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# **REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS**

## **PRUDENTIAL REGULATION OF INSURANCE**

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**Consultation Paper**

**May 2008**

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## **The Purpose Of This Consultation Paper**

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1. In December 2007 Cabinet approved a framework for the prudential regulation of the insurance sector in New Zealand. The relevant Cabinet Paper can be found on the Reserve Bank website at [www.rbnz.govt.nz/finstab/nbdt/insurance/3197254.pdf](http://www.rbnz.govt.nz/finstab/nbdt/insurance/3197254.pdf)
2. Cabinet has requested the Reserve Bank to further examine and report back with more detailed proposals on certain aspects of the proposed prudential regime by 31 July 2008.
3. In order to assist the Reserve Bank to finalise its position on these aspects of the regime, this paper details these issues and invites input on each of them.

## Prudential Requirements Agreed To Date

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1. This section outlines the prudential requirements that were approved by Cabinet in December, 2007. Further details are set out in the actual paper considered and approved by Cabinet, which can be found on the Reserve Bank's website at [www.rbnz.govt.nz/finstab/nbdt/insurance/3197254.pdf](http://www.rbnz.govt.nz/finstab/nbdt/insurance/3197254.pdf)

### The Regulator

2. Cabinet has decided that there should be a single prudential regulatory authority for the non-bank sector, including insurance, and decided in June 2007 that this authority should be the Reserve Bank. As the prudential regulator and supervisor of the insurance sector, the Reserve Bank will be the authority that:
  - a) licenses and de-licenses insurers;
  - b) prescribes and enforces compliance with prudential requirements, including the financial strength rating and disclosures;
  - c) applies the fit and proper requirements to directors and senior managers; and
  - d) can intervene in the situation of distress or potential failure of a licensed insurer.

### Summary of prudential requirements

3. The prudential regulation framework which has been developed to date and approved by Cabinet in December, 2007 has the following main features:
  - a. **Objective.** The objective of insurance prudential regulation is “to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence”.
  - b. **Scope.** All providers of insurance with a physical presence in New Zealand including overseas providers with an agent-based presence will be covered by the prudential regulation framework.
  - c. **Overall approach.** A relatively light-handed approach to supervision and regulation of the insurance sector will be taken,

placing significant reliance on strong self discipline, director responsibility and published financial statements.

- d. **Licensing.** Licensing criteria will focus on insurers' capacity to manage their business and risks, and on their financial strength. A minimum capital requirement of \$2m will apply for all insurers and New Zealand actuarial standards relating to insurers' solvency, liability valuation and other aspects of financial strength will be given the force of law.
- e. **Rating.** Financial strength ratings, from an approved ratings agency, will be mandatory for insurers. However, insurers with annual gross premium income below a threshold figure (currently expected to be \$5 Million) will be exempted from the rating requirement, except for property and disaster insurers who are already required to obtain a rating.
- f. **Fit and proper.** Insurers will be required to ensure that they evaluate the suitability and integrity of prospective directors and certain specified senior managers. Subject to natural justice requirements, the Reserve Bank will have the power to veto proposed appointments to these positions and to remove appointees from office, where the Reserve Bank is satisfied that they do not meet the suitability and integrity criteria. The Reserve Bank may also veto the appointment of, or require a change to, the insurer's auditor and/or actuary where it has serious concerns.
- g. **Foreign insurers.** For foreign insurers operating in New Zealand who are fully compliant with their home country regulator's prudential requirements, the Reserve Bank will have the discretion to accept compliance with these requirements in place of compliance with its own requirements.
- h. **Monitoring.** Risk-based monitoring will be primarily off-site, using publicly available information and regular returns provided by insurers, and will focus on those insurers who might be carrying too much risk or insufficient capital. However, the Reserve Bank will have a range of necessary additional monitoring powers, including powers to perform on-site inspections, request any information required, initiate third party reviews, meet with third parties on a tri-lateral basis and request an independent actuarial valuation. Insurers' auditors will be required to report any major concerns to the Reserve Bank.

- i. **Insurers in distress.** A range of crisis response actions, appropriate to the circumstances, will be available in order to meet the objectives of the legislation: the appointment of an investigator by the Reserve Bank, the Reserve Bank giving directions to the insurer, requiring the insurer to prepare a recovery plan demonstrating how an unsatisfactory financial position or other matter of concern will be addressed, the ability of the Reserve Bank to de-license the insurer and, if considered appropriate after further analysis, the ability to place an insurer into Statutory Management. The agreement of the Minister will be required to place an insurer into Statutory Management.

## Guiding Principles

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4. In considering the options and arriving at the preferred alternatives within this paper the following principles have been used:

- **Regulatory approach.** The regime for the prudential regulation of the insurance sector needs to place as much reliance as possible on self and market discipline so as to underline the responsibility of directors of insurers. Subject to meeting the proposed supervisory objective, prudential requirements and monitoring should be relatively non-intrusive in nature, to minimise compliance costs and regulatory distortions.
- **Benchmarking and consistency.** It is desirable that the regime for the prudential regulation of the insurance sector in New Zealand demonstrates broad compliance with the principles of the International Association of Insurance Supervisors (“IAIS”) which are internationally recognised and are an important touchstone for the International Monetary Fund (“IMF”) and other bodies. We have also had regard to the policy approach taken in some other major countries, including Australia.
- The IAIS develops principles and standards that can be used by insurance supervision throughout the world. IAIS principles represent best practices for supervisors to work towards. However, the principles can be implemented in a flexible manner depending on the circumstances within each jurisdiction and they are not legally binding on New Zealand.
- **Competitive neutrality.** Supervision should be applied on a competitively neutral basis, unless there are good reasons for departing from this principle.

### Objective of prudential supervision

5. We have also had regard to the overall objective for the prudential supervision of the insurance sector, which is “to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence.”

### **Assessment criteria**

6. The preferred option(s) and alternatives within this consultation paper have been assessed against the following criteria:
- effectiveness in meeting the relevant Regulatory Objective,
  - international credibility of the option, and
  - benefits and potential costs, including compliance costs.

## **Issues On Which We Are Seeking Input**

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7. The matters on which we are seeking your input are summarised as follows:

### **Separation of insurance business lines**

- What, if any, is the appropriate regulatory treatment to reduce the likelihood of a major reduction in life insurance funds, required to meet long term liabilities, arising from short term high impact events in other insurance lines which are not related to the life insurance fund itself? Is separation of insurance business lines the best way to achieve this and if so how should this be structured?

### **Treatment of foreign-owned branches**

- What is the appropriate framework to achieve the effective regulatory and supervisory coverage under the Insurance Prudential Supervision regime for New Zealand branch operations of foreign insurers?

### **Distress management**

- What is the appropriate legal framework to enable effective regulatory involvement in the management of a distressed insurer?

### **Connected party exposures**

- What is the appropriate framework to regulate connected party exposures within the New Zealand insurance industry in order to adequately protect policyholder interests?

### **Non-insurance activities**

- What is the appropriate framework to regulate non-insurance activities of insurance companies operating within the New Zealand insurance industry in order to adequately protect policyholder interests?

### **Amalgamations and transfers**

- What is the appropriate framework to regulate amalgamations, transfers, or other significant corporate transactions which change the ownership of policyholder liabilities in order to adequately protect policyholder interests?

### **Confidentiality of information**

- What is the appropriate regulatory approach to ensure that prudential information supplied by insurers, which is not otherwise publicly disclosed as part of disclosure requirements, will remain confidential?

## **Separation Of Insurance Business Lines**

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### **Problem**

8. If insurance business lines (i.e. life insurance, general insurance and health insurance) are booked together within the same legal entity the business lines are not legally separate, even though separation for accounting purposes may be possible. Without legal separation, there is a potential for changes in the value of one business line to adversely affect the other business line(s) booked within the same legal entity. This potential for contagion between business lines is most relevant if the value of one business line decreases, because this could be at the expense of the financial resources available for the other business line(s).
9. For example, if life and general insurance business co-exist within the same legal entity then a major general insurance event and payout, or a decline in asset values, could deplete or reduce the value of the assets available for life policyholders.
10. So the reason for requiring legal separation of life insurance business is primarily to protect the funds required to cover long term commitments on life insurance policies against unexpected severe financial loss arising from non-life insurance events. Also, the supervision of solvency and other prudential matters is more easily achieved by the separation of these two, quite distinct, classes of insurance.

### **Regulatory Objective**

11. The regulatory objective is to maintain policyholder confidence by insulating life policyholders from the effects of a significant unexpected general insurance loss or failure and against claims by other unsecured creditors.
12. This regulatory objective applies to both New Zealand-owned insurers and foreign-owned insurers, irrespective of their current corporate form (company, branch or mutual).

## **New Zealand and international practice**

13. Section 15 of the Life Insurance Act 1908 currently requires a New Zealand or an overseas incorporated life insurer to maintain a separate fund for assets relating to its life business. Industry practice is that separate subsidiaries or branches typically exist for life and general insurance and for health insurance. Some health insurance products are booked within the life insurance entity because the products can share similar characteristics and are sometimes bundled together when sold.
14. Maintaining segregated funds occurs in most developed countries, including the United Kingdom, Australia, Canada, Hong Kong and Singapore and segregation of different business lines is an IAIS expectation.
15. In Australia “statutory funds” are required under the Life Insurance Act 1995 for life insurance to clearly separate life from other types of insurance. Statutory funds are required both for Australian and foreign-owned insurers and a separate statutory fund must be maintained for non-Australian life business.

## **Separation alternatives for New Zealand and foreign-owned insurers**

16. The alternatives are set out below and are assessed against the regulatory objective and the other criteria set out in sections 4-6 above.

### **Alternative 1 – status quo, rely on existing separation**

17. The first policy alternative is to rely on the degree of business and legal separation that already exists and not introduce any requirements in this area.
18. Section 15 of the New Zealand Life Insurance Act requires the separation of accounts in respect of life insurance and annuity contracts business, and a requirement to maintain a Life Insurance Fund for the security of the life policy and annuity holders. This existing requirement does not extend to health or other non-life insurance.

The benefits of this option are:

- It would be low cost for insurers.

- Maintaining a diversity of business (life and non-life) within the same legal entity arguably reduces the overall probability of failure of an entity.

The costs are:

- It would fall short of international guidance.
- The Life Insurance Act contains insufficient detailed rules to ensure a legally robust form of legal separation in practice.
- It would not address any co-mingling of insurance business lines that exists now or that could arise in the future.

### **Alternative 2 – make clear accounting separation a formal requirement**

19. The second policy alternative is to retain the status quo (as described in Alternative 1 above) with an additional requirement that accounting separation of different insurance business lines (life, general and health insurance) within an insurer must be complete, accurate and used within the insurer's operations and board reporting.

The benefits of this proposal are:

- It would be low cost.
- It would enable the separate lines of business to be more readily identified compared with the absence of such a requirement. The Reserve Bank and policyholders would be in a better position to do their own monitoring.

The costs are:

- It would fall short of international guidance.
- It would not achieve the regulatory objective of legal separation and protection of long term life policies from “contagion” caused by claims in respect of other insurance business lines or claims from other creditors.

### **Alternative 3 – life insurance to be booked into a separate body corporate**

20. This alternative requires that life insurance business be booked into a distinct New Zealand incorporated entity, with no requirement to maintain a separate life insurance fund within that New Zealand incorporated entity.

The benefits of this proposal are:

- Life policies will be kept legally separate from other policies, and therefore would not be exposed to problems arising in the other lines of insurance business.

The costs are:

- The New Zealand incorporated entity is likely to have other creditors and liabilities apart from life insurance policyholder liabilities. As these other creditors and liabilities will also have an equal claim over the assets of the life insurer upon liquidation, the assets available to meet the claims of the life insurance policyholders may be reduced by such claims, which is an undesirable outcome.
- It would be costly for life insurers operating in New Zealand as branches of overseas companies to move their life assets into a New Zealand based fund. In addition, insurers with separation requirements in their home jurisdiction would need regulatory approval to move such assets. This issue is discussed in the next section.

### **Alternative 4 – life insurance to be booked into a statutory fund within a distinct body corporate**

21. This alternative requires that life insurance business be booked into a statutory fund (see explanation below) within a distinct life insurance entity. It is envisaged that the statutory fund would be established in a manner broadly consistent with the Australian life insurance model as this solution would achieve legally robust separation (achieving our regulatory objective). This alternative builds upon and reinforces the existing separation requirement under Section 15 of the New Zealand Life Insurance Act (see above).

22. Given that this alternative requires that a statutory fund be established for life insurance, this also achieves separation for general insurance.

## **Statutory fund**

23. A statutory fund is a fund that is established in the records of a life company and relates solely to the life insurance business of the company or a particular part of that business. The statutory fund assets can only be used to meet the liabilities of the statutory fund and all premiums payable under the policies must be credited to the fund.
24. The existence of a statutory fund would underpin the insurer's ongoing ability to meet their long term promises to policyholders. Policyholders' interests are safeguarded by ensuring as far as possible that there are sufficient assets in the statutory fund to match estimated policy liabilities and that statutory fund assets are only used for the purpose of meeting liabilities of the statutory fund.
25. The principal additional rules, based on Part 4 of the Australian Life Insurance Act 1995, which would govern the operation of the statutory fund are as follows:
  - All life insurance policies sold would be referable to the statutory fund which is established.
  - The assets of the statutory fund must be kept separate from those of the entity and any other statutory fund established. Further, the assets of the statutory fund must be sufficient to meet the liabilities of the statutory fund and the solvency requirements of the statutory fund. It is expected that the solvency requirements of the statutory fund would be based on the New Zealand actuarial standards for life insurance.
  - Inward payments to the statutory fund would comprise the premium income on the life insurance policies together with the investment income earned on the assets of the statutory fund.
  - The directors of life insurers would have a duty to take reasonable care in the management of the statutory fund to give a priority to policyholders of the statutory fund.
  - There would be other restrictions on the operation of the statutory fund in order to protect policyholders' interests. For example, the assets of the statutory fund cannot be mortgaged, a statutory fund cannot be restructured or terminated without the approval of the Reserve Bank and a distribution of the retained profits of a statutory fund cannot be made without the written

advice of the consequences of the distribution from the company's actuary.

26. As a result of these rules, the assets of a statutory fund would be legally ring-fenced which is an important benefit for life insurance policyholders. In the event of a failure of a life insurer, the claims of policyholders will rank ahead of the company's unsecured creditors upon liquidation. Hence this alternative offers a robust form of legal protection to life insurance policyholders.

### **Test of significance**

27. In order to substantially eliminate the potential contagion risks which could arise from insufficient business line separation, and to limit the potential compliance costs of the policy, it is proposed that – under this alternative - life insurance statutory funds can include general insurance where this co-mingling is not significant enough to undermine the financial position of the life insurer. The suggested test of significance is that general insurance policyholder liabilities must be less than 5% of the capital of the life insurance statutory fund. If the general insurance proportion is more than 5%, this general insurance business must be separated out of the statutory fund.

### **Domicile of statutory fund**

28. Statutory funds could be based in New Zealand, which is what would apply to New Zealand-incorporated companies, or could be based overseas for foreign-owned branches. The latter would be acceptable to meet proposed regulatory requirements where:
- The legal framework applying to the fund requires the fund to have assets sufficient to cover all life policy liabilities referable to New Zealand policyholders (in addition to others), and is robust in achieving that result.
  - The fund and compliance with the fund's rules are supervised by a prudential regulator to a standard which is acceptable to the Reserve Bank.
  - Upon insolvency of the insurer, the fund's assets are not prioritised in respect of any particular class of policyholder based on their location, ie there is no home country policyholder preference.

29. The Reserve Bank believes these tests are currently met by Australian owned branches operating under the Life Insurance Act 1995 and supervised by APRA.

### **Health and general insurance**

30. Although health insurance can involve long term relationships with policyholders similar to life policies the case for legal separation within its own statutory fund is more finely balanced than for life insurance where the benefit amounts are typically greater than for health insurance. Also because of their nature and more limited financial size, health insurance liabilities generally have less potential, compared to general insurance, to unexpectedly undermine the financial strength of a life insurance fund. There are two alternative regulatory treatments for health insurance which we are seeking respondents' views on, as follows:

- the distinct legal separation of health insurance into its own statutory fund; or
- no requirement to legally separate health insurance using its own statutory fund i.e. health insurance can be booked either within the life insurance or general insurance entity or separately within its own branch, subsidiary or mutual.

31. For general insurance, there will be no additional separation requirement, which means that general insurance can either exist on its own or with health insurance business within its own New Zealand branch or incorporated entity.

### **More than one statutory fund**

32. An insurer may choose to have more than one statutory fund to separate the assets and liabilities of differing types of insurance contracts if this is deemed desirable.

### **Possible grandfathering**

33. If it is difficult to separate existing life insurance liabilities and assets that are co-mingled with general insurance business, an option for consideration is to implement this statutory fund requirement with effect from the date of the new legislation and grandfather existing life insurance businesses that contain an element of general insurance.

## **Assessment of Alternative 4**

34. The benefits of this option are:

- It would achieve separation of life business from other insurance businesses.
- It would protect funds available for policyholder liabilities from the claims of other unsecured creditors.
- The law can be written to ensure the fund is robust.
- It builds on an existing legal requirement.
- It is consistent with international guidance.

The costs are:

- It may require some transitional cost for insurers who currently do not provide full legal separation for their life business.
- It would disadvantage other unsecured creditors by ranking them behind policyholders.

## **Preferred alternative**

35. Having considered the alternatives available, alternative 4 is the preferred option. The overall consequences of this preferred alternative can be summarised as follows:

- Life insurers doing business in New Zealand must operate a statutory fund or equivalent structure that is sufficient to ensure that assets held by the insurer are sufficient to meet the liabilities to New Zealand policyholders. New Zealand incorporated entities must have a New Zealand based statutory fund. Branches of overseas entities may operate in New Zealand provided that they operate a statutory fund or equivalent structure that:
  - Ensures assets are available to meet life policyholder liabilities.
  - Has a robust legal and supervisory framework.
  - Provides no insolvency priority in favour of local policyholders.

- If the above tests cannot be met the insurer may be required to incorporate in New Zealand.
- General insurance policyholder liabilities can be included within the life insurance statutory fund up to 5% of the capital of the life insurance statutory fund.
- Health insurance can be booked either within the life insurance corporate entity, general insurance entity or separately within its own branch, subsidiary or mutual.
- There would be no statutory fund or other separation requirements for general insurance.

#### **Questions for submission**

1. How important do you think it is to eliminate the risk of contagion between different types of insurance within the same licensed insurer?
2. For the purposes of eliminating the potential risk of contagion between different types of insurance within the same licensed insurer, do you agree that legal separation of life insurance, using a statutory fund is appropriate? (This is the preferred alternative (number 4) described.) Please indicate your support, together with any reasons, or articulate any concerns you may have, including any potential costs and implications. Any comments on the existing degree of legal separation of insurance business lines within insurers will be helpful.
3. Do you have any comments regarding the more detailed provisions of the preferred alternative (number 4), including the additional rules which will constitute the statutory fund, the test of significance, the domicile of the statutory fund, having more than one statutory fund or the possibility of a grandfathering arrangement for existing fund structures?
4. Do you consider that the legal separation of health insurance into its own statutory fund is necessary; or do you consider it appropriate that there is no such requirement for health insurance?
5. If you prefer one of the other alternative options, please indicate which and provide the reasons in support of your preference.

## **Treatment of Branches Of Foreign Insurers**

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36. Foreign-incorporated insurance companies operating in New Zealand as a branch of their parent company (“foreign-owned branches”) present issues which require different consideration and potentially different regulatory treatment to those of New Zealand incorporated organisations. These issues are explained immediately below.

### **Problem**

37. Branches of foreign-incorporated insurance entities are an integral part of their parent foreign entity and are not a separate legal entity. This gives rise to two issues in the context of prudential regulation:

38. The first issue is the fact that such branches will operate under two regulatory regimes:

- Foreign-owned branches are subject to the prudential regulation requirements of their home jurisdiction, which has responsibility for the prudential regulation (the legal requirements) and supervision (monitoring of the legal requirements) of the parent entity including any overseas branches.
- Despite foreign-owned branches being subject to home country prudential regulation requirements the Reserve Bank, as host regulator in New Zealand, will also impose its own New Zealand prudential supervision requirements on a branch of a foreign insurer.

39. The aim of the Reserve Bank in considering its prudential requirements on branches of foreign entities is to ensure that foreign-owned branches, foreign-owned subsidiaries and New Zealand-based insurance companies and mutual organisations are all subject to sufficiently high standards of licensing and prudential supervision.

40. The second issue is that the assets and liabilities of the branch will be subject to the insolvency and other laws of its home country and the home country regulator’s distress management powers and actions (should a situation of actual or potential distress arise). Note, however that section 342 of the Companies Act provides the possibility of the liquidation of the assets in New Zealand of an overseas company. This provision does not provide much protection for policyholders since in

the absence of a statutory fund New Zealand assets can be moved freely between a branch and other parts of the legal entity.

41. In a cross-border insolvency, the parent's jurisdiction will be the principal jurisdiction in and from which the company had carried on business and held assets, which is a critical test for overseas courts in deciding matters such as whether assets should be remitted to a foreign jurisdiction (eg New Zealand for a New Zealand branch) or treated under foreign law.
42. This is a very important consideration because many insurers operate internationally, and in particular reinsurance assets are held offshore.
43. It is also possible that, upon insolvency, home country laws may rank the claims of home country policyholders ahead of "overseas" policyholders. This would disadvantage New Zealand policyholders. This situation is known as "home country policyholder preference".
44. In Australia, for example, home country policyholder preference provisions exist in Australian legislation for general insurance. Section 116 of the Insurance Act 1973 provides that policyholders in Australia have first claim on assets held by an insurer in Australia. New Zealand policyholders have no claim until all liabilities in Australia have been met.

## **Regulatory Objective**

45. The regulatory objective in this context is to ensure that New Zealand policyholders are not unduly disadvantaged by the corporate form of foreign-owned insurance companies operating in New Zealand in light of other countries' supervision regimes and insolvency laws.
46. A further consideration is preserving the availability of insurance to support the New Zealand insurance industry. The sudden failure of a large insurer (in this case particularly a foreign-owned insurer operating as a branch) which commands significant market share in a particular product(s) could be particularly disruptive and reduce confidence in the New Zealand insurance sector overall.

## **Assessment of alternatives**

47. The alternatives are set out below and are assessed against the regulatory objective and the other criteria set out in sections 4-6 above.

## **Alternative 1 –The status quo**

48. Under the status quo foreign owned branches would be permitted to set up with no measures introduced to take account of the insolvency laws of the parent jurisdiction, although the Reserve Bank would have discretion to refuse to license an entity where the overall legal and accounting framework applying in the home jurisdiction presented a significant risk to New Zealand policyholders.

Benefits of the status quo are:

- It would be low cost for insurers. It would also be simpler to establish and implement for the Reserve Bank and industry.
- Foreign insurers would not be deterred from entering the New Zealand market and offering insurance to New Zealanders, nor would they feel incentivised to leave the market because of the new requirements.

Costs to the status quo are:

- It would not meet international guidance.
- In many cases New Zealand policyholders would be disadvantaged in the event of the parent's insolvency and would rank behind other foreign creditors, notably in Australia.
- New Zealand liquidators would also face additional costs and uncertainty in recovering overseas assets for the benefit of New Zealand policyholders.

## **Alternative 2 – Requirement to maintain assets within New Zealand**

49. A requirement for foreign-owned branches to maintain assets within New Zealand either equal to or greater than New Zealand policyholder liabilities could be imposed. This could be modelled on the Australian law.<sup>1</sup> The Reserve Bank would supervise this requirement to ensure the required level of assets was maintained.

Benefits of this approach are:

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<sup>1</sup> See sections 28, 116 and 116A of the Insurance Act 1973,

- In theory, it would ensure assets are always available to meet the claims of New Zealand policyholders.

Costs of this approach are:

- The Australian rules are extremely complex in terms of the legal meaning of “assets and liabilities in Australia”. These provisions have been tested in court a number of times. The requirement also introduces a complex set of prudential rules defining such matters as what may be regarded as an asset in Australia in considerable detail.
- Foreign branches currently operating in New Zealand would be required to make significant changes to their business structures. For example, they may be required to change their asset portfolios. The status of important contracts, such as those of reinsurance, could be put in doubt (in terms of whether they meet the test of an asset in New Zealand). Insurers would also require the permission of the home regulator or the courts for the transfer of assets to New Zealand. These insurers may prefer to leave the New Zealand market.
- The requirement could pose a barrier to entry to insurers considering entering the New Zealand market, to the detriment of competition and consumer choice.
- Foreign courts, particularly in the US, may find this requirement discriminatory against their nationals and refuse to remit assets to New Zealand.

### **Alternative 3 – use financial strength rating**

50. Cabinet has agreed that all insurers will be required to obtain and publish a financial strength rating issued by a rating agency approved by the Reserve Bank, but with an exemption for those insurers, except disaster and property insurers who are already required to be rated, with less than a specified amount of annual gross premium income (it is anticipated that the amount initially specified in regulation will be \$5 million).
51. This alternative requires that the New Zealand financial strength rating of the licensed insurer must reflect any home country policyholder preference arrangements or other issues which could disadvantage New Zealand policyholders, compared to home country policyholders or other policyholders of the parent company (“issues that could

disadvantage New Zealand policyholders”). Whilst the probability of default of the parent entity as a whole would be the same as the New Zealand branch, the existence of issues that could disadvantage New Zealand policyholders may cause the loss given default of the New Zealand branch to be higher than that of the parent entity. This alternative would signal to the market that such foreign-owned branches were potentially higher risk as a result of such issues. In a crisis the loss given default applicable to a branch could change quite quickly if assets were to be transferred from the branch to the parent.

52. To adequately inform policyholders and the market, this alternative also includes a requirement for licensed insurers to publicly disclose any issues that could disadvantage New Zealand policyholders, together with the implications in the event of a failure of the parent foreign entity.

53. The benefits of this alternative are:

- It would be low cost for insurers as many are already required to have ratings, so this is no extra cost at all.
- It would not require significant changes to corporate structure or business operation.
- It would therefore not represent a significant barrier to entry or encourage insurers to withdraw from the New Zealand market.
- It would explicitly signal to consumers and advisers, in a quantifiable way, the additional risks of placing insurance with a branch of a foreign insurer where there are issues that could disadvantage New Zealand policyholders.
- Even if consumers do not understand the precise subtleties of the ratings information it signals to them, to the industry and to the regulator how material the issues are and these will over time be factored into pricing and regulatory oversight.

54. The costs are:

- Although it acknowledges their existence, it does not directly address policyholder preference regimes and the issues faced with foreign insolvency laws.
- It depends on the methodology and overall effectiveness of the rating agency.

- It partly depends on consumers understanding and valuing the rating information effectively.

#### **Alternative 4 – New Zealand policyholder preference**

55. It is possible to include local policyholder preference provisions for insurance within New Zealand legislation.

56. The benefit of this alternative is:

- This would be effective in protecting the position of New Zealand policyholders over all other policyholders.

57. The costs of this alternative are:

- Such arrangements could be contrary to international financial commitments, and
- Could both disadvantage New Zealand insurers wishing to write offshore insurance business and discourage foreign-owned insurers from operating in New Zealand.

#### **Alternative 5 – local Incorporation of foreign-owned branches**

58. Where issues such as home country policyholder preference disadvantage New Zealand policyholders, an alternative is to prohibit insurers operating as branches from such a jurisdiction. This would require local incorporation of the New Zealand based branch if they wish to continue to carry on business in New Zealand.

The advantages of this requirement are:

- It would deal with the issues of principal jurisdiction in cross border insolvencies. Assets held in respect of New Zealand policyholder liabilities would be much more likely to be remitted to New Zealand to be dealt with under New Zealand law.
- It would also decisively deal with the issue of home country policyholder preference. Assets held by the locally incorporated entity would be available for New Zealand policyholders and not at risk of being remitted to the parent for the benefit of its local policyholders.

- It is much simpler than alternative 2, which is an “assets in New Zealand” requirement similar to existing requirements within Australian law.
- It does not depend on consumer assessment to judge such matters as the potential impact of foreign insolvency laws and home country policyholder preference.

The costs of the requirement are:

- It may in some cases require insurers successfully operating in New Zealand as branches to locally incorporate. This could be expensive and complex for those insurers, eg with regard to such matters as transferring policy liabilities to the new entity. These transfers require a novation of individual policies, or an application to court for an approval under a scheme of arrangement. The insurer may need permission from the courts or the home country regulator, particularly if the transfer of assets may weaken the overall entity. These costs may encourage such insurers to leave the market to the detriment of competition and consumer choice.
- Similar to the above point, it may deter insurers from entering the market if they prefer to operate as branches. This would be detrimental to competition and consumer choice.
- Such a local incorporation policy could be used only where the potential risks to New Zealand policyholders were sufficiently large to justify the costs of incorporation. Whilst the principle of competitive neutrality is extremely important, it is likely that this requirement, if applied, would be confined to the largest insurers. This would reduce the potential risks to a larger number of New Zealand policyholders. The size criteria could be based on absolute levels of gross premium income of a foreign-owned branch insurer or a sufficiently high percentage market share in an insurance product or market.
- A locally incorporated entity will be smaller and have lower financial strength than a larger company of which it was previously a part. Risk diversification and overall financial strength ratings may be lower and the position of policyholders may be less protected than it would be in a branch structure.

### **Preferred alternatives**

59. The Reserve Bank's preferred approach is to adopt one of the following alternatives, following the responses to this discussion document and any further analysis:

- **Alternative 3:** Foreign-owned branches must obtain and publish a financial strength rating which takes into account any home country policyholder preference arrangements and other legal issues which disadvantage New Zealand policyholders in any way, together with disclosure of the implications of the policyholder preference or other arrangements. In addition, the Reserve Bank will retain the right to require local incorporation of foreign-owned branches if circumstances arise which prejudice the position of New Zealand policyholders of such branches (as detailed earlier).
- **Alternative 5:** The Reserve Bank may require certain foreign-owned branches to incorporate in New Zealand, based upon size criteria which are likely to be based on absolute levels of gross premium income or a sufficiently high percentage market share in an insurance product or market.

#### Questions for submission

6. Do you agree with the first preferred alternative that foreign-owned branches must obtain and publish a financial strength rating which takes into account any home country policyholder preference arrangements and other legal issues which disadvantage New Zealand policyholders in any way, together with disclosure of the implications of the policyholder preference or other arrangements? In addition, that the Reserve Bank retains the right to require local incorporation if circumstances arise which prejudice the position of New Zealand policyholders? If not, please articulate any concerns you may have.
7. Do you agree with the other preferred alternative that foreign-owned branches may be required to incorporate in New Zealand? If not, please articulate any concerns you may have.
8. If there is a local incorporation requirement, should it relate to size, or some other measure of risk to New Zealand policyholders?
9. If you prefer one of the other alternative options, please indicate which and provide the reason(s) why?

## **Distress Management Of Insurers**

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### **Problem**

60. Like all businesses, insurers face the possibility of being unable to pay their debts when due or their liabilities exceeding their assets and they face insolvency proceedings. While the insurance prudential supervision regime can be expected to lower the likelihood of the insolvency of an insurer, it cannot be expected to, and is not intended to, eliminate the possibility of the failure of an insurer.
61. The issue under discussion is: what is the appropriate legal framework for the distress management of an insurer? The appropriate framework must take into account that insurers are subject to the general law and general insolvency procedures, as well as the fact that insurers will be supervised under an enhanced prudential framework which has its own objectives of a sound and efficient insurance sector and policyholder confidence.
62. Issues for discussion are:
- What are the goals of a distress management framework?
  - What options under the general law are current available to the creditor or the prudential regulator if an insurer is in distress?
  - Are there any issues that are particularly important in the context of the failure of an insurer?
  - What, if any, new legal mechanisms should be introduced as distress management procedures that meet the objectives of the insurance prudential framework and the goals for distress management?

### **What are the goals of a distress management framework?**

63. While the goals of a distress management framework can be defined in various ways, commonly agreed goals include:
- A.** Facilitating the exit of inefficient firms from a market in the interests of overall market efficiency;
  - B.** Maximising the realised value of the insolvent firm's assets;

- C. Coordinating the debt collection efforts of multiple creditors;
  - D. Distributing the assets equitably to the creditors where a firm is wound up;
  - E. Restoring a firm to financial health where it is determined that the firm has “going concern” value and creditors are better off if the firm is restructured rather than wound up;
  - F. Avoiding significant damage to the financial system; this is the goal underlying the statutory management provisions of the Reserve Bank of New Zealand Act 1989; and
  - G. Protecting the public from the fraudulent and reckless management of a corporation; this is a goal of the Corporations (Investigations and Management) Act 1989 (“CIMA”).
64. All of the goals specified above apply to the distress management regime to be introduced under the Insurance Prudential Supervision Bill with the exception of F. This goal is peculiar to banking where special insolvency procedures are justified because of factors like a bank’s participation in the operation of the payments system and their interconnection with the interbank market, and because banks hold large amounts of liquid liabilities that can be withdrawn immediately by creditors (eg the bank run scenario).
65. We believe that there is also an additional goal for insurance distress management:
- H. To preserve the ability of an insured to claim on the policy beyond the life of the insurer who wrote the policy. This applies particularly to long-tail policies, such as life, and certain sickness policies (eg asbestos coverage) where the ability to find replacement cover diminishes over time.

**Questions for submission:**

10. Do you agree that these are appropriate goals of a distress management framework?

11. Which goals do you think are relevant to insurance?

## **What options under the general law are currently available to the creditor or the prudential regulator if an insurer is in distress?**

66. The procedures for resolving an insolvent or near insolvent insurer are currently found in the Companies Act 1993, the Corporations Investigation and Management Act, the Life Insurance Act 1908 for life insurers, and, of less relevance, the Receiverships Act 1993. The procedures available are:

- Liquidation: This procedure provided under Part 15 of the Companies Act is intended to meet goals A – D. Liquidators can be appointed if a firm is insolvent or where it is just and equitable to do so. Liquidation provides a process for the appointment of a liquidator who has the function of realising a firm's assets for distributing to creditors.
- Interim liquidation: The High Court may appoint interim liquidators under s 246 if it is satisfied that it is necessary or expedient for the purpose of maintaining the value of assets owned or managed by the company. The threshold is whether the assets are at risk. Goal B, and maybe G, are the primary goals of interim liquidation.
- Voluntary administration (VA): Voluntary administration is provided under Part 15A and intended to provide a genuine business rehabilitation procedure for insolvent or near insolvent companies. Goal E is therefore the primary goal.
- Statutory management: Statutory management can be sought under CIMA if the affairs of a corporation are being administered fraudulently or recklessly. Statutory managers have very wide ranging powers.
- Judicial management: This is a process provided under Part 1A of the Life Insurance Act. The grounds for appointment are that it appears that there is a likelihood that the life company is, or will be, unable to meet its liabilities to policyholders. The judicial manager has the power to propose the carrying on of the business, a transfer of business and a reduction of policies. These features reflect the function of the process, being to preserve and keep intact so far as practicable, the property and assets of the company (Goals B and E appear to be the primary goals).

- Receivership: There are, in general terms, two types of receivership, both governed by the Receiverships Act 1993. The first type is receivership initiated by a secured creditor for the purpose of realising amounts secured by a security agreement. Goal B is the relevant goal, but only in the interests of the secured creditor.
- The second type is court appointed receivership. There are various grounds in 337 – 345 of the High Court Rules for appointment of a receiver. This procedure is rarely used and only mentioned here for completeness.

Also relevant are:

- Schemes of arrangement: New Zealand courts may approve schemes of arrangement under Part 15 of the Companies Act. Schemes then become binding on all creditors, including those not in favour of the scheme. The court has very wide discretion, including approving a compromise with creditors and a moratorium.

67. While schemes of arrangement are not widely used in New Zealand, solvent schemes of arrangement have been very popular in the English insurance market, which is a major global supplier of insurance and reinsurance so worth studying for its practical experience. There have also been a small number of solvent schemes of arrangement in Australia.

68. Solvent schemes of arrangement are used by insurance companies to accelerate the run-off of their businesses, or parts of their business, while they are still solvent. There are advantages to insurers in avoiding the costs of and time taken in run-off, while creditors can benefit through receiving early payment for a claim that has not yet crystallised, the removal of any uncertainty about long term insolvency of an insurer, and avoiding litigation over claims.

69. VA is more relevant for insolvent or near insolvent insurers and its Deed of Company Arrangement mechanism replicates many features of a scheme. Many advantages of schemes of arrangement would therefore apply to VA.

70. Compromises with creditors: This is mentioned for completeness only. A compromise procedure, available under Part 14 of the Companies Act, is a process for offering a compromise between a company and

its creditors that includes cancelling all or part of a company's debt or varying the terms of a debt. The procedure is not commonly used.

**Question for submission:**

12. Do you have any comment on the description of the insolvency framework above and its applicability to insurers?

**Are there any issues that are particularly important in the context of the failure of an insurer?**

71. The procedures described above apply to entities despite their line of business or the particular regulatory regime they come under. As we have noted, however, there is a special distress regime for banks because of unique considerations that arise when a bank fails.

72. Distinct issues also arise in the event of the insolvency of an insurer. The issue to be discussed is whether these warrant modification to the regimes described above, or even whether a special regime is justified.

**The nature of insurance debt<sup>2</sup>**

73. The nature of insurance debt is important because the solvency test under the Companies Act depends on a company being able to pay its debts as they become due. A company who fails this test and whose liabilities exceed its assets is insolvent. This is what triggers procedures such as liquidation and VA.

74. Insurance policies are a particular type of debt but are very different to other types of debts such as a trade account or a bank deposit. Those types of debts tend to be liquidated and easily ascertainable. However, for an insurer, on the date of its solvency being assessed most of its liabilities will be payable some time in the future, namely the obligation to make payments to insureds who the insurer is required to indemnify under a contract of insurance when an insured event occurs.

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<sup>2</sup> The following few paragraphs are drawn from John Warde and Simon McConnell Insurance Companies and Insolvency, Allens Arthur Robinson Insurance Forum, Sydney, 2 April 2003 <http://www.aar.com.au/pubs/insur/insurapr03.htm>.

75. This includes contingent liabilities for insured events that are yet to occur, incurred but not reported (IBNR) claims and reported claims which are unresolved (eg the claim is in dispute and perhaps even subject to litigation).
76. An insurer has thousands of contingent and prospective liabilities like this. Quantification requires actuarial assessment which has regard to statistical data and often patterns of insurance claims over many years. These assessments take into account the probability of insured events occurring in the future. Such assessments are ultimately estimates which are open to dispute, particularly in respect of long-tail liabilities that may arise many years into the future.
77. In a situation of insurer insolvency the regulator can represent the interests of thousands of policyholders, each of whom individually may have no knowledge of their potential claim and therefore no right to vote in insolvency proceedings. The regulator will have the right on behalf of policyholders to initiate proceedings.
78. In many cases, liquidators wait for claims under the relevant policy to be notified and agreed, rather than estimate the contingency value of the contract under the relevant provisions of the Act earlier in the liquidation. This can have the effect of freezing insurance company insolvencies for years, without any dividends paid in respect of agreed claims.
79. Liquidators may estimate contingent claims under the Companies Act for the purpose of declaring dividends and revise those estimates at intervals in light of any change in circumstances. They may also apply to court for a decision on the amount of the claim. This is potentially expensive and cumbersome due to the large number of different categories of contingent claims that are submitted to liquidators.
80. Section 30A of the Life Insurance Act 1908 provides that a liquidator of a company that is subject to that Act shall value policyholders' claims in such manner and upon such basis as the liquidator decides. Such valuation is subject to appeal to the High Court. Section 30B deals with distributions to policyholders. There are no equivalent procedures for other types of insurance.

### **Mutual set-off**

81. Specific statutory rules concerning set-off must be applied in liquidation.<sup>3</sup> Where there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming in liquidation, an account must be taken of what is due from each party to the other. Sums due from one party must be set-off against sums due from the other. Set-off is mandatory in respect of debts proved in liquidation and in VA for claims admitted under a deed of company administration.
82. This rule has consequences in the insurance company insolvency context. For example, the sums due from an insolvent ceding company to policyholders on inwards business must be set off against sums owing to those companies, eg as premiums. Similarly, if those same companies have reinsured the insolvent ceding company, claims due on the onwards contracts must be set-off against claims due to those companies from the ceding companies on inwards business. This is especially complex, since the application of set-off is rarely as straightforward as setting-off two liquidated claims. In insurance company insolvencies, claims continue to mature over a period of time. Consequently, at the time of the commencement of liquidation, or when admitting claims in the VA context, many claims, particularly claims against the insolvent company on inwards business, remain unquantified.
83. English law provides that set-off does not apply to debts acquired after the administration petition is pending, and these are not taken into account if the insurer subsequently goes into liquidation. In Australia there is no mandatory requirement for set-off in respect to claims made under a deed of company arrangement.

### **The international context**

84. It is important to bear in mind that many New Zealand insurers operate internationally. Upon becoming insolvent they may well have substantial assets offshore, particularly reinsurance. Germany, Switzerland, the UK and the US are the major markets. New Zealand does not have any locally based reinsurers.
85. A New Zealand liquidator will need to seek the assistance of foreign courts to enable those assets to be protected and collected. Those foreign courts may wish to be satisfied that they are assisting a jurisdiction with insolvency laws that are fair and do not discriminate

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<sup>3</sup> Section 310.Companies Act 1993. See also s 239AEG for the rules concerning VA.

unfavourably against their nationals. The HIH liquidators have found this to be the case in both the UK and the US.

**Question For submission:**

13. Are there any other issues that are peculiar to the insolvency of an insurer and should be accounted for in a new prudential supervision regime?

**What, if any, new legal mechanisms should be introduced as distress management procedures that meet the objectives of the insurance prudential framework and the goals for distress management?**

86. The Reserve Bank has identified a number of law reform options for reforming the insolvency laws that apply to insurers that would be consistent with the conventional goals of insolvency law generally and with the prudential supervision framework proposed for insurers.

87. These are:

- Status quo.
- A statutory management regime modelled on the Reserve Bank Act.
- Modifications to the status quo to accommodate the fact of a prudential regime and any particular issues peculiar to the insurance context.

88. Overall design considerations that influence the choice of options are:

- It must be effective in meeting the goals of insolvency law generally and the prudential regime specifically. This includes both the soundness and the efficiency of the insurance sector.
- It must provide certainty for insurers, reinsurers and policyholders to the extent possible.
- It must be fair and equitable between policyholders and classes of policyholders (and other creditors). This is in terms of

outcomes and procedure. With respect to procedure, the options should allow for fair representation and, where possible, participation by policyholders.

## **Status quo**

89. Relying on the status quo would involve retaining judicial management for life insurance while relying solely on Companies Act procedures for other insurers.

### **90. Benefits are:**

- The law is relatively certain and the procedures well established.
- Historically there have been relatively few insurance insolvencies in New Zealand so the status quo avoids the cost of designing a new regime that may be little used.
- The processes are relatively neutral, for example liquidation is overseen by the courts, ensuring all parties' interests can be represented.
- VA incorporates many features that are suitable for insolvent or near insolvent insurers, such as the flexibility that the deed of company arrangement procedure provides and a degree of involvement by policyholders. VA provides a mechanism aimed at keeping the insurer on foot for the benefit of the policyholders.
- Judicial management contains some features that allow for more flexibility for the long tail nature of many life policies, eg the ability for a judicial manager to apply to transfer policies, apply to court for a reduction in the value of policies, and for liquidators to be able to value claims.

### **91. Costs are:**

- Liquidation has certain features that do not account for particular issues that arise in the context of an insurance insolvency. These include no mechanism to value claims (other than in the life insurance context) and no ability to modify or displace mandatory set-off (an issue that also applies to VA).

- There seems to be little logic in limiting judicial management to life policies and not applying it (or something similar) to other long tail insurance policies.
- Judicial management and liquidation are heavily court-dependent processes. This can lead to high professional costs and delays, exacerbated in the insurance context by such difficulties that arise in valuing claims.
- The existing mechanisms provide little role for or recognition of the prudential supervisor, eg the supervisor is not a party to liquidation proceedings brought against the insurer and cannot invoke an insolvency procedure.
- CIMA is invoked by actions of the Ministry of Economic Development and the Securities Commission, who will be less well placed than the Reserve Bank as insurance prudential supervisor.

## **Statutory management regime modelled on the Reserve Bank of New Zealand Act**

### **Description**

92. A statutory management regime modelled on the Reserve Bank Act would have the following features:

- A comprehensive moratorium limiting the ability of creditors to claim against the insurer.
- It would displace any current liquidation, VA or similar resolution proceedings.
- Maximum flexibility and wide ranging powers for the statutory manager, including to:
  - Pay and compromise claims as it sees fit.
  - Transfer policies.
  - Reduce policies.
  - Carry on the day to day business of the licensed insurance entity and take any other actions necessary for the insurer to continue in business.

- Restructure, sell or liquidate the distressed insurer, including the power to set up a new company and transfer to it the undertaking of the failed insurer. In respect of the sale of the insurer, any consents normally required under other Acts (eg Commerce Commission approvals) are not required.
- The statutory manager would be required to receive the advice of an advisory committee, would be subject to directions of the Reserve Bank and could apply to the High Court for directions.

93. Statutory management is not a widespread mainstream international practice for insurer regulation. In particular, neither the UK nor Australia provide a statutory management regime for insurers.

#### **94. Benefits of a statutory management regime**

- It enables quick action on the part of the statutory manager to protect the assets of the insurer. It avoids the kinds of delays caused by court processes.
- It provides maximum flexibility. For example the statutory manager could attempt to run the business with the aim to rehabilitate it, it could sell portions of the business to other insurers thereby keeping policies on foot, or it could attempt a hive down or a liquidation of an insurer.
- Statutory management avoids some of the delay and cost caused by court involvement.
- Set-off can be disapplied under a statutory management regime as a feature of the moratorium.

#### **95. Costs of a statutory management regime**

- Statutory management provides a degree of uncertainty because of the level of discretion held by the statutory manager, who is also subject to directions of the Reserve Bank. For instance, under the Reserve Bank Act the statutory manager is not bound by rules of pari passu, leaving creditors less certain as to the status of their claims. A moratorium can be waived by the statutory manager for particular claims, but otherwise lasts as long as the statutory management does.

- This leaves the position of creditors very uncertain when dealing with an entity subject to statutory management. Unlike VA, statutory management does not allow for creditor participation in the resolution options being considered by the statutory manager.
- While the lesser involvement of the courts increases speed and flexibility it also means a neutral forum to resolve issues that may arise between the parties is not available.
- There is a real risk that statutory management, if too easily invoked may deter reinsurers from dealing with New Zealand based insurers. Statutory management may also be a barrier to co-operation from foreign courts which could perceive the level of discretion described above over matters such as creditor ranking as being repugnant to their own insolvency laws.

## **Assessment**

96. The Reserve Bank considers statutory management contains significant benefits, but that these are outweighed by the costs, except in very specific and rare circumstances. These are:

- The failure of the insurer could cause significant damage to the wider economy or the financial system, or
- The circumstances of the insurer involve fraud or recklessness.

And

- Statutory management is in the public interest.
- Policyholders and creditors cannot be protected under the Companies Act, the Insurance Prudential Supervision Act or in any other lawful way.

97. The Reserve Bank notes that this would set a threshold equivalent to CIMA. Therefore, insurers and creditors would not be facing any greater risk than found under the current law.

**Questions For submission**

14. Do you agree with the costs and benefits of statutory management?
15. Do you agree that statutory management should be an option available to the Reserve Bank?
16. Do you agree with the threshold for statutory management described above?
17. What powers and discretions do you think should be available to the statutory manager? And what other features should be part of a statutory management regime (eg is an advisory committee necessary?)

**Modifications to the status quo to accommodate the existence of a prudential regime and any particular issues peculiar to the insurance context**

98. The Reserve Bank considers that the status quo is the starting position when it comes to sensible options for a regime for the insolvency of insurers. Existing mechanisms, such as liquidation and VA may be effective in meeting particular goals of insolvency law, and are generally consistent with the objectives of the Insurance Prudential Supervision regime.
99. Nevertheless, the status quo would not be adequate in light of a prudential supervision regime. It does not provide opportunities for the supervisor to initiate resolution options, nor to participate in them. This leaves a gap in the regime when it is considered holistically: the supervisor oversees the insurer but only up to the point of its insolvency. The supervisor has a role to play at this point as well. These options should be available to the supervisor so it can meet its regulatory objectives.
100. The status quo also presents certain problems that are peculiar to the insolvency of insurance companies.
101. The Reserve Bank's preferred option is therefore to reform the status quo as follows:

- Provide the Reserve Bank with the ability to apply for the liquidation and provisional liquidation of an insurer. The law should provide grounds for the company to be put into liquidation additional to the Companies Act grounds. These should include matters such as the insurer's failure to meet prescribed capital and solvency standards and regulatory breaches by the insurer. The grounds would be invoked where this was in the interests of policyholders and the insurance sector as a whole.
- Liquidation proceedings invoked by the Reserve Bank should not be suspended or halted by applications for VA and the Reserve Bank should be permitted to apply for liquidation of an insurer in VA.
- Provide the Reserve Bank with the ability to apply to have an insurer placed in VA. This would be an option for the Reserve Bank where the best option was to place the insurer under a resolution mechanism that had the goal of rehabilitation for the insurer.
- Provide that the Reserve Bank is entitled to attend liquidation, VA, receivership and Part 15 proceedings (including for solvent insurers). The Reserve Bank should also be permitted to attend creditors meetings held pursuant to the VA regime. The Court should be required to notify the Reserve Bank of any applications of this nature that involve a supervised insurer. Similarly, liquidators and administrators reports should be provided to the Reserve Bank.
- Provide for the ability of a liquidator to be able to value the liabilities of an insurer, based on s 30A of the Life Insurance Act but extended to all classes of insurance.
- Allow the liquidator or an administrator to apply to the High Court for the reduction of the value or the transfer of insurance policies of an insurer in liquidation or VA.
- Repeal the judicial management provisions of the Life Insurance Act 1908.

102. The Reserve Bank is also interested on views as to whether the rules of mandatory set-off should be modified for the insurance context.

### 103. Benefits

- The main benefit of the Reserve Bank's preferred option (ie modified status quo) is that the advantages of the status quo are preserved, while providing an appropriate role for the prudential supervisor.

### 104. Costs

- There would be some administrative, including legal, costs to the Reserve Bank and to parties participating in insolvency proceedings. The Reserve Bank does not consider these are likely to be material.
- Because of the reliance on the status quo, the Reserve Bank considers the costs to be neutral overall.

## Assessment

105. The Reserve Bank believes the measures above would allow for a justifiable level of participation by the supervisor in resolution proceedings, but reliance would largely be on existing processes. The exception is where the thresholds for statutory management are crossed. The Reserve Bank notes that this regime provides a similar role for the regulator as that provided to the UK Financial Services Authority under its insolvency and prudential legislation.

106. Importantly, the modifications would provide a large degree of discretion and flexibility for the supervisor. This should complement the "upfront" licensing and supervision controls that form the day to day substance of the prudential regime.

### Questions For submission:

18. Do you agree with the approach recommended above?
19. Do you agree with the modifications to existing insolvency proceedings are appropriate as a whole?
20. Do you have any comment on particular proposals?
21. Do you consider that any modifications for the rules of set-off are appropriate for the insurance context?

## **Connected Party Exposures**

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107. Cabinet have agreed (in the December, 2007 Cabinet paper) that the Reserve Bank may place appropriate limits on connected party exposures of a licensed insurer, but the Reserve Bank needs to revert to Cabinet regarding the nature and extent of the constraints recommended.

### **Problem**

108. It is possible that funds from a licensed insurer could be used to finance another insurer or company within a group. If that connected party fails, the financial position of the insurer may be undermined. Connected party exposures are not limited to lending as they also include investments in subsidiary, parent or associated companies. Also the recoverability of connected party exposures must be certain (to the extent this is possible), so that the asset can be realised if this is necessary.

109. A connected party is defined as either an owner, an entity in which an owner has a substantial interest (i.e. holds 20% of the entity's issued securities or controls or significantly influences the composition of the board), a person (or immediate family of that person) with a substantial interest in an owner or a director of the licensed insurer.

### **Regulatory Objective**

110. The regulatory objective is to limit the risk of the insurer's financial position being undermined by such connected party exposures.

### **New Zealand Actuarial standards**

111. There are some existing requirements for connected party exposures under the New Zealand life insurance actuarial solvency standard, which are explained below. There are no New Zealand actuarial standards or guidance for the General or Health insurance sectors in this area, but there are plans to develop such standards and it is likely that the connected party provisions would be broadly consistent across the standards.

112. Connected party exposures are characterised as lending to associated companies or subsidiaries within the same group as the insurer. If the sum of secured connected lending exposures, to a particular related party, exceeds 5% of the total assets of the insurance entity, the excess asset amount cannot be included within the insurer's solvency calculations. Further, the insurer's Actuary can disallow a higher proportion of connected lending from solvency calculations if the Actuary considers this appropriate, taking into account the capital of and recoverability of the investment.
113. Unsecured lending to directors and employees must also be excluded from solvency calculations and secured lending to such persons can only be included if the Actuary is satisfied about the recoverability of the security.
114. There are no explicit limits placed upon the quantum of connected lending under life insurance actuarial standards. Accordingly, the financial constraints imposed on connected lending by actuarial standards are indirect rather than direct limits on this credit risk.

### **International principles**

115. Under IAIS principles, assets held with connected parties on a non-commercial basis are generally inadmissible or not available for solvency purposes because they may not be readily marketable or may have a value other than that which can be used to fulfil policyholder obligations, or may be unavailable due to encumbrances, special privilege or other third-party interests.
116. The twenty Insurance Guidelines issued by the OECD in 1997 ("OECD Guidelines") state that investment regulation should ensure that both security and profitability requirements are respected and that regulations might include a list of admitted assets on which ceilings may be set.

### **Alternatives and preferred option**

117. The alternatives are set out below and are assessed against the regulatory objective and the other criteria set out in sections 4-6 above.

## **Alternative 1 - status quo, with agreement of Reserve Bank and New Zealand Society of Actuaries (“NZSA”)**

118. This will give the force of law to the requirements within existing (and any new) actuarial standards as outlined above. Under this alternative, the Reserve Bank would not have its own separate requirements for connected party exposures, so the Reserve Bank would need to be satisfied with all aspects of the treatment of connected party exposures within actuarial standards (including the definition of a connected party).

119. Benefits of this approach:

- Using actuaries to make this judgement will be low cost and will lead to more accurate assessment of the capital required to support a connected exposure.

120. Costs:

- Reliance on actuarial judgement leads to the likelihood of inconsistency in treatment across different companies. This risk is especially high with companies whose governance is already weak.

121. This alternative requires a thorough review of actuarial standards in this area and the Reserve Bank approval of any refinements to NZSA standards that are considered necessary.

## **Alternative 2 - tighten requirements within actuarial standards**

122. The potential risks in this area would be reduced if the requirements within existing (and any new) actuarial solvency standards were to be tightened, for example if allowable connected party lending included within solvency calculations is restricted to say 2.5% of assets. This alternative would also have the advantage of being consistent with the principles of existing New Zealand actuarial requirements, but it may create potential commercial implications.

123. Another variation of this alternative is that any connected party exposures (either of a long term or short term nature) must be deducted from assets for the purposes of calculating a licensed insurer’s solvency calculation. This is a very conservative approach to the treatment of connected party exposures.

### **Alternative 3 - direct limits on connected party exposures**

124. This alternative would involve establishing a direct limit on connected party exposures, rather than an indirect mechanism via an insurer's solvency calculations. This approach may be more effective in limiting the absolute risk in this area, but it may also create potential commercial implications.

### **Alternative 4 - nature of connected lending clearly defined and increase disclosure**

125. To limit the potential risks in this area, any connected party exposures could be required to be on commercial terms and fully appropriate for the licensed insurer. Under this alternative, this could be achieved by requiring licensed insurers to ensure that connected party exposures are both: (a) on arm's length terms; and (b) in the interests of the licensed insurer. It is likely that this will be a licensing requirement for insurers.

126. More prominent public disclosure of the nature and extent of licensed insurers' connected party exposures could also be required, including a requirement that public financial statements of licensed insurers must include a statement that any connected party exposures are on arms' length terms and in the interests of the licensed insurer.

### **Preferred alternative**

127. Our preference is that the Reserve Bank will work together with the New Zealand Society of Actuaries to develop (and if necessary refine) and agree appropriate standards for the treatment of connected party exposures for insurers, and that these actuarial standards will be given the force of law under the Insurance Prudential Supervision regime. Connected party exposures must be appropriate for licensed insurers, and must be clearly and appropriately disclosed.

**Questions for submission**

22. Do you agree with the preferred alternative of utilising connected party exposure requirements within New Zealand actuarial standards, where those requirements are developed and agreed with the Reserve Bank?
23. If not, please outline any concerns you may have and/or your preferred approach.

## **Non-Insurance Activities**

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128. Cabinet have agreed (in the December, 2007 Cabinet paper) that the Reserve Bank may place appropriate limits on non-insurance activities (e.g. deposit-taking, non-financial business) of a licensed insurer. The Reserve Bank needs to revert to Cabinet regarding the nature and extent of the constraints recommended.

### **Problem**

129. It would be potentially misleading to policyholders if a licensed insurer was performing significant business activities not connected with insurance under the umbrella of the corporate insurance entity. Significant non-insurance activities could substantially change the nature and the risk profile of the insurance entity that the Reserve Bank is regulating.

130. The failure of an insurer resulting from non-insurance activities could lead to reduced public confidence in both the operation and regulation of the insurance sector.

### **Regulatory Objective**

131. To minimise the possibility of insurer failure resulting from non-insurance activities.

### **Definition of non-insurance activities**

132. It is proposed that the definition of non-insurance activities would be any activity not defined as insurance within the Insurance Prudential Supervision legislation.

### **International principles**

133. The IAIS principles in this area state that insurance companies should not carry on any activities other than in connection with or for the purposes of their insurance business. The operation of business not related to insurance may be allowed as an exception only in limited and defined circumstances. Where appropriate, the supervisory authority can impose additional requirements, conditions

or restrictions on an insurer (usually at initial licensing) and this may include restrictions on non-insurance activities.

134. OECD Guidelines state that the underwriting of insurance risks should be restricted to insurance companies which may transact insurance (and connected) operations only.

### **Alternative approaches**

135. The alternatives are set out below and are assessed against the regulatory objective and the other criteria set out in sections 4-6 above.

#### **Alternative 1 – status quo**

136. This alternative places no restrictions on a licensed insurer undertaking business activities not connected with insurance under the umbrella of the corporate insurance entity. Although this would be a low cost approach, it would not meet the regulatory objective above.

#### **Alternative 2 – non-insurance activities not permitted**

137. A total ban on non-insurance activities by licensed insurers would best meet the regulatory objective above and meet international principles. However this approach may be unnecessarily strict for cases where non-insurance activities are minor in relation to the core insurance activity and unlikely to significantly affect the risk or financial positions of the insurer.
138. To cater for these situations of minor non-insurance activities of an insurer this alternative also includes an appropriate financial limit on non-insurance activities such that gross income from such non-insurance activities may not exceed 2.5% of previous year's gross premium income ("financial limit").
139. The explicit approval by the Reserve Bank of any non-insurance activities will be required. As part of this approval process, the Reserve Bank must be satisfied that the nature of and risks of the non-insurance activities will not compromise the financial strength or integrity of the licensed insurer. There must be an undertaking by the licensed insurer that such non-insurance activities will not increase

beyond the financial limit. The Reserve Bank will require annual attestation that this financial limit has not been exceeded.

### **Alternative 3 – disclosure of non-insurance activities**

140. Under this alternative non-insurance activities would be permitted without limitation but licensed insurers would be required to clearly disclose the extent and nature of non-insurance activities, either publicly and/or privately to the Reserve Bank. This approach would not meet the regulatory objective above or international principles.

### **Preferred alternative**

141. Alternative 2 above is recommended which is that a licensed insurer is not permitted to conduct non-insurance activities except where they are minor and within a financial limit of 2.5% of the insurer's previous year's gross premium income. The Reserve Bank needs to approve any non-insurance activities and be satisfied that the nature of and risks of this business will not compromise the financial strength or integrity of the licensed insurer. The Reserve Bank will require annual attestation that this financial limit has not been exceeded.

### **Questions for submission**

24. Do you agree with the preferred option that, subject to an appropriate exemption limit, licensed insurers should not conduct business activity other than insurance? If not, please outline any concerns you may have and/or your preferred approach.

25. Do you agree that the proposed exemption limit for non-insurance activities of 2.5% of gross premium income is appropriate? If not, please suggest an alternative exemption limit.

## **Amalgamations And Transfers**

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142. To safeguard policyholders' interests it is recommended that the Reserve Bank, as the prudential regulator of the insurance sector, should approve amalgamations, purchases, sales, transfers, or other corporate transactions ("corporate transactions") which change the ownership of a licensed insurer's policyholder liabilities. For example when two insurers merge or when one insurer makes a sale of a portfolio of policyholder liabilities to another insurer.
143. The Reserve Bank would need to be satisfied that the policyholders of the licensed insurer(s) will not be disadvantaged by any corporate transaction. This is likely to include an evaluation of any potential financial impacts upon the policyholders and the financial strength and integrity of the new owner(s).
144. Prior to a corporate transaction occurring, the onus would be on the licensed insurer(s) to demonstrate to the Reserve Bank that the policyholders of the licensed insurer(s) will not be disadvantaged by the corporate transaction. This may entail the insurer(s) obtaining appropriate actuarial advice. This process would carry a compliance cost both for the insurance industry and the Reserve Bank.
145. In order to minimise the compliance cost of this policy, whilst still retaining its efficacy, the Reserve Bank would not be obliged to consider every small corporate transaction, but the Reserve Bank must be notified of all anticipated corporate transactions and have the opportunity to decide whether or not it wishes to consider and approve any such transaction.
146. For this purpose it is proposed that small corporate transactions, which would also encompass any series of linked transactions, be defined as those amounting to less than the greater of NZ\$10 million or 10% of the balance sheet of either party to any intended corporate transaction.

### **Proposal**

147. The Reserve Bank must be notified of, and consider approval of, all amalgamations, purchases, sales, transfers, or other corporate transactions which change the ownership of a licensed insurer's policyholder liabilities. Where the transaction, or a series of linked transactions, amounts to less than the greater of NZ\$10 million or

10% of the total balance sheet size of either party to the intended corporate transaction, the Reserve Bank must be notified, but may decline to consider the transaction.

**Questions for submission**

26. Do you agree with the proposal that the Reserve Bank must approve amalgamations, purchases, sales, transfers and other corporate transactions (“corporate transactions”) performed by a licensed insurer? If not, please outline any concerns you may have and/or your preferred approach.
27. Do you agree that the Reserve Bank should be notified of but not be required to approve small corporate transactions defined as those less than the higher of NZ\$10million or 10% of the total balance sheet size of either party to the intended corporate transaction.

## Confidentiality Of Information

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148. An essential component of the Reserve Bank's regulatory role is the gathering and assessment of information from insurers. Much of the information that the Reserve Bank requests and receives from insurers may be confidential or commercially sensitive.
149. An insurer may be concerned at the possibility that prudential information it has supplied to the Reserve Bank may be subject to discovery by other parties under the Official Information Act ("OIA"). This concern may discourage an insurer from sharing certain information with the Reserve Bank.
150. Disapplying the OIA in these restricted circumstances is likely to encourage a more frank information flow between the Reserve Bank and insurers to the benefit of the supervision regime.
151. The legislation will also list circumstances in which release of information is authorised, and unauthorised release of confidential information will constitute a criminal offence. This is the approach taken in the Reserve Bank of New Zealand Act 1989 (Section 105).
152. The OIA already provides a degree of protection for commercially sensitive information. However, for further comfort in this area an exception will be sought so that information access under the OIA shall not apply to prudential information in respect of licensed insurers. (This is consistent with the Reserve Bank Act).

### Proposal

153. All prudential information provided to the Reserve Bank in respect of a licensed insurer either by the insurer, the insurer's auditor or any other third party, or information obtained by the Reserve Bank through the use of its regulatory powers, and which is not otherwise publicly disclosed as part of disclosure requirements, will be strictly confidential and may not be subject to the provisions of the OIA.
154. Benefits of this approach are:
- Insurers will be more comfortable sharing information with the Reserve Bank. This means the Reserve Bank is better informed and able to supervise, and should be less dependent on formal powers to obtain the same information.

- Insurers can be assured that commercially confidential information will be protected.

Costs are:

- By disapplying the OIA, information will not be required to be released even when it is in the public interest that it be released.

**Question for submission**

28. Do you agree that the lack of a comprehensive confidentiality provision in respect of insurance prudential information is likely to limit the amount of information supplied by insurers or their appointed representatives to the Reserve Bank?
29. Do you agree with the proposal that prudential information about licensed insurers which is not publicly disclosed, as part of disclosure requirements, should be confidential and not subject to the provisions of the Official Information Act?

## **Additional Considerations**

155. In considering the issues on which we are seeking input, set out within this consultation paper, your opinions are invited on the following matters, where they have not been raised by other specific questions within the consultation paper:

### **Questions for submission**

30. Have the problem(s) been defined correctly? Are there any other related problem(s)?

31. Have all of the feasible alternatives (and sub-alternatives) been correctly identified? Do you consider that there are other alternatives (and/or sub-alternatives) that should be considered? If so, please identify the benefits and potential risks of each of these additional alternatives. Where a preferred alternative is put forward, do the benefits justify the costs?

32. What are the nature (e.g. taxation implications) and quantum of the costs (both transitional and ongoing operational) relating to each of these new alternatives? In particular, if you believe that the potential cost of the preferred alternative, or any other alternative, will be passed on to policyholders, please comment on the extent, likelihood and process by which this transfer will occur.

## How To Respond To This Consultation Paper

If you wish to respond to any of the above questions, please send your response to the Reserve Bank, if possible by **6 June, 2008** and by no later than **20 June, 2008** using the following contact details:

by email to: David Williams, using the following address:

[david.williams@rbnz.govt.nz](mailto:david.williams@rbnz.govt.nz)

by post to: David Williams, using the following address:

David Williams  
Senior Adviser  
Prudential Supervision Department  
Reserve Bank of New Zealand  
P.O. Box 2498  
Wellington 6140  
New Zealand

If you have any queries prior to making your submission, you can contact David Williams (on 04 471 3748) or Richard Dean (on 04 471 3711) to discuss any aspect of this discussion document.

Note that the contents of submissions provided to the Bank in response to this discussion document will be subject to the Official Information Act 1982 and the Privacy Act 1993. The Bank proposes to make the submissions available on request. Confidential submissions should be clearly marked "confidential" and should be accompanied by a non-confidential copy with reasons given for the deletions.