Reserve Bank
of New Zealand
Te Pūtea Matua

Review of the Insurance (Prudential Supervision) Act 2010.

Options Paper 2: Policyholder Security

31 August 2021

Additional information

Information about the review, including the Terms of Reference, is available on the Reserve Bank of New Zealand website at:

http://www.rbnz.govt.nz/regulation-and-supervision/insurers/consultations-and-policy-development-for-insurers/active-policy-development/review-of-the-insurance-prudential-supervision-act-2010

Submission contact details

The Reserve Bank of New Zealand – Te Pūtea Matua invites submissions on this consultation paper by 5.00pm on Monday 15 November 2021.

Please note the disclosure on the publication of submissions below.

Address submissions and enquiries to:

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Publication of submissions:

All information provided in submissions will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document (the redacted version will be published as received).

Respondents who request that all or part of their submission be treated as confidential should provide reasons why this information should be withheld if a request is made for it under the Official Information Act 1982 (OIA). These reasons should refer to section 105 of the Reserve Bank of New Zealand Act 1989, section 54 of the Non-Bank Deposit Takers Act, section 135 of the Insurance (Prudential) Supervision Act 2010 (as applicable); or the grounds for withholding information under the OIA. If an OIA request for redacted information is made the Reserve Bank will make its own assessment of what must be released taking into account the respondent's views.

The Reserve Bank may also publish an anonymised summary of the responses received in respect of this Consultation Paper.

Contents

Introduction and scope of consultation

Background

1. In 2017, the Reserve Bank of New Zealand – Te Pūtea Matua commenced a review (the Review) of the Insurance (Prudential Supervision) Act 2010 (IPSA). The first stage of the Review, which comprised identification of issues at a high level and an initial public consultation process, was completed in 2017.[1] The Review was suspended in early 2018 to allow resources to be focused on the review of the Reserve Bank Act. We announced the relaunch of the IPSA Review on 1 October 2020. [2]

2. We are now in the second stage of the review, which involves releasing a series of options papers that work through different sections of the Act. The first document, on the scope of the act and treatment of overseas insurers, was published in November 2020.

3. This second paper explores a range of issues concerning policyholder security. It provides an overview of our approach to policyholder security and looks at relevant sections of the legislation:

   - Financial strength disclosures;
   - The way solvency standards are operationalised in IPSA;
   - Termination values; and
   - Statutory funds.

4. It concludes by inviting stakeholders to assess whether the overall level of policyholder security provided by IPSA is appropriate and whether it is worth considering some form of policyholder guarantee scheme.

The IPSA review process

5. This paper is the second paper in the second stage of our IPSA review. In this stage, we are working through each of the 11 modules set out in the 2017 consultation paper (see Table 1), seeking feedback on specific options for reforming existing legislation.

6. The first two modules, scope of legislation and overseas insurers, were dealt with in the consultation published in November 2020. This paper deals with the next two modules: statutory funds and solvency requirements, along with two disclosure requirements that are particularly designed to help policyholders assess insurers' financial soundness.

1 The first issues paper, published in 2017 can be found here.
2 The relaunch paper can be found here.

Table 1: Modules for consultation

Module	Description
Scope of Legislation	Does the legislation apply to the appropriate range of entities?
Overseas Insurers	Treatment of branches and overseas insurers
Statutory Funds	Effectiveness of the current statutory fund framework
Solvency Requirements	Reviewing the effectiveness of the current solvency framework, and the possibility of adopting a ladder of intervention approach to solvency
Distress Management	Reviewing the distress management provisions available to the Reserve Bank
Enforcement Regimes	Ensuring the Reserve Bank has an appropriate range of enforcement tools
Role of Key Officers and Key Control Functions	Responsibilities of directors and key officers and effectiveness of key control functions
Supervisory Processes	Is the Reserve Bank the most appropriate entity to approve changes in control?
Disclosure Requirements	Effectiveness of current disclosure requirements
Regulatory Mechanisms	Consolidation of requirements set in the legislation, regulations and guidance notes
Other Issues	Any additional issues identified by submitters, including areas of legislation that might be identified as redundant or overly restrictive

7. The remaining modules will be grouped together pragmatically in ways that ensure, where possible, related and interacting issues are dealt with in the same consultation. We expect these subsequent papers to be issued during 2021 and 2022. After each consultation, we will produce a summary of feedback received.

8. Once the second stage of consultation is completed, we will make in-principle policy decisions on all the issues raised. We will publish those decisions in a single document for feedback in early 2023 before moving on to legislative drafting and implementation.

Considerations shaping the options presented

9. The options for consultation in this second stage of consultation have been developed based on stakeholder feedback from the first stage and in the light of recent developments in the insurance sector.

10. The 2017 issues paper attracted 42 submissions from a range of stakeholders including insurers, industry bodies and law firms. A high-level feedback statement providing a summary of responses was published in October 2017.[3] We have built on these responses to identify the most important issues for reform and shape our discussion of possible options.

11. Additionally, the discussion of options reflects our experience of supervision under IPSA and a range of important developments in the regulatory environment.

3 The feedback statement review can be found here.

12. In 2016, the IMF undertook a comprehensive review of New Zealand's financial sector as part of its global Financial Sector Assessment Programme (FSAP). The FSAP review evaluated New Zealand's alignment with the International Association of Insurance Supervisor's (IAIS) 'Insurance Core Principles' (ICPs). The ICPs are an outcomes-based global benchmark for systems of insurance supervision. The IMF identified a number of areas in which New Zealand's observation of the core principles could be improved.[4]

13. The events leading to the liquidation of CBL Insurance Ltd also provided some valuable supervisory and policy lessons to the Reserve Bank. In response, we commissioned a report from John Trowbridge and Mary Scholtens QC assessing our supervision of CBL, to identify these lessons. We haveindicated our commitment to comply with that report's recommendations[5]. There is considerable alignment between the report's recommendations and those in the FSAP review.

14. In particular, the Trowbridge/Scholtens report recommended:

- clarifying the Reserve Bank's ability to challenge the opinions of the Appointed Actuary and other professionals;
- introducing a graduated approach to solvency; and,
- strengthening some guidelines that currently do not have the force of law and expanding the Reserve Bank's power to issue new prudential standards.

15. We have conducted two important recent reviews relating to the insurance sector, whose findings will feed into the IPSA review. Together with the Financial Markets Authority, we published the findings of our joint review of life insurer conduct and culture in 2019. We also published the findings of our thematic review of the Appointed Actuary regime in 2020. The Culture and Conduct Review noted that some life insurers were complacent in considering conduct risk, showing weak governance and lack of focus on good customer outcomes. The Appointed Actuary review concluded that the Appointed Actuary role remained valuable but also identified some lack of clarity around expectations.

- Finally, the International Accounting Standards Board (IASB) has released a new international accounting standard for insurance contracts (IFRS 17 *Insurance Contracts*), which will affect some of the definitions used in IPSA.

Submission questions and procedures

16. We invite submissions on all of the paper or any of the individual issues and questions it raises.

17. The questions are also reproduced at the end of the paper to assist with making submissions.

4 The IMF's recommendations and assessment, published in 2017, can be found here.
5 The Trowbridge /Scholtens report can be found here.

IPSA and policyholder security: conceptual introduction and overview

Introduction

18. The objective of this consultation is to review how IPSA works to enhance insurance policyholders' security - to increase the likelihood that policyholders will receive the payments they are entitled to if they need to make a claim on their insurance policy.

19. Before looking at specific parts of the Act later in the paper, this section sets out our overall approach to policyholder security by exploring:

- the reasons why rules to enhance policyholder security are necessary;
- the degree to which policyholder security needs to be balanced against other important objectives (particularly cost and efficiency); and
- the way in which different aspects of IPSA's policy holder security provisions fit together in the context of the Act as a whole.

Why do we need legislation to enhance policyholder security?

20. This sub-section argues there are two primary drivers of insurer distress. Firstly, the nature of insurance business means that policyholders may find it difficult to monitor the risk of insurer failure and insurers may face short-term incentives to under-price risk and under-reserve. Secondly, a variety of tail risks (from external events to potential insurer-specific problems) are hard to fully account for.

21. We treat each issue separately, setting out the nature of the problem and potential regulatory remedies.

The nature of insurance business and incentives to underestimate risk

22. Insurance manages risk by pooling premium payments over time and across policyholders so that regular payments are enough to build up a pool of assets that can meet policyholder claims.

23. The larger the pool of assets, the greater policyholders' security but also, generally, the higher the cost of cover. If asset holdings are larger than necessary to meet claims, cover will have been unnecessarily expensive. However, there will always be uncertainty about the claims that will materialise, so insurers should be making some provision for risk above what they expect claims to be.

24. Theoretically, policyholders might be presented with a range of insurance options in the market that they could choose between, some of which were cheaper but carried more risk because of the size of the asset pool and others that were more expensive but carried lower risk. Policyholders could balance their risk appetite against the cost of cover through the market.

25. In practice though, it is difficult for even well informed market participants to know whether an attractive premium reflects greater insurer efficiency (administrative efficiency, skill in judging risk so fewer assets are required, better investment etc.) or increased asset risk.

26. Policyholders then may be tempted to purchase insurance that is cheaper, rather than more secure.

27. The way insurance business works also means policyholders will find it more difficult than consumers in other transactions to monitor their insurers on an ongoing basis. Policyholders pay in advance for a service (financial compensation in the event of loss) that is only delivered when they are already financially vulnerable. They get limited information about the ‘product’ that they have bought in the meantime and, when delivery really matters, they are not in a position to switch providers.

28. Meanwhile, insurers will also be uncertain about how much capital it is appropriate to hold because assessing risk is inherently difficult.

29. Insurers may also face short-term incentives to under-estimate or under-reserve for risk. Over-reserving against future claims will reduce the business’s apparent net-worth. The costs of over-reserving will flow-through to premium prices, which may reduce market-share and therefore income (assuming policyholders don’t fully reward insurers for prudence). Underpricing and under-reserving will ultimately threaten business viability. However, in the short-term the apparent costs of over-reserving may interact with inherent uncertainty about the risks faced in a way that results in inappropriately low reserving.

30. Even when markets are working well insurers may face incentives to under-price policies or under-reserve for risks.

31. Additionally, the difficulties of distinguishing between efficiency and risk-taking based on price signals might also facilitate or disguise inefficiency, errors, incompetence or dishonesty.

32. As we have seen, underpricing risk can boost businesses’ apparent performance. Managers who are operating their business less efficiently than their competitors may be underpricing policies even where their premiums are similar to those of competitors. Inefficiences will then manifest through a slow erosion of their asset pool, relative to the risks they are carrying, but that may not be obvious for some time.

33. Over-compensating investors or management for a given level of true business performance might also be masked in a similar way. There is a continuum here from moderate wishful thinking inflating dividends, through to rare cases of knowingly depleting insurance funds at policyholders’ expense, perhaps coupled with aggresive accounting.

34. Overall then, the difficulty of assessing the risks insurers face and the fact that under-estimating risk appears to reduce costs and enhance shareholder value combine to provide short-term incentives for both policyholders and insurers to underestimate risk.

Corrective regulation

35. Regulation can lean against these problems in two broad ways. It can work indirectly to enhance the *incentives* insurers face to hold reserves. It can also work *directly* to influence the reserves insurers hold and policyholders’ access to those reserves in the event of insolvency.

36. Insurers’ incentives to hold reserves come from at least four different sources:

- management’s understanding of the importance of reserving for long-term business resilience;

- policyholder monitoring of insurer soundness;
- long-term investors' interest in financial soundness; and
- regulatory requirements.

37. While not central to this consultation paper, IPSA's general provisions on good governance and risk management are designed to ensure that risk management is getting appropriate levels of attention and scrutiny throughout the organisation, helping to counteract any short-term incentives toward lower reserves. As part of this process, risks are identified and quantified. Regulation can also impose disclosure requirements relating to risk assessment, which will assist outsiders in their efforts to evaluate insurer soundness.

38. When it comes to policyholders, well-designed additional information disclosure may both increase policyholders' awareness that they should be monitoring insurer financial soundness and provide them with additional information to help them do so. However, the complexities of insurers' balance sheets and, in some cases the length of policyholders' contractual commitment to their insurer, limit what can be achieved in this way.

39. Investors might be expected to have superior skills for monitoring insurers. However, not all investors will have the kinds of long-term incentives that align their interests with those of policyholders. Insurers are less likely than banks to have issued long-term debt that is traded on capital markets. Equity investors may be more focussed on short-term returns than long-term viability. In any case, it is likely to take particularly sophisticated equity anlaysts with a specialty in insurance to be able to anlayse actuarial reports in a way that would expose some weaknesses.

40. Regulation can improve incentives, but we shouldn't expect to be able to fully resolve potential problems in this way.

41. So IPSA also imposes minimum standards for how insurers calculate how much 'solvency capital' to hold against the risks on their balance sheets ('solvency standards').

42. Solvency capital consists of assets that can be called on where claims turn out to be significantly higher than expected.

43. Calculating minimum solvency capital involves specifying particular risks an insurer is facing and requiring insurers to hold particular amounts of capital in respect of those risks.

44. Solvency standards serve three purposes: they influence insurer's risk management practices by identifying risks and encouraging insurers to consider them when setting capital requirements; they provide a metric for assessing insurer's financial soundness – by showing how much capital the insurer is holding above the minimum levels specified by the solvency standards; and they set minimum appropriate levels of capital.

45. Generally speaking, holding additional capital makes insurers safer, benefitting policyholders, but it also increases costs (either to shareholders through lower returns or to policyholders through higher premiums) so solvency standards need to strike an appropriate balance.

46. Where capital requirements turn out to have been insufficient and an insurer fails, regulation can seek to expand the resources that policyholders can draw on to at least partially meet their claims.

47. For example, life insurance business in New Zealand is currently organised through 'statutory funds'. Particular parts of the insurer's asset pool are set aside for life policyholders. If the insurer fails, policyholders have first claim on those assets, ahead of any of the insurer's other creditors,[6] increasing the chance that their claims can be met even if the insurer is insolvent.

48. In some overseas jurisdictions, but not currently in New Zealand, there may also be a guarantee fund, which can meet some of policyholders claims when an insurer fails.

49. These arrangements also create costs, which may be passed on to policyholders, and my also create moral hazard effects.

Tail risks: disasters and financial crises

50. One source of insurer failure is insufficient provision for the risks the insurer has taken on, driven by some combination of incorrect judgement and problematic incentives.

51. Even with good risk management, insurers may also face 'tail risks' – events that are statistically unlikely to occur but very costly when they do. These tail-risks might be the result of external events such as natural disasters, pandemics, financial crises, or economic contagion from an insurer's affiliated companies. They might also result from idiosyncratic internal problems that were difficult to detect or predict.

52. Tail events are challenging for insurers because they are difficult to identify, predict and quantify. Meanwhile, they may affect large numbers of people simultaneously, making them more difficult to deal with through the insurance function of pooling risks across a wide-range of affected people.

53. It is theoretically still possible to pool the costs over time, but the long-term time horizons of tail events can create difficult trade-offs between the interests of present and future policyholders (or alternatively, can imply liability pooling over a time-period that is not compatible with the contracts made with policyholders or even the lifetime of many businessess). Reinsurance can be helpful here. Large reinsurers can pool risks globally, reducing the range of risks that impact 'everyone'. Nonetheless, not every eventuality can be contemplated and built into a risk strategy.

54. While insurers can be more or less resilient in the face of external shocks, tail-events raise questions about how far insurers' responsibilities should reasonably extend. Covering tail-events is particularly difficult. Given their inherent uncertainty and potential large impact, coverage of some tail-events might make policies that are useful much of the time unaffordable in order to provide more complete coverage.

55. This possibility might be dealt with by allowing insurers to explicitly exclude some risks from cover but that is only possible for forseeable risks and may have problematic public-policy implications. Alternatively, there might be some level of public subsidy, effectively pooling these risks across taxpayers – either through explicit public insurance of tail risks or some form of policyholder guarantee scheme. What is appropriate will depend on public risk appetite (and the cost of additional cover).

6 While the insurer is a going concern, this also means that policyholders have less need to monitor the insurer's balance sheet as a whole, since what determines whether their claims will be made is the financial strength of the relevant statutory fund.

Calibrating regulatory responses and the scope of this consultation

56. Policyholder security is an important consideration because insurance is purchased precisely in order to provide policyholders with enhanced financial security in the face of a variety of unavoidable risks. Without insurance, a variety of risky but socially valuable activity might not take place. Insurance failure can inflict significant harm on policyholders that have already exerienced some form of adverse event. Significant levels of insurance failure also have the potential to undermine public confidence in the sector.[7]

57. Regulation is necessary to enhance policyholder security because insurance contracts are difficult to monitor and involve exposure to insurer's balance sheets, which are particularly difficult to assess and interpret. It may also be necessary to cater for tail risks that are difficult to account for in other ways.

58. However, regulation has costs. In some cases, such as the quantity of capital insurers hold, there are quite direct trade-offs between security and cost. In other cases, where regulation promotes good risk management, those trade-offs may be less sharp. Finally, there are cases where regulation might create costs through moral hazard effects, whilst also delivering benefits.

59. IPSA's statutory purposes and principles provide some broad guidance for how to think about the balance between benefits and costs. The role of regulation and supervision is to promote the soundness and efficiency of the insurance sector (suggesting a balance between regulation and costs) and public confidence in it (IPSA s.2).

60. Our role is also to 'have regard to the importance of dealing with an insurer in…distress…in a manner that aims to adequately protect the interests of its policyholders and the public interest' (IPSA s.4 (c) (i)). On the other hand the principles also explicitly say that we are not to operate a zero failure regime and have regard to the fact that 'members of the public are responsible for their own decisions' (s.4(d)) (although regulation may also need to take measures to ensure that the public have the information they need to make those decisions).

61. Overall then, IPSA should provide considerable policyholder security (otherwise there will not be 'public confidence in the insurance sector') but in a way that properly reflects the costs of regulation and, where appropriate, trade-offs between policyholder security on the one hand and the affordability of cover, sustainability of the insurance sector and risk of moral hazard on the other.

62. As we have seen, there are a variety of channels through which regulation might work to enhance policyholder security. It could improve insurers' internal governance and processes in ways that enhance awareness of risk and provision for it. It could improve information provision in the hope of producing market incentives to hold more capital through policyholder and investor monitoring. It could directly impact solvency capital, or it could increase policyholders' access to assets in the event of insurer failure.

63. These different channels may substitute for one another to a certain degree, which is why we have grouped together a range of policyholder security issues for this consultation.

7 IPSA's legislative principles say that the Reserve Bank is to have regard to the importance of insurance to the public's risk management (s.4(a)) and to the importance of maintaining a sustainable insurance market in New Zealand (s.4(b))

64. While good governance and risk management are vital contributors to policyholder security, they also serve wider purposes, so we will deal with IPSA's requirements in these areas in a later consultation.

65. In this paper we concentrate on: the disclosure of public-related information about an insurer's financial strength, particularly ratings; provisions relating to insurer solvency and capital; protection of assets through statutory funds; and specifying minimum values for policies that are terminated.

66. We explained how these different tools can contribute to regulatory goals in the previous sub-section of this paper. Table 2 provides an additional summary.

67. The rest of this paper works through each issue in turn before concluding with an overall evaluation of policyholder security.

Table 2: Summary of regulatory goals of proposed policy areas.

Area of IPSA	Regulatory goals			
	Improve insurer governance and risk management	**Improve policyholders' information**	**Increase solvency capital, to reduce the chances of failure**	**Increase policyholder returns after insurer failure**
Information disclosure	Indirect incentive effect (adds transparency to financial soundness in the face of risk)	Main target	Indirect incentive effect (in order to appeal to policyholders)	
Solvency requirements	Encourages insurers to hold sufficient assets to meet the risks they are exposed to	Might be used for disclosure	Main target	May do so indirectly by increasing pool of capital
Statutory funds	Tightens Directors duties in relation to fund assets. Places requirements on management of assets	Indirect (policyholders only need to monitor statutory fund, not whole insurer)	Somewhat, in that capital is ring-fenced for particular policyholders	Somewhat through preferential access to assets
Mandatory minimum termination values				By clarifying the value of policyholders' interests

Financial strength disclosures

68. The disclosure of appropriate financial information is a key pillar of the New Zealand regulatory framework's emphasis on market discipline. IPSA's disclosure requirements recognise the desirability of providing information to enable members of the public to make their own decisions about insurance. The disclosure of appropriate information is also important to other market participants including brokers, advisers, consulting actuaries, rating agencies, and potential investors. These other market participants play a role in communicating a complex subject to the general public.

69. Currently, IPSA requires disclosure of solvency information and a financial strength rating from an approved rating agency. The aim is to provide independent and standardised information on the relative financial strength of the insurer to consumers, policyholders and potential investors.

70. A public financial strength rating also strengthens incentives for insurers to develop and maintain sound governance and risk management practices.

71. The requirements relating to financial strength ratings are set out in sections 60-72 of the Act. The solvency disclosure requirements are set out in the Solvency Standard(s) and empowered by IPSA s56, or for overseas insurers as conditions of a section 59 solvency exemption notice.

72. Currently, the disclosure requirements are focused on financial information. However, there may be other areas that policyholders are interested in, including an insurer's risk appetite and reinsurance arrangements. For example, our guidelines on governance encourage disclosure of a corporate governance statement in an insurer's annual report that includes coverage of the insurer's corporate governance policies, practices and processes as well as information on the directors and how the governing body operates. Some insurers disclose this information while others do not.

The current IPSA requirements

Financial strength ratings

73. Currently, insurers are required to disclose their financial strength rating, the rating agency, and the rating scale in writing to policyholders before entering into or renewing a contract of insurance. The rating, agency, and scale must be disclosed and must be clear and prominent.

74. An insurer must use an approved rating agency for their financial strength rating. The Reserve Bank has currently approved three ratings agencies to provide these scores, these are:

    - A.M. Best;
    - Standard & Poor's; and,
    - Fitch Ratings.

75. There is an exemption to this requirement for some small insurers but those insurers are required to disclose their exemption in writing, together with the reasons for it, before entering into or renewing a contract of insurance.

76. If a website that is maintained by, or on behalf of, a licensed insurer contains information or advertising about the insurer's insurance products, that website must include financial strength rating disclosures. Disclosures must have the rating, agency, and scale, or a prominent link to a website that has those requirements.

77. Any advertisement that refers to a financial strength rating must state clearly and prominently the rating and agency, and that the rating scale is available for inspection at the all of the insurer's offices in New Zealand.

78. Insurers must not disclose a rating from a non-approved agency or distribute an advertisement relating to any of the insurer's insurance products that refers to a rating from a non-approved agency.

79. If an overseas policyholder preference applies, the insurer must disclose the nature and extent of the overseas policyholder preference in the prescribed circumstances and in the prescribed manner.

Q1.1: Do you consider that the current exemptions for small insurers should be maintained? Should they be extended to somewhat larger insurers?

Q1.2: Do you think that the current disclosure rules for an overseas policyholder preference are sufficient?

Solvency disclosure requirements

80. In addition to financial strength ratings, insurers are required to disclose several measures of their current solvency position. Requirements for the disclosure of key components of the solvency calculations are set out within the applicable Solvency Standard(s) or as conditions of a section 59 exemption notice for relevant overseas insurers (more information on the solvency standards can be found in section 4 of this paper). A licensed insurer must disclose, on a legal entity basis, the following:

- Actual Solvency Capital;
- Minimum Solvency Capital;
- Solvency Margin; and
- Solvency Ratio.

Box 1: Definitions of solvency terms (for further explanation, see the Solvency Requirements section below)

Actual solvency capital is the amount of eligible capital that an insurer holds against unexpected events.

Minimum solvency capital is that minimum amount of eligible capital that an insurer must hold against unexpected events, as calculated under the Reserve Bank's solvency standards.

The *Solvency Margin* is the amount of eligible capital an insurer holds above its *Minimum Solvency Capital* (so it is equal to *Actual Solvency Capital* minus *Minimum Solvency Capital*).

The *Solvency Ratio* is another measure for comparing the actual capital an insurer holds against the minimum it must hold according to the solvency standards. It is found by dividing *Actual Solvency Capital* by *Minimum Solvency Capital*.

81. These measures must be disclosed for each solvency margin required to be maintained by an insurer under its condition of licence, and in total. For example, a life insurer would disclose these values for each statutory fund, and the company as a whole. The disclosure is required in the New Zealand financial statements, including prior year comparatives.

82. For solvency exempt insurers, the disclosure should be the home jurisdiction equivalent of the specified requirements in the New Zealand branch's financial statements. Disclosure on the insurer's website (if any) of the specified requirements, is required within 10 working days following the required date for submission of the solvency return.

2017 thematic review – insurer disclosures

83. In 2017, we conducted a thematic review into compliance with the financial strength ratings and solvency disclosure requirements. The overall level of compliance was found to be well short of the minimum requirements, with 53% of participants assessed as complying at a low or poor level. Only 22% of the sample performed relatively well, ranking good overall, but with some room to improve further.

84. Several themes were identified in the review. Small insurers, overseas insurers and insurers with more complexity performed worse – for a variety of possible reasons. For small insurers, this could be because of lack of resource and/or focus, whereas for overseas insurers this could be a lack of knowledge of the New Zealand requirements and/or because of additional requirements around the disclosure of overseas policyholder preferences.

85. Our subsequent follow ups since 2017 have generally shown improved compliance with the financial strength ratings and solvency disclosure requirements.

The case for making financial and solvency information public

86. Policyholders should be evaluating the financial soundness of their insurer before purchasing cover. Disclosure gives policyholders direct access to better information and indirectly provides information to other market actors that may be advising policyholders.

87. The provision of insurance products is complex, making it inherently difficult for policyholders and their advisers to understand the risk profile and financial strength of insurance providers and take reasonable steps to protect themselves against the risk of insurer failure. The failure of policy delivery can be very serious for policyholders with particular types of insurance – especially life insurance and other long-tailed insurance, where replacement cover may be very costly or unobtainable.

88. Financial strength ratings provide a single, simple metric for comparing the relative financial strength of different insurers.

89. The key benefits of public disclosure for prudential purposes include:

- reducing information asymmetries between insurers and other market participants, thus giving market participants greater ability to make informed assessments of the relative strength of insurers;

- creating strong incentives for insurers to conduct their business in a safe, sound, prudent and efficient manner; and
- enhancing market information available to the board and senior management, including, for example, peer remuneration practices.

Q1.3: Do you consider the current financial strength rating and solvency disclosure sufficient to provide consumers and policyholder's information on the solvency of insurers? If no, what information would most help consumers and policyholders?

Shortcomings with the current public disclosure regime

90. There are several potential shortcomings in the current disclosure regime. These include potential issues in the rating process and questions around how much the public understands the financial strength and solvency information provided.

91. Under the current rating system insurers that are small, but not small enough and old enough to be exempt, have to pay to have a financial strength rating prepared annually. For a small company that collects only a few million dollars in annual premiums, the cost may be disproportionately large. This cost may discourage small, niche or innovative insurers from establishing a presence in New Zealand, potentially limiting the types of insurance products available.

92. The current regime only has three approved rating agencies. This raises questions around the approval process – is it too strict, discouraging new rating agencies from entering the market? Additionally, as no rating agency has had their approval revoked, there are questions around how the current regime would handle the removal of an approved rating agency.

93. Overseas experience has shown some weaknesses in the rating agencies. For example, S&P awarded American Insurance Group (AIG) an AA counterparty rating and gave an AA+ rating to the company's core subsidiaries in 2007 just a year before the company had to be bailed out by the US government due to rising losses. In 2007, S&P noted, "AIG's very strong capital and earnings have benefited from the diversity afforded by its property/casualty and life and retirement businesses. Furthermore, we don't have concerns regarding AIG's ability to retain at least 'AA' capital adequacy".

94. There may also be concerns that insurers can shop for the rating agency that will give them the most favourable rating as opposed to an agency that will provide a strict review of the insurer's business. This issue may become increasingly problematic if an insurer uses the same rating agency over a long period of time.

95. There are also questions around the public's comprehension of the financial strength ratings and solvency information provided. The 2016 OECD international survey of adult financial literacy competencies[8] found that New Zealand adults had higher financial literacy than the OECD average, but noted that New Zealand had a large distribution of results. This indicates that a large share of the New Zealand population may struggle to interpret financial strength ratings and solvency ratio disclosures.

8 oecd.org/finance/OECD-INFE-International-Survey-of-Adult-Financial-Literacy-Competencies.pdf

96. Public confusion is likely made worse as the three rating agencies each use a different scale to display their findings. This may be leading to confusion about the relative strengths of insurers using different ratings agencies. In addition, in many tests ordinary New Zealanders are exposed to, a 'B' is considered a good grade. However, this is not normally the case for financial strength rating scales.

Options

97. We have considered several options to ensure that appropriate information about licensed insurers is disclosed to the public. These include the status quo, the status quo with alterations, and alternative disclosure requirements. Many of these options are not mutually exclusive and could be implemented as a package of changes. When looking at options we are considering disclosures that support and make financial disclosure more meaningful to consumers and policyholders.

Option 1 - Maintain the status quo

98. The first option is to continue with the status quo. Requiring insuers to obtain a financial strength rating (unless they have an exemption) and maintain the current solvency disclosure requirements.

Option 2 – Change the exemptions for small insurers.

99. For small insurers that earn premiums in excess of the current exemption cap or that have been licensed post 2010, the cost of getting a financial stregth rating can be prohibitive. There are several options that could be used to expand the current exemption for small insurers to have a financial stregth rating. These include:

- Option 2A - Increasing the premium cap that small insurers can earn and still apply for an exemption.
- Option 2B - Allow insurers with gross premium below the cap that were licensed post 2010 to apply for an exemption.
- Option 2C - Allowing new insurers to not require a financial strength rating for a few years post licensing to encourage new entrants into the market.
- Option 2D - Allow small insurers to opt out of getting a financial strength rating in exchange for having a higher solvency requirement. This would be based on our credit rating exemption for small Non-Bank Deposit Takers.

Option 3 - Rotating rating agencies

100. In order to address concerns that insurers could 'rating shop' we could require insurers to change the rating agency they use every few years. This would be analogous to the United Kingdom's auditor rotation system. Over time this would help ensure that the ratings are of comparable strength and that no material factors are being missed. This may also encourage additional rating agencies to enter the market as there would be a larger potential flow of business from new entrants. However, it would also impose additional costs on insurers.

Option 4 - Standardise disclosure

101. To help address concerns around the public's understanding of information we could try to standardise the information consumers and policyholders receive. This would help address concerns around how much the public grasp the different rating scales. This could involve a standardised scale or a traffic light system overlay on the rating agencies' existing scales to aid comparison.

102. Alternatively, we could require insurers to attach a 'Guide to Financial Strength' with each new policy or renewal that provides a comparison of the different financial strength ratings and solvency numbers for all licensed insurers in the market. This may include a 'traffic light' system showing the relevant strength of the different ratings. The traffic light system could also be included on a Reserve Bank 'dashboard' as we have done for banks, allowing the public to compare quickly the relative financial strength of all insurers.

Option 5 – Increase solvency disclosure requirements

103. In addition to changes to financial stability ratings, we could also introduce additional solvency disclosure requirements.

104. In this option we would require the disclosure of additional solvency ratios to provide more information to the public on the financial strength and sustainability of the insurer. These ratios could be either on the insurer's current financial position or their projected financial position. An example of this would be to have insurers provide projected solvency ratios alongside their current ratios. In order to ensure comparability, this would likely require standardisation of projections. Providing this information may allow consumers to make a more informed decision around the insurer's projected ability to meet claims in the future and may be especially useful for long-tail insurance products.

105. If we proceed with this option the new solvency ratios that would need to be disclosed would be decided on in conjunction with the Solvency Standard review currently in progress.

Q1.4: Out of these options, what is your preferred option or combination or options for public solvency disclosure requirements?

Q1.5: If we increase the public disclosure of solvency ratios, what solvency measures do you think would be the most informative to the public?

Q1.6: Do you think there is a better public solvency disclosure requirement than the options here? If yes, what disclosure requirement would you like to see?

Potential costs and benefits of the options

106. Table 3 shows an overview of the costs and benefits of the alternative options compared to the status quo. Most of the options would likely improve market discipline by increasing the amount of information available to the market. However, this would come at higher cost and complexity for insurers which may flow on to fewer foreign insurers choosing to operate in the New Zealand market.It may also be difficult to provide this information to consumers and policyholders in a way that is clearer to understand than the current financial strength rating letter grades.

107. Some of the costs in this section can be addressed by implmenting a package of these option instead of implementing individual options. For example, a package of options 2, 4 and 5 may have a positive impact across most of the criteria.

108. The main benefit of the options is that they would increase the information available to the public, including both consumers and policyholders, and investors. This would have the flow on effect of improving market discipline. Removing the exemptions in the current requirements would improve the information available for consumers and policyholders by ensuring that all insurers provide similar information. However, adding additional solvency disclosures would likely have minimal effect as we do not expect many consumers would pay attention to this.

109. Only option 2 would have a negative impact on consumer information and market discipline. However, as this would only impact small or niche insurers, the systemic drop in information that is available to consumers and investors is likely to be minimal. Furthermore, these insurers are not systemically important so a failure in this area is unlikely to have wide repercussions.

110. However, the information gains from most options would also come at a cost, which could increase the costs of cover.

111. For example, under part of option 2 and option 3, small insurers and foreign branches would face increased complexity and compliance costs. The small insurers would have to obtain financial strength ratings, a cost that is likely disproportionate to the size of their annual premium. The cost and complexity would be higher for adding additional solvency disclosure requirements as this would affect all licensed insurers and not just those that currently have exemptions.

112. Further, one of the benefits of the current financial strength ratings is that they are designed to be simple to understand for consumers and policyholders. New disclosure could be more complicated to understand or simply end up replicating the work done by financial strength ratings but without the independent verification process carried out by the rating agencies.

Q1.7: Do you agree with our assessment of the potential costs and benefits of public financial strength ratings and solvency disclosure? If not, what other high level costs or benefits should be considered?

Q1.8: Are there any other ways in which we might improve financial disclosure to improve policyholders' and other interested parties'ability to assess insurer's financial strength?

Table 3: overview of the costs and benefits of alternative options compared to option 1 - the status quo.

	Option 2 – change the exemption for small insurers	Option 3 - Rotating rating agencies	Option 4 – Standardised disclosure	Option 5 - Additional solvency disclosure requirements
Provide information to a consumer or policyholder.	↓	–	↑	–
Improve market discipline.	↓	↑↑	–	↑
Complexity and cost for insurer.	↑	↓	↑	↓
Impact on market participation.	↑	–	–	↓

Solvency requirements

Introduction

113. Solvency requirements specify how insurers calculate the minimum amount of capital they must hold as a buffer to increase the chances they will be able to meet their obligations to policyholders, even in the wake of adverse events.

114. Solvency standards are most obviously important because they impose minimum capital requirements on insurers. However, specifying the calculations insurers perform to assess capital requirements also has indirect advantages.

115. Solvency calculations work by breaking down the risks insurers are exposed to and asking insurers to quantify their impact. The solvency standards focus management attention on risk as insurers seek to optimise their return on capital.

116. Since capital requirements are risk-based, solvency measures can also be used as a proxy for risk levels within the insurer's business, helping supervisors to concentrate resources and attention on businesses posing the greatest risk.

117. The actual capital requirements and calculations are not contained in IPSA but are set out in the 'Solvency Standards' that we issue.

118. IPSA empowers us to issue the standards (s.55-6) and explain how they should be applied to insurers (s.21(2)(b) and (c)). It also uses failure to meet the standards as an important criterion in decision-making and enabling some of our enforcement powers (we set out some of the details in para 144 below).

119. This consultation is not concerned with the content of the Solvency Standards – how much capital insurers must hold and how they calculate it. We are exploring those issues in a separate review (the Solvency Standard Review), which is running concurrently with the IPSA

review (so the two can be coordinated effectively).[9] Instead, it focuses on the provisions in IPSA that empower, apply and draw on the Solvency Standards. However, some of the reasoning behind the proposals in this section draws on the work we are doing as part of the Solvency Standards review and we discuss elements of that review where relevant.

120. We begin by reviewing some of the terminology surrounding solvency in IPSA and asking whether communication might be facilitated by some changes.

121. We then go on to explore whether it would be helpful to amend the way IPSA establishes solvency standards so that there was more than one solvency control level. Currently, insurers are either 'compliant' or 'non-compliant' with solvency standards. However, solvency is more a matter of degree. We therefore ask whether a more graduated view of solvency would help to re-enforce risk-based supervision – intervening early when insurers run into problems and increaseing levels of intervention as problems become more serious.

122. Finally, we look at the way IPSA empowers solvency standards, asking whether it would help to have a default solvency requirement applied independent of license conditions and whether it would be helpful to enable supervisors to adjust the way solvency calculations are carried out for particular insurers facing risks that are not well catered for in the normal solvency standard.

Terminology, solvency measures and communication

123. We begin this section with a discussion of some issues around the solvency measures used in IPSA and the way they are described. Terminology is important because as we have just explained, one important role for solvency is in measuring, communicating and understanding insurers' soundness. While the current terminology used in IPSA is logical and effective for the purpose of defining minimum capital levels, we ask whether changes might assist in communication.

124. The main way that IPSA applies the solvency standard to insurers is by enabling us to specify a 'Solvency Margin' in an insurer's license conditions. The 'Solvency Margin' is the amount of eligible capital insurers must hold above their 'Minimum Solvency Capital', which is assessed using the solvency standard.

Minimum Solvency Capital

125. Minimum Solvency Capital is assessed by looking at the assets (investments, bank accounts etc.) and liabilities (including, particularly, the amount insurer's expect to have to pay out to policyholders in response to future claims) registered in an insurer's accounts and then '*stressing*' them.

126. What that means is the Solvency Standard asks what investments or liabilities might look like, not just given what we *expect* to happen in the future (which is broadly what is shown in an insurer's accounts), but also if the future turns out badly in some way.

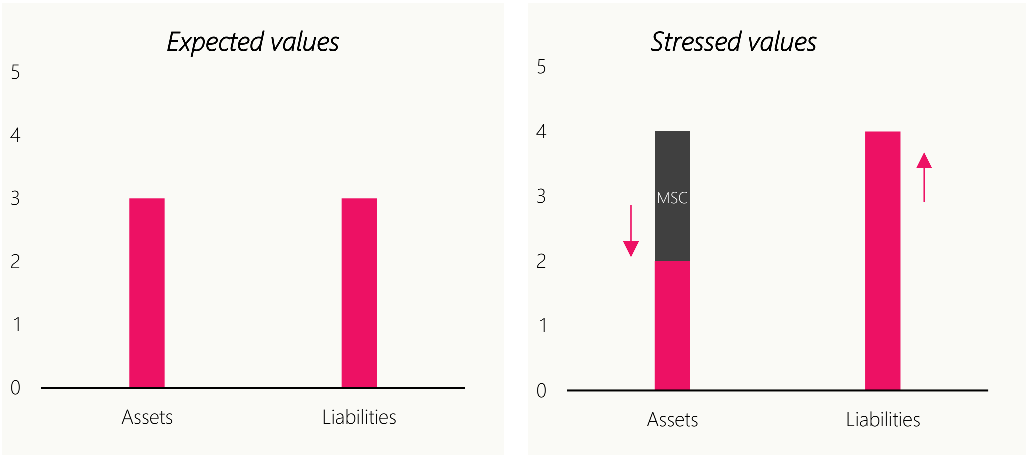
127. So, investments are 'stressed' to take into account (amongst other things) the possibility that their value might decline or that some debts might not be paid. Liabilities are 'stressed' to take into account the possibility that policyholder claims will be larger than expected (for example because of a recession, pandemic, or natural disaster).

9 Information on the Solvency Standards Review can be found here.

128. The Solvency Standards set out the severity of the stresses that are applied to the balance sheet, that is to say how severe the scenarios are that an insurer should have sufficient capital to withstand. Our solvency standards are currently designed so that insurers can withstand a 1 in 200 year event and, for earthquake risk, a 1 in 1000 year event.

129. Minimum Solvency Capital is the extra capital an insurer would need to hold in order to ensure that its assets will still match its liabilities under that level of stress.

'Minimum Solvency Capital'' (MSC)



130. The default setting for the 'Solvency Margin' in insurers' license conditions is zero. In other words, we normally require insurers to hold 'eligible capital' *equal to* the 'Minimum Solvency Capital' determined by the solvency standard. Insurers should hold enough assets to meet their expected liabilities *plus* an additional amount of capital, equal to at least the 'Minimum Solvency Capital', to reflect the possibility of adverse outcomes.

131. There is one further complication, though. It is *eligible* capital that insurers must hold. The Solvency Standard describes this as 'Actual Solvency Capital'. An insurer's capital buffer must be made up of net assets of a type that are loss absorbing (eg. retained earnings and shareholder capital). Where there is some doubt about whether net assets will be able to absorb losses (eg. goodwill) when an insurer is distressed those assets are either deducted in the calculation or included at a lower valuation.

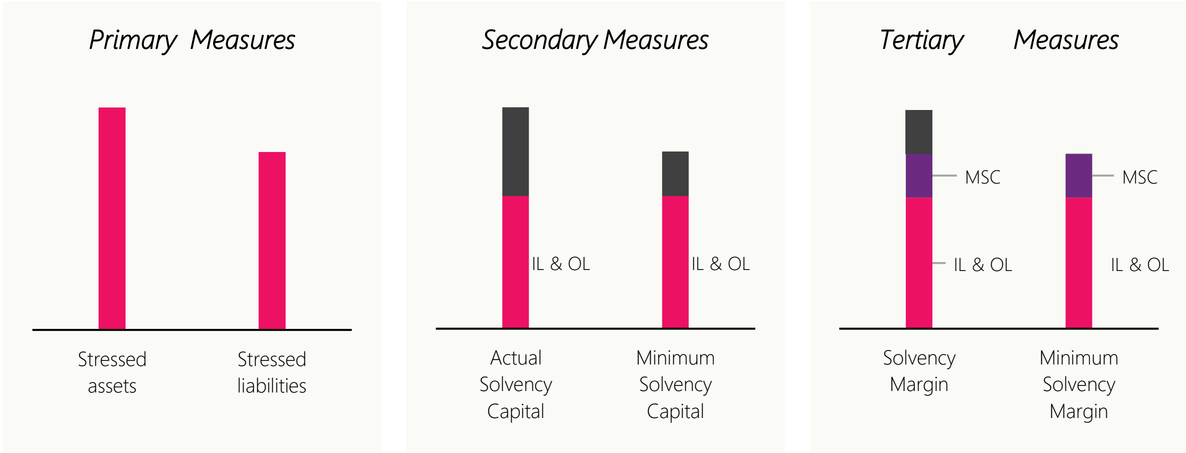
Replacing the Solvency Ratio and Solvency Margin concepts?

132. From the point of view of 'specifying how much capital an insurer should hold', the Solvency Margin concept has a precise and logical relationship to the Solvency Standard. However, it is not an easy concept to map directly onto an insurer's financial soundness and therefore may not be the ideal concept for communication to the wider public (or perhaps even insurers' management).

133. As we have seen, the Solvency Margin is derived from Actual Solvency Capital and Minimum Solvency Capital (SM = ASC-MSC).

134. Actual Solvency Capital and Minimum Solvency Capital, in turn, are derived from 'stressed liabilities' and 'stressed assets'.

Table abbreviations: Insurance Liability (IL), Other Liability (OL), Minimum Solvency Capital (MSC)



135. Without changing the fundamental basis on which solvency calculations were carried out, it would be possible to replace IPSA's references to a 'Solvency Margin' with a measure of the relationship between 'stressed assets' and 'stressed liabilities', or the relationship of Actual Solvency Capital to Minimum Solvency Capital.

Q2.1: Would it be helpful to replace the language of 'solvency margin' and 'solvency ratio' with either:

i. a metric based on the relationship between Actual Solvency Capital and Minimum Solvency Capital, or

ii. the relationship between stressed assets and stressed liabilities?

Aligning other terminology with international usage?

136. IPSA's wider solvency terminology is different to the broadly equivalent terms used in other jurisdictions and in international benchmarks. For example, IPSA refers to eligible capital as Actual Solvency Capital, while Australians talk about the 'Capital Base', Solvency II in Europe talks about 'Own Funds' and the International Association of Insurance Supervisors' model capital standard has 'Qualifying Capital Resources' (similar differences also apply to 'minimum capital standards').

137. It would be possible to change the terminology used so that it aligned with the IAIS international standard or with another jurisdiction such as Australia.

138. The advantage of doing that would be that it would facilitate engagement with international markets and international regulatory standards. The disadvantage is that it might imply more similarity between the New Zealand regime and its international counterparts than actually exists.

Q2.2: Should New Zealand solvency terminology be aligned with international standards? Why or why not?

Q2.3: Which international terminology would it be best for New Zealand to align with?

Financial condition reports and s.78 reports

139. In addition to setting out how minimum levels of solvency capital are *calculated*, the solvency sections of IPSA and the Solvency Standards also contain reporting and disclosure requirements.

140. The Solvency Standard sets out the requirements for producing a 'financial condition report', which reports on a range of issues related to insurers' financial standards but not directly related to solvency, such as recent performance, recent claims experience, risk management procedures, and a review of capital management procedures.

141. It might be more appropriate for these disclosure requirements to be set in a 'Standard' separately authorised under IPSA.

142. IPSA s.78 requires an insurer's appointed actuary to provide a separate report on the actualrial assumptions made in the accounts, the adequacy of their access to information, and whether the insurer is meeting their solvency requirement.

143. The s.78 report is designed to accompany the insurer's audited accounts so that market participants and policyholders have some comfort about the actuarial assumptions underpinning the accounts.

144. Some stakeholders have questioned whether the s.78 report provides useful information above what is contained in the financial condition report and audited financial statements. On the other hand, these reports may be useful to different audiences. We would be interested in hearing views on how useful these reports are for different audiences, whether they should continue to be required, or whether there might be a better alternative to achieve the same broad aims.

Q2.4: Should IPSA enable a separate standard dealing with Financial Condition Reports? (Why/why not?)

Q2.5: How useful are s.78 reports? Should they be continued or replaced?

Defining solvency levels and a ladder of intervention

145. At present, IPSA works on the basis of a single criterion for solvency: the solvency margin. An insurer either meets its solvency margin condition or it doesn't. In this sub-section we ask whether it would be better to have more than one control level to enable a more proactive and graduated response to insurers' difficulties.

146. When an insurer breaches its solvency requirement, a wide-range of our enforcement powers are enabled[10] including:

- requiring the supply of information;
- appointing an investigator;
- directing an insurer to prepare a recovery plan;
- issuing binding directions to an insurer; and

10 (In some cases, the same enforcement powers can also be enabled in other ways)

- applying to the Court for the appointment of an administrator.

147. Additionally, auditors and appointed actuaries have a duty to notify us if they become aware that solvency requirements are breached or they expect them to be breached over the next three years. Finally, we cannot approve the restructure of statutory funds if the insurer is in breach.

148. In practice, though, insurers do not instantly move from being 'solvent' to 'not solvent'. Rather, solvency is a matter of degree.

149. International practice is increasingly to have two solvency control levels, one designed to mark the point at which insurers begin to become high risk, and another at the point at which insurers are likely to be non-viable. This type of arrangement enables supervisors to take a more graduated approach, increasing their oversight of weaker insurers relatively early before they are in serious distress, and then escalating levels of oversight and intervention as risks increase.

150. We have been advised to introduce this type of approach by two external reviews: the IMF's Financial Sector Assessment Programme (which benchmarks New Zealand regulation against an international standard), and the Trowbridge-Scholtens report into the failure of CBL insurance ('the Trowbridge report'). We have publicly committed to implementing the recommendations of Trowbridge-Scholtens report.

151. Since IPSA was designed with one control level in mind, the legislation would need to be amended to introduce a regime with more control levels.

152. It will also be important to consider the interaction between control levels and our enforcement powers. It might be logical for some powers to be enabled at the top control level (for example those relating to information and investigation) and others (such as the appointment of an Administrator) to be unlocked at the lower level.

153. Alternatively, all powers might be *enabled* at the higher level but we might be *required* to take some particular actions at the lower level. For example, we might be required to ask an insurer to provide a resolution plan once capital reached a particular level.

154. Finally the legislation might enable our enforcement powers to be used relatively early, with us establishing and publishing non-binding policy for when different powers are likely to be used.

155. More tightly defined use of powers provides clarity for industry and would provide supervisors with clear triggers for action. On the other hand, tighter definition might reduce flexibility to respond appropriately to a variety of threats to insurer soundness.

156. As part of the Solvency Standard review, we asked stakeholders whether it would be preferable to have more than one solvency control level and how control levels should be callibrated. Stakeholder feedback favoured just two levels, in the interests of simplicity. Responses suggested that the top control level should be callibrated at around a 1:200 probability of sufficiency.

157. We ask the same questions here, given the possibility of different audiences for the two reviews.

Q2.6: Would it be helpful for IPSA to contemplate more than one solvency control level?

Q2.7: How many control levels would be useful?

Q2.8: How should the Reserve Bank's powers relate to the different control levels?

Q2.9: Should powers be unlocked sequentially?

Q2.10: Should powers unlock at the top rung, with the Reserve Bank issuing public guidance on how it intends to use its powers?

Q2.11: Should any actions on the part of the Reserve Bank be mandatory when one of the control levels is breached?

Applying the standards: a default zero solvency margin and supervisory adjustments

A default solvency margin

158. At the moment, we have to apply the Solvency Standard to insurers by specifying a Solvency Margin in the insurer's conditions of registration.

159. For the vast majority of insurers, though, the specified Solvency Margin is zero (ie insurers are asked to hold at least their Minimum Solvency Capital). It is only in special cases that we choose to specify a larger Solvency Margin.

160. We invite submitters to consider whether it would be preferable for IPSA to prescribe a default Solvency Margin of zero directly (or equivalent, if terminology is changed as discussed in the previous sub-section). License conditions could then be used to vary the default to cater for non-standard situations.

161. Doing so would have two advantages. It would be slightly clearer that zero was the 'normal' setting. It would also reduce the marginal risk of administrative error when writing license conditions.

Q2.12: Should a minimum solvency margin of zero be required by default (without the need to specify it in a license condition)?

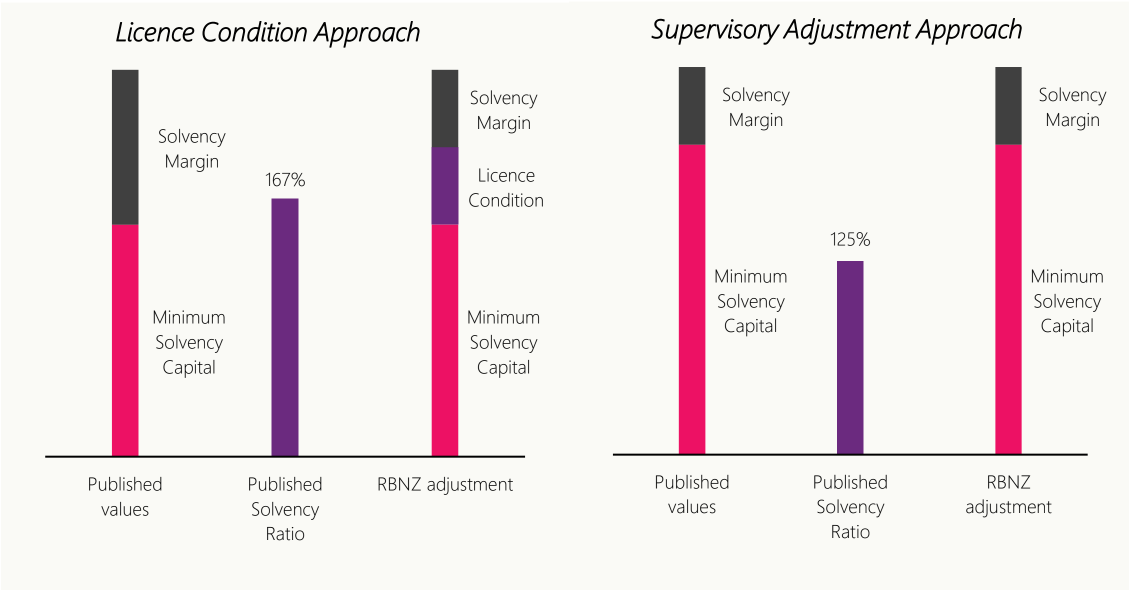
Supervisory adjustments

162. Whether or not a default is automatically specified, it will still be necessary for us to able to apply non-standard solvency requirements in particular cases, where we believe that standard calculations are not producing an accurate picture of insurers' financial soundness. At the moment, IPSA allows us to do this by specifying a larger Solvency Margin, however it might also be helpful to adjust how the actual solvency calculations are carried out.

163. The solvency standards are designed to establish appropriate minimum capital levels for most insurers in normal circumstances. However, they do not contemplate all the possible risks an insurer might be exposed to. Where we are concerned about a risk to an insurer that is not fully reflected in the solvency standard, IPSA currently allows us to ask the insurer

to hold additional capital by modifying license conditions to include a higher Solvency Margin.

164. This is a useful tool but it is not publicly transparent. That is because insurers publish their solvency margins but *not* the margin that we are asking them to hold. The public, then, are not aware when we believe a headline solvency requirement doesn't reflect the true risk an insurer is exposed to, making an insurer appear to be financially stronger than it really is.



165. An alternative mechanism would be to enable us to issue license conditions that required the insurer to *conduct its solvency calculations* differently, rather than altering the solvency margin. That way published solvency marigns would provide a better public guide for comparing insurers' financial position.

166. The rationale for expecting increased capital should also be clearer to the insurer and its board, since the specific adjustment to solvency calculations that was imposed would be more transparently linked to the risk that we were concerned about.

167. This alternative mechanism would require an amendment to the legislation to make it clear that we had the power to make specific changes to the way a particular insurer carried out its calculations using a license condition.

168. This would technically be a new power, so it is important to consider whether there should be a procedure through which insurers would have the right to challenge such a decision. However, one might also argue that the outcome (an increased requirement to hold capital) is not significantly different from our existing power to ask for a higher solvency margin through license conditions.

Q2.13: Would you support the Reserve Bank being allowed to make supervisory adjustments within the solvency calculation?

Q2.14: Should there be a mechanism by which supervisory adjustments can be challenged? If so, what should the mechanism be?

Termination values

169. Many forms of insurance available in the New Zealand market are annual or annually renewable in nature. This year's coverage is funded out of this year's premium, with no money being set aside to fund future years' claims and benefits.

170. However, some forms of insurance involve a portion of premiums being accumulated to fund benefits and claims payable in future years. In these cases, the insurance policies represent a store of value for the policyholder. Examples include:

- Conventional life insurance policies where a benefit is paid on death and on survival to an advanced age, funded by regular premiums payable throughout the term.
- Life annuities where a single premium is paid now to secure an income stream payable over future years.
- Builder's warranty insurance where an up-front single premium funds claims that may arise over the medium-long term.

171. In some cases, policies that store value have contractual provisions that provide for a benefit to be paid to the policyholder on early termination, in order to provide fair value for the premiums that have been remitted. In other cases, contracts are silent and contain no explicit protection for the policyholder.

172. Some overseas jurisdictions compensate for the lack of contractual protection by imposing minimum termination values on certain types of policy. The treatment in this case may vary depending on whether the termination is solicited by the policyholder (where there is an element of 'buyer-beware') or whether it is triggered by a decision of the insurer.

173. There are a number of possible bases upon which such minimum values could be set:

- Those that look backward to the premium received from the policyholder.
- Those that look forward to the benefits and claims potentially payable.
- Those that look at policy values as shown in financial statements.

Q3.1: Should IPSA contain provisions requiring minimum termination values for policies that store value long-term? Why / why not?

Q3.2: What would be an apppropriate basis for setting minimum termination values?

Statutory funds

Introduction

174. Under the IPSA regime, life insurers are required to establish 'statutory funds' to look after the assets that underpin their liabilities to life insurance policyholders. Statutory funds are a way of ring-fencing life insurance assets from the rest of an insurer's business and ensuring they are managed in the interests of policyholders. They provide valuable protection to policyholders, particularly when a life insurer fails.

175. These kinds of arrangements have a long history in New Zealand[11] and are common in Commonwealth jurisdictions. They usually cover life insurance business but in India, Nigeria, the Caribbean and some Pacific countries there are also statutory funds for general insurance. Meanwhile, in the UK coverage has gradually been restricted and, since 2006, only covers with-profits business.

176. The IPSA regime requires all life insurers to have at least one statutory fund.[12] The legislation requires new premiums and the returns on investment assets to stay inside the statutory fund. There are restrictions on the expenses that can be met from the fund and on the way fund assets are invested. The fund can distribute profits to shareholders arising from the life business within the fund but only according to carefully prescribed rules to ensure there is no unfairness to policyholders.

177. Indeed, the insurer's Directors have a duty to make administrative and investment decisions relating to the fund in the interests of policyholders, even if policyholders' interests conflict with those of shareholders. If that duty is breached, Directors are personally liable to refund any losses to the statutory fund.

178. Finally, if the insurer becomes insolvent, policyholders' claims on the statutory fund have priority over those of the insurer's general creditors (in contrast with general or health insurers whose claims rank equally with other general creditors).

179. Effectively, the premium contributed by life policyholders is placed in a fund that is specifically maintained in their interest. Assets can't be used to cross-subsidise the rest of the insurer's business outside the statutory fund when the business is still operating (for example, to fund investment in new capacity or temporarily cover a shortfall in some other part of the business) or to meet the businesses debts to others in liquidation.

180. These protections provide advantages and protections for consumers but also increase administrative costs for insurers and reduce their flexibility in running their business (and therefore, also the cost of cover).

181. Statutory fund protections have traditionally been provided only to life insurance policyholders in New Zealand because of the particular nature of life insurance business. Life insurance contracts are long-term and often complex. Policyholders may be in a position to monitor insurer's financial soundness at the time they enter into the policy. However, they may have few tools to monitor and sanction insurers over the length of their contract, either because they are contractually committed or because subsequent developments in their health make it costly or impossible to move insurers. Some policies may also include surrender penalties.

182. Additionally, life insurance contracts have traditionally been more likely to include an investment element. Policyholders were not not just paying income-based premium for a service at a particular point in time but were also using their premia to accrue 'savings' – the liabilities of the fund were related to the value of the assets. Statutory fund arrangements reflect that by separating the resulting assets and strengthening policyholders' rights over those assets relative to the rights of the insurer and its shareholders.

183. Our primary question for this section of the consultation is to revisit the reasons behind the association of statutory funds with life insurance business and ask whether the life / non-life

11 Dating back to the New Zealand Life Assurances Companies Act 1873.

12 The main provisions relating to statutory funds are found in IPSA, Part 2, Subpart 3.

boundary remains the appropriate one for deciding which policyholders benefit from statutory fund protections.

184. One reason for revisiting this question is that the character of new life insurance business in New Zealand has changed so that the vast majority of policies are 'yearly renewable term' (YRT) business, where policyholders are able to move life insurance provider after one year of payments (assuming their health situation has not changed in ways that make alternative cover difficult to arrange). We ask whether the justifications for the different treatment of life insurance rehearsed above apply to this type of business and whether they might apply equally to some kinds of non-life business.

185. Additionally, in its 2016 review of New Zealand's insurance regulation against international standards, the IMF suggested that we should consider extending statutory fund protections to non-life insurance policyholders or, alternatively, provide a general policyholder preference in insolvency. The IMF argued that this would add substance to the IPSA principle that we should 'have regard to the interests of policyholders' when dealing with insurers in distress (IPSA s.4(c)).

186. We therefore ask whether at least some elements of the protection afforded by statutory funds should be extended to non-life policyholders.

187. Finally, we discuss some administrative issues around how assets and cash flows are 'earmarked' as belonging to a statutory fund, asking whether the legislation should be more specific about the legal structure through which statutory funds are held or the records that are kept in relation to them.

Is 'life insurance' the right category for considering which policies should be held in statutory funds?

188. As we saw in the introduction to this section, the justification for holding life insurance business in statutory funds is that life business is:

- Long-term;
- Complex; and
- Has historically involved an investment element (so policyholders have some 'savings' in the fund and, in some cases, the value of their claim partly depends on the value of the underlying assets, as well as any loss they experience).

189. Life insurance in New Zealand has evolved in ways that make the investment element less significant than it once was. Most new life insurance business in New Zealand is 'yearly renewable term' (YRT) business.

190. Policyholders are able to withdraw from these policies after a year. However, they also have a longer-term aspect. Policyholders have the automatic right to renew the contract at the end of each year, without a reassessment of the specific health risks they pose (though premia can increase due to normal annual cost increases and to reflect policyholders' increasing age) and most policyholders expect to stay with the same provider for some time. Equally, at least some policyholders will find it difficult to switch providers if their health situation changes and so effectively have a long-term commitment to their current provider. As a result, policyholders may have a longer-term interest in asset management to protect.

However, this type of 'interest' in the policy is not directly an interest in accumulated asset value in the fund of a kind that statutory funds have historically tried to protect.

Q4.1: Is it still appropriate to provide statutory fund treatment for YRT business? Or should statutory funds only apply to business where policyholders build up a store of value over time to fund their later claims (for example, participating business, unit-linked business, investment accounts and annuities).

191. Meanwhile, health and disability insurance may both have similar structures to YRT business but, at the moment, will not be protected by statutory funds.

192. Again, there is no investment element, but health and disability insurance may create long-term claims on insurer funds for conditions that will require long-term support.

Q4.2: Should health and disability insurance assets be held in statutory funds?

193. Some forms of general insurance also involve long-term exposure and stores of policyholder value.

194. Professional liability insurance may create long-term liability where claims for negligence may not emerge until long after the original insured work was carried out. Some large claims on other contracts can also take a considerable time to settle (for example, housing rebuilds following the Canterbury earthquakes).

195. In each case, policyholders may turn out to be entitled to large sums a long time after the policy was originally taken out and are unable to exert market discipline or monitor insurer solvency by switching provider in the meantime.

196. In the case of claims that will take a long-time to settle, this entitlement may no longer be contingent on an insured event occuring but only on the outcomes of the settlement process. Broad liability to the policyholder may have been clearly established, although it may not be precisely quantified.

197. While these situations do not involve the investment element of traditional life policies, they do share elements of the store of value and time horizon criteria that currently justify statutory fund treatment for life policies.

Q4.3: Should general insurance contracts also have assets held in statutory funds?

Q4.4: If so should statutory fund requirements apply to:

- all general insurance business;
- assets backing business with a contract boundary over one year;
- assets backing accepted claims over a particular size, for claims likely to take more than a year to settle;
- some other subset of general insurance business?

Policyholder preference in insolvency?

198. If statutory funds are to remain confined to some subset of insurance business, it might still make sense to extend some of the protections statutory funds offer to policyholders more broadly.

199. The protection that comes from tight accounting rules cannot realistically be extended without a fund structure. Elements of Directors' duties might be extendable but we will consider Director's duties in a later module of the IPSA review.

200. That leaves the possibility of promoting policyholders' claims in insolvency ahead of those of other general creditors.

201. At the moment New Zealand law treats policyholder claims as of equal priority to those of other general creditors.[13] In many other jurisdictions (notably the US and across the European Union), policyholder interests are given some explicit priority in insolvency.

202. In some jurisdictions, priority is reserved for policy benefits while, in others, it also includes refunds of unearned premium. Both are clearly debts owed to policyholders. However, it may be easier for policyholders to afford to pay for new cover than it is for them to deal with non-payment of a large claim.

203. The effect of priority in insolvency is that it increases the likelihood that claims will still be met from the insurers' surviving assets. However, preference comes at the expense of the insurer's other general creditors (for example, intermediaries, reinsurers whose premiums have not been fully paid, cedents and other general creditors).

204. In contrast to the banking sector, where banks may have large amounts of unsecured debt which will compete with depositors for assets in liquidation, policyholder preference is likely to be less controversial for insurers since there are fewer other general creditor claims that might be written down (though reinsurance liabilities may be large in some cases). However, for the same reasons, policyholder preference is also likely to provide fewer benefits than it might to bank depositors.

Q4.5: Should all policyholders be given priority in insolvency over other general creditors?

Q4.6: Should priority be confined to policy benefits or also include claims for unearned premium?

Administration and 'separation' of statutory funds

205. Although a key purpose of statutory funds is to keep relevant assets distinct and account for them clearly, IPSA does not currently provide detailed guidance about asset-holding arrangements for statutory funds and, in places, is not as explicit about accounting requirements for statutory funds as some other jurisdictions.

206. IPSA s.82 (2)(a) says that a statutory fund 'is a fund that is established *in the records* of a life insurer', suggesting that the separation into a statutory fund is largely a matter of record keeping. However, s.90 (3) says that 'a life insurer must keep assets of a statutory fund distinct and separate from assets of other statutory funds and from all other money, assets,

13 With the partial exception of some reinsurance funds, which are affected by provisions in the Law Reform Act 1936.

or investments of the life insurer' suggesting some more formal separation of assets (though, explicitly, not any requirement for a trust s.90(4)).

207. The substance of the rules governing statutory funds suggests a very clearly designated pool of assets to which special rules and duties apply but, in practice, the administrative and asset holding arrangments for statutory funds vary across New Zealand insurers.

Q4.7: Should IPSA be amended so as to make it more explicit that assets (other than transactional bank accounts) should not be shared across different statutory funds?

208. IPSA also contains particular rules for managing cash-flows and allocating profits to statutory funds. In particular, IPSA s.92 lists a range of income that must be credited to a statutory fund. Sections 113-5 note that capital should be clearly allocated between shareholders' and members' capital in order to be able to make appropriate decisions as to permitted distributions from the fund. These requirements would be simpler to administer and monitor if the underpinning assets were also easier to identify.

209. One way of achieving particularly clear separation would be to establish statutory funds as a separate trust, containing all the statutory fund assets.

210. We have required some branches of overseas life insurers that are not exempt from statutory fund requirements to hold their statutory funds in this way as a condition of license.

211. It might improve transparency to make this a formal requirement of the IPSA regime for overseas branches that are required to maintain statutory funds.

212. In the process, it would also be possible to establish some guidelines for the way the trust was established so as to ensure that its legal structure helped to re-enforce the duties relating to statutory funds already contained in the Act. In particular, rules could require the legal owner of the trust to be domiciled in New Zealand. They could also specify that the trust's rules incorporated relevant provisions of IPSA, so that the trust was intrinsically required to follow the rules governing the statutory fund regime.

Q4.8: Should IPSA contain a formal requirement for overseas life insurance branches not exempt from statutory fund requirements to hold statutory funds in the form of a trust?

Q4.9: If requirements to establish a trust were included, are there any issues about the trust's constitution that should be specified in IPSA?

213. Alternatively, if trust requirements were seen as imposing too great a compliance burden, IPSA could be amended to include tighter requirements to maintain and disclose an explicit register of statutory fund assets.

Q4.10: Should statutory fund rules include a requirement to keep a register of statutory fund assets? If not, what other mechanisms could be put in place for identifying the assets subject to IPSA's statutory fund provisions?

214. In either case, it might also make sense to require insurers with participating life insurance business to keep and disclose accounts specifying how capital and retained profits in the statutory fund were allocated between shareholders and policyholders – showing both balances and movements, since insurers should be keeping account of these issues in any case.

Q4.11: Should life insurers with participating life insurance business be required to prepare accounts for capital and retained profits in their statutory funds? Should these be disclosed:

- As a note to the insurers financial accounts? Or,
- In data returns for participating businesses provided by the Reserve Bank?

Risk appetite and overall policyholder protection

215. In the conceptual introduction, we suggested that a wide-range of IPSA's rules contributed to policyholder security, including some governance and risk management provisions that are not included in this consultation. We also suggested that different elements of the policyholder security regime might substitute for one another to a certain extent.

216. In this final part of the consultation, we invite stakeholders to review their answers to previous consultation questions and consider whether a suitably amended IPSA regime would provide an adequate level of policyholder security overall, taking into account the likely costs of further enhancements.

217. As we saw in the conceptual introduction, IPSA is designed to promote the soundness and efficiency of the insurance sector and to promote public confidence in it, but without introducing a 'zero failure regime'.

218. We suggested that regulation could enhance policyholder security through the following channels:

- By enhancing insurers' risk management and governance
  - to improve the quality and sophistication of risk management; and
  - to ensure sufficient attention is paid to risk and the need to provide for it.
- By providing better information to policyholders about risk and financial soundness
  - so they can make informed decisions about where to place their cover;
  - which should provide further incentives to insurers to provide for risk.
- By increasing the level of capital held against risk.
- By enhancing policyholders' access to assets in insolvency.

Q5.1: Do stakeholders think that regulation in respect of each of the channels listed in para 217 is broadly appropriate?

Q5.2: If not, which areas are over-regulated or particularly in need of enhancement?

Q5.3: Are there any additional measures for policyholder security that the Reserve Bank should consider?

Tail events and a policyholder guarantee scheme?

219. In the conceptual introduction, we discussed two potential drivers of risk for policyholders: (1) incentives toward under-provisioning risk and (2) tail events. The majority of this consultation has considered the first driver – incentives to underestimate risk. Of course, there are overlaps between the two. The more prudent an insurer is, the more they will consider tail events as part of their risk management and the additional 1:1000 event insurance risk charge in the Solvency Standards could be seen as specifying a particular tail risk. However, as we discussed in section 2, tail events are inherently difficult to specify and there are limits to the possibilities that it is realistic for insurers to consider.

220. In some jurisdictions, authorities have introduced a policyholder guarantee scheme to meet some or all of policyholders' claims in the rare event that an insurer fails and, in some cases, to assist life insurance policyholders in obtaining continuity of cover. Policyholder guarantee schemes can serve at least two purposes. They mean that policyholders' claims can be met even when their insurance company does not have sufficient resources and (depending on the design of the scheme) that claims are met much more quickly than they would be if policyholders had to wait until the insurer's insolvency proceedings were completed.

221. In addition to the direct benefits guarantee schemes provide to policyholders, they may also increase public confidence in the insurance sector (and so, potentially, increase insurance uptake).

222. New Zealand has recently decided to introduce a 'deposit insurance' scheme for banks, which is a broadly similar idea – it aids financial security by providing compensation when a regulated entity fails. If a bank fails, some of the money in customers' accounts is guaranteed.

223. However, there are also important differences. Firstly, banks are vulnerable to 'runs', where customer uncertainty about the bank's situation can lead many customers to withdraw their money, exacerbating the situation. Additionally, because banks are often quite interconnected, problems at one bank can spill-over to other institutions. Though theoretically possible, a 'run' on an insurance company is much less likely and would certainly be much slower. Secondly, it is easier to shape the coverage of a deposit insurance regime because all depositors have similar claims (to a particular amount of money), while insurance policyholder's claims are more variable.

224. Internationally, there are diverse approaches to the provision of policyholder guarantees. About two thirds of OECD countries have some kind of guarantee but the coverage of schemes is variable.

225. The most common form of coverage is guarantees for claims on compulsory motor insurance, designed to ensure that injured third parties can receive treatment and compensation. ACC makes that much less necessary in New Zealand than in many other jurisdictions. Another common protection is for pensions in jurisdictions where insurers are heavily involved in private pension provision. That is also rarer in New Zealand. Some insurers operate KiwiSaver schemes, but not defined benefit pension schemes.

226. While the most common reasons for guarantees are not present, they might still be valuable to New Zealanders. Policyholders might find themselves in considerable hardship if, for example, their insurer failed and their house was destroyed by fire or earthquake (though, for earthquake, requirements would interact with EQC) or death benefits were unavailable to a surviving spouse when a life insurer failed.

227. A guarantee scheme should not be a substitute for sound insurance regulation. Insurance failure should be rare and, even when insurers do fail, they are often able to cover some outstanding claims (especially if there are robust solvency requirements in place). However, because insurance can be so central to policyholder's financial security, a guarantee of some kind may still be worth considering in the New Zealand context.

228. When considering the introduction of a scheme it is important to compare potential benefits to the cost of providing additional protection.

229. The cost of a scheme is difficult to estimate, partly because it depends on how often insurers are likely to fail and partly because cost depends on a range of other decisions about the coverage and funding for the scheme. However, in general terms, we would expect any scheme to be funded by industry and that industry would pass on most of the cost to policyholders. International comparisons suggest scheme costs might be in the very approximate region of 1-2% of policy premium for covered policies.

230. In practice, the Government may feel pressure to assist the policyholders of distressed insurers in any case (consider, for example, the case of AMI following the Canterbury earthquakes). Some of the apparent cost of a scheme, then, is actually shifting costs from taxpayers to industry (and, indirectly, policyholders).

231. If there was public appetite for a scheme, both us and other public sector agencies would need to carry out considerable additional policy work to decide on coverage, funding costs and administrative details for the scheme before any final decisions could be made about either introducing a scheme or the detail of how it would work. However, for this consultation we are interested in the extent to which stakeholders think a policyholder guarantee scheme is worth considering.

Q5.4: Have we correctly identified the risks that a policyholder guarantee scheme should address?

Q5.5: Are there other risks we have not considered that a scheme could also address?

Q5.6: Are there particular types of insurance for which a scheme is especially important?

Q5.7: Overall, to what extent do you think a policyholder guarantee scheme is worth considering for New Zealand?

Q5.8: Are there particular kinds of policies that should be covered?

Have your say

232. We encourage any interested parties to provide comment throughout the Review. At this time we are particularly seeking commentary on the questions in this consultation document summarised below. However, we would also welcome any general comments on policyholder security.

233. Use this email: ipsareview@rbnz.govt.nz to provide comments and include "IPSA Review Policyholder Security Consultation" in the subject line. Please clearly indicate which question or section your comments relate to.

234. Comments or submissions should be received by 5pm on Monday 15 November 2021. Submissions received after this date will not be considered.

235. It is our practice to publish submissions received unless specifically requested not to. We may also publish an anonymised summary of submissions received.

Summary of questions

Financial strength disclosures (Pages 13-20)	
1.1	Do you consider that the current exemptions for small insurers should be maintained? Should they be extended to somewhat larger insurers?
1.2	Do you think that the current disclosure rules for an overseas policyholder preference are sufficient?
1.3	Do you consider the current financial stregth rating and solvency disclosure to be sufficient to provide consumers and policyholder's information on the solvency of insurers? If no, what information would most help consumers and policyholders?
1.4	Out of the options presented in Section 3.4, what is your preferred option or combination or options for public solvency disclosure requirements?
1.5	If we increase the public disclosure of solvency ratios, what solvency measures do you think would be the most informative to the public?
1.6	Do you think there is a better public solvency disclosure requirement than the options here? If yes, what disclosure requirement would you like to see?
1.7	Do you agree with our assessment of the potential costs and benefits of public financial strength ratings and solvency disclosure (as set out in table 3)? If not, what other high level costs or benefits should be considered?
1.8	Are there any other ways in which we might improve financial disclosure to improve policyholders' and other actors ability to assess insurer's financial strength?

Solvency requirements (Pages 20-28)	
2.1	Would it be helpful to replace the language of 'solvency margin' and 'solvency ratio' with either • a metric based on the relationship between Actual Solvency Capital and Minimum Solvency Capital, or • the relationship between stressed assets and stressed liabilities?
2.2	Should New Zealand solvency terminology be aligned with international standards? Why or why not?
2.3	Which international terminology would it be best for New Zealand to align with?
2.4	Should IPSA enable a separate standard dealing with Financial Condition Reports? (Why/why not?)
2.5	How useful are s.78 reports? Should they be continued or replaced?
2.6	Would it be helpful for IPSA to contemplate more than one solvency control level?

Solvency requirements (Pages 20-28)	
2.7	How many control levels would be useful?
2.8	How should the Reserve Bank's powers relate to the different control levels?
2.9	Should powers be unlocked sequentially?
2.10	Should powers unlock at the top rung, with the Reserve Bank issuing public guidance on how it intends to use its powers?
2.11	Should any actions on the part of the Reserve Bank be mandatory when one of the control levels is breached?
2.12	Should a minimum solvency margin of zero be required by default (without the need to specify it in a license condition)?
2.13	Would you support the Reserve Bank being allowed to make supervisory adjustments within the solvency calculation?
2.14	Should there be a mechanism by which supervisory adjustments can be challenged? If so, what should the mechanism be?

Termination values (Pages 29-30)	
3.1	Should IPSA contain provisions requiring minimum termination values for policies that store value long-term? Why / why not?
3.2	What would be an appropriate basis for setting minimum termination values?

Statutory funds (Pages 30-36)	
4.1	Is it still appropriate to provide statutory fund treatment for YRT business? Or should statutory funds only apply to business where policyholders build up a store of value over time to fund their later claims (for example, participating business, unit-linked business, investment accounts and annuities).
4.2	Should health or disability insurance assets be held in statutory funds?
4.3	Should general insurance contracts also have assets held in statutory funds?
4.4	• If so should that include: • all general insurance business; • assets backing business with a contract boundary over one year; • assets backing accepted claims over a particular size, for claims that are likely to take more than one year to settle; • some other subset of general insurance business?

Statutory funds (Pages 30-36)	
4.5	Should all policyholders' be given priority in insolvency over other general creditors?
4.6	Should priority be confined to policy benefits or also include claims for unearned premium?
4.7	Should IPSA be amended so as to make it more explicit that assets (other than transactional bank accounts) should not be shared across different statutory funds?
4.8	Should IPSA contain a formal requirement for overseas life insurance branches not exempt from statutory fund requirements to hold statutory funds in the form of a trust?
4.9	If requirements to establish a trust were included, are there any issues about the trust's constitution that should be specified in IPSA?
4.10	Should statutory fund rules include a requirement to keep a register of statutory fund assets? If not, what other mechanisms could be put in place for identifying the assets subject to IPSA's statutory fund provisions?
4.11	Should life insurers with participating life insurance business be required to prepare accounts for capital and retained profits in their statutory funds? Should these be disclosed: • As a note to the insurers financial accounts? Or, • In data returns for participating business provided by the Reserve Bank?

Risk appetite and overall policyholder protection (Pages 36-39)	
5.1	Do stakeholders think that regulation in respect of each of the channels listed in para 215 is broadly appropriate?
5.2	If not, which areas are over-regulated or particularly in need of enhancement?
5.3	Are there any additional measures for policyholder security that the Reserve Bank should consider?
5.4	Have we correctly identified the risks that a policyholder guarantee scheme should address?
5.5	Are there other risks we have not considered that a scheme could also address?
5.6	Are there particular kinds of policy for which a scheme is particularly important?
5.7	Overall, to what extent do you think a policyholder guarantee scheme is worth considering for New Zealand?
5.8	Are there particular kinds of policies that should be covered by a guarantee scheme ?