RESERVE BANK OF NEW ZEALAND
TE PŪTEA MATUA

Non-technical summary

Insurance (Prudential Supervision) Act 2010 (IPSA) Options paper 1

What is the Insurance (Prudential Supervision) Act 2010 (IPSA)? Why do insurance companies need prudential supervision and regulation?

Prudential regulation of insurance companies is necessary because insurance business involves taking on risks that could materialise in the future. People that buy insurance ('policyholders') rely on insurers to offer them protection from the financial consequences of these risks (for example, the risk of an earthquake, fire damaging their home, or getting into a car crash).

Insurers collect premiums from their policyholders in advance, paying out later if policyholders need to make a claim on their policy:

- Policyholders want to be sure that they have picked a sound insurance company which will have sufficient funds to meet any claims they need to make but this can be difficult to assess.
- Meanwhile insurance companies have to make difficult judgements about how much they need to charge for policies and how many resources they need to hold in order to meet the claims policyholders will make in the future. What is the probability that a policyholder will need to be paid out and how much will the insurance company have to pay them?

Insurers use data and statistics based on past experience to give them some guidance as to the likely size of future claims but there will always be some uncertainty

While insurers' long-term incentives are broadly aligned with those of policyholders (making sure that they have enough money to pay out on any claims made), in the short-term underestimating how much they will need to pay out can make them look particularly profitable. On the other hand, being too careful about potential losses can increase the cost of insurance cover for policyholders.

Prudential regulation of insurers aims to ensure that insurance companies understand and manage their risks well so that the public can have confidence in the insurance sector and the sector can remain sound and efficient. Regulation increases the amount and quality of public information that insurers provide, making it easier for policyholders and investors to judge whether insurers have sufficient funds to meet claims. It includes rules to ensure that insurance companies appoint properly qualified people to senior positions and have appropriate procedures for managing their business.

It also sets out minimum requirements for how insurance companies gather information, analyse it to estimate how much they will need to pay out, and decide how many resources they need to hold to meet future claims, even in adverse circumstances.

Why is New Zealand's legislation being reviewed?

It is important that the Reserve Bank's insurance regulations are up to date. The current legislation was introduced in 2010. Over the 10 years since it was introduced, the Reserve Bank has gained considerable experience of how the current regulation operates. Some external reports have also looked at how the legislation is working (including an International Monetary Fund assessment of New Zealand's insurance rules in 2016 and a report into the failure of CBL insurance), and their findings will feed into our decision-making.

This consultation and the IPSA review process

This paper is the first of a series of 5 consultations which will cover different aspects of New Zealand's insurance regulation as part of the overall review process. These consultations will take place from 2020-2022, with policy decisions and new legislation expected in 2023-2024.

Issues for consultation

This paper explores the scope of the current legislation, asking questions about which businesses should be required to obey which rules.

Definitions and scope

Under the current rules, every person who carries on insurance business in New Zealand must have a licence and be subject to the rules. The first part of the paper asks whether the way the rules define 'contracts of insurance' and what it means to do business in New Zealand are appropriate to ensure that the rules cover all the businesses that should be covered.

Branches of overseas insurers

Some insurers who 'do business in New Zealand' are branches of companies based overseas. These businesses will often already be regulated in their home countries. If this regulation is at least as satisfactory as New Zealand's, they are exempt from some of the New Zealand rules. Exemptions from the rules aim to encourage overseas insurers to do business in New Zealand in order to boost consumer choice, but without creating extra risk for New Zealand policyholders. This section asks whether the current rules get this balance right or whether they should be tightened (by asking some overseas branches to hold assets in New Zealand or to set up a New Zealand-based company, subject to IPSA's rules).

Overseas reinsurance

Insurers operating in New Zealand often pass on some of their exposure to policyholders by purchasing their own insurance, which will pay out to the insurance company when its policyholders make claims. This is called 'reinsurance'. It enables insurers to issue more policies than their own financial resources would allow and can help to spread risk across different countries. For example, around 75% of the claims for the Canterbury earthquakes were paid for by reinsurance.

This section of the consultation asks whether reinsurance should be treated differently from other overseas insurance when considering how many of IPSA's rules should apply.

Relationships between companies

Insurance companies are often part of a corporate group – a collection of related companies that do business together. Organising a business as a group of companies can make it more efficient. However, the relationships between the different companies can also make running the business more complicated in ways that might create risk. This part of the paper asks whether the legislation needs to give the Reserve Bank more powers to supervise corporate groups to ensure that our supervisors are aware of any risks that spring from group structures.

Outsourcing

Insurance companies sometimes pay other business partners to do some of their work for them (for example, paying another company to underwrite new customers). This can reduce costs but may increase the risk of problems if insurance companies aren't fully able to control how their partners operate. It could also create problems if their partners decided they couldn't or didn't want to continue carrying out these tasks. This section asks whether there should be specific requirements for how insurance companies manage their outsourcing relationships, perhaps including rules about contingency plans if their business partners can no longer fulfill their contracts.

What do you think?

If you would like to contribute to the discussion, we'd like to hear from you.

Please send us your thoughts by 5pm, Thursday 18 February 2021 to ipsareview@rbnz.govt.nz

(This non-technical summary has been prepared to supplement the more formal consultation document. Please note that, where there is any ambiguity, the text of the formal consultation prevails over this summary.)