30 June 2017

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Dear Richard,

FMG submission on the IPSA review Issues Paper

FMG welcomes the opportunity to provide feedback on the IPSA review and provide specific responses to the questions raised below. In addition FMG also supports in principle the ICNZ submission which we have been party to noting that FMG has some specific concerns raised in our submission below that are not addressed in the ICNZ submission.

Question 1: Do you have any comments to make on the discussion in Part 1 of the issues paper?

We support the review of IPSA given it has been 5 years since its inception and a lot has changed during this period including major earthquakes, Insurer failure and new players entering the market.

With regard to the scope of the review we recommend the review also consider the appropriateness of the "Regulatory Purposes" which are currently a sound and efficient insurance sector and to promote public confidence in the insurance sector. When compared to other regulators we see a major gap in that New Zealand Policyholder Protection is not included. Including this as one of the purposes we believe would help to inform and improve certain provisions within the regulations. We also believe this would provide consistency with other international regulator which is important as these regulators specifically protect their home jurisdiction policyholders and therefore by default exclude New Zealand policyholders.

Small insurers are given exemptions due to size, but it is this lack of size that means they often struggle to have the right resources to effectively manage business and capital risk. It is however true that failure of these insurers in unlikely to materially impact the financial soundness of the sector, although public confidence could be impacted. Were several small insurers to suffer financial distress after a significant event it could cause a decline in public confidence. A case is point being the governments' response to the failure of AMI following the February 2011 earthquake where it was deemed necessary to create Southern Response to maintain public confidence, also the commercial losses underwritten by

Western Pacific still awaiting finalisation with no expectation of full settlement through the liquidation process.

Large insurers are predominantly owned offshore and often get exemptions due to oversight by an overseas based regulator. This over site does not necessarily focus on the security of the NZ business as a stand alone entity and could lead to a lower level of protection for NZ policy holders than would be the case for a NZ regulated entity.

The introduction of IPSA does not seem to have inhibited competitive activity in the insurance sector, with several new entrants over the period as well as exits through merger activities.

A gap we see in IPSA particularly given the purpose of a sound and efficient insurance sector and public confidence is the level of insurance being placed offshore and therefore without oversight and regulation, putting the industry and individual policyholders at risk. With brokers being able to place business offshore and the internet playing a greater role in distribution of insurance products there needs to be oversight to ensure there is a level playing field and the image and reputation of the industry is maintained. This is particularly important for domestic and small to medium business policyholders who are generally less informed than larger corporates about their insurance needs and the insurers they deal with. A general expectation of the public would be that the industry in total is regulated and not only a portion of it. This issue should form part of the IPSA review.

Question 2: Do you consider that the Review should assess the current scope of the IPSA in terms of the nature of insurance contracts or entities that are subject to the legislation?

Surely in order to have over site of the sector the RBNZ needs to at least know who is active in the sector. Some level of registration and base reporting, if not licensing and legislation should be made available under the Act. This would allow RBNZ to monitor activities and understand when it might be appropriate for a higher level of regulation to apply.

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

We are aware of issues where the RBNZ reporting requirements are ignoring the materiality provisions included in the regulation and therefore placing undue compliance costs for some insurers to meet reporting requirements at a level of detail that is not correspondent with the benefit.

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

As outlined in question 1 above the offshoring of business should be within scope under IPSA. Inclusion and oversight by the RBNZ would help ensure a level playing field, policyholder protection, and ultimately a sound and efficient insurance sector.

Question 5: Do you agree that overseas insurers provide valuable support to the NZ insurance market?

Overseas companies participate heavily in the NZ insurance market providing significant capital to the sector and thus supporting the wider NZ economy. It is uncertain if without their participation there would be sufficient NZ capital to fill this gap. Overseas participants have a diversification of geographic risk which can provide capital efficiencies to the benefit of the NZ policyholders.

We do however have concerns where overseas insurers (irrespective of their legal structure) are given exemptions from meeting IPSA regulations particularly solvency capital, as this may not in the best interests of the industry and policyholders. Exemptions to overseas insurers may be appropriate in some instance however where this creates and uneven playing field eg solvency requirements and therefore cost of capital/reinsurance costs or put NZ policyholder protection at risk or reduces the governance of NZ operations this would seem inappropriate and therefore should be included in the scope of the review.

Question 6 Do you consider that the Review should reassess the application of the legislation to insurers operating as branches?

FMG has previously raised concerns with the RBNZ with regards the application of the legislation to overseas insurers operating as branches in New Zealand. We believe that the current application of the legislation gives rise to a lower level of policyholder protection for individuals insured by these entities. FMG is not opposed to branch operations per se but rather that any legal structure should be subject to the certain regulations as other entities particularly when it concerns capital, NZ held assets, reinsurance, corporate governance and materiality.

However we further believe this review needs to be extended to all overseas entities given exemption from the New Zealand legislative framework on the basis that they are regulated by an overseas body.

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

Inadequate protection of policyholder interests in New Zealand through branch structures

1. In principle, we have no objection to the notion of foreign insurers operating in New Zealand through branches. This is a common feature of many countries' insurance markets and assists in promoting a more contestable, competitive and dynamic insurance sector. However, we do have some concerns in relation to the way current regulatory and supervisory policy applies to branches in New Zealand. One of these concerns relates to the lack of New Zealand policyholder protection that can arise from branch operations.

2. Under the IPSA, there is nothing to prevent an insurer from operating in New Zealand as a branch of a foreign insurer, provided that it obtains a license from the RBNZ to do so.

Section 19 of the Act empowers the RBNZ to license a foreign insurer to operate in New Zealand via a branch, subject to the RBNZ being satisfied on a number of matters. These include:

- whether the law and regulatory requirements in an applicant's home jurisdiction are, in terms of achieving the purposes of the Act, at least as satisfactory as the law and regulatory requirements of New Zealand that relate to those matters and apply to insurers incorporated in New Zealand, including in respect of the following matters:
    - the licensing, registration, or authorisation of insurers;
    - the supervision of insurers;
    - solvency and capital standards that apply to insurers;
    - financial reporting, accounting, and auditing standards;
    - corporate governance standards;
    - matters concerning insurers that are insolvent or otherwise in serious financial difficulties; and
    - the disqualification of persons to be or to act as directors or relevant officers of an insurer;
- whether the prudential supervision applicable to an applicant in its home jurisdiction is, in terms of achieving the purposes of this Act, at least as satisfactory as the nature and extent of prudential supervision that applies to insurers incorporated in New Zealand; and
- the existence of policyholder preference, where applicable.

3. There is no provision in the Act that requires a foreign insurer operating in New Zealand via a branch to maintain sufficient assets in New Zealand to cover policyholder liabilities in New Zealand. This raises a question as to whether policyholders in New Zealand are receiving adequate protection particularly in the case of insurance failure. This is especially the case where the insurer is domiciled in a jurisdiction which has policyholder or some other form of creditor preference which protects the home domiciled policyholders /creditors over NZ policyholders.

   It is also an issue in the case of insurers which are based in jurisdictions without policyholder preference, given the propensity, in an insurance failure situation, for the home supervisor to ring-fence assets in the home jurisdiction for the benefit of policyholders or other creditors in that jurisdiction. In the absence of a countervailing requirement for assets to be held in New Zealand sufficient to at least cover policy liabilities in New Zealand, policyholders could be seriously disadvantaged as a result of a branch structure.

4. A further consideration in this regard is reinsurance. Reinsurance proceeds may not necessarily be paid to the New Zealand branch in respect of claims made on the branch, given that reinsurance contracts are with the parent entity and do not make distinctions as to the geographic location of the claim. This could further weaken the position of New Zealand based policyholders in a failure situation.

5. There is no requirement under the Act for a Branch to disclose its solvency position as determined by the Solvency Standard applicable in New Zealand. In particular the Catastrophe Capital Charge in the Non-Life Solvency Standard charge is designed specifically for NZ conditions and has a much higher threshold of application (1:1000 years) than the standards applied by overseas regulators. It is unclear to us that the level

of protection offered to policyholders by the overseas solvency standard is “at least as satisfactory as the law and regulatory requirements of New Zealand” in this regard.

Question 9: in the context of overseas insurers, do you consider a statutory fund framework may help to protect the interests of NZ policyholders?

As a general insurer FMG does not currently operate a statutory fund. However the statutory fund regulation under IPSA has a number of attractive features when considering policyholder protection:

- they corral a group of assets specifically for the benefit of the policyholders
- the solvency standards are applied, and results disclosed, separately for statutory funds as well as the licensed entity as a whole.
- assurance as to the sufficiency of the assets is required before any distribution to non-policyholders can be made from the fund

In these regards we believe that a statutory fund framework may go some way to addressing the policyholder protection concerns where the corporate structure does not provide sufficient protection for NZ policyholders. Eg Branch’s in New Zealand, particularly if the New Zealand Solvency Standard applies to any NZ statutory fund regardless of overseas ownership.

There will still be some elements of risk with regard the reinsurance contracts (an possibly other contractual obligations) if they are not contracted directly the statutory fund. Issues relating to overseas losses eroding the protection for NZ policyholders and the payment of reinsurance recoveries to the overseas entity will remain.

Wenote that imposing a statutory fund regime for all general insurers to address these issues would impose considerable costs in establishing, administering, funding and maintaining that regime which may outweigh the benefits.

Q12 Do you consider that there may be opportunities to enhance the enforcement framework?

We would encourage the RBNZ to review the enforcement framework to ensure it is competitively neutral and does not confer advantages by of confer a competitive advantage or allow a less satisfactory and rigorous level of regulation to some market participants.

A key concern is that insurers could arbitrage regulators by choosing to incorporate in a country that has a lower capital requirements and then operate in NZ as either as a branch or subsidiary and avoiding the RBNZ’s capital requirements.

A related issue of concern to us is the risk of competitive non-neutrality arising between the regulatory treatment in relation to governance and risk management of New Zealand incorporated subsidiaries of foreign insurers and New Zealand incorporated insurers which are substantially owned by domestic interests.

In the case of governance, the requirements implemented by the RBNZ specify merely that there should be a minimum of two directors on the board of a locally incorporated insurer and that a minimum of two directors should be ordinarily resident in New Zealand. We question whether these requirements are sufficient to ensure appropriate independence of governance in the case of insurers that are predominantly owned by foreign interests.

One might reasonably expect, in such cases, that there should be a requirement for a majority of directors to be independent of the parent entity and to be ordinarily resident in New Zealand. This would promote substantive independence in the local board and better position the board to act in the interests of the insurer in New Zealand, rather than necessarily acting in the interests of the parent entity or the wider group.

A higher minimum number of directors (i.e. five directors) would also assist in this objective, not least by promoting greater diversity of view on the board and a lower risk of dominance by directors who are executives or non-executive directors of the parent entity.

In the case of risk management, the RBNZ has specified high-level principles on risk management in its guidelines, which we support. That said, we would suggest that more attention may need to be given to the extent of independent risk management in the case of foreign-owned subsidiaries. Our observation is that many foreign-owned subsidiaries have a substantial degree of dependency on the risk management strategy, risk appetite, risk management settings and risk management capacity (including systems and staffing) of their respective parent entities.

While some dependency in these areas is necessary and reasonable, we believe that the soundness of the insurers' New Zealand operations, and the soundness of the insurance sector in New Zealand, depends to a large degree on the local insurers having risk management strategies, policies and capacities that are designed for the particular characteristics of the New Zealand market.

We would also argue that the soundness of insurers in New Zealand depends on an insurer's core risk management systems and controls being in located in New Zealand. This is especially important in a crisis situation, given the need for a statutory manager to be able to assume practical and legal control of core systems and controls in order to manage the insurer.

The lack of local functionality requirements has the potential to adversely impact the insurance industry in a number of ways. In normal times, it creates an uneven playing field by potentially allowing foreign insurers to run subsidiaries as de facto branches, thereby lowering operating costs relative to what they would be if the subsidiaries had to function as truly stand-alone entities. In periods of crisis, the impediment to effective crisis resolution (i.e. by limiting the effectiveness of a statutory manager's ability to run a distressed insurer) could impact on the stability of the insurance sector, with adverse outcomes for survivor insurers. In a failure situation, it creates a greater risk of taxpayer bail-out.

We therefore suggest that further attention be given to these matters with a view to promoting sound governance and risk management of all insurers in New Zealand.

Q14 are there any areas of the framework that may pose particular concerns when considering overseas insurers (branch operations)

As highlighted previously we have concerns with branch structures/overseas insurers and therefore this should be included in scope of the review. We have particular concern as to how the purposes of IPSA are addressed for branch structures and/or overseas insurers where they are exempt from certain parts of IPSA and therefore the inconsistency and additional risk this adds to the industry. Our concerns are specifically around and uneven playing field, policyholder protection (lack of capital and ring fenced assets), corporate governance/risk management practices and ultimately the soundness of the NZ Insurance Industry.

Q 15 Do you consider the current approach to prudential capital requirements by reference to a solvency margin and conditions of licence should be within scope of the Review

The regulated approach to prudential capital management is a prescript approach largely based on accounting values of assets and liabilities. The suitability of this approach was called into question with recent review of the IFRS 15 accounting standard applicable to leases. The change in an accounting standard and the representation of assets or liabilities on the balance sheet does not impact on the risk associated with a business and thus should not result in a significant change to the regulatory capital requirements for a business. The capital requirements for an entity should be based on the regulators view of an appropriate probability of insolvency for an entity and should be calculated accordingly.

With the release of IFRS 17 the new international accounting standard for insurance a review of the prudential capital requirements would be particularly timely in order to ensure a transition to the new insurance entity accounts does not result in unintended changes in regulatory capital requirements.

Q16 Do you consider that consideration should be given to clarifying the Reserve Bank's prudential response to deteriorations in reported solvency levels?

In the interests of transparency of regulation it should be clear to insurers how the Reserve Bank responses to deteriorations in reported solvency levels. While it is tempting to think there could be more pre-defined responses to different levels of reported solvency such prescription would:

- make it difficult to take account of the unique features of an individual insurer
- have the unintended consequence of further increasing the minimum capital constraints for insurers as they prudently move to holding a level of capital above the "at risk" level as defined by the Reserve Bank

For this reason we would be supportive of understanding the framework of what the Reserve Bank consider when establishing an appropriate capital management policy for an insurer, but would be less supportive of prescription intervention thresholds.

A specific example that we believe should be included in the scope of the review is where after a major disaster where and insurer is using it's full reinsurance programme (1 in 1000 year) but not its capital reserves however as a result its reinsurance recoveries and outstanding claims liability increase dramatically and with the capital charges under the solvency standard applied this causes an insurer to dip below the minimum solvency level and therefore would need to stop writing any business. This seems counter intuitive given the insurer has met its requirement pre disaster to cope with such an event however post event it needs to stop writing business which does not fit with the purpose of IPSA for a sound insurance sector.

Q17 Do you consider the review should reassess the current framework for approval of material transactions and policy changes?

Yes this should be in scope particularly transaction that change the capital structure of an insurer eg dividends.

Question 20 Do you consider that there is information that is not currently required to be disclosed that would be beneficial to market participants?

FMG supports the maintenance of Financial Strength Rating as a consistent means of comparison between insurers that is easy for most of the public to understand. There are certainly limitations to this however we believe the benefits out way the limitations. We also believe to promote a sound insurance sector and public confidence the RBNZ should include on their website along with individual insurer's credit rating each insurers MCR which is disclosed in each entities financial statements but currently not easily compared between insurers.

Question 21 Do you consider that the Reserve Bank (or other authority) has a role in providing appropriate industry data to the market?

In considering whether the Reserve Bank has a role in providing appropriate industry data consideration should be given to:

- the objectives of the IPSA legislation
- the likely audience for such statistics and the use they have for these statistics
- what expectations are placed on the provider of such data to the ensure the accuracy and support to users of that data and how well placed the provider is to do this
- the resource required to collect, collate and maintain such a dataset

There is no doubt that to fulfil the objective of promoting a sound and efficient insurance sector the Reserve Bank needs to be able to monitor key financial metrics for the sector and compare and contrast individual participants in the sector. It is less clear whether it is necessary for this reason, or to promote public confidence, to make publically available a wide range of product and financial statistics. Noting that providing public data requires far more rigour with regards accuracy and comparability of data making it more resource intensive for both the provider (RBNZ) and for the contributing insurers who may need to restate their information into a prescribed format.

The most likely users of such publically available information are current and potential insurance practioners and financial analysts; both of whom have other resources available to them as part of their wider business operations. There would be few among the general public who would be aware this data exists, let alone have a need to interrogate it to better understand their individual insurance decisions.

The Reserve Bank needs to consider whether they believe promoting a sound insurance sector requires them to actively promote competition, or whether doing nothing to impede competition is sufficient. It is FMGs belief that providing appropriate industry data to the market is not necessary to fulfil its obligations under the legislation and that the compliance cost both on the industry and the regulator in doing this may outweigh the benefits.

Q24 are there any other issues you would like to raise that you consider should be in the scope of this review

While we believe IPSA has been a positive step for the industry and the RBNZ is providing a valuable role. We believe greater transparency of RBNZ would improve the soundness of the industry as industry players would better understand the RBNZ's thinking and approach to industry issues and individual entity exemptions etc.

Q26 Are there any areas of the legislation that you consider, having regard to the purpose of the legislation, unduly restrict competition or innovation within the New Zealand insurance market?

The only other concern is the potential for regulatory arbitrage between IPSA and overseas regulators particular where exemptions to IPSA are granted by the RBNZ. We are concerned that differences between regulatory regimes may result in overseas insures choosing to be regulated by a foreign regulator which may have more favourable regulation and therefore advantage some insurers over others (uneven playing field) eg 1 in 1000 reinsurance requirements in NZ versus 1 in 200 in other countries.(