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To Richard Johnson

Prudential Supervision Department
Reserve Bank of New Zealand

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SUBMISSION ON THE INSURANCE (PRUDENTIAL SUPERVISION) ACT 2010 (*ACT*)

Introduction

1 We thank the Reserve Bank of New Zealand (*Reserve Bank*) for the opportunity to respond to its Issues Paper: Review of the Insurance (Prudential Supervision) Act 2010 (the *Issues Paper*).

2 Whilst our submission does not expressly relate to any of the issues set out in the Issues Paper, we understand the Reserve Bank is also accepting submissions on any wider issues that submitters believe ought to be taken forward as part of the review.

3 On this basis, Manchester Unity Friendly Society (*Manchester Unity*) submits that:

3.1 there should be a change to the Reserve Bank's Solvency Standards (*Solvency Standard*) to enable friendly society insurers to issue securities (as credit unions currently do) to support their capital needs and continue to meet their capital requirements as an insurer; and

3.2 regulation 13 of the Insurance (Prudential Supervision) Regulations 2010 (the *Regulations*) should be revoked, to enable friendly society insurers to avail itself of the relief in regulation 11(1)(a)(i) (from the requirement to maintain a financial strength rating and provide financial statements to the Reserve Bank) for each accounting period, provided the $1.5 million annual gross premium income threshold has not been exceeded; and

3.3 although not a point specific to Manchester Unity, the exemption powers in the IPSA should be extended to give the Reserve Bank more power to respond with regulatory relief in appropriate cases together, the *Proposed Amendments.*

Background to Manchester Unity – need for proportionate regulation

4 By way of background, Manchester Unity is the largest traditional friendly society (formed under the Friendly Societies and Credit Unions Act 1978 (*FSCU Act*) in New Zealand and is the only one licensed as an insurer by the Reserve Bank. The Society's principal purpose is to offer financial products, including insurance products, and fraternal services for the benefit of its 16,000 members.

5 Despite our reasonably significant membership, our sector relevance is limited:

5.1 our premiums from life insurance for our 2016/17 financial year was $554,905; and

5.2 our premiums from all insurance business for our 2016/17 financial year was $1,370,595.

6 In addition:

6.1 ***Manchester Unity not of systemic importance to insurance sector –*** As a friendly society insurer Manchester Unity operate in a market which is very different to that of the shareholder-owned company. Friendly societies are owned by their members and are established for a shared member purpose, but generally access to their services is open to anyone, as is membership. The usual tension between shareholder and policy interest is not as pronounced for Manchester Unity.

6.2 ***Friendly society insurers provide a social benefit –*** One of the main functions of the friendly society insurers like Manchester Unity is to create a social benefit through the various benefits afforded to the members. This wider society benefit needs to be taken into account in setting the regulatory framework for Manchester Unity, and balanced appropriately against the systemic risks that the Act is intended to address.

7 We are not saying that Manchester Unity should not be regulated at all, and we recognise that our insured clients have a right to the basic protections and disciplines that the Act, and in particular licensing, provides. Indeed, our submission that the relevant solvency standard should be amended to expressly allow friendly society securities to be regulatory capital recognises the relevance of the solvency standards to our insurance business.

8 However, it is essential that any regulation is *proportionate*, and does not give rise to costs which are disproportionate and provide no real benefit to our insured members.

9 Against that background, our submissions are set out in further detail below. We are conscious that the number of licensed friendly society insurers is low; however we have framed our submissions as applying to all friendly society insurers, as we believe they are relevant across the entire group of such insurers.

Amendment to the Solvency Standard

10 The Act introduced minimum capital requirements for insurers, which limited how friendly societies can raise capital. Combined with the lack of access to quality capital, this places a serious limiting factor on the continuance, growth and development of friendly society insurers such as Manchester Unity.

Proposed Solvency Standard Amendment

11 Manchester Unity seeks express recognition that friendly society securities be included in the Solvency Standard (*Proposed Solvency Standard Amendment*). We are making this submission because we have recently considered raising capital through the issue of a redeemable preference share, but have found significant impediments both under the FSCU Act but also in terms of how such an instrument would be recognised under the Solvency Standard.

12 Specifically, the Solvency Standards for Life and Non-Life Insurers issued by the Reserve Bank define capital for a licenced insurer (such as Manchester Unity) as the total value of:

12.1 Ordinary Shares;

12.2 Perpetual Non-Cumulative Instruments; and

12.3 Credit Union Securities.

13 Friendly society securities issued by a friendly society insurer should be expressly recognised by the Reserve Bank for solvency purposes under the Solvency Standard in much the same way as Credit Union Securities are already recognised.

14 We submit that the Proposed Solvency Standard Amendment would read:

"2.1 Capital

26. Capital is the total value of the following items:

(a) issued and fully or partly paid-up ordinary shares, that meet the General Requirements for Capital Instruments (Section 2.4) and the qualifying criteria for ordinary shares set out in Appendix D (Subsection D.1);

(b) issued and fully or partly paid-up perpetual non-cumulative instruments that meet the General Requirements for Capital Instruments (Section 2.4) and the qualifying criteria for perpetual instruments set out in Appendix D (Subsection D.2). Perpetual instruments may not constitute more than 50% of Capital for a **licensed insurer** and that is a mutual **insurer** and 25% for all other **licensed insurers**;

(c) Credit Union Securities or Friendly Society Securities that meet the General Requirements for Capital Instruments (Section 2.4) and the qualifying criteria for Credit Union Securities and Friendly Society Securities set out in Appendix D (Subsection D.3);

(d) …"

15 The Proposed Solvency Standard Amendment would define friendly society securities as follows:

Ordinary friendly society securities means friendly society securities which provide that the holder participates in the funds and property of the society in proportion to their financial interest in the event of winding up or dissolution of the society, where that financial interest is the nominal value of the securities.

Preference friendly society securities means friendly society securities which provide that the holder's financial interest ranks ahead of the financial interests of other members in the funds and property of the society and any branch of the society in the event of a winding up or dissolution of the society, where that financial interest is capped at the nominal value of the securities.

16 In our view, it is vital that the Solvency Standard is amended to allow friendly society insurers to issue securities to meet their capital requirements as an insurer. This will allow friendly societies to access new forms of capital to support their long-term growth. Specifically, the Proposed Solvency Standard Amendment would provide friendly society insurers with access to additional capital by enabling them to issue a new class of security to raise funds, grow their business, and support their solvency.

17 The Proposed Solvency Standard Amendment resolves a basic legal problem faced by friendly society insurers, and is justifiable for the following reasons:

17.1 ***Friendly societies need to be able to adapt to the capital requirements for insurers*** – Insurance has always been a core business for friendly societies. However, friendly society insurers do not have the ability to raise capital that publicly listed companies, credit union, co-operatives and building societies do, preventing them responding to the need for additional capital. This inability has been more acute following the introduction of the Reserve Bank's capital requirements for insurers under the Act.

17.2 ***Without appropriate reform, Friendly society insurers could be driven into inappropriate corporate forms through demutualisation*** – New Zealand has seen many of its oldest mutual organisations demutualise in the period between 1980 and 2000. A lack of access to capital has been used as the key justification for this corporate change.

The process of demutualisation removes the opportunity for insurance to be provided by a friendly society, under which members can provide for each other's insurance needs on a mutual basis. Demutualisation means that consumers would no longer have non-listed, member owned options in the financial services marketplace.

17.3 ***A lack of capital limits Friendly society insurers' growth and the ability to develop new products*** – Access to quality capital permits businesses to consider innovations and investments into new business areas. The long term nature of friendly society ownership means that funds are not often available for this type of development.

Our Proposed Solvency Standard Amendment would address this concern by providing friendly society insurers with new ways of obtaining capital to develop products and grow their business, improving their ability to offer consumers choice and compete in the marketplace.

17.4 ***Friendly society insurers need access to quality capital*** – The need for friendly society insurers to raise capital is only likely to increase given the Reserve Bank's focus on the capital quality of licensed insurers.

Our Proposed Solvency Standard Amendment would improve friendly society insurers' access to quality capital (both to absorb losses and improve liquidity) to support their regulatory solvency position.

17.5 ***Friendly societies need an alternative to raising debt*** – Friendly societies are largely prohibited from borrowing under section 51 of the FSCU Act. Even if friendly societies were able to borrow, there is inevitably a limit on the amount of debt that can, or should, be raised by a mutual organisation and, more importantly, debt does not count as solvency capital under the Solvency Standards for insurers.

17.6 ***Friendly Societies should be able to access capital to consider tactical acquisitions*** – Friendly society insurers lack the capital to take advantage of tactical acquisitions. By helping to facilitate the growth of the business through acquisition, new capital could help friendly society insurers to compete.

17.7 ***Members' contributions to capital can build stable mutuals*** – There are several examples locally and globally where members and others contribute to the capital base of co-operatives. Examples include the Fonterra Shareholders Fund, which shows how mutuals can enlist their members and others in raising capital through the issuance of co-operative shares.

Our Proposed Solvency Standard Amendment would enable friendly society insurers to use this investment to build stronger mutual ties between members and institutions, and seek new sources of capital from non-member organisations including other friendly societies and mutuals.

18 We note that, concurrently with this submission, Manchester Unity is currently seeking a change to the FSCU Act to allow for friendly society insurers to raise capital like credit unions. Regardless of whether the proposals to the FSCU Act are adopted, we submit that more express recognition of friendly society securities should be included in the Solvency Standard.

Amendment to regulation 13

19 Regulation 11 provides an exemption from certain licensing requirements of the Act for insurers (including friendly society insurers) with annual gross premium income of less than $1.5 million that were carry on insurance business in New Zealand.

20 However, regulation 13 provides that the exemption under regulation 11 does not apply to an insurer in respect of an accounting period if its annual gross premium income for any "*preceding period*" exceeded $1.5 million (the term "preceding period" being defined as "*any accounting period that precedes the relevant period (whether immediately preceding it or not), being an accounting period that commences <u>after</u> the licence is issued under Part 2 of the Act"*).

21 The definition of "preceding period" means that a small insurer or friendly society insurer (as "specified persons" for the purposes of the exemption) cannot benefit from the regulation 13 exemption if it had annual gross premium income above the $1.5 million threshold during *any* accounting period that commences after it received its licence under the Act. This appears to compromise the express intention of regulation 11.

Proposed Regulation Revocation

22 Manchester Unity submits that regulation 13 should be revoked, so as to enable friendly societies to benefit fully from the exemption in regulation 11 for *each* accounting period in which the insurer has an annual gross premium income that is less than $1.5 million (*Proposed Regulation Revocation).* The Proposed Regulation Revocation would, in essence, remove regulation 13 and rely on the wording in regulation 11 to provide the intended exemption.

23 We submit that the revocation of regulation 13 is justified on the following reasons:

23.1 ***Regulation 13 compromises the express intention of regulation 11 -*** We believe that regulation 11 was made with the intention of exempting small insurers and friendly society insurers from certain requirements of the Act. The principal behind the "small insurers exemptions" was that such entities could find a number of the requirements in the full regime particularly onerous, to the point that it could put their viability at serious risk.

The Insurance (Prudential Supervision) Bill (*Bill*) contemplated that the Governor General may make regulations exempting a class of specified persons that have an annual gross premium income that is less than a specified amount (this being $1.5 million) [1]. In our view, the Bill did not contemplate that such exemption would not be available for future use if an insurer exceeded this threshold on only one occasion, but subsequently fell below it.

Our Proposed Regulation Revocation removes the overreaching effect of regulation 13 and aligns with what we perceive to be the express intention of regulation 11 – to relieve small insurers of the regulatory burden of maintaining financial strength ratings and producing financial statements for the Reserve Bank where they fall below the threshold. There should be no distinction between those insurers which were under the threshold at the time of licensing, and those which subsequently fall below the threshold.

23.2 ***Regulation 13 is limited in application -*** The current drafting of regulation 13 only applies in the scenario where annual gross premium income is below $1.5 million before the insurer's licence is issued, and stays below that threshold forever. This would only apply in a very limited number of scenarios.

It is a strange outcome that a small insurer or friendly society insurer whose annual gross premium income goes above the threshold on only one occasion, but subsequently drops below the threshold, could not avail itself of the exemption in regulation 11 in any subsequent period.

Our Proposed Regulation Revocation allows friendly society insures to avail itself of regulation 11 in the circumstances for *each* accounting period the $1.5 million threshold has not been exceeded, as intended by Parliament.

23.3 ***Disproportionate burden for friendly society insurers -*** The cost of complying with the financial strength rating and financial statement requirements is not insignificant, and in our submission is disproportionate to the benefit provided to members. The cost of maintaining a financial strength rating alone is $41,844 per annum, which represents 3.05% of gross premiums.

23.4 ***Financial statements required under other legislation –*** Even though the amendment would relieve friendly society insurers from the requirement to provide financial statements to the Reserve Bank, friendly society insurers would be "FMCA reporting entities" under section 451(h) of the Financial Markets Conduct Act 2013 (*FMCA*), so are required to register audited financial statements under that legislation in any event. If the Reserve Bank wishes to retain the requirement for financial statements, it should be possible for friendly society insurers falling within the exemption to comply with the FMCA only, and that should be sufficient for the purposes of the Act as well.

Accordingly, the revocation of regulation 13 would not expose policyholders to the risk of having no financial reporting discipline at all – rather, it would fall under the FMCA, not the Act.

[1] Insurance (Prudential Supervision) Bill, as reported from the Finance and Expenditure Committee, 29 July, 2010.

Extended exemption power

24 Currently, the Reserve Bank's exemption making powers are limited to the circumstances set out in section 232 of the Act.

25 We submit that the Reserve Bank's exemption power should be broadened so that it is able to grant class or individual exemptions where:

25.1 compliance with the relevant provision or provisions of the Act or associated regulations would be unduly onerous or burdensome for the applicant; but

25.2 the exemption is consistent with promoting the maintenance of a sound and efficient insurance sector and is not broader than what is reasonably necessary to address the matters that gave rise to the exemption.

26 We believe this would bring the Act in line with other regulatory regimes, such as the FMCA (which gives the Financial Markets Authority wide exemption powers), as well as:

26.1 section 7 of the Insurance Act 1973, which provides APRA with fairly broad powers to determine that certain provisions do not apply to an insurer or a class of insurers while the determination is in force; and

26.2 the Reserve Bank's exemption making powers under the Non-Bank Deposit Takers Act 2013 (see sections 8 and 70 to 72) – although any wider exemption powers introduced under the Act should include the ability for the Reserve Bank to exempt insurers from the requirement to be licensed, where considered appropriate.

27 In our view, these amendments would provide increased flexibility to the Reserve Bank to respond appropriately to specific circumstances, and provided suitable regulatory relief where that is within the policy and exemption making power.

Conclusion

28 We ask that the Reserve Bank consider the Proposed Amendments outlined above.

29 Thank you again for the opportunity to submit on the Act. If you require any further information, please do not hesitate to contact me.

Yours faithfully

[redacted]

Sanjiv Jetly
Chief Executive Officer