

IAG SUBMISSION

Issues Paper: Review of the Insurance (Prudential Supervision) Act 2010

30 June 2017

1. INTRODUCTION

- 1.1 This submission is a response by IAG New Zealand Group (IAG, we) to the Reserve Bank of New Zealand's (the Bank) issues paper: Review of the Insurance (Prudential Supervision) Act 2010 (the Paper).
- 1.2 IAG is New Zealand's leading general insurer. We provide more than a million insurance policies a year and protect over \$600 billion of commercial and domestic assets across New Zealand. Our business is focussed on helping make the world a safer place, and we are committed to making sure that New Zealanders have the ability to protect themselves and their assets through easily accessible and affordable insurance.
- 1.3 This submission focuses on the issues and questions raised in the Paper and where relevant the recommendations made by the International Monetary Fund (IMF) in its Detailed Assessment of Observance – Insurance Core Principles.
- 1.4 We are generally supportive of the views expressed in the submission from the Insurance Council of New Zealand (ICNZ), but acknowledge that our views differ in a number of areas.
- 1.5 Our comments do not relate to re-insurers or life-insurers unless specifically identified as doing so.
- 1.6 We would welcome the opportunity to discuss our submission with the Bank.
- 1.7 IAG's contacts for this submission are:

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2. OVERVIEW

- 2.1 The years since the passing of the Insurance (Prudential Supervision) Act (the Act) are best characterised as having been focused on implementation, the building of relationships and bedding down new ways of working. They have also been punctuated by a number of major events in the life of a new prudential regime including major disasters, insurer failure and major transactions.
- 2.2 It is right then that we take stock of this experience, draw lessons and look to ensure the regime continues to meet its objectives and principles, and remains broadly consistent with evolving international practice.
- 2.3 Overall we believe that the regime has and continues to work well. Nevertheless we also believe that it would benefit from improvements aimed at: strengthening the protections provided to policyholders and their confidence in the insurance sector; providing greater clarity and certainty to insurers; and ensuring the sustainability of the insurance market.
- 2.4 We believe that our recommendations point to a discussion and options paper that will strengthen the regime; benefit policyholders; the Bank and insurers; and meet the expectations of good regulatory practice.¹

Policyholder protection and confidence

- 2.5 The protection of policyholder interests is a key focus of the Act. We think that the existing design and implementation of the regime does not provide a consistent level of protection to all New Zealand policyholders, particularly those who purchase their insurance from a branch of an overseas insurer.
- 2.6 New Zealand relies on overseas insurers to provide specialist cover, capacity and competition that would not otherwise be available. They also bring heightened stability through their diversification and access to capital and reinsurance
- 2.7 However overseas insurers that operate as branches are in practice generally exempt from local solvency and fit and proper requirements, and have a preference for their home jurisdiction policyholders. This leaves their New Zealand policyholders exposed should the insurer become distressed or fail.
- 2.8 For policyholders to have confidence in the insurance sector we think this must be addressed so that equivalent protections are offered by all insurers operating in this market. To that end we have made specific comments in the sections relating to:
 - Overseas insurers;
 - Statutory funds; and
 - Distress management.

Clarity and certainty

- 2.9 New Zealand gains significant economic and social benefits from the presence of a sound and well functioning insurance market. This is acknowledged by both the Act and Paper.
- 2.10 The experience of the past years has highlighted that a lack of clarity reduces the efficiency of the regime and that there are opportunities to improve this and the certainty it provides insurers and ultimately the policyholders.
- 2.11 We believe this starts with being more explicit about the outcomes sought by the regime and, more specifically, the expectations, logic and assumptions that go into its design and the decisions made in its development and operation. This must be accompanied by an ability to test these decisions in an affordable and independent forum.
- 2.12 This needs to be supported by a sound evidence base that sits behind policy and regulatory decisions. We appreciate that this cuts both ways and requires the industry and individual insurers to have evidential support for their positions.
- 2.13 Lastly, we see opportunities to create greater certainty through a combination of providing new guidance where none exists and more specific guidance where it's already in place.
- 2.14 To this end we have made specific comments in the sections relating to:
- Risk and governance;
 - Solvency requirements;
 - Enforcement regime; and
 - General disclosures.

Sustainability of the insurance market

- 2.15 It is vital that the regime is able to evolve in response to changing circumstances, trends, threats, dependencies, opportunities and innovations emerging in the industry and related markets, regimes and jurisdictions.
- 2.16 The Act acknowledges this and requires the bank to take account of the importance of maintaining the sustainability of the New Zealand insurance market.
- 2.17 To this end we see a number of important issues and trends that the Bank should be actively considering as these will increasingly impact the general insurance industry over the coming years and decades. These include:
- The physical, economic and social impacts of climate change²;
 - Underinsurance and the future insurability of high-risk locations³;
 - The increasing focus on conduct risk;
 - The ability of the industry to meet the needs of customers in the face of new and emerging risks, like cyber; and
 - The impacts of technical disruption on insured risks and service delivery.

3. SUMMARY OF RECOMMENDATIONS

- 3.1 We would like the Bank to review how it treats the home regulation and supervision of overseas insurers, with the intent of eliminating the exemptions it provides to overseas branches.
- 3.2 We would like the Bank to pay more attention to amounts and types of insurance that is written by overseas insurers that are not 'operating in New Zealand' and not subject to home-host considerations.
- 3.3 We would like the Bank to explore how statutory funds could be applied to overseas branches to ensure assets are dedicated to meeting local policyholder liabilities at times of distress and failure.
- 3.4 We would like the Bank to issue more specific guidance on the role of key officers and the expectations they have of them. We also encourage the Bank to consider the IMF recommendation to extend the scope of individuals covered by the fit-and-proper regime.
- 3.5 We would like the bank to reference a risk management standard, as APRA does with CPS220. We also encourage the bank to consider the IMF recommendation for insurers to have dedicated risk control functions
- 3.6 We would like the Bank to present more evidence on the need to strengthen its enforcement powers to ensure compliance with the regime in its current and expected future form. We would also like the Bank to consider strengthening a wider range of tools, such as guidance and standards, to address current compliance gaps.
- 3.7 We would like the Bank to present options for independent merits review and strengthened appeal rights in respect of Bank decisions.
- 3.8 We would like the Bank to provide guidance on its likely response to different levels of deterioration in reported solvency.
- 3.9 We would like the Bank to update financial strength rating disclosure requirements to allow for alternative forms of disclosure, including the provision of safe harbour wording that directs current and prospective policyholders to prescribed financial strength rating information on insurer websites.
- 3.10 We would like the Bank to provide specific details on the proposed content and methods for any additional disclosures in the options paper.

4. ANSWERS TO MATTERS RAISED

Entities to be licensed

- 4.1 **We have no specific concerns with which entities are licensed.**

Overseas insurers

- 4.2 **Yes, the review should look at how legislation is applied to the branches of overseas insurers.**

Overseas insurers bring benefits

- 4.3 Overseas insurers play a vital part in the health and stability of New Zealand's insurance market. They bring specialist cover, capacity and competition to the market that would not otherwise be available. They also bring heightened stability through their diversification and access to capital and reinsurance.

Application of the Act to overseas insurers

- 4.4 We believe that all insurers operating in New Zealand should be held to the same regulatory standard and support the same prudential outcomes. This is important in achieving the policyholder protection and public confidence purposes of the Act. But we are not confident that this is currently being achieved with respect to the branches of overseas insurers.
- 4.5 The Act allows the Bank to grant the branch of an overseas insurer an exemption to some obligations in the Act where their home jurisdiction meets certain legislative requirements. In practice this appears to result in all general insurers operating as branches being exempt from meeting local 'fit and proper' and solvency requirements. We do not think this is appropriate.
- 4.6 That the Bank is *able* to assess and take action against local directors and officers after the fact is not the same as ensuring they *are* fit and proper before the fact. That the solvency requirements of the home jurisdiction are the 'same or similar' and 'at least as satisfactory' as our local requirements falls away when the branch is buying reinsurance to 1:200 or 1:250 and all others are buying to 1:1000.
- 4.7 We believe that this gives little assurance to policy holders that the branch has appropriate people leading it or that the insurer holds sufficient reinsurance for its New Zealand's exposures.
- 4.8 *We would like the Bank to review how it treats the home regulation and supervision of overseas insurers, with the intent of eliminating the exemptions it provides to overseas branches.*

Business written directly offshore

- 4.9 We suspect that a significant and growing amount of the market is written directly off shore and falls outside the safeguards provided by the Act. Anecdotal

evidence suggests this could be as much as \$300-\$500m or up to 10% of the general insurance market.

- 4.10 At a minimum the Bank should seek to understand the size and make-up of this business and the risk it poses to New Zealand and New Zealand policy holders in the event of a significant disaster or insurer failure.
- 4.11 *We would like the Bank to pay more attention to amounts and types of insurance that is written by overseas insurers that are not 'operating in New Zealand' and not subject to home-host considerations.*

Statutory funds

- 4.12 **Yes, the review should consider how best to ensure that assets are available to meet the policyholder liabilities of distressed and failed insurers.**
- 4.13 We believe that all insurers who underwrite business in New Zealand should hold assets dedicated to meeting their liabilities to New Zealand policyholders, so that those assets are retained for that purpose should the insurer become distressed or fail.
- 4.14 Once again our concern centres on the branches of overseas insurers. Typically these branches do not have legal ownership of the assets supporting policyholder liabilities and have a legal preference for policyholders in their home jurisdiction. This means that should the branch, or more likely the parent, get into distress those assets would be used to support the parent and not local policyholders.
- 4.15 In contrast we, along with many other insurers, are locally incorporated and have legal ownership of the assets supporting our local policyholder liabilities. If we were to become distressed these assets, along with the other assets of the business, remain available for that purpose.
- 4.16 We see that there is a range of options available to protect policyholders and that a one-size-fits-all approach is not needed. Insurers must be able to demonstrate to the Bank that they can secure their policyholder assets. We think that absent local incorporation and legal ownership, the use of statutory funds may provide a useful way for branches to achieve this.
- 4.17 *We would like the Bank to explore how statutory funds could be applied to overseas branches to ensure assets are dedicated to meeting local policyholder liabilities at times of distress and failure.*

Role of key officers and key control functions

- 4.18 **Yes, the review should consider improving the clarity of expectations placed on insurers' key governance and control functions and their key directors and officers.**
- 4.19 We believe the transparency of the regime and the consistency with which it is applied would be improved by clarifying the expectations of directors and relevant officers. This may well offset the scale and or need for enhanced enforcement powers (see below).
- 4.20 *We would like the Bank to issue more specific guidance on the role of key officers and the expectations they have of them. We also encourage the Bank to consider*

the IMF recommendation to extend the scope of individuals covered by the fit-and-proper regime.

- 4.21 We believe that sound risk management based on the ‘three lines of defence’ approach is vital to a well run insurer. Policyholders and the industry as a whole would benefit from greater clarity and consistency in risk management practices.
- 4.22 *We would like the bank to reference a risk management standard, as APRA does with CPS220. We also encourage the bank to consider the IMF recommendation for insurers to have dedicated risk control functions*

Enforcement regimes

- 4.23 **Yes, the review should look at opportunities to enhance the enforcement framework.**

Enforcement

- 4.24 We believe that the regime has worked well over the past six years and appropriately incentivises compliance.
- 4.25 We note the desire for proportionality and are usually supportive of this. But we are unsure, in the absence of more active supervision, what breaches have occurred or are envisaged that can’t be addressed through the Banks existing enforcement tools and considerable ‘soft power’.
- 4.26 We think that the provision of greater clarity and guidance (sought throughout this submission) will remove much of the ambiguity and the minor infringements that can currently occur.
- 4.27 *We would like the Bank to present more evidence on the need to strengthen its enforcement powers to ensure compliance with the regime in its current and expected future form. We would also like the Bank to consider strengthening a wider range of tools, such as guidance and standards, to address current compliance gaps.*

Appeal rights

- 4.28 We believe that any enforcement regime must be coupled with strong procedural requirements and appeal mechanisms. This would strengthen the overall quality and credibility of the regime and ensure that there are appropriate and adequate checks-and-balances on the exercise of regulatory power.
- 4.29 *We would like the Bank to present options for independent merits review and strengthened appeal rights in respect of Bank decisions.*

Distress Management

- 4.30 **Yes, there are concerns about the distress management framework that pose concerns and should be considered in the review.**
- 4.31 We believe that if an overseas insurer operating as a branch in New Zealand is in distress then the presence of a preference for home jurisdiction policyholders

means it is highly unlikely that the assets supporting New Zealand policyholders will be available to meet their claims.

- 4.32 We also believe that the requirement to disclose an overseas policy holder preference is not meaningful protection for New Zealand policyholders. A warning does not constitute protection. Most prospective policyholders would not be aware of the preference and would not think to seek it out as the risk of insurer failure has a minute bearing on their decision relative to brand preference and price.
- 4.33 If a branch of an overseas insurer were to become distressed it would likely only remain so and put policyholders at risk if its parent was also in distress or had no appetite or means to support the branch. Under these circumstances none of the tools available to the Bank would be capable of securing the assets to meet the local policyholder liabilities.
- 4.34 As noted above we would like to see the branches of overseas insurers hold assets dedicated to their liabilities to New Zealand policyholders. Without this there is no guarantee that the assets will be there for New Zealand policyholders when the insurer is in distress.

Solvency requirements

- 4.35 **Yes, the Bank should look at providing more clarity on aspects of the Bank's approach to solvency.**
- 4.36 We believe that the current approach to solvency is generally working well and see no need to move away from the current reference to solvency margin and conditions of licence.
- 4.37 We believe the overall solvency regime would benefit from greater clarity and timelier guidance on how the standard is to be applied and how the bank would respond to deteriorations in solvency levels. This would provide insurers with more certainty in how the regime operates.
- 4.38 *We would like the Bank to provide guidance on its likely response to different levels of deterioration in reported solvency. This would provide the industry with greater certainty as the occurrence and nature of any regulatory intervention.*

Supervisory processes – regulatory approvals

- 4.39 **We do not have any concerns with the current approval framework in terms of mechanisms or threshold.**
- 4.40 As an organization that has sought approvals in the past we believe the regime operates well.

General disclosure and Financial Strength Rating requirements

4.41 **Yes, there are elements of the current disclosure regime that can be improved.**

Disclosure of financial strength ratings

- 4.42 We agree that prospective policyholders should be able to include insurers' financial strength ratings in their decision of which insurer to use. However the current requirement for how these ratings are disclosed is unduly onerous, costly to meet, and in many ways unworkable to oversee. We also find it archaic that these must be provided 'in writing' to the policy holder.
- 4.43 *We would like the Bank to update financial strength rating disclosure requirements to allow for alternative forms of disclosure, including the provision of safe harbour wording that directs current and prospective policyholders to prescribed financial strength rating information on insurer websites.*

Additional disclosures

- 4.44 We note the desire for alignment with other regulated sectors and the general topics of disclosure that may be required, including 'corporate matters', 'prudential matters' and 'any other matters'.
- 4.45 We are cautiously open to exploring what this might mean for the general insurance sector, mindful of the cost that comes with it. Nevertheless we believe additional disclosure could include:
- Information on corporate governance policies and practices
 - Information on the Board and its operation
 - Information on risk management frameworks and policies
- 4.46 There is undoubted benefit in the 'sunlight' that disclosure brings, but this alone is not enough to warrant additional requirements. We expect the Bank will ensure that any new disclosure proposed will:
- Pass a strong 'in practice use test' to maintain the efficiency of the regime. Disclosure that does not have an immediate and ongoing use or that only provides some form of contingency should be shunned;
 - Be consistent with the principles of market and self discipline and as such, depending on the nature of the disclosure, be either unambiguous in its requirements or be left to insurers to interpret;
 - Recognise the differences between the life and general insurance industries;
 - Focus on information or documents that insurers already have to hand and or use in the running of their business;
 - Not be inconsistent with disclosures made by parent companies;
 - Be co-developed with the industry; and
 - Allow sufficient time for development, implementation and bedding down.
- 4.47 *We would like the Bank to provide specific details on the proposed content and methods for any additional disclosures in the options paper.*

Appropriate regulatory mechanisms

- 4.48 **We do not have any specific concerns with the range and balance of legislative tool that are being used.**
- 4.49 We support continued efforts that lead to more open and transparent development and review of requirements. This should include greater explanation of the decision the RBNZ makes.

¹ “Government Expectations for Good regulatory Practice”, New Zealand Government, April 2017, includes a number of relevant expectations for our three areas of focus, including:

- that a regulatory system delivers best when it:
 - has clear objectives;
 - seeks to achieve [regulatory] objectives in a least cost way, and with the least adverse impact on market competition, property rights, and individual autonomy and responsibility;
 - is proportionate, fair and equitable in the way it treats regulated parties;
 - sets out legal obligations and regulator expectations and practices in ways that are easy to find, easy to navigate, and clear and easy to understand;
 - has scope to evolve in response to changing circumstances or new information on the regulatory system’s performance.
- that regulatory agencies are expected to:
 - periodically look at other similar regulatory systems, in New Zealand and other jurisdictions, for possible trends, threats, linkages, opportunities for alignment, economies of scale and scope, and examples of innovation and good practice
 - provide accessible, timely information and support to help regulated parties understand and meet their regulatory obligations; and
 - maintain and publish up-to-date information about their regulatory decision-making processes, including timelines and the information or principles that inform their regulatory decisions.

² For example see:

- “Breaking the Tragedy of the Horizon – climate change and financial stability” a speech given by Mark Carney, Governor of the Bank of England at Lloyd’s of London, 29 September 2015;
- “The impact of climate change on the UK insurance sector”, A Climate Change Adaptation Report by the Prudential Regulation Authority, September 2015
- “Australia New Horizon: Climate Change Challenges and Prudential Risk”, a speech given by Geoff Summerhayes, Executive Board Member Australian Prudential Regulation Authority, at the Insurance Council of Australia Annual Forum, 17 February 2017;
- “The Back of England’s response to climate change”, Quarterly Bulletin, Q2 2017, pages 98-109.

³ “Treasury Report: Home Insurance – Implications of Sum Insured Cover”, Treasury, June 2015