REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS:

INSURANCE

Discussion Document

September 2006

ISBN **0478284918**

First Published September 2006
Regulatory and Competition Policy Branch
Ministry of Economic Development
PO Box 1473
Wellington
New Zealand
www.med.govt.nz

TABLE OF CONTENTS

1. EXECUTIVE SUMMARY

1.1 INTRODUCTION

1. The current legislative framework for the regulation of insurance products and providers is light-handed, in many cases extremely out-dated and not consistent with internationally recommended practices. Given the existing regulatory environment, industry has developed a strong self-regulatory environment that instils a number of disciplines on the market. Proposals and options contained in the discussion paper are intended to address problems that have arisen with the existing regime and to continue a non-intrusive regulatory environment reinforcing existing market- and self-disciplines.

2. A number of factors have contributed to the need for Government to comprehensively review the regulatory framework for the insurance market and there is general consensus within the insurance industry that change is needed.

3. While most of the insurance sector is operating responsibly there are providers at the fringes who are not adhering to acceptable standards. The existing regulatory framework provides the opportunity for some providers to adopt practices considered by industry (and internationally) to be imprudent when providing insurance products to the public. In addition, a few providers register entities in New Zealand, but only provide products outside New Zealand, in order to hold out that they are supervised under New Zealand insurance law when they are not. These fringe providers are causing reputation problems for the New Zealand insurance market, which may impact on responsible providers.

4. Consultation has identified that some finance companies providing insurance are failing to comply with insurance regulation. This unduly exposes consumers, unjustly provides competitive advantages to the non-compliant providers and compromises the efficacy of regulation. The Ministry of Economic Development has also received a number of queries regarding whether a specific product or provider is or should be complying with insurance law. Without a centralised register of insurance providers the market is unable to ascertain this for itself.

5. The limited monitoring and enforcement powers under the current regime make it difficult for the Regulator to identify troubled insurers or to do anything to assist in their rehabilitation where they are identified. If a financially distressed insurer collapses there is little that can be done to limit the impact on consumers. This is especially the case where New Zealand policyholder assets are not ring-fenced from those of a foreign parent or where policyholders are trapped in products without the ability to obtain replacement cover on the same terms due to materially changed circumstances (e.g. health conditions). This puts policyholders in a vulnerable position. It also creates moral hazard for Government because we have an insurance Regulator (the Insurance and Superannuation Unit) that lacks enforcement powers. It therefore appears as if Government should be able to do something where insurers are financially distressed but in fact this is not the case.

6. Some insurance legislation is nearly a century old so does not reflect the insurance market today. Other insurance legislation has been developed in a piecemeal way, causing inconsistencies and differing levels of protections for consumers, and making it difficult for consumers to compare providers of similar products. The problems with the current legislation are is imposing unnecessary cost and impeding innovation. Hence, aligning the regulatory framework with current practices in a consistent manner across

the sector and developing a flexible framework which accounts for future market changes is the desired approach.

7. Feedback from the insurance industry is that they are eager for the reform of the legislation and keen to resolve the above issues along with others discussed in this paper. In developing the proposals and options for a new regulatory framework for insurance products and providers, we have considered and accounted for the existing market disciplines and best practices. Much of what is set out below may be considered as giving regulatory backing to these. Our research and consultation has highlighted that most of the insurance market is or will be able to meet most of these requirements. Where insurers are not in compliance, we believe it is unlikely the cost of change will exceed the benefits derived.

1.2 OUTCOMES SOUGHT

8. The overall outcomes Government is specifically seeking from the insurance sector are:

- A sound and efficient insurance sector;
- Facilitation of effective risk management;
- Confidence in the insurance sector that encourages participation by consumers, firms and providers; and
- Not to compromise or constrain contestability, competitiveness and innovation in the insurance sector.

1.3 REASONS FOR REGULATORY INTERVENTION

9. There are five main areas that give rise to the need for regulatory intervention in the insurance market.

- **Asymmetries of information and complexity.** Consumers need to be well informed about insurance products and providers through accessible, timely, and easily understood information in order to assess which product and provider will best meet their financial needs. Due to the complexity and long term nature of some insurance products insurers may not have sufficient incentives to ensure the consumer is provided with the information they need and in a readily understandable form.
- **Issues of transferability.** Consumers of some insurance products are unable to act upon information that alerts them to the vulnerability of an insurer's financial position. This is because they may be unable to obtain replacement cover from another insurer on similar terms, or at all, due to material changes in their insurable circumstances. As these policyholders have become effectively locked in to their policies they will be exposed to financially debilitating events, without the ability to take any meaningful mitigating action, if their insurer becomes insolvent.
- **Unfair or fraudulent conduct.** This is not a major feature of the insurance market, but potentially relates to all participants (insurers, intermediaries and policyholders). Practices which may be misleading, unfair, or fraudulent may arise because of unaligned incentives between the participants and the difficulties faced by individuals in monitoring the conduct or behaviour of others, especially since insurance products can be complex and of a long term nature.

- **Expectations and confidence.** Currently some entities operating in the market are taking advantage of the regulatory environment. This relates to feedback regarding some finance companies offering insurance products without complying with insurance legislation and a few New Zealand domiciled insurance companies only providing products overseas but holding out they are regulated under New Zealand insurance law when they are not. This is causing reputation issues for the New Zealand market both domestically and internationally. Also, consumers have uninformed expectations about the role of the Accident Compensation Corporation ("ACC"), the Earthquake Commission ("EQC") and Government in relation to the provision of cover, contributing to a lack of clarity about where individual responsibilities lie. Non-compliance with international best practice also has the potential to reduce confidence in, and damage the reputation of, the New Zealand insurance market.

- **Externalities.** Distress or failure in the insurance industry is unlikely to pose a risk to the soundness of the financial system, but potentially has international reputation impacts. Large scale events, like a natural disaster, may have some implications for the economy in terms of business interruption.

1.4 OBJECTIVES

10. The Government's objectives regarding the regulation of the New Zealand insurance sector are as follows.

1.4.1 Prudential Regulation

- To promote policyholder confidence in the soundness of the insurance sector.
- To encourage soundly governed insurers.
- To ensure timely and orderly resolution of distressed insurers.

1.4.2 Market Conduct Regulation

- To promote well-informed insurance policyholders.
- To promote effective use of an intermediaries market.
- To deter, detect and minimise the risk of unfair or fraudulent conduct.

1.5 PROPOSALS AND OPTIONS FOR REGULATION

11. The proposals and options for the insurance regulatory framework are summarised below.

1.5.1 Proposal - Regulatory Boundaries

12. The proposal is that the insurance regulatory regime will be applied to all insurance products and providers who provide cover for any New Zealand or foreign risks, i.e. to all types of general insurance, life insurance, disability insurance, professional indemnity insurance, public liability insurance and health insurance.

1.5.2 Proposal - Licensing and Prudential

13. The proposals relating to licensing and prudential requirements are noted below. Most of these requirements are already being met by industry and complement the existing self-regulatory disciplines developed through insurance industry associations.

Proposals	**Explanation**
Registration of corporate form	Registration as different corporate forms retained.
Registration as a financial services provider	An insurer must register as a financial services provider of insurance.
Board structure and significant owners/director/senior management capability	The insurer must comply with requirements approved by the Regulator regarding board composition, suitability of key persons, fit and proper person vetting, functions and responsibility, and external auditors.
Approval of changes in control	Changes in control (significant owners, directors, senior managers) must be notified to, and approved by, the Regulator pursuant to criteria.
Categorisation by licence	Insurers must obtain a separate licence for life/ general/ health insurance.
Provide products in New Zealand	To obtain a licence an insurer must have a physical presence and provide products in NZ.
Agent of the insurer	Agents will be able to apply for a licence to supply insurance products in the NZ market on behalf of overseas entities which do not have a NZ presence. Criteria will be set against which approvals will be made by the Regulator.
Start-up solvency support plan	Required on entry. The insurer must present a solvency support plan outlining its proposed business and how it will meet the ongoing enhanced solvency requirements (see below).
Flexible start-up capital requirement	Required on entry. The Regulator will approve the level of start-up capital an insurer must have to obtain a licence. The level will be commensurate to the insurer's business, assessed by vetting the insurer's solvency support plan.
Enhanced solvency requirements	An ongoing requirement. The insurer must comply with an enhanced solvency regime, which will determine the level of reserving to ensure book and entity survival, for each class of insurance (general, health and life).
Solvency standard setting - co-regulatory model	A co-regulatory model will be used to develop the enhanced solvency standards. This will involve establishing an Enhanced Solvency Standards Board and utilising the New Zealand Society of Actuaries in standards development with Regulator approval against set criteria. The standards relate to matters that have an actuarial element only.
Financial condition report	Insurers must prepare a financial condition report annually with director attestation to the Regulator that it has been prepared.
Licensing subject to conditions	Regulator may issue a licence subject to conditions (and may amend or revoke at any time), if justified for the purposes and objectives of the legislation.
Licensing fees	Potentially, fees will be charged to obtain a licence.
Insurer appeal rights for	The insurer may appeal to the courts, under judicial review, decisions made

prudential requirements	by the Regulator in relation to prudential requirements.

1.5.3 Options - Licensing and Prudential

14. The areas where further discussion and feedback is sought in relation to licensing and prudential requirements are set out below. In considering these requirements and providing submissions it is important to consider what problems the options will overcome and their consistency with the outcomes and objectives of the regulatory framework.

Options	**Explanation**
Separation of classes life/general/health	The proposal is for insurers to comply with accounting separation (with segregated funds) rules for life, general and health insurance business, with the option of the Regulator requiring incorporation under the Companies Act 1993, plus conditions, determined against criteria.
Legal form of foreign insurers	In addition to compliance with accounting separation (with segregated funds), the option is that the Regulator may determine, against criteria, whether the foreign insurer can operate as a branch or a subsidiary, and may impose additional conditions.
Ratings	The three options being considered are mandatory ratings (for all insurers with exemptions considered), no mandatory ratings (under which no insurers would be required to obtain a rating, but if they did have a rating, it would have to be disclosed to policyholders), or retain mandatory ratings for disaster and property.
Transition of existing insurers	Existing insurers in NZ must obtain a licence. The two options for a transition period are either setting a defined period or stepped milestones within which existing insurers must comply with the new regulatory regime, or insurers applying to the Regulator for consideration of an exemption, subject to criteria plus any terms the Regulator may impose.
Risk management strategy	The option is for an insurer to provide director attestation to the Regulator regarding its risk management strategy and practices, with a fitness for purpose framework, which would include key areas.
Insurer appeal rights for licensing and de-licensing decisions	There are two options for the insurer's right of appeal to the courts for decisions made by the Regulator in relation to licensing requirements and de-licensing; either merit review or judicial review.

1.5.4 Proposals - Monitoring and Supervision

15. The proposals for monitoring and supervision requirements are set out below. These requirements are standard to any regime to enable effective monitoring and enforcement. Currently the Regulator does not have the necessary regulatory powers to effectively monitor the insurance market, and the insurance industry has recognised the need for improved tools for the purposes of supervision. While some insurers will be complying with some of the reporting requirements, many of the monitoring powers of the Regulator will be new. Therefore, we are keen to receive feedback on the appropriateness of these proposals and the potential impacts of change.

Proposals	Explanation
Financial reporting	Annual audited financial reporting under the Financial Reporting Act 1993 (FRA) must be carried out by all insurers, with no exemptions for size, and will be available on a centralised register of financial providers. A similar report, unaudited, must be made half-yearly.
Director attestation	The directors and chief executive must attest in public disclosure statements to compliance with the supervisory requirements, and that adequate systems and controls exist to identify, monitor and control its material business risks. If the risk management plan option referred to above is adopted, an attestation will also be required in that regard.
Key information summary	Insurers must publish ongoing financial information about the stability of the insurer in a summary short form document.
Licence status disclosure	Insurers must publicise (in their disclosure documents) their licence issue date and any terms or any exemptions. It must be updated when changed.
Reports	Insurers must report directly to the Regulator reports made under the FRA, the half-yearly version and compliance with the licensing and prudential requirements, by class of insurance business (i.e. by licence).
Confidentiality of reports to the Regulator	Reports to the Regulator will be subject to similar levels of confidentiality as reports to other regulators in NZ.
Frequency of reporting to the Regulator	Reports to the Regulator must be made half-yearly (unaudited) and annually (audited). The Regulator will have the power to require an insurer to report more regularly.
Reporting on a solo and consolidated basis	Regulator may require an insurer that is part of a group, to provide reports to the Regulator on each solo entity in the group and on a group consolidated basis.
Exemption for certain approved jurisdictions	Regulator may authorise a foreign insurer to comply with prudential regulation imposed in its home jurisdiction instead of equivalent requirements in NZ and/or give the NZ Regulator the same reports it gives to its home Regulator.
Information sharing with foreign regulators	Regulator may seek and share information with regulators/supervisors in foreign jurisdictions.
Require additional information	Regulator may obtain information from the insurer or third parties, e.g. insurer's auditors or reinsurers, if justified for the purposes and objectives of the legislation.
Meet with the board and senior management	Regulator may call for meetings with the board and senior management if justified for the purposes and objectives of the legislation.
Directives to board and senior management	Regulator may give directives to the board and/or senior management, if justified for the purposes and objectives of the legislation.
Regulator required audit	Regulator may require an insurer to have information audited by an auditor approved by the Regulator, if justified for the purposes and objectives of the legislation.
Self-correction plan	Regulator may require a recovery plan that sets out how the insurer intends to correct the position itself within a specified timeframe, if justified for the purposes and objectives of the legislation.
Book transfers	Regulator may require the compulsory transfer of a failing insurer's book to another insurer that voluntarily accepts this transfer, if justified for the purposes

	and objectives of the legislation.
Onsite inspections	Regulator may undertake onsite inspections either themselves or through a third party appointed as inspector, at any time.
Sanctions and penalties	Regulator may apply to the courts to impose penalties on the insurer, and in some cases the directors and officers of the insurer, of amounts set out in legislation.
Conditions of de-licensing	Regulator may withdraw an insurer's licence temporarily or permanently if not used within 12 months of its issue, or if the licensing, prudential and other requirements are not met.
Regulator appointment of statutory manager	Regulator may recommend to the Minister, subject to criteria, that a statutory manager be appointed to an insurer. The Regulator will have the power to direct the actions of the manager.
Checks and balances	As a check and balance on the use of the Regulator's powers, directives and restrictions imposed on insurers by the Regulator will only apply temporarily; to impose them permanently will require de-licensing.
Insurer appeal rights for monitoring and intervention powers	The insurer may appeal to the courts under judicial review for decisions made by the Regulator under monitoring requirements and intervention powers.

1.5.5 Proposals - Market Conduct

16. The proposals for insurance regulation relating to market conduct are noted below. They are intended to cover aspects of the conduct of providers in the insurance market. The requirements focus on clarifying who is responsible for disclosure of information about insurance products (plus what, how, and when) in order to deter unfair or fraudulent conduct. They also review the registration system for assignments and mortgages of life policies, and propose an approach for dealing with the contractual relationship between the insured and the insurer regarding the duty of disclosure and the insurer's remedies for non-disclosure and mis-statement.

Proposals	**Explanation**
Insurance contracts duty of disclosure	The duty is to remain the same.
Insurance contracts mis-statement and non-disclosure	The remedy of avoidance will be limited to specified circumstances, and other remedies will apply to breaches outside of those circumstances.
Registration of assignments and mortgages of life policies	A notice procedure will apply.
Product disclosure	A product disclosure regime may be developed for insurance products.
Intermediaries as agents	This clarifies when the intermediary becomes the agent of the insurer, and the policyholder's rights of redress.

2. INSURANCE

2.1 NEW ZEALAND INSURANCE MARKET

17. The New Zealand insurance market is best described as diverse and unique. This is a result of features such as the products offered and how they are delivered, the legal form of players, the domicile of the insurer's parent, composition of consumer consumption and the provision of public insurance through vehicles such as ACC and EQC.

18. With the current regulatory environment for insurance being extremely light-handed the market has invested significantly in developing a model of self-regulation that has led to a stable and well-managed market over time. Industry bodies such as the New Zealand Insurance Council ("ICNZ"), Health Funds Association of New Zealand (HFANZ), Investment Savings and Insurance Association ("ISI"), New Zealand Society of Actuaries (NZSA) and the Insurance and Saving Ombudsman (ISO) have been important players in promoting and facilitating this self-regulatory environment for their members and the insurance sector.

19. At a broad level there is low market penetration of some insurance products in New Zealand. Recent data implies that almost 50 percent of New Zealanders have no cover on their life or health.[1] When probing the data further it becomes apparent that this figure may not accurately reflect the depth of coverage as the data also identifies a strong correlation between those who hold one policy and those who own a number of insurance policies. Therefore, the total number of people holding insurance coverage may in fact be substantially less.

20. This is consistent with general public discussion, not only around the level of under-insurance in New Zealand, but around the wider issues of high levels of personal borrowing and spending, and failure to prioritise the need to self-insure or obtain insurance to mitigate exposure to financial hardship due to unforeseen events. It has been reported that the level of under-insurance could in fact be NZ$1.8 to $2.8 billion[2] meaning that roughly 40 percent of New Zealanders would not be able to financially withstand three months without income. Currently only approximately 32 percent of the New Zealand population have private health insurance. New Zealand-specific research suggests there is a public expectation that ACC[3], work, friends, sickness benefits, credit cards, revolving mortgages and overdrafts would somehow enable them to "get by".[4]

21. The life insurance component of the sector has a total of 37 entities.[5] However, the traditional life assurance market (relating to whole of life and endowment policies) is in decline, with total annual premiums in force for this area continuing to fall as the

---

[1] Blackwood King Adpartners, Oct 2005, *AIA Life Matters Survey*, Commissioned by American International Assurance New Zealand.
[2] Weir, J. (2005), *Kiwis' spend-up bypasses insurers*, Dominion Post 5 December 2005.
[3] A contributing factor to the levels of under-insurance in New Zealand is the assumption by many New Zealanders that ACC and the Government will "take care of things" when times become tough. See Boyes, P. *Insurance Competition Heats up in the Insurance Market*, New Zealand Herald, 22 May 2006
[4] Blackwood King Adpartners, Oct 2005, *AIA Life Matters Survey*, Commissioned by American International Assurance New Zealand.
[5] Source: Insurance and Superannuation Unit, MED.

popularity of whole of life and endowment insurance wanes.[6] In March 2003 total annual premiums in force for traditional life policies were roughly $274 million.[7] By the end of March 2006 the total annual premiums in force were around $234 million.[8] However, there has been a growth in the risk and group market of the life sector as demonstrated through the continued expansion of annual earned premiums in what is a relatively contestable market.[9] The growth in risk products in the life insurance market has resulted in total life insurance premiums growing from $1.037 billion in March 2003 to $1.273 billion in March 2006.

22. General insurers provide a range of risk products and this diversity is promoted by a competitive market comprised of 104 entities.[10] Total net written premiums have grown from approximately $1.65 billion in 2001 to $2.53 billion in 2005 with the largest area of growth being in the motor vehicle (commercial and private) market.[11]

23. The private health insurance sector is characterised by a strong interface with the public provision of health services. There are 11 insurers in a highly concentrated market where most players (almost 75 percent by number) are not-for-profit organisations that write a small number of premiums annually. These small insurers provide 23.5 percent of New Zealand's health cover (some totalling only $1 million in premiums annually).

24. The total number of New Zealanders with private health coverage tends to fluctuate more sharply than with other types of insurance products. Currently, there are approximately 1.354 million New Zealanders with private health insurance, representing approximately 32 percent of the total population.[12] In comparison with insurance consumption trends generally in New Zealand, this is below the global average. These figures are in part due to the supplementary and complementary relationship private health insurance has with the public provision of health services in New Zealand.

2.2 PURPOSE OF INSURANCE

25. The insurance sector is important not only to individuals, but to the financial sector, contributing significantly to the sustainable economic development of the New Zealand community. Specifically, there are six main areas where insurance contributes to sustainable economic development and Government's focus on economic transformation.

2.2.1 Reduces Risk Volatility Among Households and Firms

26. Insurance enables households and firms who are least able to withstand unforeseen events carrying weighty financial consequences to transfer those risks to parties who

---

[6] The decline in the popularity of traditional whole of life insurance products has been attributed to the taxation basis for life insurance business.
[7] Source: www.isi.org.nz/files/ISITraditionalRiskBus30.09.2003(Sum1).PDF last accessed Monday 10 May 2006.
[8] Source: www.isi.org.nz/Qtrly%20Statistics/TraditionalRiskBus31.03.2006(Sum1).pdf last accessed Monday 10 May 2006.
[9] Source: www.isi.org.nz/stats.htm last accessed Thursday 11 May 2006.
[10] Insurance and Superannuation Unit, *Structure of NZ Insurance Sector*, Ministry of Economic Development.
[11] Source: www.icnz.org.nz/media/review/05-06/industry-statistics.php last accessed Monday 8 May 2006
[12] Source: Health Funds Association of New Zealand.

are more able to manage the risks and withstand the events.[13] This overcomes the need for a household or firm to self-insure by holding sums of capital to weather such events and enables them to stabilise their financial position over the long term. It also promotes efficient allocation of capital.

2.2.2 Facilitates Economic Activity

27. Innovation and entrepreneurship, fundamental building blocks of economic activity, are typically accompanied by higher levels of risk. Therefore, new business ventures are often dependent on the ability to avoid or minimise risk outside their control. As Arrow (1970) has described it[14];

> …insurance in the broadest sense, permits individuals to engage in risk activities that they would not otherwise undertake.

28. Take for example, the case of goods being transported distances for reasons such as firm production or to connect a buyer and seller. By covering the potential loss in transit, insurance facilitates exchange. Insurance may be a precondition for commercial activity (e.g. for borrowing/lending). It can also reduce the risk of costly interruption and even fend off liquidation altogether, smoothing the progress of trade and commerce for activities that may have previously been viewed as uneconomical. Hence, commercial access to insurance facilitates improved resource allocation within the economy.[15]

2.2.3 Provides the Capacity for Communities to Mitigate Risk

29. Insurers enable community risk to be managed more efficiently through risk pricing, transformation of the individual's risk profile, risk pooling and risk reduction. The greater the potential for loss the higher the premium charged (the price of that risk). In pricing risk, consumers adjust their behaviour to attain an optimal economic position. Hence, insurance products create an incentive structure for policyholders to undertake loss management activities or risk mitigation strategies, which can benefit the community at large.

2.2.4 Reduces Pressure on Government Welfare Programmes

30. Insurance can act as a substitute for or complement to Government welfare programmes and safety nets. Higher levels of private consumption of insurance products have been associated with, and some would argue correlated to, lower Government expenditure on Government welfare programmes.[16] It lessens the pressure or dependence on Government to "rescue" communities following natural disasters. In addition, the need for insurance is more pertinent today given the current demographic transitions in New Zealand which will impact upon the provision of public goods and services, such as health care, in the future.

---

[13] Carmichael, J., Pomerleano, M., 2002, *The Development and Regulation of Non-Bank Financial Institutions*, The World Bank.
[14] Arrow, K., 1970, *Essays in the Theory of Risk-Bearing*, North Holland Publishing Co, Amsterdam and London.
[15] Webb, I.P., Grace, M.F., Skipper, H.D., March 2002, *The Effect of Banking and Insurance on the Growth of Capital and Output*, Centre for Risk Management and Insurance Working Paper 02-1, Robinson College of Business, Georgia State University
[16] Skipper, Jr., H.D., Starr, C.V., Robinson, J.M., 2000, *Liberalisation of Insurance Markets: issues and Concerns*, OECD.

2.2.5 Provides a Capacity to Mobilise Savings

31. Life insurance products were some of the first vehicles to enable low income individuals to more effectively engage in saving and investing for the long term (e.g. insurance consumption can mitigate the risk that a consumer will need to call on their superannuation funds for financial hardship). This was due to the ability of individuals to purchase life insurance and savings contracts in small amounts on a regular basis over time, rather than to hold stores of capital (either liquid or illiquid) to overcome financially debilitating events.[17] Through the pooling of funds and risks, an insurer becomes a part of the group of institutional investors.

2.2.6 Enables a More Efficient Allocation of Capital

32. At a high level, premiums collected from policyholders are mobilised and invested in capital markets. This has broader benefits for the economy as this stimulates growth of the capital market.

33. Insurance prices risk at two levels. First, by placing a price on the potential for loss, (which is done through premiums), and second, through the pursuit of particular rates of return through the insurer's investment activities. An insurer has a vested interest in information collection to evaluate individuals and firms in deciding whether they will offer insurance and at what price. This results in an efficient allocation of insurance risk-bearing capacity.[18]

34. The insurer has an advantage over individuals and firms (as do other intermediaries) in allocating capital efficiently as the insurer is able to better allocate funds to the most sound and efficient firms and investments.[19] It is important that regulatory requirements do not interrupt and consequently stifle this valuable process.

2.3 OUTCOMES SOUGHT

35. Given the benefits the consumption of insurance products provides to the economy, the overall outcomes Government is specifically seeking from the insurance sector are:

- A sound and efficient insurance sector:
- Facilitation of effective risk management:
- Confidence in the insurance sector that encourages participation by consumers, firms and providers; and
- Not to compromise or constrain contestability, competitiveness and innovation in the insurance sector.

[17] Dickinson, G. *Encouraging a Dynamic Life Insurance Industry: Economic Benefits and Policy Issues*, Professor and Director, Centre for Insurance and Investment Studies, City University, Business School, London.
[18] Skipper, Jr., H.D., Starr, C.V., Robinson, J.M., 2000, *Liberalisation of Insurance Markets: Issues and Concerns*, OECD.
[19] Centre for International Economics, *General Insurance Sector: Big benefits but overburdened*, August 2005.

2.4 REASONS FOR REGULATORY INTERVENTION

36. Market imperfections impacting on the above outcomes, which may compromise the benefits that can derived from the consumption of insurance products are:

- Information asymmetries and complexity;
- Issues of transferability;
- Unfair or fraudulent conduct;
- Expectations and confidence; and
- Externalities.

37. It is not reasonable to expect the insurance sector to overcome these market imperfections on its own to achieve the desired outcomes of the Review of Financial Products and Providers ("RFPP"). Government intervention is necessary:

- To complement market forces in increasing the capacity for the New Zealand economy to derive benefits from the consumption of insurance products, while attaining the desired Government outcomes from the insurance industry; and
- For New Zealand to meet international guidelines and principles under, for instance, International Association of Insurance Supervisors ("IAIS") and Financial Action Task Force ("FATF").[20]

38. These market imperfections provide rationale for regulatory intervention in the insurance sector through prudential regulation and market conduct requirements.

2.4.1 Information Asymmetries and Complexity

39. By way of standard definition, asymmetric information is a situation in which one party to an economic relationship is better informed than the other. At different times in the ongoing association between the policyholder and the insurer, this can involve either party. Consequently, a number of adverse selection issues arise. This means that due to the incomplete or inaccurate information held by one party, the transaction may be biased in favour of the other party.[21] Hence, economic efficiency and its benefits may be compromised.

40. Government can assist the market through regulatory intervention directed at these asymmetries. Specifically, the proposed regulatory tools are focused on overcoming information asymmetries in relation to the product, the insurer as an entity, and disclosure by the policyholder.

[20] See www.iaisweb.org and see FATF (Financial Action Taskforce).GAFI (Groupe d'action financiere sur le blanchiment de captaux), *The Forty Recommendations*, 20 June 2003.
[21] See Abelson, P, (2000) *Lectures in Public Economics*, Published by Applied Economics, Sydney, Australia.

2.4.1.1 The Product

41. For an individual to make an informed choice about whether an insurance policy is appropriate for their personal financial needs, it is important the consumer is aware of the features of the product they may purchase. Well-informed consumers can, in addition to determining the appropriateness of the insurance product to their needs, undertake comparisons between similar products being offered by other insurers.

42. Some of the primary details a consumer needs about the product before entering into a contract of insurance relate to, for example, the terms (including any exclusions), total sum insured, what costs the policyholder must bear, price of the policy, data which allows comparison between products, and the level of insurance they require. The reasons a consumer may not have the information to determine which product is most appropriate for them may include:

- How often people take out an insurance product and the ease of understanding of the product;
- The longevity of some products making it difficult for a policyholder to adequately assess their individual needs at a point in time a number of decades away;
- Lack of knowledge of the costs involved in self-insurance. For example, the cost of cardiac surgery in a private hospital or angiography services vs the cost of private health insurance;
- Lack of consistent information making it difficult for consumers to compare products;
- Lack of desire or resources to interpret or internalise the information available; and
- Lack of incentives for insurers to provide information beyond a certain point.

43. Due to the information asymmetries relating to insurance products, some of the regulatory tools needed to overcome information asymmetries involve improved product disclosure. The types of product disclosure are discussed in the *Market Conduct* section.

44. Financial intermediaries can play a role in informing policyholders about the appropriateness of a product for their needs. This can assist in overcoming some of the problems associated with asymmetric information and consumers' ability to determine the optimal product on offer. Research shows that consumers regularly seek the assistance of insurance intermediaries to obtain advice on the appropriateness of insurance products for their personal needs.[22] This is due to the experience and expertise held by many intermediaries.

45. However, at times, intermediaries can suffer from unaligned incentives to provide policyholders with optimal information. For instance, where an intermediary's remuneration is commission-based there may be incentives to offer products based on

---

[22] See studies referred to in the *Market Conduct* section.

commissions received rather than a product which will best meet the consumer's needs. In addition, due to the irregularity of purchasing an insurance policy or it being unlikely that consumers will make repeat purchases, some intermediaries may not have strong reputation incentives to adjust behaviour.

46. The *Financial Intermediaries* discussion paper sets out the generic discussion on how the skills and competencies of intermediaries can be enhanced. Hence, the *Market Conduct* section focuses more on insurance specific regulatory tools that are proposed in relation to intermediaries providing advice on insurance products and providers.

2.4.1.2 The Insurer as an Entity

47. The stability of an insurer is important to the policyholder as it will impact on whether the insurer has the adequate longevity to provide cover when an insured event arises. Without appropriate insurer longevity, the policyholder will have to bear the costs of the insured event. In some circumstances, this can be financially debilitating, and potentially contribute to the financial ruin of the policyholder.

48. An insurance promise can be complex for the insurer to determine in relation to the probability of the event arising and the ability to assess the size of that promise. Even if information about associated risks to the insurer's stability were provided in a timely manner some consumers may lack the necessary skill set to usefully interpret it to achieve the optimal individual benefit. In that regard, it is appropriate to consider what form this disclosure should take. Sometimes the problem cannot be fixed by disclosure alone. This is where licensing and prudential requirements become important, since they encourage insurers to focus on stability issues. Discussion of regulatory tools to facilitate insurer stability are set out in the *Licensing and Prudential Requirements* section and the *Monitoring and Supervision* section.

49. As is the case with product disclosure, insurance intermediaries play a role in disseminating information to consumers about the longevity of the insurer. The role of an intermediary in informing consumers about the stability of the insurer is discussed in the *Market Conduct* section.

2.4.1.3 Disclosure by the Policyholder

50. To appropriately underwrite the risks of an individual, the insurer is reliant on the consumer disclosing all material circumstances relevant to the contract. Failure to do so results in a scenario where not all risks attached to the policy are underwritten, and therefore, risks in a policy are not correctly priced by the insurer. At the same time, it is difficult for the insurer to identify all potential risks of a policyholder, but the policyholder may be unaware of what is material to a prudent insurer. This creates an adverse selection issue which may result in a contract that is inadvertently biased in favour of one party over the other.[23] The consumer may unknowingly be left without cover, or the insurer exposed to unidentified risk.

51. From a market conduct perspective, a further regulatory tool available to help resolve some of the issues relating to imperfect or asymmetric information is improvements in the level of public education around insurance products and financial knowledge

---

[23] See Rickets, M. (2002) *The Economics of Business Enterprise: An introduction to Economic Organisation and the Theory of the Firm,* Third Edition, Edward Elgar Publishing, Inc USA.

generally. Issues regarding materiality, non-disclosure and mis-statement, and remedies are discussed in the *Market Conduct* section.

2.4.2 Issues of Transferability (Lock-in)

52. Some insurance products exhibit characteristics of lock-in due to the inability of a policyholder to transfer between providers. This is because material circumstances of the policyholder can change over the duration of the contract. If the consumer were to transfer between providers, material circumstances that have developed would require re-underwriting. These risks may be subject to exclusions, and higher excesses or increased premiums may apply. Consequently, the policyholder will either be in an inferior position, or in some circumstances, unable to obtain cover at all.[24] The significant impacts of change for the policyholder highlights the importance of an insurer's longevity.

53. For example, at the time a consumer enters into an insurance contract, they may have received all the necessary information to make an optimal decision regarding the appropriateness of the product and provider for their needs. Some time later, during the term of the contract, the consumer receives information about detrimental changes to the product or stability of the insurer. In the same time period there may have been significant changes in the personal circumstances of the policyholder (such as deterioration of their health). Therefore, even with the existence of simplified information about either the product or the insurer's stability, the policyholder may be unable to act on the information due to the prohibitive cost of transferability noted above. Hence, the policyholder has no choice but to bear the cost of changes outside their control.

54. Regulatory intervention can be utilised to limit the negative effects of lock-in experienced by consumers of certain insurance products. For instance, prudential regulation can constrain excessively risky behaviour or poor risk management by the insurer through encouraging more effective corporate governance and risk management. [25] Also, the Regulator may focus on applying more of the intervention powers to insurance products that exhibit problems of lock-in and where an insurer is experiencing financial distress. Regulatory tools to help overcome transferability issues are discussed further in the *Licensing and Prudential Requirements* section and the *Monitoring and Supervision* section.

2.4.3 Unfair and Fraudulent Conduct

55. There is scope for some insurers, policyholders and intermediaries to partake in practices that unfairly disadvantage or commit fraud against another party to the insurance arrangement. For instance, an insurer or its directors may misrepresent the stability of the entity, or provide disclosure which is misleading about a product. The policyholder may misrepresent or withhold information crucial to the underwriting of a policy. An intermediary may not disclose information that enables a policyholder to determine whether they are acting in the policyholder's best interests, for instance, whether they are tied or independent.

---

[24] The FSA states, customers who have developed a medical condition (or any material condition) during the life of a policy are effectively 'trapped' with their existing provider. See FSA Consultation Paper 160, Insurance Selling and Administration: The FSA's high-level approach to regulation.
[25] J. David Cummins, Scott Harrington and Greg Niehaus, *An economic overview of risk based capital requirements for the property-liability insurance industry*, Journal of Insurance Regulation, Vol 11, No 4.

56. How regulation can minimise the incentives for parties to partake in unfair or fraudulent conduct is discussed in the *Licensing and Prudential Requirements* section, *Monitoring and Supervision* section, *Market Conduct* section and the Financial *Intermediaries* discussion document.

2.4.4 Expectations and Confidence

57. There is an expectation that New Zealand should be meeting international guidelines and principles relating to the supervision of insurance, where it is currently not doing so. Non-compliance presents reputation risks for the New Zealand insurance sector. Hence, the proposed insurance regulatory framework should address this issue.

58. The existence of ACC and EQC has created uninformed (and perhaps unrealistic) expectations about the support provided by these forms of public insurance. Public pressure on Government to assist communities when natural disasters occur may also contribute to a blurred understanding of where individual responsibility lies. In addition, research has identified that consumers have an expectation that work, friends, sickness benefits, credit cards, revolving mortgages and overdrafts would somehow manage them to 'get by'.[26] While this expectation continues it is unlikely that consumer participation in the insurance sector will improve.

59. With any Government regulatory intervention there is an inherent risk that consumers develop an expectation that the regulation provides them with a Government guarantee. To overcome this moral hazard[27] issue, it is important Government reinforces that financial decision-making responsibility is still the responsibility of the individual.

60. Failure to identify and account for factors such as expectations and confidence, which impact on consumption, affects the appropriateness of regulatory tools used to resolve market imperfection issues. Tools designed to mitigate moral hazard risks are looked at further in the *Licensing and Prudential Requirements* section, *Monitoring and Supervision* section, and the *Market Conduct* section.

2.4.5 Externalities

61. We consider there are limited externalities to justify regulatory intervention in the case of insurance. Distress or failure in the insurance sector is not likely to pose a risk to the soundness of the financial system. This reflects several factors, including that insurance is not a significant source of intermediation or payment system functions, and that there are only limited inter-connections and exposures between insurance and other parts of the financial system.

62. However, we believe large-scale distress or failure in the insurance sector could have potentially significant adverse impacts on the wider economy. For instance, through business interruptions due to the unavailability of insurance cover; especially, where parts of the economy are dependent on a small number of dominant insurers.

---

[26] Blackwood King Adpartners, Oct 2005, *AIA Life Matters Survey*, Commissioned by American International Assurance New Zealand.

[27] Traditionally stated, "moral hazard" is the presence of incentives for individuals to act in ways that incur costs that they do not have to bear. Moral hazard is one of those important market distortions based on imperfect information. It also relates to a dependency culture, incentive compatibility and the principal-agent problem. See Graham Bannock, R.E. Baxter, and Evan Davis, *The Penguin Dictionary of Economics*, 7th Edition, 2003.

63. There is also an externality in terms of the impact of insurance failure on the international reputation of the New Zealand financial system. A significant spate of distress or failure in the insurance sector could be damaging to the reputation of the financial system as a whole, with potential flow-on effects to the financial system and markets.

64. Conduct of an insurer regulated under New Zealand insurance law can also created implications for the New Zealand insurance sectors international reputation. It is important the regime does not provide incentives for entities to arbitrage into the New Zealand market and compromise the sector's reputation through its conduct overseas.

2.5 OBJECTIVES

2.5.1 Prudential Regulation[28]

65. The objectives for prudential regulation are:

- To promote policyholder confidence in the soundness of the insurance sector.
- To encourage soundly governed insurers.
- To ensure timely and orderly resolution of distressed insurers.

2.5.1.1 Promote Policyholder Confidence in the Soundness of the Insurance Sector

66. Promoting policyholder confidence in the soundness of the insurance sector is closely linked to the other objectives of the regulatory framework. Soundly governed insurers who have good financial disciplines and manage risks effectively, policyholders who are well informed, and a competitive market are all factors that will contribute to this objective.

2.5.1.2 Encourage Soundly Governed Insurers

67. The core business of an insurer is the management of pools of risk. An insurer needs to be soundly governed to facilitate a well-run business, and to minimise the risk that the insurer will not be able to meet its liabilities as they fall due.

68. Encouraging sound governance that is integrated into the insurer's business supports the Government's objective of providing policyholders with confidence in the insurance sector. It further facilitates effective risk management both in the insurance sector and, depending on consumption of insurance products, the broader economy.

2.5.1.3 Ensure Timely and Orderly Resolution of Distressed Insurers

69. To provide confidence in the sector that encourages participation by consumers, it is important that the Regulator exert a proactive stance in the performance of its role. For instance, in relation to the potential for a consumer to be locked in to their long-tail

[28] Note the IAIS, OECD and other jurisdictions have the protection of policyholder interests as an objective for regulation in the insurance sector. Although not expressly listed, we believe the objectives stated above cover this issue.

insurance product (e.g. life insurance) the Regulator may focus on a timely and orderly approach to resolving problems that put the insurer at risk of failure. In relation to short-tail insurance (e.g. property insurance) without issues of transferability or lock-in the focus may be more on orderly exit from the market. On the basis that different classes of insurance pose different risks there may be more reason for the Regulator to intervene in one class of insurance than another. It is also important that insurers are encouraged to resolve their own problems, which could be achieved through providing the Regulator with a wider range of intervention tools that allow a more granulated approach to the issues faced by financially distressed insurers.

2.5.2 Market Conduct Regulation

70. The objectives for market conduct regulation are:

- To promote well informed insurance policyholders.
- To promote effective use of an intermediaries market.
- To deter, detect and minimise the risk of unfair or fraudulent conduct.

2.5.2.1 Promotion of Well-informed Insurance Policyholders

71. A key component of the regulatory regime is fostering policyholders who are well informed about both the products they are purchasing and the providers of these products. This will facilitate an environment in which the policyholder can assess the appropriateness of the product and provider to their individual needs. That is, they can determine whether the policy terms, price of the risk and characteristics of the insurer are compatible with their individual needs.

2.5.2.2 Promote the Effective Use of an Intermediaries Market

72. Insurance intermediaries play a valuable role in connecting consumers and insurers. The expertise and experience of an intermediary can overcome some of the information issues that face a consumer in determining the appropriateness of a policy and insurer for their personal needs. In addition to this an intermediary can help mitigate adverse selection issues which face insurers. This function of the intermediary facilitates an efficient allocation of resources in the sector.

2.5.2.3 Deter, Detect and Minimise Fraudulent Conduct

73. The objective to detect, deter and minimise fraudulent conduct is applicable to the insurance framework on a number of levels. Regulation that detects and minimises the incentives for participants to partake in such behaviour may range from simply informing participants to placing prohibitions on certain actions. It will also involve meeting the recommendations outlined by the Financial Action Task Force (FATF).[29]

[29] FATF (Financial Action Taskforce).GAFI (Groupe d'action financiere sur le blanchiment de captaux), *The Forty Recommendations*, 20 June 2003, see the *Licensing and Prudential Requirements* section for more detail.

Questions for Submission

1. Are the outcomes being sought from the insurance sector appropriate? If no, are there additional outcomes that should be sought?

2. Are the reasons for regulatory intervention correctly identified? Are there other reasons for regulatory intervention that also require identification?

3. Are the objectives for insurance legislation appropriate? Are there any other objectives which should be included?

2.6 CURRENT REGULATORY FRAMEWORK

74. Historically, New Zealand insurance legislation has focused on protecting the interests of policyholders driven by the fact that insurance contracts are based on utmost good faith. A policyholder, depending upon the class of insurance, will be reliant on a promise that may not eventuate for potentially 30 or 40 years. In addition, it is difficult for a policyholder to determine the long-term viability of their chosen provider. The regulatory framework was driven by disclosure, based on the premise that appropriate disclosure would enable consumers to make informed decisions and bear the risk of these decisions themselves.

75. The main tools used in the regulation of the New Zealand insurance sector are outlined below.

2.6.1 Deposit Requirement

76. A de facto registration system operates by virtue of the Insurance Companies Deposits Act 1953[30], Life Insurance Act 1908[31], and Mutual Insurance Act 1955[32], which require insurers carrying on insurance business in New Zealand to lodge a specified monetary deposit with the Public Trustee. The entry deposit was established to provide protection to policyholders in the event of the insurer's failure, where the funds could then be distributed amongst policyholders of that provider.

2.6.2 Ratings

77. Insurers offering disaster and property insurance[33] in New Zealand are required under the Insurance Companies (Ratings and Inspections) Act 1994 to obtain a rating from one of the approved rating agencies.[34] Each rating must be registered with the Registrar within five days of receipt, and disclosed to consumers prior to entering into or renewing a contract of insurance. Any downgrade to the insurer's rating must be disclosed to the

---

[30] Deposit required for general and some other insurers is $500,000. Other amounts apply to entities which paid deposits under the Insurance Companies Act 1940 and Insurance Companies Deposits Amendment Act 1950.
[31] Deposit required for life insurers ranges between $100,000 (1975) and $500,000 (1979 onwards) depending on the year the deposit was made.
[32] Deposits required for mutual insurance associations relating to agriculture (currently there is only one such entity) vary, depending on the line of business, from $10,000 to $45,000.
[33] This includes loss or damage to tangible property, and due to natural disasters and fire caused by those disasters. See section 2 of the act. It does not include life, health or non-property related insurance.
[34] Current approved rating agencies are A.M. Best, Standard & Poors and Fitch Ratings.

Registrar and to the public, within 10 days of that downgrading. Those insurers failing to comply with the requirements will be subjected to monetary fines, as will its directors. Consumers have the right to avoid the contract if there is a failure to disclose a mandatory rating.

2.6.3 Insurance Contracts

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

2.6.4 Insurance Intermediaries

79. The statutes that govern the insurance intermediary's contractual relationship are the Insurance Intermediaries Act 1994, which relates to insurer liability on the payment to the intermediary of premiums by the policyholder and claims money by the insurer; and the Insurance Law Reform Act 1977 which defines when an intermediary is the agent of the insurer. There are no insurance specific formal conduct requirements.

2.6.5 Financial Reporting

80. Reporting requirements for insurers vary. Insurance products that include the issuing of securities must comply with the Financial Reporting Act 1993 (FRA), including full reporting, auditing, and then lodgement with the Companies Office for public viewing. Those who are not issuers for the purposes the FRA, but take on a company structure must prepare financial reports and obtain an audit. An exemption process exists for small entities that meet prescribed criteria. Insurers that do not take a company structure fall outside the FRA, but have specific reporting requirements in the legislation that relate to their legal form (i.e. Friendly Societies and Credit Unions Act 1982).

81. Other financial reporting requirements are outlined in the schedules to the insurance legislation. For example, a life insurer must produce an annual, audited statement of its revenue account and financial position in accordance with the Life Insurance Act 1908.

2.6.6 Monitoring and Supervision

82. The primary supervisory tool across the industry is the lodgement of returns with the Insurance and Superannuation Unit (ISU) on behalf of the Chief Executive of the Ministry of Economic Development. The Government Actuary receives a copy of life insurance returns for review.[35] The insurer is required to complete a number of schedules as included in the Insurance Companies' Deposits Act 1953 and/or the Life Insurance Act 1908.

83. Under the Insurance Companies (Ratings and Inspections) Act 1994, the Registrar of Companies has the power to require insurers to produce documents for the purpose of determining whether the insurer is able to pay its debts as they fall due. An inspector can be appointed for this purpose. The inspector's report becomes admissible in liquidation proceedings. Under that Act, the insurer can be required to stop writing new

---

[35] This is in addition to the disclosure required under the Financial Reporting Act 1993.

business either temporarily or permanently. This power is also contained in the Life Insurance Act 1908 in relation to life insurers only.

2.6.7 Exit Management

84. The two primary tools for managing the failure of an insurer are statutory management and judicial management (applying to life insurers only).

- The Life Insurance Act 1908 makes provisions, upon application, for the court to appoint a judicial manager to a life insurer:

  > …where it appears that there is a likelihood that the company is, or will be unable to meet any of its liability to policyholders.[36]

- The Corporations (Investigation and Management) Act 1989 (CIMA) applies to any corporation:[37]

  a. That is or may be operating fraudulently or recklessly; or

  b. To which it is desirable that the Act should apply –

     i. For the purpose of preserving the interests of the corporation's members or creditors; or

     ii. For the purpose of protecting any beneficiary under any trust administered by the corporation; or

     iii. For any other reason in the public interest.

2.7 PROBLEMS IDENTIFIED

85. The problems identified with the existing insurance regulatory framework that need to be addressed are outlined below.

2.7.1 Lack of Merit Requirements

86. There is no merit licensing procedure for providers of insurance in New Zealand either on entry to the market or an ongoing basis. Lack of a basic minimum qualitative standard is problematic because there is no means of controlling the quality of entrants to the market or continuing vetting to assess whether an insurer should remain.[38] Internationally a combination of qualitative and quantitative measures are recommended to more effectively assess an entrant's ability to perform, and for ongoing purposes.[39]

87. The requirement to lodge a deposit under the Insurance Companies Deposits Act 1953, Life Insurance Act 1908 and Mutual Insurance Act 1955, is a quantitative

---

[36] Refer s 40A(2) of the Life Insurance Act 1908.
[37] Refer s 4(a) and (b) of the Corporation (Investigations and Management) Act 1989.
[38] There are requirements regarding structure and governance in the Companies Act 1993, Industrial and Provident Societies Act 1908, Friendly Societies and Credit Unions Act 1982, and Incorporated Societies Act 1908.
[39] IAIS, *Supervisory Standard on Licensing,* October 1998.

measure. It was originally intended to provide policyholder protection. However, as a licensing requirement it:

- Operates as a blunt quantitative tool, merely restricting entry to those who can raise the monetary amount for the deposit. The current amount does not preclude the entry of under-funded insurers, and is low by international standards;

- Does not specifically address qualitative factors such as governance, risk management and solvency assessment, and has no relationship to an insurer's total policyholder obligations, investment or other risks[40]; and

- Is efficient from a process perspective, but compromises economic equity considerations, since it is difficult to find one optimal level that accounts for different types of insurance and for providers of different scale and scope.

88. There is no publicly available centralised register of insurance providers in the financial sector. Consumers are unable to verify whether an insurer is in compliance with New Zealand regulatory requirements. Publicly available information on insurers is limited.

2.7.2 Inconsistent Governance Requirements

89. Registration under different Acts provides different levels of governance and negative assurance requirements for key functionaries in the entity (eg directors, officers, and senior management). This inconsistency means that holders of the same type of policy from different legal entities may not be afforded the same protections. Having inconsistent principles of governance across the sector fails to meet the Government's objective of facilitating contestability and competitiveness. Further, it fails to meet the desired regulatory attribute of reducing regulatory arbitrage.

2.7.3 Inappropriate Governance Requirements

90. Governance requirements for certain expertise to ensure soundly governed entities in the insurance market do not exist. Also, New Zealand has a number of obligations under international treaties and arrangements, with which it is seeking to comply as part of this review. For instance, none of the existing formal requirements in New Zealand meet the fit and proper person tests under FATF recommendations[41], OECD guidelines[42], and IAIS principles[43].

2.7.4 Ratings

91. Ratings are required for disaster and property insurers only. This creates inconsistency across the sector, does not allow competitive neutrality due to the differing models used by the approved ratings agencies, and permits regulatory arbitrage.

---

[40] Comment in relation to state laws in the United States requiring a fixed monetary deposit, Insurance Committee Secretariat, for OECD, *Glossary of Policy Terms*, 1999.
[41] Recommendation 23, FATF (Financial Action Taskforce).GAFI (Groupe d'action financiere sur le blanchiment de captaux), *The Forty Recommendations*, 20 June 2003.
[42] Jörg Volbrecht, for OECD, *Insurance Regulation and Supervision in OECD Countries*, 2000.
[43] IAIS, *Insurance Core Principles and Methodology*, October 2003, ICP 7.

92. At the time of the 2001 review of the existing mandatory ratings regime there was a recognised need for improved internal management rigour within each insurer. When this approach was retained there was no capacity for the Ministry of Economic Development ("MED") to consider other regulatory tools such as formalised prudential regulation.[44]

2.7.5 No Formal Requirement for Separation of Classes of Insurance

93. Unlike some other jurisdictions,[45] New Zealand has no formal requirements for an insurer to only offer insurance business (ownership separation),[46] to conduct each class of insurance business through separate legal entities (legal separation),[47] or to maintain separate book-keeping and funds for each class of insurance business (accounting separation with segregated funds).[48] This means there are intra-class contagion risks, difficulties in applying actuarial solvency standards and a limited ability for the Regulator to licence and monitor effectively.

2.7.6 Lack of New Zealand Policyholder Asset Ring-fencing for Foreign Insurers

94. There is no requirement that a foreign insurer's assets in New Zealand be kept separate from its home jurisdiction assets. As such, there is a failure to adequately protect New Zealand policyholder interests at time of insolvency. This is of particular concern where the insurer's home jurisdiction gives statutory priority to policyholders in that home jurisdiction.

2.7.7 Public Reporting

95. Not all insurance providers are required to report financial statements under the Financial Reporting Act 1993 ("FRA"). Requirements for public reporting of financial statements that are audited only apply to certain entities over a specific size. This is not consistent with international recommendations on reporting requirements for insurance entities.

96. Reporting is not a costless exercise. Despite the significant number of insurers in New Zealand that have their parent domiciled in a foreign jurisdiction, the legislative framework does not provide the Regulator with the authority to accept reports provided to home jurisdiction regulators to meet some or all of the reporting requirements in New Zealand.

2.7.8 Insufficient Monitoring and Enforcement Tools

97. Assessment of whether an insurer is responsibly managing the risks its business is exposed to or the underlying financial viability of its book is difficult. This is amplified by

---

[44] Ratings and Deposit Review carried out by MED in 2001.
[45] Jörg Volbrecht, for OECD, *Insurance Regulation and Supervision in OECD Countries*, 2000.
[46] For instance, the United States where specialisation was originally very strict but has moved to allowing ancillary subsidiaries that do non-insurance business. See Jörg Volbrecht, for OECD as above.
[47] For example, South Africa. See Financial Services Board, Republic of South Africa, *Guideline Paper for registration as a long or short term insurer,* 1 September 2004
[48] For example, Singapore. See www.mas.gov.sg, and Canada see http://laws.justice.gc.ca/eu/I-11.8/244640.html#rid-244653

the lack of legislative powers afforded to the Insurance and Superannuation Unit[49] to call for further information to discharge the assigned supervisory role. [50] The main problems inhibiting assessment are:

- **Time lag in information.** Current reporting to the Regulator is nine months following the close of the financial reporting period. This results in the disclosure providing limited meaningful information as problems that have developed may have already reached a point where they cannot be readily resolved.

- **Lack of financial information.** The existing schedules in insurance legislation provide limited information for the assessment and understanding of the insurer's solvency position based on the performance of the classes of insurance business an insurer may undertake.

- **Inability to call for information.** There are limited circumstances under which the Regulator can call for further information and no ability to change the frequency of reporting by the insurer.

98. Supervisory tools that allow proactive risk management and timely corrective action across the insurance market do not currently exist. There are some standards that must be met (e.g. reporting, deposits, and for disaster and property insurers, ratings), which are subject to fines where breached. However, in terms of enforcement powers there is little else. There is a need for more tools than monetary penalties to provide flexibility of response in supervisory actions and to create appropriate incentive structures.

2.7.9 Managing Distress Limited

99. The powers to manage financially distressed insurers are either non-existent or too strong; for a large part of the insurance market there is little in between. There are limited regulations that can be applied by Government prior to exit under the investigation sections in the Corporations (Investigation and Management) Act 1989 (CIMA) and under the Life Insurance Act 1908. The investigation powers contained in these acts are not granulated sufficiently to provide optimal intervention outcomes.[51]

2.7.10 Exit Tools Blunt

100. The existing regulatory exit tools applying to insurers are in the nature of a final step and for use in drastic cases. In this sense, statutory management and judicial management are blunt tools. There is also an inability for the Regulator to direct the actions of the manager appointed under the existing tools.

101. The threshold for intervention under CIMA is fairly high.[52] The insurer must either be operating fraudulently or recklessly, or any action taken must be to preserve the

---

[49] This is part of MED.

[50] This is also consistent with the results of the Financial Sector Assessment Program report on New Zealand's securities market. IMF Country Report No.04/417, December 2004, New Zealand: Financial Sector Assessment Program – Detailed Assessment of Observance of Standards and Codes – International Organisation of Securities Commission (IOSCO) – Objectives and Principles of Securities Regulation.

[51] The Advisory Groups and the Insurance and Superannuation Unit believe there needs to be powers for the Regulator to intervene in a timely manner to assist a financially distressed insurer to either rehabilitate itself or facilitate orderly exit.

[52] As stated in the Law Commission's Report on Life Insurance (2004, Report 87).

interests of members, shareholders or creditors (including policyholders) or to act in the public interest, where those parties are not able to be adequately protected under the Companies Act 1993 or any other lawful way. CIMA is designed to deal with corporate collapses of such magnitude that the normal legal procedures available are inadequate.

102. Although the judicial management regime applying to life insurers under the Life Insurance Act 1908 has an emphasis on carrying on the business and preserving assets, it also sets out a process for a scheme of transfer of policies and assets, and for liquidation. The criteria for intervention only relates to the likelihood that the insurer is, or will be unable to, meet its liabilities to policyholders. Therefore, this mechanism only covers performance based on quantitative criteria not qualitative criteria.

103. While judicial and statutory management provide the option of "trading out" of the situation, this is not commonly done. The procedures are more focused on exit than rehabilitation, providing no clear interim tools to assist a financially distressed insurer, but rather relying on the discretion of the manager, once appointed, to decide on the best course of action, without the Regulator having the power to direct the actions of the manager. No other statutory tools for exit are available to the Regulator in the current legislative framework.

2.7.10.1 Inconsistent Treatment of Insurance Categories

104. There is a lack of consistent treatment and prudential oversight of products that present similar risk to consumers. This is due to the different types of requirements adopted by industry associations. From the perspective of an insured, oversight of the insured person's insurer's business activities and solvency is determined by whether the insurer is a member of an industry association or not. Therefore, policyholders of one product class are afforded differing levels of protection depending on the association their provider is a member of.

2.7.11 Limited Regulation of Insurance Intermediaries

105. There is no conduct legislation that governs the practices and quality of insurance intermediaries outside of the Consumer Guarantees Act 1993 and the Fair Trading Act 1986. This may cause differing standards in the insurance market that can inhibit efficient matching of consumers with insurers.

2.7.12 Insurance Contract Legislation

106. There are a number of existing statutes that specifically govern insurance contracts, which causes confusion in the market. Some of the legislation is out-of-date or not consistent with New Zealand conditions, specifically:

- There are problems relating to non-disclosure and mis-statements, including:

    a. That the duty to disclose is not understood by policyholders,[53] is uncertain and can create unfairness;[54] there is no obligation on the insurer to ask

---

[53] See for example Neil Campbell *Insurance* [1999] New Zealand Law Review 191.

[54] Note that Australia discarded the prudent insurer test over 20 years ago, see section 21 Insurance Contracts Act 1984 (Cth) ("ICA". Also it appears to be the same position in Scotland, see The Law Commission (UK) and the Scottish Law Commission, *Insurance Contract Law: A Joint Scoping Paper*, January 2006, page34; *Life Association of Scotland v Foster* (1873) 11 M 351.

questions;[55] and there is limited understanding by policyholders that there is a duty to disclose matters outside the scope of any questions asked;[56]

b. The all or nothing remedy of contract avoidance is disproportionately harsh on policyholders[57] (i.e. there is a lack of distinction in the consequences of innocent, negligent and fraudulent non-disclosure,[58] there is absence of a need for a causal link between non-disclosure and loss, and a lack of reciprocity in remedies);

c. A lack of alignment with the law on misrepresentation;[59] and

d. Consumer expectations that underwriting occurs at contract formation rather than at the time of claim are not always being met.

- The registration system for assignments and mortgages of life policies is out-of-date, is not widely used and is not consistent with New Zealand conditions. For instance, it still requires presentation of paper policy documents to the insurer, placing unnecessary transaction costs on the process.
- There are no legal requirements relating to the form, content and timing of product disclosure of risk-based insurance products. This is inconsistent with other products in the financial sector. Consequently it is difficult for consumers to compare products from different providers, and to be well informed of the particular details of the contract applying to them prior to the commencement of the insurance policy.
- There is a greater need for clarity around when an intermediary is the agent of the insurer or agent of the policyholder. Product disclosure obligations on the insurer and intermediary also need to be addressed to balance the incentives for efficient contracting.

2.7.13 No Legislatively Required Enhanced Solvency Regime

107. Although the insurance industry, through its associations and the New Zealand Society of Actuaries, has developed prudential frameworks and created solvency regimes, insurance legislation in New Zealand does not require compliance with formalised prudential or enhanced solvency requirements. [60] This is inconsistent with

---

[55] See *Lambert v Cooperative Insurance Society Limited* [1975] 2 Lloyd's Rep 485.

[56] *Quinby Enterprises* supra. *Misirlakis v NZ insurance Co Ltd* (1985) 3 ANZ Ins Cas 78,893 (CA).

[57] This is on the basis that the contract is a nullity and the insurer therefore sacrifices its right to the premium. There is an exception in the case of fraud, in which case the insurer may keep all premiums paid by the policyholder; see *Rivaz v Gerussi Bros & Co* (1880) 6 QBD 222 (CA) at 229.

[58] Fraud in respect of non-disclosure means deliberate concealment or recklessness amounting to indifference about whether this occurs; see *NRG Victory Australia Limited v Hudson* [2003] WASCA 291.

[59] The remedies under the Contractual Remedies Act 1979 apply subject to any provision in the contract that provides a remedy for misrepresentation. Insurance contracts usually provide for avoidance for misrepresentation, hence the contract provision will apply subject to the Insurance Law Reform Act 1977. As material misrepresentation (i.e. material mis-statement or material oral misrepresentation) often also involves material non-disclosure, where a contract does not state a remedy for misrepresentation, insurers generally o proceed on the basis of material non-disclosure rather than material misrepresentation. This reduces the relevance of the Contractual Remedies Act 1979 and the three year limitation applicable to life insurance contracts under section 4(1) of the 1977 Act.

[60] This limits the ability of the regime to facilitate targeted effective risk management that reduces the probability, to an acceptable level, that the financial obligations of the insurer will not be met. See

international practices outlined by the IAIS and OECD which promote risk-based management of organisational risks. Jurisdictions such as Canada, South Africa, United States, Australia and United Kingdom have all adopted risk-based solvency regimes that their insurers must comply with.

108. Although good self-discipline exists, it is difficult for an industry association to take enforcement action following identification of a member in breach of the industry association's or society's guidelines and requirements. Directives can be issued, but if there is non-compliance the primary remedy is expulsion from the association. This provides little benefit to policyholders of the insurer or in ensuring rectification of insurer breaches. More particularly, it places policyholders in a more financially vulnerable position where they experience prohibitive costs to change due to either being in the process of claim or because their policy is underwritten on the basis of their health, which has deteriorated. An insurer that is not a member of any association is not bound to comply at all with self-regulatory disciplines.

109. The financial reporting requirements under New Zealand International Financial Reporting Standards ("NZIFRS") outline requirements for the providers of insurance products to disclose their solvency position under NZIFRS4. Appendix C relates to life insurance and Appendix D relates to non-life insurance. The only requirement the standards specify is that the insurer disclose its solvency position.

Questions for Submission

4. Do these problems accurately reflect issues in the current insurance sector? Is the magnitude of these problems correctly identified in the discussion?

5. Are there any other problems which have not been identified?

2.8 RESEARCH TOOLS

110. We have considered recommendations from the International Association of Insurance Supervisors,[61] Organisation for Economic Co-operation and Development,[62] European Union,[63] International Actuarial Association and other academic literature.

111. The comparative analysis undertaken covers the jurisdictions of Canada, Singapore, South Africa, United Kingdom, Trinidad and Tobago, and Australia.[64]

112. The principles of regulatory design for the proposed insurance regulatory framework have been applied in accordance with the Legislation Advisory Committee Guidelines[65] and the core regulatory design principles[66] of efficiency, effectiveness,

---

Torrance, D. (2001), *The Development of Prudential Requirements for Private Health Insurers*, Prepared for the IAAust Biennial Convention where this is outlined as one of the key objectives for solvency requirements of the Private Health Industry in Australia.

[61] October 2003, see www.iaisweb.org.
[62] See www.oecd.org.
[63] See www.europa.org.
[64] For a list of insurance regulators globally see http://facpub.stjohns.edu.
[65] For details see www.justice.govt.nz.
[66] For details of each of these see the Code of Good Regulatory Practice, November 1997, www.med.govt.nz

transparency, clarity, and equity, under the Code of Good Regulatory Practice, as discussed in the *Overview of the Review and Registration of Financial Institutions* discussion document.

3. LICENSING AND PRUDENTIAL REQUIREMENTS

3.1 PRINCIPLES OF REGUALTORY DESIGN FOR LICENSING AND PRUDENTIAL REQUIREMENTS

113. The International Association of Insurance Supervisors has remarked that it:

> …firmly holds the view that it is first of all the responsibility of the insurer to manage its risks under both normal and adverse circumstances, so that policyholder interests are protected during ongoing operations and in the event of run-off or insolvency. The role of the regulatory regime and supervisory authority is to see to it that this responsibility is met. The regulatory regime and supervisory authority should thus give insurers the opportunity to manage their business and provide incentives for sound risk management appropriate to the size and nature of their business. [67]

114. Consistent with this, the Government is of the view that the core function of an insurance business is the prudent and effective management of the risks it underwrites and the subsequent risks its business is exposed to in both normal and adverse circumstances. The following proposals and options for prudential regulation, to be achieved through licensing and ongoing prudential requirements, are to establish a framework that will provide the insurer with the appropriate behavioural incentives to effectively manage its risks and solvency position. The licensing and prudential requirements are focused on maximising the insurer's responsibility to manage its business whilst also enabling the Regulator to assess whether insurers are prudently doing so.

115. The primary outcome sought from licensing requirements is prudent and honest management of an insurer by fit and proper persons with appropriate skills and experience. This is crucial to the capacity of the insurer's managers to appropriately identify and quantify risk. A secondary outcome sought is an appropriate level of funding for the business the insurer intends to undertake. Given there is no historical operational data at start-up it can be difficult to assess the probability of survival in the initial years of operation.

116. Establishing common licensing and prudential requirements that account for good governance and appropriate funding will institute consistent minimum access standards across providers of all classes of insurance business. Consequently, consumers will be afforded uniform levels of protection which can facilitate the confidence to participate in the insurance sector.

117. Ongoing licensing and prudential requirements regarding governance and solvency are key features of an insurance regulatory framework. The primary outcome sought from an enhanced solvency regime is the creation of the appropriate incentives for the insurer, in conjunction with risk management, to reserve in a manner that will maximise the probability of portfolio and entity survival under both normal and adverse conditions.

118. The regime seeks to provide for sufficient flows of information to give confidence to the market and the Regulator that the insurer's responsibilities are being met. This will

---

[67] International Association of Insurance Supervisors, *The IAIS common structure for the assessment of insurer solvency,* Draft 31 May 2006.

facilitate sound risk management within each insurer, contributing to a sector that is resilient in the face of economic and financial shocks.

119. Additionally, requiring insurers to be licensed and supervised is an appropriate way of facilitating consolidated group supervision of insurers that provide a wide range of insurance products enabling the supervisor to adequately evaluate and address intra-group contagion issues, while also facilitating effective home/host supervision.

3.2 BACKGROUND

120. An effective prudential regime places formal obligations on insurers relating to governance, merit licensing and solvency assessment, among other matters.

121. Governance and merit licensing are distinct from registration in that registration is a procedural system that identifies and records entity structures, sometimes with rules relating to the constitutional documents, management and legal form of an entity. It can also operate as a central register of the providers of insurance products in the market and one location for obtaining publicly available information filed by a provider. Registration is addressed in the *Overview of the Review and Registration of Financial Institutions* discussion document. Licensing is a system that authorises an insurer on the basis of merit to offer identified products within the insurance sector. Generally, these requirements must be continually fulfilled.

122. The international view is that a licensing regime provides two main benefits. First, licensing of insurers plays an important role in ensuring efficiency and stability in the insurance market;[68] second, licensing protects the public, and more particularly, uninformed insurance purchasers.[69]

123. A licensing procedure is intended to operate as a *de minimus* benchmark, which will act as an initial vetting process to assess the likelihood of a new insurer keeping future promises. When applied on an ongoing basis it promotes a stable sector in which consumers can have the confidence to participate. However, there is no settled best practice model. Internationally, licensing requirements cover a variety of tools. The IAIS principles[70] set out that an insurer must be licensed before it can operate within a jurisdiction and that the requirements for licensing are clear, objective and public.[71]

124. Licensing procedures and ongoing supervision consistent with internationally accepted general standards, promote domestic and international confidence in the supervisory system,[72] and create ease of access for insurers operating internationally (subject to meeting local requirements). In relation to prudential requirements, the IAIS core principles recommend that the supervisory authority require insurers to recognise the range of risks that they face and to access and manage them effectively. [73]

125. In the absence of a legislated solvency regime the New Zealand insurance industry, through its associations and societies, has invested significantly in developing the skill

---

[68] Insurance Committee Secretariat, OECD, *Glossary of Insurance Policy Terms*, 1999.
[69] Insurance Committee Secretariat, OECD, as above.
[70] IAIS, *Supervisory Standard on Licensing,* October 1998.
[71] IAIS, *IAIS expands core principles for insurance: Insurance Core Principles and Methodology,* ICP 6
[72] IAIS, as above.
[73] ICP 18, IAIS core principles, October 2003.

and expertise to ensure there is prudent management of the risks the industry participants underwrite and the insurance sector is exposed to. The discipline the industry has achieved regarding the management of solvency has meant the levels of self-regulation have contributed to a stable insurance sector over a number of decades. However, there are reputation risks to New Zealand in not meeting international guidelines and principles (for instance, under FATF and IAIS[74]) regarding the monitoring of compliance and enforcement of these and other recommendations.

126. The licensing and supervision proposals for insurers will reinforce existing self and market discipline in the insurance sector by building on existing standards for insurers, enhanced monitoring by an independent government agency, and the capacity for effective legal enforcement where there are breaches of requirements or an insurer is in financial distress.

3.3 CRITERIA

127. The criteria the Regulator must have regard to in carrying out its functions and powers, and in setting standards are:

- The owners and operators have the expertise to undertake the business of insurance and can be held accountable;
- The entity has the capacity and capability to undertake insurance;
- No unnecessary barriers to entry and recognition of different legal forms;
- Sound management of the risks that are underwritten by the insurer and business practices that will prudently manage external risks the business is exposed to;
- Sensitivity to the diversity of the insurance market so that requirements do not adversely impact on the contestability and competitiveness of the insurance sector, beyond that which is required to promote a sound insurance sector, and can therefore facilitate innovation; and
- International principles and guidelines relating to licensing and prudential requirements.

3.4 REGULATION BOUNDARIES

128. Three main options for setting licensing and supervisory boundaries were considered in this review:

- Requiring only insurers that use protected words (such as “insurance” “assurance” or “insurer”) to be licensed and supervised;
- Requiring only insurers of a “high impact” nature to be licensed and supervised – such as insurers providing long-tailed insurance policies (where the failure of the insurer would inflict potentially severe costs on policyholders) or insurers

[74] FATF (Financial Action Taskforce).GAFI (Groupe d’action financiere sur le blanchiment de captaux), *The Forty Recommendations*, 20 June 2003, and IAIS core principles, October 2003.

whose size or dominant market position could cause difficulties were they to fail; and

- Requiring all insurers, regardless of the types of insurance products they provide, or their size, to be licensed and supervised.

129. The proposal is that the insurance regulatory regime to be developed for New Zealand be applied to all insurance products and providers – i.e. to all types of general insurance, life insurance, disability insurance, professional indemnity insurance, public liability insurance and health insurance. The options for partial or targeted regulation have been considered, with the assistance of the Advisory Groups, but were discarded as they did not meet the Government's objectives for the insurance regulatory regime.

130. Specifically, the proposal is as follows.

3.4.1 Proposal - Supervision of All Insurance Business

131. Under this proposal, an entity wishing to provide insurance products or conduct the business of insurance will be required to be licensed and supervised by the Regulator.[75] This will apply to the provision of insurance to any persons (whether in New Zealand or offshore) where the insurer has a presence in New Zealand. It is not practicable to licence and supervise insurers that market their products in New Zealand via remote means, such as the internet; however, requirements regarding agents acting on behalf of an insurer will apply.

132. Although licensing and supervision will apply to all insurers, the requirements may vary, depending on the nature of the insurance products provided and the risks inherent in these products. Specifically, this will relate to the class of insurance business licensed and the short-tail or long-tail nature of the products concerned, which will mean there are differing solvency standards, reporting, and monitoring and intervention powers applied by the Regulator.

3.5 LICENSING AND PRUDENTIAL PROPOSALS

3.5.1 Governance Proposals

133. Sound governance principles, through the appropriate mix of incentives, can facilitate an environment where fit and proper persons with appropriate experience are held accountable for the management of risk and competing interests within the insurer.[76] This has positive externalities of an effectively managed pool of risk in the insurance sector and broader economy.

3.5.1.1 Proposal - Registration of Legal Form

134. The ability to register in different legal forms will be retained. Insurers currently register their corporate form under the Companies Act 1993, Industrial and Provident

---

[75] Reinsurers and captive insurers may apply for a licence subject to terms. Not included are product & service guarantees.

[76] The OECD considers licensing to be the main means of preventing unsound or rogue insurance companies from entering the market. Member countries have licensing requirements for both domestic insurers and branches (or subsidiaries) of foreign companies. Jörg Volbrecht, for OECD, *Insurance Regulation and Supervision in OECD Countries,* 2000.

Societies Act 1908, Friendly Societies and Credit Unions Act 1982, or Mutual Insurance Act 1955. These acts provide certain governance requirements already, which will assist with vetting. For mutuals, see the *Mutuals' Governance* discussion document.

3.5.1.2 Proposal – Registration as a Financial Service Provider

135. The proposal is that insurers must register as a financial services provider of insurance on a centralised register. This would be a procedural aspect performed by the Registrar of Companies and done in conjunction with the merit licensing process, which would be dealt with by the insurance Regulator. The registration process will include negative assurance checks on shareholders, directors and senior management (see the *Overview of the Review and Registration of Financial Institutions* discussion document). Positive assurance fit and proper person requirements will be applied by the insurance Regulator, as part of the merit licensing process and are set out directly below.

3.5.1.3 Proposal - Board Structure and Director / Senior Management Capability

136. The primary responsibility for fit and proper vetting of boards and senior managers lies with those responsible for making appointments, that is, the shareholders/members in the case of boards and the board and/or chief executive in the case of senior managers. While the Regulator will review shareholder, board and chief executive appointment decisions in line with FATF and IAIS requirements, the expectation will be that in almost all cases such a review will be light-handed because those making the appointment will have themselves already made appropriate checks.

137. Bearing this in mind, it is proposed that the Regulator will have the power to set requirements with which the insurer must comply in relation to:

- **Composition.** The number of directors, the mix and number of independent (or non-executive) directors and numbers of executive directors Different considerations will apply for mutuals where directors must also be members of the mutual entity or association (see *Mutuals' Governance* discussion document).

- **Suitability of shareholders with control or significant influence, directors and senior management.** The Regulator will have the power to apply a fit and proper persons test to directors and senior management. The fit and proper requirements will be designed to ensure that these parties meet appropriate expertise and experience requirements.[77] The suitability of shareholders with control of or significant influence over the insurer will also be vetted by the Regulator. This will include factors such as identification of the natural persons holding a direct or indirect qualifying participation in the applicant, negative assurance (e.g. no criminal convictions for money laundering), and whether there is connected shareholding with the applicant that would render effective supervision impossible. This needs to be done to meet the positive assurance principles and guidelines under FATF and IAIS.[78]

---

[77] See FATF (Financial Action Taskforce).GAFI (Groupe d'action financiere sur le blanchiment de captaux), *The Forty Recommendations*, 20 June 2003 and the IAIS principles, *Supervisory Standard on Fit and Proper Requirements and Assessment for Insurers*, October 2005.

[78] In the nature of Fit and Proper Requirements set by APRA under Prudential Requirement GPS 520.

- **Functions and responsibility.** Board sign-off of overall strategy, major action plans, internal risk management policy, pricing, performance objectives, auditing and actuarial functions, and legal compliance.

- **External auditors.** The supervisor would have the ability to dis-approve the appointment of an auditor to an insurer, so as to ensure that auditors have the appropriate skills and experience to perform the audit tasks in question.

138. The Regulator's review may involve the consideration of the following types of matters:

- Assess the competency of the board as a whole to ensure that there was a range of skills, experience and competencies needed to manage and supervise the insurer;

- Perform a qualitative assurance check to ascertain whether the senior managers and directors would have the skills, experience, integrity and competencies needed for their positions;

- Check with other relevant regulators, both domestic and foreign, to ensure that there were no adverse findings against potential appointees;

- Have the power to accept an assessment already done on the persons for fit and proper purposes in another jurisdiction; and

- Assess whether prospective appointees to senior management and board roles have conflicts of interest which will make them unsuitable for their proposed role. For example, in some cases a person who is a major customer of an insurer as well as a director of the insurer might have a conflict of interest.

3.5.1.4 Approval of Changes in Control Proposal

139. The proposal is that changes in control (significant owners, directors, senior managers) must be notified to, and approved by, the Regulator pursuant to the above criteria.[79]

3.5.2 Categorisation Proposals

3.5.2.1 Proposal - Categorisation by Licence

140. The proposal is that an insurer must obtain a separate licence to offer or carry on the business of life, health and general insurance. These classes of insurance will be defined using both a purposive definition and an example product list, so that the categorisation gives the features (i.e. a description) of a class and then product examples for clarity and transparency when applying for a licence. It will also afford flexibility to the categorisation, allowing for innovation and products to change over time with a focus on substance over form. The Regulator will have the final approval of which class an insurer's application falls within.

---

[79] An area identified as weak internationally. See the *Experience with the Insurance Core Principles Assessment under the Financial Sector Assessment Program*, prepared by staff at the International Monetary Fund and the World Bank, August 21, 2001.

141. Separation into classes of insurance business for the purposes of licensing and prudential supervision is important in order to:

- Limit intra-class contamination and contagion, i.e. the effects of unexpected losses or shocks for one class of insurance can be relatively contained so as not to detrimentally expose other classes of insurance business undertaken by the same entity;
- Enable the enhanced solvency standard for each class of insurance business to be effectively applied; and
- Recognise that each class of insurance business entails different risk and requires differing experience and expertise to manage the business effectively.

142. The sector currently provides products along these class categories, and once further consultation with industry as to the appropriate wording for the definitions has been completed, it is thought to be the optimal approach.[80]

3.5.3 Proposal - Provide Products in New Zealand

143. The proposal is that in order to obtain a licence to operate as an insurer in New Zealand the entity must have a physical presence and provide products in New Zealand.

3.5.4 Proposal - Agent of the Insurer

144. It is proposed that agents will be able to apply for a licence to supply insurance products in the New Zealand market on behalf of overseas entities which do not have a New Zealand presence. Criteria will be set against which approvals are made by the Regulator, in line with the process of licensing on terms and conditions. This is a complex issue which will require further consultation once the rest of the framework is agreed on.

3.5.5 Solvency and Capital Proposals

145. In summary, it is proposed that there will be three requirements in relation to solvency and capital which an insurer will have to meet to obtain and then hold a licence.

- Solvency Support Plan (a start-up requirement).
- Flexible start-up capital requirement (a start-up requirement).
- On-going enhanced solvency requirements (a continuing requirement).

146. Start-up requirements (two in total), will be as follows.

- **Produce a solvency support plan.** The insurer will be required to present a solvency support plan to the Regulator outlining its proposed business and how in the future the insurer will meet the ongoing enhanced solvency requirement. The plan will have a three-year focus; and

[80] Feedback from the Advisory Groups is consistent with this view.

- **Meet a start-up capital requirement.** The Regulator will approve the level of start-up capital, by assessing the solvency support plan and determining the appropriate level of capital required which is commensurate to that business.

147. Ongoing requirement (one in total).

- **Enhanced solvency requirement.** The insurer will have to comply with an enhanced solvency regime which relates to the class of insurance the insurer is licensed to operate (general, health and/or life). The enhanced solvency framework will determine the insurers appropriate level of reserving which will enable both:

  a. Book survival (i.e. the level of capital will allow the insurer to meet the obligations of its insurance book); and

  b. Entity survival (i.e. the level of capital will facilitate growth of the business, write new business etc).

- Because the enhanced solvency regime will determine the appropriate level of reserving, based on the obligations and risks of the insurer, the start-up capital requirement becomes redundant. Therefore, at the end of year one, because the first fully audited reports will be provided to the Regulator, the insurer will need only to comply with the enhanced solvency framework relevant to the class or classes of business the insurer is licensed to undertake. This is because the enhanced solvency regime will require reserving which will meet the insurer's actual obligations in accordance with the international approach as set out by the International Actuarial Association and the IAIS.

148. The solvency position of an insurer is an important component of effective prudential regulation. An insurer with a sound financial position is able to meet its obligations as they fall due in foreseeable and unforeseeable, normal and adverse conditions.[81] Operating in a competitive and dynamic market, which is exposed to volatility in economic conditions, may impact differently on the insurer's balance sheet and in some instances on both sides of the balance sheet. This can have adverse implications for the sufficiency of reserves, commensurate to the insurer's risks, as well as the liquidity position of the business. It is important the insurer have an affirmative plan on how to manage these risks so existing conditions do not compromise the insurer's solvency position and capacity to meet obligations as they fall due.

149. We consider that mandatory requirements on solvency and capital are fundamental to the insurance regulatory framework for the purposes of promoting insurers to internally manage their financial strength while also achieving the Government's regulatory objectives. For this purpose, the IAIS is clear that solvency reserving requirements are an important element in the supervisory framework for insurance companies. This principle is adhered to by insurance regulators internationally.

150. In the past, the main international regulatory focus has been on insurer's base level capital needs alone, i.e. that the insurer should hold sufficient assets to ensure solvency while also acting as a buffer to absorb losses from other unexpected events. However,

---

[81] See IAIS, The IAIS Common Structure for the Assessment of Insurer Solvency, Draft 31 May 2006.

the current trend is for solvency and capital requirements to be set in conjunction with risk management requirements. Hence, because of the inter-related relationship between risk management and reserving, we note that this section on solvency and capital cannot be read in isolation of the risk management option discussed later.

151. The proposals for each of the solvency and capital requirements (discussed above) are set out separately in detail below.

3.5.5.1 Proposal - Solvency Support Plan

152. It is proposed that, at the time of licensing, all new insurers must provide to the Regulator for approval a solvency support plan, which will have prior approval by an independent actuary, and be certified by the directors of the insurer. The solvency support plan will set out how the insurer expects to meet enhanced solvency requirements on an ongoing basis, including:

- Intended type of insurance business to be written (general/health/life);
- Size of business to be undertaken (size of book with projections);
- Access to capital;
- Information on risk management strategy;
- Claims-paying policy and systems;
- Reinsurance arrangements;
- Outsourcing;
- Start-up capital; and
- Technical provisions and reserves.

153. This proposal is intended to deliver some certainty, based on the plan presented to the Regulator, that the insurer will be able to meet its obligations over the first three years of operation. The solvency support plan is flexible, taking into account different legal structures, classes of insurance business, and scale and scope of operations. It is intended to provide a holistic assessment of the business the insurer proposes to undertake, accounting for both quantitative and qualitative factors relating to solvency and ability to meet obligations as they fall due. Hence, the Regulator is afforded a more granulated approach to vetting entrants.

3.5.5.2 Proposal – Flexible Start-Up Capital Requirement

154. It is proposed that the Regulator approve the level of capital required for a new entrant to the insurance market to obtain a licence by vetting the insurer's solvency support plan. This will enable the Regulator to determine the adequacy of start-up capital in reference to the insurance business the insurer is applying to undertake, having regard to the proposed nature of business of the insurer, underwriting policy, nature of reinsurance arrangements, risk management capacity and quality of assets.

155. The start-up capital requirement will be approved on the basis of the above criteria with regard to factors such as:

- Is there sufficient capital to pay for the infrastructure and operations planned?

- How does the insurer plan to meet the requirements of an enhanced solvency regime for the proposed book size?

- Are there sufficient reinsurance arrangements, which satisfy the capital needs for the underwritten business?

- Does the level of capital demonstrate commitment to policyholders and other stakeholders?

156. The start-up capital requirement will not be applied on an ongoing basis. The requirement will cease to apply at the end of year one because the insurer will be required to comply with an enhanced solvency framework (discussed below), which will determine the necessary level of capital, based on actual obligations, through an actuarial framework consistent with IAIS principles.

157. Adopting a flexible approach to determining start-up capital requirements means the capital requirement will be commensurate to the risks of the business while accounting for equity considerations. Thus, the start-up capital requirement will not operate as a barrier to entry. In addition, a flexible approach to start-up capital will become redundant at the end of year one, which means it should help mitigate policyholder expectations that there is some form of guarantee or "special fund" for the obligations in the possible event of an insurer's failure. Therefore, it will also reduce moral hazard incentives for policyholders.

158. With a risk-based focus there will be no need to provide an exemption process, but this brings the disadvantage of no pre-defined figure as a signal to potential entrants to the insurance sector. A further limitation is greater complexity for the process the Regulator must undertake.

3.5.5.3 Proposal - Ongoing Enhanced Solvency Requirements

159. It is proposed that, as an ongoing requirement, all insurers must comply with enhanced solvency requirements applicable to the class of business or classes of business the insurer is licensed to carry out.[82]

160. Given the diversity of risks an insurance business is exposed to and the unique risk profile of each insurer, it is proposed that the solvency requirements be risk-based, taking into account the specific nature of an insurer's risk profile. This flexibility will ensure that the insurer's reserving is proportionate to its risk and is achieved in a transparent and equitable manner.

161. The purpose of a risk-based enhanced solvency regime is to ensure that all insurers have sufficient assets, at all times, to meet their expected liabilities while also absorbing unexpected economic and financial shocks (which can affect both the assets and liabilities of the insurer). The prescribed model will, in accounting for the current risks the business faces:

---

[82] Enhanced solvency requirements will be specific to general, health and life insurance as is currently the market practice.

- Allow an insurer to assess the appropriate level of reserving so when the fund is closed to new members and in run-off, the insurer can be reasonably expected to meet existing obligations to the members and other creditors of the fund; and

- Enable the insurer to calculate the level of assets that will enable the insurer, with a reasonable degree of confidence, to continue to meet its obligations to both existing and new policyholders into the future.

162. In short, the enhanced solvency regime will provide a model that will enable the insurer to assess the overall financial position of its business, accounting for the relevant risks, and for the Regulator to have a clear understanding of this position. The two primary focuses in achieving this, as outlined by the IAIS and as included in the standards developed by the NZSA, are technical provisions (which focus on portfolio survival) and reserving (which focuses on an entity's survival).

163. As the enhanced solvency regime is risk-based, accounting for each insurer's risk profile, and sensitive to the class of business, it is not intended that an exemption process exist. Every insurer will need to ensure it reserves in a manner that will enable it to meet its obligations under a diversity of conditions.

164. As the calculations used to assess the solvency position and determine the necessary levels of reserving are highly technical, actuarial input and independent review in this area are essential. The development of a proposed co-regulatory model for enhanced solvency standards setting (discussed later in this section) will need to consider and have regard to the existing actuarial standards and guidance notes prepared by the New Zealand Society of Actuaries ("NZSA") and those standards developed by the Health Funds Association of New Zealand ("HFANZ") in concert with the NZSA. Further standards will be required to be developed for classes of insurance business where there are gaps.

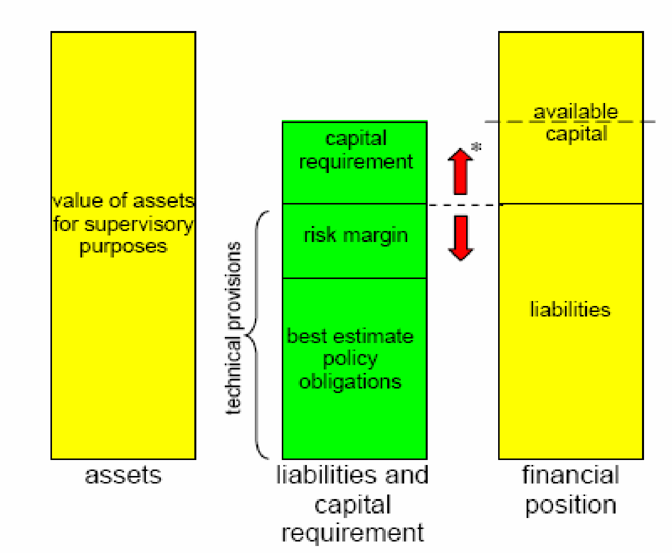
165. Adopting an internationally consistent enhanced solvency regime enables ease of access to the New Zealand insurance market for multinational insurers and benefits domestic insurers as their operating environment enables them to remain contestable with multinational firms, and provides them greater ease of access to international markets.

166. The enhanced solvency requirements will be based on the following:[83]

167. **Total Balance Sheet Approach.** The financial position of an insurer is subject to a diversity of interdependent variables and factors such as assets, technical provisions, reserving requirements, resources and the need to assess the overall financial position of an insurer.[84] Therefore, we believe it important to adopt a total balance sheet approach so that the prudential requirements do not create hidden deficits or surpluses.[85] This "whole of book" approach is generally represented by the following diagram.

---

[83] See the IAIS, OECD, IAA and other jurisdictions where these are key components to an enhanced solvency framework.
[84] See IAIS, "The IAIS Common Structure for the Assessment of Insurer Solvency", Draft 31 May 2006.
[85] See International Actuarial Association, "A Global Framework for Insurer Solvency Assessment" accessible at http://www.actuaries.org/index.cfm?DSP=MENU&ACT=HOME&LANG=EN



Source: IAIS, Towards a common structure and common standards for the assessment of insurer solvency: cornerstones for the formulation of regulatory financial requirements. October 2005

168. **Common Valuation and Market Consistency.** The enhanced solvency framework will be supported by having a common valuation process consistent with generally accepted accounting and actuarial practice, and market valuations. This is important to the undertaking of comparative analysis and will enable more informed decision-making by both the market and Regulator.

169. **Categorisation of risk.** The primary categories of risk outlined by the International Actuarial Association (IAA) and IAIS are:

- *Underwriting risk* - incorporates the risk of loss due to factors such as pricing, product design and claims risks.

- *Credit risk* - relates to the risks of default, concentration risks and counterparty risks through say reinsurance and derivatives contracts.

- *Market risk* - arise from economic and market volatility. For example, changes in asset prices, exchange rate movements, interest rate risks, equity risks and concentration risks.

- *Operational risk* - involves reputation and strategic risks that the insurer is exposed to as well as risks that arise from process failure or system failure. This also includes risks relating to being a member of a financial group.

- *Liquidity risk* - the insurer has need for cash flows to meet obligations as they arise. Liquidity problems may arise because of a number of factors such as difficulties in asset conversion or drops in the stock market.

170. All of these risk categories can impact differently on the balance sheet of the insurer and not all are easily quantifiable. In modelling these risks there are three key components that need to be considered to better enable an insurer to determine the appropriate action to deal with these characteristics. These are[86]:

[86] See International Actuarial Association, "A Global Framework for Insurer Solvency Assessment" at http://www.actuaries.org/index.cfm?DSP=MENU&ACT=HOME&LANG=EN.

- *Volatility risk* - risk of random fluctuation in either the frequency or severity of an event;
- *Uncertainty risk*-- risk that the models used are mis-specified or parameters are mis-estimated; and
- *Extreme events* - these are generally high impact and low frequency events.

171. Analysis of these key characteristics assists in informing how the different risks can be managed and play an integral role in informing the insurer of the appropriate level of reserving.

172. **Longevity focus.** Risk margins and reserves need to be calculated on the basis of how best estimates will be affected by future deviations. This requires an approach where an insurer's financial obligations, both today and in the future, should be factored into assessments through financial modelling and stress testing so that reserving requirements are calibrated in a manner that enable assets to exceed technical provisions at the end of the defined period with a degree of certainty. The approach will also focus on what financial provisioning will be necessary to maximise the probability of the company's survival.

3.5.6 Proposal - Enhanced Solvency Standard Setting

3.5.6.1 The Role of the New Zealand Society of Actuaries (NZSA) in Solvency Standards Setting

173. Currently, the NZSA performs a pivotal role in developing standards and guidance notes such as PS3 and GN5 for life insurance, and PS4 for general insurance. However, insurers are not legally bound to comply with these standards.

174. There are no corresponding standards for health insurance. Although, since 2001 the NZSA in conjunction with HFANZ (Health Funds Association of New Zealand) has been developing a solvency regime which will apply to the Association's members, and non-members where they choose to be accredited under the regime. This is a risk-based regime that is consistent with the Australian two-step test equivalent. Although this new regime has not yet been made publicly available we have been informed by HFANZ that the regime has focused on five main areas: liability risk, inadmissible asset revenue, resilience, expense risk, and management of capital.

175. The standards development by the NZSA involves consultation with a number of stakeholders and considers factors such as the interplay between actuarial and accounting standards, and the need for consistency internationally. Standards developed by the NZSA to assist an actuary to assess the solvency position of an insurer are risk-based, take a prospective approach, involve stress testing of calculation, and prescribe levels of conservatism in calculations and assumptions. [87]

176. The standards are designed to be viewed as a financial safety net within a framework that includes qualitative factors such as prudent and honest management by fit and proper persons.[88] This is in recognition of the importance of governance and integrated

[87] See www.actuaries.org.nz and the professional standards and guidance notes that the Society has issued for the assessment of an insurers solvency position. This is consistent with the approaches that are recommended and have been adopted internationally.

[88] This is consistent with the approach endorsed by the International Actuarial Association and the IAIS

internal risk management to facilitate an insurer identifying and managing risks which may impact upon the financial stability of their portfolio(s), therefore limiting the probability an insurer will need the safety net provided by prudential reserving.

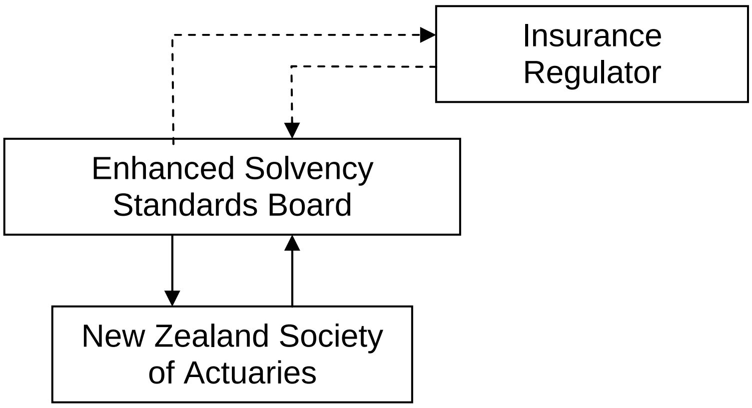
177. Approaches developed by the NZSA are consistent with the current international position on insurance solvency assessment as outlined by the IAIS, OECD, World Bank and IMF, and are closely aligned to the Australian equivalents. The profession relies on academic research and analysis of failures elsewhere to calibrate the various prudential factors. It is involved in the ongoing development of standards internationally. The NZSA already has a standards-setting model which is consistent with the co-regulatory framework set out in this section.[89]

178. Against this background the proposal for standard setting for enhanced solvency assessment is as follows.

3.5.6.2 Co-Regulatory Model

179. It is proposed that a co-regulatory model be adopted as shown diagrammatically below. The standards covered by this model will relate to matters that have an actuarial element and do not include standards the Regulator has the power to set under the legislation, for example, governance and licensing conditions.

Co-Regulatory Framework



180. The co-regulatory model[90] will involve:

- Establishment of a new entity, the Enhanced Solvency Standards Board (ESSB) made up of actuaries, industry, the Regulator and other relevant professionals;

- The Regulator will have the power to instruct the ESSB to undertake work on existing standards or to produce new standards if there is a belief the standards are deficient or do not meet current market conditions;

---

[89] As confirmed to us by letter from the NZSA, and stating that the NZSA is prepared to continue performing this function.

[90] This is consistent with other jurisdictions, e.g. Australia has the LIASB www.apra.gov.au/Life/LIASB.cfm, in the UK the Financial Reporting Council is establishing an Actuarial Standards Board as a new operating body to set technical actuarial standards, the Morris Report on the Actuarial Profession, commissioned by HM Treasury at www.hm-treasury.gov.uk/media/CA0/9C/morris_final.pdf, and the UK Government's response to the Morris Report at www.apra.gov.au/Life/LIASB.cfm.

- The ESSB/NZSA will have the ability to initiate the standards development process and seek approval from the Regulator;

- The ESSB will instruct the New Zealand Society of Actuaries ("NZSA") to enhance or develop standards consistent with gaps in the existing standards and market developments;

- The NZSA will invoke their standards-setting process, which involves consultation with their members and fellows;

- The proposed standards will be put back up to the ESSB for assessment of adequacy and for broader public consultation;

- Once the members of the ESSB have reached agreement, the ESSB will seek approval of the standards from the Regulator;

- The Regulator will have the power to approve the standards developed by the NZSA and agreed by the ESSB, on the following criteria:

    a. They take into account international best practice and New Zealand's international obligations;

    b. They have been consulted on with the appropriate stakeholders; and

    c. They meet the objectives of the insurance legislation.

- If the Regulator considers that the proposed standards fail to meet the criteria, the Regulator will have the power to veto the standard, returning it to the ESSB for further review through the above process.

- Where the Regulator has vetoed the proposed standards twice, the Regulator will have the power to set the standard itself. In setting the standard the Regulator must:

    a. Have regard to the standard proposed by the ESSB, and the consultation done under the previous reviews; and

    b. Meet the criteria above for Regulator approval in the same manner as applied to standards proposed by the ESSB.

- The Regulator will monitor the insurer's compliance with the standards, which will be legally binding (see the *Monitoring and Supervision* section);

- The Regulator will have enforcement powers where there is a breach of the standards by an insurer (see the *Monitoring and Supervision* section).

181. Members of the ESSB will be appointed on the basis of expertise, and will include:

- Membership by the Regulator, which is important to provide checks and balances to the standards development process and to ensure the Regulator's perspectives are taken into account;

- Expert actuarial skills, which are crucial;

- A member versed in accounting standards development, which is key to ensuring the actuarial standards are consistent with financial reporting standards. This may involve membership from the Accounting Standards Review Board; and

- Industry expertise from the relevant classes of insurance business (general, health and life), which is important to consistent development and sound standards. This expertise may come from the current industry associations.

3.5.7 Proposal - Financial Condition Report

182. The financial condition report is an important tool to an insurance entity. It contains detailed and commercially sensitive information about the insurance business. The insurer's actuary provides significant input in to this document and outlines performance of the business and future direction. Despite some jurisdictions requiring this document to be provided to the Regulator as part of standard reporting, such a requirement may create the wrong incentives structures for sound risk management.

183. The proposal is to require an insurer to prepare this document annually, but with only director attestation to the Regulator that it has been prepared. The Regulator will have the power to call on the document if justified for the purposes and objectives of the legislation.

3.5.8 Operational Proposals

3.5.8.1 Proposal - Licensing Subject to Conditions

184. The proposal is that the Regulator will have the power to issue a licence subject to conditions.[91] The Regulator may amend, add to or revoke the conditions at any time, subject to the purposes and objectives of the legislation.

185. The conditions will allow an insurer to comply with the licensing and prudential requirements to different degrees or impose different requirements at the discretion of the Regulator to give flexibility to the regime. The conditions may be applied to an insurer's licence by the Regulator where, for instance, the Regulator considers it necessary to cover situations relevant to the New Zealand insurance market. For example, where:

- An insurer is small, or a mutual whose activities are limited to a certain geographical area, and/or limited to a certain number of policyholders, and/or who offers special types of cover.

- Insurance contracts concluded with an insurer in another jurisdiction on a services basis (without local establishment), where they are entered into without the initiative of the insurer.
- There is an "insurance shortage" in the domestic market that can only be met by a foreign insurer that cannot meet the licensing or prudential requirements.

[91] To allow flexibility within the regulatory regime, some jurisdictions allow exemptions from the licensing requirements, see IAIS, as above.

- Some of the licensing and prudential requirements can be reduced because an insurer meets comparable requirements in an overseas jurisdiction. This may be most relevant to reinsurers.

- There are other factors which the Regulator considers appropriate to meet the Government's regulatory objectives.

3.5.8.2 Proposal - Licensing Fees

186. Potentially, fees will be charged to obtain a licence. If they are, they will be determined following Government fee guidelines, and will be consulted on.

3.5.8.3 Proposal - Insurer Appeal Rights for Prudential Requirements

187. It is proposed that the insurer have the right of appeal to the courts, under judicial review, for decisions made by the Regulator in relation to prudential requirements.[92]

188. Judicial review is considered more appropriate for prudential requirements because merit appeal rights may interfere with the timeliness and consistency of their application, which is key to their success as a prudential tool. Internationally it is common for entities to have a right of appeal to an appellate authority (in most countries this is the courts).[93] The right of appeal operates as an appropriate check and balance providing transparency and accountability for the regulatory decisions made. The IAIS principles state as an essential criteria that administrative decisions of the supervisory authority must be subject at least to substantive judicial review.

Questions for Submission

6. Do the above proposals overcome the problems identified in the Introduction section of the discussion paper?

7. Are the proposals consistent with the objectives of regulation outlined in the Introduction?

8. What are the benefits and costs of each proposal to an insurer?

9. What implications do these proposals have for the sector as a whole?

10. Are there any other comments on the proposals made?

3.6 LICENSING AND PRUDENTIAL OPTIONS

189. The areas where further discussion is required in order to seek feedback on remaining issues are set out as follows.

[92] For types of appeal rights in New Zealand see the Chapter 13 Appeal or review (2003 supplement), Legislation Advisory Committee, Guidelines, 2001. www.justice.govt.nz/lac/index.html.
[93] OECD, as above.

3.6.1 Option - Risk Management Strategy

190. An option for the insurance regulatory regime, for the purpose of complementing the enhanced solvency requirements, is the requirement that each insurer have an integrated risk management strategy to proactively identify, quantify and resolve risk that may arise or has arisen. Rather than prescribing a framework, directors would be required to attest on an annual basis to the Regulator that they have implemented an integrated risk management strategy and process which is consistent with a fitness for purpose framework. The fitness for purpose framework may include key areas such as:[94]

- Does the framework identify relevant standards, policies and legal requirements?
- Does the framework enable proactive identification, quantification and management of existing or potential risks?
- Is there capacity to distinguish between risk types (i.e. strategic risk, market risk, operational risk)?
- Are the stated management of risk objectives, constraints and concerns agreed (or validated)?
- Has the framework established how a successful outcome is to be judged?
- Does the framework identify the tools and techniques to be adopted, and the scale for evaluation of risk?
- Will the risk management framework instil the appropriate incentives and behaviours?

191. Under this option, the Regulator would have the power to call for details of the risk management strategy and practices if justified for the purposes and objectives of the legislation.

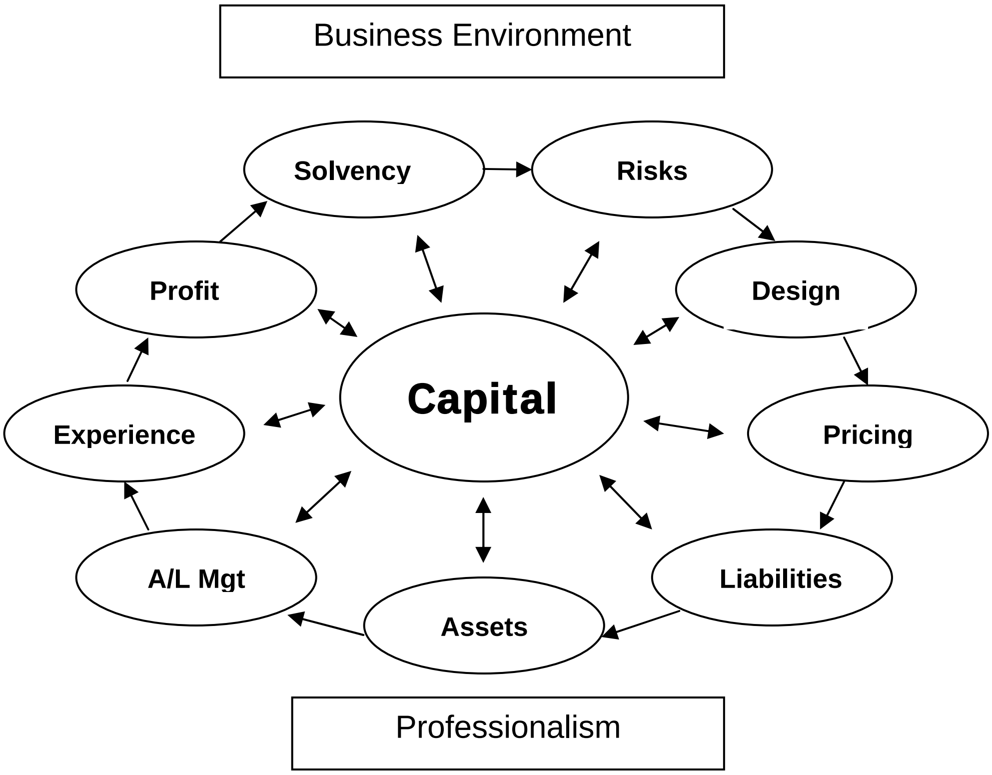
192. A risk management strategy option has been considered on the basis that the core business of an insurer is risk management. This is reflected in the enhanced solvency framework which requires the insurer to turn its mind to a number of risks. Therefore, the insurer should be able to prudently and proactively manage the risks its business is exposed to under a diversity of conditions to reduce the probability it will not be able to meet its obligations.[95] Hence, the regulatory framework for insurance may need to be designed so the Regulator is provided with flows of information to assess whether an insurer is managing its risks appropriately with an acceptable degree of clarity.

193. This supports the approach promoted by the IAIS and IAA where they state regulatory capital is an important component of an insurance Regulator's toolbox, but is

[94] Fitness for purpose frameworks have been supported and adopted by the UK Office of Government Commerce where they ask six questions in relation to the appropriateness of the risk management framework. See http://www.ogc.gov.uk/sdtoolkit/Reference/documentation/p47_riskframe.html
[95] See IAIS, "The IAIS Common Structure for the Assessment of Insurer Solvency", draft 31 May 2006

not the entire answer.[96] There is a strong interdependency between sound governance, good risk management and an effective solvency regime. Hence, risk management requirements may be viewed as being on a continuum with the tools that address governance and solvency matters.

194. Implementing a "one size fits all" approach to integrated risk management is inherently problematic given insurance entities are exposed to a diversity of risks with magnitudes unique to each insurer. Therefore, under this option it is suggested that the requirements are sufficiently flexible to achieve proactive risk identification and quantification. Such an approach is consistent with international models[97], which have highlighted that rather than presenting solutions, the risk management models should provide guidance. This is due to the interdependent factors involved in effective risk management including the internal identification of appropriate tradeoffs, and is represented by the following diagram.



Source: IAA Actuarial Control Cycle

195. Following implementation of an integrated risk management framework in conjunction with sound governance, an insurer should be better able to proactively identify and quantify potential risks. Therefore, the insurer should have less dependency on solvency reserving as proactive risk management can facilitate behaviours that will assist in overcoming potentially financially debilitating events, or at the very least,

[96] See Vaughan, T. "Financial Stability and Insurance Supervision: The Future of Prudential Supervision", *The Geneva Papers on Risk and Insurance*, Vol. 29 No.2 (April 2004) pp. 258-272.
[97] See COSO, Enterprise Risk Management: International Framework, September 2004.

improve the ability of the insurer to mitigate the impact certain events may have on their solvency position.[98]

Questions for Submission

11. Should the insurance regulatory regime require high level risk management strategy requirements that are attested to by the insurer's directors annually?

12. What are the costs and benefits of adopting such an option?

3.6.2 Option - Separation of Classes Life / General / Health

196. The IAIS has stated that separation of classes of insurance business is a commonly accepted practice across a diversity of jurisdictions.[99] An IAIS survey of member jurisdictions in 2005 reported that in 75 percent of the jurisdictions insurance companies are allowed to transact life and non-life business simultaneously. All OECD member countries require life and non-life business to be separated in some way, so that one activity cannot be used to support the other. Especially reserves in life insurance.[100] In most member countries, separate licences are issued for each class of insurance business or for several classes of business grouped under a common denomination.[101] See the *Categorisation Proposals* section for discussion on the rationale for separate licences.

197. The issue licensing requirements are seeking to address is the separation of life, health and general insurance business where more than one is undertaken by the insurer. This is to ensure one class of insurance business does not support another class, and limits cross-contagion of funds and cross-subsidisation of products.

198. The option for addressing this issue is:

- All insurers will be required to comply with the accounting separation (with segregated funds) requirement for the class or classes of insurance business they are licensed to carry out. This will also be required for the New Zealand operations of a foreign insurer; plus

- The option of the Regulator having the power to require incorporation for each class of insurance business under the Companies Act 1993, plus conditions, which will be determined against criteria.

3.6.2.1 Accounting Separation (With Segregated Funds)

199. All insurers will have to comply with the accounting separation[102] (with segregated funds) requirement. The Regulator will have the power to set rules and monitor compliance with requirements that an insurance business is licensed to carry on or offer

[98] See IAIS, Principles on Capital Adequacy and Solvency, January 2002.
[99] And are recommended by IAIS, *Supervisory Standard on Licensing*, October 1998.
[100] Jörg Volbrecht, for OECD, *Insurance Regulation and Supervision in OECD Countries*, 2000.
[101] Jörg Volbrecht, for OECD as above.
[102] This is commonly done in other industries, such as telecommunications and electricity. See Telecommunications Amendment Bill 2006, and Steven Dounoukos & Angus Henderson, *Unscrambling the Omelette: Achieving Effective Accounting Separation of Telstra*, ww.findlaw.com.au/article/5578.htm.

life, health and general insurance business in one entity, that these classes be separated under accounting and segregated funds rules, such as:

- **Separate accounts.** An entity authorised to provide life insurance and another class of insurance business (i.e. health and/or general) must maintain separate accounts for each.

- **Separate reporting and auditing.** Account and statement rules requiring an entity to prepare and report separate revenue accounts, balance sheets, and profit and loss accounts for each class of insurance business they undertake, and a requirement to have those accounts audited. The Regulator would have the power to grant *de minimus* exemptions where a risk category that falls within another class is too small to separate.

- **Allocation rules.** Allocation rules relating to premiums, costs and profits for products covering more than one class of insurance business.

- **Segregated funds.** In addition to the separate accounts requirement above, a further requirement in relation to policies for each of life, health and general insurance:

  a. To establish and maintain funds that are segregated from the other assets of the entity; and

  b. There are specified assets, the market value of which are relied on to meet the liabilities of the entity in relation to those policies.

  A claim against a segregated fund under a policy for which the fund is maintained would have priority over any other claim against the assets of that fund. Only where the assets of that fund are insufficient to meet its claims would a claim against other assets of the entity arise.

- **Connected lending.** A prohibition on connected lending/security or intermingling of funds within the group or with related parties.

- **Winding-up rules.**[103] Applying statutory management to one class of insurance business without doing so for others undertaken by the entity.

200. Note the new legislation will apply standard governance requirements for all insurers. See the *Governance Proposals* in this section.

3.6.2.2 Incorporation Under the Companies Act 1993

201. In addition to the accounting separation (with segregated funds) requirement, the option is that the Regulator be able to require incorporation under the Companies Act 1993. This would occur when the Regulator considers that the accounting separation (with segregated funds) requirements do not provide satisfactory separation in relation to a particular insurer. The Regulator will have the power to require the insurer to:

- Incorporate each class of insurance business (health, life and general) into separate companies under the Companies Act 1993; and

---

[103] See equivalent power that does this in relation to banks, section 117(3) Reserve Bank of New Zealand Act 1989.

- Comply with accounting separation (with segregated funds) requirements; and
- Comply with further conditions such as acting in its own best interest, having a separate board of directors, and/or other separation requirements determined to be appropriate by the Regulator.

202. The criteria the Regulator would need to have regard to in determining whether incorporation plus conditions is required are:

- Whether it is in the best interests of policyholders;
- Whether each licensed insurance business is operated using a corporate form that meets the purposes and objectives of the legislation in a way which imposes the least costs on business;
- The size of the insurer and whether it presents risks to the stability of the New Zealand insurance market;
- The current structure of the insurer's business and the transition costs of change; and
- The relative size of each insurance business class undertaken.

203. A benefit of this option is that it gives flexibility to the regime, leaving the Regulator to adopt the most advantageous form for the New Zealand regulatory environment having regard to a particular insurer's business. The limitation is that the Regulator may tend towards a risk-averse stance if they are criticised for taking a light-handed approach.

Questions for Submission

13. For the purposes of categorising insurance businesses and granting a licence to operate more than one class of insurance business (general, health and/or life) is accounting separation (with segregated funds) and the option for the Regulator requiring legal separation plus conditions sufficient?
14. What are the costs and benefits of accounting separation (with segregated funds) and/or legal separation plus conditions?
15. Should the requirements be set out in legislation or be set by the Regulator?

3.6.3 Option - Legal Form of Foreign Insurers

204. The IAIS core principles require that foreign insurers be licensed before operating in a jurisdiction or operating on a services-basis only, but they do not set out recommendations for legal form.[104] Some OECD member countries allow branches of foreign insurers to operate in their market without requiring separate legal

[104] ICP 6 IAIS as above.

incorporation.[105] However, the branches are required to have their own capital resources controlled through accounting separation and segregated funds rules.

205. The main issue for licensing requirements relating to foreign insurers operating in New Zealand that the regulation is seeking to address is the ring-fencing of assets for New Zealand policyholders. The option for addressing this issue is that the Regulator will have the power to determine whether the foreign insurer may operate as a branch or a subsidiary, against criteria, such as, whether:

- It is in the bests interest of policyholders;
- The insurance business is operated using a corporate form that meets the purposes and objectives of the legislation;
- The insurer is small or does not present risks to the stability of the New Zealand insurance market;
- New Zealand policyholders and other creditors would not be disadvantaged by financial losses within a part of an insurance group in another country, for instance, there are no policyholder preference arrangements in legislation in the insurer's home jurisdiction;
- The New Zealand management/board is to operate using adequate governance arrangements, including having all the powers to manage, direct and supervise the affairs of the business in the best interests of New Zealand policyholders and other stakeholders;
- The legal, accounting and governance requirements of the parent company are satisfactory to the Regulator, and are being met by the parent; and
- Any other factor the Regulator considers appropriate to meet the purposes and objectives of the legislation.

206. The foreign insurer, whether a branch or a subsidiary, would have to comply with the accounting separation (with segregated funds) rules above for classes of insurance business, as well as separation from its parent in the home jurisdiction and group internationally.

207. The Regulator would also have the power to impose conditions on the foreign insurer regarding matters such as:

- **Connected lending.** A prohibition on connected lending/security or intermingling of funds within the group or with related parties.
- **Act in own best interests.** If a subsidiary company, it must act in the best interest of itself rather than its parent.
- **Winding-up rules.**[106] Where operating in New Zealand as a branch, the Regulator would have the power to apply statutory management to the property, rights, assets and liabilities relating to its New Zealand business.

---

[105] Jörg Volbrecht, for OECD, *Insurance Regulation and Supervision in OECD Countries*, 2000

- **Separate board.** For a subsidiary, a board of directors would be required for the New Zealand company (the Companies Act only requires one director).

- **NZ chief executive.** Whether operating either as a branch or a subsidiary, to appoint and maintain a chief executive in New Zealand who is responsible for the conduct of the New Zealand operations (the Companies Act does not require directors to reside in NZ).

208. The main advantage of requiring legal separation relates to situations where the Regulator needs to take intervention action urgently. It provides a better mechanism for winding-up situations since the Regulator can directly deal with outsourcing, derivatives and other contracts.

Questions for Submission

16. For the purposes of ring-fencing the New Zealand operations of a foreign insurer operating in New Zealand, is accounting separation (with segregated funds) and the option of the Regulator requiring legal separation and/or further conditions sufficient?

17. What are the costs and benefits of accounting separation (with segregated funds) and/or legal separation for a foreign insurer?

18. Should the requirements be set out in legislation or be set by the Regulator?

3.6.4 Option - Ratings

209. One option being considered in the changes to the insurance regulation relates to the role played by a financial strength rating for insurers.

210. The three options being considered are:

- **Option 1:** Mandatory ratings for all insurers as a licensing requirement and as an ongoing prudential requirement. Under this option, insurers would be required to:

    - Maintain a financial strength rating from a rating agency approved by the Regulator; and

    - Publicly disclose the rating to policyholders in disclosure statements and on insurance renewal notices including any recent negative changes to the rating.

    In the case of very small insurers, where a rating could be impracticable or prohibitively expensive, an exemption could be considered, on the basis that the absence of a rating would have to be disclosed.

---

[106] See equivalent power that does this in relation to banks, section 117(3) Reserve Bank of New Zealand Act 1989.

- **Option 2:** No mandatory ratings, where no insurers would be required to obtain a rating, but if they did have a rating, it would have to be disclosed to policyholders.

- **Option 3:** Retain mandatory ratings for disaster and property insurers under licensing and prudential requirements, and to extend to all general insurers, subject to scope for a *de minimus* exemption for very small insurers. The rating would have to be obtained from a rating agency approved by the Regulator. Where the insurer has been authorised not to obtain a rating, this would have to be disclosed to policyholders. If ratings are obtained voluntarily (by insurers not required to obtain one), from a rating agency approved by the Regulator, the rating would have to be disclosed to policyholders.

211. The three options are discussed below in terms of their ability to meet Government objectives, and the benefits and limitations of them being mandatory.

212. In particular, the ratings proposal is assessed on the basis of ratings' ability to:

- Provide policyholders and others with a relatively simple means of assessing the financial soundness of an insurer and comparing one insurer with another;

- Strengthen market discipline on insurers and increase the incentives for sound governance and risk management; and

- Provide a tool to supplement and complement prudential supervision of insurance.

3.6.4.1 Possible Benefits of Financial Strength Ratings

- A rating can provide a relatively simple grading system to enable policyholders and their advisors to identify and compare an insurer's financial strength, reducing the need for them to obtain and interpret complex information about an insurer's financial strength. Given the inherent complexity of financial and actuarial disclosures issued by insurers, and the extent of expertise required to understand these disclosures, a rating can assist considerably in the assessment of an insurer's financial strength. It can readily alert policyholders and their advisors to an insurer's relative position on the risk scale, particularly if the rating is disclosed by reference to the full rating scale. It can also reveal any recent changes to the rating, including downgrades or credit watch status.

- There is also scope to reduce possible confusion with the meaning of ratings through education of policyholders and their agents, such as by web-based publication of comparisons of the different rating scales. Confusion would be avoided if just one rating agency were approved for use by insurers for disclosure purposes.

- Ratings are also used for commercial purposes such as by independent financial advisors, insurance brokers, corporate buyers of insurance, and investors and banks in assessing credit risk, and for reinsurance security assessment by cedants.[107]

---

[107] Jean-Louis Bellando, Expert, OECD, *Assessing the Financial Health of Insurance Undertakings to Protect the Insured from the Risks to which these firms are exposed: Solvency Rules*. See www.oecd.org. This is also consistent with feed back from the Insurance Advisory Groups.

- Ratings may assist in encouraging consumers to take responsibility for their decision-making and reduce reliance on the prudential supervisor. Ratings are therefore an important means of reducing moral hazard risks.

- Ratings may be an important source of market discipline on insurers, encouraging them to maintain robust governance and risk management systems and controls. Regular scrutiny by an international rating agency can add to the effectiveness of market disciplines, given that the rating is likely to be used by many market participants as a key indicator of insurer financial strength. Insurers may have strong incentives to manage their affairs in ways that avoid the likelihood of a rating downgrade or a rating lower than their competitors.

- The rating process may also provide an important source of internal self-discipline on insurers, given that it requires the board and senior management of an insurer to prepare for the annual rating assessment, while also sharpening the focus on risk management issues and respond to concerns or questions raised by the rating agency.

- A rating may be able to be used as a supplement to other prudential tools to assist in the supervision process. It can be used as a trigger to determine when monitoring should be escalated. By enhancing market and self discipline, ratings can assist in reducing the extent of supervision required to attain the desired outcomes for the insurance sector, with lower supervisory costs.

- Supervisors have a mixed track record in anticipating distress and failure, and reacting quickly. Moreover, public disclosures are inevitably dated and do not provide a reliable means of anticipating incipient distress. Therefore, though by no means perfect, rating agencies nonetheless may provide additional information to policyholders.

- A *de minimus* exemption for very small or mutual insurers, where it is not practicable to produce a meaningful rating, may address any issues of whether ratings fairly rate small and mutual insurers or that they are cost prohibitive.

3.6.4.2 Possible Limitations of Mandatory Ratings

- Although there are close similarities between the rating scales of the different international rating agencies, there are some differences. For instance, a weak rating from Standard and Poors is BB whilst the same weak rating from AM Best is B.[108]

[108] *Standard and Poor's* Insurer Financial Strength Rating Definitions state that an insurer rating of BB or below is regarded as having vulnerable characteristics that may outweigh its strengths. It is a marginal rating.
A.M. Best's Financial Strength Ratings Definitions state that an insurer rating of B or below is regarded to have a fair ability to meet their current obligations to policyholders, but are financially vulnerable to adverse changes in underwriting or economic conditions.
Fitch Ratings Financial Strength Ratings Definitions state that an insurer rating of BB is viewed as moderately weak with an uncertain capacity to meet policyholder and contract obligations. Though positive factors are present, overall risk factors are high, and the impact of any adverse business and economic factors is expected to be significant. A rating of B is viewed as weak with a poor capacity to meet policyholder and contract obligations. Risk factors are very high, and the impact of any adverse business and economic factors is expected to be very significant.

Consultation has revealed this as one reason ratings may not be clearly understood by consumers. Due to the overall complexity arising from different scales and methodologies rating may not be the most optimal signalling tool for consumers.[109]

- A mandatory ratings requirement is internationally inconsistent with other jurisdictions and frameworks recommended by the IAIS and OECD. Internationally the more common tool is a formal prudential regime with appropriate disclosure. [110]

- Research on New Zealand's consumption of insurance products[111] shows ratings do not feature in the decision-making process of consumers for determining which insurance product to purchase. This is consistent with literature on ratings as a tool for informing consumers.[112]

- For policyholders in the process of a claim, or with policies underwritten on the basis of their health or life, ratings provide no benefit because the policyholders are effectively locked in to their policy. The prohibitive cost of change, due to material changes in their personal circumstances, means the policyholder is unable to find replacement cover on similar terms. Therefore, in the event of a rating downgrade the policyholder is unable to act upon the information and is exposed to the insurer's failure.

- Previous reviews of the Insurance Companies (Ratings and Inspections) Act 1994 by MED[113] identified that claims-paying capacity only provides short term solvency information, rather than making comment on the long term ongoing viability of the insurer. In that regard, it could be argued that ratings is not an appropriate signal of quality to potential long-tail policyholders, since they are not predictive of the longevity of an insurer, which is key to policies that may not be met until 30-40 years time.

- Rating agencies are not always able to accurately assess the true risk profile of an insurer. The experience with Reliance Insurance in the USA and HIH in Australia has demonstrated that rating agencies do not always move sufficiently quickly to adjust ratings when insurers are in financial difficulty.

---

[109] Views of the Advisory Groups and the Consumers' Institute.

[110] OECD, *Glossary of Insurance Policy Terms*, 1999, and ratings are not recommended by the IAIS. And see KPMG, for the European Union, *Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision*, May 2002, Contract no: ETD/2000/BS-3001/C/45.

[111] Blackwood King Adpartners, *AIA "Life Matters Index" – New Zealand Questionnaire*, Commissioned by American International Assurance New Zealand, October 2005

[112] Jean-Louis Bellando, Expert, OECD, *Assessing the Financial Health of Insurance Undertakings to Protect the Insured from the Risks to which these firms are exposed: Solvency Rules*. See www.oecd.org. General financial knowledge is very low in New Zealand, see the results of the Financial Knowledge survey commissioned by the ANZ Bank, MED and the Retirement Commissioner and done by Colmar Brunton, reported on in 2006, www.med.govt.nz KPMG, for the European Union, *Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision*, May 2002, Contract no: ETD/2000/BS-3001/C/45. This is also consistent with feedback from the Insurance Advisory Groups.

[113] MED has carried out a number of consultative reviews on ratings, including of the Insurance Companies (Ratings and Inspections) Act 1994, from 1988 to 2002. The Act applies to insurers offering fire and disaster insurance in New Zealand. They must obtain a rating from an approved rating agency (currently, A.M. Best, Fitch Australia, Standard & Poor's).

- It has been argued that ratings from international rating agencies are inherently biased against small and mutual insurers, because the rating process is geared to large, international institutions.[114] This is an arguable point, with little evidence either way. However, to the extent that small and mutual insurers do tend to get lower ratings on average than larger insurers, this probably reflects several factors which, taken together, may justify lower ratings for small and mutual insurers. These factors include:

  a. Small and mutual insurers may not have the risk diversification benefits of having a large balance sheet – they generally have larger exposure concentrations to individual or related counterparties, or to particular sectors of the economy;

  b. Operational risk tends to be larger with small and mutual insurers due to increased key person risk, less capacity for diversification of operational risk shocks, and fewer resources devoted to operational risk management;

  c. Corporate governance and risk management systems may be weaker in small and mutual insurers than in larger insurers; and

  d. Shareholder support may be weaker in small insurers compared to many large insurers. Raising capital can be much harder for a small or mutual insurer than a large one with institutional investors and high standing. Moreover, small and mutual insurers may be prone to connected exposure risks to a greater extent than in the case of large insurers.

- Using an exemption power for some insurers may send conflicting signals to the market. It may also create an "uneven playing field" for participants in the industry; it is not a competitively neutral requirement.

- Ratings can potentially be quite costly to obtain. Feedback from the Advisory Groups is that ratings can cost around NZ$40,000[115] plus NZ$5,000 to $10,000 per subsidiary in direct rating agency fees. Management time involved in preparing for the rating adds to these costs. Feedback from industry is that to support the cost of a rating of $100,000 (fee plus management costs), the amount of annual premiums written would have to be in the vicinity of: life insurance $1 million; health insurance $3 million to $5 million; and general insurance $1 million to $2 million. These figures relate to a period of medium to high profitability; in a period of low profitability they will be significantly higher.

213. We are keen to receive feedback on whether the prudential regime and market conduct framework alone are sufficient to meet Government objectives for the insurance regulatory framework or whether ratings are also required. Particularly, from a regulatory policy design perspective, whether they meet the central elements of user embeddedness. User embeddedness describes the degree to which information that is mandated in a disclosure system is integrated into the decision-making process of a

[114] MED received a large number of submissions on this point in its previous review on ratings. It is reported in the KPMG empirical study done for the European Union (referenced earlier), and is also consistent with feedback from the Advisory Groups.

[115] We understand from the Advisory Groups that same rating agencies have higher fees than others, so this is an average.

policy's intended users.[116] While ratings currently do not appear to be integrated into consumer's decision-making process, it is possible that other disclosure systems proposed will exhibit the same concerns.

Questions for Submission

19. Do ratings provide policyholders and their agents with useful information with which to assess the financial soundness of an insurer and compare one with another?

20. Are they currently used by retail consumers or policyholder agents/advisors in New Zealand?

21. Do ratings provide an effective source of market discipline on insurers?

22. Do ratings assist in promoting the incentives for sound governance and risk management in insurers?

23. In addition to the other prudential requirements, such as governance, risk management and enhanced solvency standards, will ratings act as a sound supplementary tool for the purposes of supervision by the Regulator?

24. Should there be a mandatory requirement that all insurers obtain a financial strength rating from an approved rating agency, subject to a *de minimus* exemption for very small insurers?

25. Should a mandatory ratings requirement be retained for disaster and property insurers only?

26. What costs will a rating have for an insurer?

27. Does a mandatory ratings requirement meet the objectives of the regulatory framework?

3.6.5 Option - Transition of Existing Insurers

214. The two options identified for dealing with the new legislation applying to existing insurers are:

- **Option 1: Set transition period.** This option involves setting a defined period within which existing insurers must comply with the new regulatory regime.

- **Option 2: Regulator approve transition period.** This option involves providing existing insurers with a more flexible approach to transition into the new regulatory framework. On application to the Regulator for approval, the Regulator may approve the terms and conditions of an insurer's licence or licenses. This will mean the Regulator will be able to determine an appropriate

[116] The central elements of an effective transparency system require relevance, compatibility, comprehensibility, cost of collection, and the role of intermediaries. See David Weil, Archon Fung, Mary Graham, and Elena Fagotto, *The Effectiveness of Regulatory Disclosure Policies*, Journal of Policy Analysis and Management, Vol 25 No 1, 155-0181 (2006)

transition period for the insurer. This approach gives recognition to the fact that some insurance businesses may not need a significant time period to meet a licensing term or condition. However, other insurers may have different considerations in transitioning to compliance with the proposals and options for the new regulatory regime. The time period approved by the Regulator would need to be consistent with the purposes and objectives of the Act.

215. The benefits of Option 1 are that it is transparent, certain and consistent. The limitation is that it may be blunt; for some it may be too long and for others too short. The benefits of Option 2 are that it takes account of the diversity of insurers in the market, and it is likely that many of the existing insurers in the market will already comply with the licensing requirements, so for much of the market application of a transition period will not be necessary. A limitation of this approach is a lack of clarity about who is currently complying with the regime and confusion for consumers as to which insurers are yet to comply with terms and conditions of their licence. This also may lead to concern that some insurers will be given a competitive advantage over others.

Questions for Submission

28. Should there be a fixed transition period for existing insurers or should the Regulator have the ability to approve an insurer's transition period?

29. Other jurisdictions have adopted a "milestone" approach to transitions. This involves implementing set targets that licensed entities much comply with over a defined period in order to comply. Is there merit in considering this approach?

3.6.6 Option - Insurer Appeal Rights for Licensing and De-licensing

216. The two options for the insurer's right of appeal to the courts for decisions made by the Regulator relating to licensing requirements and de-licensing are:[117]

- Merit review; or
- Judicial review.

217. Internationally it is common for entities that are denied a licence or de-licenced to have a right of appeal to an appellate authority (in most countries this is the courts).[118] The IAIS principles state as an essential criteria that administrative decisions of the supervisory authority must be subject at least to substantive judicial review. Given that licensing decisions affect property rights and entering into commercial activity, it may be appropriate that merit review apply. However, it may be that since the licensing requirements were subjected to a significant consultation process all that is required is that the Regulator follows, for instance, due process in their application.

Question for Submission

[117] For types of appeal rights in New Zealand see the Chapter 13 Appeal or review (2003 supplement), Legislation Advisory Committee, Guidelines, 2001. www.justice.govt.nz/lac/index.html
[118] OECD, as above

30. Should the appeal right for the licensing and de-licensing decisions made by the Regulator be on the basis of merit review or judicial review?

4. MONITORING AND SUPERVISION

4.1 PRINCIPLES OF REGULATORY DESIGN FOR MONITORING AND SUPERVISION

218. The proposals for monitoring and supervision of the insurance sector have been designed to ensure effective monitoring and enforcement of compliance with licensing and prudential requirements, to evaluate the financial condition of insurance providers, and to take action where the requirements are breached or an insurer's soundness is at risk. An effective monitoring and supervision framework is an important means of meeting the objectives of:

- Promoting policyholder confidence in the soundness of the insurance sector;
- Encouraging soundly governed insurers; and
- Ensuring timely and orderly resolution of distressed insurers.

4.2 CRITERIA

219. The criteria used to assess the proposals for monitoring and supervision are whether they:

- Provide consistent reporting requirements across the insurance sector;
- Reduce time lags in reporting and increase powers to call for further information from insurers;
- Enhance regulatory powers to require reporting on both a solo and consolidated basis, where the insurer is part of a group;
- Enhance regulatory powers to monitor and enforce standards applying to insurance products and providers;
- Create regulatory powers to provide authorisation to limit duplication in reporting, or engage in information sharing, in relation to insurers also reporting to foreign regulators;
- Improve regulatory tools that enable timely intervention to manage rehabilitation or orderly exit of financially distressed insurers; and
- Provide proactive supervision of economic/financial risks to the sector that can impact on individual insurers.

4.3 BACKGROUND

220. New Zealand's insurance supervisory regime is currently disclosure focused, and characterised by a high level of industry-led self-regulation. This has provided for a

relatively trouble-free market.[119] Hence, there is no calamity that we are seeking to remedy. Rather, we are looking for the most optimal regulatory tools which will better aid the attainment of the Government's objectives for the insurance regulatory framework.

221. Internationally, ongoing monitoring and supervision of licensed insurers is recommended.[120] However, the ways and means of implementation vary across jurisdictions, there being no mandated or uniform method. The internationally preferred conditions for effective insurance supervision are a sound policy, institutional and legal framework for the financial sector, well developed and effective financial market infrastructure, and efficient financial markets.[121]

222. Supervision of the insurance sector by a Regulator is considered important because policyholders, who have a vested interested in the performance of their insurer, are unlike other creditors or shareholders as they are not as well placed to put pressure on an insurer to comply with prudential regulation. Policyholders are a dispersed group with little power to compel insurers to take certain actions,[122] the information reported may not be provided in an easily understood fashion, and individual policyholders may lack the expertise to sift among the various technical parameters. In this sense, the power asymmetries and lack of alignment in incentives arguably cause the economic efficiency of the market to be compromised.[123]

223. Internationally, insurance core principles see on-going supervision as an essential criterion for a supervisory authority. The International Association of Insurance Supervisor (IAIS) lists as a core principal, that the supervisory entity:

> …monitors and analyses all factors that may have an impact on insurer and insurance markets.[124]

224. In terms of experience with the IAIS core principles, under the financial sector assessment program, the International Monetary Fund and World Bank[125] have commented that insurance supervisors began working together at the broad international level less than a decade ago. These supervisors are primarily concerned with policyholder protection rather than systemic risk or development issues. The underlying philosophy of modern insurance supervision is to identify problem entities early, act promptly, and apply effective intervention.

225. The supervision needs to include a focus on the financial soundness of an individual insurer, and the group it is a part of, as well as the market and the environment within which it operates. Market analysis of past developments, the current market environment, and identification of future trends and risks are considered important as

---

[119] We understand that no life insurers have failed in New Zealand in the last 10 years. Broadly, for general insurance, there have been four incidents of concern in the last 10 years (rather than full scale insolvency) – The New Zealand HIH group did not fail in New Zealand as such, its insurance book was mostly sold off; the NZ Underwriters Limited receivership which occurred pre 1995; the Trenwick International NZ Branch, where the UK supervisor put the parent company into statutory run-off in 2002; and International Casualty and Surety Co Ltd, did not sell policies in New Zealand only in USA, went into liquidation in 2000.
[120] IAIS, *Insurance Core Principles*, 3 October 2003.
[121] IAIS as above.
[122] New Zealand Law Commission; Life Insurance Report No 87, November 2004 .
[123] OECD Directorate for Financial Enterprise Affairs, Insurance and Private Pensions Committee, *OECD guidelines for insurers' governance,* 28 April 2005.
[124] See ICP11 IAIS, *Insurance Core Principals and Methodology*, October 2003.
[125] August 21, 2001, see www.imf.org/external/np/mae/ins/2001/eng/index.htm.

they allow for timely and proactive supervisory action with a view to reducing the frequency and severity of future problems in the insurance market. The risks to an insurer's stability are greater in situations in which the preconditions for effective insurance supervision are not fully met and there is less than full compliance with prudential principles.[126]

4.4 PROPOSALS

226. Monitoring and supervision covers two distinct areas: supervisory monitoring and supervisory powers.

227. Supervisory monitoring relates to insurers undertaking regular reporting regarding the insurer's financial position and risk management strategies, both to the public and to the Regulator, and the Regulator monitoring ongoing compliance with licensing and prudential requirements.

228. Supervisory powers relates to monitoring powers (the ability to achieve/fulfil the roles above) such as inspections, meetings with board/senior management, requiring self-certification from directors/officers (e.g. director attestation), and requiring further information, and intervention powers, (the ability to undertake enforcement) such as issuing directives to the board, requiring a self-correction plan, facilitating book transfers, seeking the appointment of a statutory manager.

229. There will be two streams of reporting under the insurance regulatory regime: public reporting and private reporting (reporting to the Regulator), as outlined below.

4.4.1 Proposal - Public Reporting

230. It is proposed that enhanced public disclosure will form an important part of the supervisory arrangements, as a mechanism for promoting stronger governance and market discipline on insurers. The main features of the proposed arrangements are as follows.

4.4.1.1 Proposal - Financial and Risk Management Reporting

231. The proposal is that financial reporting will be required in accordance with the Financial Reporting Act 1993 (FRA), and will be publicly available as currently, but will also be on a centralised register of financial providers (see the Overview of the Review and Registration of Financial Institutions). The four additions to this will be:[127]

- **FRA reporting.** The FRA requirements will be extended to cover all licensed insurance providers, so there is consistent reporting across the market. This will be done because insurance entities are seen as public interest entities; that

---

[126] See the *Experience with the Insurance Core Principles Assessment under the Financial Sector Assessment Program*, prepared by staff at the International Monetary Fund and the World Bank, August 21, 2001.

[127] In accordance with international recommendations. For example see *8th Company Law Directive on Statutory Audit – Vote in EP Plenary*, 28 September 2005. http://europa.eu.int/comm./internal_market/auditing/index_en.htm. And see the *Experience with the Insurance Core Principles Assessment under the Financial Sector Assessment Program*, prepared by staff at the International Monetary Fund and the World Bank, August 21, 2001.

is, they have sufficient public relevance due to the financial nature of their business to require public reporting in this manner;

- **Auditing.** The financial reports under the FRA of all licensed insurance providers must be audited by an approved auditor (as set out in the Institute of Chartered Accountants Act 1996 and section 199 of the Companies Act 1993);

- **Half-yearly reporting.** Similar reports to the FRA reports (though unaudited) must to be made by all licensed insurers to the Regulator on a half-yearly basis; and

- **Risk management reporting.** If this option is adopted, board attestation that the entity has sufficient risk management for the nature and scale of the business (see the *Option - Risk Management Strategy* section).

232. These reports will be required on a solo and consolidated group basis, and must be made public including on the website and in branches of the insurer.

233. This approach is consistent with international practices.[128] For instance, all OECD member countries require annual public financial reports and the majority require quarterly reports (even of branches of foreign insurers). For examination of reports and other financial documents, in the majority of countries, the supervisory authorities co-operate more or less with the appointed actuaries and auditors (even if this is not legally regulated).

4.4.1.2 Proposal - Director Attestation

234. It is proposed that the directors and chief executive must attest in public disclosure statements that the insurer is complying with the supervisory requirements and has adequate systems and controls to identify, monitor and control its material business risks. For example, that the financial condition report has been done, and if the risk management strategy option set out in the *Licensing and Prudential Requirements* section is adopted, attestation that this has occurred.

4.4.1.3 Proposal - Key information Summary

235. The proposal is that the insurer must publish a synopsis of the information shown in the public financial reporting, perhaps annually or every six months, which is a short form summary document, similar to the one required for banks. This report is in the nature of a statement of key information that sets out the financial stability and solvency position of the insurer.

4.4.1.4 Proposal - Licence Status Disclosure

236. The proposal is that the insurer must publicise (on their disclosure documents) the date they were issued their licence and whether the licence has been issued subject to terms or any exemptions. It must be updated where these terms or exemptions change. There will be penalties for failure to publicise.[129]

---

[128] And the views expressed by the Advisory Groups.
[129] This proposal was considered appropriate by the Advisory Groups and is consistent with international recommendations.

4.4.2 Proposals - Reporting to the Regulator

4.4.2.1 Reports

237. The proposal is that the following reports must be made directly to the Regulator.

- **Financial reporting.** The reports made under the FRA, and the half-yearly version; and

- **Licensing and prudential requirements reporting.** Compliance with the licensing and prudential requirements, by class of insurance business (i.e. by licence) reported half-yearly (unaudited) and annually (audited).

4.4.2.2 Proposal - Confidentiality of Reports to the Regulator

238. The proposal is that the reports to the Regulator will be subject to similar levels of confidentiality as reports to other regulators in New Zealand.

4.4.2.3 Proposal - Frequency of Reporting to the Regulator

239. The proposal is that the reports to the Regulator must be made half-yearly (unaudited) and annually (audited) based on the date of the insurer's financial year (within 3 months of the insurer's standard reporting cycle). The Regulator will have the power to require an insurer to report more regularly where this is justified for the purposes and objectives of the legislation.

4.4.2.4 Proposal - Reporting on a Solo and Consolidated Basis

240. The proposal is that the Regulator would be able to require an insurer that is part of a group, to provide reports to the Regulator on each solo entity in the group and on a group consolidated basis. This would also apply to foreign insurers.

241. In addition to the benefits for the Regulator in being able to see the "entire picture" of the organisation it will be beneficial for judging the insurance sector as a whole. The globalisation of financial markets means it is likely to be important that the supervisory authority have the capacity to monitor developments both in New Zealand and in foreign jurisdictions that could impact on the New Zealand insurance sector.

4.4.2.5 Proposal - Exemption for Certain Approved Jurisdictions

242. The proposal is that the Regulator will have the power to authorise insurers, either from a particular jurisdiction or on a case-by-case basis, to:

- Comply with some or all of the prudential requirements of the foreign insurer's home jurisdiction instead of equivalent requirements in New Zealand; and/or

- Give the New Zealand Regulator the same reports they give to their home jurisdiction Regulator to satisfy some or all of their reporting requirements in New Zealand.

243. The Regulator would need to be satisfied with the quality of the regulatory regime of the foreign jurisdiction and the insurer's compliance with this regime before this could occur.

4.4.2.6 Proposal - Require Additional Information

244. The proposal is that the Regulator will have the power to obtain information from the insurer at any time. The power will include the ability to call for information from third parties, such as the insurer's auditors, or reinsurers. As a check and balance on the Regulator's power to seek information, this will have to be justified to meet the purposes and objectives of the legislation.

4.4.2.7 Proposal - Information Sharing with Foreign Regulators

245. It is proposed that the Regulator will have the power to seek and share information about an insurer with regulators/supervisors in foreign jurisdictions, in a similar manner to that authorised under the Reserve Bank of New Zealand Act 1989. It is also intended that development of memoranda of understanding with insurance regulators in foreign jurisdictions be pursued in order to enhance the effectiveness of monitoring the New Zealand insurance sector. This will assist with the process of monitoring and supervision as it will allow the Regulator to remain abreast of developments in insurance internationally.[130]

4.4.3 Proposal - Intervention

246. To protect policyholders[131] and enhance confidence in the insurance market, the Regulator needs to have the legal and operational capacity to bring about timely corrective action. No matter the regulatory regime and despite the efforts of regulators, situations can occur where insurers fail to meet prudential and supervisory requirements. It has long been recognised that there needs to be some form of supervision of these entities to attempt to minimise the risk of failure.[132]

247. Depending on the nature of the problem detected, a graduated response may be required. There also needs to be prescribed criteria for the supervisory intervention to provide checks and balances on its use, and to have structured decision-making lines that allow action to be taken immediately in the case of the rapid advancement of adverse circumstances.[133]

248. It has been noted internationally that remedial measures have the greatest chance of success when they are part of a comprehensive programme of corrective action developed by the insurer, with an implementation timetable.[134] However, failure to achieve agreement with the insurer's management should not inhibit the Regulator from requiring corrective action or using other regulatory intervention tools in an attempt to remedy the situation or seek orderly exit.

249. The New Zealand regulatory intervention ladder for insurers will consist of an escalating series of actions that may be taken by the Regulator where justified for the purposes and objectives of the legislation. Hence, the regulatory intervention tools identified as appropriate for New Zealand to give effect to this approach are as follows.

---

[130] See *Experience with the Insurance Core Principles Assessment under the Financial Sector Assessment Program*, prepared by staff at the International Monetary Fund and the World Bank, 21 August 2001.
[131] ICP14, Explanatory note, IAIS, *Insurance core principles*, 3 October 2003.
[132] KPMG, *Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of prudential supervision* for the European Commission, May 2002.
[133] As recommended under ICP15, Explanatory note, IAIS, *Insurance core principles*, 3 October 2003.
[134] Jörg Vollbrecht, for the OECD, as above.

4.4.3.1 Proposal - Meeting With the Board and Senior Management

250. The proposal is that the Regulator will have the power to call for meetings with the board and senior management to discuss issues of concern identified from the reports received or through other sources, and generally to get an update on the insurer and its stability, where justified for the purposes and objectives of the legislation.

4.4.3.2 Proposal - Directives to Board and Senior Management

251. The proposal is that the Regulator will have the power to give directives to the board and/or senior management that must be followed. Directives may include requiring the insurer to:

- Refrain from taking on new business for some or all types of contracts;
- Limit premium income;
- Refrain from certain types of investment;
- Realise certain assets within a defined period; or
- Retain sufficient assets in New Zealand to cover technical provisions.

252. This power can only be used where the Regulator's response is justified against specified criteria, such as that the breach is significant, the insurer has been given a reasonable period of time to remedy the situation but has failed, or there are a number of breaches that together present serious cause for concern.

4.4.3.3 Proposal - Regulator Required Audit

253. It is proposed that the Regulator will have the power to require an insurer to have information audited by an auditor approved by the Regulator, where justified for the purposes and objectives of the legislation.

4.4.3.4 Proposal - Self-correction Plan

254. The proposal is that where the insurer has not complied with the licensing, prudential and/or monitoring and supervision requirements, the Regulator will have the power to call for the insurer to present a recovery plan that sets out how the insurer intends to correct the position itself within a specified timeframe. If the self-correction plan is not acceptable to the Regulator, or not complied with by the insurer, the Regulator will be able to work with the insurer to change it, or use the other regulatory intervention or exit tools available. This approach is commonly used internationally[135] as a regulatory tool for assisting an insurer to be rehabilitated.

---

[135] See Jörg Vollbrecht, for the OECD, as above.

4.4.3.5 Proposal - Book Transfers

255. The proposal is that the Regulator will have the power to require the transfer of a failing insurer's book to another insurer that voluntarily accepts this transfer (subject to the rules applying to mergers and acquisitions under New Zealand law).[136]

256. The insurance market has for some time taken the approach of buying portions of a failing/failed insurer's book to manage the impacts of the insurer's failure on the sector even where the book may not represent best value for the purchaser. Feedback from the Advisory Groups is that this is because the reputation consequences of a participant's failure are viewed as important by the insurance industry and hence a willingness to purchase portions of a failing competitor's book exists.

4.4.3.6 Proposal - Onsite Inspections

257. The proposal is that the Regulator will have the power to undertake onsite inspections either themselves or through a third party appointed as inspector, at any time. The insurer must give all the information available and allow the Regulator/inspector to look into all business documents, so long as this is justified in terms of the purposes and objectives of the legislation. The Regulator/inspector will be subject to confidentiality in a similar manner to that applied for other regulators in New Zealand.[137] This is consistent with practice internationally.[138]

4.4.3.7 Proposal - Sanctions and Penalties

258. The proposal is that the Regulator will have the power to apply to the courts to impose penalties of amounts pre-set in legislation that will apply to the insurer, and in some cases the directors and officers of the insurer, where:

- The insurer has failed to comply with the licensing, prudential and/ or supervisory requirements; and/or
- They have mislead the Regulator or the public, or failed to provide information in a timely fashion.

259. Where the breach is serious and/or includes a large number of breaches of the licensing, prudential and monitoring and supervision requirements, the Regulator will have the power to apply to the courts to have certain individuals barred from the business of insurance.

4.4.4 Proposals - Exit

260. To meet the core principles established by the IAIS[139], New Zealand's regulatory framework will need to define a range of proposals to use in facilitating orderly exit of distressed insurers from the marketplace. The regulatory tools identified as appropriate for New Zealand are as follows.

---

[136] See ICP8, IAIS, *Insurance Core Principles: conditions for effective insurance supervision*, October 2003.
[137] For instance, see the Securities Act 1978 and the Reserve Bank of New Zealand Act 1989.
[138] Jörg Vollbrecht, for the OECD, as above.
[139] ICP16, IAIS, *Insurance Core Principles: conditions for effective insurance supervision*, October 2003.

4.4.4.1 Proposal - Conditions of De-Licensing

261. It is proposed that the Regulator will have the power to withdraw an insurer's licence either temporarily or permanently if:

- Licensing, prudential and other requirements are not continually met, or
- The licensee does not provide products for the business licensed within 12 months of its issue.

262. Many OECD member countries have a "use it or lose it" requirement. That is, failure to offer insurance within a certain period (usually one year) after licensing means the authorisation may be withdrawn.[140] This is used as a means of meeting the supervisory focus on continuing licensing requirements, and is desirable, since the insurer is prevented from obtaining a licence, then not participating in the sector until some later date, rendering the initial vetting process redundant and ineffective due to potential changes in material circumstances.

4.4.4.2 Proposal - Regulator Appointment of Statutory Manager

263. The proposal is that the Regulator will have the power to recommend to the Minister that a statutory manager be appointed in relation to an insurer. The Regulator will have the power to direct the actions of the manager, and other powers similar to those applying to banks under the Reserve Bank of New Zealand Act 1989.

264. The criteria for the Regulator's recommendation to the Minister will be, for instance, that:

- The insurer is in breach of licensing, prudential requirement and/or monitoring and supervision requirements, and has been given a reasonable period of time to remedy the situation but has failed; or
- The breach or series of breaches together are of a serious nature or at a significant level to justify the appointment of such a manager.

265. The power proposed here may become particularly important where the Regulator has de-licensed an insurer leaving policyholders and creditors in an uncertain position, and where as a dispersed group they would have difficulty in seeking the appointment of a receiver or liquidator. It would also assist with timely and orderly exit of a financially distressed insurer from the market.

4.4.5 Proposal - Checks and Balances

266. As a check and balance on the use of the Regulator's powers, directions or restrictions imposed by the Regulator under the Regulator's intervention powers, will only apply temporarily to an insurer. To impose them permanently will require de-licensing.

[140] OECD, as above.

4.4.6 Proposal - Insurer Appeal Rights

267. To provide checks and balances on the actions of the Regulator it is proposed that the insurer have a right of appeal to the courts, under judicial review, for decisions made by the Regulator in relation to monitoring requirements and intervention powers.[141]

268. Judicial review is considered more appropriate for monitoring requirements and intervention powers because merit appeal rights may interfere with the timely application of them, which is key to their success as a supervisory tool.

269. Internationally it is common for entities to have a right of appeal to an appellate authority (in most countries this is the courts).[142] The right of appeal operates as an appropriate check and balance providing transparency and accountability for the regulatory decisions made. The IAIS principles state as an essential criteria that administrative decisions of the supervisory authority must be subject at least to substantive judicial review.

Questions for Submission

31. Will the proposals resolve the problems identified in the *Introduction* section of the discussion paper and enable the Regulator to achieve its supervisory objectives?

32. Are the checks and balances on the regulators use of its powers appropriate?

33. What costs and benefits will these requirements have for insurance businesses?

[141] For types of appeal rights in New Zealand see the Chapter 13 Appeal or review (2003 supplement), Legislation Advisory Committee, Guidelines, 2001. www.justice.govt.nz/lac/index.html.
[142] OECD, as above

5. MARKET CONDUCT

270. The market conduct section covers four areas, which will be discussed under individual headings. These are:

- Insurance Contracts – duty of disclosure, and remedies for non-disclosure and mis-statements;
- Registration of assignments and mortgages of life policies;
- Insurance intermediaries and agency; and
- Product Disclosure.

271. We intend that the proposals and options below, which all relate to insurance contracts and their formation, be included in one piece of legislation.

5.1 DUTY OF DISCLOSURE AND REMEDIES FOR NON-DISCLOSURE & MIS-STATEMENTS

5.1.1 Purpose

272. As recommended by the Law Commission Report 87: *Life Insurance*,[143] the legislation governing insurance contracts in New Zealand, which is currently contained in a number of Acts, needs to be gathered together under one Act. Also, the current legislation does not meet the Government's objectives for the insurance regulatory regime, particularly regarding the promotion of well-informed insurance policyholders and to deter, detect and minimise the risk of unfair or fraudulent conduct (see problem identification in the Introduction section of this discussion document). This section relates to the uncertainty and misunderstandings around consumer disclosure to the insurer and the disproportionately harsh outcomes the remedies impose for non-disclosure and mis-statements by policyholders.

5.1.2 Background

273. There are deficiencies in New Zealand's insurance contract law, as noted by industry participants, professional bodies, the judiciary, the Law Commission and Government. A key area of concern relates to non-disclosure and mis-statements. The Law Commission Report 87:Life Insurance, annexed a draft Insurance Contracts Bill, which includes (as clauses 14 and 15) provisions in relation to non-disclosure that substantially reflect the recommendations of the Law Commission Report 46: *Some Insurance Law Problems*.[144] Issues regarding mis-statements (contained in the Bill as clauses 9 to 13) are also discussed in this paper.

274. The Law Commission Report 87 (at para 8.40) stated that it viewed clauses 14 and 15 as provisional measures aimed at providing redress for policyholders[145] who can be affected disproportionately by the insurer's remedy of avoidance for non-disclosure. They noted that there may be some merit in reviewing the preferred approach once the

---

[143] New Zealand Law Commission report 87: *Life Insurance*, November 2004.
[144] New Zealand Law Commission, Report 46: *Some Insurance Law Problems*, May 1998
[145] Reference to "policyholder" in this document means the "insured".

Australian Treasury's review of the Insurance Contracts Act 1984 (Cth) had occurred, which is now the case.[146]

275. In its response to the Law Commission's Report 87, Government agreed to consider the insurance contract issues identified. Hence, as part of its current Review of Financial Products and Providers, MED has undertaken to complete the review of insurance contract law relating to non-disclosure and mis-statements in consultation with stakeholders through the Insurance Advisory Groups and through the release of this discussion paper.

276. Feedback from the Advisory Groups is that the Law Commission has correctly identified the problems with the existing law, but while much of the Law Commission’s preferred approach has merit, some aspects might not be optimal for either insurers or policyholders. The Law Commission’s reports set out the current position in relation to non-disclosure and the position for mis-statement is as set out in the Insurance Contracts Bill (largely the current position unchanged), so these will only be briefly stated here. A number of cases which discuss the boundaries of the duty of non-disclosure have been considered in this review.[147]

5.1.3 Criteria

277. The criteria used for reviewing insurance contracts legislation in relation to non-disclosure and mis-statements are as follows:

- Facilitate economically equitable outcomes such as remedies proportionate to breaches of the duty of disclosure and mitigating risks of bargaining inequality;
- Proposals and options should minimise costs and not create barriers;
- Provide transparent options that will enable market participants to clearly understand their respective obligations;
- Promote requirements which are consistent with other proposals and options for an insurance regulatory framework; and
- Relevant parties should be accountable for their actions and have access to appropriate dispute resolution processes.

---

[146] See *Review of the Insurance Contracts Act 1984 (Cth); Final Report on Second Stage: Provisions other than section 54* ("Report of the Review Panel") Australian Government Treasury, June 2004. We understand that the Australian Government Treasury is consulting with the insurance industry and other interested parties on draft wording for legislation consequent upon the Report of the Review Panel.

[147] See, for instance, *State Insurance General Manager v McHaleheld* [1992] 2 NZLR 399; *Economedies v Commercial Assurance Co Plc* [1998] QB 587 (CA); *Quinby Enterprises Ltd v General Accident Fire & Life Assurance Corp PLC* [1995] 1 NZLR 736; *McFarlane v State Insurance Office General Manager* (1989) 5 ANZ Ins Cas 60,887; *New Zealand Insurance Co Ltd v Forbes* (CA) 178/86 22 August 1988; *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501; *Going v Farmers Mutual Insurance Association* (CP 17-99) HC Whangarei, O'Regan J, 17 February 2003; *Benjamin v State Insurance Ltd* (1998) 10 ANZ Ins Cas 74,654 (CA*); Assicurazioni Generali SpA v Arab Insurance Group* The analysis relates to non-marine insurance. The Marine Insurance Act 1908 (MIA) is a code in respect of marine insurance. However, section 18 of the MIA, which sets out the law relating to non-disclosure under marine insurance, accurately reflects the law relating to non-disclosure under non-marine insurance, except perhaps as regards the issue of constructive knowledge

5.1.4 Proposals

278. Problems have been identified with the current law in relation to insurance contracts regarding the duty of disclosure by policyholders and the remedies for non-disclosure and mis-statement, as set out in the introduction section of this paper.[148] In addition, the Insurance and Savings Ombudsman has advised that during the five years from 2000 to 2005 non-disclosure and mis-statement accounted for 24 percent of all complaints investigated by her office.

279. In order to address these issues officials propose the following.

5.1.4.1 Duty of Disclosure and Remedies for Mis-Statement and Non-Disclosure

280. The Law Commission's approach (which is set out in greater detail in the Law Commission's Report 87[149]), is proposed, with the exception of carelessness being removed as a circumstance where the insurer has the right to avoid the contract, and the addition of more granulated remedies where the right to avoid does not apply. The proposal applies to both non-disclosure and mis-statement. It is intended to:

- Clarify the duty of disclosure;
- Align the position for non-disclosure and mis-statement;
- Set out when the insurer's right to avoid exists; and
- Specify what remedies are available where the right to avoid does not apply.

Proposal - Leave the Duty Unchanged, but Impose Limitations Relating to Remedies

281. The approach preferred by the Law Commission dealt with the duty of disclosure in relation to non-disclosure only. It did not cover mis-statement. The proposal set out here is that the Law Commission's preferred approach regarding the duty of disclosure and the insurer's right to avoid a contract in relation to non-disclosure should also apply to mis-statement. It should also apply equally to life and non-life insurance. Hence, the clauses set out in the Insurance Contracts Bill relating to mis-statement and non-disclosure would need to be redrafted to fit with the proposal set out here, if it is adopted.

282. It is proposed that the duty of disclosure be retained but the rights of an insurer to avoid a contract of insurance due to non-disclosure or mis-statement be limited to four circumstances.[150]

283. The four circumstances where the insurer's right to avoid the contract is retained are:

---

[148] See generally: New Zealand Law Commission, Report 46: *Some Insurance Law Problems*, May 1998; The [England and Wales] Law Commission and the Scottish Law Commission, *Insurance Contract Law: A Joint Scoping Paper*, January 2006. Also, this was the feedback from the Advisory Groups.

[149] New Zealand Law Commission Report 46.

[150] This proposal is the one preferred by the Law Commission in relation to non-disclosure. See New Zealand Law Commission Reports 46 and 87.

- **In the case of fraud**. A mis-statement or non-disclosure is fraudulent where, for instance, the insured making the statement or failing to disclose does so intentionally or recklessly.

- **Specific answer to a specific question put by the insurer.** Where the mis-statement or non-disclosure is contained in an answer to a specific question expressly put by the insurer, and is substantially incorrect and material. An answer to a question would be substantially incorrect and material where, for instance, the difference between what is stated or failed to be disclosed and what is actually correct would have influenced the judgement of a prudent insurer in fixing the premium or in determining whether the prudent insurer would have taken or continued the risk on substantially the same terms.

- **Where the insurer seeks to avoid the contract within 10 days of the risk first attaching.** This caters for market practice of interim cover to allow time for the insurer to ask questions. The time allowed may need to be longer than 10 days.

- **Where the contract is for reinsurance.** Where the contract relates to reinsurance the parties are deemed to know the duty and have ability to discharge their disclosure obligations.

284. The overall intent of limiting the duty of disclosure to these four circumstances is that for the insurer to retain the remedy of avoidance they will need to shift their emphasis towards asking appropriate questions. Reference in the second exception to "specific question" is intended to prevent reliance on a general "catch all" question for the purposes of avoidance.[151]

285. Removing the duty of disclosure entirely from the consumer and replacing it with a requirement that the insurer ask all relevant questions of the insured in order to extract necessary information, has been discarded as an option[152] because it presents several problems.[153] These include that the length of proposal forms and complexity in contract formation would likely increase, there would be double handling of new contracts by insurers who granted interim cover to allow themselves time to ask specific questions, and the burden of the duty should not simply be shifted from one party to another, as that approach would not present appropriate incentives for bilateral disclosure.

286. Under this proposal the retention of the duty is preferred (albeit in a limited form) because the information asymmetries regarding personal information are such that there should be a positive incentive on insureds to make disclosure when seeking insurance. Removing the duty to do so distorts the incentive, and fails to place consumers on adequate notice of the possible effect of non-disclosure.

287. The proposed approach provides the insurer with the option of how far they wish to go in asking questions. If they wish to retain the remedy of avoidance they will need to have specific and detailed questionnaires. Other insurers may take the approach of short-form questionnaires accepting that the restitution remedies (discussed below) will

---

[151] New Zealand Law Commission Report 46.
[152] In accordance with consultation with the Advisory Groups.
[153] New Zealand Law Commission Report 46.

apply to matters not covered by the questions listed. Hence, the proposed approach balances out the incentives between the insured and the insurer.

288. It is also proposed that the insurer or any one required to ensure product disclosure is made to the insured would be required to warn policyholders about the duty of disclosure and consequences of non-disclosure and mis-statement prior to entering into the contract.[154] Failure to make this disclosure will attract penalties, and will prevent an insured from exercising any right of avoidance. It seems fair that if the insured is not put on notice as to consequences, the insurer be estopped from exercising any such rights.

289. The warning requirement is proposed because in practice, insurers in New Zealand already inform customers of the duty of disclosure. For instance, the voluntary industry code, the Fair Insurance Code, requires that members of the Insurance Council of New Zealand advise customers of the need to provide complete and accurate material information. For life insurance, the Practice Guidelines issued by the Investment Savings and Insurance Association do not require members to warn policyholders of the duty of disclosure, although in practice most do so. We believe it is helpful to build on this market discipline. Hence, the proposal above is merely giving regulatory backing to the industry recommended best practice approach.

290. However, the warning cannot be used alone since despite the industry initiatives, the incidence of innocent non-disclosure and mis-statement remains significant and provision of a warning without further attention to the duty and/or remedies for its breach appears not to provide a solution to the problems identified, nor does it meet the Government's objectives under the insurance regulatory framework.

Proposal – Remedies Other than Avoidance

291. The approach to remedies proposed by the Law Commission only related to non-disclosure, which required review because none were contained in the insurance legislation. Remedies for mis-statement, as set out in the current legislation, were not looked at. The proposal set out in this paper considers the remedies for non-disclosure and mis-statement should apply equally, and equally to life and non-life insurance.

292. It is proposed that where the right of avoidance is not available to the insurer (i.e. none of the four circumstances apply to the mis-statement or non-disclosure), the insurer may invoke a remedy which follows the restitution approach (referred to below). These remedies will apply where:

- The insurer is not entitled to avoid the contract, and in the circumstances a reasonable person ought to have known that the undisclosed or mis-stated fact would have influenced the judgment of a prudent insurer in relation to that insurance contract; or

- For life insurance, an incorrect statement of the age of the insured.

293. The restitution remedies that will apply to the insurer are:

- Declining to accept the risk on any terms – i.e. exclude a particular risk prospectively, or cancel the policy prospectively;

[154] In Australia the insurer must make the policyholder aware of the general nature and effect of the duty of disclosure Insurance Contracts Act 1984 section 22.

- Accepting the risk only at a higher premium;

- Accepting the risk on different terms regardless of the premium; and

- For life insurance age mis-statements, the formula in clause 13 of the Insurance Contracts Bill will apply.

294. Note that this approach will still leave an insurer with the right to avoid the contract where a non-disclosure or mis-statement was contained in the answer to a specific question, which was substantially incorrect and material, as a circumstance for avoidance noted above. Also, where the contract could be avoided by the insurer, the insurer will be able to voluntarily adopt the restitution remedies rather than avoiding the contract. A general "catch all" question can still be used, but the restitution remedy with apply instead of the avoidance remedy.

295. The restitution approach includes elements of the proportionality approach,[155] but the range of available remedies is broader. The insurer's restitution remedies under the proposal are designed to put the insurer in the position it would have been in had disclosure been made or not been mis-stated. The restitution remedy is dependent on the response the insurer would have made if it had known the undisclosed or correct material.[156] For example, if a policyholder of health insurance had not disclosed a condition (but had not acted fraudulently and had not been asked a specific question regarding it), and the condition gave rise to a claim, the insurer would be liable to pay the claim (assuming coverage more generally applied). Where in the circumstances a reasonable person ought to have known that failure to disclose the condition would have influenced the judgement of a prudent insurer in relation to that insurance contract, the insurer may reassess the risk and:

- Deduct any adjusted premiums from the claim amount;

- Exclude that condition from future cover; or

- Cancel the policy.

296. Problems with adopting the restitution approach entirely are that it does not consider the issue of fraud on the part of the insured or specific answers to specific questions put by the insurer, where avoidance may still be an appropriate remedy. It has also been noted that the approach, as in force in Australia, introduces the need to make and prove difficult hypothetical and retrospective assessments of the insurer's likely response to an insured having disclosed a matter. The insurer in effect is able to retrospectively underwrite the risk at the time of claim. However, feedback we have received on this point is that such assessments are not really that difficult for an insurer to make, and retrospective underwriting is not a general practice a prudent insurer would follow.

297. The circumstance of carelessness as a right to avoid the contract has not been adopted because the proposed regime seeks to encourage insurers to ask specific questions to best enable insureds to make proper disclosure, and apportions the risk for failing to do this depending on whether the insured has asked specific questions.

[155] The proportionality approach is where the policyholder bears any loss resulting from the greater cost to the insurer of the increased risk attributable to the non-disclosure or mis-statement.

[156] We note that this is a variation of the approach taken under section 191 of the now repealed Accident Insurance Act 1998, and In Australia the remedies for non-disclosure and misrepresentation are aligned.

Therefore, there is no need to address the degree of care with which the insured has acted.

298. Concerns have been raised about whether adopting the restitution remedies would cause policyholders to “game” the process by hoping the insurer will not pick up the non-disclosure and mis-statement. This “hope” will render the non-disclosure or mis-statement fraudulent. This is also a problem under the current law. Therefore, the response is the same under this proposal as it is under existing law, i.e. where the insurer picks up the fraudulent non-disclosure or mis-statement the remedy of avoidance will apply.

Questions for Submission

34. Do you agree with the proposal for the duty of disclosure and remedies?

35. Should the interim cover circumstance giving the right to avoid be limited to 10 days or a longer period?

36. Should the Contractual Remedies Act apply in addition to the proposal above, or where circumstances exist that are not captured by the avoidance or restitution remedies?

37. Should the duty of disclosure be limited and the restitution remedies apply to consumers only, leaving the avoidance remedy in place for business policyholders?

38. What are the costs and benefits of this proposal?

5.2 REGISTRATION OF LIFE POLICY ASSIGNMENTS AND MORTGAGES

5.2.1 Purpose

299. The registration system for assignments and mortgages of life policies does not currently meet New Zealand conditions. It requires the paper policy documents to be sent to the insurer for registration, and for the policy document to be physically held by the assignee or mortgagee (interest-holders) in order to make a claim under the policy. This is in contrast to the:

- Electronic registration of property security in New Zealand; and
- Evidence of agreement and retention of documents rules under the Electronic Transactions Act 2002.

300. The aim is to provide a system under the new insurance regulatory regime that better meets the needs of stakeholders, so they can have confidence in the priority they obtain where life policies are assigned or mortgaged to third parties, and no longer have to hold paper policy documents.

5.2.2 Background

301. The Life Insurance Act 1908 contains the recording and priority rules of the current paper-based registration system for interests in life policies. Interests in life policies are

generally taken by lenders in support of loans to customers. The Law Commission's Report on Life Insurance[157] was not tasked with reviewing the sections in the Act that relate to the registration system; hence the Bill retains them without amendment. However, given the current system is largely unused[158] (because interest-holders take the risk that their failure to register with the insurer will not result in loss – though this does occur[159]), and that electronic retention of documents is standard practice, the approach set out in the Insurance Contracts Bill warrants reform.

302. Part 4 of the Insurance Contracts Bill (which are sections 41-63 of Part 2 of the Life Insurance Act 1908) deals with interests in life policies. The sections set out that in order for interest-holders to obtain legal priority, assignments and mortgages of life policies must be registered with the insurer concerned.[160] This gives the interest-holder legal priority against the insurer and third parties, thus giving higher security value to the life policies for use as security in lending transactions, which reduces the cost of funds.

303. Assignments and mortgages of life policies are exempted from registration where they are taken by the entity that is also the insurer under the policy.[161]

304. Interests in property in New Zealand (real and personal) can be registered, but these exclude insurance policies. There are a number of registries, which apply for particular types of property.[162] The bulk of registrations for security purposes relate to land under the Land Transfer Act 1952 and personal property under the Personal Property Securities Act 1999 ("PPSA").

305. In considering the approaches taken by other jurisdictions, we have particularly focused on those with a similar approach to personal property security interests as New Zealand. This is because one option looked at was to include interests in life policies under the PPSA. In that regard Canada is the closest[163] (for life insurance policy interests, those with particularly similar personal property security legislation to New Zealand are Ontario, Saskatchewan and Manitoba[164]).

306. In Canada, the general approach is that since insurers hold title record systems for life insurance policies, the interest-holder can give written notice of their interest to the

[157] New Zealand Law Commission, Life Insurance Report 87, November 2004.
[158] As ascertained from discussions with several New Zealand banks and finance companies.
[159] Through delays in payment from the insurer because they are not aware of the assignment or mortgage, or the funds are paid the deceased estate so cannot be paid to the assignee or mortgagee until probate has been obtained, or where the policyholder fraudulently obtains a replacement copy of the policy document (using the declaration process contained in the legislation), which is then assigned or mortgaged to another lender and is registered with the insurer, hence taking priority.
[160] This is required to be done by producing the policy document, already endorsed with a statutorily prescribed memorandum (signed by the parties to it, e.g., transferor and transferee, assignee and assignor, or mortgagee and mortgagor, as applicable) to the insurer for endorsement. The policy and memorandum are then returned to the transferee, assignee, or mortgagee to hold. Re-transfers, re-assignments, and discharges of mortgage are processed in the same way.
[161] See section 43(3).
[162] For instance, Land Titles Office, Personal Property Securities Register, Fishserve, FASTER Share Security Interest registries, Ships Register, Fonterra Dairy Shares Security Interest Register.
[163] However, Australia and the UK are looking at adopting a similar regime, see article on *Overseas Approaches* by the Australasian Legal Information Institute at www.austlii.edu.au
[164] These are all based on art. 9 of the US Uniform Commercial Code published in 1951 by the National Conference of Commissioners of Uniform State Laws and the American Law Institute as model legislation which was eventually enacted by all of the states.

insurer concerned, which is recorded on that system.[165] The noting of the interest on that system triggers the priority status of the interest-holder.

5.2.3 Criteria

307. The criteria used for reviewing the registration system for assignments and mortgages of life policies are:

- A registration framework which will not significantly alter existing market practices;
- Facilitate a flexible approach that will enable innovation and account for future market developments;
- Consider the best practice of jurisdictions with similar personal property security interest registration systems.
- Promote a consistent framework which minimises the differences between interests in life and non-life policies;
- Provide clarity and security of interest-holder priority; and
- Establish a framework that allows registration in a simplified manner, which does not incur unnecessary cost.

5.2.4 Proposal - Notice Procedure

308. It is proposed that the interest-holder in a life policy will send the insurer a notice of assignment or mortgage.[166] There will be an exemption from the notice procedure where the entity taking the assignment or mortgage of the life policy is also the insurer under the policy.

309. Interest-holders would be able to move to electronic storage of policy documents, since the original policy document would no longer be required for registration or claim purposes. Feedback is that many interest-holders would be able to continue with existing internal procedures, with only some having to change their approach to the adoption of the "written notice" process (which could also be done electronically). Removing the requirement for a paper policy will enable disclosure by the insurer to be done electronically in accordance with the Electronic Transactions Act 2002.

310. Under this proposal, insurers will have direct knowledge of the interest so that claims under the policy can be paid in accordance with the interest. Also, the insurer will be able to contact the interest-holder where the policy has lapsed due to non-payment of premiums where it is in the interest-holder's interest to meet the payment in the place of the customer in order to protect the security position.

311. The procedure is the same process as used for general insurance policies, e.g. in relation to home loans, and it is less costly overall than registration on the Personal

---

[165] Section 200 Insurance Act 1990, Ontario, section 162 Insurance Act of Saskatchewan, and section 177(1) Insurance Act of Manitoba.
[166] As can occur under section 130 Property Law Act 1952.

Property Securities Register (PPSR). However, the notice procedure would mean there is no public or centralised register to search for pre-existing interests.

312. The option of bringing assignments and mortgages of life policies under the PPSA[167] was considered; however, several problems were identified. These included that:

- Permanent transfers would still be required to be processed by the insurer even if the paper policy document is dispensed with (so the system could not be removed entirely);

- The insurer might still pay out claims to beneficiaries under the policy rather than the interest-holder because they had no actual knowledge of the security (registration in the PPSR is not notice of the existence of a security,[168] it merely effects priority); and

- Some of the interests taken over life policies are by the same entity which issued the policy, therefore, registration in the PPSR would have required the addition of unnecessary process costs.

313. The transfer of life policies will also need to be reformed so that presentation of the paper policy document is no longer required. The identification of the policyholder who is the transferor could be adopted, in line with processes applied to the transfer of other assets, for instance, motor vehicles.

Questions for Submission

39. Should the existing system be retained, or replaced by the notice procedure?

40. What are the costs and benefits of the notice procedure proposal?

5.3 INSURANCE INTERMEDIARIES AND AGENCY

5.3.1 Purpose

314. Clarification is needed regarding whether an insurance intermediary is the agent of the insurer or the agent of the consumer. Determining agency will assist in locating where the responsibility lies for the activities of an insurance intermediary during contract negotiation and formation, and provide important transparency for consumers regarding what rights they have and against whom. It will also provide transparency of an insurance intermediary's duties and obligations in situations of a breakdown in the relationship between the consumer, intermediary and insurer.

5.3.2 Background

315. Insurance intermediaries[169] play an important role in the insurance sector, using expertise and skill to match prospective consumers with insurance products that meet

---

[167] By removing their exclusion from section 23(e)(vi) and covering under the definition of intangibles in section 16.
[168] Section 20 PPSA.
[169] "Intermediary" for the purpose of this discussion is any individual or firm who undertakes an intermediation role. That is they bring consumers and insurers together.

their personal financial needs. This function can mitigate the magnitude of the earlier identified market imperfections of asymmetric information and complexity of information about insurance products and providers. The use of insurance intermediaries will also bring the benefit of reduced transaction costs involved in information search for both the consumer and the insurer.

316. It is important that insurance intermediaries possess the requisite competencies and incentives to discharge their function. The *Financial Intermediaries* discussion document provides conduct and disclosure options for a range of intermediary categories. The purpose of which is to facilitate the consumer's assessment of whether the advice provided is impartial, and to ensure competency of intermediaries. Proposals in this paper are not intended to overlap with the options outlined in the *Financial Intermediaries* discussion document as the discussion here only relates to the establishment of agency to determine the location of responsibility for insurance intermediaries actions.

5.3.3 Current Position

317. The three main areas insurance intermediaries are involved in during the formation of an insurance contract are:

- Insurance Intermediary agency for contract negotiation and formation;
- Receipt of premiums from policyholders and claims money from insurers; and
- Investment or tailored financial advice.

318. The last category, investment advice or tailored financial advice, is covered in the *Financial Intermediaries* discussion document on financial intermediaries, so is not addressed here.

5.3.3.1 Insurance Intermediary Agency for Contract Negotiation and Formation

319. The Insurance Law Reform Act 1977[170] sets out when an insurer is responsible for the conduct of those who negotiate the sale of their products during the contract formation process,[171] although the agency relationship can at times be unclear. For instance, it is clear that where insurance products are purchased directly from an insurer, the insurer is responsible for the actions of its employees in relation to the contract negotiation and formation process. However, it is less clear whether an insurer is responsible for the actions of an insurance intermediary involved in the sale of the insurer's product.

320. The lack of clarity around whether an insurance intermediary is acting on behalf of the insurer as its agent is due to the wording of section 10 "Salesmen etc to be agents of insurer" of the Insurance Law Reform Act 1977. The section refers to a representative:

---

[170] See section 10 Insurance Law Reform Act 1977, which has been updated and inserted as clause 104 "Representatives of insurer are agents of insurer" in the Insurance Contracts Bill.
[171] Recommendations regarding responsibilities for agents are intended to equally apply to employees. See The Law Reform Commission, *Insurance Agents and Brokers*, Australian Government Publishing Service, Canberra 1980.

> …who acts for the insurer during the negotiation of any contract of insurance, and so acts within the scope of [their] actual or apparent authority, shall be deemed, as between the insured and the insurer and at all times during the negotiations until the contract comes into being, to be the agent of the insurer.

321. A representative is defined as including a person "entitled to a commission or other valuable consideration from the insurer". The problem is in determining when an insurance intermediary is "entitled to a commission". Feedback has been that most insurance intermediaries receive a commission or other valuable consideration from the insurer. However, in the absence of a formalised contractual relationship it is difficult to determine whether they are entitled to receive a commission, or whether the bill for services rendered to the consumer is paid by the insurer by tacit agreement with the consumer (as occurs with mortgage brokers).

322. This can cause confusion for consumers and create problems where there is a failure in the contract negotiation and formation process, which is caused by the insurance intermediary. This is further exasperated by there being no specific legislative requirement for the insurance intermediary to disclose their agency status to the consumer. Also, the consumer may be unaware that in using an insurance intermediary in some cases means they will have no recourse against the insurer for a failure in the contract negotiation and formation process, since the intermediary is the agent of the consumer, not the agent of the insurer.

5.3.3.2 Receipt of Premium or Money and Agency

323. There is a definition of agency for another purpose – the receipt of premiums from consumers and the receipt of claims money from insurers. The Insurance Intermediaries Act 1994[172] states that when a premium is paid by a policyholder to the insurance intermediary in relation to a contract of insurance that has been arranged or affected by the insurance intermediary, the liability for the policyholder to pay that money to the insurer is deemed to have been met. This means the contract is formed once the premium is received by the intermediary regardless of whether it is ever passed on to the insurer. Also, where the insurance intermediary receives claims money from an insurer to pass onto a policyholder the insurer's liability for the payment is not deemed to have been met until the money is received by the policyholder.

324. This legislation is designed to protect the consumer's interest in the policy where the premium or claims money paid to the insurance intermediary does not make it to the intended final party. Therefore, an insurance intermediary who originally was deemed to be the agent of the consumer (for the purpose of arranging the contract), becomes the agent of the insurer for the purposes of receipt of the premium and receipt of claims money.

5.3.4 International Position

325. In most jurisdictions the majority of insurance policies are not sold by insurers but rather through intermediaries.[173] Hence, the clarity of the agency relationship is then important. In response, these jurisdictions have implemented legislation to transparently

---

[172] See section 4 Insurance Intermediaries Act 1994.
[173] See IAIS, Report on Insurance Laws, Regulations and Practices in IAIS Member Jurisdictions, October 2005.

determine when an intermediary is the agent of an insurer. This is generally done on either the basis of contract or remuneration.

326. In Australia agency, for the purposes of information, notices and reasons, is defined in the Australian Insurance Contracts Act 1984 by way of a binder.[174] In Canada insurance intermediaries are regulated at Province level. In the province of New Brunswick[175] any person who for compensation, solicits, effects, or negotiates insurance on behalf of any insurer will be deemed to be the agent of the insurer. Conversely, if that same person transmits an application or negates an insurance policy for another person they are deemed to be agent of the insured. Individuals authorised by the Superintendent are deemed to be agent of the insurer.

327. The approach adopted in the United Kingdom focuses on an appointed representative regime.[176] An appointed representative is a person (including a firm) who is authorised in writing to carry on regulated activities on the behalf of an authorised insurer.

5.3.5 Criteria

328. The criteria used to assess the proposals for the clarification of an insurance intermediary are:

- Establish a transparent definition which will clarify where agency lies and provide clarity as to individual's rights and obligations;
- Promote a framework which will not significantly alter existing market practices for the delivery of insurance products and minimise the costs of change;
- A flexible regime that will account for future developments;
- Facilitate economically equitable outcomes where industry participants do not have to unfairly bear the costs of others actions; and
- Consider international frameworks in the assessment of proposals for the New Zealand insurance sector.

5.3.6 Proposals

329. Feedback from industry is that it is unreasonable that the insurer should bear the cost of an intermediary's failure to conduct themselves appropriately during the contract negotiation and formation process on the basis of entitlement to a commission or other valuable consideration only. At the same time, the policyholder should be informed as to whether the intermediary they are dealing with is acting as the agent of the insurer or as their agent, since this has consequences regarding who they have would have recourse against where there is a failure in the contract negotiation and formation process caused by the intermediary. Therefore, a conclusive system of determining an insurance intermediary's agency status should be set out in insurance legislation.

---

[174] See s 71 of the Australian Insurance Contracts Act 1984.
[175] The regulation of insurance intermediaries is undertaken at a state level. This definition of agency relates to New Brunswick and is outlined in the Insurance Act (I-12).
[176] See ICOB 1.6.1 and MIGI 9.2 of the Financial Services Authority (UK) Handbook.

330. The existing position regarding receipt of premiums and claims money as set out currently in legislation works and is well understood by industry, therefore, does not require substantive review.

331. The two proposals to deal with agency issues are as follows.

5.3.6.1 Proposal - Intermediary Agency at Contract Negotiation and Formation

332. The proposal is that agency[177] for the purpose of contract negotiation and formation be determined on the basis of written[178] authorisation by a licensed insurer.

333. For an insurance intermediary to be the agent of a licensed insurer, the insurer must have confirmed with the intermediary in writing that this is the case. This will move the focus away from entitlement to a commission or other valuable consideration, to a focus on appointment certainty.

334. Where a written authority is not in place the insurance intermediary will be deemed to be the agent of the consumer.

335. Appointment of an agent by an insurer will not restrict the agent from acting as agent for other insurers. The authorising insurer will only be responsible for the conduct of the insurance intermediary in relation to the insurer's products.

336. Hence, there are three categories of insurance intermediary agent that apply during contract negotiation and formation. They will be:

- **Exclusive Agent.** The insurance intermediary is the authorised agent of only one insurer;

- **Non-exclusive Agent.** The insurance intermediary is the authorised agent of more than one insurer; and

- **Consumer Agent.** The insurance intermediary is the agent of the consumer.

337. The insurance intermediary will be required to disclose to the consumer whether they are the agent of the insurer or a number of insurers, or the agent of the consumer during contract negotiation and formation and the general effect of that agency status. Failure to disclose this will attract penalties.

338. The effect of the agency status is that it will determine where responsibility lies for failure to comply with product disclosure by the insurer, failure of the intermediary to correctly pass on the consumer's disclosure to the insurer, and failure of an intermediary to appropriately assess the needs of a consumer.

339. The *Financial Intermediaries* discussion document addresses issues regarding independence and places disclosure obligations on intermediaries, tailored for the different categories of intermediaries, to facilitate a consumer's assessment of whether an intermediary is providing impartial advice and acting in the consumer's best interest. It will also deal with the levels of competency and skills required. The categorisation of intermediary relates to the type of service provided, and proposes that different levels of

---

[177] An agent will include an employee.
[178] Which may be electronic in accordance with the Electronic Transactions Act 2002.

service must comply with particular requirements. The categorisation in that paper is intended to operate in conjunction with an insurance intermediary's particular agency status referred to above. Further work done on this agency issue will be considered in conjunction with the *Review of Financial Intermediaries* once submissions on the discussion documents have been reviewed.

340. It is proposed that agency for the purposes of product disclosure and consumer disclosure will work as follows:

- If an insurer provides product information to an insurance intermediary who is a consumer agent then the insurer will be deemed to have fulfilled its obligations, and only the insurance intermediary will be held responsible for any failure to disclose. This means that because the consumer in this instance only has recourse against the intermediary there may not be an ability to recover. This is the current position under the Insurance Law Reform Act 1977, which is being retained. The requirement for intermediaries to disclose their agency status and the effect of the status, is the mechanism for warning consumers prior to dealing with a consumer agent. Since the insurer has not agreed to the intermediary being their agent, and hence have no control over them, they should not be held responsible for the intermediary's actions in this regard;

- If an insurer provides information to an insurance intermediary who is the insurer's agent, it will have the same effect as if the insurer were disclosing to itself. Hence, if disclosure is not made by the insurance intermediary to the consumer, both the insurer and the intermediary will be held responsible. Since the insurer has appointed the agent to act on their behalf they will be held responsible for their actions in this regard;

- Where an insurance intermediary is the insurer's agent, the insurer is liable for the intermediary in relation to product disclosure information only during contract negotiation and formation. Also, where the consumer provides information to the insurer's agent the consumer will have met their duty of disclosure to the insurer. If the insurer's agent fails to disclose this information or misinterprets it to the insurer, the insurer will *not* have the right to remedies for non-disclosure or mis-statement caused by the failure of the insurance intermediary; and

- Where an insurance intermediary is the consumer's agent, the insurer is not liable for the insurance intermediary in relation to disclosure of product information during contract negotiation and formation. Also, where the consumer provides information to the consumer's agent the consumer will not have met their duty of disclosure to the insurer if the intermediary fails to disclose or mis-states the information to the insurer. Thus, the insurer will have the right to remedies for non-disclosure or mis-statement against the consumer caused by the failure of the insurance intermediary. The consumer's only recourse for this will be against the insurance intermediary.

5.3.6.2 Proposal – Receipt of Premium and Claims Money

341. It is proposed that the position set out in the Insurance Intermediaries Act 1994 (as retained in the Insurance Contracts Bill[179]) regarding the receipt of premiums and claims money, be repealed and re-enacted in the new insurance contract legislation. The wording suggested in the Insurance Contract Bill, with appropriate wording updates that reflect proposed money handling regulation discussed in the *Financial Intermediaries* discussion document, should be used.

Questions for Submission

41. Are the above proposals appropriate for the New Zealand insurance intermediaries market?

42. What implications will these have for existing market practices?

43. Is this an ideal approach for providing clarity as to when an intermediary is the agent of the insurer or agent of the consumer?

44. What are the costs and benefits of the proposal?

5.4 PRODUCT DISCLOSURE

5.4.1 Purpose

342. The intention of this section on product disclosure is to explore whether the implementation of a mandatory product disclosure framework is appropriate for the New Zealand insurance sector. The options provided below are designed to facilitate feedback through submissions which will enable officials to undertake more targeted consultation following assessment of the submissions and further research.

343. Options discussed below are focused at enabling consumers to be more informed about the products they are purchasing and to facilitate a consistent disclosure framework so as to aide greater capacity to undertake product comparisons. This should facilitate consumers being able to assess the appropriateness of insurance products for their personal needs and provide confidence to participate in the insurance sector. Subsequently this will facilitate a more efficient allocation of resources and more effective pooling of risk.

5.4.2 Background

344. As the providers of insurance products only have incentives to produce information to a certain point, consumers can experience difficulties in obtaining all the necessary information to make informed choices.[180] Therefore, a consumer may be unaware of all of a product's features and what risks the insurance product covers. Consequently,

---

[179] Annexed to the Law Commission Report 87.

[180] An insurer will only have the incentive to produce information about their products until the net private benefits exceed the costs of producing that information. Unfortunately the public benefits of the information exceed the private benefits but the insurer does not want to internalise those extra costs. Further discussion of this issue can be found in standard economic literature on externalities.

consumers may enter in to products that do not meet their financial needs and expose them to potentially financially debilitating events.

345. In addition to the asymmetries of information, for some insurance products, the information can be highly complex and non-expert consumers are unable to translate this information into something meaningful for their decision-making process. For example, when determining the adequacy of a health policy the consumer may need to know the cost of cardiac surgery in a private hospital or angiography services (or predict what these might be at some time in the future). Without a clear understanding of costs like these it makes it difficult for the consumer to determine how the benefits of the product will meet their individual financial needs.

346. Currently, those life insurance products which contain an investment element are required to comply with the disclosure frameworks of the Securities Act 1978 and the Securities Regulation 1983 but there is no insurance specific regulatory product disclosure framework applying to risk-based insurance products.[181] While insurers may be complying with their relevant association codes and standards, some insurers do not belong to any industry association. Consequently, there is a lack of regulatory consistency and a lack of certainty that consumers are being given the basic information they need to make informed decisions to enter into insurance policies.

347. The Fair Trading Act 1986 and the Consumer Guarantees Act 1993, which is general legislation, imposes standards of service and remedies for product failure. For example, reasonable standards of care and skill are required to ensure products are fit for purpose. Self-regulation has resulted in the development of disclosure rules which are generally followed by industry. For general insurers, the voluntary Fair Insurance Code requires that members of the Insurance Council of New Zealand provide customers with information which allows the customer to select the cover that best suits the customer's needs. For life insurance, the Practice Guidelines issued by the Investment Savings and Insurance Association do not set out disclosure requirements, although in practice most life insurers do disclose product details and information regarding the duty of disclosure required of policyholders.

348. After assessing the general legislation which imposes some requirements on an insurer and the self-regulatory frameworks we do not feel that these frameworks go far enough to sufficiently inform consumers about the suitability of a product for their needs. The options below attempt to account for the existing information required through self-regulation and industry codes and incorporate the frameworks for product disclosure included in the Securities Act 1978 and Securities Regulations 1983, and the Credit Contracts and Consumer Finance Act 2003 (CCCFA).

349. We are interested in whether the options below accurately reflect the scope of information already provided by industry and whether the disclosure frameworks of the Securities Act and CCCFA could be valuably applied, with adjustments, to the providers of insurance products. Also, whether this will assist in promoting well-informed consumers.

---

[181] However, investment-based products, as debt issuers must comply with the securities regime.

5.4.3 Criteria

350. The criteria used for determining whether insurance product disclosure requirements are necessary and what a framework should involve.

- Assessment of whether consumers are currently well informed about the insurance products they purchase and whether that information is accessible and readily understood;

- A disclosure framework which provides targeted information in a short-form format and gives consumers a greater ability to compare products from different providers;

- Disclosure which provides consumers with accurate and readily understood information in a timely manner so that informed decisions can be made about the appropriateness of the product for their personal needs;

- Accounting for existing practices and development of a framework which will minimise the cost of change and compliance;

- Provision of clarity of market participants' respective obligations to disclose product information to consumers while not imposing unnecessary compliance costs; and

- Ensure that those parties responsible for product disclosure can be held accountable for failure to fulfil their obligations through appropriate redress and enforcement.

5.4.4 Options

351. The options outlined below are addressed at a high level. We are to do further work and consultation on this area in order to provide details for informing proposal selection. At this stage, we are interested in receiving feedback on whether a product disclosure regulatory regime is required for insurance in order to meet the Government's objective of well-informed insurance policyholders, and whether the options set out below provide an appropriate regulatory framework for this.

5.4.4.1 Application of Requirements

352. A product disclosure framework would set different product disclosure requirements for different times over the duration of the insurance contract. The distinct time periods could be for example:

- Pre-contract formation;

- On formation of the contract, or within a specified time period following formation;

- On renewal;

- For mid-contract changes; and

- Requests for information.

353. Setting different requirements on this basis would assist in ensuring the consumer receives a minimum level of information for decision-making purposes at key points in the insurance contract. This is consistent with the approach taken in other jurisdictions, such as Australia and the United Kingdom.[182]

5.4.4.2 What should be disclosed?

354. Internationally there are a variety of approaches regarding what must be disclosed about an insurance product being sold. Some jurisdictions take a highly prescriptive approach to ensure clarity and transparency while others are more flexible and principles based promoting innovation and market development. Current disclosure frameworks in New Zealand adopt a flexible approach to product disclosure, although there is nothing that currently applies to risk only insurance products.

355. Insurance products can be highly tailored for a specific consumer. Consequently, a challenge for a product disclosure regulatory regime is to take account of this aspect without making the requirements overly complicated. A prescriptive approach to product disclosure would potentially impose unnecessary regulatory burdens due to the variety of permutations. Also, some insurance products (e.g. life) include an investment element, so must already comply with the disclosure framework contained in the securities legislation.

356. There are, however, certain minimum information categories and primary details which a consumer needs in order to be well-informed for decision-making purposes. These could be set out in legislation. For example, it is important that the consumer receive product key terms, and customer specific product information (eg relating to price, payments, term of policy, excess on claims, renewability, cancellation rights etc).

5.4.4.3 How should disclosure be made?

357. The key to effective delivery of disclosure is that consumers receive the information by commonly used methods and in an easily accessible format, without restricting innovation in the market. The methods and channels of delivery of insurance products can vary significantly:

- Channels include intermediaries and insurers; and
- Methods include over the phone, face to face (e.g. in branch or through mobile managers or agents) or remotely (by post, electronically – internet and fax).

358. Other jurisdictions have adopted a variety of approaches to deal with the channels and modes of delivery that are either highly prescriptive or principle-based. Since products sold in New Zealand reflect the methods and channels above, it is important that any regulatory approach to product disclosure account for this. It is also important to consider the wider legislative framework that deals with contractual agreement in New Zealand, such as the processes for receipt and agreement under the Electronic Transactions Act 2002.

---

[182] See Australian approach under the Insurance Contracts Act 1994, and the United Kingdom the Financial Services Handbook at www.fsa.gov.uk

5.4.4.4 What format should product disclosure take?

359. To facilitate comparability of insurance products it is common practice internationally[183] to prescribe a consistent format in which the required information about the product being sold is delivered to the consumer. A consistent framework is more likely to provide clarity to insurers on how to present the information and certainty to consumers regarding the minimum level of information they are supposed to receive.

360. Some pieces of legislation adopt a safe-harbour approach which establishes a standard framework but provides capacity for an insurer to adopt an individualised framework at their own risk.[184] Hence, model forms or templates could be developed and contained in legislation. The model form may be combined with the policy document of the product or given separately. They could contain two parts; customer specific information and product key terms, which are outlined as follows.

- **Customer specific information.** A model form for customer specific information would need to include a summary of only consumer specific particulars, based on template headings. These could be similar in nature to those adopted under the CCCFA, but adjusted to reflect insurance product features. For example:

    1. Full name and address of insured and any policy beneficiaries (if any);
    2. Full name, address and telephone number of insurer;
    3. Premium – the amount of the premium to be paid either in one lump sum or by instalments, including the dates and frequency of payment(s);
    4. Other fees;
    5. Total cover amount – the total amount the policy covers;
    6. Term of the contract, including the start and end dates;
    7. Renewal rights;
    8. Special conditions and exclusions;
    9. Cancellation rights and process;
    10. Claims process; and
    11. Any requirement to notify change of circumstances.

- **Product key terms.** A model form for the minimum product terms a consumer would need to receive would be a summary product terms, based on a series of template questions. These could be similar in nature to those required under the securities regulations, but adjusted for insurance product features. For example:

[183] For example, Australia, Canada, and the United Kingdom.
[184] For example, the CCCFA.

1. What sort of insurance is this?
2. Who is it right for?
3. What will it cover me for?
4. What are the main exclusions?
5. How much do I pay?
6. What period does the payment of the premium cover?
7. What must I tell you? And what happens if I don't tell you something important?
8. How do I make a claim?
9. How do I cancel the policy and what happens if I do?
10. What do I do now?

361. The model forms would be developed having regard to international practices, in consultation with industry and then tested through consumer groups, to facilitate the optimal information disclosure outcomes. As noted above, similar forms would need to be developed to apply to the other disclosure occassions, such as renewal and mid-way contract changes.

5.4.4.5 When should product disclosure be made?

362. The disclosure would have to be done within certain timeframes. For example, it may be that for initial disclosure the information would need to be given in writing before the contract is entered into and where this is not reasonably practicable, given orally and then given in writing to the policyholder after the contract is formed. Similar timing rules would be developed for the other disclosure times, such as renewal and mid-way contract changes.

5.4.4.6 Who should be responsible for product disclosure?

363. The responsibility for product disclosure would need to lie with the insurer. Where the contract of insurance is arranged through an agent of the insurer or consumer, the issue of responsibility may need to be adjusted to reflect the different relationships which apply.[185] Discussion of this issue is contained in the *Insurance Intermediaries and Agency* part of the *Market Conduct* section. Further work will also be done on this once the review of the submissions on the *Review of Financial Intermediaries* discussion document is completed.

5.4.4.7 What powers should the enforcement authority have?

364. The Securities Commission would be given similar powers regarding product disclosure for risk-based insurance products as it has for securities.[186] These include

---

[185] This is consistent with the Australian approach under the Insurance Contracts Act 1994
[186] These powers are in addition to those applying in relation to the issuing of securities.

inspecting and obtaining information, prohibiting advertisements, making corrective orders for breaches and in circumstances of extreme or persistent breaches the power to seek a management banning order. Also, the Registrar of Companies would be given similar investigation and enforcement powers to those used for securities, such as[187] inspections, prosecuting offences for contravention of the product disclosure requirements, and for misleading statements in advertisements or disclosure documents, statements or forms relating to product disclosure requirements.

365. Consideration of how the product disclosure requirements for an insurance product with both an investment element and a risk-based element will need to be made, so that there is certainty for consumers as to the information they need to make well-informed decisions on the insurance product.

Questions for Submission

Given that further detailed work and consultation is yet to be done on this area:

45. Should there be product disclosure requirements for insurance that are contained in legislation?

46. Is the product disclosure framework set out above a move in the right direction for the insurance sector, or is a different approach to the framework required?

47. What would be the costs and benefits of an insurance product disclosure regime?

[187] These powers are in addition to those applying in relation to the issuing of securities.

6. QUESTIONS FOR SUBMISSION

Introduction section

Objectives and outcomes

1. Are the outcomes being sought from the insurance sector appropriate? If no, are there additional outcomes that should be sought?

2. Are the reasons for regulatory intervention correctly identified? Are there other reasons for regulatory intervention that also require identification?

3. Is there the appropriate mix in the objectives for insurance legislation? Are there any other objectives which should be included?

Problem identification

4. Do these problems accurately reflect the current insurance sector? Is the magnitude of these problems correctly identified in the discussion?

5. Are there any other problems which have not been identified?

Licensing and prudential requirements section

Proposals

6. Do the above proposals overcome the problems identified in the Introduction section of the discussion paper?

7. Are the proposals consistent with the objectives of regulation outlined in the Introduction?

8. What are the benefits and costs of each proposal to an insurer?

9. What implications do these proposals have for the sector as a whole?

10. Are there any other comments on the proposals made?

Options

Risk management

11. Should the insurance regulatory regime require high level risk management requirements that are attested to by the insurer’s directors annually?

12. What are the costs and benefits of adopting such an option?

Separation of classes life/general/health

13. For the purposes of categorising insurance businesses and granting a licence to operate more than one class of insurance business (general, health and/or life) is accounting separation (with segregated funds) and the option for the Regulator requiring legal separation plus conditions sufficient?

14. What are the costs and benefits of accounting separation (with segregated funds) and/or legal separation plus conditions?

15. Should the requirements be set out in legislation or be set by the Regulator?

Legal form of foreign insurers

16. For the purposes of ring-fencing the New Zealand operations of a foreign insurer operating in New Zealand, is accounting separation (with segregated funds) and the option of the Regulator requiring legal separation and/or further conditions sufficient?

17. What are the costs and benefits of accounting separation (with segregated funds) and/or legal separation for a foreign insurer?

18. Should the requirements be set out in legislation or be set by the Regulator?

Ratings

19. Do ratings provide policyholders and their agents with useful information with which to assess the financial soundness of an insurer and compare one with another?

20. Are they currently used by retail consumers or policyholder agents/advisors in New Zealand?

21. Do ratings provide an effective source of market discipline on insurers?

22. Do ratings assist in promoting the incentives for sound governance and risk management in insurers?

23. In addition to the other prudential requirements, such as governance, risk management and enhanced solvency standards, will ratings act as a sound supplementary tool for the purposes of supervision by the Regulator?

24. Should there be a mandatory requirement that all insurers obtain a financial strength rating from an approved rating agency, subject to a de minimus exemption for very small insurers?

25. Should a mandatory ratings requirement be retained for fire and disaster insurers only?

26. What costs will a rating have for an insurer?

27. Does a mandatory ratings requirement meet the objectives of the regulatory framework?

Transition of existing insurers

28. Should there be a fixed transition period for existing insurers or should the Regulator have the ability to approve an insurer's transition period?

29. Other jurisdictions have adopted a "milestone" approach to transitions. This involves implementing set targets that licensed entities much comply with over a defined period in order to comply. Is there merit in considering this approach?

Insurer Appeal Rights for Licensing

30. Should the appeal right for the licensing process carried out by the Regulator be on the basis of merit review or judicial review?

Monitoring and Supervision

Proposals

31. Will the proposals resolve the problems identified in the *Introduction* section of the discussion paper and enable the Regulator to achieve its supervisory objectives?

32. Are the checks and balances on the regulators use of its powers appropriate?

33. What costs and benefits will these requirements have for insurance businesses?

Market Conduct

Duty of disclosure and remedies for non-disclosure and mis-statements

34. Do you agree with the proposal for the duty of disclosure and remedies?

35. Should the interim cover circumstance giving the right to avoid be limited to 10 days or a longer period?

36. Should the Contractual Remedies Act apply in addition to the proposal above, or where circumstances exist that are not captured by the avoidance or restitution remedies?

37. Should the duty of disclosure be limited and the restitution remedies apply to consumers only, leaving the avoidance remedy in place for business policyholders?

38. What are the costs and benefits of this proposal?

Registration of life policy assignments and mortgages

39. Should the existing system be retained, or replaced by the notice procedure?

40. What are the costs and benefits of the notice procedure proposal?

Insurance intermediaries and agency

41. Are the above proposals appropriate for the New Zealand insurance intermediaries market?

42. What implications will these have for existing market practices?

43. Is this an ideal approach for providing clarity as to when an intermediary is the agent of the insurer or agent of the consumer?

44. What are the costs and benefits of the proposal?

Product disclosure

Given that further detailed work and consultation is yet to be done on this area:

45. Should there be product disclosure requirements for insurance that are contained in legislation?

46. Is the product disclosure framework set out above a move in the right direction for the insurance sector, or is a different approach to the framework required?

47. What would be the costs and benefits of an insurance product disclosure regime?