

CABINET ECONOMIC DEVELOPMENT COMMITTEE

**REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: PRUDENTIAL REGULATION
OF INSURANCE**

PROPOSAL

1. In September 2006 a public discussion document was released regarding the proposed prudential and market conduct regulation for the insurance sector (“Discussion Document”). In June this year, the Committee agreed that the Reserve Bank (“Bank”) will be the prudential regulator and supervisor of the insurance sector. This paper sets out proposals for the prudential regulation and supervision of the insurance sector and the legislative powers that the Bank will need to manage its responsibilities. For several regulatory matters, such as solvency requirements and fit and proper requirements, it is not appropriate to articulate detailed requirements within legislation. These matters will be best dealt with by separate regulations, conditions of licence, notices or guidance published by the Bank.
2. A separate paper is being tabled today which recommends amendments to the market conduct regulation of the insurance sector: this aspect of regulation will be taken forward in parallel with the prudential regulation requirements. This paper seeks approval for the submission of drafting instructions to Parliamentary Counsel Office on the basis of the proposals outlined within this paper. The proposals are broadly consistent with those set out in the Discussion Document, but this paper contains more detail about the nature of the Reserve Bank’s proposed requirements and powers.
3. A subsequent paper will be brought to the Committee, by 31 July 2008, for agreement on some specific matters that I have requested officials to report back on together with any remaining details of the prudential supervision regime which Cabinet need to be aware of.

EXECUTIVE SUMMARY

4. The current regulatory arrangements for insurance providers (“insurers”) 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. The Discussion Document proposed some substantive changes to the regulation of insurers to address these problems, while seeking to keep regulatory costs low and preserving competitive neutrality in the insurance sector. The proposals:
 - included a requirement for all insurers to be licensed and to meet minimum prudential requirements, both at licensing and on an ongoing basis;
 - were aimed at promoting a sound and efficient financial system, by ensuring all insurers meet a transparent set of prudential requirements designed to promote policyholder confidence in the soundness of the insurance sector;
 - sought to provide policyholders with a clearer basis for distinguishing between lower-risk and higher-risk insurers; and

- aimed to provide the regulator with sufficient powers to resolve the distress or failure of an insurer in an orderly and timely manner, with minimum disruption to policyholders.
5. Most submissions to the Discussion Document focused on specific details and did not express fundamental disagreement with the need for reform and the overall intent of the proposals. Officials have assessed submissions received on the proposals and undertaken further analysis to refine the proposed arrangements for prudential supervision. One notable change to the proposals set out within the Discussion Document is that the proposal to establish a new statutory body, whose role was to approve solvency and capital adequacy standards, is now not proposed. Whilst the cost of such a body would not be high, it would unnecessarily add to the overall marginal cost of these proposals.
6. Accordingly, I am recommending that the Committee agree to the details of the insurance regulatory and supervision framework, as set out in the recommendations section of this paper, with the following main features:
- a. I am recommending a relatively light-handed approach to supervision and regulation of the insurance sector, with a view to minimising compliance costs and regulatory distortions. This reflects a risk-based approach in calibrating the regime and the level of the regulator's powers. Although the current level of regulation is not adequate to address the potential risks to policyholders, the risk of failure is lower than for certain parts of the non-bank deposit taking sector, for example.
 - b. The outcomes sought are the maintenance of a sound and efficient insurance sector, policyholder confidence in the insurance sector and not to unduly compromise or constrain contestability, competitiveness and innovation. The objective of regulation is "to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence".
 - c. The overall approach to insurance regulation is intended to place significant reliance on strong self discipline, including director responsibility, and published financial statements, which will include a director attestation statement. Licensing and supervision will be applied on a competitively neutral basis. Risk-based monitoring by the Bank will be primarily off-site, using regular returns provided by insurers, and will focus on those insurers who might be carrying too much risk or insufficient capital. However, the Bank will have a range of necessary additional monitoring powers, including powers to perform on-site inspections, request any information required, initiate third party reviews, meet with third parties on a tri-lateral basis and request an independent actuarial valuation. Insurers' auditors will be required to report any major concerns to the Bank.
 - d. All providers of insurance with a physical presence in New Zealand including overseas providers with an agent-based presence will be covered by the prudential regulation framework, supported by appropriate definitions of insurance and insurance provider. However, the Bank will have appropriate powers to exempt activities or institutions that fall within the scope of the legal definitions but should not be subject to prudential regulation because this is an unintended consequence. For licensed insurance providers, the Bank will have exemption powers covering any requirements of the proposed regime, but these will only be exercised where a justifiable case exists.
 - e. Licensing will be on the basis of criteria which primarily focus on insurers' capacity to manage their business and risks and sufficient financial strength. There will be a

minimum capital requirement of \$2m for all insurers, with an ability to amend this amount by regulation.

- f. A less onerous regime has been considered for smaller institutions that provide insurance, but this has been rejected, following analysis and consultation by officials. Whilst the compliance costs for smaller insurers may be reduced by such an approach, there are additional costs which outweigh this potential advantage: competitive neutrality would be compromised, ceteris paribus smaller institutions are typically more risky than larger institutions and there are design and implementation costs associated with a separate treatment for smaller insurers.
- g. New Zealand actuarial standards relating to insurers' solvency, liability valuation and other aspects financial strength, adopted by the Bank for the purposes of its prudential regulations, will be given the force of law. Minimum solvency and capital adequacy ratios will be established for the insurance sector and there will be flexibility to vary requirements for individual institutions, but only where warranted. Foreign insurers can use home regulator calculations provided the Bank is satisfied with the approach used. More detailed work in this area will be conducted next year in consultation with industry. As part of this work I have asked officials to consider whether sophisticated insurers will be permitted to apply to use statistical models to meet prudential solvency and capital adequacy requirements. This will meet international best practice and may develop a stronger link between economic and regulatory capital.
- h. Financial strength ratings, from an approved ratings agency, will be mandatory for insurers. However, I am proposing that insurers with annual gross premium income under \$5 million will be exempted from the rating requirement, except for property and disaster insurers who are already required to obtain a rating.
- i. Insurers will be required to maintain policies and procedures to ensure that they evaluate the suitability and integrity of prospective directors and certain specified senior managers, with the ability to vary the list of specified senior managers by way of regulation. Subject to natural justice requirements, the Bank will have the power to veto proposed appointments to these positions and to remove appointees from office if already appointed, where the Bank is satisfied that they do not meet the suitability and integrity criteria. These criteria will be developed in consultation with industry and will be set out in principles or other guidance issued by the Bank.
- j. I am also proposing that the Bank can veto the appointment or require a change to the insurer's auditor and actuary where it has serious concerns.
- k. For foreign insurers operating in New Zealand who are fully compliant with their home country regulator's prudential requirements, my intention is to minimise the potential compliance costs of the regime, to the extent possible. Where the Bank is satisfied with the adequacy of the home country regulator's prudential requirements, the Bank will have the discretion to accept compliance with these requirements in place of compliance with its own requirements.
- l. I am recommending that the legislation empower the Bank to be able to take a range of crisis response actions, appropriate to the circumstances, in order to meet the objectives of the legislation. The powers that I am proposing are the appointment of an investigator by the Bank, the Bank giving directions to the insurer, requiring the insurer to prepare a recovery plan demonstrating how an unsatisfactory financial position or

other matter of concern will be addressed, the ability of the Bank to de-license the insurer and place an insurer into statutory management, under the new prudential supervision insurance legislation. The agreement of the Minister will be required to place an insurer into statutory management.

7. The proposed regulatory framework for the insurance sector will require legislation and I propose that a new prudential Insurance Act will be created, which will include the ability to make supporting regulations and for the Bank make conditions of licence specific to individual insurers, to issue notices to insurers and to publish principles and other guidance in respect of prudential regulation.
8. 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.

Background

Proposals released last year

9. A Discussion Document was released in September 2006, which was one of the suite of Review of Financial Products and Providers ("RFPP") discussion papers, relating to the proposed prudential and market conduct regulation of the insurance sector. The Discussion Document highlighted the following deficiencies in the existing regulation of the insurance sector in New Zealand:
 - 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 intended to provide a degree of policyholder protection, but it is an ineffective and outdated tool for this purpose;
 - the treatment of providers under different Acts causes different levels of governance requirements;
 - 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 class of insurance business using separate legal entities or accounting requirements which creates the possibility of contagion between classes of insurance;
 - there is no requirement that a foreign insurer's assets be kept separate from its home jurisdiction assets. This may provide inadequate protection for New Zealand policyholder interests in insolvency;
 - not all insurance providers are required to report 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 (the Insurance and Superannuation Unit in the Ministry of Economic Development) has limited monitoring, enforcement and distress management powers.
10. 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, are not comprehensive 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”.
- 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.

11. The main results of the consultation exercise were that most submitters did not express fundamental disagreement with the overall thrust of the proposals. However, there was concern that the style of regulation will be prescriptive and onerous (although the proposals in the Discussion Document were relatively light-handed) and likely to increase the cost of insurance for consumers. The proposals within this paper are broadly consistent with the regulatory approach and proposals outlined within the Discussion Document.

Supervisory Authority for Non-Bank sector

12. Cabinet has decided that there should be a single prudential regulatory authority for the non-bank sector, including insurance, and decided in June 2007 that this authority should be the Reserve Bank (refer to EDC Min 07 11/14, confirmed by CAB Min 07 21/4). Cabinet have seen the Discussion Document, but have not seen any papers on the proposed arrangements for insurance regulation since then.
13. There are synergies and efficiencies in having one regulator with prudential regulatory responsibility for banks, insurers and Registered Deposit Takers (“RDTs”). There is also a need for a degree of consistency in prudential regulation across some of these categories of financial institution, including in respect of fit and proper requirements, ratings and corporate governance.
14. As the prudential regulator and supervisor, the Reserve Bank will be the authority that:
- a) licenses and de-licenses insurers, subject to appropriate checks and balances;
 - b) prescribes and enforces compliance with the regulatory prudential requirements, including the financial strength rating and disclosure requirements;
 - c) applies the fit and proper requirements to directors and senior managers;
 - d) can intervene in the situation of distress or potential failure of a licensed insurer.

Industry structure

15. 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 product areas 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 owned

entities dominate in the New Zealand life and general insurance sectors. These operate via a mixture of subsidiaries and branches.

Responsibilities of other Government Agencies

16. 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 the insurer's directors and senior managers, as required for FAFT anti-money laundering requirements.
17. 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. 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.
18. The division of responsibilities across agencies is structured no differently for insurers than for other parts of the financial sector such as RDTs. As such, it is not as complex as it appears and should be well understood by the agencies and stakeholders.

Trans-Tasman harmonisation

19. In developing these proposals, the Reserve Bank has consulted with the Australian Prudential Regulation Authority ("APRA") and the Bank intends to work closely with APRA to achieve an efficient home/host supervisory approach for Australian owned insurers operating in New Zealand. This will help to achieve wider trans-Tasman harmonisation objectives.

INTERNATIONAL GUIDANCE AND OTHER COUNTRIES' REGIMES

20. The primary intention of the regulatory regime for insurance is that it needs to be appropriate for New Zealand conditions. At the same time there is a need to ensure that the regime is developed having regard to appropriate international best practice. The International Association of Insurance Supervisors ("IAIS") principles are the best source of international guidance in this area. I believe the most important elements of these principles are covered by the proposed regime, for example the Bank's ability to establish licensing requirements and the measurement of financial strength using solvency and capital adequacy calculations. However, the proposed regime may not be fully compliant with several aspects of IAIS principles, for example the IAIS requirements contain an expectation that the regulator will perform on-site inspections. However, the IAIS requirements are not legally binding and I consider the prudential requirements proposed are an appropriate light-handed regime which is appropriate for New Zealand.
21. The regime proposed has the same key elements as that used in Australia and the U.K., but these countries use regular on-site examinations, require more reporting to the supervisor than is proposed here and typically have greater prescription in their requirements.

PROPOSED CHANGES TO INSURANCE REGULATION

22. In light of the submissions and further consideration by officials, I am proposing a regulatory framework that is appropriate to the needs of New Zealand policyholders and other stakeholders.
23. I believe the key benefits of the overall regime are that they better align New Zealand requirements with international standards and that they provide a much greater level of transparency and certainty to policyholders.
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 is not 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, it may be difficult to identify weaker insurers and remedial action may be more difficult to take. I would add that ongoing confidence in a sector can be quickly undermined by even a small amount of unexpected distress where the supervisor is ill equipped to take effective mitigating action.
25. The regime is a holistic one, drawing on international standards, and, as a whole, is fully justified against any necessary establishment and compliance costs. I can say that 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 rightly fall upon those insurers where improvement is needed to better support the confidence which policyholders must have in the sector.
26. The proposals are set out below. In some specific areas, where indicated, more detailed proposals will be brought to Cabinet for approval by 31 July, 2008.

Outcomes sought

27. Whilst the outcomes sought will not be explicit within the new legislation or regulations, nevertheless the Bank and Cabinet need to ensure the objectives of the legislation will result, to the extent possible, in the desired outcomes. The three outcomes that I am proposing, which were included within the 2006 Discussion Document, are:
 - a) a sound and efficient insurance sector;
 - b) confidence in the insurance sector; and
 - c) not to unduly compromise or constrain contestability, competitiveness and innovation.

Objectives of regulation

28. The Discussion Document stated that the three objectives of regulation should be to:
 - promote policyholder confidence;
 - encourage soundly governed insurers; and
 - ensure the timely and orderly resolution of distressed insurers.

29. The objectives of the prudential regulation of insurance will be stated in legislation and the Bank will be required to exercise many of its proposed powers by reference to these objectives, which necessarily must be sufficiently broad. I am seeking to ensure the strengthening of the weakest insurers within the sector (those with a high probability of default), or their exit if satisfactory improvements cannot be made.
30. **Policyholder confidence.** Policyholder protection is a key driver for prudential supervision of the insurance sector. I recommend the broader objective of “promoting policyholder confidence” because this does not imply insulating policyholders from loss, or providing an assurance to policyholders or others that all insurers are of equal risk, or seeking to regulate to that outcome.
31. **Soundness and efficiency.** Soundness and efficiency of the insurance sector will help to achieve policyholder confidence and I believe that it is important that the Bank has objectives to maintain the soundness and efficiency of the insurance sector that are consistent with the Bank’s responsibilities towards the banking sector.
32. These objectives will be achieved using appropriate powers stated within the legislation and which are detailed within this paper. The Bank’s powers must be appropriate to fully discharge its wide-ranging responsibilities towards the sector, which includes the ability to define insurance activity, establish appropriate licensing conditions, disclosure and monitoring requirements and necessary intervention and distress management courses of action.
33. I consider that sufficient financial strength of each insurance provider, compared to the level of risk, is of primary importance to help to ensure the soundness of the insurance sector and underpin policyholder confidence. Insurers should also have sound governance arrangements and risk management practices to effectively manage their business and levels of risk. In the exercise of its powers and practices, the Bank will be seeking to achieve an insurance sector which is comprised of insurers with a relatively low risk of default. I am proposing that there should be transparent disclosure of risks in the sector and for insurers whose risks are considered by the Bank to be too high should not be allowed to continue operating unless their level of risk is reduced to acceptable levels.
34. The use of mandatory financial strength ratings in the sector will provide an independent measure of levels of risk, sufficiency of financial strength and the effectiveness of risk management within the insurance sector. Financial strength ratings will also provide policyholders and financial intermediaries with an ability to more easily compare the risk profiles and financial strength of alternative insurance providers, which will help to ensure that policyholders are well informed and have confidence in the insurance sector.
35. It is not the Bank’s role, as regulator of the insurance sector, to eliminate the potential for insurance entities to fail: this would certainly be an unrealistic objective. However, where situations of distress or exit do occur, the Bank’s role is to ensure, to the extent possible, this occurs in an orderly manner so as to minimise any adverse impacts on policyholders and the wider insurance sector.
36. Drawing these three themes together I propose that the objective for the prudential supervision of the insurance sector will be: to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence.

Scope of regulation and definition of insurance

37. I am proposing that all providers of insurance in New Zealand are subject to prudential regulation and, in addition, market conduct regulation, so that policyholders can have confidence that the obligations of insurers will be fulfilled irrespective of the size or corporate form of the insurance provider.
38. To ensure that all providers of insurance are subject to prudential supervision (subject to any exemptions granted by the Reserve Bank), I am proposing a comprehensive definition of insurance, such that the insurance supervisory framework will apply to all providers of insurance operating within New Zealand, including life, general and health insurers. The legislation will make provision for the definition to be amended by regulation.
39. The definition of insurance provider will be independent of corporate form, so that any limited company, branch of a limited company, building society, finance company, friendly society, credit union, discretionary mutual organisation, captive insurance company, trust or any other corporate form which provides insurance will be included within the regime and subject to prudential supervision.
40. I am proposing that all insurers with a physical presence (including tangible premises, representative office, staff or agents) and providing products for insurable risks in New Zealand or abroad must be licensed. In addition the definition of insurance provider includes overseas providers with an agent-based presence, representative office, or other physical presence in New Zealand. I also propose that the definition of insurance provider should look to include overseas providers who are actively promoting their products in this country, but who may not have a physical presence or agent in New Zealand.
41. To create a comprehensive robust approach towards the inclusion of all insurance providers in the prudential regulation regime, I propose that an overall definition of insurance is used which will draw on the existing common law definition of insurance, which focuses on the payment of monies creating a contract, where the insurer is bound to pay a sum of money on the occurrence of an event outside the control of the insured person. I further propose that the overall definition of insurance business is accompanied by additional definitions of life, general and health insurance because this is consistent with industry structure and practice. The intention of the overall definition of insurance is to ensure effective capture of all contracts or other arrangements that can be considered insurance activity and as such should be subject to prudential regulation.
42. I propose that ACC and EQC will come within the definition of insurer, but that these institutions will not be required to be licensed and subject to prudential regulation by the Bank because they are Crown Agents and are adequately covered by existing oversight arrangements.

Exemption powers

43. To cater for the unintended consequence that some institutions or products are captured by the legal definition of insurance, but which are clearly not intended to be within the scope of the prudential regime, I am proposing that the Bank will have a general power to exempt institutions, products and other activities, from licensing and prudential requirements, who are captured by these definitions, but are not in substance providers of insurance to New Zealand policyholders.

44. In addition to this general exemption power, the Bank will have the ability to exempt providers from any specific aspect of the regime. The most likely example of this is an exemption from the mandatory ratings requirement, which is explained below. The extent of exemptions from other prudential requirements is expected to be limited, so as not to create issues of competitive neutrality.

Licensing

45. A consistent licensing regime will be used for all insurers using the licensing criteria set out below. The application of the criteria will incorporate a degree of variation to reflect that the risks inherent in different products vary and so there may be a need for higher or different prudential requirements either for life, health and general insurers. There will be a single licence approach covering the whole of the insurer's business, but with separate consideration and distinct conditions of licence for life, general and health insurance, where this is necessary. The licence provided to each insurer will specify the broad types of insurance policy that can be written (e.g. life, health). Cabinet has already decided that licensing fees will not be charged.
46. Under existing legislation, all insurers are required to lodge a deposit of up to NZ\$0.5million with the Public Trust. The original intention of the deposit was a form of policyholder protection mechanism, in the event of the failure of an insurer – however, the deposits that have been lodged are now small compared to the balance sheet size of most insurers. I propose that these existing deposits that have been lodged with the Public Trust by insurers will be returned.

Licensing criteria

47. The purpose of licensing is to ensure that insurers are “fit for business” by demonstrating the capacity to manage the business they undertake, identify and manage their risks effectively and have sufficient financial strength. I propose that licensing of each insurer, subject to prudential regulation by the Bank, will be on the basis of criteria relating to broad-based matters (“licensing matters”) specified in legislation supported by additional licensing criteria as necessary. The list of licensing matters that I am proposing will be applied in respect of the licensing of each insurer is set out below. Some further explanation regarding the Bank's expectations in these areas is detailed in the subsequent sections of this paper:
- (a) a minimum capital requirement (it is anticipated that the amount initially specified in regulation will be \$2 million);
 - (b) sufficient financial strength, both at the time of licence application and projected, in relation to the size, nature and risks of the insurance business;
 - (c) the insurer having a financial strength rating issued by a rating agency approved by the Bank;
 - (d) levels of risk that are suitable to the nature of the insurer's business and risk management policies, systems, reporting and other procedures that are effective to manage the amount and nature of the insurer's risks;
 - (e) directors and senior management who are sufficiently qualified and appropriate to operate the business;
 - (f) suitable ownership, corporate form and appropriate governance arrangements;
 - (g) appropriate actuarial and accounting arrangements;
 - (h) the extent and nature of connected lending and non-insurance activities undertaken;
 - (i) the actuary and auditor of the insurer are satisfactory to the Bank and there are no matters of an accounting or actuarial nature which cause the Bank concern;

- (j) corporate form or other arrangements that provide adequate separation between different types of insurance business;
 - (k) for foreign branches, that the home supervisor's prudential requirements and home country legal and accounting requirements are considered satisfactory by the Bank; and
 - (l) such other matters that the Bank may have regard to as specified by regulation made under the legislation;
48. The additional, more detailed, licensing criteria ("licensing criteria") that the Bank will use when it makes licensing decisions will either be specified in regulations or principles and/or other guidance. Regulations will be used to define many of the more tangible aspects of the above criteria, for example the minimum capital amount and financial strength measurement approach and calculations. Notices, issued to insurers are another more flexible method, than regulation, which I am proposing that the Bank can use to issue its requirements, with due consultation. Other licensing criteria such as the fit and proper tests to be applied to directors and senior management and risk management practices are matters that are more appropriate to establish using a statement of principles and/or other guidance, which the Bank will issue in due course.
49. I propose that, where appropriate, the Bank also has 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.
50. 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.

Minimum capital

51. A minimum capital requirement will be required to demonstrate a financial commitment to the industry by new entrants and ongoing participants within the insurance industry. The minimum dollar level of capital is not a substitute for capital adequacy. It is merely a minimum entry hurdle - large insurers will obviously need to have much greater amounts of capital, commensurate with their size of operation and nature of business, as will be required under the capital adequacy requirements. I am proposing a minimum capital requirement of NZ\$2 million for all insurers.

Financial strength

52. Solvency calculations performed by an insurer's actuary are designed to ensure that an insurer has sufficient assets to meet its obligations to existing policyholders and creditors under a range of adverse circumstances. Solvency calculations will be fully defined in regulations based on New Zealand actuarial standards developed by the New Zealand Society of Actuaries. This will give legal backing to New Zealand actuarial standards in this area 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. I am proposing that each licensed insurer must have sufficient financial strength demonstrated by compliance with solvency and capital adequacy calculations together with any other financial measures or criteria considered appropriate by the Bank. Accordingly I am proposing that the Bank will be able to establish minimum solvency, capital adequacy and any other financial measures or criteria considered necessary to measure the financial strength of insurers. 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. I am also proposing that the Bank has 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. I am further proposing that the Bank has the ability to establish conditions of licence, specific to individual insurers, in this area based on the risk, financial strength or business of a licensed insurer.
54. 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. In principle I support this approach, provided the following conditions are met:
- i) The Bank must be satisfied that the calculations are at least as stringent as the New Zealand calculation method(s); and
 - ii) 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.

Enhanced Solvency Standards Board

55. 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 representation 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, I believe the new Board is not needed because:
- a similar degree of co-regulation (between the Bank, industry and the NZSA) can be achieved without the establishment of a new statutory body;
 - the Bank would have a responsibility to consult appropriate stakeholders on proposals in respect of solvency and capital adequacy, have regard to any submissions they make and ensure that the proposals meet the objective of the insurance legislation. 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.

Ratings

56. I am proposing that all insurance providers would be required to obtain and disclose a financial strength rating (“rating”), subject to granting an exemption from this requirement for small insurers, issued by a rating agency approved by the Bank. In the insurance market, the use of ratings is already well established in many areas. Ratings are mandatory for disaster and property insurance, with A.M. Best, Standard & Poor’s and Fitch being the current approved rating agencies. Also many life insurers, particularly the major life insurers and the largest health insurer, Southern Cross, already have a credit rating on a voluntary basis. Accordingly, the amount of change in respect of this new requirement should not be overwhelming at an industry level.
57. The rationale for and benefits of financial strength ratings for the insurance sector are as follows:
- **Rationale for prudential supervision.** One of the key rationales for the prudential regulation of the insurance sector is the existence of information asymmetry i.e. the difficulty of appraising institutional risk. Policyholders need to know the likelihood that their insurer will be unable to pay a claim – but currently have no means of assessing it. Ratings directly address this information asymmetry problem and are an important element of the Bank’s supervisory approach for the insurance sector, for this reasons explained below.
 - **Simple accurate guide to institutional risk to assist financial intermediaries and others.** Ratings provide a single metric that allows comparison of the financial strength and risks of different insurers. Ratings thereby provide a powerful tool to assist policyholders, brokers and analysts to distinguish between lower and higher risk insurers. Empirically ratings are an accurate guide to institutional risk and the potential probability of default.
 - **Assisting in the supervision process.** A rating will be an important input to the Bank’s risk-based monitoring approach to the insurance sector - providing an independent broadly based appraisal of insurers’ financial strength and risks, including the quality of management and insurers’ business models. This will allow the Bank to run a low cost and relatively unintrusive supervision regime. The main alternative to mandatory ratings is the use of more intrusive supervisory techniques, such as on-site examinations and increased prescriptive requirements which would increase the cost of the prudential requirements to the Bank and insurers.
 - **Consistency of approach to regulation of financial sector.** Ratings form an important part of the existing regulatory requirements for Registered Banks and the proposed new requirements for Registered Deposit Takers (“RDT”). Property and disaster insurers are already required to have a rating by statute. Life and health insurers are not required to obtain a rating, but several major insurers in these sectors currently voluntarily elect to have a rating.

- **Other benefits.** Market and self discipline on insurers will be increased and policyholders will be more aware of their insurer's rating because it will be disclosed as part of the point of sale product disclosure (proposed in the market conduct proposals).
58. **Minimum rating requirement and rating agency approval.** I am not proposing a minimum rating requirement because this would unduly constrain choice within the industry. The Bank will need to publish the criteria upon which rating agency approval decisions are made.
 59. **Rationale for and calibration of exemption limit.** Mandatory ratings for small insurers can be justified on risk-based grounds but competition and contestability considerations argue for the exemption of smaller entities – although this may undermine competitive neutrality. Accordingly, I am recommending an exemption from this requirement for insurers with an annual gross premium income of less than \$5 million, on grounds of cost benefit, but only applied to non-disaster and property insurance, leaving the existing mandatory rating requirement for all disaster and property insurers in place. The inconsistency is justified on the basis there is a stronger case for having mandatory ratings for disaster and property insurance and this will reduce the degree of implementation change needed, which will limit transition costs. I should note that, for the proposed Registered Deposit Taker legislation, the equivalent exemption threshold was \$10 million assets: an asset metric is not as good a measure of size for insurers.
 60. I further propose that there would be scope for the exemption threshold to be amended by way of regulation and further provision for exemptions from the ratings requirement under the Bank's proposed ability to grant exemptions from any aspect of the prudential requirements.
 61. Cost of ratings. The direct cost of obtaining a rating is approximately \$20,000 to \$40,000 per annum, depending upon the size of the insurer, plus the cost of senior management time absorbed by the ratings process. Assuming \$30,000 for a smaller insurer, this represents 3% of annual premium income for an insurer with annual premium income of \$1 million, which is quite significant, but only 0.6% for an insurer with annual premium income of \$5 million. Ratings costs need to be viewed in the context of other costs that would be required in the absence of ratings (as explained above). Also, as an offset to the direct cost of ratings, insurers (particularly smaller businesses) may have incentives to improve their risk management or other business practices.
 62. One intention of the exemption from the mandatory ratings requirement is to exempt the small Friendly Societies and new entrants to the market. There are over a hundred and fifty small Friendly Societies who can offer insurance, but the number of these organisations that do offer insurance is not known. As the annual premium income of each of the small Friendly Societies is not expected to exceed \$1 million, these entities will be exempt as long as the exemption level is set above \$1 million.
 63. There are also other small providers of insurance for whom the cost of ratings is genuinely quite significant. The potential impact of different exemption levels for these small insurers has been considered, as shown in the table below. As the exemption limit is increased, more small insurers would be exempt from the mandatory ratings requirement, but the cost of additional monitoring by the Bank and/or additional requirements on insurers would increase and the other benefits of ratings would be reduced (increased market discipline, improved self discipline, preservation of competitive neutrality and disclosure to policyholders as part of product disclosure requirements).

	Number of insurers exempt from ratings requirement, by exemption limit for gross annual premium income (estimated data)			
	\$2.5 million	\$5 million	\$15 million	\$30 million
Small insurers	21	26	33	41
% of market premium income	0.3%	0.6%	1.9%	5%
Cost of additional monitoring by Bank and/or additional requirements on insurers	Small	Low	Medium	Higher
Market, self discipline, competitive neutrality and product disclosure benefits	Largely preserved	Partly reduced	Further reduced	

On balance, the Bank considers that an exemption level of \$5 million premium income is appropriate for the policy objectives outlined.

64. The policy intention of the exemption from mandatory ratings for RDTs is the same as for insurers, although a different metric is more appropriate (\$10 million assets).
65. **Dynamic impact on insurance sector, including small insurers.** The overall business impact of a mandatory ratings requirement is expected to be minimal because it represents an extension of the already fairly well established use of ratings. Whether or not there will be any exits as a result of a mandatory ratings requirement is not known with certainty, but I can say that the above exemption policy has been established in order to minimise any potential impact in this area and that the introduction of the existing mandatory ratings requirement in the disaster and property sector is not believed to have caused any significant exits from the market.
66. Small insurance providers are likely to exist alongside larger providers with their competitive advantage being a niche market or service quality. Large competitors may try to use a higher rating to their advantage, but the larger providers can already promote their current rating and financial size. So for small sound insurers, it is not obvious that their marketing approach would be significantly undermined by a requirement to obtain a rating.

Risk management

67. I am recommending that insurers be required to have risk management policies, limits on levels of risk (for example, insurance and investment risk), robust board reporting of risk exposures and effective systems and procedures suitable to the nature of its business and financial strength. Accordingly, I am proposing that the Bank has the power to establish specific requirements in relation to risk management using published principles or other guidance.

Fit and proper

68. I am proposing that the directors and certain senior management of an insurer must meet the Bank's fit and proper positive assurance requirements and that the Bank will perform positive assurance fit and proper checks. In addition, the Companies Office will be responsible for the performance of negative assurance tests (criminal records and declared bankrupts) for the insurer's directors and senior managers, as required for FAFT anti-money laundering requirements.

69. For the scope and operation of the fit and proper regime, I propose the following:
- insurers will be required to maintain fit and proper policies and procedures for directors and senior management in accordance with guidelines promulgated by the Bank.
 - the legislation will empower the Bank to have a right of veto over the appointment of directors and senior managers if the Bank is satisfied that the person does not meet the fit and proper requirements and to require the removal of a director or senior manager if the Bank is satisfied that the person no longer meets the fit and proper requirements. This requirement will provide for a right of appeal, on natural justice grounds, for individuals who are removed from office as a result of such decisions.
70. I do not see a compelling case for the inclusion of all senior management in the fit and proper regime, because of the reduced likelihood of failure, compared to some other financial sectors. I am content initially to confine the Bank's fit and proper checks to directors, the CEO, the actuary and the CFO (given the vital roles of these individuals) but with provision in the legislation to extend the coverage of this requirement, by way of regulation, to a different population of senior management.

Ownership

71. Suitable ownership of licensed insurers is also important to safeguard policyholders' interests. For example policyholders' interests could be compromised in the unlikely event that a licensed insurer is found to be owned by an insolvent owner or an owner involved with significant fraudulent activities, or where the ultimate owner cannot be traced.
72. In respect of licensed insurers' significant shareholders, where the Bank has such concerns it would have the ability not to grant a licence or to withdraw an existing licence.

Governance

73. There is no evidence of widespread governance failings in the sector and, in the spirit of light-handed regulation I do not propose significant regulations in this area initially. But, as with RDTs, I consider it is important for the Bank to have the power to set governance standards by way of regulation. Accordingly, I propose that the primary legislation give the Bank power to make regulations or publish principles or guidelines as appropriate relating to matters of Board size and composition, including independent directors, and Board Committee structures. To safeguard policyholders' interests, I am recommending that there is a prohibition on the insurer's constitution including a provision that permits a director to act other than what he believes to be the best interests of the insurer. As this is an important area, I propose that the Bank has a broader power to regulate the content of insurers' constitutions in order to meet the regulatory objective.

Connected exposures

74. I propose that a limit is placed 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 I have asked officials to perform further research and analysis to determine the appropriate limitation that is considered necessary in this area.

Non-insurance activities

75. I am proposing that the Bank will have the power to limit the extent to which insurance entities can perform non-insurance activities (e.g. deposit-taking, non-financial business), in order to limit potential contagion. I have asked officials to perform further research and analysis to determine the appropriate nature of limitation that is considered necessary in this area.

Actuarial and accounting practices

76. Satisfactory actuarial and accounting arrangements are very important, given the complex nature of insurers' financial statements. I propose that 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 (adopted by the Bank), included within an insurer's financial accounts.
77. I further propose that each insurer maintains satisfactory accounting systems, actuarial valuation and other actuarial practices and robust internal controls, including measures to ensure regulatory and professional compliance, commensurate with the scale and nature of an insurer's business.

Home country requirements

78. For foreign branches, I am proposing that the Bank must be satisfied that the home supervisor's prudential requirements and home country legal and accounting requirements do not by their nature put New Zealand policyholders at risk.

Other

79. To cater for other important matters which the Bank may rightly need to properly license all insurance entities, I am proposing that the Bank will be able to specify such other licensing matters that are considered appropriate by the Bank to meet its statutory objective under the legislation, by way of regulation.
80. An example of such an important matter is insurers' re-insurance requirements. As I am proposing a light-handed prudential regulatory regime, I am not proposing very detailed requirements in the important area of re-insurance as it intended that adequate consideration of re-insurance can probably be dealt with under the licensing matter that insurers must have sufficient financial strength. However, if it becomes necessary that further requirements in respect of re-insurance, or any other matter, need to be established I propose that the Bank rightly needs this flexibility to manage the prudential regime that is suitable both to our current purpose and in the future.

Other licensing matters***Insurers in run-off***

81. For insurers who are not writing new business - usually referred to as insurers who are in "run-off"- it is still very important that their financial strength is sufficient to meet any claims from their policyholders as they arise. It is also most important that it is transparent to the market that insurers in run-off cannot write new business. Accordingly I propose that insurers who are in run-off will have a different class of licence which prohibits the writing of new

business, but that they must 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.

Continuous disclosure

82. I propose that there will be a requirement placed upon licensed insurers to report to the Bank on a continuous basis, 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.

Transition period

83. 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.

De-licensing

84. The Bank will have the power to de-license an insurance entity, with the grounds for de-licensing specified in the Act, which would be when an insurer is in significant breach of the Bank's prudential requirements and is unable to satisfy the Bank that it will be able to return to compliance within a reasonable timeframe. Voluntary de-licensing may also occur from time to time as insurers leave the market.

Auditor and actuary

85. It is proposed that 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. The Bank will develop appropriate criteria which would determine the suitability of the persons for these roles, for example: sufficient experience and standing, not personally involved in a fraud, litigation, professional misconduct action or other events which have caused an adverse impact on the reputation, judgement or independence of the person.
86. Given the importance of actuarial methodologies used to arrive at policyholder liability, solvency and other calculations, it is also proposed that the annual audit of an insurer includes a review by an actuary of the actuarial valuations and the required disclosures of an actuarial nature made within insurers' financial statements.

Legal separation of businesses using funds or other means

87. New Zealand industry practice is that separate entities (subsidiaries or branches) typically exist for life, general and health insurance whilst some products combine elements of life and

health insurance. In Australia “statutory funds” are used to clearly separate life insurance business and the life insurance legislation is built around this requirement.

88. Segregation of different business lines is an IAIS expectation. The main rationale is that it provides assurance, in the event of insolvency, that one set of policyholder funds (for example those relating to life insurance) cannot be undermined by unrelated policyholder claims, for example in respect of general insurance claims. Under existing insolvency laws, the only wholly reliable way of ensuring such segregation is to set up separate companies for each line of business.
89. Some of the broad policy options in this area are to rely on the degree of accounting and business separation that already exists within the insurance sector or to introduce - with new legislation - a “statutory fund” concept, along the lines of the Australian life insurance model.
90. As the legal position and potential business and implementation impacts of these policy options are complex, I have asked officials to perform further research and analysis to determine whether any requirements are necessary in this area in order to protect the confidence of New Zealand policyholders. If additional requirements are necessary, I propose that the requirements are implemented in the following manner. If regulations or guidance is required in this area, this is catered for under the proposed recommendations and bill whereas if additional legislation is required, the bill will need to await the necessary revisions.

Branches and possible local incorporation powers

91. For foreign insurers, I intend to give the Bank the power to delicense a branch entity in limited circumstances. Such branches would have the option of incorporating as New Zealand companies if they wished to continue business in New Zealand. The criteria under which this power would be exercised are where the home country supervisor’s prudential requirements or home country legal or accounting requirements are unsatisfactory and potentially put New Zealand policyholders at risk. This is one of the licensing matters covered above.
92. One example of home country legal requirements which would place New Zealand policyholders at a relative disadvantage, in the event of the insolvency of an insurer, is the existing policyholder preference legislation for general insurance in Australia. This preference operates through the Australian law and provides that assets of general insurers in Australia are only available to meet policyholder liabilities in Australia. New Zealand policyholders do not have a claim on Australian assets, which effectively limits the assets available to support their claims.
93. Some examples of broad policy options that could be used to address this concern are disclosure, by insurers, of the implications of insolvency upon policyholders and more direct supervisory intervention, for example not allowing branches from a jurisdiction that has policyholder preference legislation in place.
94. As the legal position and potential business and implementation surrounding these issues are complex and would require significant legislation, I have asked officials to perform further research and analysis to determine whether any requirements are necessary in this area in order to protect the confidence of New Zealand policyholders. If additional requirements are necessary, I propose that the requirements are implemented in the following manner. If regulations or guidance is required in this area, this is catered for under the proposed

recommendations and bill whereas if additional legislation is required, the bill will need to await the necessary revisions.

Public disclosure required by insurers

95. I am recommending increased public disclosure by insurers because there will be benefits both at an overall market level and within insurers as this will strengthen internal financial disciplines, including greater focus by the board on publicly reported financial information. The potential benefits of increased disclosure should also be enhanced by initiatives that the Bank and others plan to take to improve financial literacy. I recommend that insurance will be part of this.

Six monthly public financials and director attestation statement

96. I propose that annual audited financial reporting under the Financial Reporting Act 1993 must be met by all insurers, with no exemptions for size. These financials together with disclosure of the credit rating and the director attestation, that I propose below, will comprise the annual Disclosure Statement. I further propose that insurers will also publish a six monthly version of the Disclosure Statement, which will include a reduced version of the annual financial statements, so as to limit compliance costs for insurers.
97. I propose that a six monthly director attestation statement will be an integral part of the public Disclosure Statement. The director attestation will state that the insurer is in compliance with its conditions of licence, that the insurer has satisfactory risk management systems and appropriate amounts of risk commensurate with the insurer's financial strength, the Disclosure Statement has been prepared in accordance with New Zealand actuarial standards and by an actuary who is a member of the New Zealand Society of Actuaries. The precise wording of the director attestation is a matter that I have requested the Bank to draft and promulgate.
98. Sufficiently prompt disclosure is important for maximum effectiveness, so I am proposing that the six monthly Disclosure Statement must be publicly available within three months of the financial period end.
99. I propose that the Bank will administer and enforce the new disclosures that I am proposing for all insurers.

Short form disclosure

100. The Discussion Document proposed that all insurers must publish a short form disclosure document, but submitters argued that the costs of this proposal were likely to exceed the benefits. An alternative which I am proposing is that insurers be required to publish their salient financial strength indicators, as determined by the Bank, prominently on their websites for the benefit of policyholders. This will allow policyholders to readily compare one insurer with another.

Licence status disclosure

101. Insurers will be required to publicise (in their Disclosure Statements and on their website) their licence issue date together with any conditions of licence together with any exemptions from the Bank's prudential requirements.

Product documentation

102. It has been agreed with the Ministry of Economic Development that the financial strength rating of an insurer, together with an explanation of financial strength ratings, will be included within the product disclosures required under other legislation. This proposal will be brought to Cabinet under a separate paper which addresses the market conduct aspects of insurance regulation.

Reporting by insurers to the Bank

103. The Bank will need the power to obtain appropriate information from regulated entities on a regular basis. Six monthly reporting, using a limited number of reporting schedules, is envisaged together with a continuous obligation to report any material change in business or financial circumstances. I propose that the Bank has the ability to establish these requirements by written notice to insurers.

Monitoring and supervision activity by the Bank

104. I am also proposing that the Bank has a general power to obtain any additional information needed from insurers to fulfil its statutory responsibilities and this power will extend to the ability to have the information audited at the insurer's expense. Some key examples of information the Bank may need are:

- **Risk management information.** The Bank may request the insurer's risk management strategy, policies or risk reports, particularly where there are concerns about existing or rising levels of risk.
- **Future financial strength.** To provide more information about an insurer's prospective financial strength the Bank can request or require the preparation of a Financial Condition Report, capital plan, business plan or other appropriate document.

105. I propose that the Bank has powers for on-site examination, to initiate third party reviews, including an independent actuarial valuation of any aspect of the insurer's financial position, and to meet with third parties, on a tri-lateral basis (i.e. the Bank, third party and insurer). It is expected that these powers will be used sparingly. I propose that the Bank will also have powers to call meetings with the board and senior management.

106. I propose that the new legislation will include a provision requiring the auditors of licensed insurers to report any major concerns to the Bank.

Consolidated supervision

107. Where an insurance business is comprised of more than one entity, I am proposing that licensing, monitoring and other supervision arrangements will be applied on a consolidated group basis and to each solo entity within the group.

Home-host supervision

108. Home-host supervisory coordination will be an important feature of the insurance supervision arrangements and the Bank will seek to limit compliance costs for overseas insurers operating in New Zealand where possible. To that end, it is proposed that the Bank will develop

requirements in areas such as solvency and capital adequacy with regard to best practice and the requirements of key overseas regulators.

109. How the Bank will achieve an effective relationship with home regulators will involve certain practical matters such as regular communication and perhaps establishing a Memorandum of Understanding or joining on-site visits by foreign regulators, to the extent the Bank considers appropriate. The key outputs that the Bank is seeking in this area are information exchange on areas of risk and a co-ordinated approach on issues of concern. In a distress or crisis management situation, this will be crucial.

Distress and exit

Judicial Management

110. Under current New Zealand (and Australian) life insurance legislation, there is a judicial management process which can be used to manage life insurers who are unable to meet policyholder liabilities. Court approval is required to appoint a judicial manager and the judicial manager can apply to the Court for directions. The major disadvantages of judicial management process is that Court involvement could limit the speed at which necessary resolution actions could occur and the Bank would have no direct power to provide directions to the judicial manager. Also it is not clear that the main function of the judicial manager, which is asset preservation, would always accord with the Bank's statutory objective. I do not see sufficient advantage in retaining this mechanism for managing distress and I propose that it is repealed.

Corporations Investigation and Management Act

111. The Corporations Investigation and Management Act 1989 ("CIMA") allows the Securities Commission to appoint a statutory manager when an entity is operating fraudulently or recklessly, to prevent further financial deterioration. The Securities Commission recommends appointment to the Minister of Commerce. The CIMA will need to be amended so that the Bank receives prior notification and an ability to object to this action for insurance entities. The Companies Office also has a more limited ability to intervene under CIMA, including powers to obtain information, give directions and appoint an investigator to an "at risk" institution.

Distress management powers needed by the Bank

112. In order to minimise the risk of policyholders being disadvantaged by a rapid deterioration in the financial or business condition of an insurer, during a period of distress, I propose that the Bank will have appropriate powers to take necessary corrective action to safeguard policyholders' interests and to meet the Bank's statutory objective.
113. I am proposing that the Bank will have an explicit power to require an insurer in actual or potential distress to prepare and implement a recovery plan which sets out how an insurer intends to correct an unsatisfactory matter within a specified timeframe. I also propose that the Bank can also require a recovery plan where there is no actual or potential distress, but the Bank has other concerns arising from the Bank's monitoring activity. The content of the recovery plan will not be prescribed but will focus on a demonstration of improved financial strength, reduction in risk or other matter of prudential concern.

114. The distress management powers I am proposing are the Bank's ability to appoint an investigator and give directions, for example the removal of directors or management or a request to cease specified business.
115. Also, in appropriate circumstances the Bank should have the ability to recommend statutory management to the Minister, under the new insurance prudential legislation, if this appears to be the best course of action to meet the Bank's statutory objective. The Bank's ability to initiate statutory management will require prior approval of the Minister.

Insurer rights of appeal

116. Insurers will have the right to apply to the Courts under judicial review for decisions made by the Bank in respect of licensing, monitoring and intervention powers. For licensing decisions, although a merit review was proposed in the Discussion Document, following further analysis by officials I do not recommend this because it would be inconsistent with our current banking legislation and that proposed for RDTs.

Penalties and sanctions

117. Appropriate penalties and sanctions are necessary to support the goal of compliance. To be effective, the penalties available should be sufficient to discourage the potential behaviours of concern and should aim to encourage future compliance by the affected party and other insurance providers.
118. The ability to penalise insurers for fundamental breaches of the Bank's requirements is important and I want to ensure that market discipline supports regulatory discipline in this area.
119. For breaches of the Bank's prudential requirements, I am proposing that the Bank will be able to apply to the Courts to impose criminal penalties on the directors and officers of the insurer of maximum amounts set out in legislation. For this purpose, I recommend that "officers" includes the insurer's actuary. For serious and/or a large number of breaches of prudential requirements, the Bank will also be able to apply to the Courts to bar individuals from insurance. The circumstances that will attract penalties will be prescribed and these are set out below.

Offences and penalties for non-compliance with requirements

120. I am proposing that the offences under the prudential insurance legislation will be consistent with current and intended legislation and, in particular, the current penalties within the Reserve Bank of New Zealand Act for breaches of specific requirements include the following:
- Provision of false or misleading information by an applicant or their agent in respect of an application to be licensed as an insurer.
 - Falsely holding out to be an insurer.
 - Conducting the business of an insurer if not licensed as an insurer (unless an exempt entity).

- In the case of an insurer or its directors or CEO, failing to comply with regulatory requirements imposed under the Act or with conditions attaching to a licence or an exemption notice issued by the Reserve Bank.
- In the case of an insurer or its directors or CEO, failing to comply with a request from the Bank to provide the Bank with information, or providing false or misleading information.
- In the case of an insurer, failure to notify to the Reserve Bank a change in director or senior manager.
- Failure by an insurer to notify the Bank of a material breach of regulatory requirements as soon as the insurer becomes aware of the breach.
- Failure by an insurer to make a required attestation to the Bank or making a false or misleading attestation to the Bank.

121. I propose that the new Insurance (Prudential Supervision) Act will set out penalties for offences, on the following basis:

- i. fines on insurers be prescribed in a range of \$500,000 to \$2 million, depending on the severity of the offence;
- ii. 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;
- iii. 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
- iv. 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.

LEGISLATIVE IMPLICATIONS

122. Legislation is required to enact the proposals in this paper. The proposals relating to the licensing of insurers will contain cross references to the Financial Providers Bill being drafted by the Ministry of Economic Development, as the licensing and fit and proper regime is interconnected with the registration process to be implemented under that bill.

123. It is proposed that 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. As the primary objective for both prudential regulation and market conduct regulation is policyholder protection, there may be a case for combining these two aspects of regulation into a single Act. However, despite the common over-arching goal of policyholder protection, the Bank's and my own preference would be, for ease of administration, to have a separate Act solely covering the prudential aspects of insurance.

124. 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 and the obligations upon insurers;
- 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.

125. 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:

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

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

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

127. The secondary legislation will take a form of regulations and deemed regulations. For some requirements, matters will be at the discretion of the Bank but this will be subject to appropriate constraints and consultation. 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 PCO and LDC.

128. 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:

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

129. It is intended that legislation to give effect to the Insurance regulatory framework will be introduced in 2008 and the Minister of Finance will seek a priority for a Insurance (Prudential Supervision) Bill on the 2008 Legislation Programme.

130. It is expected that most of the legislation arising from the RFPP project, including insurance, will be brought into force at some point in 2010.

REGULATORY IMPACT ANALYSIS

131. The Regulatory Impact Statement is attached. I confirm that the principles of the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIS requirements, have been complied with.

132. A RIS was prepared and the Regulatory Impact Analysis Unit considers the analysis and the RIS to be adequate.
133. The final version of the RIS was not circulated to other government agencies, for consultation, with this Cabinet paper because of time constraints.

IMPLICATIONS FOR THE TREATY OF WAITANGI

134. There are no implications for the Treaty of Waitangi.

HUMAN RIGHTS

135. There are no implications in relation to the Human Rights Act or the New Zealand Bill of Rights Act.

FISCAL IMPLICATIONS

136. As agreed by Cabinet in June 2007, the Reserve Bank will fund its costs associated with insurance regulation through its Funding Agreement (refer to EDC Min 07 11/14, confirmed by CAB Min 07 21/4). Thus insurance regulation will be funded on the same basis as some of the Bank's other regulatory activities, rather than through charging fees to insurers.

PUBLICITY

137. It is proposed that this paper will be publicly released if approved by Cabinet.

CONSULTATION

138. The proposals in this broadly reflect the proposals set out in the Discussion Document released in 2006. The most significant difference relates to the proposal not to introduce a new statutory Board for solvency and capital adequacy standards. In addition to that, the proposals in this paper provide greater clarity regarding the nature of the prudential regime and the regulator's associated powers.
139. The main results of the public consultation exercise on the Discussion Document were that most submitters did not express fundamental disagreement with the overall thrust of the proposals. However, there was concern that the style of regulation will be prescriptive and onerous (although this approach was not expressed in the Discussion Document) and likely to increase the cost of insurance for consumers.
140. 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.
141. The following government agencies were consulted in the preparation of this paper: Treasury, Ministry of Economic Development and the Securities Commission.

RECOMMENDATIONS

142. I recommend that the Committee:

Background

1. **note** that in September 2006 a public Discussion Document was released proposing substantive changes to the prudential and market conduct regulation of insurers to address current inadequacies;
2. **note** that the overall result of the consultation exercise in respect of the prudential proposals was broad support for the proposed regime, with some concern expressed that the requirements should not be overly prescriptive and onerous;

Outcomes and objective

3. **agree** to establish a legislative regime for the prudential regulation of insurance providers;
4. **agree** that the Reserve Bank of New Zealand (“the Bank”) be given responsibility for the regulation and supervision of insurers;
5. **agree** that the outcomes sought from the prudential regulation of the insurance sector are:
 - b. a sound and efficient insurance sector;
 - c. policyholder confidence in the insurance sector; and
 - d. not to unduly compromise or constrain contestability, competitiveness and innovation;
6. **agree** that the objective for the prudential supervision of the insurance sector will be: to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence;

Scope of regulation and definition of insurance

7. **agree** that all providers of insurance will be subject to prudential regulation unless specifically exempted by the Reserve Bank, with appropriate definitions of insurance and insurance provider which can be amended by regulation;
8. **agree** that the Bank will have exemption powers in relation to the definitions of insurance and related definitions and in respect of any aspect of the prudential requirements;
9. **agree** that a wide definition of insurance will be used, based on a common law definition of insurance, accompanied by additional definitions of life, general and health insurance. The definition of insurance provider will be independent of corporate form and will include all insurers with a physical, agent-based or other presence in New Zealand who provide products for insurable risks in New Zealand or abroad. ACC and EQC will come within the definition of insurance provider, but these institutions will be exempt from all aspects of the prudential requirements;

Licensing

10. **agree** that under the regime, all insurers will be required to be licensed by the Bank, unless granted an exemption by the Bank, and that providing insurance without a licence (or exemption) will be prohibited;
11. **agree** that all insurers will be required to obtain and publish a financial strength rating issued by a rating agency approved by the Bank, but with an exemption for those insurers, except disaster and property insurers who are already required to be rated, with less than a specified amount of annual gross premium income (it is anticipated that the amount initially specified in regulation will be \$5 million);
12. **agree** that the Bank may place limits on the connected lending of a licensed insurer and the degree of non-insurance activities that a licensed insurer can undertake;
13. **agree** that decisions on licensing will be made on the basis of some or all of the following licensing matters which will be specified in legislation:
 - a. a minimum capital requirement (it is anticipated that the amount initially specified in regulation will be \$2 million);
 - b. sufficient financial strength, both at the time of licence application and projected, in relation to the size, nature and risks of the insurance business;
 - c. the insurer having a financial strength rating issued by a rating agency approved by the Bank;
 - d. levels of risk that are suitable to the nature of the insurer's business and risk management policies, systems, reporting and other procedures that are effective to manage the amount and nature of the insurer's risks;
 - e. directors and senior management who are sufficiently qualified and appropriate to operate the business;
 - f. suitable ownership, corporate form and appropriate governance arrangements;
 - g. appropriate actuarial and accounting arrangements;
 - h. the extent and nature of connected lending and non-insurance activities undertaken;
 - i. the actuary and auditor of the insurer are satisfactory to the Bank and there are no matters of an accounting or actuarial nature which cause the Bank concern;
 - j. corporate form or other arrangements that provide adequate separation between different types of insurance business;
 - k. for foreign branches, that the home supervisor's prudential requirements and home country legal and accounting requirements are considered satisfactory by the Bank; and
 - l. such other matters that the Bank may have regard to as specified by regulation made under the legislation;
14. **agree** that the detailed licensing criteria the Bank will use when it makes decisions on the licensing matters, set out in recommendation 13 above, will be specified in regulations (e.g. minimum capital and financial strength requirements), conditions of licence or at the Bank's discretion in accordance with published guidelines or principles (e.g. fit and proper tests, governance and risk management);
15. **agree** that the Bank must publish a statement of principles which will govern the exercise of its regulatory discretion (e.g. when imposing conditions of licence);
16. **note** that further consultation with industry and other affected parties will be required in order to finalise the detailed licensing criteria;

17. **agree** that the Bank will have powers to establish licensing conditions, specific to insurers, based on the list set out in recommendation 13 above;
18. **agree** that the Bank may establish licensing criteria by class of business, broad groupings of product line or characteristics of provider (such as size or corporate form);
19. **agree** that the Insurance (Prudential Supervision) Act will provide for a class of licence for insurers who are in run-off and are prohibited from writing new business;
20. **agree** that the Insurance (Prudential Supervision) Act will include appropriate de-licensing powers;
21. **agree** that all licensed insurers must demonstrate ongoing compliance with the Bank's prudential requirements and that failure to comply may be grounds for delicensing;
22. **agree** to a transition period following passage of the Insurance (Prudential Supervision) Act during which insurers may prepare and apply for licensing;

Financial strength and other aspects of the prudential regime

23. **agree** that minimum solvency, capital adequacy and other financial strength ratios or metrics which insurers will be required to meet, will be established by regulation giving the force of law to appropriate actuarial standards, based on those developed and issued by the New Zealand Society of Actuaries;
24. **agree** that the Enhanced Solvency Standards Board proposed in the public Discussion Document will not be established, principally on the grounds that it is an unnecessary cost;
25. **agree** that foreign-owned insurers can use the financial strength calculations that are prepared for their home regulator, if the Bank is satisfied with the home regulator's calculations, and subject to suitable public disclosure;
26. **agree** that insurers are required to have a fit and proper policy for their directors and senior management which meets guidance issued by the Bank;
27. **agree** that the Bank will apply fit and proper tests to the insurer's directors, the Chief Executive Officer, Chief Financial Officer and Actuary and other senior office holders with the power to veto appointments to these positions and to remove people from these positions, subject to natural justice requirements;
28. **agree** that 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;
29. **agree** that the Bank has the power to regulate the content of the constitutions of insurers in order to meet the objectives of prudential supervision;

Public disclosure

30. **agree** that all insurers, with no exemptions for size, meet public financial reporting requirements specified by the Bank and that this financial reporting together with disclosure of the insurer's credit rating, licence status, director attestations and any other requirements the

Bank requires would comprise the annual Disclosure Statement, to be publicly available within three months of the reporting period end;

31. **agree** that all insurers will also be required to publish a reduced six monthly version of the Disclosure Statement, to be publicly available within three months of the reporting period end;
32. **agree** that insurers will be required to publish their salient financial strength indicators, as determined by the Bank, prominently on their websites;
33. **agree** that the Bank will administer and enforce the new disclosures for all insurers;
34. **agree** 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);
35. **agree** that 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;
36. **note** that, under separate legislation, product disclosure requirements will also require disclosure of the insurer's financial strength rating and an appropriate explanation of financial strength ratings;

Monitoring and Supervision

37. **agree** the Bank have the function of supervising insurers to monitor their financial strength, compliance with prudential requirements and any other aspect of their business in order to meet statutory objectives;
38. **agree** that legislation give the Bank the 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;
39. **agree** that 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;
40. **agree** that 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;
41. **agree** that the Bank may require information provided to it by insurers, for prudential purposes, to be audited at the insurer's expense;
42. **agree** that the Bank will have the powers to:
 - a. perform on-site reviews;
 - b. initiate third party reviews, including an independent actuarial valuation;
 - c. 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;
 - d. call for meetings with the licensed insurer's board, directors and senior management;and

- e. require insurers to comply with any other monitoring actions necessary for the Bank to fulfil its objectives;

43. **agree** that 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;
44. **agree** that the legislation will include a provision requiring auditors to report any major concerns they may have about an insurer they audit to the Bank;

Insurer distress and exit

45. **agree** that in circumstances where the insurer 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, the Bank will have powers to take the following action, as appropriate to the circumstances and severity of the distress and the risk to policyholders, 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 statutory objectives; and
 - de-license an insurer;
46. **agree** that, in appropriate circumstances, such as where the potential failure of an insurer may cause significant loss to policyholders or damage to the insurance sector, the Bank may seek the Minister of Finance's approval to place the insurer and any associated person in statutory management under the Insurance (Prudential Supervision) Act;
47. **note** that further details of the nature and extent of statutory management, including the powers of the statutory manager will be developed and provided to Cabinet;
48. **note** that the repeal of the Life Insurance Act will also repeal the judicial management process, which can be used to manage life insurers who are unable to meet policyholder liabilities;

Penalties and offences

49. **agree** that the Bank will be able to apply to the Courts to impose criminal penalties on the directors and officers of the 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:
- i. fines on insurers be prescribed in a range of \$500,000 to \$2 million, depending on the severity of the offence;
 - ii. 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;
 - iii. imprisonment terms for directors and senior managers be prescribed in the range of 3 to 18 months, depending on the severity of the offence;
 - iv. 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;

50. **agree** that the new Insurance (Prudential Supervision) Act will set out offences for failure to comply with regulatory requirements, including:
- a. failure by insurers to comply with the obligations imposed upon insurers by regulation, such as to have a financial strength rating;
 - b. failure to comply with fit and proper requirements, such as employing a senior manager who has been vetoed or removed by the Bank;
 - c. failure to provide information requested by the Bank;

Legislative implications

51. **agree** that the proposed regulatory regime be implemented via a new Insurance (Prudential Supervision) Act;
52. **note** that the Minister of Finance will seek a priority for a Insurance (Prudential Supervision) Bill on the 2008 Legislation Programme;
53. **agree** that enactment of an Insurance (Prudential Supervision) Act will make the following Acts redundant and they will be consequentially repealed:
- Parts 1 and 1A of the Life Insurance Act 1908;
 - Insurance Companies Deposits Act 1953; and
 - Insurance Companies (Ratings and Inspections) Act 1994;
54. **note** that consequential changes may be required to a number of other Acts including the Financial Reporting Act 1993, the Companies Act 1993, the Marine Insurance Act 1908, the Mutual Insurance Act 1955 and the Corporations (Investigation and Management) Act 1989;

Next steps

55. **invite** the Minister of Finance to issue drafting instructions to the Parliamentary Counsel Office to prepare legislation and give effect to the decisions above; and
56. **note** that I will report back to the Economic Development Committee by 31 July, 2008 with more detailed proposals relating to the following matters:
- a. whether any requirements relating to the separation of insurance business are needed;
 - b. whether any requirements relating to the local incorporation of foreign owned insurance business are needed; this to include an examination of the implications for the insolvency regime of an insurer being a branch of a foreign insurer;
 - c. further details of the nature and extent of statutory management, including powers of the statutory manager;
 - d. the nature and extent of constraint(s) recommended in order to limit the incidence of non-insurance activities by licensed insurers and related party exposures, within insurance groups and to other related parties; and

- e. any other matters necessary for a comprehensive prudential regime for insurers which require Cabinet approval.

Hon Dr Michael Cullen
Minister of Finance

Date signed: / November/ 2007

Regulatory Impact Statement

Review of Financial Products and Providers: Prudential Regulation of Insurance

Executive Summary

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.

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.

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.

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.

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.
- The Bank would have the ability to exempt insurers or classes of insurers from requirements and the Bank would have distress and exit management powers.

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 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

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

Status Quo and Problem

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.

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.

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.

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. 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.

Further details are provided below:

Deposit Requirement

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.

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

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

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

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 requirements.

- 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.
- There 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.
- 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.

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”.
- 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.

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.

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.
- 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.

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.

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.

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

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.

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.

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

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

- **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.

- **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.

- **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.

- **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.

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

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

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

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”)

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

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

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

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

- 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

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).
- 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.
- Licensing will also involve consideration of insurer ownership and place of incorporation, among other factors.
- 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.
- 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 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- The Bank has the power to establish specific requirements in relation to risk management using published principles or other guidance.

- 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- 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.

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

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.

- 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.
- 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.
- 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.

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.

- 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.
- 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.

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

Benefits of preferred option

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

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

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

Implementation and Review

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.

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.

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.

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

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.

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.

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

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.

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.