New Zealand Society of Actuaries (Inc)

10 February 2010

Clerk of the Committee
Finance and Expenditure Committee
Select Committee Office
Parliament Buildings
Wellington

Dear Sir

Insurance (Prudential Supervision) Bill

We refer to the Finance and Expenditure Committee's call for submissions on the Insurance (Prudential Supervision) Bill.

The attached submission is made by the New Zealand Society of Actuaries, the professional body representing Actuaries practising in New Zealand. The New Zealand Society of Actuaries contributes to debate from the perspective of the public interest and from a professional viewpoint, rather than the commercial interests of institutions that employ or contract actuaries. Our members have most recently been active in discussions with officials on the new life insurance tax regime and on the proposed insurance supervision regime.

We have attached as Appendix A to our submission some information about the actuarial profession in this country and its work.

The Society would be pleased to appear in support of our submission or to discuss the contents of our submission in more detail if required. For further information regarding our submission please contact the undersigned.

Yours faithfully

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Submission on Insurance (Prudential Supervision) Bill

This submission is made by the New Zealand Society of Actuaries ("NZSA", "the Society") in relation to the Insurance (Prudential Supervision) Bill.

Our submission concentrates on specific clauses of the Bill and does not purport to be a comprehensive review.

Introduction

1. NZSA supports the overall objectives of the Bill. We appreciate the earlier constructive consultation with the Reserve Bank of New Zealand ("the Reserve Bank") on a draft Bill prior to the Select Committee process. We also commend the high level of both practicality and effectiveness that is being sought in this legislation.

2. In the prudential supervision regime outlined in the Bill the Reserve Bank is placing a heavy reliance on actuaries to provide professional guidance to directors concerning the ongoing financial strength of insurers. The profession welcomes this opportunity to provide support to insurers in the financial protection of policyholders, in line with best practice overseas.

3. Certain critical matters are to be set out in regulations (e.g. solvency standards) and may be specific to some types of insurers or insurance policies and not relevant to other types. With the regulations and guidelines not yet available, only part of the proposed regime is visible. We recognise that some of the issues we raise in this submission may be resolved once this further material is in the public arena.

4. Our submission is focused on the sections of the Bill that relate to our professional work as actuaries, and the related practical implications for insurers. Our submission is in 3 parts:

   Part I - definitions of some terms used in this submission.
   Part II - comments on specific sections of the Bill.
   Part III - comments on the transition process.

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Part I – Definitions

The following definitions relate to certain types of business to which we refer in this submission.

Investment account policies – the savings elements of such policies are determined by rolling up contributions plus interest less fees. The interest rate applied is calculated by the insurer in accordance with principles set out in the policy documents and is often smoothed.

Unit-linked policies – the savings elements are denominated in numbers of "units". Premiums are used to purchase units, the values of which are calculated by reference to the values of specific assets.

Participating policies - profits are shared between policyholders and shareholders

Consumer Credit policies – benefits cover repayment of personal loans in the event of death, disability, redundancy and sometimes bankruptcy.

Part II – Comments on Specific Sections of the Bill

Interpretation (6 to 10)

5. We note that there is no definition of 'insurance,' because of the difficulties of defining the concept with precision, although clause 7 sets out a definition of 'contract of insurance' and clause 84 defines a life policy. We support the approach that has been taken, i.e. a core definition of contract of insurance in the Bill with the ability to further define in regulations, thus providing the ability to deal with unintended consequences for types of business that either already exist or arise in future.

Likely failure to comply with solvency margin (23)

6. Both subclauses 23(1) and 23(2) contain a requirement that the insurer report a likely failure to maintain a solvency margin "at any future time". It is not reasonable to make a professional judgement of this type over an unlimited timeframe. An actuary can only form a view based on the information available, so it is preferable to specify the requirement in these terms rather than a time period which may be shorter or longer than the period into which the actuary has any insight.

7. We suggest that the requirement as drafted be replaced by a requirement that the insurer report to the regulator if there is a significant risk that it will become insolvent based on its current business plans and a range of adverse but reasonably possible future expense levels, experience and market conditions. It may be that the word "likely" (as in, likely to fail to maintain) is considered to encompass such matters, but we are concerned to ensure that that a prospective test is specified. Otherwise, a different test may be applied in retrospect to wrongly conclude that an insurer had acted imprudently.

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Cancellation of licence (28 to 31)

8. The Reserve Bank may direct an insurer to assign its liabilities to 1 or more other licensed insurers (clause 29). If the receiving insurer is selected by the Reserve Bank and is obliged to accept the liabilities in question, the assignment may require the Reserve Bank to provide indemnities to the assuming insurer if it has been unable to conduct due diligence in a short timeframe. However, we support this clause which provides more scope for the Reserve Bank to maintain insurance protection for the policyholders of a distressed insurer.

Fit and proper requirements (32 to 41)

9. Relevant officers for 'fit and proper' certification are defined in clause 6 to be the CEO, CFO and actuary. There may be a number of other senior executives who have significant influence on the direction and strategy of the insurer and who should therefore be included, for example a Chief Risk Officer. We also suggest an extension of the definition of relevant officer to include any other person who reports directly to the CEO (akin to the requirements for senior managers in banks).

Publication of policies (52)

10. We support the requirement for the Reserve Bank to publish its policies in various matters. Without publication, insurers may find themselves working in a vacuum. However, we suggest that there may be circumstances in which it is reasonable that the Reserve Bank diverges from its published policies, so it should be made clear that the published policies are not a complete 'rule book'.

Solvency standards (53 to 60)

11. We welcome the requirement for the Reserve Bank to consult before approval of a solvency standard or any change (other than a minor change) in a standard. The Society has already been working with the Reserve Bank to draft appropriate solvency standards and we look forward to this continuing.

12. Clause 56 sets out the matters that <u>may</u> be contained in a solvency standard and we note that the standard does not need to cover all of the matters listed. We suggest that the list as it stands, although expressed in fairly general terms, may not allow sufficient flexibility for further additions to solvency standards over time as experience in the application of such standards emerges. The closed nature of the list could also give rise to different opinions as to whether a particular aspect of a solvency standard has been validly included. We suggest the addition of a further point, for example: "such other matters as the Reserve Bank may determine from time to time."

13. The current draft solvency standard for non-life insurers contains a requirement for the "annual solvency return" to be audited. As clause 56 stands, this requirement is not a matter that is permitted to be included in the solvency standard.

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14. The various reports and returns noted below are mentioned in different places. It is important that the Reserve Bank's different requirements relating to the content, authorship, frequency, audit requirements etc. of the different reports are clear, and we feel that this has not yet been achieved.

- Financial condition report – clause 56(c)
- Appointed actuary's report – clause 78
- Annual solvency return – section 4.4 of draft non-life solvency standard.

15. From what we see in the Bill, the process that is envisaged is as follows:

a) The appointed actuary prepares calculations of various items to appear in the financial statements, which may include some aspects relating to solvency margins.
b) The appointed actuary undertakes work to consider and report on the overall financial condition of the insurer, including prospective solvency consideration.
c) The appointed actuary provides a statement to accompany the financial statements regarding whether certain figures contained within the financial statements comply with the solvency standards and regarding the maintenance of the solvency margin.
d) The appointed actuary prepares a report regarding the overall financial condition of the insurer.

The work undertaken for a) and b) will overlap significantly, but it is useful for clarity to set it out separately.

We would consider c) to be the report referred to in clause 78. While it is referred to in the Bill as a "report," we see it more as a statement or certification, similar to the auditor's report accompanying the financial statements which is more in the nature of a statement or certification than a "report". The reference to the clause 78 report in clause 79 would seem to be consistent with this view.

16. As we understand the situation in the non-life insurance industry in Australia, responsibility for the calculation of the solvency position lies with the insurer, not with the appointed actuary. The actuary may be asked to provide input by way of figures for technical provisions (premium liability and liability for outstanding claims) but does not have the overall responsibility for the calculation. This is in contrast to the position of the appointed actuary to a life insurer, who does have the specific responsibility for calculation of the solvency requirement. It seems likely that this fundamental difference has arisen from the differing histories including the relatively more recent involvement of actuaries in general insurance than in life insurance.

It is not clear to us whether the responsibilities in this regard envisaged in the Bill are placed on the insurer or on the actuary and whether it is intended that there should be differences between life insurance and non-life (as in Australia). If it is the case that wider responsibility is being placed on the general insurance actuary in New Zealand, further discussions around the issue may be useful.

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17. Clause 56(c) allows the solvency standard to prescribe requirements relating to a financial condition report.

The regulator's requirements for a financial condition report may be less comprehensive than the requirements of an insurer's Board. The financial condition report provided to the Board would normally discuss solvency as well as provide commentary on matters such as the insurer's products, pricing, experience, profitability, distributions and reinsurance as well as the environment (current and future) in which the insurer operates. The regulator's primary concern relates to sound governance and particularly ongoing solvency.

While it is likely to be possible to meet the regulator's requirements by simply providing a copy of the financial condition report that has already been presented to the Board, it is not reasonable to expect insurers to be comfortable with this arrangement unless they are confident that confidential analysis and strategy matters cannot in any circumstances be disclosed by the Reserve Bank. We comment further on confidentiality (clause 133) in paragraphs 72 to 74 of this submission.

18. We agree that the minimum detail of what must be contained within a financial condition report given to the Reserve Bank is most appropriately dealt with in regulations. However, we submit that the following related matters should be set out within the legislation, along with our suggestions of appropriate detail:

a) Who can prepare the report (the appointed actuary)

b) When the report must be submitted to the Reserve Bank (to be defined by the Reserve Bank, but we note that a financial condition report is a forward-looking report that is of most value to insurers if it ties in with annual budgeting and business planning)

c) Who must receive a copy (the directors of the insurer and the Reserve Bank)

Of course others may also receive a copy, but only at the discretion of the insurer's Board.

19. The financial condition report will be one of the most critical documents a Board has to consider, and it is particularly important that a prospective assessment of solvency be required. We look forward to discussions with the Reserve Bank in due course on the regulations relating to the prescribed minimum content of financial condition reports.

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Financial strength ratings (61 to 71)

20. We understand that the reason for an exemption for small Friendly Societies and Credit Unions from the requirement to obtain and publish a financial strength rating is cost. We expect that any exemption for this type of entity is considered appropriate because of the fact that they provide insurance only to their own close-knit group of members rather than to the public at large. Policyholders/members and potential policyholders/members of small Friendly Societies and Credit Unions need protection at least as much as those who have contracts with larger entities. As the intent of requiring ratings is to allow consumers to make informed choices, any distinction by size does not seem logical.

21. The use of ratings as part of a regulatory regime has been widely discussed, with the Society expressing the view on a number of occasions that, while the intent is to allow consumers to make informed choices, it is far from clear that the use of ratings is of much assistance in achieving this. Ratings do not provide full information and may not always be of value.

22. We wish to comment particularly on the requirement in clause 69 for <u>any</u> downgrade in ratings to be notified to the owners of policies with a term of more than 12 months. A requirement expressed in these absolute terms may result in the creation of unreasonable uncertainty. We submit that it should be possible for the Reserve Bank to have discretion to decide whether a downgrade is material, with the requirement to notify all policyholders limited to material downgrades. For example, a downgrade from AA to A+ may not be deemed material.

    The Reserve Bank would take into consideration what actions policyholders might reasonably be able to take once they learn of the downgrade. For example, if the downgrade results from an agency revising its outlook of the insurance sector as a whole, the policyholders may not be able to improve their perceived security by moving insurers.

23. There is a further risk of insurers suffering a compounded effect after notification of a downgrade to all policyholders, with increased lapses of those lives insured in good health who are disconcerted by the downgrade and the insurer being left with a substantially worse claims experience on the remaining policies. Thus, it is critical that some discretion be available, to prevent creating avoidable shocks to the stability of the insurer.

Risk management (73 to 75)

24. We note that a range of expertise, including actuarial skills, may be required to draw up an appropriate risk management programme. We look forward to discussions with the Reserve Bank in due course as to the detail of any proposed regulations and/or guidelines.

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Appointment of actuary (76)

25. There are several references to "an" appointed actuary, which we suggest should be changed to refer to "the" appointed actuary. Examples are clauses 76(3), 77(1), 79(2), 80(6)(a), 147 and the definition of relevant officer. In other places, "the" has been used.

Actuarial information in financial statements (77)

26. Clause 77 requires the appointed actuary to review the actuarial information contained in the insurer's financial statements. "Actuarial information" as currently defined includes premiums and claims, items for which the primary professional responsibility lies within the professional domain of accountants and auditors. Other items in the financial statements do fall within the actuarial domain, for example a non-life insurer's outstanding claims liabilities (a component of the technical provisions) and a life insurer's Policy Liabilities. However transactional details are captured in the accounting systems which auditors are far better equipped to consider than actuaries. Actuaries may be asked to consider the way the information they have provided is presented in the financial statements, but we do not think that it is reasonable to ask actuaries to take responsibility for any part of the financial statements themselves.

27. Actuarial information is also defined to include insurance and annuity rates, which are not items that we would expect to see in financial statements. We would however expect to see commentary on premium rates and product profitability within a financial condition report.

28. We expect that one purpose of clause 77 is to require actuaries to have formally considered whether any information they have taken from the financial statements is reasonable for the purpose to which they have put it and to state that they have done so and found the information to be reasonable. The statement often made in a similar context is: "the actuary has confirmed that the data used are sufficient for the purposes of this valuation". We submit that the purpose of the clause may be better expressed in these terms than by a very general use of the word review.

29. We further submit that the detail of which items should be formally considered (and reported on) by the actuary should be specified only after the solvency standards are complete and is therefore a matter for regulation rather than the Act.

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Actuary should be able to rely on auditor (78)

30. As the Bill stands, there is some circularity in the actuary's responsibilities. Clause 78(f) requires comment in the appointed actuary's report on the extent to which the actuarial information in the financial statements complies with the solvency standard.

The items for which auditors are responsible in terms of their audit of the financial statements include the amount of equity retained as solvency for life insurers and all actuarial information for all insurers. For example, under the draft solvency standards for non-life insurance business, the financial statements are used as a basis for the solvency margin calculations.

In our view the appointed actuary should be able to rely on the audited financial statements for those items that do not require professional actuarial judgement, and the appointed actuary's report under clause 78 should include a statement confirming that in his or her view the information used is fit for purpose.

Appointed actuary's report (78)

31. Clause 78 sets out the required content of the appointed actuary's report. Such content will to some extent be a function of the solvency standard (clause 56(c)). We therefore submit that the detailed content of the actuary's report should be a matter for regulation rather than be specified in the Act.

Auditor relying on actuary (79)

32. An ability for the auditor to rely on the actuary's work is implicit in clause 79(2), which requires the auditor to summarise "the extent to which" it has relied on the actuary. This concept of 'reliance' could in some circumstances be seen to be overriding the purpose of an audit. We expect that audit firms will have more informed comment to make on this provision.

33. We are also concerned that the concept of the auditor relying on the actuary may result in the actuary having some liability to the auditor. We understand that there has been considerable discussion in Australia between the auditing and actuarial professions around formal reliance processes. We expect that similar discussions will take place in New Zealand in due course.

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Actuaries must have access to information (80)

34. NZSA supports the requirement for the insurer to give the actuary whatever information and access to employees he or she may need.

35. We expect that financial condition reports will include a statement on the adequacy of data, and it is possible that actuaries may find themselves in the position of having to qualify some of their reports in this regard (at least during the first few years of the regime). We expect that the actuary will need to comment on the appropriateness of the data for the purpose, and on certain reconciliations performed e.g. to accounting figures. However, the actuary cannot certify that the data is correct; we understand it to be one of the roles of the auditor to express an opinion on the data.

Statutory Funds (82 to 117)

Current market and initial introduction of statutory fund structure

36. Australian insurance legislation requires a separate "life" statutory fund. However, we understand that this arrangement has been in place since at least 1945, under the legislation that preceded the 1995 Life Insurance Act. Thus, when this particular separation was first required, the types of business in the market were very much simpler than the products seen today, and the distinction between traditional life and non-life contracts was obvious. The market in Australia has developed taking this regulatory requirement into account, with products and the associated systems and processes being developed against that known background.

With the variation in risks and complexity of products that are found in the New Zealand market today, moving directly to a 'traditional' statutory fund structure such as is being proposed raises very significant issues of practicality, some of which we discuss below. It is unlikely that we will have been able to identify all such issues, and we think it will be particularly difficult to write legislation in such a way that all circumstances are covered. Further, we do not think that the intention of the legislation is to ignore the current contract structures within the insurance industry in order to impose a traditionally 'pure' structure.

Against this background, we submit that the Reserve Bank should be given discretion to determine the statutory fund requirements that relate to each existing insurer, taking into account the types of business already in force and the views of the insurer's appointed actuary on matters relating to policyholder protection.

If such discretion is not acceptable in the long term, we suggest that at least some grandfathering or transitioning provisions could be appropriate.

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General requirement for separate "life insurance" statutory fund

37. NZSA supports the policyholder protection principles that underlie the requirement for life insurance policyholder funds to be ring-fenced within a Statutory Fund. We can see benefit, from the policyholder protection point of view, in business with a significant investment component being segregated. A statutory fund for such business (which we would deem to be *participating* business and the savings components of *unit-linked* and *investment account* business) would provide a level of protection akin to superannuation scheme and unit trust arrangements. However, we question the need, from a regulatory perspective, to split policies that provide only risk benefits into separate legal structures.

38. We understand that a separate statutory fund for life insurance is being required because of a perceived contagion risk, that is, the risk of non-life insurance experience affecting the assets available for long-term life insurance policies. We submit that if the solvency provisions for the various classes of business are determined appropriately, there should be reasonable provision for each of the different types of risk and any 'contagion risk' between business lines will be minimised.

39. From the policyholder's point of view, the important feature of a life insurance policy is that the insurer cannot unilaterally cancel the contract. The fact that deterioration in health may mean that a new policy is not readily available on similar terms to an existing policy means that policyholder protection in especially important. This right of renewal is one of the main reasons to split what are traditionally called "life" policies from "non-life", and could provide a tidier basis for definition of a separate statutory fund.

40. The right of renewal feature is also present in most health insurance policies. One argument often heard against the use of the right of renewal as a point of distinction is that it would result in health insurance being put into the same class as "life". However in practice there is little difference between some types of health insurance and some types of trauma insurance, and there appears to be no suggestion that trauma contracts should be separated from "life".

41. The proposals make no allowance for materiality of volumes of business. Insurers may have a trivial amount of business defined as life insurance as a proportion of their total portfolio, yet still be required to establish a separate fund for a tiny amount of business. The insurer would also be required to hold in each of the two funds any minimum dollar amounts of capital that are in due course specified in the solvency standards. We suggest that further consideration be given to the issues involved in such circumstances.

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42. In this regard, we note that clause 84(4) envisages regulations which allow a "class" of contract to be declared not to be life policies. We suggest that consideration be given to allowing for further regulations which permit insurer-specific matters to be similarly taken into account, so long as both the Reserve Bank and the appointed actuary are satisfied that the result is reasonable from the viewpoint of policyholder protection and the Reserve Bank is comfortable that there is no resulting unfairness to other market participants.

43. The wide variety of individual insurer circumstances and modern product designs means the proposed structure is likely to present a number of difficulties. We expect that insurers will make submissions on their own particular issues. However, we have particular concerns that:

a) The proposed 25% / 75% proportions (or indeed any other proportions) for determining the life / non-life status of policies may not be practical for insurers that sell policies with "mix-and-match" benefits selected by the policyholder, i.e. cover for health, life, disability, and trauma risks under a single umbrella contract. A policy that is 20% life and 80% health could be a non-life policy, while a policy that is 40% life and 60% health would be 'composite' and as such have to be split. Further, the policyholder may have an option to "re-mix" benefits from time to time.

b) The proposed process of splitting composite polices makes no allowance for materiality of volumes of business. Insurers may have a trivial amount of composite business as a proportion of their total portfolio, yet still be required to split those policies and possibly establish a separate fund for a tiny amount of business.

c) The proposed split raises particular issues for the *consumer credit* insurance market in New Zealand. This is discussed further in paragraphs 52 to 54 of this submission.

d) We understand that there is at least one non-life insurer that writes significant volumes of disability business which would be classified as life policies under the Bill. We suggest that in these circumstances there would be no benefit in requiring such business to be suddenly reclassified as life insurance

<u>Life policies (84)</u>

44. The definition of "life policy" in subclauses 84(d)(ii) and (iii) needs some minor tidying up, in that references to policyholders should be changed to "person whose life is insured".

45. The definition of life insurance does not appear to include the savings elements of *investment account* policies. We suggest that this be added. In particular, we are aware that there are some insurers with old *investment account* "superannuation" business, effectively backed by a life policy but with no underlying insurance risk as the benefit on death or withdrawal is the account balance. As the Bill is drafted, this business would not fall under the definition of life insurance and would not benefit from the security of the statutory fund.

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46. The classification of some contracts as life or non-life remains unclear. One example is the benefit "tails" remaining in the market from the year ACC was privatised. It may be that these contracts are deemed life policies under clause 84(1)(d)(ii) because benefit payments could continue for more than 12 months. (As far as we know, this business is managed by insurers whose only other business is non-life and we cannot see any benefit in these insurers now having to reclassify these closed blocks as their only life insurance.) Alternatively it may be that these blocks are already defined as non-life business under clause 84(1)(d), since the original contracts were for 12 months only and cancellable by the insurer at that point.

47. A similar issue of classification may arise for disability contracts where the term of the policy is 12 months or less but the benefit is payable in the form of an income which may be for longer than 12 months. It is not clear from the wording in clause 84(1)(d) whether such a contract is life insurance or not.

48. We note that regulations made under clause 84(4) may classify “classes” of contract to not be life insurance. We suggest that provision also be made for regulations to classify classes of contract to be life insurance, including insurer-specifc consideration as discussed in paragraph 42.

Composite policies (85)

49. The split of composite policies into life and non-life insurance (as set out in clause 85(2)) will require judgement based on best estimates of expected life and non-life benefit payments over the term of the policy. We expect that the intent of the Bill is that the split is intended to be made at the time a policy is issued on the basis of the outcomes expected at that time. If this is the case, then we suggest that the wording should be amended to clarify that intent. Note that this means an implicit assumption that the effect of policyholders re-mixing their mix-and-match policies, as noted in paragraph 43(a) above, is not material.

50. It is possible that an alternative approach is intended, under which the life and non-life parts are assessed initially but then reassessed from time to time as best estimates of expected claims change in the light of actual experience. If this is the case, it may be necessary to transfer policies into or out of statutory funds and issues of practicality may arise. Some adjustments to clauses 91 and 93 would also be needed.

51. Under clause 85(3), whether composite policies are life, non-life or split for statutory fund purposes is to be determined by the appointed actuary. There remains a question as to the level at which the test should be done. Possibilities include individual risks, individual contracts, and various groupings thereof. It is common with some products, especially *consumer credit insurance*, for many individual policyholders to be covered under a single master contract. It would be useful if the legislation either specified the required level, or (preferably) confirmed that the level at which the test is performed is a matter for the judgement of the actuary.

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52. There remains a particular issue with single premium *Consumer Credit policies*. These contracts are generally written with terms of between 6 months and 5 years. Some insurers may find that they are required to split some (but not all) of these policies between life and non-life elements, in which case the death benefits are deemed "life" and within the statutory fund, and the redundancy and bankruptcy benefits are deemed non-life and outside the statutory fund, but the disability benefits are split between life and non-life according to whether the policy term is greater or less than 12 months. This seems an unreasonable outcome for contracts with identical provisions (other than the term) and for which each of the types of cover insures the same policyholders.

53. It also follows that insurers which write only *Consumer Credit* business may be required to hold two solvency margins, which may be unreasonable if the solvency standards prescribe a minimum dollar amount for each fund.

54. On balance, if the life/non-life split for composite policies in the Bill is retained, we suggest that a pragmatic approach would be for the Reserve Bank to have discretion to permit departure from the life/non-life split so that a portfolio of composite policies such as *Consumer Credit* can be written wholly into one fund.

Policy liabilities (86)

55. We note the definition of policy liabilities set out in clause 86. "Policy liabilities" is the name commonly used for one of the amounts in a life insurer's financial statements. The use of this name in the Bill appears to relate to a different amount, which will in due course be defined in the solvency standards. There is a reference in clause 97(4) to policy liabilities being "in accordance with the regulations" and we suggest that for clarity this reference be added to the definition in clause 86 (and in any other similar contexts).

56. Since there may be some confusion arise from the use of the name "policy liabilities" for two different amounts in different but closely related contexts, we submit that a different name should be used, perhaps "solvency liabilities" or "prudential policy liabilities."

Policyholders' interests (87)

57. Clause 87(2) refers to the interests of policyholders (87(5): viewed as a group) having priority over the interests of shareholders or members of an insurer. In the case of a mutual insurer the same individuals are both policyholders and members, and their interests under each category are closely interrelated. A member's interest through surplus generated generally gives rise to subsequent interest as a policyholder (e.g. through reduced future premiums, enhanced benefits or greater security). The potential for conflicts appears to be mainly in actions which benefit some members but not others.

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Initial establishment of statutory funds

58. The initial establishment of statutory funds may impose additional costs on life insurers because clause 89(3) requires real separation of assets and disallows notional separation. The Society supports the requirement for real separation, however some transitional arrangements may be needed for assets which exist at the time of the separation.

59. The initial establishment of a statutory fund will require a transfer of assets into the fund. It is not clear that clause 91 covers this initial transfer.

60. We expect that the policy liabilities (as defined in the solvency standards) will have a minimum of zero i.e. will not be negative. However, if this is not the case, the initial establishment of the fund will require a transfer into the fund of an asset that is a negative policy liability.

Investment performance guarantees (97)

61. The policy intent of clause 97 is not clear to us. The wording of the clause appears to be identical in all material respects to that of clauses 14(4) and 42 of the Australian Life Insurance Act 1995. However, the differences in other aspects of the two pieces of legislation lead us to question whether clause 97 has any practical meaning in the New Zealand context. The main point is that in Australia, a separate statutory fund(s) is required for the business in question, but that is not the case in the proposed New Zealand regime.

62. The explanatory discussion on this matter is rather long and we have set out the detail in Appendix B of this submission.

63. Further, the proposed limitation relates to an amount (the policy liabilities – see paragraph 55 above) that is to be calculated in accordance with solvency standards which will be in the form of regulations. As consultation is required before these standards are set, and that process has not yet occurred, we submit that the appropriate place for any specification of a limitation is within those (or other) regulations rather than within the Bill.

Duties of directors (103 to 106)

64. Clauses 103(1) & (2) require directors to ensure that the interests of policyholders are given priority over the interests of shareholders in the event of a conflict, or where investment, administration, and management of the fund's assets are concerned. Clause 87(2) contains a similar requirement. The transfer of any money out of a statutory fund will, to some extent, weaken the policyholders' interests and strengthen the shareholders' interests. In a strict interpretation, these clauses could lead to any distribution being challenged as not putting policyholders' interests first, however reasonable the transfer might be.

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65. It may be that the requirement to use reasonable care and due diligence is to be interpreted as having the effect of disallowing transfers if there is any weakening of financial strength to the extent that solvency is at risk. If this is not the case, we suggest that this concept be introduced explicitly e.g.:

- the Board must confirm (having considered the advice of the appointed actuary) that there is no significant risk that the insurer will become insolvent, based on its current business plans, its expected expense levels and reasonable expectations of future experience and market conditions.

66. We note that there is a similar issue, albeit with different wording, in the Friendly Societies & Credit Unions Act 1982. The NZSA standard PS6 deals with this issue in section 5.2.4 by defining an adverse effect on financial position as one where following the change the Friendly Society is no longer financially sound.

Restructuring of statutory funds and transfer of policies between funds (107 to 109)

67. Subclause 109(4)(b) mentions the "reserves" of a life insurer, as distinct from policy liabilities and current liabilities. It is not clear to us what would comprise "reserves", and this needs further explanation.

Distributions (112 and 113)

68. Clauses 112 and 113 allow distributions of retained profits and capital respectively to be made only "in accordance with the prescribed requirements". We submit that regulations made in this regard should include the requirement for directors to consider actuarial advice before making such distributions.

69. Clause 112 refers to distributions being "in accordance with the prescribed requirements" whereas clause 97(4) refers to policy liabilities being "in accordance with the regulations". (Both phrases are used in other places as well.) We expect that the intention of the two descriptive phrases is the same, in which case it would be helpful if the same wording was used.

Supply of information (119 to 127)

70. We support the clear statement in clause 125 of the existence of a whistle blowing obligation. However, there needs to be a common understanding between the Reserve Bank and those with a responsibility to whistle blow on the thresholds for whistle blowing. We appreciate that this is always going to be an especially difficult area. Our view is that the words "is likely to become insolvent" are not practical in this context – refer to the discussion in paragraphs 6 and 7 above. We submit that this wording should be tied back to that in clause 23.

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71. We submit that the wording "every person who holds office" should be extended to include past as well as current office holders. The legislation needs to be clear that the protections in clause 127 covers whistle blowing that occurs either while holding office or thereafter.

Confidentiality of information (133 to 135)

72. Sensitive information needs to be fully protected otherwise the regime will not work. Confidentiality will be a particular issue for any financial condition report addressed to the Board that may be provided to the Reserve Bank. If complete protection cannot be provided, the type of information that is written into financial condition reports provided to the Reserve Bank is likely to become narrowed down, with some information transferred to other reports that are retained by insurers for internal use only.

73. It follows that the legislation needs to state clearly:

- which information may or will become public in summary form subject to subclause 133(2)(b), and
- that all other information received by the Reserve Bank will be held wholly confidentially in all circumstances.

74. Subclause 133(2)(b) allows the Reserve Bank to publish "information in a statistical or summary form." This form may still have the potential to reveal information that is able to be identified as relating wholly or mainly to one insurer. For example, some lines of business are dominated by a single insurer. Thus, we submit that some limitation be introduced, such as a restriction that the Reserve Bank may publish summary data only if it is aggregated in such a way that information on individual insurers cannot be identified either directly or indirectly by way of their predominance in a particular category or statistic or in any other way.

Distress management (136)

75. Clause 136 refers to "business being conducted in a prudent manner". It may be helpful for clause 136 to contain a reference to the list in clause 19 of matters the Reserve Bank may consider in relation to whether a business is being conducted in a prudent manner.

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Part III – Transitional Matters – "path to compliance" (233 to 239)

76. The expected timeframe for the licensing process to be completed has been set out in the Bill. We understand that the Reserve Bank intends to meet with each insurer to agree the expected steps and timeframes according to their individual situations. We very much welcome this approach which should lead to an orderly transition that will be able to deal with any unexpected problems that arise from the application of the new regime and regulations.

77. Clause 233 states that a provisional licence must be provided if the insurer has taken reasonable steps to provide a fit and proper policy and risk management programme. We infer from this that if an insurer does not have a policy and programme at the time of application, it may not receive a provisional licence. This differs from our understanding from previous discussions, namely that all existing insurers will be granted a provisional licence, and a "path-to-compliance" set which would incorporate the development of a fit and proper policy and a risk management programme.

78. Data quality issues for some insurers will require a pragmatic approach by the Reserve Bank to transition requirements and timeframes. Where there are problems, the actuary will have to take a conservative approach in making his or her assessments until the issues can be resolved.

79. Some general insurers in particular may face difficulties in providing the data necessary for the appointed actuary's work. We expect there to be some insurers which find that data appropriate for actuarial investigations are not available. This may happen where an insurer has not traditionally made use of actuarial services and so its processes and systems have not been set up to collect, store and report on appropriate data for actuarial investigations. If such data have not been captured in the past it will take some time to establish such processes and systems, and to build up a suitable volume of data for actuarial analysis. In these cases, we suggest that the first two or three years' financial condition reports are completed on a "best endeavours" basis, with acceptance that some aspects may be simply noted as missing provided a description of specific plans to ensure completion within agreed timeframes is made.

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Appendix A

The Actuarial Profession in New Zealand

Actuaries are experts in assessing the financial impact of tomorrow's uncertain events. They enable financial decisions to be made with more confidence by analysing the past, modelling the future, assessing the risks involved and communicating what the results mean in financial terms.

Actuaries provide businesses with valuable information with which to make secure, long-term strategic decisions, as well as providing practical solutions to problems involving the impact of uncertain events. Our traditional areas of work are insurance and superannuation.

On 1 October 2009 the NZ Society of Actuaries had 268 members, including 105 Fellows working in NZ and 41 Fellows resident overseas. The Society also has 105 student members and a few retired members. All members are required to adhere to standards designed to ensure competence, impartiality and the highest standard of business ethics.

NZSA is not itself an examining body. The FNZSA qualification is obtained by:

(1) Passing professional exams and meeting the experience requirements of an approved examining body (e.g. the Institute of Actuaries of Australia or the UK Actuarial Profession);
(2) Being resident in New Zealand or doing work that relates to New Zealand;
(3) Meeting ongoing continuing professional development requirements;
(4) Maintaining the highest standard of business ethics as set out in our code of professional conduct and adhering to mandatory practice standards.

Typically, it takes about 7 years of part-time post-graduate study to qualify as an actuary, generally undertaken during study leave granted by employers. Study courses provide a thorough grounding for the complex financial analysis that members of the profession are required to undertake. A quicker route to qualification is available overseas via full-time university courses.

NZSA members are governed by a code of conduct and relevant standards designed to protect the public interest. Our members have a collective responsibility for the maintenance of standards. On noting a potential breach by another member, they are expected to discuss that matter with the other member and, if it cannot be easily rectified, to bring it to the attention of the Society to take action. NZSA is a full member of the International Actuarial Association and meets the international benchmarks for qualification, standards, disciplinary process and continuing professional development.

Professional standards are drafted and subsequently maintained by NZSA practice committees, comprising experienced actuaries specialising in a practice area. The standards are reviewed by a Professional Standards Committee and by the Society's Council. Draft standards are circulated to members as Discussion Drafts and Exposure Drafts before being adopted. The process allows standards to be updated to meet changing circumstances and provides for scrutiny and robust debate during drafting.

Members are governed by the Society's standards whether or not they are remunerated for the work that they do. They are required to disclose any potential conflict of interest and to provide advice only if they are competent in the relevant practice area.

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Appendix B

Clause 97 – investment performance guarantees

B.1 As noted in paragraph 61 above, the policy intent of clause 97 is not clear to us.

B.2 The wording of clause 97 of the Bill appears to be identical in all material respects to that of clauses 14(4) and 42 of the Australian Life Insurance Act 1995. However, other aspects of the two pieces of legislation are different in such a way that we question whether clause 97 has any practical meaning in the New Zealand context.

B.3 We have set out in the following table a summary of the relevant aspects of the two countries' legislation and practice. This is followed by more detailed descriptions.

Element	Australia	New Zealand
Statutory Funds	Separate statutory fund required to segregate investment-linked business from other (non investment-linked) business – Life Act clause 31. Purpose is to recognise the essentially different nature of the two types of business.	No separate statutory fund required for investment-linked business. Insurer has option to segregate if it wishes.
Investment account business	Benefits calculated by reference to (a) a running account, or (b) units the value of which are guaranteed by the contract not to be reduced - Life Act 14(2)(b)	No definition in legislation. Standard practice is to use the name "*investment account*" only for benefits with a running account. Any business that provides a guarantee of no negative returns (either running account basis, or unit values guaranteed not to reduce) is described as "capital guaranteed".
Investment performance guarantees - contracts may provide guarantees in respect of the investment performance of the underlying assets – examples for *Investment Account* business	(a) above – guarantee of minimum return on account balance e.g. 0%p.a., 3%p.a. (b) above – guarantee that unit values will not reduce, effectively a guarantee of no negative return (other than the effect of certain types of fees)	Same as Australia

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Investment-linked business	Benefits calculated by reference to units the value of which is related to the market value of a specified class or group of assets – Life Act clause 14(4)(a)	Identical definition in clause 97(5), but without a preceding definition of investment account business this category could be taken to include "capital guaranteed" investment-linked business
Investment performance guarantees – examples for investment-linked business	Guarantee of minimum increase in unit values e.g. 0%, 3%. Guarantee of minimum increase in value over lifetime of not less than a specified index return. Minimum benefit payment not less than premiums paid + x% less withdrawals.	Same as Australia
Limit on investment performance guarantees	5% of policy liabilities in the required separate statutory fund(s)	5% of policy liabilities in any statutory fund(s) the insurer chooses to set up for investment-linked business only

B.4 The relevant provisions of the Australian Life Act are summarised below.

a) Clause 31(b) of the Act requires the segregation of business which consists of the provision of Australian investment-linked benefits from the other (non investment-linked) life business of the insurer. This is achieved through the establishment of a separate statutory fund and is recognition of the essentially different nature and risk profile of the two types of business [refer Introduction to APRA Prudential Standard LPS 5.02 *Cost of Investment Performance Guarantees*].

b) The principal objective of an investment-linked contract is the provision of benefits calculated by reference to units the value of which is related to the market value of specified assets. Within the parameters of this 'definition', it is possible to structure a contract that offers guarantees in respect of the investment performance of those underlying assets. In order that the nature of an investment-linked contract and the requirement to segregate such business are not undermined, the Act requires the identification of, and quantification of the cost of, investment performance guarantees. The extent to which such guarantees can be provided within an investment-linked statutory fund is then subject to a limit which is prescribed in clause 42 of the Act [refer LPS 5.02 Introduction].

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c) We do not know for sure the reasoning behind this requirement for a separate fund for the business in question. However, we infer that it is related to the fact that the policyholders of investment-linked business are themselves taking the investment risk within the savings elements of their contracts. The life insurer is providing only an administration service for that part of the contract, with any associated risk benefits being separated and lumped together with the insurer's other risk benefits. The investment-linked policyholders should not be exposed to the possibility of having the investment returns on their savings elements contaminated by the other business of the insurer, for example by poor claims experience or by poor investment returns on the assets backing other business. On the other side of the coin, the limitation on investment guarantees is necessary to keep the investment-linked fund close to a 'pure' investment fund, with only minimal other benefits such as guarantees which reduce the inherent investment risk.

d) The Australian Act contains a separate definition of investment account business. A contract defined in terms of units the values of which are guaranteed by the contract not to be reduced is investment account business, whereas any other contract defined in terms of units (guaranteed or otherwise) is investment-linked business. Therefore no limitation on guarantees applies to investment account business. This is consistent with the concept in the previous paragraph of maintaining an investment fund that is close to 'pure' investment.

B.5 The business defined in the Australian Act as investment linked business with non-reducing unit values, plus that subsection of the business defined in the Australian Act as 'running account' investment account business which has a minimum return of 0% p.a., is usually referred to as "capital guaranteed" business in New Zealand.

B.6 The proposed New Zealand regime set out in the Bill takes a different approach from that used in Australia. There is no definition akin to the Australian investment account business (as noted above in paragraph 45) and no requirement to segregate investment-linked business into a separate statutory fund.

B.7 Given this fundamental difference - the lack of a requirement for a segregated statutory fund under the New Zealand regime - we question whether it is appropriate to have clause 97 at all.

B.8 It is not clear whether or not 'capital guaranteed' business of the type that is technically unitised but has unit values guaranteed not to fall would come within the definition of investment-linked business in the Bill. In this case, the unit values may differ from the values that would be derived directly from asset values, therefore may not be considered "related to" (the wording in the Bill) those asset values. However, including this type of business would have an effect contrary to that we believe is intended by the Australian approach (as explained in paragraph B.4(c) above).

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B.10 We further comment that the limitation on the amount of the investment performance guarantees is based on the amount of the "policy liabilities". As the policy liabilities themselves are (we assume – refer paragraph 55) to be calculated in accordance with solvency standards / regulations, we submit that the proper place for any limitation is also within regulations.

B.11 If our points are accepted and limitations are to be placed in the solvency standards, the following comments may be helpful in consideration of the standards. Otherwise, they may be useful in any reconsideration of clause 97.

B.12 Clause 97(2) states that investment performance guarantee costs must not exceed 5% of the policy liabilities of a statutory fund that comprises only investment-linked business. In practice, it is possible that if asset values decrease, the guarantee costs will increase (depending on the nature of the guarantee) and it is not clear what action the insurer is supposed to take if this causes the investment performance guarantee factor to rise above 5%.

Some actions that might be considered, but which may not actually correct the underlying rule breach issue, are:

- An injection of capital into the statutory fund – this is the most sensible course of action and effectively means that the shareholder is funding the cost of the guarantee, rather than other policyholders in the fund. However such action would not affect either the policy liabilities or the investment performance guarantee factor and therefore, on the face of it, not fix the "problem".
- A change in asset mix in order to reduce the cost of the guarantees – this may affect the factor, but may be contrary to policyholders' expectations (as formed by the information in marketing material, investment statements or policy documents).

B.13 We cannot comment on whether the figure of 5% is a reasonable figure until the regulations relating to the calculation of both policy liabilities and the factor are available.

B.14 If there is a requirement introduced to have a separate statutory fund for investment-linked business, the wording will need to be clear that any risk benefits issued under the same contract as the investment-linked savings elements are not to be included in the investment-linked fund.

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