RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Building confidence and reducing risks in the insurance sector

A speech delivered at the Insurance Council of New Zealand Conference

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“You never know these days. Uninvited guests may force you to take an unplanned trip to an unknown destination; doesn’t hurt to be in your Sunday clothes.”

– Anurag Shourie, Half A Shadow

Tēnā koutou katoa

My thanks to the Insurance Council for inviting me to speak with you this morning. It is a pleasure and privilege to be here.

In the almost-decade since Parliament passed the Insurance Act in 2010[1], the insurance industry has had to deal with the consequences of many ‘uninvited guests’. The Christchurch and Kaikoura earthquakes presented unique ongoing challenges to the industry. So too have other single-firm-specific events, such as the failure and liquidation of CBL Insurance.

Furthermore, the findings from the Australian Royal Commission and our recent Conduct and Culture Review - jointly undertaken with the Financial Markets Authority (FMA) - demonstrate the need for ongoing constructive change across the sector.

I am going to share with you today the Reserve Bank’s perspectives on some of these events, and about the future direction of our insurance policy and supervision work - including some of the initiatives that we will seek your feedback on in due course.

Our desire is to ensure that the insurance sector is financially sound and trusted. We must be in our best ‘Sunday clothes’ all week long.

Promoting soundness and confidence is challenging

The insurance industry is a crucial part of any modern economy. It is the part of the ecosystem that society relies heavily on to both mitigate risks and/or transfer the risk-burden to those best able to manage it.

There are just under 90 licensed insurers operating in New Zealand. Through the Insurance Act, the Reserve Bank is tasked with maintaining the soundness of the insurance sector, and public confidence in the sector.

By definition, this task is far from straight forward. The nature of insurance contracts can vary greatly between insurers or insured events, and are often dependent on the individual circumstances of the policy holder.

Furthermore, there are significant information-asymmetries between an insurance provider and their customer, and the risks of providing poor or outdated information run in both directions. ‘Who is good for what, and when?’.

For example, often there is a long period of time after a customer-relationship has been established. In very difficult circumstances, a customer may find that they do not have the coverage they

[1] http://www.legislation.govt.nz/act/public/2010/0111/latest/DLM2478122.html

believed would be available to them. And, on the other side of the ledger, insurers rely on accurate information from customers about their own circumstances.

Finally, the Reserve Bank is not tasked with guaranteeing insurers against failure. As we have seen with the collapse of CBL and the bailout of AMI, the failure of an insurer is a significant event. Even if a single-firm-failure does not threaten the financial system as a whole, such events challenge public confidence.

Insurance challenges continuously evolve

Further complicating the task of promoting a sound and trusted insurance sector is that expectations and circumstances continuously change.

Customer expectations of 'good outcomes' from insurance are evolving, and there is a heightened awareness across the financial sector as a whole of the importance of good business conduct.

Risks also evolve. For example, climate change is leading to more frequent insurance events, and this is driving new ways of thinking about risk. Just as advances in technology are providing more data and insight into insurance risk pricing.

The Reserve Bank believes that the insurance sector must ensure that high quality risk management capability is in place, to support appropriate insurance outcomes. We support insurers using the best information to understand their customers and the risks faced by the insurer. We also respect that insurers are free to make their own commercial decisions. Getting your risk management and pricing right is an important foundation to a sound insurance sector.

However, we are conscious of the wider implications on the economy and asset prices as insurance providers make their individual business decisions. Orderly and well-articulated changes in insurance and pricing strategies are needed, so that all participants in the financial sector – and wider economy - can adapt their behaviour without creating unintended outcomes.

The Reserve Bank will be monitoring the development of insurance risk-based pricing, to ensure we understand the potential wider economic consequences and any impact on New Zealand's financial stability. We will comment on what we are observing to date in our upcoming *Financial Stability Report* on 27th November.

The Reserve Bank's policy and supervision challenges also evolve

Just as the challenges and complexity of the insurance sector evolve, so must the Reserve Bank's regulatory activity.

Our regulation and supervision of the insurance sector remains based on the same 'Three Pillars' philosophy we apply when supervising registered banks and the other financial sector participants: self, market and regulatory discipline. However, over the next year or so we expect to consult with the industry on a range of changes that will look to strengthen each pillar.

Self-discipline

The first pillar, self-discipline, refers to the strength of governance, processes, and internal controls of a firm. Our view has not changed over the years: directors are ultimately responsible and accountable for ensuring that a firm operates prudently.

Good self-discipline goes hand in hand with the culture of a firm and is key to ensuring high-quality outcomes for customers. Unfortunately, our recent review of *life* insurer conduct and culture found areas needing significant improvement. I will return to these findings later.

Market discipline

The second pillar, market discipline, means the way in which a firm is perceived by others (such as investors, clients and competitors) and how this information is acted upon.

In 2018 we introduced the *Bank Financial Strength Dashboard*, to give the public more easily digestible information about the banks they deal with. Our experience indicates that the information has been well received and it is our intention to develop a similar dashboard for insurance firms.

Regulatory discipline

The third pillar, regulatory discipline, is the rules and regulations overseen by the Reserve Bank and other agencies, established though legislation.

Our review of the Insurance Act will commence in earnest in 2020. There are very likely to be some clear areas of read-across from the current review of the Reserve Bank Act.[2] For example, there has been focus on a broader range of enforcement tools, and on a new accountability regime for directors and senior executives.

Managing the pace of change together

We are aware that the pace of change in legislative policy intentions and broader societal expectations is intense. Insurers tell us that they see regulatory change as a key risk to monitor and manage.

Our commitment is to ensure that you will have ample opportunities to contribute to these developments, and that there will be ample time for your views to be taken into consideration.

As you are aware, the review of the Insurance Act was put on hold while the Reserve Bank Act review took place. The themes and issues that were identified in our 2017 discussion paper[3] will be considered further in 2020.

We expect to give initial priority to the scope of the Act, in terms of how we adequately cater for innovation, different business models, and new entrants competing with established insurers. We will consider whether we need to make changes to the legislation that better ensures appropriate competition between overseas branches and locally incorporated insurers. And we will look to enhance the enforcement tools available to the Reserve Bank, to better align with our supervisory approach.

Additionally, the International Financial Reporting Standard, IFRS 17, is scheduled to take effect in 2022 for most insurers. While it sounds minor and detailed, this is a once-in-a-generation set of changes to the way insurance contracts are accounted for and reported to the market.

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[2] https://treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act
[3] https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Insurers/IPSA-review/20170911%20Issues%20Paper%20Feedback%20Summary%20Oct%2020174.pdf?

Critically for the Reserve Bank, the standards we set for insurer solvency are based on the information and data generated from these accounting standards. We thus need to review our solvency standards to ensure they are effective and in line with lessons from other jurisdictions, such as Australia.

It is too early to say whether or not our review of insurer solvency will lead to the kind of uplift we have proposed for bank capital. However, we do expect that the current 'black line' of a single regulatory minimum limit for solvency will be replaced with a more graduated series of thresholds - and varied regulatory response options - as we have proposed for banks.

Show and tell

A criticism identified in the Trowbridge-Scholtens report into our regulation of CBL, was the lack of 'show us' challenges we put to CBL. There was a similar, more general, point made in the International Monetary Fund's (IMF) Financial Sector Assessment Programme 2017 (FSAP) review.

When we meet with banks and insurers as the supervisor of their businesses, we have typically relied on the information given by, and word of, decision makers within those businesses. This is because we have wanted to very clearly ensure accountability sits with the directors, and also because these individuals are much closer to their day-to-day operations.

The importance of open and honest disclosure from insurers is clear. Sadly, this openness has proven to not always exist.

In CBL, we now have an example of a regulated entity that did not engage with the Reserve Bank openly. Justice Courtney's judgement in the hearing for CBL's liquidation noted "*a lack of candour in dealing with the company's auditors and the regulator*"[4]

The Reserve Bank's Relationship Charter[5] seeks – in part – to address these kinds of issues in a practical and positive manner. By establishing how we will interact with an institution, we are laying down a clear marker. What does this mean in practical terms?

The Reserve Bank needs to more often positively verify the information and assurances it receives from regulated institutions. We will be intensifying our "show me, don't just tell me" style of engagement with the industry. And, we will be expecting to see a great deal more of this verification activity happening at the senior management and board level.

An example of this new approach being applied is our review of the Appointed Actuary regime. You will be aware that this review is ongoing, and some of you have received visits from the Reserve Bank's team. A sample of 15 insurers were selected for this review, aimed to represent the diversity of the New Zealand insurance industry (e.g., small and large insurers, life and general, branch and locally incorporated, directly employed and external consultant.

For those who took part in the interviews or provided us with submissions, we thank you for your time and your open, free and frank discussions.

[4] https://forms.justice.govt.nz/search/Documents/pdf/jdo/cc/alfresco/service/api/node/content/workspace/SpacesStore/193a6a73-1a5b-436e-af77-e6ef7173c9fa/193a6a73-1a5b-436e-af77-e6ef7173c9fa.pdf

[5] https://www.rbnz.govt.nz/news/2018/12/reserve-bank-aims-for-best-regulatory-relationships

Appointed actuaries play an important and valuable role to both the industry and the Reserve Bank. We consider the appointed actuary to be a key voice at the table when an insurer is seeking to understand its financial health and future prospects.

Our review team expects to make best practice recommendations to insurers and appointed actuaries, as well as provide recommendations to our own policy and supervision teams that will feed into our review of the Insurance Act. The public report of this review is expected to be published in the first quarter of 2020.

Putting on our 'Sunday best' – closing the conduct gap

As already mentioned, earlier this year the FMA and Reserve Bank released a joint report[6] called *Life Insurer Conduct and Culture*. We believe that conduct within financial institutions is a contributing factor to customer outcomes, and can result in a gain or loss of trust and confidence in the industry.

Based on our joint analysis, we found:

- extensive weaknesses in systems and controls for managing conduct risk, coupled with a lack of governance and management oversight;
- a lack of focus on customer outcomes and limited evidence of customers being adequately considered in product design and sales;
- that sales incentives were prioritised over good customer outcomes;
- a serious lack of oversight and monitoring of intermediaries; and
- a poor and inconsistent approach to dealing with complaints and remediating issues.

Since the report was made public, we have worked with life insurers while they develop their action plans for remediating the issues and mitigating the risks we identified.

We strongly believe that all insurers - including health and general insurance – should learn from the review and its findings. This is why we have subsequently written to the boards of *general* insurers setting out our expectations that they will review the culture and governance within their own firms.

A "nothing to see here" mentality is not, and never will be, a sensible response to such an array of serious findings in a sister industry. We will be following up with non-life insurers to understand how they are reviewing these issues within their own firms.

How a firm monitors and addresses conduct and culture issues will be a part of our ongoing 'business as usual' supervision with all insurers. We will also monitor insurers to make sure their planned actions are implemented effectively.

Conclusion

The public is demanding that both insurers and regulators play a part in providing greater confidence in the health and conduct of the sector. The Reserve Bank's insurance agenda for the coming year (or years) is thus very full.

We are committed to openly communicating our development priorities to insurers and the wider public, so that individuals and firms have the opportunity and ability to be an active participant in the policy development.

[6] https://www.rbnz.govt.nz/news/2019/01/fma-and-rbnz-report-on-life-insurer-conduct-and-culture

What we ask of you, is that you engage openly and early with us, and that you heed the lessons of the banking and life insurer conduct and culture reviews.

We look forward to working with the industry and other interested parties as we embark upon this next phase of our insurance supervision development.

Thank you for your time today, and in the near-future.