New Zealand
Society of Actuaries (Inc)

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NZSA submission re

Law Commission PP53

22 March, 2003

presented to the Law Commission

by the NZSA

1. Introduction

1.1. Many of the members of the New Zealand Society of Actuaries (the Society) play a major role in the financial management of insurance companies. The Society is therefore well placed to contribute to the current review of life insurance legislation.

1.2. The role of the actuary within life insurance companies is critical to the maintenance of a financially sound industry. It is essential to ensure that insurers obtain advice from professionals with the competence and qualifications required for risk identification and control.

1.3. The following definition has been considered by the International Actuarial Association (IAA):

> "An actuary is a professional trained in evaluating the current financial implications of future contingent events. An actuary is a member of a full member association of the IAA or an actuarial association with a code of conduct at least as strong as is required for an association to become a full member association of the IAA. An actuary is often used in establishing premiums and technical provisions for insurance products, as well as determining appropriate levels of capital, but their work is not limited to insurance."

1.4. It is the intention of the NZSA to retain membership of the IAA by adhering to the requirements of this organisation.

Structure of paper

1.5. The Law Commission has asked 82 questions regarding the regulation of life insurance in New Zealand. We have first set out our response to questions on the actuarial profession itself. This can be found in section 2. Section 3 comprises our response to the remaining questions. We have kept our responses here relatively brief, and we would be happy to expand on any of the points.

1.6. We have found a number of instances where statements made in PP53 are not correct, or where we did not understand what was written. Most of these are not important to the discussion, but we have included them as Appendix A for completeness.

1.7. Various other documents referred to in responses to some of the questions are set out in Appendices B to E.

Definition of "life insurance"

1.8. While we understand that Chapter 1 of PP53 is setting out the current legal definitions of "life insurance", we find continued use of the phrase "life insurance" to be too limited for a wholly constructive discussion of the matters in question. The discussion on roles for insurance in 1.3 and 1.5 refers specifically to death. However, it is widely accepted that there are other contingencies covered by insurance and relating to human life which are equally important, for example, critical illnesses and disablement.

We are strongly of the view that, in order to manage financial risks, all forms of renewable long term insurance should be regulated in the same manner. The concept of including such business with "life insurance" doesn't arise until Q76.

However, we must make two important points in this regard at this early stage:

- We have found particular difficulty in defining exactly what forms of insurance should be covered by "life" insurance legislation. Further discussion is required,

including a review all of the various classes of insurance business written and identification of the important differences between them. Insurance products are continually evolving, and different forms of cover are often provided within one policy. It may be that such definition will need to be made within actuarial standards, rather than within legislation, in order to respond to such evolution in the marketplace.

- The comments in this submission are made in the context of the business currently written by “life insurance” companies. None of our comments should be taken to apply to other classes of business (such as “general insurance” or “health insurance”) without further consideration of how the inherent differences between the various products affect the manner in which they should be regulated.

Further discussion

The Society would welcome the opportunity to meet and discuss our submission, or provide any further information required. To arrange this please contact:

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2. Regulation of the actuarial profession

The Society has considered the issues raised in Chapter 15 and questions 45, 46 and 47 under 3 headings:

1. What statutory role should actuaries have within life insurance?
2. What requirements must a person meet to be allowed to perform this role?
3. How should the actuarial profession be regulated?

We have commented below under each of these headings. Finally, we have also commented on the issue of "whistle blowing".

What statutory role should actuaries have within life insurance?

We see the role of the actuary as a key provider of financial advice to the Board with a primary responsibility for policyholder protection.

Actuaries have had a long history of involvement in the financial management of life insurers. The management of the financial risks associated with long term mortality and other contingent events is an integral part of the profession's training and expertise. Whilst actuaries generally have a wide ranging role within life insurers, the Society considers that there are four tasks only that are required specifically of actuaries and that should be addressed in legislation. These are:

1. Calculation of policy liabilities to be included in the life insurer's accounts.
2. Advice on solvency of the life insurer.
3. Distribution of surplus to both shareholders and policyholders.
4. Preparation of an annual Financial Condition Report.

To complete these roles the actuary will need to have a statutory right to access the necessary information.

While we see this role as quite different from an "appointed actuary" role, which has come to be seen as an arm of the regulator, the actuary would need to be named and identified as having the role of completing the 4 tasks identified above. The role we envisage would, we believe, strengthen both the financial management of the life insurer and provide a means of ensuring that the interests of policyholders were protected.

The 4 tasks noted should be completed at least annually. These are the areas where the expertise of the actuary is required in order for the life insurer to make appropriate decisions. In this respect the Board should be required to take advice from an actuary. We consider it important that the responsibility for the on-going profitability and solvency of the life insurer lie clearly with the Board and that there is no joint responsibility with the actuary. The role of the actuary, therefore, should be seen in this light.

The Board should be required to appoint an actuary to perform the four tasks noted. Some of the tasks are already provided for in legislation.

Task 1: Policy liabilities FRS-34, the applicable accounting standard, already requires that an actuary calculate policy liabilities for inclusion in the insurer's accounts. PS3, the Society's professional standard pertaining to the calculation of policy liabilities, requires that the actuary furnish the Board with a report detailing the results of the calculation as well as methods of calculation and assumptions adopted.

Task 2: Solvency An assessment of the solvency position of the insurer is effectively required under FRS-34 which requires disclosure of the amount by which assets exceed the solvency standard. FRS-34 does not, however, define what solvency standard to use or that an actuary be used to undertake the calculation. We believe that legislation should require that an actuary report to the Board on the solvency position of the life insurer and that that assessment be made on a basis no less stringent than that specified by the Society's current professional standard regarding solvency. We note that there is currently no professional standard on solvency of life insurers, rather a guidance note exists. The Society acknowledges that this needs to become a professional standard and is moving to make this change this year.

We believe that the actuary should be required to advise the Board whether there is material reason to expect that the life insurer may be at risk of breaching the solvency requirement over the coming 12 months, and whether there is any reason to believe it did at any point breach the solvency requirement in the last 12 months. Such a provision is included in Australian legislation. Also, if the actuary has reason to believe that the solvency requirement has been breached at any point, he or she must inform the Board immediately.

Task 3: Surplus The distribution of surplus is fundamental to the operation of life insurers that have participating policies. Under whole of life and endowment contracts, policyholders effectively share in the profitability of the life insurer taking similar, although not equal, risks as shareholders. An actuary should be required to advise on the equitable treatment of policyholders and shareholders in this regard. Further, the distribution of surplus impacts directly on solvency.

Task 4: Financial Condition Report Actuaries currently prepare, at least annually, reports for the Board concerning the financial condition of life insurers as required under paragraph 18 of the Life Insurance Act 1908. The long term solvency and other risks associated with life insurance make it different from most other businesses, including other financial services businesses. The Board's ability to appropriately manage the life insurer is aided by the receipt of such reports. We therefore consider that this requirement should continue. The content of such reports should be left to the professional standards of the Society. We note that this requirement will, in effect, require the actuary to comment widely on the life insurer's activities and so will ensure actuarial oversight more generally.

The FCR may be useful to the regulator and perhaps should be provided as part of the regulatory reporting requirements. These reports may contain competitively sensitive information and should not be available to the public. Some form of protection to these reports must be considered if they are to be most useful to the life insurer and to the regulator.

What requirements must a person meet to be allowed to perform this role?

The Society considers that the 4 tasks noted should be performed by an actuary. For this purpose we consider that an actuary must:

- be a Fellow of the Society,
- have a minimum of 5 years' post qualification experience working in life insurance, and
- be familiar with New Zealand conditions.

In particular we do not consider that the actuary should be required to be resident in New Zealand so long as they meet the above requirements.

The first of the requirements is readily assessed. We consider it necessary that actuaries fulfilling a statutory role within New Zealand be members of the Society so that they are subject to the requirements of New Zealand standards.

The second and third requirements have some level of subjectivity about them. The Society is best placed to determine whether a member is qualified to provide advice in the areas noted above. It is recommended that we follow the Institute of Chartered Accountants of New Zealand model and make the Society responsible for approval of an actuary to provide the advice envisaged, following agreed standards. As in other jurisdictions, the Government regulatory body could be empowered to approve and remove individuals as well. There may need to be a designation, similar to Chartered Accountant, for this purpose.

How should the actuarial profession be regulated?

The Society acknowledges that some principles of regulation of the profession must be agreed if it is to have a role for its members enshrined in legislation.

We consider that our profession should be regulated in a way similar to that which applies to the Institute of Chartered Accountants, with a requirement to meet certain minimum standards imposed by parliament as to disciplinary procedures, involvement of non-actuaries in such procedures and professional standards. We consider that the right that might be accorded to the Society is not more than is currently accorded to the Institute of Chartered Accountants, and so a consistent model of regulation is appropriate. In this model, the Society's current status as an incorporated society would continue.

Whistle Blowing

As is noted in PP53, whistle blowing is a requirement of actuaries in other jurisdictions and of superannuation actuaries in New Zealand. This is a difficult area with arguments in favour and against. We do not know the "right" answer to the questions around if and when a whistle blowing obligation should arise. The matter has been widely discussed in other jurisdictions, and we suggest the best way forward will be a detailed consideration of the arguments put forward and decisions made elsewhere. We have made some initial observations below.

The difficulty with placing this obligation on the life insurer's actuary is that it may result in him or her being excluded from certain issues, something that is unlikely to help the achievement of a constructive outcome. Whilst not formally required under the Society's code of conduct, actuaries would effectively be required to resign if they considered the Board and/or management were acting in a way that they considered to be in conflict with their professional obligations.

The purpose of whistle blowing is to prevent unethical or irresponsible action by a Board. This purpose relies on the actuary being able to identify such action, and although we might like to think that will always be the case, the promise cannot be absolute. The actuary is required, by professional standards, to ask questions which are necessary to form an opinion on the financial aspects of current obligations of the life insurer. However, the actuary is not always in a position to audit practices or affect changes planned in those practices.

We suggest that an obligation to whistle blow would need careful definition so that an actuary can work with a life insurer to rectify non serious issues and disclose only those issues having significant financial impact. The actuary should also be given the opportunity to assess and have some confidence in the potential outcomes before having to disclose an issue.

3. Questions from PP53

Chapter 1 – Role of life insurance

Q1 Do you have any comments on chapter 1 ?

Please refer to our comment in 1.7.

Chapter 2 – Philosophy of financial regulation

Q2 Do you have any comments on chapter 2 ?

2.5 refers to research on life insurance. It seems to us that all forms of long term insurance (see 1.8 above) would be similarly important.

2.13 refers to the life insurer and its representatives. It is necessary to be clear that brokers are deemed to be "representatives" for this purpose.

We consider that regulation of life insurance must be consistent with that adopted in other areas.
New Zealand's light-handed approach to finance sector regulation is in striking contrast to the approach taken in other countries.

In the field of life insurance overseas models primarily involve tight regulation. This is typified by the core principles set out in the codes promulgated by the International Association of Insurance Supervisors (IAIS).

Overall, it seems likely that the main driver of the level of regulation for life insurers will be the same as the driver of regulation for other businesses, that is, Government policy.

We would also point out that the existence of regulation, under whatever framework, cannot be assumed to prevent all problems. A balance must be sought between the benefits and costs of regulation.

Chapter 3 – Regulation of New Zealand financial markets

Q3 Do you have any comments on chapter 3 ?

3.10. Sensible investors should make known their desired purpose or result; in practice, protection can only be obtained by a requirement that advisers / companies ask them to do so (and confirm that they have refused in instances where this occurs.)

3.14. The lack of regulation for risk only products, compared to investment products, is very noticeable.

Chapter 4 – New Zealand life industry

Q4 Do you have any comments on chapter 4 ?

No comments other than those in Appendix A.

Chapter 5 – New Zealand life insurance law

Q5 Do you have any comments on chapter 5 ?

5.17. We note that although section 15 clearly refers to a separate Life Fund, the separation does not appear to have been carried through into the current Financial Reporting Standards.

5.88. We suggest that *no* life insurer should be exempt from compliance with the Financial Reporting Act.

Chapter 6 – Australian life insurance law

Q6 Do you have any comments on chapter 6 ?

6.25 and 6.34. We note that directors are specifically required to consider the interests of policyholders, and to give policyholders' interests priority.

In our view, these points are important to the ongoing discussion of the New Zealand position, where directors are not required to consider the policyholders at all.

Chapter 7 – UK life insurance law

Q7 Do you have any comments on chapter 7 ?

No comments other than those in Appendix A.

Chapter 8 – Life insurance in other overseas jurisdictions

Q8 Do you have any comments on chapter 8 ?

No comments.

Chapter 9 – International obligations and guidelines

Q9 Do you have any comments on chapter 9 ?

We believe that the Insurance Core Principles form the best available framework in which to consider regulation subject to our comments under Q2. We have set out in Appendix B our preliminary views of how the principles could apply in New Zealand.

Chapter 10 – Introduction to the issues

Q10 Do you agree with the statement of risks set out in paragraphs 10.2 and 10.3? Are there any other risks?

We broadly agree with the overall statement, although we don't agree with the split of those risks between 10.2 and 10.3. In particular, the first four bullet points in 10.3 could apply equally to life insurance and to other financial products.

Q11 Do you agree with paragraph 10.9 that regulation of New Zealand life insurers is not needed to protect the stability of New Zealand's financial system?

We tend to agree, although we do wonder whether failure of a large insurer or of more than one insurer could transmit a loss of confidence in other institutions such as banks. Failure of an insurer could particularly affect the capital markets, given the role insurers still play in New Zealanders' savings. There may also be political consequences, with unforeseeable secondary effects creating general and/or financial instability.

We wonder whether there are any instances overseas where there has been a major insurance failure which has damaged a country's financial or political stability.

Q12 Are there any issues relevant to the regulation of the New Zealand life insurance industry that are not addressed in chapters 10 to 18?

10.3. The first bullet referring to "especially savings policies" should not have made that limitation. The various benefit provisions of some income protection policies, for example, may be regarded by policyholders as equally complex.

10.3. For the fifth bullet, this issue is not so much conflicts of interest as the fact that there are discretions and they can be difficult to manage objectively. The actuarial processes are complex and involve significant levels of judgement, making transparency difficult to achieve. Generally, there are other controls in place to govern the management of discretions, such as companies' Articles of Association and the provisions of policy documents.

Chapter 11 – Financial market integrity issues

Q13 Life insurance market integrity – Are there areas other than those set out in paragraphs 11.5 to 11.65, where New Zealand's existing law may be regarded as unsatisfactory in relation to life insurance market integrity?

We have no areas to add.

Q14 Financial reporting - Do you have any comments on the possible problems and options in paragraphs 11.11 to 11.15? Are there any problems or options we have not considered?

11.11. We certainly agree that the reports currently made under the Life Act are of little relevance or help.

11.13. The practical difficulties in assessing financial information should not be underestimated. The need to provide information in an easily understandable form and simplifying financial and actuarial information is agreed, but to actually meet that need is not necessarily very easy.

11.14. Taking the bullet points in turn:

- updating the schedules to the Life Act - at the request of the Ministry of Economic Development, we made suggestions in June 2003 for updating the schedules to the Life Act. A copy of that letter is attached as Appendix E.
- combining Life Act and Financial Reporting Act requirements into one document – see Q50.
- public availability of a financial condition report - see Q49.
- reducing time available to lodge Life Act Returns – see Q 54

- extending the role of the ASRB – see Q 52

11.15. Taking the bullet points in turn:

- extending the Securities regime – see Q 24.
- implementing periodic disclosure regime – we can see that there may be advantages, but the practicality (including costs) would need to be carefully considered against the value of the exercise. We would question whether, if a satisfactory regulatory regime were established, the value would be more than trivial.
- requiring life insurers to obtain and publish a rating – see Q35.

Q15 Valuation of assets and liabilities – Are there any problems with the current requirements for valuation of assets and liabilities? If so, what could be done to remedy these problems?

The current requirements relate to the public reporting of profit or loss, and are thus the province of the accounting profession. Measurement and reporting of solvency is a matter for life insurance regulation, rather than accounting.

It would be common for companies to perceive that publicly reported information is not sufficient for the management of their business, in which case separate internal reporting on an acceptable basis would be prepared.

Q16 Financial records - Are there any problems with the current requirements for financial record keeping by life insurers? If so, what could be done to remedy these problems?

As far as we know, there are no such problems.

Q17 Directors (and senior management) - Do you have any comments on the problems and options in paragraphs 11.31 to 11.34? Are there any problems or options we have not considered?

We suggest that whatever requirements are imposed on the directors and senior management of banks would be appropriate for life insurers, with the addition of a requirement to consider policyholders' interests. The question of giving priority to policyholders' interests needs further discussion, with consideration of how (or whether) this requirement can be defined. In some circumstances, giving priority to policyholders could be interpreted as excluding shareholders completely.

Q18 Actuaries – Are there any financial market integrity issues relating to actuaries other than those in paragraphs 13.33 to 13.36 and chapter 15?

Please refer to section 2 of this submission for discussion of these issues.

Q19 Auditors – Do you have any comments on the possible problem and option in paragraphs 11.43 to 11.44? Are there any problems or options we have not considered?

Auditors' obligations for life insurers should be the same as their obligations for other financial institutions.

Q20 Transfers and amalgamations - Do you have any comments on the possible problem and option in paragraphs 11.49 to 11.52? Are there any problems or options we have not considered?

11.50. Consultation with policyholders is generally of little practical value. Unless there is a requirement that all (such as under the Superannuation Schemes Act) or perhaps a majority of policyholders need to consent, only a very small percentage actually vote.

In our view, an independent actuary's report on policyholders' interests should be required in respect of any transfer or amalgamation, and the regulator should be able to give the necessary approvals. Only in exceptional circumstances should reference to the Courts be necessary, where the regulator needs some clarification before being able to sign off.

We support the third option. However, we wish to add that the interests of policyholders in the life insurer receiving the transfer need to be considered, as well as the interests of policyholders being transferred.

Q21 Surrender values and terms – Do you have any comments on the possible problem and options in paragraphs 11.55 to 11.57? Are there any problems or options we have not considered?

11.55. The question of what is inequitable in a surrender value is likely to be viewed very differently from the policyholder's point of view and the insurer's point of view. Policyholders often believe that they should get their premiums back with interest, regardless of the risk cost of providing cover and of the need for insurers to recoup expenses (including commissions) and make a profit for their shareholders. The effect on the remaining policyholders of surrender values paid to departing policyholders must also be considered. Equity between all policyholders is of prime importance, and if surrender values are too large it will be at the expense of those still in force.

11.57. A review of surrender value provisions before a person takes out a policy implies that the surrender value will be guaranteed in advance. While this might be technically possible, any guarantee has to be paid for and so surrender values will have to be reduced accordingly. It is likely to also have the effect of limiting the life insurer's investment choice, thereby reducing investment returns and reducing surrender values even more.

We do not think that a minimum surrender value regime should be imposed. The effect of a minimum of course depends on the level actually set. A minimum is simply a form of guarantee, and minima set at any meaningful level will impede the life insurer's choice in the same way as noted above.

In practical terms, the imposition of guarantees or minima on the surrender values of participating policies is likely to result in a swing away from reversionary bonus declarations, in which the bonuses declared become guaranteed additions to the sum insured, towards terminal bonuses which are not guaranteed.

Q22 Allocation of profits – Do you have any comments on the possible problem and options in paragraphs 11.63 to 11.65? Are there any problems or options we have not considered?

11.58. The profit sharing basis is not generally at the discretion of the insurer. In all but one case that we know of the share is defined legally or quasi-legally, such as in a life insurer's Articles of Association, or by statements made in marketing or other material, or in commitments made during demutualisation. Profits are shared in the sense that if $x is given to policyholders then a specified amount for shareholders follows. However the timing

of profit emergence and therefore of bonus declaration may be “managed” in a number of ways, for example to smooth declarations so that returns to policyholders do not fully reflect investment market swings.

11.60. The ownership of assets now has to be disclosed under MoS.

We are not sure of the process of changing a life insurer’s Articles of Association – can the provisions for profit-sharing be changed without the consent of the policyholders affected? If only directors’ and/or shareholders agreement is required, this is one area in which directors need to take an ethical stand on fairness to policyholders.

Essentially we support the option in 11.64. An addition to this option may be to require directors to be fair and equitable in their allocation of profits. This would be part of the requirement that directors consider policyholders’ interests, as noted in Q17 above. Note that it is the directors that make the distributions, not the actuary. We often hear mention of Policyholders’ Reasonable Expectations, and the need to ensure that these are understood and are met, but we are unsure whether this is a sufficiently well-defined concept for practical application.

A further issue for directors to consider in profit allocations is the amount of expenses to be charged to with-profits policyholders. This charge can affect the profits emerging and therefore the bonuses declared. It is possible that a requirement for statutory funds (see Q37), coupled with a requirement for a “fair and reasonable” allocation of expenses between funds, would assist in this aspect.

We would support the option in 11.65 to apply in situations where there are no rules already in place.

Chapter 12 – Consumer protection issues

Q23 Consumer protection – Are there areas other than those set out in paragraphs 12.5 to 12.70, where New Zealand’s existing law may be regarded as unsatisfactory in relation to consumer protection?

None that we are aware of.

Q24 Product disclosure - Do you have any comments on the possible problems and options in paragraphs 12.10 to 12.15? Are there any problems or options we have not considered?

12.11. Savings life policies are not necessarily more complex than other savings vehicles. We see no need for any additional disclosure to apply to a vehicle simply because it is in a life policy structure.

12.13. We would support the 2nd option in 12.13, although it is not obvious what a risk-policy disclosure regime would actually require. An extension of any such requirements to general insurance could be made.

12.14. Part of the current “problem” (if there is one) is that the information already disclosed is so voluminous. Another issue sometimes raised is that people do not even bother to read and try to understand what they have, although we do think that realistically most of them are not in a position to understand such matters. It is very difficult to find the correct balance between sufficient information and overload. We have attached in Appendix C a short article from a recent Institute of Actuaries publication, which we found gave an interesting viewpoint.

12.15. This appears to be a legal issue, so we have no comment on this option.

Q25 Financial advisers and brokers - Do you have any comments on the possible problems and options in paragraphs 12.23 to 12.31? Are there any problems or options we have not considered?

The Society does not wish to comment on these matters.

Q26 Terms of policies - Do you have any comments on the possible problems and options in paragraphs 12.35 to 12.40? Are there any problems or options we have not considered?

12.39. The rate of interest paid on delayed claims would be better specified as related to the official cash rate, for example, rather than allocating responsibility for causing delay. Such an approach would be neutral to both parties.

This is one of the more obvious areas in which treating all forms of insurance the same way would need to be carefully considered. For example, with some forms of "health insurance", policyholders are encouraged to submit one claim form per year regardless of how many claim events have occurred.

Otherwise, the Society does not wish to comment on these matters.

Q27 Secondary markets – Do you have any comments on the issue referred to in paragraph 12.41? Are there any issues we have not considered?

We have no comment to make.

Q28 Human Rights Act – Do you have any comments on the issue referred to in paragraph 12.42? Are there any issues we have not considered?

It is not clear from the text just what the issue is. The Human Rights Act has resulted in significant limitations on life insurers' freedom to underwrite. A life insurer's financial security depends on being able to charge the appropriate premium for the risks it is taking, and there is an implicit assumption in the Human Rights Act that credible data, advice or opinion can be found in all cases.

From a practical point of view, this is not always true. Even if data can be found, the costs of researching the "right" charge to make for severely substandard lives can be substantial.

In our view, offices should have the right to either charge the potential policyholder for the costs of any necessary research or to decline a proposal when data is not available or when it is too expensive to obtain.

Q29 Genetic Information - Do you have any comments on the issue referred to in paragraphs 12.43 to 12.47? Are there any issues we have not considered?

We suggest that these are not matters for regulation, but rather for an agreed industry standard. Continual scientific advances mean that the whole area is fast-moving and regulation may not be able to be updated quickly enough to respond to systemic changes.

Full disclosure of any available genetic information is necessary for a life insurer's protection against anti-selection. Although this disclosure is vital, life insurers should not be able to insist on a genetic test being taken.

The principal issue for life insurers is that they are able to obtain access to all available information to protect against anti-selection. The applicant must not have any information relating to the risk that the life insurer does not also have.

Q30 Complaints handling - Do you have any comments on the possible problems and options in paragraphs 12.57 to 12.62? Are there any problems or options we have not considered?

The Society does not wish to comment on this matter.

Q31 Insured's duty to disclose - Do you have any comments on the issue referred to in paragraphs 12.63 to 12.70? Are there any issues we have not considered?

It is not clear from the text just what the issue is.

As we see it, the duty of disclosure is often grey, rather than black and white. When statements made by a proposer are spoken to an advisor rather than written down, the rights and wrongs of a case can only be one person's word against another, often weeks or months after the event. From the point of view of the life insurer's financial security, we can support only the position that the life insurer can void any policy if material non-disclosure is found.

12.67. We question how a life insurer is expected to find out about an insured's non-fraudulent nondisclosure. We would have thought cancelling from inception was actually more generous to the policyholder as it means he or she gets his or her premiums back. If a policy is cancelled prospectively, is the suggestion that he can still actually make a claim?

In practice, cancelling policies for non-disclosure is an important tool for the financial security of life insurers. We believe that companies recognise such matters must be handled with as much tact and consideration of policyholders as possible.

Chapter 13 – Financial safety issues

Q32 Does New Zealand need financial safety regulation for life insurers or for particular kinds of life policies?

Yes. In order to be consistent with other "first-world" countries, New Zealand needs to regulate the life insurance industry. The best approach is to define the business to be regulated, and then to regulate the companies that write it.

However, we reiterate our comments on Chapter 2. Overall, it seems likely that the main driver of the extent of regulation for life insurers will be the same as the driver of regulation for other businesses, that is, Government policy.

Q33 Should New Zealand simply "tidy up" its existing financial safety regulation of life insurers or is a higher level of regulation needed in relation to all or some kinds of life policies?

New Zealand's existing regulation is beyond tidying up. To be consistent with other "first-world" countries, we need a system of regulation that has been considered in the framework of the headings set out in the IAIS Insurance Core Principles.

Q34 Should New Zealand have a financial safety regulator of life insurers, along the lines of Australian Prudential Regulation Authority in Australia?

The fundamental question is whether the Government is committed to best practice as stated by the IAIS Core Principles. If it is, then a financial safety regulator will be required. The question does not exist in isolation.

The concept of one regulator is appealing, but the approach taken to the regulation of life insurers should be consistent with the general approach taken to regulation in other New Zealand markets. This may preclude a regulator "along the lines of" APRA.

13.8. Our understanding of Australian regulation is that a separate statutory fund is required for offshore business only if that business is written in a branch of the life insurer, and that grandfathering provisions in respect of funds established prior to 1945 mean significant portfolios of business do not have the suggested protection.

13.10. The main goal may be to recognise warning signs in time to require, not just to allow, the insurer to take remedial action. However, the extent to which even the most experienced regulator can achieve this degree of prescience in practice must be open to question.

Q35 Should life insurers in New Zealand be required to obtain an annual credit rating from one of the internationally recognised credit rating agencies?

No. We prefer a requirement for companies to meet technical solvency standards as a means of ensuring policyholders' security as far as is practically possible. We feel that a requirement to have a rating is something of an abdication of responsibility by government. We are unsure of the consistency of ratings agencies, particularly as there is necessarily some level of subjectivity about ratings decisions.

Please refer to Appendix D for a more detailed discussion of ratings. While Appendix D was written in the context of considering general insurers, the discussion is equally relevant to life insurers.

Q36 Should life insurers in New Zealand be required to put in place an independent trustee and trust deed in relation to all or some kinds of life policies?

This form of regulation would not add anything to the security of policyholders under an appropriately constituted Board of Directors which is specifically required to consider policyholders' interests. There may be additional cost in such a structure, without equivalent value being added.

13.24. We don't believe the Government Actuary has a prudential supervisory role in relation to life insurance in any practical sense.

Q37 Should life insurers in New Zealand be required to operate all or some (being particular kinds of policies) of their life business through a statutory fund?

Yes. The existence of statutory funds can help ensure that policyholder funds are not used for inappropriate purposes. This structure effectively imposes restrictions on transfers between policyholders and shareholders.

In particular, a statutory fund is likely to enhance the protection of policyholders who have rights to some share of the profits that arise from specified classes of business, and in assessing the reasonable expectations of such policyholders. The explicit recording of transactions to and from a statutory fund that relate to such policyholders can assist in monitoring the appropriateness of decisions on such matters. Further, the greater transparency provided would, we believe, be an aid to effective regulation.

An appropriate regime in respect of statutory funds would have the following features:

1. Each statutory fund has separately identifiable assets.
2. A statutory fund is not allowed to give off balance sheet guarantees other than those relating to the insurance policies in the fund.
3. A separate statutory fund is required in respect of participating business.
4. A separate statutory fund is required for investment-linked business.
5. Subject to 3 and 4 above, a life insurer is allowed but not required to set up more than one statutory fund relating to different classes of business.
6. Transfers between statutory funds or from a statutory fund to shareholder funds require the support of a certificate from the life insurer's actuary.

We believe this structure to be no different from the systems that companies will already have in place in order to monitor the progress of the various segments of their business. The definitions of statutory funds need to be made sufficiently robust to encompass all classes of business.

Some problems may arise in the very long term, in relation to solvency provisions held in a statutory fund nearing the end of its natural life as policy numbers become very small. Such matters would need to be considered in further detail.

The existence of statutory funds should not change the life insurer's tax calculation in any way.

13.26. The last sentence is not correct. "The life element of bundled policies" cannot exist, by definition. There would likely be a statutory fund for all bundled policies. There may be confusion here between unit linked ("unbundled") and traditional participating ("bundled") business.

Q38 Should life insurers (or life insurers who issue particular kinds of policies) in New Zealand be required to register with a Government agency? If so, should a "fit and proper" assessment of business plan soundness be undertaken at the time of registration?

Registration on its own accomplishes little without a form of licensing. However, we do see some merit in a Government agency being able to at least identify who is selling insurance cover.

In general terms, the requirements for life insurers should be consistent with those for other financial institutions, with the addition of technical actuarial solvency requirements.

An actuarial assessment of its business plan would be a standard management requirement for any life insurer starting out in business. The assessment would normally include consideration of capital requirements in future years, including the capital required to meet any published solvency provisions.

Q39 Should life insurers in New Zealand be prohibited from carrying on business other than life insurance? If so, how would "life insurance" be defined for the purposes of this prohibition and would the definition include, for example, products such as insurance bonds and disability insurance?

No. Ring-fencing ("statutory funds") is preferable to restriction of business classes. We note that there are different capital requirements for different classes of business and that this may lend further weight to the argument that the business should be ring-fenced into statutory funds.

Please note that, in making this response, we are using the definition of life insurance we have set out in 1.7 above.

Q40 Should the bond requirement be retained; and if so, should the bond amount be increased to, say, $5 million (or another amount)?

No. An absolute amount is too blunt an instrument. Demonstration of solvency according to a proper technical basis (such as GN5) should be required.

A larger deposit may be seen as a barrier to new entrants. We suggest that other requirements, such as for fit and proper directors and submission to a regulator of a business plan, would be a preferable approach.

Consideration may need to be given to whether any solvency requirements required for the market generally are appropriate for a start-up operation. Some further requirements may need to be added, perhaps along the lines of the second tier "capital adequacy" standards applied in Australia. These standards require consideration of the effect of new business plans on future solvency, as well as experience more adverse than the first tier solvency standard.

Appendix D contains further discussion of this issue. While Appendix D was written in the context of considering general insurers, the discussion is equally relevant to life insurers.

Q41 Should life insurers be required to maintain a minimum amount of paid-up capital?

No, not if it is expressed as an absolute dollar amount – see Q40 above.

Q42 Could a system of regulation be supported by a requirement that life insurers in New Zealand obtain an annual credit rating from an international credit rating agency?

Please see our response to Q35 above. We see no benefit in this approach.

Q43 Should there be rules limiting the ability of life insurers to enter into transactions with related parties?

No, provided there are requirements for the directors to treat participating policyholders equitably.

Q44 Should corporate governance standards be introduced for life insurers in New Zealand, in particular, setting out principles of best practice in relation to risk management systems? If so, should these standards have a statutory basis?

Life insurers should be subject to the same standards as other companies, with the addition of actuarial standards as appropriate.

Q45 Should an "appointed actuary" regime be introduced in New Zealand?

Please refer to section 2 of this submission for discussion of the role for actuaries that should be enshrined in statute.

Q46 Should life insurer actuaries have "whistle blowing" obligations to a Government regulator or trustee?

Please refer to section 2 of this submission for discussion of this issue.

Q47 Are there other issues concerning the current role of actuaries in the life insurance regime that need to be considered (for example, rights of access to company information)?

Please refer to section 2 of this submission for discussion of this issue.

Q48 Should the whole financial condition report be filed with the Government Actuary or another Government regulator?

Some confusion can arise over the phrase "financial condition report". In what follows, we use:

- "FCR" to refer to the report on long-term business prepared in accordance with the NZ Society of Actuaries Professional Standard,
- "Actuarial Return to the Regulator" to refer to a disclosure report required by a regulator, and
- "Life Act Returns" to the schedules currently required under the 1908 Life Act, although these are described in the Act as an extract of the company's financial condition report.

The FCR is specifically designed to assist the Board of Directors in its oversight of the life insurer. This is entirely different from a regulator's role. A regulator would need to design its own reporting requirements in order to fulfil its specified role.

If the FCR is to be made publicly available, there is likely to be pressure to produce a "watered down" report and sensitive information put into other internal-only reports.

Q49 Should the whole of the actuary's annual financial condition report on a life insurer be made publicly available?

In our view, the FCR should not be publicly available. The FCR is specifically for the Board, and contains confidential information that should remain internal to the life insurer. Board reports in other industries commonly contain confidential material, such as plans for the future, and candid commentary, which would not be considered for publication. The FCR may also include commercially sensitive recommendations from the actuary, for example that commission rates should be reduced. As a further minor point, we note that the FCR is designed for an audience with a particular level of knowledge of the business in question, and the information could be misinterpreted by other parties.

We think an approach of strengthening the disclosures made in financial statements is preferable to making the FCR publicly available.

In principle, the Actuarial Return to the Regulator could be made publicly available. However, our considered view would depend on what is actually specified as required in the document.

We suggest that questions of public availability of information need to be further discussed.

Q50 Should the financial condition report required under the Life Act be required to be prepared in accordance with PS1?

The Actuarial Return to the Regulator should be prepared under whatever principles the regulator requires. The principles set out in PS1 should be applied as far as they are applicable. We would expect that information pertaining to the life insurer's solvency would be required as a minimum..

We agree that Life Act Returns should be incorporated into financial statements, rather than remaining as separate documents.

Q51 Should GN5 be given statutory recognition by requiring compliance with it when an actuary advises on solvency for the purposes of the Financial Reporting Act, and the Life Act?

The current actuarial requirement is in the form of a Guidance Note GN5, this would need to become a Professional Standard for this purpose. Subject to GN5 becoming a standard, our answer is yes, in the sense that statute should require compliance with whatever solvency standards have been agreed by the appropriate parties (see Q52 below). The standards should be able to be changed without statutes being changed.

Q52 Are there other ways that solvency and/or capital adequacy standards could be incorporated into New Zealand's life insurance regime? For example, a body like the Australian Life Insurance Actuarial Standards Board could be established with the power to establish standards which all actuaries must comply with, or this role could be given to the (New Zealand) Accounting Standards Review Board?

We think that the idea is sound, in that we agree there should be a separate body (including actuaries but not exclusively actuaries) to deal with standards of public reporting. Further discussion would be needed to explore how this could work in practice.

We do not believe that the NZ ASRB is qualified to deal with life insurer solvency matters. Nor do we see the Society having the sole responsibility for establishing solvency standards, although the Society should have significant input. We suggest an approach of co-operation between the relevant professionals, working in co-operation with the regulator.

Q53 Should there be a requirement for an actuarial audit of the financial condition report? If so, who should undertake the audit and who should receive the audit report?

The FCR should be audited if that is the wish of the Board to which it is directed.

The Actuarial Return to the Regulator should be audited. The audit report should form part of that return.

An actuarial audit process already happens in some companies via the audit of the financial statements. Other companies' auditors rely on the life insurer's actuary or consulting actuary as an expert.

13.39. It is not membership of the NZSA alone that would give somebody the experience and expertise to undertake an actuarial audit. We would need to know more about the proposed audit process before we could really comment on how useful such a process would be.

Q54 Should the actuarial report required under the Life Act (whether it be the existing abstract or an expanded report) have to be filed earlier than nine months after balance date? If so, what is an appropriate time limit?

Yes. The same time limit as already applies to the registration of financial statements should be imposed.

Q55 Should there be a requirement for more regular (possibly three monthly) reporting by actuaries to the board and/or to a Government regulator?

Decisions on the frequency of Board reporting are up to individual Boards.

In specified circumstances, such a requirement could be imposed regarding reporting to the regulator e.g. a "new" life insurer, or one "in trouble". Similarly the regulator could require additional information in such circumstances.

Q56 Should the Government Actuary be entitled to refuse a request under the Official Information Act for disclosure of a financial condition report or other commercially sensitive information received in the course of his or her review of a life insurer's operations?

See Q48 and Q49.

We see no reason why life insurers should be treated any differently from other financial institutions, but we must make the caveat that we are not familiar with the detail of the OIA.

Q57 Should the Government Actuary or another entity be given the power to set standards on any or all of the matters set out in paragraphs 13.42 or any other matters relating to the business of life insurance?

No, not sole power. Refer to Q52.

We think there should be accounting standards, and actuarial solvency standards. In both cases, there should be regulator involvement in setting the standards. The regulator may rely on others as necessary, and appoint professional advisers to assist with technical matters.

Q58 Does the Government Actuary (or another regulator) require a greater degree of investigative power than already exists under the Life Act (and other Acts)?

Yes. The current process of the Government Actuary reporting to the Minister and the Minister requesting information from the life insurer seems unnecessarily long-winded.

Q59 Should overseas life insurers operating in New Zealand be required to operate through a company incorporated in New Zealand? If so, why?

Yes. The New Zealand government is entitled to ensure that New Zealand policyholders are protected under its own regulation, rather than relying on an overseas jurisdiction.

Q60 Does the concept of policy-only liability insurance as an alternative to Government regulation require further consideration and investigation?

Our initial thoughts are that it would not be viable.

The proposal seems to us to be abdicating responsibility. It would translate to reliance on overseas solvency regimes, with no local control. To be of any practical use in the

protection of long-term insurance liabilities, the proposed insurance would need to be guaranteed renewable and that seems unlikely to be obtainable.

The industry would be at the mercy of overseas events. The price of catastrophe cover on life portfolios, which used to be a commonplace protection, sky-rocketed after 11 September 2001, and many companies found cover was simply unobtainable.

Q61 Should a guarantee system be established along the lines set out in paragraph 13.46 (or in another form) to assist payments to policyholders in the event of a life insurer insolvency?

The Society does not wish to comment on this issue.

Q62 Should friendly societies be bought within the ambit of the Life Act?

Yes, to the extent that they sell the same business as life insurers. In our view, any entity writing long-term business (as we have defined it in 1.7) should be included. We note, however, that for organisations writing small volumes of long term insurance business that some exemptions may be appropriate, otherwise the regulation will be out of proportion with the business risk entailed. Such exemptions, however, should not be limited to Friendly Societies nor applied to Friendly Societies as a matter of course.

Q63 Are there any other measures that should be taken to increase the prudential supervision of life insurers in New Zealand?

None that are immediately apparent to us.

Q64 Are there any other issues in relation to financial safety that have not been addressed (for example, the possibility of a two-tiered system of regulation that recognises that different financial safety issues may apply to larger insurers (who are likely to be subject to offshore regulation) as compared with smaller insurers)?

No. New Zealand regulation should apply to companies operating in New Zealand.

Chapter 14 –Reinsurance

Q65 Reinsurers – Are there areas other than those set out in paragraphs 14.11 to 14.22, where New Zealand's existing law may be unsatisfactory in relation to reinsurers?

14.8. We note various references to HIH. It seems to us that if people set out to act fraudulently there can be no guarantee that any amount of regulation will stop them. Making something that is already illegal even more illegal is unlikely to stop the problem.

Q66 Reinsurance arrangements - Do you have any comments on the problems and options in paragraphs 14.12 to 14.17? Are there any other problems or options we have not considered?

There is only one problem identified as far as we can see. We support the option set out in 14.14.

Note that in determining a life insurer's prudential reserving (solvency) requirement under GN5, the actuary is required to consider the creditworthiness of its reinsurers.

If a regulator is given a general role to review life insurers, we expect that reinsurance is one of the things he or she would look at.

Q67 Regulation of reinsurers - Do you have any comments on the problems and options in paragraphs 14.18 to 14.22? Are there any other problems or options we have not considered?

The possible problem relates to reinsurance arrangements, rather than reinsurers themselves. Again, we note that in determining a life insurer's prudential reserving (solvency) requirement under GN5, the actuary is required to consider the creditworthiness of its reinsurers.

It would be unreasonable to expect a local regulator to regulate specialised operations such as large overseas reinsurers. However, it would be appropriate to regulate any New Zealand based reinsurer in the (we think unlikely) event that one were established.

Chapter 15 – Regulation of the actuarial profession

Q68 Do you have any comments on the problems and options in paragraphs 15.22 to 15.27? Are there any other problems or options we have not considered?

Please refer to section 2.

Chapter 16 – Cross-border issues

Q69 Are there areas of possible reform in relation to cross border issues that are not mentioned in paragraphs 16.10 to 16.32?

None that we can see.

Q70 Differences in treatment of foreign versus domestic policyholders by overseas law and regulators – Do you have any comments on the problems and options in paragraphs 16.10 to 16.16? Are there any problems or options we have not considered?

Refer to Q59. In our view, life insurers writing business in New Zealand should be incorporated in New Zealand.

Q71 Taking action against overseas insurers who operate in New Zealand – Do you have any comments on the problems and options in paragraphs 16.18 to 16.21? Are there any problems or options we have not considered?

Again, refer to Q59.

Q72 Maintenance of operations and records in New Zealand – Do you have any comments on the problem and options in paragraphs 16.23 to 16.26? Are there any problems or options we have not considered?

The Society does not wish to comment on this issue, except to the extent that data may be required for actuarial valuations and other such processes. We can see no practical problem in such data being held overseas.

Q73 Offshore branches/subsidiaries of New Zealand insurers – Do you have any comments on the problem and option in paragraphs 16.28 to 16.30? Are there any problems or options we have not considered?

If the overseas operation is a branch, we suggest that a separate statutory fund should be established in order to protect the New Zealand part of the life insurer from, for example, overseas political instability. New Zealand solvency standards would have to be met.

If the operation is a subsidiary, it will be independent of the New Zealand parent.

Q74 Foreign insurers acting through brokers in New Zealand - Do you have any comments on this issue, which is discussed in paragraphs 16.31 and 16.32?

The Society does not wish to comment on this issue.

Q75 Are there any problems with the financial market integrity regulation, consumer protection regulation or financial safety regulation of general insurers in New Zealand? If so, give details.

Please refer to Appendix D for the Society's views on this matter.

Chapter 17 – Other insurance and long-term financial products

17.22. The third bullet mentions actuaries querying the accuracy of ratings. We understand that some individual actuaries may have made such statements, but the Society did not.

Q76 Do you support the extension of the Insurance Companies (Ratings and Inspections) Act, which requires credit ratings to be obtained, to health insurers?

Appendix D includes comment on the Society's views on this matter.
In addition, we note that the Society is currently developing a solvency standard for health insurers along similar principles as that that applies in Australia.

Q77 Do you support the extension of the Insurance Companies (Ratings and Inspections) Act to other unrated (non-life) insurers?

Please refer to Appendix D for the Society's views on this matter.

Q78 Do you have other suggestions for financial safety regulation of health and other unrated (non-life) insurers? In particular, do you support including certain products, which might not include a life element, such as disability, income protection and trauma insurance, within the life insurance regime?

Most certainly. The only sensible way we can see for the regulation of long-term business to proceed is that it includes <u>all</u> long-term business. The name "life insurance" is no longer an adequate description of the business in question.

The main distinguishing feature of long-term insurance business as we see it is that the contracts cannot be cancelled by the provider. Thus, as well as life insurance and annuities, the various forms of disability and trauma cover are included. Any long-term insurance business written by friendly societies, general insurers, health insurers or other entities could also be included.

However, as noted in section 1.8, we do recognise that we have not yet been able to define exactly what forms of insurance we mean. Further discussion is required, including a review all of the various classes of business written and identification of the important differences between them. Insurance products are continually evolving, and different forms of cover are often provided within one policy. It may be that such definition will need to be made within actuarial standards, rather than within legislation.

We also stress that the comments in this submission are made in the context of the business currently written by "life insurance" companies. None of our comments should be taken to apply to other classes of business (such as "general insurance" or "health insurance") without further consideration of how the inherent differences between the various products affect the manner in which they should be treated.

Q79 Do you consider there are other issues (such as in relation to financial market integrity or consumer protection) concerning health and other unrated (non-life) insurers? If so, give details.

Please refer to Appendix D for the Society's views.

Q80 Are there any problems with the regulation of superannuation schemes that are similar to problems with the regulation of life insurance? If so, give details.

The regulation of superannuation schemes is an entirely different matter incorporating a whole range of issues that do not affect life insurance, not least of which is Government policy. The Society does not wish to comment on this area at this time.

We note that some defined benefit type superannuation schemes include benefits that are technically life insurance. Whilst most would insure the majority of this with a life insurer, there are some schemes that carry the risk directly. We would recommend an exemption be given from the requirements of the Life Act for these schemes.

Chapter 18 – Regulators

Q81 Who should be the regulator - Do you have any comments on the options in paragraphs 18.4 to 18.10? Are there any other options we have not considered?

We have no particular view on this matter. Wherever a regulator sits, the critical point is that he or she is adequately funded and resourced for the task at hand.

Q82 Liability of a regulator - Do you have any comments on the options in paragraphs 18.11 to 18.17? Are there any other options we have not considered?

The Society does not wish to comment on this issue.

Appendix A

Minor comments on detail in PP53

Definitions

Income Protection insurance – should read: "…loss of income through an inability to work *as a result of* sickness or accident".

Investment linked – should note that the investment risk is borne by the policyholder.

Mortgage insurance – this type of policy doesn't necessarily guarantee to repay a mortgage. Some have this feature, others have the sum insured decreasing as the mortgage is *expected* to decrease. Also, the policyholder and the life insured may be different people.

Endowment – the reference to bonuses in relation to Whole of Life is equally relevant to Endowment.

Chapter 1 – Role of life insurance

1.1 - the last clause appears to refer to "insurance for death…. as the result of a specified sickness". We do not see any need to limit sicknesses to specified ones.

1.10 – as the Human Rights Act means that poor health is not a permissible reason for an insurer to decline cover, deteriorating health should not result in an absolute inability to obtain cover. However, the terms offered may become prohibitive.

Chapter 2 – Philosophy of financial regulation

2.14 – the exposure to the start of a claim might terminate within 12 months, but there may still be an ongoing obligation to continue claim payments (possibly for years). Further, delays in notifying claims to the insurer may be longer than 12 months.

2.15 – we are not sure what point this is trying to make. If it is a reference to requiring something like community-rating for medical insurance, the important issue would be that these obligations are ring-fenced from any other liabilities.

Chapter 4 – New Zealand life industry

4.11 – covers are also issued for personal loans.

4.14 – we doubt if the popularity of risk policies actually caused the decline in savings policies. Rather, the savings elements of policies were redirected into other vehicles.

4.23 – disability is a form of risk-only business, not a separate business.

4.34 – these descriptions are confused.

- The notes on bonuses in WoL appear to state that reversionary bonuses are not always guaranteed; this is not correct, although they are not guaranteed in advance.
- A distinction should be made for terminal bonuses, which are not guaranteed at all.
- There is reference to cash values under EA but not under WoL, whereas both have cash values.

- WoL and EA should include reference to paid up policies, but unbundled should not.
- The reference to EA under unbundled is also not correct.
- The reference under unbundled to drawing down on savings for interest-free loans is not correct.
- To use “risk only” insurance referring to death cover only is not standard practice.
- Equating the lack of an investment element and being non-participating is not standard practice.
- The reference to salary under personal accident insurance should be limited to disability covers.
- The wording under investment bonds seems to imply that all investment returns are positive.
- The last sentence says that all insurance policies are either capital stable or investment linked and again that isn’t correct.
- The distinction between investment linked and investment account is not correct. The process is generally that a smoothed crediting rate is determined, to be applied to all investment account policies; the rate may be based on returns of a pool of assets but that return is not passed on directly.

4.36 – We doubt that there has been a massive increase in accidental death insurance. Is this a misprint?

4.40 – This should include reference to PS3 as well as GN5.

4.62 – The definition of deadlock in the footnote isn’t quite correct. The complainant may ask for a letter of deadlock to be issued.

4.64 – this wording may give the impression that 234 out of the 236 complaints received were resolved. In fact there are a number in the pipeline at any time.

4.75 – GN1 is defunct now that the Code of Business Practices no longer exists.

4.87 – We don’t see why the Commissioner of Inland Revenue is interested in whether policyholders are disadvantaged.

4.107 – we are unsure of the reference to “one farmers’ mutual insurance association”. Does the word “farmers” need to be included?

Chapter 5 – New Zealand life insurance law

5.58 – it is interesting that a critical illness or income protection policy would appear to be a term life insurance policy under regulation 2A of the Securities Regulations 1983. This seems inconsistent with other legislation, and with the use of words within the paper.

5.81 – we do not understand the link between the second bullet and the footnote.

5.99 – this states that there is only one mutual life insurer now operating in New Zealand. Which is it?

5.134 – to what does the statement that regular payments other than annuities may be taxable as income refer? It would appear to relate to some forms of income protection business, which are not deemed life insurance under the tax legislation.

Chapter 6 – Australian life insurance law

6.8 – APRA is responsible for companies other than life insurers.

6.57 – It would be interesting to know what ability the court has to ignore misrepresentations even if fraudulent, also how does this limit the effectiveness of pre-existing condition exclusion clauses.

Chapter 7 – UK life insurance law

7.40 – the note defining an actuary as a member of the Actuarial Profession is explained in 15.16, it is a term meaning either FIA or FFA. The explanation would have sat better here.

7.58 – we note the requirement to make publicly available each life insurer's principles and practices of financial management, applied in management of the participating funds, as from March 2004. We will be interested to see what such documents look like, given the complexity of the processes involved. We will be even more interested to see whether the documents are judged to be of any use at all to the policyholders concerned.

7.58 – As we understand it, the stated abandonment of the Appointed Actuary regime in UK is still only a proposal.

Chapter 9 – International obligations and guidelines

9.7 – What does recognition of another WTO member's prudential measures actually mean – preferential treatment over whom?

9.31 – we question why the Registrar of Companies is our representative on the IAIS. Insurance being a specialised field, is he the person who is best qualified for the role?

9.11 – What is "the horizontal section of the schedule"?

Chapter 14 – Reinsurance

14.3 – The final bullet refers to a summary prepared in accordance with GN5. Does this actually mean PS3?

Chapter 15 – Regulation of the actuarial profession

15.5 – This wording is somewhat misleading. The word "join" is used in reference to a student. Then it moves on to membership requiring FIA, then it goes back to students.

15.7 – NZSA members are also members of overseas actuarial bodies (such as the UK Institute of Actuaries), and required to work within the codes of conduct of those bodies as well.

Appendix B

Insurance Core Principles

The full document runs to 50 pages and includes a significant amount of description and commentary. We have summarised each core principle (in italics), and commented where appropriate. The Society endorses each principle unless otherwise stated. In some places we have suggested that the principle is covered by legislation already in force. However, we are unable to comment fully on legal matters, and any such suggestions require confirmation from those qualified to do so.

ICP 1 - Conditions for effective insurance supervision

Insurance supervision relies upon:

- *a policy and institutional framework for financial sector supervision*
- *well developed and effective financial market infrastructure*
- *sound macro economic policies, and efficient financial markets.*

No further comment.

ICP 2 - Supervisory objectives

The principal objectives of insurance supervision are clearly defined.

However, regulation should be limited to these areas rather than, for example, protecting existing insurers against competition by introducing inappropriate barriers to new entrants.

Clear definition of the objectives of supervision provides clarity over the scope of regulation (refer also to our comments on supervisory philosophy). The IAIS essential criteria include reference within the supervisory objectives to the protection of policyholders and the maintenance of efficient, fair, safe and stable insurance markets for the benefit of the policyholders.

ICP 3 - Supervisory authority

The supervisory authority:

- *has adequate powers, legal protection and financial resources to perform its functions and exercise its powers*
- *is operationally independent and accountable in the exercising of its functions and powers*
- *hires, trains and maintains sufficient staff with high professional standards*
- *treats confidential information appropriately.*

If NZ insurance legislation is improved to a standard consistent with that in other comparable countries, then it will be necessary to appropriately resource the supervisory authority.

ICP 4 - Supervisory process

The supervisory authority conducts its functions in a transparent and accountable manner. Internal governance procedures necessary to ensure the integrity of supervisory operations, including internal audit arrangements, are in place.

No further comment.

ICP 5 - Supervisory co-operation and information sharing

The supervisory authority co-operates and shares information with other relevant supervisors subject to confidentiality requirements.

No further comment

ICP 6 - Licensing

An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.

The Society agrees that insurers should be licensed.

The IAIS essential criteria for a licensing system are summarised below. The level of supervision implied by these criteria is high. We have included this level of detail to contrast the internationally recommended criteria to the current situation in New Zealand. Some aspects may be inconsistent with the general level of regulation within New Zealand. We consider that it may be possible to achieve the aims of this core principle without implementing all of the details within the criteria.

a. The insurance law:
   - includes a definition of insurers
   - requires licensing of insurers, and prohibits unlicensed insurance activities
   - defines the permissible legal forms of insurers
   - allocates the responsibility for issuing licences (refer to ICP 2 supervisory objectives).

b. Clear, objective and public licensing criteria include requirements in respect of:
   - suitable board members, senior management, auditor, actuary and controlling shareholders
   - capital
   - risk management and internal control systems, policies and procedures
   - reinsurance arrangements
   - specified details of business plan for not less than three years into the future
   - products to be offered, including policy conditions and technical bases for the calculation of premium rates and provisions
   - affiliation contracts and outsourcing arrangements
   - reporting arrangements, both internally and to the supervisor
   - input from the home supervisor, where appropriate.

c. The insurance law determines the method(s) by which a foreign insurer can carry on business.

d. No domestic or foreign insurance establishment can escape local supervision. Any insurer subject to supervision in its home jurisdiction, which has been recognised as adequate by NZ, may be subject to sanction if it does not meet NZ legal provisions.

e. If a foreign insurer is allowed to carry on business in NZ, the NZ supervisor must be provided with specified details of the insurer.

f. An insurer licensed to underwrite long-term insurance business must not also be licensed to undertake other business, and vice versa, unless the supervisor is satisfied that the insurer has satisfactory processes to ensure that risks will be handled separately on both a going-concern and a winding-up basis.

g. The supervisor can impose additional conditions if it considers this appropriate.

h. No licence is issued without the supervisor's approval. The supervisor refuses to issue a licence where it considers the applicant not to have sufficient resources to maintain the insurer's solvency on an ongoing basis, or where the application is not in accordance with the licensing criteria.

ICP 7 - Suitability of persons

The significant owners, board members, senior management, the auditor and the actuary of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.

We note that this is an ongoing role for the supervisor, as each new appointment will have to be notified and approved. Objective criteria for suitability will need to be determined.

ICP 8 - Changes in control and portfolio transfers

The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer. The supervisor in a jurisdiction approves the portfolio transfer or merger of insurance business.

The Commerce Commission's overriding purpose is to promote market efficiency by enforcing and fostering healthy competition amongst businesses, informed choice by consumers and sound economic legislation

Existing legislation is targeted towards maintaining commercial competitiveness, and is not sufficient to protect the interests of long-term insurance policyholders. Legislation should include a requirement for an independent actuarial report on the effects on existing policyholders of any proposed transfer or merger of long-term insurance business.

ICP 9 - Corporate governance

The corporate governance framework recognises and protects rights of all interested parties as established by law. The supervisory authority requires compliance with corporate governance standards.

Insurance Companies are required to comply with the Companies Act. Part of this Act includes controls to protect shareholders and creditors, but this covers only some of the interested parties in a long-term insurance operation. As noted under ICP 8 above, formal policyholder protections should also be introduced.

ICP 10 - Internal control

The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.

Under the Companies Act, Life Insurance companies are required to maintain accurate accounting records that are audited annually by an external auditor. However, this really only covers "financial" controls. The supervisor should also require that adequate controls over other aspects of the company are in place. We have discussed wider risk management further under ICP 18.

ICP 11 - Market analysis

Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurers and the insurance markets. It draws the conclusions and takes action.

While the supervisor would no doubt be monitoring the market and factors that impact insurers (such as taxation changes etc), it isn't necessarily appropriate to include a requirement under the Life Insurance Act. This principle is simply asking the supervisor to pay attention to what's going on, which would be a fundamental part of any such role.

ICP 12 - Reporting to supervisors and off-site monitoring

To form an opinion, particularly on the financial strength of insurers, the supervisory authority receives information necessary to conduct effective off-site monitoring and to evaluate the condition of any insurer as well as the insurance market.

We agree that the supervisor needs authority to obtain the information necessary to determine the condition of individual insurers, but don't think that the principle extended to the "insurance market" can reasonably be included in legislation.

ICP 13 - On-site inspection

The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

The Companies Act enables the authorities to undertake inspection in certain circumstances, although doesn't state whether it is "on-site". We do not think any form of routine on-site inspection would add any further information to that which could be gleaned from physical reports, but the supervisor should have the authority to undertake inspections if necessary.

ICP 14 - Intervention

The supervisory authority takes preventive and corrective measures that are suitable and necessary to achieve the objectives of insurance supervision.

The Society expects that the range of options available to a supervisor would include the power to:

- direct a company to cease writing new business (generally or a specified class),
- require information and/or data to be supplied ,
- require independent actuarial review,
- impose fines,
- direct a company to dispose of, or not dispose of, specified assets,
- make or cancel specified reinsurance arrangements,
- place a company under judicial management, and
- direct that specific remedial action be taken.

Policy guidelines would need to be determined for trigger points (breach of solvency, non-filing of documents etc) for various levels of supervisor action. The publicity given in various circumstances would also need to be determined.

ICP 15 - Enforcement or sanctions

The supervisory authority enforces corrective action and, where needed, imposes sanctions.

The Society would expect legislation to provide the supervisor with power to enforce compliance and / or impose sanctions on offending parties.

ICP 16 - Winding up & exit from the market

The legal and regulatory framework defines a range of options for orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.

No further comment.

ICP 17 - Group-wide supervision

The supervisory authority supervises its insurers on a solo and a group-wide basis to avoid the consequences of double gearing and to assess the risk profile of the whole group.

The Society's view is that:

- supervision on an individual insurer basis is required,
- documents for filing to be specified and requirements to be consistent for all insurers, and
- there is no need for a NZ supervisor to monitor groups apart from any statistical reporting purposes.

Special consideration will need to be given to the supervision of New Zealand branches of overseas insurers. The protection of New Zealand policyholders should be paramount in the supervisor's approach.

ICP 18 - Risk assessment and management

The supervisory authority requires insurers to recognise the range of risks that they face and assess and manage them effectively.

The Society expects:

- that under an Appointed Actuary regime, companies would receive regular reporting on all aspects of risk management (underwriting, market, credit, and operational), and the supervisor could request access to such reports
- that if there were no Appointed Actuary regime in place, the supervisor would have to specify the information insurers are required to provide, and have expertise and processes in pace to be able to evaluate that information.

ICP 19 - Insurance activity

Since insurance is a risk taking activity, the supervisory authority requires insurers to evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums.

The Society expects:

- that under an Appointed Actuary regime, the Appointed Actuary would produce reports in respect of such activities as a matter of course, and the supervisor would have access to these reports on request .
- that if there were no Appointed Actuary regime in place, the supervisor would have to specify the information insurers are required to provide, and have the expertise and processes in place to evaluate the information received.

ICP 20 - Liabilities

The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions (policy liabilities) and other liabilities, and making allowance for reinsurance recoverables. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require these provisions be increased, if necessary.

The Society would expect:

- any relevant actuarial standards in respect of both policy liabilities and solvency to be mandatory,
- if an Appointed Actuary regime were in place, a legal requirement for the Appointed Actuary to certify the adequacy of liabilities,
- the supervisor to be able to request a valuation on a specified basis, and
- actuarial audit to be required by the supervisor only in certain circumstances.

The Society suggests that the question of whether the supervisor should have the power to unilaterally impose reserving or solvency requirements over and above recognised standards needs further discussion.

The Society stresses that if the supervisor is to have the ability to assess provisions as well as the authority to do so, adequate funding and staffing of the supervisor will be required.

ICP 21 - Investments

The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mix, valuation, diversification, asset liability matching, and risk management.

There are no standards currently in place in respect of such matters. The Society expects:

- that the supervisory process should be sufficiently flexible that the ability of companies to respond to changing circumstances is not hindered, particularly if quick action is required,
- that if an Appointed Actuary regime were in place, the Appointed Actuary's duties would include sign-off of suitability of assets, and
- otherwise, the supervisor would need to develop its own standards, specify the information insurers are required to provide, and have the expertise and processes in place to evaluate the information received.

ICP 22 - Derivatives and similar commitments

The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use, disclosure requirements as well as internal controls and monitoring of the related positions.
The Society expects:

- that as in ICP 21 above, companies' ability to respond to changing circumstances is not hindered by supervisory requirements,
- that if an Appointed Actuary regime were in place, the Appointed Actuary's regular reports would include details of all internal and external guidelines on the use of such instruments, the monitoring process applied, any breach of the guidelines and action taken; the supervisor would have access to such reports on request

- otherwise, the supervisor would need to develop its own standards, specify the information insurers are required to provide, and have the expertise and processes in place to evaluate the information received.

ICP 23 - Capital adequacy and solvency

The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and suitable forms of capital that enable the insurer to absorb the unforeseen losses that can occur.

The Society expects:

- that under an Appointed Actuary regime, the Appointed Actuary's regular reports would cover the solvency regime(s) applied, details of the assumptions used including reasons for selection of assumptions where choices are made, the amount of solvency requirement(s), and the amount of assets available; the supervisor would have access to such reports on request.
- otherwise, the supervisor would need to specify the information insurers are required to provide, and have the expertise and processes in place to evaluate the information received.

ICP 24 - Intermediaries

The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.

We understand the Commerce Commission is currently reviewing such matters. While the Society endorses the principle, we would not wish to see over-regulation. Review of advisor regulation in other countries may reveal excessive compliance costs for little benefit.

ICP 25 - Consumer protection

The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before and during the contract. Therefore supervisors have the necessary powers available and effective means to enforce these powers to give existing and potential policyholders protection.

The Society believes that such requirements are better dealt with in legislation other than the Life Insurance Act. Protection is required in respect of products that would not normally be covered under long-term insurance business legislation, such as pure investment contracts. General protection is already provided through, for example, the Fair Trading and Consumer Guarantees Acts and the Office of the Insurance and Savings Ombudsman. The ISI Code of Conduct also plays an important part in consumer protection, although of course membership of the ISI and adherence to its Code are not compulsory.

We suggest it be borne in mind that there are in practice limits on what real protection can be provided by regulation. We further comment:

- sufficient information on investment products is already provided under the Securities Act,
- further consideration is required as to what information on risk products should be provided (although the Life Insurance Act is not the place for any resulting regulation),
- it is clear from the ISO case studies that policyholders making no attempt to understand or even read product material is an ongoing problem,

- there are dangers in providing too many documents all trying to give the same information (for example, a policy illustration, an investment statement or similar, and a policy document).

ICP 26 - Information, disclosure & transparency towards the market

The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position.

We comment first that the matters that are important to the various stakeholders (supervisory authority, policyholders, shareholders, employees, creditors, reinsurers, brokers, IRD, rating agencies) may be very different.

In respect of an insurer's financial position and activities, what information is required in addition to the company's financial statements needs to be carefully considered. A view that would be deemed "clear" by the proverbial man in the street will be particularly difficult to obtain. Rating agencies may attempt to provide such a view, although whether they are successful as predictors of problems and should have a role enshrined in legislation is debatable.

ICP 27 - Fraud

The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.

The Society comments first that "consumer-friendly" legislation does nothing to discourage fraud. In such an environment, insurers may be unable to take the steps they and we would see as necessary.

The term fraud carries the connotation that the activity is illegal with prosecution and sanctions as the threatened outcomes. Current reality is an expanded notion of fraud that covers many opportunistic manipulations of the system that fall short of criminal behaviour. Commonly known as moral hazard, this unfortunate by-product of human nature is likely to remain the major issue, and would seem better suited to resolution by a civil adjudication process. We suggest that discussions with claims managers of major reinsurance companies would give useful insights into the sorts of problems that arise.

Dealing with fraud is generally part of an insurer's standard risk management practice, and we see legislation requiring insurers to act as unnecessary.

ICP 28 - Anti-money laundering

The supervisory authority requires insurers and intermediaries to take effective measures to prevent, detect and report money laundering and the financing of terrorism.

The Society comments that these matters are already covered by the Financial Transactions Reporting Act.

Appendix C

Article from The Agenda

– published by the Institute of Actuaries 7 Jan 2004

People should stop pretending that personal investment is simple.

John Shuttleworth explains why.

Imagine your reaction if someone offered you a ride on a giant ball hurtling through space, with you strapped to the outside, spinning at 1,000 miles per hour. But what if they called it Earth (and offered to unstrap you)? Personal investment theory contains lines of thought just as unobvious.

Basics: most individual investors' objective can be simply put: it is to optimise their spend on goods and services over their lifetime. To do this, the investor has four assets: their future state pension, any future inheritance, their investment portfolio, and what for most people is the most important, their human capital (a fancy name for earnings from all employments before retirement). Human capital falls with age, is impaired by booze, and can be enhanced by education. Most people's human capital is bond-like: salaries are paid monthly and are correlated with inflation. Most people's spend on goods and services is also bond-like; it can be replicated, more or less, by a portfolio of inflationlinked bonds.

Equities, finance theory teaches us, must have a higher expected return than bonds – to compensate for their greater risk. Equities go up and down; and sometimes they stay down for longer than the investor can hold his breath. Do the maths. Equities get riskier the longer they are held. It is a fallacy that time diversifies risk. In fact, the volatility of an equity investment's end-value increases the longer the investor's timehorizon. The reason for this is simple – the long-term investor has more time to encounter stock market crashes.

Most people have a "must have" level of retirement income below which they cannot risk falling. It follows that every investor should hold a portfolio of the lowest risk investment (inflation-linked bonds) to supplement their state pension to this bare minimum. Beyond this point the choice of mix of bonds and risky investments (such as equities) is anything but obvious. There are just too many factors to do more than generalise. The people who can afford to take more risk in their investment portfolio include those who are young, those who are prepared to delay their retirement, and those who are wealthy.

Whether equities are bought first and bonds second, or vice versa, the expected amount of money at the end is the same. The numbers do not lie. Hmm.

So why the rule of thumb that the investor should cut their equity holdings as they age? It's because our (bond-like) human capital falls in value as we grow older, and so we need more actual bonds to maintain the overall desired risk level that we're comfortable with. And we don't want surprises near retirement. We need time to accommodate our standard of living to our wealth (or lack of it).

British investors have been slow to understand the importance of diversifying their equity portfolios. This is curious, given that Britain has for three centuries been the premier trading nation in the world. Equities are weakly correlated with an investor's spend on goods and services. An equity portfolio should therefore be diversified: by industry and by economy; and stock-specific risk should be minimised. This suggests an equity benchmark that is global, not biased to constituents of the FTSE All-Share. Anyone who tells you that personal finance is easy has got it wrong. The immensity of the task of educating our children should not be underestimated.

Appendix D

Regulation of General Insurance – Q77

In March 2001, the Society's General Insurance Committee was sent the following request by the MED:

The Ministry of Economic Development is currently reviewing the application of the Insurance Companies' Deposits Act 1953 and the Insurance Companies (Ratings and Inspections) Act 1994. The focus of the review is on the non-life insurance business of insurers. In particular, the review is considering the following options:

- *abolishing the requirement for non-life insurers to lodge deposits*
- *with the Public Trustee under the Insurance Companies' Deposits Act 1953;*
- *increasing the deposits required;*
- *abolishing the requirement for non-life insurers to file returns under the Insurance Companies' Deposits Act 1953;*
- *requiring all non-life insurers to have ratings under the Insurance Companies (Ratings and Inspections) Act 1994; and*
- *requiring all non-life insurers to prepare and file audited accounts complying with Financial Reporting Standard 35.*

What follows is the Committee's response to that request.

Submission on the Review of the Insurance Companies' Deposits Act 1953 and the Insurance Companies (Ratings and Inspections) Act 1994

Introduction

The New Zealand Society of Actuaries (the "Society") welcomes the opportunity to present a submission on this review of insurance legislation.

The Society is the professional body to which all qualified actuaries practising in New Zealand belong. Actuaries have a close involvement with all aspects of the general insurance industry. Many of the large general insurance companies employ the services of actuaries in determining premium rates and for calculation of provisions and solvency reserves.

Opening Comments

The Society is of the view that the Insurance Companies' Deposits Act 1953 (the "Deposits Act") and the Insurance Companies (Ratings and Inspections) Act 1994 (the "Ratings Act") are not an effective form of prudential supervision for general insurance companies in New Zealand.

We do, however, understand that this review is much more specific and is not looking at a total change in the way that general insurance companies are supervised. Rather it is looking at changes that can be made to the current legislation to improve their operation.

We have therefore made specific recommendations below that could improve the current regime. However our strong recommendation is that an overall review of the way general insurance companies are supervised is required. We further recommend that such

supervision should take the form of a Solvency Standard that all general insurance companies must comply with. We believe that the current Australian Solvency Standard would be a good starting point for developing a New Zealand Standard and would be very pleased to assist in the development of such a Standard.

Insurance Companies (Ratings and Inspections) Act 1994

As noted above, the following comments and recommendations are made on the basis that the current legislation is retained, rather than replaced with legislation introducing a Solvency Standard.

The Ratings Act ensures a minimum level of prudential control by requiring general insurance companies, that are subject to the Act, to prepare financial reports and business plans for the purposes of obtaining and establishing their rating. The Ratings Act does provide a regulatory environment that is reasonably transparent and has relatively low compliance costs. It is however somewhat freer than the environment in many overseas countries and, in particular, Australia. The key question that needs to be asked is whether the environment is effective in protecting policyholders' and shareholders' interests.

There is a concern that some insurers use the easy regulatory environment in New Zealand as a base for writing insurance overseas. These insurers use a New Zealand base solely to avoid prudential supervision, as much as possible. The insurers tend to write high risk, hard to place business and offer little protection to the policyholder. We do not see this as good for New Zealand's international reputation. The Society recommends that the legislation should be amended to cover all insurers registered in New Zealand and not just those writing insurance in New Zealand.

The Society questions the effectiveness of ratings in enabling consumers to select insurers that are prudently managed and remain financially solvent. Overseas experience suggests that the rating agencies do not always move sufficiently quickly to adjust ratings when companies are in financial difficulties. This limits their effectiveness to consumers as a tool for determining which insurers are financially sound and able to meet their commitments to consumers.

An example that illustrates this, is the recent failure of Reliance Insurance in the USA. We attach fuller details concerning this failure as an Appendix. This shows that in this case there was ample evidence of the financial problems of the insurer well before the rating agencies moved to adjust the rating. We understand that this is not an isolated example and that further investigation will show that this is often the case with companies that get into financial difficulties.

The Ratings Act does not set a minimum rating that insurers must obtain. It leaves consumers to take account of the rating obtained by an insurer in deciding whether to transact business with that insurer. It is our view, that in many cases, consumers do not take account of the rating in selecting an insurer as they do not understand the ratings and other factors, such as price, are much more important in making that decision. The Society recommends that consumer research should be undertaken to determine whether consumers do actually notice and use the ratings as part of their insurance purchase decision making.

The current legislation, as a result of the opt out provisions in Section 9, only requires insurers writing property insurance in New Zealand to obtain and maintain a current rating. Insurers writing liability, health and consumer credit insurance, and reinsurers are not required to obtain a rating. These classes of business are generally more technically difficult with longer tail liabilities (claims take longer to be notified to the insurer and take longer to be finally settled and paid). Many cases of insurers that have become insolvent or had financial

problems have resulted from these classes of business that insurers can write in New Zealand without obtaining a rating. The financial problems have often been caused by insurers failing to allow sufficiently for claims that have occurred but have not yet been advised to the insurer. This leads to the insurer not only having insufficient claim reserves but also failing to adjust premiums sufficiently to allow for the claims experience. The end result is financial problems that lead to insolvency.

Although we are generally of the view that health insurers should be required to obtain a rating there are a number of small health insurers for who the cost of obtaining a rating would be out of all proportion to the amount of business that they transact. It does not seem unreasonable to exempt such health insurers from the need to obtain a rating. We understand that the health insurers are currently working on developing a self-regulated solvency standard and believe that adherence to this standard should be sufficient for the smaller health insurers.

Thus if ratings are to be required for general insurers, the Society recommends that they should be required for all general insurers (apart from small health insurers) and that the opt out provisions in Section 9 of the legislation that mean only those general insurers writing property insurance in New Zealand are required to have a rating, should be removed.

The Insurance Companies' Deposits Act 1953

The Society's view is that the current deposits required under this legislation do not provide much in the way of protection to policyholders and are unlikely to be of much assistance in meeting claimants needs in the event of an insurer becoming insolvent.

The Deposits Act is however more significant given that the Ratings Act currently allows some insurers to opt out. If the need to provide a Deposit was removed without our recommended changes to the Ratings Act being made, the way would be open for insurers to write a range of long-tail insurance without either a deposit or rating.

As noted earlier, we believe that a specific Solvency Standard for general insurers is more appropriate than the deposits required under the Deposits Act. This would require insurers to hold a solvency margin of a certain level in their balance sheet and would also set rules concerning the quality and type of assets that made up that solvency margin. Ideally the level of the solvency margin for a specific insurance company would depend on the riskiness of the business underwritten.

In conclusion, we do not believe that the current Deposits Act is of any value, and therefore recommend that the need for general insurers to hold deposits be removed. This recommendation is contingent on either a Solvency Standard being introduced or the recommendations we have made regarding the Ratings Act (and in particular the removal of the opt out provisions in Section 9) being accepted. If these changes are not made then we believe the need to hold a deposit should be maintained.

FRS 35 Accounts

We believe that all general insurers in New Zealand are now required to prepare their accounts in line with this Financial Reporting Standard. If there are some insurers that do not need to do this then we recommend that they be required to do so.

The Society believes that FRS35 is an appropriate reporting regime for general insurance companies and that a requirement for all general insurers to file audited accounts prepared on this basis rather than the current returns would be appropriate.

If our suggestion of a Solvency Standard is accepted, we believe that the FRS35 audited accounts could be a simple way of monitoring that all general insurers are meeting this requirement.

Summary of Recommendations

An overall review of the way general insurance companies are supervised is required. We recommend that such supervision should take the form of a Solvency Standard that all general insurance companies must comply with.

Consumer research should be undertaken to determine whether consumers do actually notice and use ratings in making their insurance purchase decisions.

If ratings are to be maintained, the Ratings Act should be amended to cover all general insurers registered in New Zealand and not just those writing insurance in New Zealand.

If ratings are to be maintained, the Ratings Act should be amended to remove the opt out provisions in Section 9. Small health insurers should be allowed to opt out as long as they adhere to the solvency standard that health insurers are developing.

The need for general insurers to hold deposits under the Deposits Act should be removed, if either a Solvency Standard is introduced or the recommendations we have made regarding the Ratings Act (and in particular the removal of the opt out provisions in Section 9) are accepted. If these changes are not made then the need to hold a deposit should be maintained.

If there are some general insurers who are not required to prepare FRS35 accounts, we recommend that they be required to prepare such accounts.

All general insurers should be required to file audited FRS35 accounts rather than the current returns.

Further Consultation

The Society has, in general, restricted its comments to the areas that it has been specifically requested to comment on in this review. If you have specific queries you would like to discuss these further we would be happy to do this.

We do however believe that a wider review of insurance company prudential supervision leading to the introduction of a Solvency Standard is required and would be very keen to participate in such a review.

For further information or consultation please contact Peter Brown, Chairperson, General Insurance Committee on direct dial 09 363 2415 or email pbrown@royalsunalliance.co.nz.

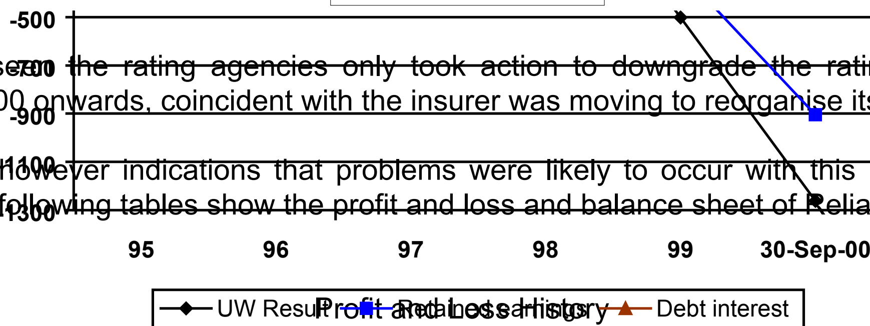
Appendix – Case Study on Reliance Insurance Company

Reliance Insurance is a US insurer that has operated since 1817. It has recently had significant financial problems that have resulted in it having to reorganise its business.

The following chart shows the ratings history of this company:

As can be seen the rating agencies only took action to downgrade the ratings from the middle of 2000 onwards, coincident with the insurer was moving to reorganise its operations.

There were however indications that problems were likely to occur with this insurer much earlier. The following tables show the profit and loss and balance sheet of Reliance.



Balance Sheet

USD millions	97	98	99	30 Sep 00
Shareholders' Funds	962	1,316	1,018	-279
Debt	904	720	736	711
Reinsurance Recoverables	4,131	4,801	6,263	6,713
Debt Gearing Ratio	48%	35%	42%	165%
RI Recoverable Gearing	429%	365%	615%	-2,406%

Source: Consolidated Report & Accounts

As can be seen the underwriting result in 1999 was extremely poor and the reinsurance recoverables in the balance sheet had increased substantially. The company's ongoing solvency was very dependent on its ability to recover from reinsurers the amount shown in the balance sheet. This clearly did not happen during 2000 and this resulted in the insolvency.

The poor 1999 financial results were released in early 2000, but no action was taken by the rating agencies at that time. The rating agencies should have been aware of the reasons for these poor results. However, they did not act to amend the ratings substantially until the company was effectively on the precipice of insolvency in the 3rd quarter of 2000. At that stage it was too late and the company was already having to reorganise its operations.

The performance of the company's share price clearly showed that investors in the company could see that the company was in financial difficulty. The following chart shows that the price has been onward a clear downward trend since the middle of 1998. The bottom had in fact almost been reached by the end of 1999.

It seems clear that, in this case, potential purchasers of insurance from Reliance, would not have been aware, from the ratings published, of the financial problems that the company was in.

Set out below is the General Insurance Committee's response (February 2002) to the specific suggestions made by MED, following the consultation process during 2001.

Submission on the Review of the Insurance Companies' Deposits Act 1953 and the Insurance Companies' (Ratings and Inspections) Act 1994

1 Introduction

1.1 The New Zealand Society of Actuaries (the "Society") welcomes the opportunity to present a submission on this review of insurance legislation.

1.2 The Society is the professional body to which all qualified actuaries practising in New Zealand belong. Actuaries have a close involvement with all aspects of the general insurance industry. Many of the large general insurance companies employ the services of actuaries in determining premium rates and for calculation of provisions and solvency reserves.

2 Initial comments

2.1 The Society is of the view that the Insurance Companies' Deposits Act 1953 (the "Deposits Act") and the Insurance Companies (Ratings and Inspections) Act 1994 (the "Ratings Act") are not an effective form of prudential supervision for general insurance companies in New Zealand.

2.2 We do, however, understand that this review is much more specific and is not looking at a total change in the way that general insurance companies are supervised. Rather it is looking at changes that can be made to the current legislation to improve their operation.

2.3 We have therefore made specific recommendations in this submission that could improve the current regime. However our strong recommendation is that an overall review of the way general insurance companies are supervised is required. We believe that a good starting point for such supervision is the regime currently being introduced in Australia by way of the General Insurance Reform Act 2001. The Society would be very pleased to assist in the development of such a system of prudential supervision.

2.4 We note that the Review mentions the failure of HIH in Australia. That company illustrates the severe effects that an insurer's failure can create in many areas and shows that it is extremely difficult for a regulatory authority to implement measures to provide suitable protection to consumers in all situations. We comment that HIH had met the existing APRA requirements and that the proposals as set out in the current Review would have had no impact, since HIH did have a credit rating. It must be recognised therefore, that legislation cannot ensure that failures do not occur. At best, it can reduce the probability of failures happening by improving insurers' practice and ensuring that information on the financial position of insurers is available to consumers.

3 Insurers to which the revised Ratings Act should be applied

3.1 The Review focuses on "insurers incorporated or carrying on business in New Zealand" but exempts "captives, reinsurers and those offering only life insurance".

3.2 The Society strongly supports the view that the Act should apply to all insurers incorporated in New Zealand and carrying on insurance business anywhere.

3.3 We do have concerns that the term "insurer" is not clearly defined. There may be many entities that transact business of a general insurance nature, such as consumer credit or some very specialised niche insurances, which are not identified under current legislation as general insurers. Consideration needs to be given to whether all such entities, including friendly societies and incorporated societies providing forms of insurance only to their members, should be required to comply with the revised legislation.

3.4 Insurance companies that transact life insurance business must comply with the Life Insurance Act. This requires a separate fund to be set up for any business not falling under that Act. Some life insurers currently make returns under the Life Insurance Act that include their "accident insurance" business, whilst other life insurers choose to exclude such business from those returns. To be consistent, all life insurers transacting other business that is not life insurance business should be required to comply with the revised Act in respect of that other business. This may add significant extra complexity to their administration. Also, we assume that their rating company will provide a rating for the company as a whole. The relative status of the various policyholders and the nature of assets providing support for the various liabilities may not be clear.

3.5 Our view is that insurers offering the same products should be subject to the same supervisory regime. Thus any insurer offering "accident insurance" should be subject to the same supervisory regime whether they are a general insurer, life insurer or even a friendly society or incorporated society providing that insurance only to their members. Our suggestion is that in the case of "accident insurance" the general insurance regime should apply.

4 New provisions regarding Ratings

4.1 The Society supports the change to ratings showing "financial strength" rather than "claims paying ability".

4.2 We note that financial strength for a New Zealand insurer does not indicate that the assets of the insurer are necessarily held or controlled in New Zealand to meet liabilities within New Zealand. One advantage attaching to the current requirement under the Insurance Companies Deposits Act, particularly in relation to smaller insurers, was that a deposit was lodged in New Zealand with the Public Trustee.

4.3 The Society supports requiring the Registrar of Companies, rather than the Insurance Council, to select rating agencies and requiring insurers to provide the meaning of a rating when they disclose the rating.

4.4 The Society also holds a view on the number of agencies that should be approved. We consider that a much more transparent and level playing field would result from all ratings being provided by the same agency, to provide certainty that all ratings have been undertaken on a consistent basis. This would also ensure an obvious comparability between ratings, as the presence of more than one rating agency can raise the question of whether certain insurers use a particular agency because it is easier to obtain a good rating from that agency. We have heard comment that suggests that some market participants believe it is easier to obtain a better rating

from one agency that it is from another. Whether it is in fact the case is not an issue - however, the perception is of concern.

4.5 We understand that this would be at variance to the normal competitive market practice, which generally aims to provide consumers with a choice. However, in this case, the rating agencies are being asked to perform a task that is undertaken in most other countries by a government agency.

4.6 A particular consideration in regard to ratings is that the cost of obtaining a rating may be insignificant for large insurers, but relatively high for very small insurers. Also it is most likely that a small financial entity operating as an insurer will only be able to obtain a comparatively low rating, even if their experience is good and they have relatively high solvency margins. Therefore, imposing the proposed regime may adversely affect the position of such insurers in the market without reasonable underlying justification.

4.7 The Registrar of Companies should be required to take into account the opinions of insurers regarding the choice of a particular rating agency, particularly the levels of fees that may be payable to obtain ratings.

4.8 We also note that requiring a rating for all general insurers may introduce a barrier to market entry. In general, rating agencies are reluctant to provide ratings to companies without a track record, unless another rated entity guarantees that company. The proposed regime will widen the field of operations affected by this situation.

5 Financial reporting

5.1 The Society believes that FRS35 is an appropriate reporting regime for general insurance companies and that a requirement for all general insurers to file audited accounts prepared on this basis would be appropriate.

5.2 If our recommendation of a supervisory regime based on the New Australian regime was developed in future, we believe that FRS35 audited accounts would be a simple way of monitoring that all general insurers were meeting the solvency requirements.

5.3 The Society supports the maintenance of a register of insurers by the Registrar of Companies. Also, we recommend that audited returns should be required to be lodged annually with the Registrar within a specified period following the completion of the financial year.

6 The Insurance Companies' Deposits Act 1953

6.1 The Society's view is that the deposits required under this Act do not provide much in the way of protection to policyholders and are unlikely to be of much assistance in meeting claimants needs in the event of an insurer becoming insolvent.

6.2 The Society believes that a specific Solvency Standard for general insurers is more appropriate than the deposits required under the Deposits Act. A Solvency Standard would require insurers to hold a solvency margin of a certain level in their balance sheet and would also set rules concerning the quality and type of assets that made up that solvency margin. The level of the solvency margin for a specific insurance company would depend on the riskiness of the business underwritten by that company.

7 Protection for consumers using overseas insurers

7.1 The requirement for brokers arranging insurance with overseas insurers to disclose their ratings details has merit. However, the Society sees little advantage in continuing to require deposits from such brokers under the Deposits Act.

7.2 We agree that at present there is no means of regulating overseas insurers who may target New Zealand consumers directly. We recommend that one means of assisting consumers placing business via brokers with an overseas insurer, is to require the broker to provide a clear statement that the insurer falls outside the regulatory control of the New Zealand authorities. While the brokers may not always provide ratings of the overseas insurers, the consumer would be alerted to the need to make their own judgement of the strength of the insurer.

8 Small insurance companies and societies

8.1 We note that the review has considered the possibility of allowing an exemption regime for small insurers, but concluded that the disadvantages would outweigh the benefits.

8.2 The Society agrees that all insurance entities should file FRS35 audited accounts. This may create extra administration expense for entities such as friendly societies that do not currently prepare such accounts. The benefits in this case are expected to outweigh the extra cost.

8.3 However, we believe that small entities are likely to be charged heavily to obtain ratings that may not appropriately reflect the nature of their operations. The Society recommends that further thought should be given to allowing an exemption regime for small insurers who belong to industry associations that are both registered and enforce stringent solvency standards on their members.

9 Summary of Views

9.1 The Ratings Act should apply to all insurers incorporated in New Zealand and carrying on insurance business anywhere.

9.2 Insurers offering the same products should be subject to the same supervisory regime. In particular any insurer that offers a “general insurance” product should be subject to the general insurance supervisory regime whether they are a general insurer, life insurer or even a friendly society or incorporated society providing that insurance only to their members.

9.3 The ratings should show “financial strength” rather than “claims paying ability”.

9.4 The Registrar of Companies should select rating agencies and require insurers to provide the meaning of a rating when they disclose the rating. The views of insurers should of course be taken into account regarding the choice of rating agencies. Our view is that a much more transparent and level playing field would result from all ratings being provided by the same agency.

9.5 FRS35 is an appropriate reporting regime for general insurance companies and a requirement for all general insurers to file audited accounts prepared on this basis would be appropriate. Audited FRS35 accounts should be required to be lodged annually with the Registrar of Companies within a specified period following the end

of the financial year.

9.6 The Registrar of Companies should maintain a register of insurers. .

9.7 Deposits required under the Deposits Act are unlikely to be of much assistance in meeting claimants needs in the event of an insurer becoming insolvent. The requirement for these deposits should be repealed.

9.8 The need for a deposit should be replaced with a specific Solvency Standard for general insurers. A Solvency Standard would require insurers to hold a solvency margin of a certain level in their balance sheet and would also set rules concerning the quality and type of assets that made up that solvency margin. The level of the solvency margin for a specific insurance company would depend on the riskiness of the business underwritten by that company

9.9 The requirement for brokers arranging insurance with overseas insurers to disclose their ratings details has merit. However, we see little advantage in continuing to require deposits from such brokers under the Deposits Act.

9.10 Where consumers place business via brokers with an overseas insurer, the broker should be required to provide a clear statement that the insurer falls outside the regulatory control of the New Zealand authorities.

9.11 Small entities are likely to be charged heavily to obtain ratings that may not appropriately reflect the nature of their operations. It is recommended that further thought should be given to allowing an exemption regime for small insurers who belong to industry associations that are both registered and enforce stringent solvency standards on their members.

10 Further Information or Consultation

10.1 The Society would welcome the opportunity to meet and discuss our submission or provide any further information required. To arrange this please contact:

Peter Brown
Chairperson
General Insurance Committee
New Zealand Society of Actuaries

Direct dial (09) 363 2415
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Appendix E

Letter from NZSA

27 June 2003

Mr N O Harris
Executive Director Commercial Affairs
Ministry of Economic Development
P O Box 1473
WELLINGTON

Dear Mr Harris

Life Insurance Act 1908 – Annual Returns

Thank you for your invitation to the New Zealand Society of Actuaries to suggest revisions to the reporting required from life offices under the Life Insurance Act. The Life Committee of the Society is responding on the Society's behalf.

We had originally thought to make our comments by updating the Society's letter dated 29 September 2000 to the Government Actuary, in response to his letter dated 14 July 2000. However, we found on reviewing that correspondence that some of the matters raised by the Government Actuary related to wider issues of solvency and equity, rather than to reporting requirements. We expect that those wider issues are now more sensibly debated within the Law Commission review, and we have therefore restricted our comments here to specific reporting matters.

The first of the four aims identified in the Government Actuary's letter was "to ensure that information being provided is sufficient to enable the Government Actuary to provide reports anticipated under the Act". What we infer to be the thrust of this point could, we suggest, be stated as "to ensure that information provided is sufficient to enable the regulator to provide prudential supervision of life insurers". We expect that one result of the Law Commission review will be better definition of the regulator's role, and only once that has been achieved will we be able to consider what information we think the regulator will find useful.

Certainly we support the other three more specific aims, namely:

- to minimise the need for additional requests for information,
- to eliminate any information which is no longer required, and
- where possible, to reduce duplication of information required for other regulatory purposes.

The Life Insurance Act was originally based on the principle of freedom with publicity, and we believe that this is still a valid approach. This would mean that sufficient information on a life company's financial position should be publicly available to provide understandable and comparable information for the regulators, policyholders and other interested parties. We agree that the format of the current schedules does not allow that. However, the accounting and actuarial standards for profit reporting and prudential reserving requirements, introduced several years ago, are intended to provide such information.

Another important consideration behind any changes to the schedules should be to keep compliance costs down, and minimise the reworking of information already prepared for other purposes.
We recommend that:

- Schedules 2 to 5 be replaced by financial statements prepared under FRS34,
- the 6th Schedule be revised to set out the amount of the Prudential Reserving Requirement (or other solvency measure) and the assumptions used in that calculation,
- the 7th Schedule be deleted, and
- the 20th Schedule be split into related product groups, such as companies apply for determining profit under FRS34. Where related product groups are at a very high level, the related product groups should be further split into major product lines.

We have set out in an Appendix our recommendation for the format of a revised 6th schedule.

One further point that needs to be defined is exactly what business is to be covered under the Life Act returns. With product developments since 1908, "Life" is no longer a reasonable reference to the business companies are writing. Our initial thoughts are that any contracts that cannot be cancelled by the issuing office should be included, but there may be some debate. This is another area better left to the Law Commission review.

Any additional information that the Government Actuary may require to more fully assess the financial condition of a life company in the event of the information provided as above raising concerns could be made available in the form of the Financial Condition Report. Clearly any access to the Financial Condition Report would need to be on a confidential basis, as the report routinely contains commercially sensitive information. Section 21 of the Act gives the Secretary of Commerce the right to ask for any further information relating to the existing schedules that is considered necessary in any case.

It should be noted that detailed insights into the workings of a life company as set out in the Financial Condition Report may highlight tax issues. As a result the Government Actuary may find there is a conflict of interest between his role as prudential supervisor and his role as adviser to the Commissioner of the Inland Revenue. This would need to be resolved in advance.

We would be happy to discuss our recommendations further.

Yours sincerely

Linda Caradus
Acting Chairman, Life Committee

Appendix: Recommended replacement for 6th Schedule

We expect the solvency requirement to be calculated in accordance with NZ actuarial guidance notes and/or standards, and our recommendation is constructed accordingly. If some other standard is used, for example an overseas standard, appropriate details should be reported.

Our recommendation for a replacement format for the numerical reporting is set out below. In addition, the following commentary should be provided:

- description of related product groups (or major product line, where related product groups are at a very high level and a breakdown by major product line within a related product group is required).
- the methodology used to calculate the Prudential Reserving Requirement,
- details of the best estimate assumptions as required in notes to the FRS34 financial statements, and the margins applied for the Prudential Reserving Requirement, and
- a statement that the requirement was calculated in accordance with the NZ Society of Actuaries guidance or standard.

	Related Product Group	Number of policies	Annual premiums in force	Current Terminatio n Value NZ$000	MOS Policy Liabilities	NZ Prudential Reserving Requirement NZ$000
Net Assets						A
Policy Liabilities						M
Equity of Shareholder						SE = A - M
Prudential Reserving Liability	RPG 1					X
	RPG 2					Y
	et al					Z
Total Prudential Reserving Liability						B = X + Y + Z
Other Liabilities						O
Expense Reserve						E
Resilience Reserve						R
Inadmissible Assets Reserve						I
Increase to minimum of Policy and Other Liabilities						M – (B + E + R + I)
Total Requirement						T = B + O + E + R + I
Equity Required for Solvency						S = T – M