RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

The insurance regulatory landscape in New Zealand

A speech delivered to the Australasian General Insurance Exchange Conference in Sydney, Australia

On 19 March 2013

By Toby Fiennes, RBNZ Head of Prudential Supervision

2 The Terrace, PO Box 2498, Wellington 6140, New Zealand
Telephone 64 4 472 2029 Online at www.rbnz.govt.nz

Introduction

"Human history becomes more and more a race between education and catastrophe"

H G Wells

Overview

Today I'd like to discuss the Reserve Bank's approach to regulation of the insurance sector. I'll discuss:

- our approach to insurance regulation;
- the relatively new regulatory regime;
- the Canterbury earthquakes; and
- emphasise that the insurance prudential regime isn't a zero failure regime and doesn't provide for a Reserve Bank or government guarantee.

Reserve Bank approach to insurance regulation

We were given the task of regulating and supervising the New Zealand insurance sector with the passage of the Insurance (Prudential Supervision) Act 2010 ("the Act"). We are charged with promoting a sound and efficient insurance sector, and one in which people have confidence.

In terms of the quote from the peerless H G Wells, we see a large part of our role as being to make sure that everyone (insurers, policyholders and indeed the Reserve Bank) is as well-informed and prepared as possible. This will minimise the risk of insurer failure, albeit in the context of the "art of the possible" – there are limits on what regulation can realistically achieve, and certainly on government's ability to support.

Let me explain how we go about that task. Our approach to insurance prudential regulation and supervision is based on three pillars: self-discipline, market discipline and regulatory discipline.

Self-discipline

Responsibility for a firm's internal risk management and governance systems rests firmly and primarily with the insurer's board, senior managers and its appointed actuary. We seek to enhance self-discipline in every way that we can. This includes setting governance requirements and emphasising independent scrutiny by the Board of Directors.

Market discipline

Investors and policyholders are responsible for monitoring financial risk and performance of financial institutions, and influence their risk-related behaviour.[1] We mandate various disclosure requirements to support market discipline.

Regulatory discipline

Our risk-based approach involves imposing certain rules and mandatory requirements in areas such as solvency, and general requirements in areas such as risk management and governance. The approach is risk-based in that we will set tougher requirements, and / or

[1] For a fuller discussion see Mortlock, G 'Strengthening market disciplines in the financial sector', Reserve Bank of New Zealand *Bulletin*, 65 (3). September 2002

exercise more intensive supervision where we perceive the risks to our objectives to be higher.

A satisfactory solvency margin and minimum capital are key licensing criteria under the Act.

Externalities and information asymmetries

Two basic purposes of our regime are to mitigate externalities within the financial system and information asymmetries between policyholders and insurers.

Externalities

Insurers are an integral part of the financial system. But in managing their own solvency position, insurers won't typically consider potential implications for the wider financial system. The failure of a major insurer could potentially damage the soundness of the rest of the New Zealand insurance sector and possibly also the wider financial system. Certainly, confidence in the insurance sector would be lessened.

Information asymmetries

Policyholders need information to understand the likelihood that their insurer will be able to pay claims. Typically policyholders don't have the financial experience to appraise insurers' published financial statements and make an informed assessment of an insurer's solvency position. Mandatory disclosure requirements in areas such as solvency and the financial strength rating aim to overcome these information asymmetries and help policyholders to make informed decisions. Advisers and commentators play a critical role in helping policyholders interpret the information.

Purpose of regulation and supervision

Our approach to regulation and supervision is based on the Insurance (Prudential Supervision) Act 2010 and aligns well with our approach in other sectors such as banking. The Act is comparatively non-intrusive in its application and places strong emphasis on director and senior officer obligations, as well as on accountability and market discipline.

As noted, our purpose as set out in the legislation is to:

- promote the maintenance of a sound and efficient insurance sector; and
- promote public confidence in the insurance sector.

It seeks to achieve this by:

- establishing a system for licensing insurers;
- imposing prudential requirements on insurers;
- providing for the supervision by the Bank of compliance with those requirements; and
- conferring certain powers on the Bank to act in respect of insurers in financial distress or other difficulties.

New to regulation

Licensing of insurers is a fundamental step. All insurers (of which there turned out to be more than 100) were required to be licensed by 7 March 2012: this could be a full, provisional or run-off licence. Before that date, seven insurers exited the market, primarily due to the Act, representing about 0.02 percent of the market as measured by annual premiums.[2]

We are likely to see further consolidation in parts of the insurance sector or other insurers leaving the sector, as a result of our higher minimum solvency standards. This is positive for the sector and for policyholders, because reducing areas of high risk assists in the correction of any mispricing of risk and will improve the soundness of the New Zealand insurance sector.

Sectoral information

Table 1 shows the approximate share of gross written premium of licensed insurers (excluding those in run-off) by industry type.

Table 1: Approximate share of licensed insurers (excl run-off)

% of gross annual premium income	Number		
Total licensed insurers	100%		
By predominant type of insurance:			
Reinsurance	7%		
Life insurance	25%		
Health insurance	12%		
Non-life insurance	57%		
By domicile:			
New Zealand	81%		
Australia	13%		
United Kingdom	2%		
Japan	< 1%		
USA	< 1%		
Bermuda, France, Germany, India, Neth.	3%		
By insurer/reinsurer and type:	**Insurer**	**Reinsurer**	**Total**
Life (re)insurer	25%	3%	28%
Health (re)insurer	12%	0%	12%
Non-life (re)insurer	57%	3%	60%
Total	94%	7%	100%
By domicile and type of insurance:	**NZ**	**Offshore**	**Total**
Reinsurance	0%	7%	7%
Life insurance	18%	7%	25%
Health insurance	12%	0%	12%
Non-life insurance	50%	6%	56%
Total	80%	20%	100%

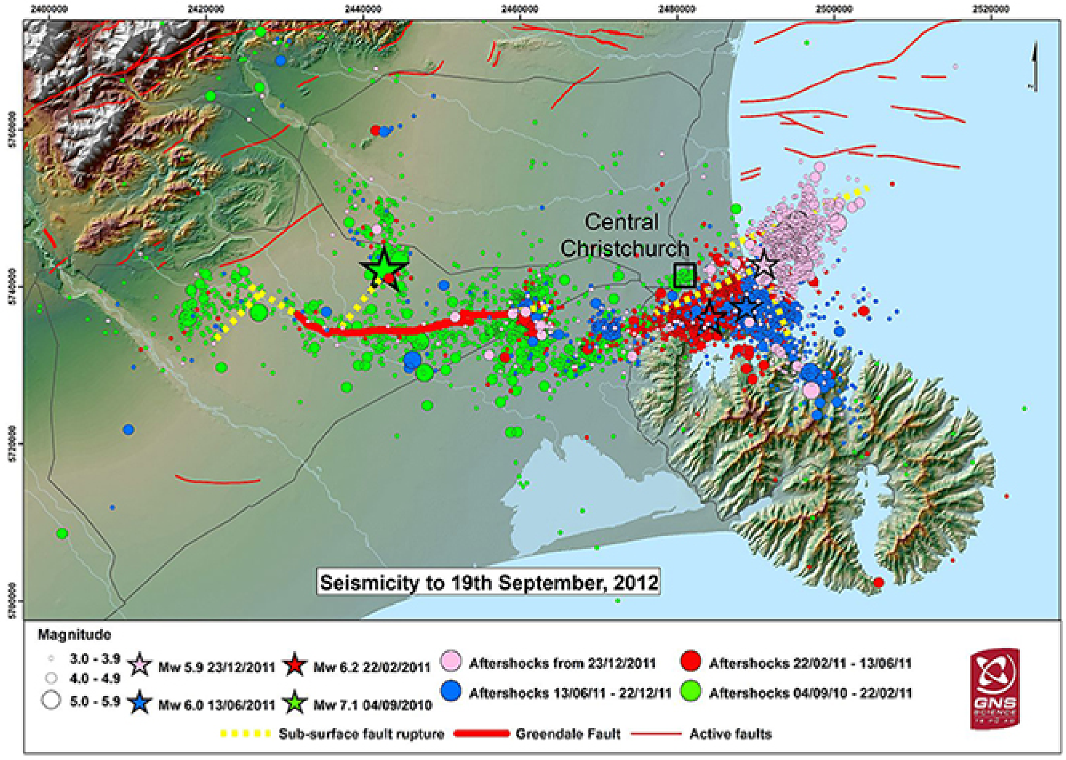
Christchurch earthquakes

The Canterbury earthquakes of 2010 – 2012 are the most significant natural disaster to affect New Zealand for the past 80 years. They are among the top 10 largest insurance

[2] Reserve Bank of New Zealand, *Financial Stability Report*, May 2012.

payouts ever made. The first earthquake in the 2010 – 2012 Canterbury earthquake sequence, on 4 September 2010, struck three days before the Act was signed into law.

The picture, from GNS, depicts the location of the main earthquakes and aftershocks in relation to central Christchurch, and by time period.

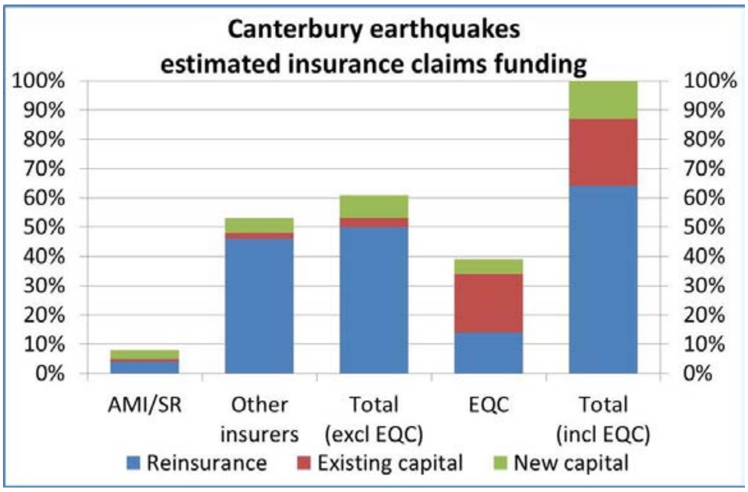


New Zealand is fortunate that the level and take-up of earthquake insurance coverage are currently extremely high by global standards. As a result, a substantial proportion of costs will be funded by insurance, and shared globally by reinsurance. After reinsurance, existing capital is the second most important source of funds.[3]

Chart 1 shows the estimated insurance claims and how they are funded. New capital for AMI includes Crown support as well as the proceeds of the sale of 'new AMI' to IAG.

[3] Cole, R; *Canterbury earthquakes 2010 – 2012: Insurance supervision in the first 2 years*; NZSA Conference 2012, 18-21 November

Chart 1



Key: 'SR' stands for Southern Response Earthquake Services Limited.

AMI Insurance Limited

AMI was one of the largest household insurers in New Zealand. Being based in Christchurch it had a very high exposure to the Canterbury earthquakes. Following the February 2011 earthquake AMI advised the Minister of Finance that it might not have sufficient reinsurance to meet its claims following that earthquake. As a mutual insurer it didn't have a parent to call upon for capital support. AMI requested Crown assistance, and we provided information and advice around the eventual Crown support package.

Western Pacific Insurance Limited

At the same time, Western Pacific advised that they had insufficient funds to make payments required by its reinsurers before they would pay any further reinsurance recoveries. Western Pacific requested Crown assistance, which was not provided and it went into liquidation.

Moral hazard

Moral hazard is an important consideration. If insurers believe that government assistance in the event of failure is relatively likely, then insurers may assume less prudent levels of risk or hold less capital than would otherwise be the case. Government support of AMI has increased the moral hazard to the extent that other insurers that get into difficulty, especially in the aftermath of a tragic natural disaster, may expect to be supported also.

A key priority for us in our regulatory settings, our supervision and our communications is to minimise moral hazard.

Catastrophe risk capital charge

In October 2011 we released a policy position paper on the calibration of the catastrophe risk capital charge in the Solvency Standard for Non-life Insurance Business. Our basic premise is that insurers, reinsurers and property owners should rightly bear the risks of a catastrophe, rather than government whose costs are ultimately borne by all taxpayers.

We calibrated the capital charge to a loss return period of 1 in 500 years, or the maximum level of catastrophe reinsurance held by the insurer prior to full licensing if this is higher, for financial reporting periods commencing until 7 September 2015. We also clearly flagged our intention to ultimately increase this to 1 in 1000 years over a defined period.

What the regime is and is not

Our regime is designed to underpin confidence in New Zealand insurers. By setting minimum standards, enforcing market disclosure and engaging with individual insurers, we provide a basic level of assurance and transparency to counter the externalities and information asymmetry that I referred to earlier.

The regime is also strongly about self-discipline. It firmly places reliance on the insurer's board, senior management and the appointed actuary. The board and chief executive have to satisfy themselves, and attest to us as part of the licensing process, that the business is being run prudently and that they operate a satisfactory risk management programme.

A key part of the appointed actuary's responsibility is the calculation of the insurer's solvency position. All solvency margin calculations must be either prepared or reviewed by the insurer's appointed actuary. The insurer's board is responsible for ensuring that the solvency standard is being met in full. Implicit within the board's role is consideration of the assumptions made by the appointed actuary.

The intention is to significantly reduce the likelihood of failure. Where there are concerns about financial distress or the prudent management of a licensed insurer, we have powers to enable, if necessary, the orderly wind-down of a licensed insurer.

So what does the regime not do? It does not provide for a zero failure regime. It remains possible, if unlikely, that a licensed insurer will fail and policyholders' claims will not be met in full. If that happens, there should be no expectation of recourse to either the taxpayer or the Reserve Bank.

Conclusion

The regulation of the insurance sector is consistent with the Bank's approach to regulation and supervision in other sectors. As with the banking and non-bank deposit taking sector, there's no Government or Bank guarantee against the failure of a licensed insurer. The prudential requirements of the Act significantly reduce the likelihood of failure and provide the Bank with appropriate tools to manage financial distress of an insurer. However, we do not run a zero failure regime, nor is there any Reserve Bank or government guarantee against failure.