Regulatory Impact Statement
Review of Financial Products and Providers: Prudential Regulation of Insurance

Executive Summary

1. The insurance sector comprises three broad product areas: life insurance, general insurance and health insurance, with some providers operating in one or more of these sectors and with some overlap between life and health insurance products. Each of the life, general and health sectors is characterised by a small number of large insurers with large market share and some quite small providers. Farmers Mutual is a major mutual provider of insurance and Southern Cross and Manchester Unity are friendly societies. There are a large number of small Friendly Societies who may also provide insurance. Australian ownership dominates the New Zealand life and general insurance sectors.

2. There are estimated to be several million policyholders, including households and business, and in relation to a wide range of insurance products. There is a wide range of size of insurance providers ranging from those with less than a million dollars of premium income to those with many hundreds of million dollars of premium income.

3. The current prudential regulatory regime is overseen by the Insurance and Superannuation Unit (ISU) in the Ministry of Economic Development. It is minimal in scope and the arrangements are inadequate in several respects. The deficiencies include: inconsistency in regulatory requirements and supervision across different sectors, the absence of minimum entry requirements and insufficient monitoring and enforcement powers for the current regulator. A public discussion document was released in September 2006 ("Discussion Document") which proposed some substantive changes to the regulation of insurers to address these problems, while still seeking to keep regulatory costs low and preserving competitive neutrality in the insurance sector.

4. A relatively light-handed, risk-based approach to regulation and supervision is considered to be the most appropriate response and the preferred approach to regulatory intervention. This would entail establishing minimum standards for insurance providers, both at the point of licensing and on an ongoing basis (including in relation to solvency and capital adequacy), regular monitoring by the Reserve Bank, powers to enforce compliance with regulatory requirements and fit and proper requirements for directors and certain senior management of insurers. Significant reliance would be placed on the directors' ability to manage their businesses, with the Reserve Bank ("the Bank") having a wide range of monitoring and intervention powers, used only as necessary to fulfil its regulatory objectives.

5. A relatively light-handed, risk-based, approach to regulation and supervision is considered to be the most appropriate approach to regulatory intervention. The preferred option would have the following main features:

   - All insurers would be required to be licensed by the Bank. Only entities that meet the required standards would be licensed, including standards relating to solvency and capital adequacy;

   - entities seeking a licence would also need to have demonstrable capacity to manage the insurer's business or proposed business prudently, and directors and senior

managers that meet fit and proper requirements (such as skills, experience and integrity);.

- in respect of the fit and proper requirements, where the Bank does use its right of veto regarding appointments of directors and senior management, there will be a right of appeal on natural justice grounds;
- licensing will also involve consideration of insurer ownership and place of incorporation, among other factors;
- the financial strength of insurers would be measured using minimum solvency and capital adequacy requirements, together with any additional calibration that may be required to recognise institution or sector risks. Insurers would be required to comply with minimum standards in relation to solvency and capital adequacy designed to promote a relatively low probability of default. These requirements would be modelled on appropriate international and industry standards, and will be developed in liaison with the insurance industry;
- insurers incorporated in New Zealand would be required to have a minimum capital – proposed to be $2 million;
- insurers would also be required to comply with other prudential requirements, potentially including a limit on exposures to related parties and risk management and governance requirements. The latter may include a minimum size of board, requirements for the composition of the board and restrictions relating to the constitution of the company. It is proposed that the Bank will have the powers under statute to set requirements in these areas;
- all insurance providers would be required to obtain and disclose a financial strength rating from a rating agency approved by the Bank, subject to an exemption from this requirement for small insurers (except for disaster and property insurers, who are already required to have a rating). It is proposed that insurers with annual gross premiums of less than $5 million would be exempted from the rating requirement;
- insurers will be required to meet an increased level of financial disclosure, including financial statement disclosures, under the Financial Reporting Act, and attestations signed by an insurer's directors as to the adequacy of the insurer's risk management systems and controls, its compliance with regulatory requirements and other relevant matters;
- the Reserve Bank would be empowered to obtain information on a regular basis from insurers to enable the Bank to monitor compliance with regulatory requirements and the financial condition of insurers. In addition, the Bank would be able to require additional information, which the Bank can require to be audited and appoint a third party to review any aspect of an insurer's operations; and
- the Reserve Bank would have the ability to exempt insurers or classes of insurers from requirements and the Bank would have distress and exit management powers.

6. The proposed regulatory and supervisory requirements will impose additional compliance costs on insurers, including the need to maintain structures to verify compliance with requirements, to maintain capital in line with minimum standards and to report regularly to the Bank. These costs are not expected to be significant relative to insurers' revenue

and profits and are not likely to affect the ability of insurers to continue to provide insurance services at current levels, although the impact on small insurers is likely to be greater than for the large insurers (on a proportional basis).

7. Regulatory requirements will place constraints on insurers' business operations to some degree because insurers will need to comply with capital adequacy and other requirements. These constraints are not expected to be significantly out of line with those generally imposed in comparable countries and, in some cases, will not be greater than insurers currently bear by adopting prudential standards imposed by parent supervisors.

Adequacy Statement

8. The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the adequacy criteria.

Status Quo and Problem

9. The insurance sector comprises three broad product areas: life insurance, general insurance and health insurance, with some providers operating in one or more of these sectors and with some overlap between life and health insurance products. Each of the life, general and health sectors is characterised by a small number of large insurers with large market share and some quite small providers. There are over a hundred commercial insurers, including some finance company groups who have insurance subsidiaries and some insurers who are in run-off (i.e. no longer writing new business). Farmers Mutual is a major mutual provider of insurance and Southern Cross and Manchester Unity are friendly societies. There are a large number of small Friendly Societies who may also provide insurance. Australian ownership dominates the New Zealand life and general insurance sectors. Some Australian-owned insurers operate as subsidiaries and some as branches. There are estimated to be several million policyholders, including households and business, and a wide range of insurance products. There is a wide range of size of insurance providers ranging from those with less than a million dollars of premium income to those with many hundreds of million dollars of premium income.

10. The current prudential regulatory regime is overseen by the ISU in the Ministry of Economic Development. Compared to other western jurisdictions it is minimal in scope, with the only significant prerequisite for registration being provision of a $500,000 deposit, which is held in trust. There is minimal reporting and minimal prudential oversight by the ISU. Disaster and property ("D and P") insurers must obtain and make public a credit rating from an approved rating agency.

11. The Ministry of Economic Development have responsibility for policy advice on market conduct issues. Under the financial service provider registration framework, as agreed to by Cabinet in June 2007, the Companies Office will be responsible for the registration of all insurers and the performance of negative assurance tests (criminal records and declared bankrupts) for an insurer's directors and senior managers, as required for under the Financial Action Task Force anti-money laundering requirements.

12. The role of the Securities Commission is to enforce any requirements relating to product disclosures, insurers' financial statements disclosures, advertisements and any other information disclosed to the market, for life insurance contracts with an investment element (covered by the Securities Act). Given the current relatively low use of life insurance contracts with an investment element, these arrangements may be reviewed.

The Securities Commission will also monitor the approved professional bodies who will oversee insurance financial intermediaries.

13. The Minister of Commerce will oversee consumer dispute resolution and the Ministry of Justice will establish anti-money laundering requirements which the Bank will interpret and administer.

14. Further details are provided below:

Deposit Requirement

15. Insurers carrying on insurance business in New Zealand are required to lodge a specified monetary deposit with the Public Trustee. This deposit requirement was established to provide protection to policyholders in the event of an insurer's failure, where the funds could then be distributed amongst policyholders of that provider.

16. Under the Insurance Companies Deposits Act 1953, a deposit for general and some other insurers of $500,000 is required. Other amounts apply to entities which paid deposits under the Insurance Companies Act 1940 and the Insurance Companies Deposits Amendment Act 1950. Under the Life Insurance Act 1908 a deposit of between $100,000 (1975) and $500,000 (1979 onwards) is required for life insurers depending on the year the deposit was made.) Also, under the Mutual Insurance Act 1955 deposits are required for mutual insurance associations relating to agriculture, depending on the line of business, from $10,000 to $45,000.

Ratings

17. Insurers offering disaster and property insurance (this includes loss or damage to tangible property, and due to natural disasters and fire caused by those disasters) in New Zealand are required under the Insurance Companies (Ratings and Inspections) Act 1994 to obtain a rating from one of the approved agencies (current approved ratings agencies are A.M Best, Standard and Poor's and Fitch Ratings). Each rating must be registered with the Registrar within five days of receipt, and disclosed to consumers prior to them entering into or renewing a contract of insurance. Any downgrade to the insurer's rating must be disclosed to the Registrar and to the public, within ten days of the downgrading. Those insurers failing to comply with the requirements can be subjected to monetary fines. Consumers have the right to avoid the contract if there is a failure to disclose a mandatory rating.

Insurance contracts

18. There are a number of statutes that specifically govern the contractual relationship between the insurer and policyholder, including the Life Insurance Act 1908, the Marine Insurance Act 1908, the Insurance Law Reform Act 1977 and the Insurance Law Reform Act 1985.

Deficiencies in the existing regulation

19. The Discussion Document highlighted the following deficiencies in the existing regulation of the insurance sector in New Zealand:

- The New Zealand approach is not consistent with international practice as outlined by the International Association of Insurance Supervisors (IAIS) and OECD which both promote risk-based solvency regimes. Jurisdictions such as Canada, UK, Australia and USA have all adopted such regimes. The International Monetary Fund raised a number of issues in this respect after their 2003 Financial Sector Assessment Program;

- there is no licensing procedure for providers of insurance, to act as a means of controlling the quality of providers, either on entry to the market or an ongoing basis;

- the requirement to lodge a deposit was originally intended to provide policyholder protection, but it is an ineffective tool for this purpose;

- the establishment of providers under different Acts causes different levels of governance requirement;

- financial strength ratings are required for disaster and property insurers only, which creates inconsistency across the sector;

- there are no formal requirements for the separation of business for each sector of insurance business which creates the possibility of intra-sector contagion risks;

- Ttere is no requirement that a foreign insurer's assets be kept separate from its home jurisdiction assets. This may mean that there is inadequate protection for New Zealand policyholder in the event of insolvency;

- not all insurance providers are required to publish financial statements under the Financial Reporting Act 1993. Requirements for public reporting of financial statements that are audited only apply to entities over a specific size; and

- the current regulator has limited monitoring, enforcement and distress management powers making it difficult to identify troubled insurers or to do anything to assist in their rehabilitation where they are identified.

20. The Discussion Document also commented on the status of the current regulatory arrangements and the key rationale for change, as follows:

    - The current regulatory arrangements are outdated, lack teeth and fall well short of international standards, but this is "not an industry in crisis" and that government should "continue a non-intrusive regulatory environment"; and

    - policyholders' interests are the prime motivation for insurance supervision and the supervision regime would have comprehensive coverage of all NZ-based insurers. The proposed regime would be broadly in line with international expectations and a core feature is legal / regulatory backing to actuarial standards.

21. Submissions to the consultation exercise expressed no material disagreement with this analysis. Most of those consulted agreed that there are deficiencies in the existing regulatory framework for insurance and saw merit in the proposed changes. However, some expressed concern over the risk of excessive regulation and supervision, with associated compliance costs and impact on market efficiency. The proposals presented in the Cabinet paper have taken into account these concerns and have sought to minimise

compliance and efficiency costs by promoting a relatively light-handed regulatory framework.

22. The retention of the status quo would have the benefit of minimising change and any new compliance costs but is not considered viable, for the following reasons:

    - For international acceptability, New Zealand should bring its regulatory regime up towards IAIS compliance;
    - failure of a major insurer could be catastrophic for (some) policyholders, especially those with significant claims outstanding at the time of collapse;
    - the existing regulatory arrangements do not adequately meet the proposed policy objective which is to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence;
    - the deficiencies described above impede the ability to maintain a sound and efficient insurance sector, undermine competitive neutrality in the sector and have the potential to lead to a misallocation of resources;
    - the existing regulatory arrangements do not adequately utilise the potential for market discipline to provide benefits to support the proposed regulatory policy objectives, because there is a lack of focus on the most important key financial metrics which must be prominently disclosed in order to ensure market discipline is operating as effectively as possible in the insurance market;
    - the absence of merit licensing requirements creates a risk that insurers may be operating who are not fit for business which could jeopardise their ability to meet their obligations towards policyholders; and
    - the lack of sufficient supervision, including an absence of prudential requirements relating to solvency and capital adequacy, means that there is little capacity to promote a minimum level of prudential soundness in the insurance sector.

23. As noted in the Discussion Document, the insurance sector is not in any apparent difficulty, notwithstanding the inadequacy of the regulatory framework. However, there is a strong case for implementing a more effective regulatory framework, given that the current framework does not provide any assurance that insurers will comply with appropriate prudential standards consistent with achieving a reasonable level of policyholder confidence. This creates a risk that policyholders may be less inclined to obtain insurance than in a situation where they have confidence in the regulatory arrangements for the sector. To the extent that there is a degree of under-insurance, this could have adverse implications for the economy by reducing the propensity for risk-taking by investors and other market participants.

24. The primary risk of not implementing prudential regulation is that New Zealand policyholders would be at risk of contracting with weaker insurers and that this will not be transparent either to the market or to the policyholders themselves. Insurance supports economic activity and policyholders must have a high level of confidence that the commitments made by insurers will be honoured. Well-designed prudential regulation can play an important role in supporting policyholder confidence and hence economic activity. In the absence of effective prudential regulation, the extent of weaker insurers

will be far less transparent and remedial action more difficult to take. Also ongoing confidence in the sector could be quickly undermined by even a small amount of unexpected distress where the government is ill equipped to take effective mitigating action, as is currently the case. In effect, the inadequacies in regulation and supervision of insurance expose potential risks for the Crown to the extent that they result in a higher risk of insurance failure and possible claims on the Crown's balance sheet.

25. Retention of the status quo also creates increased reputation risks for the New Zealand financial system, with possible consequences for a lower level of foreign investor participation in the economy to the extent that investors attach importance to a country's compliance with international standards and codes.

Outcomes sought and objectives of regulation

26. The three outcomes sought (which were included within the Discussion Document) from the improved regime for prudential regulation and supervision are:

- A sound and efficient insurance sector;
- confidence in the insurance sector; and
- not to unduly compromise or constrain contestability, competitiveness and innovation.

27. The outcomes create a balance between the need for effective regulation and regulatory requirements that are not unnecessarily onerous and which are therefore suitable for the New Zealand insurance sector.

28. The objective of prudential regulation is to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence. The objective is closely related to and supports the fulfilment of the outcomes sought.

Alternative Options

29. A number of options have been considered in assessing how the prudential regulation of the insurance sector could be improved to meet the proposed regulatory objective. These options are summarised below. The main criteria against which the options have been assessed are:

- Effectiveness in meeting policy objectives;
- maximising the benefits of strengthening market and self discipline (in order to effectively support increased regulatory discipline, which will occur as a result of the prudential supervision proposals);
- industry compliance costs;
- relevant international principles and guidance;
- administration costs and risks to government; and

- competitive neutrality and impact on market efficiency.

Alternative Options

30. **Option 1** – a prudential regime which relies solely on principles and guidance for its operation. This option would not involve licensing insurers or requiring them to comply with minimum prudential standards. It would also not involve regular monitoring by the Bank or the ability of the Bank to intervene in situations of imprudent management of an insurer's business. This option would also not include mandatory financial strength ratings or enhanced public disclosure by insurers.

    - Costs of option: The costs of this option on insurers may be relatively low if insurers were already compliant with the guidance and principles issued by the Bank. However, where insurers were not compliant, their compliance would attract a cost. In practice latent costs and risks are likely to be implicit in such an approach because interpretation and application of the principles by individual market participants could vary greatly. This would raise issues of competitive neutrality, create inconsistencies which are unlikely to meet the government's policy objectives, and would fail to provide the level of protection for policyholders that would be provided by licensing requirements, ongoing minimum prudential standards and regular monitoring and enforcement powers by the Reserve Bank.

    - Benefits of option: The benefits of this option are that it would rely on guiding principles and therefore would be very light-handed, allowing insurers a wide degree of discretion in respect of the way the Bank's principles and guidance were applied.

    - Why this option is not preferred: Whilst this option may appear to be attractive because of its relative simplicity of approach, it is considered unsuitable because it would not result in the following important elements of a prudential regime needed to meet the regulatory objective: standardised licensing requirements, effective standardised reporting requirements by insurers to the Bank, effective monitoring powers of the Bank, increased public disclosure and effective intervention powers to limit the impact of distress in the insurance sector.

31. **Option 2** – a prudential regime based solely on publicly disclosed financial statements prepared by insurers. Like Option 1, this option would not involve licensing insurers, applying minimum prudential standards, detailed monitoring by the Bank or the capacity of the Bank to intervene in situations where an insurer is not managing its affairs prudently.

    - Costs of option: This option would impose significant costs on insurers in terms of complying with the disclosure requirements. It would also entail costs for the government to educate policyholders and their agents on the disclosures and how to interpret them. There would also be a high cost associated with the monitoring, by the Bank, of the disclosure requirements made by insurers.

    - Benefits of option: As there would be no licensing or ongoing prudential requirements imposed upon insurers, apart from the disclosure requirements, this would limit the overall implementation and compliance cost of the regime. Another benefit is that insurers would not be unduly constrained by prudential requirements in the operation of their business.

- Why this option is not preferred: This option is considered unsuitable because it would rely almost entirely on market discipline and would fall well short of international best practice. It would also rely too heavily on consumers' ability to fully understand complex financial statements that are prepared by insurers. This option would fail to provide the protections for consumers associated with minimum prudential standards, including licensing and financial strength requirements. This option would also not result in effective monitoring powers of the Bank and effective intervention powers to limit the impact of distress in the insurance sector.

32. **Option 3** – a scheme whereby the government fully or partially guarantees policyholder losses in the event of an insurer failure. The option was considered both on a stand-alone basis and in conjunction with the other options described and the preferred option.

    - Costs of option: The cost of such a scheme could potentially be very large indeed and, as with any government guarantee scheme, there is the 'moral hazard' risk that both industry and consumers would not pay sufficient attention to risk. It would also reduce market disciplines on insurers. The costs and risks of this option for the government are high, given that it would involve the government effectively underwriting policyholder losses. In the event of a substantial insurer failing, this option would expose the government to a potential cost of tens of millions of dollars, depending on the size of the insurer, the extent of failure and the extent of risk lay-off by the government.

    - Benefits of option:The key benefits of this option is that it represents an arrangement that would be relatively transparent to policyholders and the market and would certainly offer some protection to policyholders, depending upon the degree of loss support provided.

    - Why this option is not preferred: The major disadvantage of this option is that it does not address the root cause of the distress (and it is therefore an ex-post solution) and is therefore only a partial solution to the problem requiring regulatory intervention. This option is also considered unsuitable because it would not provide the Bank with effective intervention powers to limit the impact of any distress in the insurance sector.

33. **Option** 4 - a prudential regime with very prescriptive standardised prudential requirements, which did not adequately cater for the different risks of insurance sectors – for example a higher level of hurdles for licensing, more prescriptive prudential and governance requirements, frequent and detailed reporting to the regulator, regular on-site supervisory inspections, and strong powers of intervention by the Bank to enforce compliance and investigate insurers.

    - Costs of option: As such an approach would be highly intrusive to business, the costs of this option to business would be very high and substantially more than the preferred option. Also cost to government would be substantially higher given the higher resourcing of the Bank that would be needed to regulate the insurance sector. This approach also carries the risk that too many requirements will dilute attention on the most important risks and other key issues that are critical to promote the prudential soundness of the insurance sector.

- Benefits of option: The benefits of this option would be that the requirements would be very prescriptive, detailed and certain. This might lower the risk of potential insurance failure, and therefore provide more effective protection to policyholders, but this is debateable and uncertain.

- Why this option is not preferred: This option is considered unsuitable because it is too costly, prescriptive and not risk-based. A regime that is not risk-based would fall short of international standards and best practice.

34. As part of the evaluation of the alternative options set out above, the following specific aspects of the prudential requirements have been evaluated, as set out below:

Definitions of insurance

35. There are alternative ways to construct the definition of insurance, for example: a distinction could be made between long term and short term insurance, with different prudential regulations for each class. The distinction between long and short term insurance has been rejected because it would be difficult to specify and is therefore not considered practicable. The definition of insurance could include product lists, but this is considered a cumbersome approach, which would be costly to administer. The definition and application of the prudential framework could make a distinction between retail and non-retail consumers of insurance. However, there would be significant additional costs and complexity which would be associated with this approach, for example the definition of retail and non-retail consumers. It could also be confusing to consumers and the market as to which prudential requirements applied to which category of insurer. The potential benefits of this approach are that it could better cater for the needs of retail and non-retail consumers, but this is not a strong argument because retail and non-retail consumers both need the same level of confidence in the insurance sector.

Licensing

36. A multiple licensing approach whereby the Bank would issue an individual licence in respect of each of life, health and general insurance, as applicable, to an insurer who conducted more than one type of insurance business was considered. This option has been rejected on the grounds of minimising the costs and complexity of the regime. Such an approach could also be confusing to consumers and other market participants – for some insurers more than one licence would be needed and the existence of several licences would need to be disclosed whereas under the preferred option only a single licence would be necessary.

Enhanced Solvency Standards Board

37. For solvency and capital adequacy standards (only), the Discussion Document proposed a new statutory body: the Enhanced Solvency Standards Board ("ESSB"). The ESSB would be comprised of industry and technical representatives and the Bank would also have a seat on the board. The ESSB would act between the Bank and the New Zealand Society of Actuaries ("NZSA"). The ESSB would instruct the NZSA to prepare standards, but the Bank would have the power of veto over proposed standards and the ability to prescribe standards if the ESSB did not develop appropriate standards. There was some industry support for the establishment of the ESSB during the consultation process but also some submissions that questioned the need for the Board. Following recent consultation with the main industry bodies and the New Zealand Society of Actuaries, it is considered that the new Board is not needed because:

- The Bank would have a responsibility to consult stakeholders on proposals in respect of solvency and capital adequacy. This requirement to consult, in the absence of the ESSB, was not explained in the Discussion Document;

- whilst the set up and ongoing cost, including the Bank's resource input, of establishing a new statutory body would not be high, it would unnecessarily add to the overall marginal cost of insurance prudential supervision to New Zealand; and

- it may compromise the independence of the NZSA if the NZSA were to sit on the Board, which was intended.

Financial strength ratings ("ratings")

38. Alternative options that have been considered and rejected in this area are:

    - Mandatory ratings for all insurers with no exemptions. This is considered to not properly cater for smaller insurers, where an exemption from a mandatory ratings requirement may be justified.

    - No mandatory ratings, but insurers would be required to disclose their rating if a rating was obtained voluntarily. This alternative has been rejected as it would not deliver a consistent approach across the insurance sector.

    - Retain mandatory ratings for disaster and property insurers and extend to all general insurers (i.e. this option would exclude health insurers and life insurers). This alternative has been rejected as it would not deliver a consistent approach across the insurance sector.

Risk management strategy

39. A requirement that insurers must have a risk management strategy has been considered and rejected on the grounds that this requirement would be too prescriptive and also costly for insurers to comply with.

Minimum capital requirement

40. In arriving at the $2 million minimum capital requirement included in the preferred option, regard has been had to the minimum capital requirement for Registered Deposit Takers of $2 million, the Bank's requirements for registered banks, and the requirements in Australia, which are A$5 million for general insurers and A$10 million for life insurers. A flexible approach to establishing the amount of minimum capital, with different levels of minimum capital for each insurance sector, has been rejected on the basis of competitive neutrality and simplicity of the regime, and in order to limit implementation and compliance costs. The disadvantage of this approach is that it would be inconsistent with the requirement for Registered Deposit Takers in New Zealand and insurers in Australia.

Alternative reporting requirements

41. The Discussion Document proposed that all insurers must publish a short form disclosure document (i.e. a Key Information Summary), but this was not well received by submitters on the Discussion Document. This requirement has been dropped in order to limit the compliance costs of the regime. Alternative frequencies for the production of Disclosure Statements (which mainly comprise the insurer's financial statements) of both three

monthly and annually were considered. A frequency of three monthly was considered too costly for insurers and an annual frequency was considered inappropriate because this would not provide sufficiently timely information to policyholders and other stakeholders.

Transition period

42. A more flexible approach to transition has been considered where the Bank would determine an appropriate transition period for an insurer. This case-by-case approach has been rejected on the grounds that it would raise issues of competitive neutrality and uncertainty in the market about which insurers were licensed at the introduction of the prudential requirements.

Preferred Option

43. A relatively light-handed, risk-based, approach to regulation and supervision is considered to be the most appropriate approach to regulatory intervention. The preferred option would have the following main features:

    - All insurers would be required to be licensed by the Bank. Only entities that meet the required standards would be licensed, including standards relating to solvency and capital adequacy, compliance with prudential standards, demonstrable capacity to manage the insurer's business or proposed business prudently, and directors and senior managers that meet fit and proper requirements (such as skills, experience and integrity).

44. In respect of the fit and proper requirements, where the Bank does use its right of veto regarding appointments of directors and senior management, there will be a right of appeal on natural justice grounds. The Bank will ensure that the legislation contains provisions along the following lines:

    - Fair procedure for any fit and proper vetting. This must ensure that the applicant:

        - knows the grounds upon which any unfavourable judgement is to be made; and

        - has the opportunity to be heard and to respond to allegations.

    - Because of the serious impact that an unfavourable finding can have on a person's career and reputation the decisions made by the regulator would be overseen by the Courts. Natural justice rights encompass the concept of an appeal and we envisage that fit and proper applicants may appeal to the District Court for a review of the Bank's decision.

45. Licensing will also involve consideration of insurer ownership and place of incorporation, among other factors.

46. Insurers incorporated in New Zealand would be required to have a minimum capital requirement to demonstrate shareholder commitment and the availability of sufficient financial resources, to underpin policyholder confidence – proposed to be $2 million.

47. All insurance providers would be required to obtain and disclose a financial strength rating from a rating agency approved by the Bank, subject to an exemption from this

requirement for small insurers (except for disaster and property insurers, who are already required to have a rating). It is proposed that insurers with annual gross premiums of less than $5 million would be exempted from the rating requirement.

48. Insurers will be required to meet an increased level of financial disclosure, including annual (and reduced form on a six monthly basis) financial statement disclosures, and attestations signed by an insurer's directors as to the adequacy of the insurer's risk management systems and controls, its compliance with regulatory requirements and other relevant matters.

49. The Reserve Bank would be empowered to obtain information on a regular basis from insurers to enable it to monitor compliance with regulatory requirements and the financial condition of insurers. In addition, the Bank would be able to require additional information, require that additional information to be audited and appoint a third party to review any aspect of an insurer's operations.

50. Where appropriate, the Bank will have the ability to establish licensing criteria by class of business, broad groupings of insurer product line or characteristics of provider, such as size or corporate form.

51. The licensing matters and licensing criteria will be applied both at the time of licensing and also on a continuous ongoing basis, to each licensed insurer. As part of licensing I also propose that the Bank has the ability to set conditions of licence, specific to the licensed insurer, in respect of the above licensing matters or licensing criteria. Insurers will be required to notify the Bank of any actual or potential breach of licensing conditions and the Bank will expect remedial action if the insurer is to retain its licence.

52. The financial strength of insurers would be measured using minimum solvency and capital adequacy requirements, together with any additional calibration that may be required to recognise institution or sector risks. These requirements would be modelled on appropriate international and industry standards, and will be developed in liaison with the insurance industry. There will be areas of similarity between these calculations across the life, health and general insurance industry sectors, but there will also necessarily be areas of difference to reflect different sector risks. The Bank will also have the ability to establish requirements above the minimum requirements by industry class or other distinction considered appropriate by the Bank. The detailed requirements in this area will be set out in regulation which will be developed in consultation with industry and other stakeholders. This will give legal backing to New Zealand actuarial standards and will provide a sound basis for ensuring the financial strength of the sector. Capital adequacy calculations further protect policyholders by requiring a level of financial strength over and above that required by solvency calculations. The Bank will not be compelled to adopt standards developed and issued by the New Zealand Society of Actuaries and it will only do so when it is satisfied that they are fully appropriate for the purposes of prudential regulation and supervision.

53. Subsidiaries of foreign insurers, may wish for reasons of cost and simplicity to use the same solvency and capital adequacy calculations that are prepared for their home regulator. Subsidiaries of foreign insurers can do so, provided the following conditions are met:

- the Bank must be satisfied that the calculations are at least as stringent as the New Zealand calculation method(s); and

- use of the home regulator’s calculation method must be clearly disclosed, including a statement that the calculations produce an output which is at least as high as New Zealand calculations.

54. The Bank has the power to establish specific requirements in relation to risk management using published principles or other guidance.

55. In respect of licensed insurers’ significant shareholders, where the Bank has any concerns it will have the ability not to grant a licence or to withdraw an existing licence.

56. Primary legislation will give the Bank the power to make regulations or publish principles or guidelines, as appropriate, relating to any matters of risk management or corporate governance. This may include, for example, matters relating to board size and composition, including independent directors, board committee structures and the ability of the Bank to regulate the content of insurers’ constitutions in order to meet the regulatory objective.

57. A limit on the extent of exposure that an insurer may have to connected parties to limit the risk of the insurer’s financial position being undermined by such exposures. This limit is likely to be expressed as a percentage of assets eligible for inclusion within solvency calculations, but further research and analysis will be performed to determine the appropriate limitation that is considered necessary in this area.

58. Each insurer must use a qualified actuary to arrive at the valuation of insurance liabilities and any other asset or liability required by New Zealand actuarial standards (i.e. those standards adopted by the Bank for its prudential requirements), included within an insurer’s financial accounts.

59. The Bank must have no objection to the actuary and auditor of the insurer, on grounds of professional misconduct, inappropriate experience or any other concerns which the Bank may have, and that there are no significant matters of an accounting or actuarial nature relating to the insurer which cause the Bank concern.

60. Each insurer must maintain satisfactory accounting systems, actuarial valuation and other actuarial practices and robust internal controls, including measures to ensure regulatory and professional compliance.

61. For foreign branches, the Bank must be satisfied that the home supervisor’s prudential requirements and home country legal and accounting requirements do not put New Zealand policyholders at risk.

62. To cater for other important matters there will be provision for additional licensing matters that are considered appropriate for the purposes of the Bank’s statutory objective to be specified in regulations. An example of such a matter could be insurers’ re-insurance requirements, but this is merely indicative of the type of issue which requirements could be established in respect of. This flexibility is needed to manage the prudential regime that is suitable both to New Zealand’s current purpose and in the future.

63. For insurers who are not writing new business - usually referred to as insurers who are in “run-off”- there be a different class of licence which prohibits the writing of new business. Such insurers will still be required to otherwise comply with standard licensing

matters and licensing criteria, unless exempted by the Bank. This will help to ensure that insurers in run-off still have the ability to meet any claims arising from their policyholders and other creditors. Insurers in run-off will also be monitored by the Bank. If at the introduction of these new prudential requirements some insurance businesses are placed in run-off, they will be treated in this manner by the Bank.

64. Licensed insurers must report to the Bank, in a timely manner, any significant changes to their financial condition, levels of risk, directors, senior management or any other changes to their business. This will be effected as a condition of licensing and also in the exercise of the Bank's monitoring powers.

65. The Bank will have the power to de-license an insurance entity, with the grounds for de-licensing specified in the Insurance (Prudential Supervision) Act.

66. The Bank has the power, at licensing of an insurer and on an ongoing basis, to dis-approve either the insurer's auditor or the insurer's actuary where the Bank has serious concerns about their professional competence or integrity.

67. The annual audit of an insurer must include a review by an actuary of the actuarial valuations and the required disclosures of an actuarial nature made within insurers' financial statements.

68. The Bank will have the power to require an insurer to prepare and give to the Bank reports on the insurer's financial, business and prudential affairs and/or a recovery plan as needed for prudential purposes.

69. The Bank may require information provided to it by insurers, for prudential purposes, to be audited at the insurer's expense.

70. The Bank will have the powers to:

    - perform on-site reviews;
    - initiate third party reviews, including an independent actuarial valuation;
    - request the insurer to arrange for the Bank to meet with third parties, such as the licensed insurer's auditors, in the presence of the licensed insurer;
    - call for meetings with the licensed insurer's board, directors and senior management; and
    - require insurers to comply with any other monitoring actions necessary for the Bank to fulfil its objectives.

71. The Bank may perform licensing, monitoring and other supervision arrangements both on a consolidated group basis and in respect of each solo insurance entity within the group.

72. The legislation will include a provision requiring auditors of licensed insurers to report any major concerns they may have about an insurer they audit to the Bank.

73. In circumstances where the insurer is in actual or potential distress, the Bank will have powers to take the following action, as appropriate to the circumstances of the distress to:

- appoint an investigator, to investigate any aspect of the business, financial or prudential affairs of the insurer;
- require the preparation and implementation of a recovery plan by a licensed insurer;
- give directions to an insurer or an associated person, including ceasing writing new business, removal of directors and management and any direction needed to meet the statutory objective; and
- de-license an insurer.

74. An insurer will be in distress if it is in actual or potential breach of its prudential requirements and is not able to satisfy the Bank that it will be able to return to compliance within a reasonable period of time.

75. In appropriate circumstances of insurer distress, the Bank may recommend statutory management of an insurer, and any associated person, under the Insurance (Prudential Supervision) Act to the Minister whose prior approval is required. The Bank will have an ability to direct the statutory manager in a manner which meets the Bank's statutory objective.

76. The Bank will be able to apply to the Courts to impose criminal penalties on the directors and officers of an insurer of maximum amounts set out in legislation and to bar individuals from insurance. The new Insurance (Prudential Supervision) Act will set out penalties for offences, on the basis that:

- fines on insurers be prescribed in a range of $500,000 to $2 million, depending on the severity of the offence;
- fines for directors and the Chief Executive Officer of an insurer be prescribed in the range of $50,000 to $200,000, depending on the severity of the offence;
- imprisonment terms for directors and senior managers be prescribed in the range of 3 to 18 months, depending on the severity of the offence; and
- fines in the range of $10,000 to $50,000 for lower level offences such as failure to provide information requested by the Bank within required timeframes.

77. The new Insurance (Prudential Supervision) Act will set out offences for failure to comply with regulatory requirements, including:

- failure by insurers to comply with the obligations imposed upon insurers by regulation, such as to have a financial strength rating;
- failure to comply with fit and proper requirements, such as employing a senior manager who has been vetoed or removed by the Bank; and
- failure to provide information requested by the Bank.

78. It is intended that legislation to give effect to the insurance prudential regulatory framework will be introduced in 2008, with the legislation being brought into force at some point in 2010. During this transition period all insurers must apply for a licence, which will only be granted once the Bank is satisfied that an insurer meets the prescribed licensing requirements. At the end of the transition period, insurers will be prohibited from operating without a licence, unless they have been specifically exempted from licensing requirements.

79. An Insurance (Prudential Supervision) Act will be created for the prudential regulation of insurance, distinct from the current Reserve Bank of New Zealand Act. This is because the objectives of regulating the insurance sector, as well as the functions of the Bank are sufficiently different from those for banking.

80. The new Act, focused on prudential and associated regulation of insurers would set out, among other matters:

    - the definition of insurance and insurer and the scope for exemptions;
    - the requirement for all providers of insurance to be licensed and supervised;
    - the powers of the prudential regulator and supervisor of insurers and the purposes for which those powers may be exercised;
    - insolvency and distress arrangements that apply distinctly to insurers.

81. An Insurance (Prudential Supervision) Act would replace the need for the following statutes that collectively provide for the current prudential regulation and supervision of insurance:

    - Parts 1 and 1A of the Life Insurance Act 1908;
    - Insurance Companies Deposits Act 1953; and
    - Insurance Companies (Ratings and Inspections) Act 1994.

82. Certain aspects of the framework will be enacted by secondary legislation, eg:

    - the amount of minimum capital;
    - financial strength requirements and limits on the nature and extent of connected lending and non-insurance activities;
    - corporate form;
    - risk management; and
    - governance and ownership.

83. The secondary legislation will take a form of regulations and deemed regulations. In some cases matters will be at the discretion of the Bank. This is because the rules upon which insurance supervision is based are technical and detailed, and in some cases required to be customised to particular institutions or lines of business. The precise nature of the

regulatory approach will be determined in the drafting process in conjunction with Parliamentary Council Office.

84. In addition to creating a new Act and repealing a number of Acts, elements of the framework may be enacted through consequential amendments to other Acts, including the following:

    - The Financial Reporting Act 1993;
    - The Companies Act 1993;
    - The Corporations (Investigation and Management) Act 1989;
    - The Marine Insurance Act 1908; and
    - The Mutual Insurance Act 1955.

85. The Minister of Finance will seek a priority for a Insurance (Prudential Supervision) Bill on the 2008 Legislation Programme.

Benefits of preferred option

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

    - Greater consistency in supervisory requirements across the insurance sector and minimum financial strength requirements that will assist in promoting prudential soundness of the insurance sector and policyholder confidence in dealing with insurance providers.
    - Prudential requirements will help to promote sound risk management practices by insurers and promote a relatively low probability of default consistent with policyholder interests.
    - A risk-based supervision regime will allow the Bank to establish sector-specific (general, life and health insurance) and institutional requirements which are appropriate to ensure a consistent level of policyholder confidence throughout the sector.
    - Providing all policyholders, financial intermediaries and market analysts with a much-improved capacity to identify and compare risk in the insurance sector, via ratings and other salient disclosures.
    - Ratings and increased financial disclosure are expected to strengthen market and self disciplines in the insurance sector, which will also assist in promoting sound governance and risk management practices by insurers. Ratings provide a relatively simple metric summarising, in one measure, the risk of an insurer defaulting on its financial obligations. A rating therefore reduces the need for policyholders to try to understand more complex and voluminous published financial information.
    - Ratings provide a sound independent appraisal of an insurer's financial strength, risk profile, quality of management and business model. This would facilitate more

efficient, and potentially more productive, resource allocation in the insurance sector and help to promote financial system soundness.

- Ratings would also strengthen market disciplines in the insurance sector and improve the self discipline of insurers to strengthen their business where shortcomings are identified by the rating process. For a ratings requirement to be effective, it will need to be accompanied by a requirement for insurers to make clear, prominent and user-friendly public disclosure of their ratings, which is being proposed.

- The use of ratings is also 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.

- The regime will better meet international requirements and expectations.

- In the event of distress in the sector, the 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.

Costs and risks of preferred option

87. The overall marginal cost of the regime should not be high for two reasons. It is designed as light-handed, without prescriptive requirements, and the foreign-owned insurers operating in New Zealand are already regulated by their home country supervisors. It is possible that the main incidence of compliance cost will fall upon those insurers where improvement is needed to better support the confidence which policyholders must have in the sector. This incidence of this compliance cost (i.e. where improvement is required) may fall on either New Zealand based insurers or foreign owned insurers. However, these costs may be less for foreign-owned insurers that are already compliant with prudential regulation requirements of their home country supervisor which are at least as stringent as those required by the Bank. The detailed costs and risks of the preferred option are expected to comprise those set out below:

    - The proposed regulatory and supervisory requirements will impose additional compliance costs on insurers, including the need to maintain structures to verify compliance with requirements, to maintain capital in line with minimum standards and to report regularly to the Bank. These costs are not expected to be significant relative to insurers' revenue and profits and are not likely to affect the ability of insurers to continue to provide insurance services at current levels, although the impact on small insurers is likely to be greater than for the large insurers (on a proportional basis).

    - Regulatory requirements will place constraints on insurers' business operations to some degree in order to comply with capital adequacy and other requirements. These constraints are not expected to be significantly out of line with those generally imposed in comparable countries and, in some cases, will not be greater than insurers currently bear by adopting prudential standards imposed by parent supervisors.

    - The public disclosure requirements will impose some additional costs on insurers, but these are not expected to be significant relative to their revenue and profitability.

- The proposed mandatory rating requirement will impose additional costs on those insurers without ratings, but not for those already rated by approved rating agencies. Ratings are mandatory for disaster and property insurance, with A.M. Best, Standard & Poor's and Fitch Ratings being the current approved rating agencies. Also, many life insurers already have a credit rating on a voluntary basis. Accordingly, the marginal cost change should not be overly significant at an industry level. For those insurers required to obtain a credit rating under the proposed requirements, the mandatory credit rating requirement will impose additional costs on insurers. These are expected to be relatively modest in relation to insurers' revenue and assets. It is anticipated that the annual cost to insurers would be in the range of $30,000-$50,000. In addition, there would be indirect costs associated with ratings, such as management time and the provision of information. In some cases, the costs of ratings will be absorbed by insurance providers, while in other cases some or all of the costs might be passed on to policyholders. In the latter case, the cost impact on policyholders is expected to be very small, given that the costs would be spread across many thousands of policyholders. However, to mitigate the cost of ratings there will be an automatic exemption for those insurers, except property and disaster insurers, with annual gross premium income of less than $5 million.

- Ratings could result in some higher risk insurers being identified. This could place commercial pressure on some insurers and potentially lead to consolidation in parts of the insurance sector, including the possibility of some insurers merging with others or leaving the sector. This is not a negative outcome for the insurance sector or for policyholders as highlighting the risks within the sector will help to ensure a soundly managed insurance sector. However, if this does occur, there will be costs to policyholders of changing insurance provider.

- There may be some public education costs associated with bedding down the ratings regime. The costs of this are likely to be shared between government and the private sector and are likely to be modest given that the education campaigns can be delivered at relatively low cost and as part of a broader financial literacy initiative.

- The proposal to exempt small insurers from the need to have a rating will, for those insurers exempted, significantly reduce the compliance costs of the prudential requirements and will also reduce the overall cost of the mandatory ratings requirement.

- The Bank has the power to require information from insurers, which the Bank can require to be audited, at the insurer's expense.

- Minimum prudential, governance and fit and proper requirements will impose some compliance costs and operational constraints on insurers, but the proposed requirements are considered quite moderate and are not expected to impose significant costs. The fit and proper requirements will involve a base compliance cost as insurers will need to maintain a policy and report against it to the Bank. Where the Bank has questions or requires additional information in relation to the operation of the fit and proper policy or in respect of persons within the scope of the policy, this may involve additional compliance costs.

- There may also be costs in relation to the following aspects of the proposals, but these cannot be quantified and overall are not expected to be significant: the Bank has the power to veto the appointment or require a change to the insurer's auditor and actuary

on grounds such as professional misconduct or inappropriate experience; the Bank has the power to regulate the content of the constitutions of insurers in order to meet the objectives of prudential supervision; that insurers will be required to publish their salient financial strength indicators, as determined by the Bank, prominently on their websites; the Bank will administer and enforce the new disclosures for all insurers; that each licensed insurer must use a qualified actuary to arrive at the valuation of insurance liabilities and any other asset or liability included within an insurer's financial statements required by New Zealand actuarial standards (i.e. those standards adopted by the Bank for its prudential requirements); the annual audit of an insurer must include a review by an actuary of the actuarial valuations and the required disclosures of an actuarial nature made within insurers' financial statements; the Bank's power to establish reporting requirements to the Bank, to be met by all insurers to cover the information needed by the Bank for prudential supervision, including, on an ongoing basis, changes to a licensed insurer's financial circumstances, levels of risk, changes to directors, senior management or other changes to their business; the Bank will have the power to obtain any information from insurers, and any associated person, it needs in order to fulfil its statutory objective; the Bank will have the power to require an insurer to prepare and give to the Bank reports on the insurer's financial, business and prudential affairs and/or a recovery plan as needed for prudential purposes; and the Bank's powers to:

- perform on-site reviews;
- initiate third party reviews, including an independent actuarial valuation;
- request the insurer to arrange for the Bank to meet with third parties, such as the licensed insurer's auditors, in the presence of the licensed insurer;
- call for meetings with the licensed insurer's board, directors and senior management.

88. The Reserve Bank will not be charging fees for its regulatory functions.

89. There may be costs in respect of a reduction in the number of market participants, the passing of compliance costs on to policyholders and the licensing entry requirements representing a barrier to entry for potential new market participants. However, these potential costs are unknown.

90. There will be transition costs for some insurers to comply with the proposed requirements – effectively implementing any measures needed to satisfy the Bank regarding matters in respect of licensing for example addressing any deficiency in financial strength. A transition period is envisaged, between 2008 and 2010, in order to provide sufficient lead-in time for insurers to meet the new prudential standards, which will to an extent ameliorate the compliance costs.

91. The fiscal costs for the Reserve Bank associated with the insurance proposals are estimated to be in the range of $2.5 million to $4 million per annum on an ongoing basis, once the prudential regulation proposals for insurance have been fully implemented. This funding will be obtained through the Bank's funding agreement.

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

Implementation and Review

93. Legislation will be required to implement the insurance arrangements. It is proposed that the legislation will take the form of a stand-alone Act, separate from the Reserve Bank of New Zealand Act.

94. It is intended that legislation to give effect to the insurance prudential regulatory framework will be introduced in 2008, with the legislation being brought into force at some point in 2010. During this transition period all insurers must apply for a licence, which will only be granted once the Bank is satisfied that an insurer meets the prescribed licensing conditions. At the end of the transition period, insurers will be prohibited from operating without a licence, unless they have been specifically exempted from licensing requirements.

95. Implementation of the arrangements will include the development of appropriate and transparent co-ordination arrangements between the Reserve Bank, Securities Commission and the Ministry of Economic Development.

96. Regulations made under the new Insurance (Prudential Supervision) Act would be subject to full consultation with stakeholders. Regulations are likely to include those relating to minimum capital and solvency and capital adequacy requirements.

Consultation

97. Consultation leading to these proposals involved the following elements which are described further below:

    - The establishment of two Insurance Advisory Groups (one in Auckland and one in Wellington), with several meetings held by each Advisory Group, mainly in 2006. The groups focused both on problem identification and preliminary assessment of policy options;

    - The Discussion Document released in September 2006 which described the proposals for the prudential regulation of the insurance sector;

    - Individual consultation with industry bodies and other stakeholders; and

    - Inter-agency consultation with the Ministry of Economic Development, the Treasury and the Securities Commission.

    - Targeted consultation was undertaken with several industry experts using an Advisory Group process. These Advisory Groups operated as a sounding board for policy development in advance of the preparation of the Discussion Document and as the Discussion Document was being prepared. The Discussion Document that was subsequently released reflected appropriate technical input and other recommendations and comments raised during this Advisory Group process. The Reserve Bank of New Zealand was also involved in the Insurance Advisory Group process and provided comments on the Discussion Document to the Ministry of Economic Development.

    - Public consultation was undertaken using the Discussion Document referred to above and which was entitled: “Review of Financial Products and Providers: Insurance”.

The submissions received on the Discussion Document were fully considered upon receipt and during further analysis work performed by officials in developing the proposals set out in this paper. Submissions were generally supportive of the proposals, although some raised concerns over whether licensing and minimum prudential requirements are necessary, the risks of excessively intrusive regulation and supervision, and the potential compliance costs associated with the proposals. These concerns have been addressed by designing the proposals in ways that retain a relatively light-handed approach to regulation and supervision.

98. This Cabinet paper is more focussed, compared to the Discussion Document, regarding the proposals to prudentially regulate the insurance sector. In developing the proposals set out in this Cabinet paper, there has been further consultation with the main New Zealand insurance industry bodies (representing the life, health and general insurance sectors), the Australian Prudential Regulation Authority, the New Zealand Society of Actuaries and some other stakeholders.

99. Given that some of the detailed regulatory requirements are intended to be set out in regulations, there will be thorough consultation with stakeholders at the time those regulations are prepared.

Government Departments/Agencies Consultation

100. 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 and the Securities Commission.

101. The Ministry of Economic Development, Treasury and the Securities Commission have not raised any significant matters of concern with the proposals outlined within the preferred option.