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Dear Richard

**Issues Paper: Review of the Insurance (Prudential Supervision) Act 2010**

**Introduction**

The New Zealand Law Society (**Law Society**) welcomes the opportunity to comment on the Reserve Bank of New Zealand's *Issues Paper: Review of the Insurance (Prudential Supervision) Act 2010* (IPSA) (**Issues Paper**).

Since the Issues Paper was written, the International Monetary Fund report: *Detailed Assessment of Observance – Insurance Core Principles*, May 2017 (**IMF Report**), referred to at paragraph 10 of the Issues Paper, has been published.<sup>1</sup> The Law Society understands that the Reserve Bank will be commenting on that report, to the extent appropriate, during Phase 2 of the review process. The Law Society looks forward to providing further input then.

In the meantime, we respond below to the questions in the Issues Paper.

**Question 1: Do you have any comments to make on the discussion in Part 1 of the Issues Paper?**

No.

**Question 2: Do you consider that the Review should assess the current scope of IPSA in terms of the nature of insurance contracts or entities that are subject to the legislation? Please provide commentary in support of your view.**

Yes, the Review should focus on the nature of insurance contracts and entities that are subject to the legislation.

The provisions in IPSA are not fit for purpose because they do not provide for new forms of insurance enabled by technology which is not limited by geographical boundaries.

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<sup>1</sup> <http://www.imf.org/en/Publications/CR/Issues/2017/05/10/New-Zealand-Financial-Sector-Assessment-Program-Detailed-Assessment-of-Observance-Insurance-44904>

### *Overseas insurers offering insurance contracts in New Zealand*

As noted in the Issues Paper, not all foreign insurers that provide insurance coverage in New Zealand are necessarily required to be licensed.<sup>2</sup> The Reserve Bank considers whether foreign insurers should be licensed on a case by case basis taking into consideration whether they have a place of business, staff or infrastructure in New Zealand and whether they market insurance directly to New Zealand customers.<sup>3</sup> The IMF Report has highlighted that there is no data on the number of overseas insurers offering insurance contracts in New Zealand without a licence.<sup>4</sup>

The insurance prudential regulator needs to have sufficient detail of the insurance business written in New Zealand in order to be able to appropriately supervise insurers. As such, the Law Society submits that the Reserve Bank should have the power (and should, to the extent appropriate, exercise that power) to collect information about all insurance written in New Zealand including insurance provided by foreign insurers.

The Law Society does not consider it is necessary to apply all aspects of the IPSA regime to all insurers providing insurance coverage in New Zealand. To do so may have a damaging impact on the availability of reinsurance cover or the participation of foreign insurers in the New Zealand insurance market more generally. The Law Society recommends that the Reserve Bank be provided with more flexible exemption powers to permit appropriate oversight without inhibiting participation in the New Zealand insurance market.

#### **Question 3: Do you consider that there are entities where the current provisions of the legislation result in inappropriate compliance costs or inappropriate regulatory obligations relative to the risks being addressed by the legislative framework?**

The Law Society has no information about the costs of compliance. It is concerned that the enforcement provisions are too inflexible and could be perceived as harsh: significant criminal penalties can be imposed for minor administrative breaches, such as a fine of up to \$100,000 that can be imposed upon an insurer if a third party broker fails to disclose the insurer's financial strength rating (section 64).

#### **Question 4: Are you aware of any currently non-licensed (under IPSA) insurance business activity in New Zealand that you consider should be within the scope of regulation in some form to enhance the effectiveness of the framework?**

The Law Society considers that, as prudential regulator, the Reserve Bank should hold information on all entities providing insurance cover in New Zealand (see question 2 above). Without an understanding of

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<sup>2</sup> Issues Paper at [51].

<sup>3</sup> Page 56, IMF Report.

<sup>4</sup> Page 56, IMF Report.

the scope and extent of unregulated insurance, the Reserve Bank cannot assess if the purposes and principles of IPSA are being met.

**Question 5: Do you agree that overseas insurers provide valuable support to the New Zealand insurance market? Please provide commentary in support of your view.**

Yes. As the Canterbury earthquakes illustrated, it is essential that New Zealand can access global capital in order to manage risk appropriately. The Law Society supports the Review examining whether the light touch regulation afforded to overseas insurers (particularly branches of Australian insurers) adequately protects policyholders and meets the wider purposes and principles of IPSA.

**Question 6: Do you consider that the Review should reassess the application of the legislation to insurers operating as branches? Please provide commentary in support of your view.**

Yes. In practice, the current regime relies heavily on work carried out by the Australian Prudential Regulation Authority (**APRA**). The Issues Paper does not articulate in detail the basis on which New Zealand policyholders of a branch of an Australian insurer have protection equivalent to Australian policyholders.

**Question 7: In the context of overseas insurers, what do you consider are the most significant risks posed to the New Zealand economy or New Zealand policyholders that need to be taken into account?**

The most significant risk is that the claims of New Zealand policyholders will not be paid, either because the New Zealand policyholder cannot enforce its claim or there is an overseas policyholder preference which leaves no money for the New Zealand policyholders.

A second risk is that local insurers bear a greater regulatory burden and so are not able to compete with Australian or other overseas insurers.

Finally, it is important to ensure that overseas insurers continue to participate in the New Zealand insurance market to ensure competition and also in terms of reinsurance of local insurers. This means that the regulatory requirements for overseas/foreign insurers should, where possible, be in line with the overseas insurers' local requirements provided those requirements are broadly the same as New Zealand's. However, as noted above, in assessing this the Reserve Bank needs to check that a disproportionate regulatory burden is not placed on local New Zealand insurers in comparison to the overseas insurers which might stifle the local New Zealand insurers' ability to compete.

**Question 8: Do you consider that there is opportunity to clarify or enhance the effectiveness of the statutory fund framework? Please provide commentary in support of your view.**

Yes. There are a number of aspects of the statutory fund regime that require review:

- The director liability provisions in respect of statutory funds (under sections 105-107) are onerous and out of step with other financial services legislation, such as the Financial Markets Conduct Act 2013 (**FMCA**).

- Currently disclosure does not state where the fund or assets are located or how the statutory fund protects the policyholder. The disclosure should include information on the extent to which the statutory fund protects policy holders.
- Further recommendations regarding disclosure more generally are set out in response to question 19.

**Question 9: In the context of overseas insurers, do you consider a statutory fund framework may help protect the interests of New Zealand policyholders? Please provide commentary in support of your view.**

Requiring overseas non-life insurers to create and administer statutory funds may protect the interests of New Zealand policyholders, particularly if the assets of the fund are located in New Zealand. This could also have the effect of growing New Zealand’s capital markets (which would be a secondary effect of this requirement). However, it is necessary to balance this with the need to ensure that participation of overseas insurers in the New Zealand insurance market is not inhibited by such a requirement. This is worth further investigation.

If statutory funds were required for overseas insurers, the points set out in question 8 above would need to be addressed.

It is unclear from the Issues Paper whether it is proposed that reinsurers would be subject to this requirement. This should be carefully considered as it may inhibit some reinsurers from participating in the New Zealand insurance market, which would be counter-productive as reinsurance assists local insurers to spread their risk thereby increasing protection for policyholders. Instead of a statutory fund requirement, it might be sufficient for the Reserve Bank to obtain information from reinsurers to ascertain that sufficient assets are held to respond to any exposure and that the reinsurance contracts do not contain any unusual or onerous terms.

**Question 10: Do you consider that the expectations placed on the directors, chief executive officer, chief financial officer or appointed actuary of insurers, would benefit from being considered further within the Review? This may include clarifications of current expectations or expansion of responsibilities.**

Yes. The non-prescriptive nature of the current regime allows different types of business to efficiently meet the regime’s requirements. However, the Reserve Bank places considerable weight on the role of directors and senior managers – particularly the role of independent directors. In such circumstances, it is important that the Reserve Bank clearly articulates its expectations.

**Question 11: Do you consider that the Review should encompass further consideration of an insurer’s key control functions (paragraph 84) to promote effective risk management and consistent application of requirements across the sector?**

Yes. As “self-discipline” is the key pillar of the regime, it is timely and appropriate to consider insurers’ key control functions as part of this review.

**Question 12: Do you consider that there may be opportunities to enhance the enforcement framework? Please provide comment in support of your view.**

The Law Society favours the proportionate enforcement approach taken in the FMCA. However, that regime applies to conduct regulation not prudential regulation. The IMF Report recommended that the Reserve Bank take a more active approach to supervision of insurers,<sup>5</sup> which would require a significant change in resourcing.<sup>6</sup> In the absence of more active supervision, a greater range of alternative enforcement tools may not be of much assistance.

It is also important that the Reserve Bank's expectations are clearly articulated. For example, the Reserve Bank has not always clearly set out its expectations around data collection. In such circumstances, it would not be appropriate to enable the Reserve Bank to exercise increased enforcement powers in relation to data collection until insurers have been provided with clear expectations.

Some of the current penalties appear to be disproportionate. For example, failure by a third party broker to disclose a financial strength rating (in accordance with section 64 of IPSA) exposes an insurer to a fine of up to \$100,000 each time a policy is sold without disclosure.<sup>7</sup>

The Reserve Bank should be sufficiently resourced to operate an appropriate and responsive enforcement regime.

**Question 13: Do you consider the distress management framework within IPSA could be considered within the Review to enhance the expected effectiveness of the framework, particularly for smaller licensed insurers?**

Yes, it is appropriate for the Review to consider the distress management framework as this is a key aspect of the IPSA regime. It may be appropriate to examine if there should be more equivalence with the regulation of the banking sector.

**Question 14: Are there any areas of the framework that may pose particular concerns when considering overseas insurers (branch operations)?**

The IMF Report recommended that the Reserve Bank review its approach to licensing of overseas insurers. If the current approach for branches is maintained, this Review should articulate why that approach remains appropriate, how policyholder interests are adequately protected and why local insurers are not disadvantaged.

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<sup>5</sup> IMF Report at pages 4-5.

<sup>6</sup> IMF Report at page 6.

<sup>7</sup> Section 64(5), IPSA.

**Question 15: Do you consider that the current approach to prudential capital requirements by reference to a solvency margin and conditions of licence should be within scope of the Review? Please provide commentary in support of your view.**

Yes, prudential capital requirements are a core part of the regime and so should be included in the Review.

**Question 16: Do you consider that consideration should be given to clarifying the Reserve Bank's prudential response to deteriorations in reported solvency levels? Please provide commentary in support of your views.**

Yes. The IMF report recommended that although the Reserve Bank has a range of options in managing distressed insurers, it should develop an internal policy on the use of powers in relation to two solvency control levels to ensure regulatory intervention occurs at an appropriate stage.<sup>8</sup>

**Question 17: Do you consider the Review should reassess the current framework for approval of material transactions and policy changes? Please provide commentary in support of your view.**

Yes. This should be reviewed to ensure that the approval framework is responsive and meets international best practice. The current IPSA's definition of "control" is higher than equivalent regulatory frameworks (such as the Takeovers Code). It is unclear if there is a rationale for this inconsistency. The Reserve Bank should also consider whether it is appropriate that a change in control (requiring a full reconsideration of licensing eligibility) is treated differently to a transfer of insurance business from a licensed issuer (requiring a direct approval). A properly resourced Reserve Bank approval process may be more appropriate and responsive for a change of control. If there are differences in how these matters are dealt with, the Reserve Bank should identify a reason for this based on higher or lower levels of risk to policyholders.

**Question 18: Do you consider that approval by the Reserve Bank is more or less effective than alternative mechanisms e.g. court based systems?**

Approval by the Reserve Bank will generally be more appropriate than a court-based system. The Reserve Bank has expertise in making assessments of this nature and is in a position to make decisions in much shorter timeframes. In addition to efficiency, maintaining the Reserve Bank's involvement in such processes has the benefit of increasing its supervisory expertise and strengthening its relationships with the regulated community of insurers.

**Question 19: Are there any aspects of the current disclosure requirements that you consider do not provide useful information or are unduly onerous or costly to prepare? Please provide commentary in support of your view.**

The IPSA requirement for disclosure in writing of a financial strength rating prior to the inception of a policy is unduly onerous and, as explained further below, is of unclear benefit to the policyholder.

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<sup>8</sup> IMF Report at page 5.

Because distribution of insurance products is generally conducted by an intermediary (via a broker), insurers have limited control on whether section 64 of IPSA is complied with – yet are exposed to significant fines. Furthermore, the costs of complying with this section are prohibitive, particularly if there is a change in the insurer’s financial strength rating and it becomes necessary to reprint all policy documentation and other collateral.

We recommend that consideration be given to formulating a defence, available to the insurer of “taking reasonable steps” to notify policyholders including (for instance) that the insurer has:

- set the information out in the policy documents on the first page;
- required its brokers to disclose this information to the potential policy holder; and
- made the information available prominently (on the home page) on the insurer’s website.

If the information does not, in fact, reach the policyholder (because the broker failed to provide it), the insurer would then have a defence of having taken the specified “reasonable steps”.

Further consideration should be given to the usefulness of financial strength ratings. As ratings issued by different ratings agencies are not equivalent, there is a risk that the information could mislead consumers. More generally, consideration should be given to whether the reliance on financial strength ratings effectively furthers the purposes of the IPSA. As an illustration, Moody’s, Standard & Poor’s and Fitch Ratings all maintained investment grade ratings on AIG and Lehman Brothers immediately prior to the global financial crisis.

**Question 20: Do you consider that there is information that is not currently required to be disclosed that would be beneficial to market participants? Please provide commentary in support of your view.**

This question is dealt with in part at question 8 above.

More broadly, although disclosure is a tool which fits with the Reserve Bank’s preferred approach of self and market discipline, this Review should consider whether more active supervision by the prudential regulator would be appropriate. Generally, regulators are moving away from light touch regulation to more actively supervise licensees. The IMF Report recommended that the Reserve Bank take a more active approach to supervision. This Review should weigh and consider whether, rather than relying primarily on disclosure (which is often not read or not well understood by policyholders), more active supervision is required.

**Question 21: Do you consider that the Reserve Bank (or other authority) has a role in providing appropriate industry data to the market? Please provide commentary in support of your view.**

Yes. The access that the Reserve Bank has to industry data gives it a unique ability to assist New Zealanders to appropriately manage risk.

**Question 22: Do you consider that the Review should reassess the manner in which requirements are currently specified and the mix between requirements set out in legislation, standards or guidance? Please provide commentary in support of your view.**

Yes. This should form part of the Review to ensure that the prudential supervision of insurers is as responsive, flexible and accessible as possible.

**Question 23: Are there any aspects of the current requirements that you consider would be better specified using different regulatory tools?**

Yes, the Law Society supports the availability of a range of regulatory tools. This would mean that the Reserve Bank could take a tailored approach by issuing conditions, declarations and exemptions. We refer to the example set out in question 2 above regarding exemptions for foreign insurers.

**Question 24: Are there any further issues you would like to raise that you consider should be within scope of the Review? Please provide commentary in support of your view.**

Yes, consideration should be given to including conduct of insurers within the scope of the Review. The International Association of Insurance Supervisors' recent consultation on conduct of business identified that conduct can impact the prudential regulation of whole markets.<sup>9</sup> In its submission on the review of the Financial Advisers Act 2008, the Reserve Bank identified that there are circumstances where conduct of business risk can erode the solvency position of an insurer.<sup>10</sup> Global regulators now recognise the links between prudential supervision and conduct of business risk. The IMF Report also recommended that the FMA and Government review the scope of conduct regulation for insurers.<sup>11</sup>

**Question 25: Are there any areas of the legislation that you consider are now redundant or you feel could have clearer drafting or require technical corrections?**

No.

**Question 26: Are there any areas of the legislation that you consider, having regard to the purposes of the legislation, unduly restrict competition or innovation within the New Zealand insurance market? Please provide commentary in support of your view.**

The Law Society has not identified any further areas of legislation which it considers may have this effect.

As the IMF recommended, consideration should be given to the resourcing of the Reserve Bank. The licensing process and supervisory process can be slow. Although the Reserve Bank is engaged and helpful, it is limited by availability of resources.

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<sup>9</sup> <https://www.iaisweb.org/page/consultations/closed-consultations/issues-paper-on-conduct-of-business-risk-and-its-management//file/52875/issues-paper-on-conduct-of-business-risk-and-its-management>

<sup>10</sup> <http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/options-paper/options-paper-submissions/RBNZ.pdf>

<sup>11</sup> IMF Report at page 6.



## **Conclusion**

These comments were prepared with the assistance of the Law Society's Commercial and Business Law Committee. If you have any questions or wish to discuss further, please do not hesitate to contact the committee convenor, Rebecca Sellers, via the committee secretary, Jo Holland at [jo.holland@lawsociety.org.nz](mailto:jo.holland@lawsociety.org.nz) / 04 463 2967.

Yours sincerely

A handwritten signature in black ink, appearing to be 'K. Beck', written in a cursive style.

Kathryn Beck  
**President**