



7 July 2017

Richard Johnson
Senior Adviser
Prudential Supervision Department
Reserve Bank of New Zealand
By email: ipsareview@rbnz.govt.nz

Dear Richard,

Tower Submission to Reserve Bank of New Zealand Issues Paper

Please find enclosed Tower Insurance Limited's submission to the Reserve Bank of New Zealand's Issues paper reviewing the *Insurance (Prudential Supervision) Act 2010*.

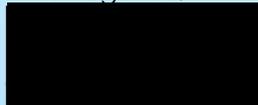
This submission has been co-authored with input from John Trowbridge (independent consultant and former Australian Prudential Regulation Authority Executive Member). Notwithstanding John's previous role, many of the views expressed in this submission are provided by reference to international benchmarks (including the Insurance Core Principles published by the International Association of Insurance Supervisors) and do not necessarily reflect a direct comparison with any particular jurisdiction, except where that comparison has been specifically made.

Some of the views expressed in this submission are distinct from the views provided in the ICNZ submission, in particular with regard to the suggested adoption of a revised approach by the RBNZ to supervision and guidance. Notwithstanding those specified areas of difference, Tower Insurance supports the submission provided by the ICNZ in all other areas.

If you have any questions about this submission, please contact me directly, or Tower's Chief Risk Officer David Callanan by emailing David.Callanan@tower.co.nz.

We look forward to the outcome of the review.

Kind regards,



Richard Harding

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Tower Insurance Limited
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Submission to RBNZ Issues Paper:

Review of the Insurance (Prudential Supervision) Act 2010

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Part 1 – Executive Summary

Tower Insurance has examined the Reserve Bank of New Zealand (RBNZ) Issues Paper in its capacity as a general insurer headquartered in New Zealand and as New Zealand’s number three general insurer by premium income.

Tower Insurance is a New Zealand-based insurance company which provides general insurance products to New Zealanders and, through its subsidiaries, Pacific Islanders. Tower’s foundation dates back to 1869 when the New Zealand Government provided the capital for the creation of the New Zealand Government Life Insurance Department. It became Tower Corporation in 1987 and in 1999 Tower Limited was listed on the New Zealand stock exchange.

As an independent, listed, general insurance underwriter and brand, Tower has a unique position in the New Zealand market and financial services sector. Tower Insurance currently underwrites 5% to 10% of New Zealand’s Home, Contents and Motor Vehicle insurance product market by premium. It is New Zealand’s third largest general insurer and the largest locally owned insurer.

The Issues Paper, released in March 2017, contains 26 questions covering a wide range of issues. Tower has elected to respond to only some of these 26 questions in order to concentrate this submission on attributes of the RBNZ prudential regime that Tower contends would strengthen the New Zealand financial system by:

- reducing system risk
- enhancing the level of protection of policyholders, and
- offering greater competitive neutrality.

To elaborate, this submission seeks to demonstrate that the approach currently taken by the RBNZ to the regulation and supervision of insurers raises issues of:

- **system risk** (vulnerability on account of the small economy, its unique risk profile and exposure of the government)
- **policyholder protection** (where there are limitations for all policyholders and where the limitations are greater for the policyholders of foreign insurers and for some local insurers than for other local insurers), and
- **competitive neutrality** (where foreign insurers, whether branches or subsidiaries, enjoy some regulatory concessions over local insurers).

The submission also draws attention to the RBNZ position that pro-active supervision is not undertaken by the RBNZ as a matter of policy. This position is criticised by the IMF in the FSAP report and is explored in some depth in the submission.

Tower submits that the system risk, policyholder protection limitations and the competitive advantages for foreign insurers under current arrangements could be substantially resolved by introducing a combination of pro-active supervision, as recommended by the IMF in the FSAP report, additional guidance for insurers, and some regulatory changes to the requirements for foreign insurers, both branches and subsidiaries.

More specifically:

(1) Source of and solution to minimising general insurance system risk and the industry's vulnerabilities

Source:

Insufficient measures by individual insurers to manage the complexities of general insurance risk exposure, and potential non-compliance or partial compliance by insurers with the intent of the requirements of the RBNZ on solvency, governance and risk management.

Solution:

Provide more guidance to boards and management to assist them in dealing with the complexities of the insurance business

and

introduce pro-active supervision, on-site and off-site, that reduces risk to the government and the community by holding both management and boards of insurers operating in New Zealand, whether local or foreign, subsidiaries or branches, fully accountable for meeting RBNZ's regulatory requirements.

(2) Source of and solution to offshore insurer concessions that detract from policyholder protection and competitive neutrality

Source:

RBNZ demanding less of foreign insurers regarding governance and capital, through relying on foreign regulators without insistence on local policyholders having the same capital and other protections as are available to policyholders of local companies:

- applies to companies and branches
- there is extra vulnerability for policyholders of branches

Solution:

As for (1) above

and

implement regulatory requirements for foreign insurers, both companies and branches, that are directly equivalent to the requirements for local insurers

(3) Source of and solution to compliance differentials that affect both policyholder protection and competitive neutrality

Source:

RBNZ reliance on off-site reviews and occasional direct interaction with boards and senior management

Solution:

As for (1) above

and

implement stronger regulatory requirements for safeguarding capital held for the protection of New Zealand policyholders.

This submission

The suggestions for changes to the RBNZ approach nominated above would, in Tower's view, strengthen the New Zealand financial system by reducing system risk, giving improved protection for all policyholders and creating a level playing field for all insurers operating in New Zealand, large and small, local and foreign owned, companies and branches.

The remainder of this submission elaborates on the background to the Tower position described above, including a critique of the RBNZ's approach to prudential regulation and supervision.

In summary

Tower submits that the RBNZ should take three sets of initiatives, in the interests of the government, the economy and consumers –

- **provide extra guidance for insurers in managing the complexities of the business**
- **introduce pro-active supervision, as advocated by the IMF in its 2017 FSAP report, and**
- **create a level playing field for local and foreign insurers.**

Part 2 – Identifying the Key Issues

The main issues addressed in this submission relate to dealing with –

- **system risk:** ensuring compliance by insurers with the RBNZ’s prudential requirements
- **policyholder protection:** some limitations, and
- **competition:** the advantages that foreign insurers enjoy over local insurers.

In Tower’s view the explanation for these issues being important, and also capable of resolution, lies mainly in the low emphasis on supervision by the RBNZ and the associated reasons for this approach.¹

Reducing system risk

The NZ general insurance industry can be characterised by four points of vulnerability that generate a unique risk profile for the industry, the economy and the government. Relative to larger insurance markets in other countries, we see:

- the small scale of the economy, leading to a lower ability to spread risk across the country
- a unique risk profile from natural disasters arising from high earthquake risk in major urban centres (as witnessed by the 2010 and 2011 Canterbury earthquakes)
- exposure of the government to the risk of bailing out insurers or claimants in the event of insurer failure (which exacerbates the government’s exposure beyond the EQC, which itself exposes the government to risk as was seen in 2010 and 2011)
- a narrower scope of regulatory guidance from the RBNZ than from many other regulators and narrower than advocated in the international Insurance Core Principles (ICPs) of the International Association of Insurance Supervisors (IAIS). Tower sees this narrow scope as a gap in the RBNZ armoury which, if closed, would reduce system risk.

Tower submits that this risk profile creates a **system risk** that warrants not only very good regulation but also a pre-emptive approach by the RBNZ to supervision. Such an approach is different from the RBNZ’s current “hands off” approach to supervision (as distinct from regulation).

Given the inherent complexity of the insurance business and its role as a taker of risk to which all other businesses transfer risk and thereby reduce their own risk, Tower believes that the RBNZ should issue more guidance to assist boards and management to meet RBNZ’s regulatory requirements.²

¹ Tower is supportive of the ICNZ and FMG submissions on the second and third of these topics, while noting the ICNZ submission differs in its reference to holding insurers more accountable for meeting the RBNZ requirements through greater emphasis on insurer supervision.

² Some of the areas where additional guidance would be valuable by reference to other international jurisdiction practices include reinsurance management, corporate governance, risk management including risk

In summary, Tower believes that pro-active supervision by the RBNZ, supported by additional guidance, would go a long way towards facilitating compliance by insurers with the intent of the RBNZ prudential requirements and to ensuring that compliance.

Enhancing policyholder protection

On policyholder protection, Tower believes that the effectiveness of the RBNZ regulatory regime has certain limitations for all insurers and also has some differential limitations according to the compliance obligations and practices of different classes of insurer.

Despite some competitive advantages for foreign insurers, their policyholders enjoy less protection in the event of failure or distress of either the parent insurer, including failure in which the NZ business played no part, or the local subsidiary or branch.

Initiatives to enhance policyholder protection would also correspondingly reduce system risk. As noted above, Tower believes that more extensive guidance to insurers along with supervisory programs that aim to hold insurers accountable for meeting RBNZ's prudential requirements should be introduced by the RBNZ. To make this protection more effective, this could be coupled with the implementation of stronger regulatory requirements for safeguarding capital held for the protection of New Zealand policyholders such as through the adoption of a regulatory 'Assets In New Zealand' requirement whereby general insurers must hold assets in New Zealand of a value that is equal to or greater than the total amount of the general insurer's liabilities.

Creating competitive neutrality

As a locally domiciled general insurance company, Tower submits that the RBNZ's approach to regulation and supervision discriminates against local insurers relative to foreign insurers, as a result of the different regulatory treatment by RBNZ of foreign insurers and local insurers.

The competitive discrimination arises essentially from the different regulations that apply to local and foreign insurers, whether companies or branches, arising from the RBNZ's willingness to rely heavily on the home regulators of foreign insurers while applying more stringent requirements to local companies. The most significant consequences relate to branches of foreign insurers which can operate with lower effective capital requirements than local companies. The main factors are:

- the 1 in 1000 year requirement for local insurers versus a more common 1 in 200 requirement by other regulators)
- use by the RBNZ of Section 59 of IPSA to exempt branches of some foreign insurers from meeting full solvency requirements in New Zealand, and
- no requirement to maintain assets in New Zealand to support their solvency and capital position.

Furthermore, subsidiaries of foreign insurers are in a similar position regarding assets in New Zealand because there are no restrictions on the levels of reinsurance that they can use to move both assets and liabilities to another jurisdiction.

appetite and business continuity, remuneration, and outsourcing of services (which would include intermediaries as well as suppliers such as technology providers).

These factors enable a lower cost of capital and lower operating costs for foreign insurers, leading to pricing and/or profitability advantages for those insurers.

Tower also submits that the RBNZ's "hands off" approach to supervision discriminates against conscientious and diligent local insurers who invest seriously in complying with the RBNZ's governance, risk management and other requirements relative to both local insurers who do not so invest and to foreign insurers who are not obliged to so invest.

In summary:

- the absence of more extensive guidance to insurers and active or pre-emptive supervision by the RBNZ limits the protection of all policyholders and creates risk for the economy and the government
- there is lower protection for policyholders of foreign insurers than for diligent local insurers
- the policyholders of diligent local insurers are better protected than those of less diligent local insurers, and
- local insurers suffer some competitive disadvantages relative to foreign insurers.

These differences arise from three sources, being the 'hands off' supervisory approach of the RBNZ, the limited guidance provided by the RBNZ on some of the complexities of the insurance business and the different regulatory treatment between foreign and local insurers.

Part 3 – Exploring the RBNZ Approach to Regulation and Supervision

The RBNZ approach in perspective

Tower is conscious of the reasons and explanations for the approach taken by the RBNZ that leads to the issues of industry vulnerability, policyholder protection and competition described in the previous part of this submission. They are well publicised by the RBNZ as sensible and appropriate features of the NZ prudential regime.

The essence of this approach is firstly reliance on insurers to comply with the regulations, with very limited oversight by the RBNZ (“hands off” supervision which contrasts with that of most other prudential regulators). Secondly it is a substantial reliance on the home regulators of foreign insurers, including some exemptions from local requirements. Thirdly it is reliance on financial strength ratings and their disclosure.

Regulation and Supervision

Usually regulation refers to the rules or requirements of the regulator and supervision refers to the set of activities undertaken by the regulator to monitor and encourage or enforce the rules or regulations. Supervision usually consists of a combination of on-site reviews and scrutiny along with off-site reviews and analysis. These activities are pre-emptive and designed to prevent or to minimise the risk of insurer failure and consequential losses to policyholders and claimants.

It is notable that, since the GFC, it has become apparent that in several countries where major problems emerged among banks and insurers, it was largely the lack of effective supervision rather than shortcomings in the regulations that characterised the poor performance of those regulators.

In the Issues Paper, the RBNZ uses the term supervision in a different way. Applying normal usage, the Issues Paper makes some reference to off-site reviews, which it does undertake, and also to on-site reviews, which it generally does not carry out. It makes no reference, however, to supervisory programs of the kinds generally designed and used by prudential regulators in other countries.

It is this feature of the RBNZ regime – the absence of proactive supervision – which is the primary criticism in the FSAP report of the RBNZ’s approach. Indeed it leads to these two findings which are prominent in the FSAP report –

“The approach of the RBNZ to supervision should be strengthened by increasing the weight of regulatory discipline in its three-pillar framework. “

and

“Increasing supervisory resources for all financial sectors is key.”

These features derive from a philosophy of and framework for prudential regulation and supervision that has been defended and indeed promoted by the RBNZ, historically and in the Issues Paper, as being appropriate to New Zealand’s market, with its small size and the predominance of well regulated foreign insurers, mostly from Australia, along with a desire to minimise interference in the

market by the regulator. At the same time, if judged against other regulators and the recent NZ FSAP report by the IMF, it is out of step with the rest of the world's regulators.

Hence the RBNZ appears to have a lower emphasis on competition (lack of a level playing field for local and foreign insurers) and on policyholder protection than on maintaining a 'sound and efficient' system.

In terms of policyholder protection, the absence of full local governance and capital requirements for foreign insurers means that, in the event of the local branch or subsidiary of a foreign insurer experiencing difficulty, the RBNZ may not have the tools or the jurisdiction to enforce the actions that it would wish to take and which it could take with a local company.

Further, this limited attention to supervision explains why the Issues Paper concentrates very heavily on regulatory matters. It makes very little reference to the kind of supervision that involves monitoring compliance with the regulations and holding insurer management and Boards to account for their levels of compliance. It is also evident in the Issues Paper that the RBNZ relies heavily on –

- disclosure, including financial strength ratings by rating agencies, as a means of accountability to the public and others: this disclosure reliance appears to be unique to New Zealand
- self-discipline and regulatory compliance of management and Boards: also unique to New Zealand, and
- the appointed actuary.

While providing valuable support to the regulatory regime, in Tower's view these features are not a substitute for more substantial supervision as envisaged in the FSAP report.

The RBNZ Mandate

The RBNZ has a mandate that is not greatly different from that of other regulators, including APRA.

The RBNZ, APRA and the ICPs

For the purpose of this submission we make several references to APRA for the sake of convenience. APRA itself is not taken as the sole model for comparison with the RBNZ but rather as an exemplar of a prudential regulator that obtains a high score in the FSAP reports and as such is comparable with mainstream regulators around the world who generally aspire to conform to the ICPs and largely do so.

Tower understands that the insurance core principles (ICPs) issued by IAIS are the reference point for prudential regulators around the world and have been wholly or substantially adopted by most regulators.

The RBNZ position is demonstrably and publicly that it does not aspire to meet the spirit or the letter of a number of the ICPs.

The RBNZ mandate includes promoting a "sound and efficient insurance sector" and promoting "public confidence in the insurance sector". It also refers to policyholder protection, competition and financial stability: see in the appendix Sections 3 and 4 of the Insurance (Prudential Supervision) Act 2010.

For comparison, APRA's dominant requirements are around policyholder protection (in the Insurance Act) and APRA is also required to fulfil financial stability and competition objectives (in the APRA Act) – see legislative excerpts in the appendix.

These mandates, while superficially similar, can be interpreted and managed differently with different parts of the legislation being given different emphases according firstly to the policy of the government and the regulator and secondly to the chosen modus operandi and internal culture of the regulator. They can also be influenced or qualified by other parts of the legislation or by other aspects of government policy.

Such differences exist starkly as between the RBNZ on the one hand and APRA and most other prudential regulators on the other hand. Hence the FSAP findings quoted below.

To the extent that there is a trade-off between compliance effort and costs on the one hand ("red tape") and insurer or regulatory efficiency on the other, the RBNZ appears to come down strongly on the side of efficiency in the form of its "hands off" supervisory approach. The moral hazard argument above seems to be an important part of the justification for making this trade-off.

Accordingly the RBNZ mandate can justify the lack of a strong emphasis on supervision and on policyholder protection. The RBNZ also gives greater priority to minimising "red tape" and intrusiveness than to undertaking pre-emptive initiatives that minimise risk to policyholders (and hence also to shareholders and to the government – if it has to step in when an insurer fails).

The NZ FSAP report – challenging the RBNZ philosophy

The NZ FSAP report compares the regulatory regime in New Zealand against the IAIS Insurance Core Principles (ICPs). The report takes a strong position on just one issue relating to insurance. It is supervision (and it applies equally to banking).

The Executive Summary of the FSAP report states that –

“The approach of the RBNZ to supervision should be strengthened by increasing the weight of regulatory discipline in its three-pillar framework. The RBNZ approach to supervision relies on three pillars: self, market, and regulatory discipline. The authorities have strengthened regulatory discipline since the last FSAP, but the three-pillar framework should be improved by adopting a more intensive approach to supervision. This would increase the ability of supervisors to be proactive to exercise regulatory discipline and obtain reliable information to enforce self- and market-discipline. The RBNZ is encouraged to issue enforceable supervisory standards on key risks, review the enforcement regime to promote preventive action, and initiate on-site programs targeted on areas of high risk. In addition, clarifying the responsibilities of the Treasury and RBNZ on financial sector issues and

reinforcing the role and autonomy of the RBNZ as prudential regulator and supervisor would enhance the ability of the RBNZ to respond swiftly to ongoing and emerging risks.

“Increasing supervisory resources for all financial sectors is key. This would support the highly qualified RBNZ staff in improving the effectiveness of the supervisory process, enhancing their knowledge of financial institutions’ operations, and deepening risk assessment of supervised entities—and strengthening their ability for early preventive action.”

The basis of these findings is the material in paragraphs 27 to 31 of the FSAP report (see Appendix B). In particular, Paragraph 31 notes that –

“The non-intrusive approach to supervision of the RBNZ stands in contrast with the ... Insurance Core Principles (ICP) and can impair the effectiveness of market and self-discipline. The effectiveness of the RBNZ approach ... Is hindered by (i) the absence of supervisory testing to determine compliance and the effectiveness of risk management and (ii) limited supervisory guidelines and regulations that could serve as benchmarks for the three pillars ... there is a need to close the most significant gaps by:

- ...
- Initiating on-site programs to test the foundation of the three-pillar approach and directors’ attestations.”

Section 9.8 of the ICPs gives an extensive description of the functions and goals of on-site reviews – see Appendix C.

The RBNZ’s public reaction to the FSAP outcome, which it regards as favourable, indicates that what is important to the RBNZ is different from the IAIS position and almost all other countries’ regulators.

Such findings are unusual in FSAP reports, reflecting the fact that most other prudential regulators embrace pro-active supervision. As, however, the RBNZ has a deliberate policy of low supervision, these findings would have come as no surprise to it. In other words, the RBNZ position demonstrates views on regulation and supervision of insurers that are different from those of most other regulators. These views apply to both banking and insurance. They include –

- Reliance on regulation and off-site reviews of governance and risk management (i.e. no on-site supervision or active scrutiny of governance and risk management)
 - ever since the main lessons for regulators of the GFC have been absorbed, the importance of good quality supervision has been widely recognised and accepted, except in NZ
- A willingness to rely heavily on offshore regulators, especially APRA. This reliance works well enough, largely because of the domination of the NZ market by strongly regulated and supervised offshore companies. At one level this situation protects the local market (whether that is well recognised or not). At another level it can breed a degree of both regulator complacency and limited regulator awareness of the risks.

The RBNZ rationale for limited supervision

The RBNZ has explained what it sees as the moral hazards associated with on-site reviews and conventional prudential supervision. It has explained that if it becomes involved in pro-active supervision, of the kind recommended in the FSAP report, boards will simply take less responsibility because the regulator would be doing the board's job for it.

This view is contrary to the views of the IAIS and of many other regulators. Tower understands that it is also counter to the evidence of historical experience of regulators who have been in a position to compare both approaches.

This experience demonstrates that pro-active supervision actually makes boards much more aware of their responsibilities and risks, with the result that they do their jobs better not worse. In fact they become acutely sensitised to prudential risks including capital management, risk management and proper governance.

In summary, there is a philosophy within the RBNZ around supervision which is out of step with the rest of the world, as is evidenced by the content of the Issues Paper, a reading of the ICPs and the findings of the FSAP report. It appears nevertheless to be a strongly held view by the RBNZ.³

Principles-based versus prescriptive regulation

There has been a widespread move towards principles-based regulation in many jurisdictions in recent years. Two examples are cited from Australia, one from APRA and one from the NSW Government.⁴

RBNZ is generally prescriptive in its regulations. The Issues Paper canvasses options for increasing and for reducing various aspects of its regulations and prefers less regulation rather than more.

Principles-based regulation in general is less extensive (less 'red tape'), more flexible and more suitable in a market-based economy than prescriptive regulation.

However reliance on regulatory principles rather than "black and white" rules leads to greater reliance on effective supervision.

This topic is relevant to RBNZ if it wishes to reduce 'red tape' and the burden of prescriptive regulation: it comes at a price and that price is more pro-active supervision.

³ See also commentary on principles-based versus prescriptive regulation, which adds to the case for more pro-active supervision in the RBNZ quest for more efficient regulation.

⁴ APRA explicitly adopts principles-based regulation through the use of Prudential Standards, being rules that in most cases are not prescriptive, and Prudential Practice Guides, which give advice that is not mandatory on how to meet the principles in the regulations. In 2013 the NSW Government issued a then confidential internal document entitled "Guidance for regulators to implement outcome-based and risk-based regulation". This document was made public in October 2016 and applies to all use NSW Government regulators, across many industries not just insurance. The document is like a textbook on the subject of principles-based regulation.

Regulatory guidance

As indicated previously in this submission, the complexities of the insurance business are such that ensuring compliance by insurers with the RBNZ's prudential requirements is a difficult task for insurance company boards and management.

In expressing its concern at the narrow scope of regulatory guidance from RBNZ, tower believes that there is considerable scope for the our BNZ to offer more guidance through adopting more of the standards, guidance and assessment methodology laid out in the documents in the eye AIS documents documentation of the insurance core principles. Some excerpts are set out in appendix D.

As already noted in the previous section there are a number of areas where additional guidance would be valuable.

Part 4 – Questions in the issues paper addressed in this submission

This submission can be read as responding to seven of the 26 questions in the Issues paper. They are Questions 6, 7, 10, 11, 14, 16 and 22.

Tower's responses to these questions are implicit if not explicit in this submission. Below, however, are some brief additional comments in direct response to these questions:

Question 6: Do you consider that the Review should reassess the application of the legislation to insurers operating as branches? Please provide commentary in support of your view.

The answer is yes, in the interests of both competitive neutrality and policyholder protection.

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?

The main risk to the economy, beyond the effects of competitive disadvantages to New Zealand-based companies, is that sufficient capital may not be available to support New Zealand policyholders in the event of insurer difficulty inside or outside of New Zealand.

The main risk to policyholders in addition to possible lack of available capital in a time of difficulty is policyholder preference in another jurisdiction that would prevent NZ policyholders from receiving their 'fair share'.

Question 10: Do you consider that the expectations placed on the directors, chief executive officer, chief financial officer or appointed actuary of insurers, would benefit from being considered further within the Review? This may include clarifications of current expectations or expansion of responsibilities.

Tower believes that the primary issue here is not the expectations but the need for the RBNZ to hold companies accountable for these expectations, i.e. the supervision question. There are also competition neutrality issues where foreign insurers have lesser obligations to the RBNZ than local insurers.

Question 11: Do you consider that the Review should encompass further consideration of an insurer's key control functions (paragraph 84) to promote effective risk management and consistent application of requirements across the sector?

As for question 10.

Question 14: Are there any areas of the framework that may pose particular concerns when considering overseas insurers (branch operations)?

Branch operations are more vulnerable than foreign owned subsidiaries. Tower believes that a special regime to deal with branches should be introduced, for both competitive and

policyholder protection reasons, if branches are to continue to be allowed to operate in New Zealand.

Question 16: Do you consider that consideration should be given to clarifying the Reserve Bank's prudential response to deteriorations in reported solvency levels? Please provide commentary in support of your views.

It would be helpful if the RBNZ were to articulate a more complete system for assessing capital adequacy must specifying insurer responses when solvency levels reduce.

Question 22: Do you consider that the Review should reassess the manner in which requirements are currently specified and the mix between requirements set out in legislation, standards or guidance? Please provide commentary in support of your view.

The commentary and proposals in this submission regarding supervision be taken is offering an extensive response to this question.

Appendix A – Legislative excerpts

New Zealand Legislation

Insurance (Prudential Supervision) Act 2010

3 Purposes

- (1) The purposes of this Act are to—
- (a) promote the maintenance of a sound and efficient insurance sector; and
 - (b) promote public confidence in the insurance sector.
- (2) Those purposes are achieved by—
- (a) establishing a system for licensing insurers; and
 - (b) imposing prudential requirements on insurers; and
 - (c) providing for the supervision by the Reserve Bank of New Zealand (the Bank) of compliance with those requirements; and
 - (d) conferring certain powers on the Bank to act in respect of insurers in financial distress or other difficulties.

4 Principles to be taken into account under this Act

In achieving the purposes of this Act, the Bank must take into account the following principles that are relevant to the performance of functions or duties imposed, or the exercise of powers conferred, on the Bank by this Act:

- (a) the importance of insurance to members of the public in terms of their personal or business risk management:
- (b) the importance of maintaining the sustainability of the New Zealand insurance market:
- (c) the importance of dealing with an insurer in financial distress or other difficulties in a manner that aims to—
 - (i) adequately protect the interests of its policyholders and the public interest; and
 - (ii) ensure that any failure, or possible failure, of the insurer does not have the potential to significantly damage the financial system or the economy of New Zealand:
- (d) the importance of recognising—
 - (i) that it is not a purpose of this Act to eliminate all risk of insurer failure; and
 - (ii) that members of the public are responsible for their own decisions relating to insurance:
- (e) the desirability of providing to the public adequate information to enable members of the public to make those decisions:
- (f) the desirability of consistency in the treatment of similar institutions (while recognising that the New Zealand insurance market comprises a diversity of institutions):
- (g) the need to maintain competition within the insurance sector:
- (h) the need to avoid unnecessary compliance costs:
- (i) the desirability of sound governance of insurers:
- (j) the desirability of effective risk management by insurers.

Australian legislation

Australian Prudential Regulation Authority Act 1998 (APRA Act)

“In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.”

Insurance Act 1973 (Australia)

“The main object of this Act is to protect the interests of policyholders and prospective policyholders under insurance policies (issued by general insurers and Lloyd’s underwriters) in ways that are consistent with the continued development of a viable, competitive and innovative insurance industry.”

APRA Act S8A

“Trans-Tasman cooperation

(1) In performing and exercising its functions and powers, APRA must:

- (a) support the prescribed New Zealand authorities in meeting their statutory responsibilities relating to prudential regulation and financial system stability in New Zealand; and
- (b) to the extent reasonably practicable, avoid any action that is likely to have a detrimental effect on financial system stability in New Zealand.

(2) APRA must balance the requirements of subsection (1) with the requirements specified in section 8.

(3) If:

- (a) APRA proposes to take an action; and
- (b) APRA has reasonable cause to believe that the action is likely to have a detrimental effect on financial system stability in New Zealand;

APRA must, to the extent that APRA considers reasonably practicable in the circumstances, having regard to urgency or other similar constraint, consult with and consider the advice of each prescribed New Zealand authority APRA considers to be relevant in the circumstances before taking the action.

(4) The performance of a function or the exercise of a power by APRA is not invalid merely because of a failure by APRA to comply with this section.

Appendix B – FSAP Report extracts

The Executive Summary of the FSAP report states that –

The approach of the RBNZ to supervision should be strengthened by increasing the weight of regulatory discipline in its three-pillar framework. The RBNZ approach to supervision relies on three pillars: self, market, and regulatory discipline. The authorities have strengthened regulatory discipline since the last FSAP, but the three-pillar framework should be improved by adopting a more intensive approach to supervision. This would increase the ability of supervisors to be proactive to exercise regulatory discipline and obtain reliable information to enforce self- and market-discipline. The RBNZ is encouraged to issue enforceable supervisory standards on key risks, review the enforcement regime to promote preventive action, and initiate on-site programs targeted on areas of high risk. In addition, clarifying the responsibilities of the Treasury and RBNZ on financial sector issues and reinforcing the role and autonomy of the RBNZ as prudential regulator and supervisor would enhance the ability of the RBNZ to respond swiftly to ongoing and emerging risks.

Increasing supervisory resources for all financial sectors is key. This would support the highly qualified RBNZ staff in improving the effectiveness of the supervisory process, enhancing their knowledge of financial institutions' operations, and deepening risk assessment of supervised entities—and strengthening their ability for early preventive action.

The report proper includes:

29. The overall framework for prudential regulation is well-developed, though there is scope to extend the powers of the RBNZ and develop enforcement practices. While the RBNZ has extensive powers in relation to licensing, supervision and enforcement, its effectiveness would be strengthened with broader powers to impose binding standards in all areas of prudential regulation (powers are limited to solvency and fit-and-proper requirements). The framework for licensing of overseas insurers (branches) could be strengthened to ensure the RBNZ assesses the equivalence of foreign regulatory regimes. Supervisory engagement, particularly with large institutions, needs to move towards communicating supervisory expectations and requiring action.

30. While RBNZ staff are highly competent, insufficient resources are an impediment to enhancing the effectiveness of the three pillar approach, even if the low-intensity approach is retained. The competence and professionalism of staff is recognized by market participants, but the RBNZ operates under specific resource constraints and numbers are insufficient. Strengthening the regulatory discipline pillar will require increased resources, including technical capacity to develop prudential requirements and guidelines, deepen the analysis that supports the supervisory ratings, and to develop a supervision policy that reflects a balance between risk and efficiency costs of supervision. The FMA, in turn, needs to build more insurance expertise to promote adequate conduct supervision of the sector.

31. The non-intrusive approach to supervision of the RBNZ stands in contrast with the Basel Core Principles for Effective Banking Supervision (BCP) and Insurance Core Principles

(ICP) and can impair the effectiveness of market and self-discipline (Annexes V and VI). The effectiveness of the RBNZ approach—and its convergence with the BCP and ICP—is hindered by: (i) the absence of supervisory testing to determine compliance and the effectiveness of risk management, and (ii) limited supervisory guidelines and regulations that could serve as benchmarks for the three pillars. While policy implementation will take significant time, there is a need to close the most significant gaps by:

- **Issuing enforceable supervisory standards on key risks.** Such standards, tailored to reflect the complexity and risk profile of the institutions and the system, would provide transparency to market participants regarding the supervisor’s expectations in the areas being attested to by directors. Standards also help support supervisory judgment to implement preventive enforcement. Regulation of governance, risk management and controls and undertaking risk assessment in these areas need to be strengthened to promote the effectiveness of governance in practice.
- **Reviewing the enforcement regime to promote preventive action.** Compliance with the guidelines issued by the RBNZ should serve as evidence of prudent banking and insurance. Also, in the case of banking, the legal need for the consent of the MoF to issue directions in cases not involving a systemic impact should be removed.
- **Initiating on-site programs to test the foundation of the three-pillar approach and directors’ attestations.** The RBNZ has performed off-site thematic reviews to profile banks’ risk management in areas of concern, such as dairy and real estate. The off-site process (PRESS) and (iPRESS) rates financial institutions based on their risk profile (and their systemic impact). The onsite activity, which could be undertaken by the staff of RBNZ or by external experts, should be targeted to areas of high risk, to issues identified through off-site analysis, or to determine how banks and insurers are managing new risks and products. It is also important to test the accuracy of the regulatory reports.
- **Clarifying the responsibilities of the Treasury and RBNZ for financial sector issues, reinforcing the RBNZ’s role as prudential regulator and supervisor.** Unclear boundaries could potentially compromise RBNZ independence and limit its ability to fulfil its supervisory role. Further delineating the boundaries with the Treasury would enhance the ability of the RBNZ to undertake effective supervision by responding swiftly to ongoing and emergent situations (Appendix V).

Appendix C – International ICP 9 and On-site Inspection

ICP 9 Supervisory Review and Reporting

The supervisor takes a risk-based approach to supervision that uses both off-site monitoring and on-site inspections to examine the business of each insurer, evaluate its condition, risk profile and conduct, the quality and effectiveness of its corporate governance and its compliance with relevant legislation and supervisory requirements. The supervisor obtains the necessary information to conduct effective supervision of insurers and evaluate the insurance market.

On-site inspection

9.8 The supervisor sets the objective and scope for on-site inspections, develops corresponding work programmes and conducts such inspections.

9.8.1 On-site inspection may provide information that can supplement the analysis from off-site monitoring and the supervisor should take the opportunity to verify information it has received. On-site inspection may also help detect problems that may not be apparent through off-site monitoring.

9.8.2 On-site inspections should be tailored to the particular insurer and to any detected problems. However, an on-site inspection plan should remain flexible since new priorities might arise.

9.8.3 The supervisor may use on-site inspections as an opportunity to interact with the Board, Senior Management and Key Persons in Control Functions. This enables the supervisor to assess their ongoing suitability, the insurer's organisational culture, the quality of their corporate governance, risk management and internal controls and to explore the rationale behind their strategy and business plan.

9.8.4 Important objectives in conducting an on-site inspection include reviewing the insurer's risk management processes and compliance with relevant insurance laws and regulations. This review helps the supervisor identify the strengths and weaknesses in the insurer's approach, and assess and analyse the risks to which an insurer and its customers are exposed.

9.8.5 The supervisor may delegate part of an on-site inspection to independent experts.¹⁸ If it does so, the supervisor should:

- be satisfied that independent experts possess the necessary competence and skills;
- monitor their performance and retain the ability to take any necessary action against them;
- be satisfied of their independence from the insurer; and
- have regard to the consideration they give to the protection of the policyholders' interests.

9.8.6 The frequency, scope and depth of on-site inspections should take account of the insurer's distribution model, the nature, size and sophistication of its customer base and its relative importance in the market. On-site inspections should be more frequent and more in-depth when

they concern insurers which are in a difficult financial position or where there is concern that their business practices pose a high risk of negative customer outcomes.

9.8.7 The supervisor may conduct on-site inspections on either a full scale basis, or limited scale basis focused on area(s) of specific concern. A full-scale on-site inspection would be expected to include at least the following:

- evaluation of the on-going effectiveness of the corporate governance structure including its risk management and internal control systems;
- analysis of the nature of the insurer's key business activities (e.g. type of business written, customer base, distribution model(s) used);
- analysis of the relationships with external entities, such as through outsourcing or with respect to other companies in the same group, including any resultant conflicts of interest;
- analysis of the insurer's underwriting policy and reinsurance agreements;
- assessment of the insurer's financial strength; and
- assessment of the insurer's fair treatment of customers, including observance of conduct of business requirements and consumer regulations.

9.8.8 Advance notice to the insurer is not required before conducting an on-site inspection, although advance notice is normally given.

9.8.9 Although the supervisor may not have the power to conduct on-site inspections of non-regulated entities, including a holding company within the group, it should review, at a minimum, the potential adverse impact on the insurer of such non-regulated entities through on-site inspection of the insurer.

9.8.10 Similarly, where the group-wide supervisor does not have the power to conduct on-site inspection of a group entity in another jurisdiction, it may approach the host supervisor to propose a joint inspection or recommend that the host supervisor undertake such an inspection, when deemed necessary.

9.8.11 Further examples of how Standard 9.8 and guidance under it can be pursued can be found in the Annex to this ICP.

Supervisory feedback and follow-up

9.9 The supervisor discusses with the insurer any relevant findings of the supervisory review and the need for any preventive or corrective action. The supervisor follows up to check that required actions have been taken by the insurer.

Appendix D – International ICPs: selected excerpts

ICP 7 Corporate Governance

The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer’s business and adequately recognises and protects the interests of policyholders.

Objectives and strategies of the insurer

7.1 The supervisor requires the insurer’s Board to set and oversee the implementation of the insurer’s business objectives and strategies for achieving those objectives, including its risk strategy and risk appetite, in line with the insurer’s long term interests and viability.

Remuneration policy and practices

7.6 The supervisor requires the insurer’s Board to:

- adopt and oversee the effective implementation of a remuneration policy, which does not induce excessive or inappropriate risk taking, is in line with the identified risk appetite and long term interests of the insurer, and has proper regard to the interests of its stakeholders; and
- ensure that such a remuneration policy, at a minimum, covers those individuals who are members of the Board, Senior Management, Key Persons in Control Functions and other employees whose actions may have a material impact on the risk exposure of the insurer (major risk-taking staff).

Overall remuneration strategy and oversight

7.6.1 As a part of effective risk management, an insurer should adopt and implement a prudent and effective remuneration policy. Such a policy should not encourage individuals, particularly members of the Board and Senior Management, Key Persons in Control Functions and major risk-taking staff, to take inappropriate or excessive risks, especially where performance based variable remuneration is used.

7.6.3 The Board should ultimately be satisfied that the overall remuneration policy and practices are consistent with the identified risk appetite and the long term interests of the insurer and its stakeholders.

Supervisory review

7.10 The supervisor has the power to require the insurer to demonstrate the adequacy and effectiveness of its corporate governance framework.

7.10.1 The supervisor plays an important role by requiring the Board and Senior Management of the insurer to demonstrate that they are meeting the applicable corporate governance requirements, consistent with these standards, on an on-going basis. For this purpose, the supervisor should assess whether the insurer’s overall corporate governance framework, including remuneration policies and practices, is effectively implemented and remains adequate by undertaking periodic on-site

inspections and/or other (including offsite) reviews as appropriate to the nature, scale and complexity of the insurer's business and its risk profile. Where significant changes in the insurer's corporate governance framework are identified, including through information provided by the insurer, the supervisor should update its assessment.

7.10.2 The onus for demonstrating, to the satisfaction of the supervisor, that the corporate governance framework is effective and operates as intended rests with the insurer. The supervisor should provide any guidance and rulings as appropriate to facilitate this process. The supervisor should, for the purposes of monitoring due compliance, establish effective channels of communication with the insurer, and have access to relevant information concerning the governance of the insurer. This may be obtained through periodic reports to the supervisor and any information obtained on an ad-hoc basis (see also Standard 7.8).

ICP 8 Risk Management and Internal Controls

The supervisor requires an insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit.

ICP 13 Reinsurance and Other Forms of Risk Transfer

The supervisor sets standards for the use of reinsurance and other forms of risk transfer, ensuring that insurers adequately control and transparently report their risk transfer programmes. The supervisor takes into account the nature of reinsurance business when supervising reinsurers based in its jurisdiction.

13.0.10 The administrative arrangements surrounding a reinsurance programme can give rise to operational risk, for instance through inadequate contractual arrangements, inadequate administration and IT system capabilities, ineffective tracking of aggregate claims which may give rise to a recovery under the reinsurance programme, failure to collect receivables as they fall due, and untimely reporting to reinsurers.

13.0.11 Reinsurance contracts may pose legal risk as they can be relatively complex and may not always respond in the way in which the cedants expect that they will. Legal risk is the possibility that lawsuits, adverse judgments or contracts that are disputed or turn out to be unenforceable disrupt or adversely affect the operations or condition of a cedant.

Link to capital assessment

13.1.9 The cedant should ensure that the characteristics of its reinsurance programme, including associated counterparty risk, are adequately reflected in any assessment of risk-based solvency capital.