in one measure, the risk of an insurer defaulting on its financial obligations, and better enable policyholders, financial intermediaries and market analysts to identify and compare risks associated with different insurers;
- ratings would signal to the market that such branches of foreign insurers may be higher risk as a result of home country policyholder preference;
- ratings and increased financial disclosure will strengthen market and self disciplines in the insurance sector, and promote sound governance and risk management practices by insurers;
- the use of ratings is consistent with the current requirements for registered banks in New Zealand, where all banks are required to maintain and disclose a rating from an approved rating agency;
- it would not require significant changes to corporate structure or the business operation of insurers;
- it would not represent a significant barrier to entry or encourage insurers to withdraw from the New Zealand market;
- New Zealand policyholders will be better informed of potential disadvantage arising from home country regulation and supervision or the legal or accounting framework of foreign insurers; and
- it delivers an appropriate light-handed but effective approach for foreign-owned branches that promotes public confidence in the insurance sector.

**Costs and risks of preferred option**

27. The costs and risks of the preferred option are that:

- The disclosure of policyholder preference within a rating does not directly address policyholder preference regimes and the issues faced with foreign insolvency laws;

- there will be increased disclosure requirements for branch insurers that are subject to home country policyholder preference legislation. However, this additional cost may be low for insurers that already obtain and publish a financial strength rating;

- it is dependent upon the effectiveness of the rating methodology and the overall credibility of the rating agency used;

- it depends on consumers and other market participants' understanding of and ability to evaluate the rating information;

- the identification of "higher risk" insurers could place commercial pressure on some insurers; and

- policyholders of insurers who are granted an exemption for the requirement to obtain a rating due to annual gross premium income of less than $5 million may be exposed to higher risks.

28. It is considered that the benefits of the proposals outweigh these costs.

## Distress management powers for failing insurers

### Status Quo and Problem

29. Situations of insurer distress are currently managed through judicial management under the Life Insurance Act 1908, or relying on existing Companies Act procedures or statutory management under the Corporations Investigation and Management Act 1989 ("CIMA"). There is no current prudential regulation of insurers and therefore no direct regulator involvement in situations of insurer distress.

30. It will not be the Reserve Bank's role, as regulator of the insurance sector, to eliminate the potential for insurers to fail. However, where situations of distress or exit do occur, the Bank's role will be to ensure, to the extent possible, that this occurs in an orderly manner so as to minimise any adverse impacts on policyholders and the wider insurance sector.

31. Cabinet have previously approved that the Reserve Bank will have the following distress management powers: the ability to appoint an investigator, require the preparation and implementation of a recovery plan by an insurer, the ability to give directions to an insurer or an associated person, including ceasing writing new business, and the power to de-license an insurer.

32. Further safeguards are necessary in this area to underpin policyholder confidence and ensure the soundness of the insurance sector. The further distress management powers recommended are set out under the preferred option below.

### Alternative Option

33. The other alternative considered in this area is maintaining the status quo as set out above.

**Benefits of alternative**

- The existing law is relatively certain and status quo avoids the cost of designing a new legal regime for the management of insurers in distress; and
- voluntary administration in its current form and judicial management incorporate many features that are suitable for insolvent or near insolvent insurers.

**Costs of alternative**

- Existing distress management mechanisms provide little direct involvement for, or recognition of the role of, a prudential supervisor;
- current liquidation and voluntary administration proceedings have certain features that do not account for particular issues that arise in the context of an insurance insolvency;
- judicial management is limited to life insurers;
- judicial management and liquidation are heavily court-dependent processes which can lead to delays in taking action, and also generate high costs; and
- statutory management under CIMA is invoked by the Securities Commission - which would be less well placed than the Reserve Bank to exercise statutory management powers in respect of an insurer.

34. This option is considered unsuitable because it does not meet the objective of effective regulatory involvement in insurer distress management.

**Preferred Option**

**Statutory Management**

35. On the recommendation of the Reserve Bank the Minister may seek an Order in Council to place an insurer into statutory management under the new insurance prudential supervision legislation, if this appears to be the best course of action to meet the Reserve Bank's statutory objective.

36. The appropriate circumstances would be where:

- The failure of the insurer could cause significant damage to the wider economy or the financial system, or
- the circumstances of the insurer involve fraud or recklessness;
- statutory management is in the public interest; and
- policyholders and creditors cannot be adequately protected under the Companies Act, other provisions of the Insurance Prudential Supervision Act or in any other lawful way.

37. These grounds are similar to those provided in The Corporations Investigation and Management Act 1989 ("CIMA") which may be invoked against insurers. Separate statutory management powers are required under the Insurance Prudential Supervision legislation because CIMA is invoked on the recommendation of the Securities Commission, which will be less well placed than the Reserve Bank to exercise statutory management powers in respect of an insurer.

38. If the Securities Commission wishes to invoke CIMA in respect of an insurer the Reserve Bank must be consulted before such action is taken and the Reserve Bank will have the power to assume control over such proceedings.

39. If the Registrar of Companies plans to take any action related to or arising from CIMA in respect of a distressed insurer the Reserve Bank must be consulted before any such action is taken.

40. The nature and extent of statutory management powers needed will be consistent with similar statutory management powers found in CIMA and in the Reserve Bank of New Zealand Act 1989:

- The statutory manager will have full authority to carry on the day to day business of the insurer and to take any actions necessary for the insurer to continue in business;

- the statutory manager will have the power to restructure, sell or liquidate the distressed insurer, and the ability to pay and compromise insurance claims, transfer or reduce insurance policies and establish a new company and transfer to it the undertaking of the failed insurer;

- Statutory management would impose a comprehensive moratorium limiting the ability of creditors (which includes policyholders) to claim against the insurer and would also displace any other resolution proceedings which the insurer is subject to, for example voluntary administration;

- the statutory manager would be required to receive the advice of an advisory committee established by the Minister of Finance on the recommendation of the Reserve Bank; and

- the statutory manager would be subject to direction from the Reserve Bank and will also have the ability to apply to the High Court for direction.

**Modifications to existing Companies Act distress management processes**

41. The Reserve Bank will have powers to apply to the Court to place an insurer under voluntary administration, or into liquidation or interim liquidation if this is appropriate. These proceedings may be invoked by the Reserve Bank irrespective of whether the insurer is already subject to any other legislative proceedings, and may not be suspended or halted by applications for these or any other legislative proceedings initiated by the insurer or any other party. The Reserve Bank will have the right to appear in any insolvency-related proceedings brought against any insurer by other parties.

42. The grounds for the Reserve Bank to place an insurer into voluntary administration, liquidation or interim liquidation will be necessarily lower than those for statutory management, and will include circumstances where the insurer is in actual or potential breach of its prudential requirements - for example solvency requirements or a regulatory direction from the Reserve Bank - and where the insurer is unable to satisfy the Reserve Bank that it will be able to return to compliance within a reasonable period of time.

43. The liquidator, interim liquidator or voluntary administrator of an insurer will be able to value the liabilities of the insurer using an actuarial valuation or another appropriate basis and that the liquidator, interim liquidator or voluntary administrator of an insurer may apply to the New Zealand High Court for the purposes of:

- Reducing the value of insurance policies and other liabilities of the insurer subject to these proceedings in order to create an equitable outcome for all policyholders; or

- transferring the assets, insurance policies and other liabilities of an insurer subject to these proceedings to another corporate entity or to any other party for the continuation of policyholders' insurance coverage.

44. The New Zealand High Court will be required to notify the Reserve Bank of any applications for insolvency-related procedures under the Companies Act initiated by an insurer or any other person.

45. To ensure that the Reserve Bank is able to provide informed input to these Companies Act proceedings, the Reserve Bank will be entitled to receive reports arising from, and attend, court or any other proceedings relating to the Companies Act distress management actions. This will include the ability of the Reserve Bank to attend creditors meetings held pursuant to the voluntary administration regime.

46. Access to judicial management currently exists under the Life Insurance Act 1908. The reforms recommended above will adequately take the place of this process so the Life Insurance Act 1908 will be repealed.

**Benefits of preferred option**

47. The key benefits of the preferred option, relative to the status quo, are that:

- Statutory management confers considerable benefits as it avoids the potential delays and costs caused by court processes and enables quick action to best protect the assets of the insurer and interests of policyholders. It provides maximum flexibility - for example the statutory manager could attempt to run the business with the aim to rehabilitate it, it could sell portions of the business or it could liquidate it if this was in policyholders' best interests;

- revisions to Companies Act proceedings preserves the advantages of the status quo and also makes these proceedings more appropriate to a situation of insurer distress;

- in the event of distress in the sector, the Reserve Bank will be able to better respond to the situation and limit the potential damage to the regulatory objective, including the impact on policyholder confidence; and

- avoiding the potential delays and costs caused by court processes in respect of Judicial Management (which will be repealed). Court approval is required to appoint a Judicial Manager who can also apply to the Court for directions.

**Costs and risks of preferred option**

48. The costs and risks of the preferred option are that:

- The status of policyholders' claims under statutory management may be less certain (because of the level of discretion held by the statutory manager);

- statutory management does not allow for policyholder participation in any resolution options;

- the absence of court involvement under statutory management means that a neutral forum to resolve issues that may arise between the parties is not available; and

- revisions to Companies Act proceedings would entail some administrative and legal costs to the Reserve Bank and to parties participating in insolvency proceedings, but such costs are unlikely to be material.

49. It is considered that the benefits of the preferred option outweigh these costs.

## Connected party exposures

### Status Quo and Problem

50. There is currently no legislated limitation on the extent to which the funds of an insurer may be used to finance a connected party such as another insurer or company within a group, the insurer's directors or a person with a substantial interest in an owner of the insurer. Although some guidelines published by the New Zealand Society of Actuaries exist in this area, they do not have the force of law and are applied on a differential basis across insurers.

51. If the connected party should face financial distress, the financial position of the insurer may be undermined.

### Alternative Options

52. The other alternatives considered in this area are as follows:

- The establishment of direct limits on connected party exposures; and
- more prominent public disclosure of the nature and extent of insurers' connected party exposures.

### Benefits of alternatives

- The establishment of direct limits on connected party exposures, rather than an indirect mechanism via an insurer's solvency calculations (which is the preferred option set out below) may be effective in limiting the absolute risk in this area; and
- more prominent public disclosure of connected party exposures would be low cost and increase transparency of the potential risks of the connected party exposures.

### Costs of alternatives

- Imposing direct limits on connected party exposures is a crude tool that, depending on the size of the insurer, could result in limitations which are either ineffectively small or disproportionately large; and
- more prominent public disclosure of connected party exposures relies entirely on market discipline which is unlikely to effectively limit the potential risks in this area.

53. The alternative options are considered unsuitable because they do not meet the regulatory objectives of effective risk management, transparency and management.

### Preferred Option

54. To limit this potential risk it is recommended that beyond an allowed threshold level, connected party exposures of an insurer will be disallowed from inclusion in any calculation of the insurer's solvency.

55. New Zealand life insurance actuarial solvency standards currently contain requirements for connected party exposures based on this approach. There are no New Zealand actuarial standards in this area for the general or health insurance sectors, but such standards will be required under insurance prudential supervision legislation and it is likely that the connected party provisions will be broadly consistent across the standards.

56. In respect of connected party exposures, requirements contained within actuarial standards, to be developed by the New Zealand Society of Actuaries and confirmed by the Reserve Bank, will be given the force of law. The Reserve Bank must be satisfied that all aspects of the treatment of connected party exposures within these actuarial standards, including the definition of a connected party, will meet its regulatory requirements.

57. There will be no additional requirements for connected party exposures except for a licensing requirement that all connected party exposures must be on arm's length terms and in the interests of the insurer – which will also be a required disclosure in director attestations.

**Benefits of preferred option**

58. The key benefits of the preferred option, relative to the status quo, are that:

- Using an established and accepted actuarial approach to solvency calculations in respect of connected party exposures will be an effective method of limiting the risks associated with connected party exposures; and

- the preferred option limits marginal compliance costs.

**Costs and risks of preferred option**

59. The costs and risks of the preferred option are that:

- Reliance on actuarial judgement can lead to inconsistent treatment across different insurers and this risk can be higher for insurers whose governance is already weak; and

- there will be some compliance costs for insurers that need to make changes to meet revised actuarial standards.

60. It is considered that the benefits of the proposals outweigh these costs.

**Non-insurance activities**

**Status Quo and Problem**

61. There is currently no legislated limitation in New Zealand on insurers carrying out "non-insurance" activities in New Zealand.

62. It is potentially misleading to policyholders if an insurer undertakes significant business activities which do not fall within the definition of “insurance”. Significant activities of this nature may substantially change the nature and the risk profile of an insurer.

**Alternative Options**

63. The other alternatives considered in this area are as follows:

- Maintaining the status quo, which is no limitation on non-insurance activities conducted by insurers;
- a total ban on non-insurance activities by insurers; and
- full disclosure of non-insurance activities, with no limitation on such activities.

**Benefits of alternatives**

- Retaining the status quo would be very low cost on insurers;
- a total ban on non-insurance activities by insurers would best meet the regulatory objective; and
- disclosure alone would also be a low cost approach.

**Costs of alternatives**

- Maintaining the status quo could be potentially expensive to the industry because there are no effective measures to address the potential risks in this area;
- a total ban on non-insurance activities may be unnecessarily strict and costly for cases where non-insurance activities are minor, justified and unlikely to significantly affect the risk or financial positions of the insurer;
- full disclosure would notify, but do little to limit, the risks in this area.

64. The alternative options fail to meet the regulatory objectives of “effective risk identification, transparency and management” and “cost-effective regulation and supervision”.

**Preferred Option**

65. Ideally, insurers should not conduct non-insurance activities, so that the capital of insurers is not exposed to risks untypical for an insurer. However, there may be justifiable reasons for minor other activities by insurers. Accordingly, non-insurance activities will be allowed where neither the potential financial loss from such activities exceeds 2.5% of the insurer’s capital nor the gross income from such activities exceeds 2.5% of the insurer’s most recently reported annual gross premium income.

66. All non-insurance activities will require case-by-case assessment, as part of licensing and supervision, and will be subject to the approval of the Reserve Bank. This approval will only be given if the Bank is satisfied that the insurer's non-insurance activities will not compromise the financial strength or integrity of the insurer. Insurer's directors must attest, at least annually, that the above limits have not been exceeded.

67. Separate capitalisation of non-insurance activity is important and assets thus committed will be disallowed from inclusion in any calculation of the insurer's solvency.

68. The insurance prudential supervision legislation will provide an appropriate definition of non- insurance activities and the appropriate regulatory tests to apply when considering approval of these activities.

**Benefits of preferred option**

69. The key benefits of the preferred option, relative to the status quo, are likely to comprise:

- Insurers, and therefore policyholders, are not exposed to significant, untypical risks which are not related to insurance;
- the potential for financial distress, or even insurer failure, as a result of non-insurance risks is greatly reduced; and
- the activities and risk profile of insurers will substantially relate to insurance, which is the basis upon which licenses will be granted to insurers. This best protects the interests of policyholders and maximises transparency in the insurance sector.

**Costs and risks of preferred option**

70. There may be some compliance costs associated with this policy where non-insurance activities of insurers need to be discontinued or established under a separate corporate structure, but the extent of these costs is not known.

71. It is considered that the benefits of the proposals outweigh these costs.

**Amalgamations and transfers**

**Status Quo and Problem**

72. There is currently no insurance regulatory oversight in New Zealand which focuses on the protection of policyholders' interests in circumstances of corporate mergers, acquisitions, purchases, sales, and transfers involving insurers operating in the New Zealand market.

73. Corporate mergers, acquisitions, purchases, sales, transfers, or other corporate transactions ("corporate transactions") can significantly change the ownership of an insurer's policyholder liabilities. For example when two insurers merge or when one insurer makes a sale of a portfolio of policyholder liabilities to another insurer.

**Alternative Options**

74. The other alternatives considered in this area are as follows:

- Maintaining the status quo, which is no requirement for regulatory approval of amalgamations and transfers; and
- Reserve Bank approval for amalgamations and transfers only being required for transactions above a certain size.

**Benefits of alternatives**

- The status quo would be a very low cost approach; and
- Reserve Bank approval of transactions only above a certain size would also limit the compliance costs of this policy both for the Reserve Bank and insurers.

**Costs of alternatives**

- The status quo continues to expose policyholders to latent risks; and
- potential risks to policyholders would also exist for transactions that are not considered and approved by the Reserve Bank, under the second alternative above.

75. These options are considered unsuitable because they fail to meet the regulatory objectives of "effective risk identification and transparency", they do not adequately protect policyholders' interests and they may lead to a loss of policyholder confidence in the insurance sector.

**Preferred Option**

76. Reserve Bank prior approval of all "corporate transactions" will be required in addition to existing Companies Act, Takeovers Act and Income Tax Act responsibilities for such approvals.

**Benefits of preferred option**

77. The key benefits of the preferred option, relative to the status quo, are that:

- the policyholders of insurer(s) who are affected by a corporate transaction will not be significantly disadvantaged by the transaction; and
- there will be increased transparency and governance within the insurance sector as a result of the involvement of the prudential regulator.

**Costs and risks of preferred option**

78. There may be some compliance costs associated with this policy, with the costs partly depending upon the volume of transactions. The extent of the costs is not known.

79. It is considered that the benefits of the proposal outweigh these costs.

## Confidentiality of information

### The Problem

80. An essential component of an effective insurance prudential supervision regime is the gathering and assessment of information obtained about and from insurers. Appropriate protection over this information is required because much of this information will be confidential or commercially sensitive. Insurers may be concerned at the possibility that information supplied to the Reserve Bank may be subject to discovery by other parties.

### Alternative Option

81. The other alternative considered in this area is maintaining the status quo, which is no requirement to protect information obtained from or in respect of insurers.

### Benefits of alternative

82. The status quo would be a low cost approach as there would be no responsibilities placed upon the Reserve Bank to adequately safeguard information obtained from or in respect of insurers.

### Costs of alternative

83. This option could potentially impose significant costs on the insurance sector because relevant information might be withheld from the Reserve Bank by insurers – because of the possibility that information supplied to the Reserve Bank may be subject to discovery by other parties under the Official Information Act. Without all relevant information, the effectiveness of the Reserve Bank's role as prudential regulator may be compromised.

84. This option is considered unsuitable because it would potentially constrain full and open disclosure of prudential information from insurers and prevent achievement of the regulatory objective.

### Preferred Option

85. All prudential information provided to the Reserve Bank (which is not publicly disclosed as part of disclosure requirements) in respect of an insurer either by the insurer, the insurer's auditor or any other third party, or information obtained by the Bank in the use of its powers, or any related documents arising from or in relation to such prudential information will be strictly confidential and the proposed insurance prudential supervision legislation will contain provisions prohibiting the disclosure of such information except in certain defined circumstances.

86. Consistent with the Reserve Bank of New Zealand Act, confidential information can be released in specific limited circumstances, for example in statistical or summary form, and criminal offences will apply for the unauthorised release of information.

**Benefit of preferred option**

87. The key benefit of the preferred option, relative to the status quo, is that prohibiting the Reserve Bank from disclosing prudential information (except in restricted, permitted circumstances) is likely to encourage a more frank information flow between insurers and the Reserve Bank, to the benefit of the supervisory regime.

**Costs and risks of preferred option**

88. There will be some costs involved with applying this policy including the implementation of measures at the Reserve Bank to protect information received in respect of insurers.

89. It is considered that the benefits of the proposal outweigh these costs.

## Implementation and Review

90. Legislation will be required to implement the prudential requirements and regulatory powers arising from the preferred alternatives set out above. It is proposed that the legislation will take the form of a stand-alone Insurance (Prudential Supervision) Act, separate from the Reserve Bank of New Zealand Act. An Insurance (Prudential Supervision) Act will replace the need for the following statutes that collectively provide for the current prudential regulation and supervision of insurance:

- The Life Insurance Act 1908
- The Insurance Companies Deposits act 1953
- The Insurance Companies (Ratings and Inspections) Act 1994

91. It is intended that legislation to give effect to the insurance prudential regulatory framework will be introduced in 2009, with the legislation being passed at some point in 2010.

92. Implementation will include the development of appropriate co-ordination arrangements between the Reserve Bank and other New Zealand government agencies and - in respect of the prudential treatment of foreign-owned insurers - the Reserve Bank and home country supervisors.

## Consultation

93. A public consultation was released in September 2006 which described the overall proposals for the prudential regulation of the insurance sector (“Discussion Document”). This Discussion Document including comments on most of the issues which are described above and on which recommendations are made.

94. The Reserve Bank issued a consultation paper which discussed the issues set out within this paper in May 2008 (“Consultation Paper”). The Consultation Paper was distributed to a wide range of stakeholders including all insurers operating in New Zealand, including insurers that operate as branches of foreign insurers, the industry organisations representing insurers, all insurers who are not member of these bodies, the legal and accounting

professions, some overseas counterpart insurance regulatory bodies including Australian regulators, and relevant New Zealand government agencies. The preferred alternatives in this paper broadly reflect the preferred alternatives set out in the Consultation Paper.

95. The submissions received on the Consultation Paper were considered in developing the proposals set out in this paper. The Reserve Bank received a relatively strong level of engagement from a range of stakeholders, with approximately fifty submissions received. As well as individual responses, industry representative feedback has been obtained from the three main insurance industry bodies: the Investment Savings and Insurance Association of New Zealand, the Insurance Council of New Zealand and the Health Funds Association of New Zealand (representing the life, general and health insurance industries respectively), as well as the New Zealand Society of Actuaries. The overall response to the Consultation Paper was supportive in principle, with useful inputs received suggesting refinement in certain areas. There was a variety of opinions regarding the treatment of foreign branches. For all the other issues canvassed there was either good support or majority support for the Reserve Bank's preferred alternatives.

96. Following release of the Consultation Paper the Reserve Bank met or obtained feedback from the following government agencies and public sector bodies: Ministry of Economic Development, Treasury, the Securities Commission, Department of the Prime Minister and Cabinet, the Law Commission, the Ministry of Justice and the Office of the Ombudsmen. The following government agencies were consulted in the preparation of this paper: Treasury, the Ministry of Economic Development, the Department of Prime Minister and Cabinet and the Securities Commission.

97. It is anticipated that there will be further consultation with stakeholders as the prudential insurance legislation is developed.

## Government Departments/Agencies Consultation

98. This Cabinet paper, including the RIS, was prepared by the Reserve Bank of New Zealand. The following government agencies have been consulted on the proposals in this paper: Ministry of Economic Development, Treasury, the Securities Commission, Department of the Prime Minister and Cabinet, the Law Commission, the Ministry of Justice and the Office of the Ombudsmen.

99. The Ministry of Economic Development, Treasury, the Securities Commission, Department of the Prime Minister and Cabinet, the Law Commission, the Ministry of Justice and the Office of the Ombudsmen have not raised any significant matters of concern with the preferred options within this paper and the recommendations within the associated Cabinet paper.