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# Bringing financial stability legislation to the insurance industry – the Insurance (Prudential Supervision) Act 2010

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Insurers face a number of significant areas of risk in the operation of an insurance business. As well as pure insurance risk, there are credit risk, investment (or market) risk, liquidity risk and operational risks to consider. Financial weakness or failure of an insurer can have significant impacts on large numbers of policyholders of all descriptions. In order to properly protect policyholder interest, it is therefore clear that the financial strength of the insurance industry should be subject to appropriate prudential regulation.

Until the enactment of the Insurance (Prudential Supervision) Act 2010 (the Act) in September, there had been no previous comprehensive prudential regulatory regime covering the activities of insurers carrying on insurance business in New Zealand.<sup>1</sup> Now the industry is subject to a world-class regulatory model administered by the Reserve Bank.

This article explores the reasons behind the introduction of the new legislation, its objectives and the Reserve Bank's intended approach in achieving these.

## 1 Introduction

Insurance is an important (but not systemic) component of the financial services sector in New Zealand. The protection provided by insurance is a significant element in the financial security of individuals and companies in New Zealand, as is the case worldwide, and the lack of insurance through the failure of an insurer could have significant impact on those who are directly or indirectly affected. Whilst the failure of an individual insurer may not have the same systemic importance in New Zealand as the failure of one of New Zealand's major banks, independent failures within the insurance industry would certainly have a degree of impact on the economy's security. Accordingly, it is important that the New Zealand insurance industry is financially stable and soundly regulated, and, equally importantly, is seen to be so by external observers.

For many years, the New Zealand insurance industry has carried something of a "wild west" reputation, at least as viewed from overseas. The country had one of the least regulated insurance markets in the world and, despite a reasonably effective self-regulatory approach taken by insurers, New Zealand remained firmly out of line

with established international expectations of insurance regulation.<sup>2</sup> All our relevant trading partners have well-established and strong regulatory models covering the activities of insurers; for example the Australian Prudential Regulation Authority (APRA) regulates insurance in Australia, the Financial Services Authority (FSA) in the UK, the Office of the Superintendent of Financial Institutions (OSFI) in Canada, the Monetary Authority of Singapore (MAS) in Singapore, and there are many state regulatory models in place across the US.

Government acknowledged this regulatory shortfall early in the decade and, in 2003 and 2004, the New Zealand Law Commission produced reports on life insurance, including recommendations regarding an overhaul of existing outdated legislation and the establishment of a prudential regulator for the New Zealand insurance sector; ie, a watchdog over the financial stability of insurers carrying on insurance business in New Zealand.

Following this report, and as part of its ongoing "Review of Regulatory Frameworks", the government announced a review of the Regulation of Non-Bank Financial Products and Providers (RFPP) in 2005, with the intention of ultimately

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<sup>1</sup> For details see the Insurance (Prudential Supervision) Act 2010 and related documents provided in Finance and Expenditure Committee 2009.

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<sup>2</sup> See Jessup (1990) and Jessup (1998) for earlier descriptions of insurance supervision and life insurance law in New Zealand.

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developing an effective and consistent regulatory framework and promoting confidence and participation in sound and efficient financial markets. This review included the insurance sector. Arising from the RFPP was the government decision to appoint the Reserve Bank as the prudential regulator and supervisor for insurers.

## 2 Designing a new regulatory regime

A strong Reserve Bank understanding of the New Zealand insurance industry was a critical factor in the successful design of an effective and appropriate regulatory model for insurers carrying on insurance business in New Zealand. New Zealand's population of just over 4 million people is served by a diverse insurance industry that currently comprises approximately 160 registered entities that have paid their statutory deposits as required by the Insurance Companies Deposits Act 1953.<sup>3</sup>

Insurers are split approximately 75 percent non-life (including medical insurers) and 25 percent life insurers. There are a large number of small companies and a smaller number of large companies – at least large by New Zealand standards. (By worldwide standards all insurers operating in New Zealand are small, and the total New Zealand insurance market is tiny when viewed in a worldwide context). There are a large number of companies that are sourced offshore, some of which exist in New Zealand as locally incorporated subsidiaries and some as branches of overseas insurers. There are also a number of indigenous insurers. There are reinsurers and captive insurers. In summary, the market is small, comparatively well developed, diverse – and (until now) virtually unregulated from a prudential perspective.

The creation of a new regulatory model, to apply to an industry that has never been subject to such regulation, is not a task that is achieved in a vacuum. The Reserve Bank undertook an extensive review of existing legislation (see section 3 below), relevant precedent regulatory models from

overseas, and the model Insurance Core Principles published by the International Association of Insurance Supervisors (IAIS). The Bank had significant regard to these references which continued to serve as a guide throughout the period of preparation of the legislation. In addition, there was proactive and extensive consultation with stakeholders from within the industry as well as related support professions.

The requirement was to design a regulatory model that:

- would promote the maintenance of a sound and efficient insurance sector and promote confidence in the sector;
- would achieve this, where possible, in a light-handed manner;
- would bring New Zealand into general alignment with established international standards of insurance regulation;
- would recognise the realities and idiosyncrasies of the New Zealand market and maintain the general balance of the market, including maintaining the interest of overseas support; and
- would not unduly restrict the industry from carrying on its business.

## 3 Existing legislation

Existing legislation that impacts the insurance sector, and is being repealed wholly or in part and replaced by the new Act, is as follows:

- the Life Insurance Act 1908
  - which provides for rudimentary reporting requirements only;
- the Mutual Insurance Act 1955
  - which is no longer applicable in New Zealand;
- the Insurance Companies Deposits Act 1953
  - which requires insurers to maintain a statutory deposit of up to \$500,000 NZ with the Public Trustee; and
- The Insurance Companies (Ratings and Inspections Act) 1994

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<sup>3</sup> See Ministry of Economic Development (2008) for a list of insurers with a deposit listed at the Public Trust.

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- which requires property and/or natural disaster insurers to obtain and publicise a financial strength rating from a rating agency

## 4 History of insurer failure in New Zealand

There have been only a small number of insurer failures in New Zealand, all of comparatively minor industry and public impact, including:

- Maoriland Life (liquidated 1952);
- Standard Insurance Company (1961);
- Guarantee Mutual Life (wound up 1980);
- Superannuation Mutual and Tasman Mutual (liquidated 1989);
- Capital Life (1989); and
- ACL Life Insurance (placed under judicial management 1989).

However, the historical infrequency of failure is, of itself, no guarantee against future failures. The intentions of the new legislation are:

- firstly, to ensure that companies are in a position of financial strength that renders failure unlikely (without going as far as to provide a guarantee against failure); and
- secondly (but also importantly) to facilitate the orderly resolution of distress management situations that may arise, whether by way of directed recovery or by facilitation of an orderly market exit of the distressed insurer.

It is expected that the great majority of supervisory effort will be applied in a 'business as usual' focus on the first intention, with distress management activity being required only infrequently.

## 5 The development of the legislation, and support along the way

A draft Insurance (Prudential Supervision) Bill was released to stakeholders for consultation in mid-2009. The finalised Bill was given its first reading in Parliament in December 2009. During its six-month period at Finance and Expenditure Committee, the Bill was released for public comment, generating 61 submissions in response. Following its second reading in July 2010, and committee stages and third reading in August, it received the Royal Assent on 7 September 2010 and became the Insurance (Prudential Supervision) Act 2010.

The Bill received unanimous cross-party support at all stages of its progress through Parliament. In addition, the insurance industry has been generally supportive through the development phase of the legislation. Broader stakeholder engagement has also been strong and a range of constructive inputs has significantly informed the final form of the legislation.

## 6 The key features of the legislation

The Act focuses only on prudential regulation – it is not focused on market conduct issues. Regulation of market conduct matters is the subject of other legislation, currently administered mainly by the Ministry of Economic Development and Securities Commission, although much of this responsibility is expected to pass to the (about to be established) Financial Markets Authority.

### a. The Reserve Bank's functions under the Act are to:

- issue licences to qualifying insurers;
- undertake prudential supervision of licensed insurers;
- take appropriate action in relation to insurers that have failed, are failing or are likely to fail to comply with the requirements of the Act; and
- carry out other functions as required by the Act and regulations.

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## **b. Licensing, and scope of the Act:**

The Act requires that all persons carrying on insurance business in New Zealand must be licensed, and it is an offence for an unlicensed person to carry on insurance business in New Zealand, or to hold itself out as a licensed insurer. The definition of “carrying on business in New Zealand” is subject to certain exclusions, including Crown or public entities and incorporated societies that provide insurance only as an incidental service within a broader primary purpose, and the Act enables the Reserve Bank to declare certain persons not to be carrying on insurance business in certain defined circumstances.

The definition of “carrying on insurance in New Zealand” under the Act is tied to the definition of “contract of insurance”. In turn, the definition of “contract of insurance” is subject to a number of exclusions, to minimise the unintended capture of concepts that are not, in substance, insurance for the purposes of the Act. Examples of this include derivative transactions, financial guarantees, product or service warranties, and Kiwisaver benefits.

The Act does not license insurers that do not carry on insurance business in New Zealand. Therefore, overseas or New Zealand insurers that do not offer insurance in New Zealand are not eligible for licensing under the Act. However, the Act does not prevent New Zealand-based residents and businesses from seeking insurance outside New Zealand, nor does it prevent licensed New Zealand insurers that carry on business in New Zealand from offering insurance in other countries. Table 1 shows the requirements an insurer must comply with to be entitled to a licence.

## **c. Prudential regulation of insurers includes:**

### **\* *Solvency standards (separate standards for life insurers, non-life insurers and captive insurers)***

Key components in assessing the financial stability of an insurer are solvency, capital adequacy and liquidity. Solvency is a measure of whether an insurer has adequate assets to cover its liabilities. Capital adequacy is a measure of whether or not an insurer has adequate capital backing to support the assessed risks to which the insurer is exposed. These risks include insurance risks as well as investment risk, operational

risk, credit risk, liquidity risk and other risks that may be specific to the insurer. Liquidity is a measure of the insurer’s ability to meet its current day-to-day financial obligations. For an insurer, this usually means having enough cash readily available to pay current and near-term claims.

The nature of solvency, capital adequacy and liquidity considerations varies between different categories of insurers. The fact that life insurance liabilities tend to be longer term than those of non-life insurance gives rise to different capital and liquidity requirements. For example, claims on life insurance are less frequent and tend to occur much further out into the future than domestic contents or motor-vehicle claims which tend to occur at greater frequency and over a shorter timeframe. In addition, captive insurers, as defined by the Act, which are insurers that are wholly owned by a non-insurer parent company and that insure only the risks of the non-insurer parent, present different capital and liquidity considerations due to the internal financial structure within the parent company.

The Act allows for the development of as many standards as may be required to cover the full range of insurer categories in an appropriate manner. There are separate standards currently in preparation for life insurance, non-life insurance and captive non-life insurance. Others may be prepared as they become necessary.

Insurers are required to disclose their solvency position in their annual financial statements and on their website (if applicable). In addition, insurers must constantly monitor their solvency position and report to the Reserve Bank on any current or future likelihood of breaching required solvency standards.

### **\* *Financial strength ratings requirement***

Financial strength ratings of insurers are provided by specialist independent rating agencies, and assess the ability of insurers to pay the claims for which they are liable. Ratings have been a legislated requirement in New Zealand on the majority of non-life insurers since 1994 under the Insurance Companies (Ratings and Inspections) Act 1994. The new Act extends the rating requirement to all insurers, with only very limited exceptions (e.g., captive insurers). Financial strength ratings,

Table 1

Reserve Bank requirements for an insurer to be entitled to a licence

Licensing requirements for each insurer	Rationale
Must hold a financial strength rating from an approved rating agency	Ratings are a useful independent opinion of the financial strength of an insurer which can assist policyholders and prospective policy holders to assess the risks associated with particular insurers
Has the ability to carry on its business in a prudent manner	Includes considerations of appropriate resources and internal controls, nature of insurance products offered, reinsurance arrangements, non-insurance activities and related party transactions
Has the ability to comply with requirements on solvency standards, financial strength ratings, risk management, appointed actuary, financial reporting and statutory funds	
Has the ability to comply with any proposed conditions of licence	Given the diversity of the New Zealand market it is likely that many licences will be issued subject to conditions relating to matters specific to the insurer concerned
Holds and can maintain the required capital specified in the solvency standards	Adequate capital is the key component in assessing the financial stability of an insurer
Has and operates an appropriate fit and proper policy	Fitness and propriety of directors and officers are key determinants in assessing the governance, management and leadership of an insurer
Has and operates an appropriate risk management programme	Risks to the financial health of the insurer must be adequately identified and provided for
Has ownership and governance structures and financial strength appropriate to the size and nature of its business	The insurer must be adequately resourced, have sufficient ownership strength and be appropriately governed for the business it intends to carry on
If the insurer is an overseas insurer, has home-country legal environment and insurance regulatory requirements that meet Reserve Bank required standards	Certain recognition may be considered for home-country regulation of insurers from approved jurisdictions with appropriate regulatory standards
Is registered under the Financial Service Providers (Registration and Dispute Resolution) Act 2008	Alignment to other insurance-relevant legislation
Can comply with the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 if that Act is applicable to the insurer	An insurer must be able to ensure that its activities do not unwittingly assist criminal or terrorist purposes
Can comply with any other prescribed requirement	

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which must be renewed annually, provide policyholders with an independent specialist opinion on the financial strength of an insurer, and also a useful cross-check on the Reserve Bank's view of the financial stability of insurers.

Insurers are required to disclose their ratings to the public in a prescribed manner. Rating agencies must be approved by the Reserve Bank, and an insurer may only disclose a rating provided by an approved rating agency.

\* ***Risk management requirements***

Another key component in the assessment of the current and likely future financial stability of an insurer is its ability to properly identify, and then effectively manage, the risks to which it is exposed. Risk in the insurance context extends well beyond the common perception of insurance risk; i.e. the risks for which the insurer offers insurance. Areas for consideration under this heading also include credit risk, investment (or market) risk, liquidity risk and operational risk. The Reserve Bank requires an insurer to demonstrate the extent of its risk awareness as well as its documented approach to the management of such risks.

The nature of risk can vary widely between categories of insurer as well as individual insurers within each category. Therefore, there is no fixed template model for risk assessment that can apply generally to all insurers. The risk approach of each insurer will be assessed individually by the Reserve Bank.

\* ***Appointed actuary requirement, including the financial condition report***

The assessment of insurance liabilities, in addition to many other insurance-specific concepts and calculations, is the specialist territory of an actuary. The Act requires that all insurers (with very limited exceptions) must have an appointed actuary as one of their relevant officers, and the responsibilities of the appointed actuary are clearly stated in the legislation.

The involvement of an actuary in specialist areas is important in increasing public and regulatory confidence in the methodology and consistency supporting, and the accuracy

of, insurers' self-reported financial data. As the majority of insurers already contract the services of an actuary – either internally employed or an external consultant – this legislated requirement will not mean a major change for them.

\* ***Financial reporting requirements***

To date, public disclosure of an insurer's financial position has been limited to financial reporting required under the Financial Reporting Act 1993 or similar legislation. In addition to current annual public reporting, the Act requires insurers to provide regulatory reporting to the Reserve Bank every six months. The annual reporting requirement is more detailed than the six-monthly reporting.

By reviewing formal reporting on a six-monthly basis, as well as requiring the insurer to constantly monitor its solvency position and report to the Reserve Bank on any likely breach, the Reserve Bank will maintain a close and effective watch over the financial position of each insurer and thereby the industry as a whole.

As with all prudential data reported by insurers to the Reserve Bank, the regulatory material provided in these reports will remain confidential between the insurer and the Bank.

\* ***Statutory fund requirement for life insurers***

Life insurance liabilities tend to be long-term in nature, and therefore the assets that cover those liabilities must be preserved to ensure adequate coverage of the liabilities right through to their settlement. However, day-to-day operational requirements of a life insurer may be much shorter-term in nature, and there is therefore the necessity to protect long-term liabilities from being undermined by supporting assets being stripped out to cover short-term requirements.

The Act requires life insurers to establish a statutory fund vehicle within their accounts. This is a means of ring-fencing all assets and liabilities relating to the life insurance business to ensure that they are only available for use in respect of the life insurance business. All life insurance revenues and appropriate asset coverage must be credited to the fund (or funds) and all liabilities must be paid from the fund. The

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fund may not contain anything that does not relate to the life insurance business of the insurer.

A number of life insurers already operate a 'life fund' model, so the requirement under the Act for the establishment of at least one statutory fund will not mean a significant operational change. However, the legal status of the statutory fund under the legislation is enhanced and, therefore, the protection of life policyholder funds will be significantly increased.

**d. Prudential supervision provisions include:**

**\* *Information gathering***

The Act includes broad information-gathering powers empowering the Reserve Bank to seek and obtain information from insurers, associated persons and other persons in respect of any matters relating to the business, operation or management of the insurer. Such information must be used for the purposes of prudential supervision. This information-gathering power applies to all insurers at all times, not limited to situations of actual or suspected insurer distress. The Reserve Bank may require that information provided to it be independently reviewed for verification.

This power enables the Reserve Bank to remain fully aware of an insurer's position at all times, without having to wait until six-monthly formal reporting dates specified elsewhere.

**\* *Investigations***

If the Reserve Bank has cause to suspect that an insurer is failing to maintain solvency requirements, or is not conducting its business in a prudent manner, or is operating fraudulently or recklessly, or has failed to supply information or supplied false information (this also applies to associated persons of the insurer), or an insurer is failing to comply with any direction of the Reserve Bank, the insurer may be required to supply information either direct to the Reserve Bank or to an investigator appointed by the Reserve Bank to obtain such information.

There are significant penalties for failure to comply with the requirements under the information gathering and investigation provisions.

**e. Distress management provisions include:**

**\* *Recovery plans***

If an insurer is failing to maintain solvency requirements, or fails to comply with any direction of the Reserve Bank, or its business is not being conducted in a prudent manner, the Act empowers the Reserve Bank to direct an insurer to prepare a recovery plan that must be satisfactory to the Reserve Bank. The recovery plan must set out actions and a timetable toward the achievement of a compliant position and the maintenance of that position.

**\* *Giving of directions to licensed insurers***

The Act gives the Reserve Bank broad direction-making powers to require an insurer to carry out, or refrain from carrying out, certain actions in the event of certain failures, transgressions or situations of breach. Directions are wide ranging, from requiring the insurer to consult with the Reserve Bank on certain issues right through to requiring the insurer to cease to carry out its business or a part thereof. The Reserve Bank may also issue directions to associated persons of an insurer in certain circumstances.

There are significant penalties for failure to comply with the requirements relating to recovery plans and directions.

**\* *Removal, replacement or appointment of key officers***

In circumstances similar to those that give rise to the requirement for recovery plans or the giving of directions, the Act empowers the Reserve Bank to remove, replace, or appoint directors, the auditor or the appointed actuary of the insurer.

**\* *Reserve Bank may apply for the liquidation or voluntary administration of licensed insurers***

In cases of severe insurer distress, the Act empowers the Reserve Bank to seek the liquidation or voluntary administration of an insurer. The Reserve Bank retains a wide range of rights to participate and be represented at proceedings during the period of liquidation or voluntary administration.

- **Reserve Bank may request the appointment of a statutory manager to a licensed insurer**

In the most severe cases of insurer distress or non-compliance, and where such issues may cause significant damage to the financial system or the economy of New Zealand, or where the insurer is acting fraudulently or recklessly, the Reserve Bank may recommend that the Minister of Finance request the Governor General to place an insurer or an associated person of the insurer into statutory management, and appoint a person as statutory manager of the insurer. The Reserve Bank powers in this respect are broadly similar to those in the Reserve Bank Act 1989 and the Corporations (Investment and Management) Act 1989.

## 7 Implementation programme

The Act was passed into law on 7 September 2010. Certain provisions commenced immediately upon enactment and a number of operational provisions will commence on 1 February 2011. Provisions relating to licensing requirements and the repeal or amendment of existing legislation become effective on 7 March 2012; ie, 18 months following enactment.

All insurers are now required to move through the licensing process. Full compliance with all requirements of the Act will not be possible for any insurer immediately upon enactment and, therefore, there will be a transitional path to compliance available to insurers that will last for a maximum of three years from the date of enactment. Upon application and evidence of satisfactory compliance with initial requirements, insurers will be issued with a provisional licence that will contain conditions detailing their required path to full compliance with the requirements of the Act.

All insurers must have a licence by 7 March 2012, whether this is a provisional or a full licence. All insurers must be fully compliant with the requirements of the Act, and therefore be fully licensed, by 7 September 2013. Any insurer that does not meet either of these licensing requirements by the required dates will be in breach of the Act and will be required to cease carrying on insurance business in New Zealand.

## 8 Format of the legislation

Formal documentation relating to this legislation will comprise:

- the Act (the primary legislation);
- regulations attaching to the Act, which have the force of law. Solvency Standards and Fit and Proper Standards (and possibly others in the future) will be deemed regulations attaching to the Act; and
- guidance notes. These do not have the force of law, but are intended to explain the Reserve Bank's expectations behind the various legislative requirements as well as how to complete documentation relating to the administration of the Act.

The required regulations and guidance notes are currently under preparation.

## 9 Reserve Bank intentions and expectations

The delivery of brand new legislation into a previously unregulated sector is inevitably a complex task. Delivery of the Insurance (Prudential Supervision) Act 2010 is no exception.

The Reserve Bank has clear objectives in the delivery and implementation of the Act. In addition to the stated purpose of the legislation, which is to "promote the maintenance of a sound and efficient insurance sector and promote public confidence in the sector", the Reserve Bank expects the following outcomes from this legislation:

- an ongoing principles-based and outcome-focused approach to regulation;
- an efficient style of prudential supervision that does not unnecessarily disrupt industry;
- an efficient transitional path toward full licensing for the industry;
- a general raising of industry standards, especially in the areas of risk management and corporate financial understanding;
- clear recognition of the obligations upon directors and

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- senior officers and the importance of their contributions to corporate outcomes;
- a generally raised public perception of the New Zealand insurance industry, both within New Zealand and overseas; and
  - better information about the financial strength of insurers available to policyholders.

## References

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