# Public to Private – and Making it Work

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## Summary of Conclusions

This paper argues that if accident insurance is to be written in the private sector, strong regulation is needed to protect stakeholders, and strong prudential supervision is required to minimise the risk of writing unprofitable business, which may threaten the security of the insurer.

The path to a competitive market for accident insurance in NZ would require careful decisions in many areas including:

- Product design
- Market creation
- Consumer issues
- Actuarial issues.

The proposed new NZ prudential regime for insurance takes a light-handed approach, and we think there are dangers inherent in such an approach - especially for the security of insurers writing long tail business.

In these areas, NZ has an opportunity to minimise the risk of 'mistakes' by using experience from both NZ's history as well as from elsewhere in the world.

## Background

### Politics and Policy

This paper was written in late October 2008, and it reflects the current political and policy environment at that date. Specifically, at the time of writing, there appears to be a good chance that NZ's National Party will gain power at the 8 November election.

The National Party's formal policy statement relating to the ACC (an undated document titled "National Party ACC Policy Background") notes a numbers of areas where the current ACC scheme is "capable of improvement" and includes the following statements:

- "The National Party supports the principle of competition and choice in the delivery of ACC Services in the Work Account"
- "The experience of competition in the late 1990's was healthy for ACC"
- "An incoming National Government would conduct a full stock-take of the state of the various components of the ACC scheme"
- "The National Party is investigating opening only the Work Account to competition".

Some hold the view that despite the party's stated restriction of interest in competition to the Work Account, in fact the Nationals are keen to 'privatise the lot' (Merrill Lynch report, parliamentary debate). The Motor Vehicle Account and Treatment Injury Account are considered the next most likely to be privatised after the Work Account.

### The Current NZ General Insurance Market

The current GI market for private insurers in NZ can be characterised as follows:

- Two thirds or more of the market is written by Australian-based insurers, with IAG being the dominant player in this group
- The remainder is split between NZ-domiciled insurers and international insurers from other origins.

With minor exceptions, the insurance market provides short tail coverages, with little experience of long tail or bodily injury classes.

If privatisation of NZ accident compensation were to proceed, many of the current Australian players would be very interested in participating in the new lines of business – largely as a source of growth, since the Australian market is mature. Presumably there would be strong interest from other international quarters as well.

## Our Angle - or, Why Listen to Us?

In this paper we comment broadly on the options for privatisation of long tail business in the NZ market, and the implications for market regulation and prudential supervision. We consider potential privatisation of the whole ACC scheme, but do not intend to imply that this is the most likely - or most favourable - outcome.

The experience on which we base our comments is:

- We have had wide-ranging experience with the Australian accident compensation schemes, as well as the ACC
- We believe we can make some useful and practical comments about the path to privatisation – including specific issues around the actuarial role
- We are very familiar with the Australian general insurance market and with the Australian regulatory regime and its practical outworkings
- Our firm has had discussions with Australian insurers who would be keen to participate in a privatised NZ long tail market.

We note that we don't profess to be experts on the detail of the NZ market and regulatory environment – if we're off the mark in any area, we're happy to be told that!

## The Nature of the Beast

Any discussion about the introduction of competition in accident insurance, and its regulation and prudential supervision, needs to keep in mind the key characteristics of this type of insurance:

- It is **long tail** business, with (unavoidably) long delays between writing business and the point where there is certainty about its financial outcomes. It can take a long time to understand the profitability of a year's business – and by the time you understand it, you have already written another few years' worth
- The **third party beneficiaries** are outside the insurer-insured relationship, and to some extent need 'protection' against the inherent motivations of insurer and insured to reduce claim costs.

In Australia – in response to these characteristics - workers' compensation and motor vehicle bodily injury insurance are written in state-based arrangements where:

- A regulatory authority is responsible for scheme delivery, almost always including pricing
- In all but a few schemes, private insurers do not underwrite the business – it is underwritten by the state, and claim payments are in effect backed by state government guarantees
- In some of the government-underwritten schemes, insurers act as claims managing agents only.

This is illustrated in Table 1.

**Table 1 – Australian Workers' Compensation and MVBI Arrangements**

| | | Fault | Private insurer involvement | | |
|---|---|---|---|---|---|
| State | Regulator | vs No Fault | Claims mgmt | Underwriting | Pricing |
| **Workers' Compensation** | | | | | |
| NSW | NWA | No fault | Yes (agents) | No | Scheme |
| Vic | WorkSafeVic | No fault | Yes (agents) | No | Scheme |
| Qld | QComp | No fault | No | No | Scheme |
| SA | WCSA | No fault | Yes (agent) | No | Scheme |
| WA | WCWA | No fault | Yes | Yes | Insurers |
| Tas | WCTas | No fault | Yes | Yes | Insurers |
| National | Comcare | No fault | No | No | Scheme |
| **Motor Vehicle Bodily Injury** | | | | | |
| NSW | MAA | Fault [1] | Yes | Yes | Insurers - within regulated limits |
| Vic | TAC | No fault | No | No | Scheme |
| Qld | MAIC | Fault | Yes | Yes | Insurers - within regulated limits |
| SA | MAC | Fault | Yes (agent) | No | Scheme |
| WA | ICWA | Fault | No | No | Scheme |
| Tas | MAIB | No fault | No | No | Scheme |

[1] Coverage of children and of serious injuries requiring lifetime care is on a no-fault basis

The state-based schemes are **not** supervised by APRA, the prudential regulator for authorised insurers. The scheme regulators are responsible for prudential management (noting that where insurers are involved in underwriting they are supervised by APRA).

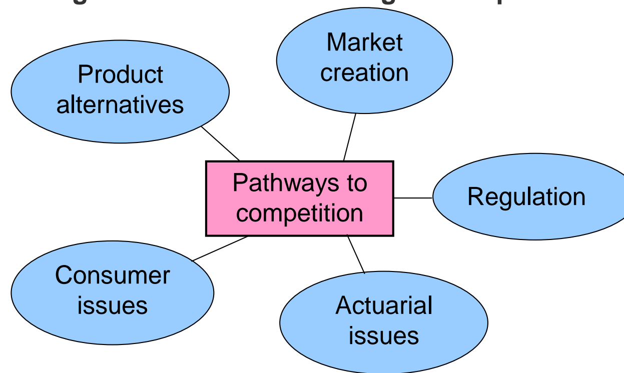
There is one additional feature not apparent in the table above, which is self insurance for workers' compensation. In each jurisdiction, large employers may – subject to conditions – meet their own workers' compensation costs.

We have assumed for the remainder of this paper that there would need to be at least one regulator in a privatised NZ accident compensation environment.

## Pathways to a Competitive Market

In this section we look at some of the questions and options that arise in relation to moving to a competitive market. These topics are covered under five headings which are shown in the diagram below.

**Figure 1 – Issues in Moving to Competition**




We note that in all of these areas, the experience of the temporary privatisation of the ACC in 1999 will form a useful source of experience and insights.

### Product Alternatives

The significant product design issues to be considered as part of a move to competitive accident insurance include:

- What are the 'benefits' for claimants?
  - the same as the current ACC payments?
  - same as ACC but with the option to add additional covers? (e.g. higher lump sum scales or increased dollar income limits)
  - or would a new framework be drawn up?

  *There is no call for a wholesale review of benefits. Some benefit improvements might be desirable, to improve social justice and make the new scheme attractive, although benefit improvements generally imply higher prices - and that may be unattractive. Significant benefit reductions are quite unlikely from a public acceptance angle, although it is possible we might see 'populist' restrictions such as exclusions for criminal and high risk activities.*

- Can universal no fault cover be maintained?

  *It would surprise us to see any winding back of no fault cover, with the exception of the populist issues mentioned above. In a competitive market, however, there are serious issues about which insurer should pay – yours, or the insurer of the person who caused the injury. This will need serious thought and is counter-intuitive for insurers, who regard a fault basis*

*as natural. For Earners and Non-Earners the issue of guaranteed insurability raises its head.*

- To what extent would a regulator impose restrictions on premium structures? For example, for workers' compensation, would there be specified premium rate ranges by industry, restrictions on the impact of experience premiums? Would there be an upper limit on target profit margins?

  *Standard products seems the likely way to go, and that implies reasonably standard premium rates. We return to this in the section on 'creating a market'. Large employers will want more flexible products including self insurance.*

- Would the streamlined system for approving and paying medical accounts be maintained?

  *At present GPs act as their own 'gateway' to the accident insurance system, essentially self-authorising claims. Is this system acceptable in a competitive market, and should there be a 'clearing house' for settling medical claims so that the doctors don't face a major system change?*

## Market Creation

Considerations in relation to the creation of a market place for privatised accident compensation business are discussed below:

- Do the insurers take the underwriting risk? (straight away?)

  *In our view a compromise using claims management agents is unlikely, although in the realm of political compromises it cannot be ruled out. Transfer of underwriting risk is likely to be one of the first steps to occur.*

- Would the benefits/premium structure be seen by insurers as presenting opportunities to produce profitable business?

  *This is one of the fundamental tensions to be managed by government. Insurers are likely to require something of a 'leap of faith'.*

- Would initial market shares be allocated, auctioned, unregulated?

  *The unregulated approach – which was adopted in 1999 - requires a marketplace 'big bang' which can be very unsettling. An auction makes economic sense but in practice insurers are unlikely to pay good prices. The allocation approach would require the regulator to play a key role.*

- Would compulsory acceptance of policies be required? If not, does there need to be an insurer of last resort?

  *Compulsory acceptance can be made to work, but requires a firm regulator to prevent gaming by insurers. It is probably better to start with this approach, with a reserve power to*

*create an assigned risk pool or risk equalisation pool, rather than allowing selection and establishing an insurer of last resort from the beginning.*

- What restrictions, if any, should there be on distribution methods and payment of commissions?

  *It is likely that for Motor Vehicle some form of efficient distribution linked to registration will be desired – noting that moving from the current use of a mix of registration 'premium' and petrol levy would present a potential complication for transition. For the Work Account the professional insurance brokers will be important players. Likely options are to prohibit commissions altogether or (more likely) apply a low regulatory limit such as 3% or 5% of premium.*

- Is there enough capital available to absorb the privatised business, among the NZ and foreign insurers?

  *It seems that the answer would currently be yes (even allowing for the impacts of the recent financial crisis). As recently as last year, there were Australian insurers who were ready to 'step right in' if the set-up looked like producing profitable business.*

- Would there be any doubt about the reinsurance market being able to absorb the privatised business?

  *Almost certainly not, we think. Coverage of the earthquake risk that accumulates between the Work Account and property insurances will be a technical issue, but well within the product and financial capacity of the professional reinsurance market.*

- Who would run off the tail of ACC claims? (noting that this includes the whole of the existing tail, not only the pre-1999 tail)

  *Financial transfer of the tail to new insurers is an interesting idea, but probably too difficult to implement. This leaves open the question about whether ACC might use insurers as claims management agents, which (following a short transition to allow short term claims to finish) has merit from a skills and expertise point of view. For the Work Account in particular there is merit in having the same insurer deal with old and new claims from the same employer.*

- Would the ACC stay in as a player in a competitive market?

  *Ultimately a political question as much as an economic or practical one. Insurers are likely to favour abolition of the ACC, in order to make a subsequent return to public provision more difficult. This leaves aside the question of the potential need to retain the ACC to underwrite Earners and Non-Earners.*

## Consumer Issues

Many aspects of a privatised market would be of concern to consumers; the consumers in this context include both insureds and potential claimants. Their issues would include:

- Maintenance of:

  - no-fault cover
  - cover for non-work injuries for earners and non-earners
  - coverage of NZ residents outside NZ, and non-NZ residents in NZ
- Potential loss of cover due to uninsured employers, vehicles etc
- Price increases due to profit margins and marketing/distribution costs. These would be an issue at an overall level, as well as at the individual insured level where the effects of changes to risk rating would impact.
- There would be instances where it would not always be clear where a claim should go, and this would be much more significant than under the current ACC scheme. For instance, in relation to motor vehicle accidents which occur during work, there may be overlap (or gaps between) the coverage provided by motor vehicle bodily insurance and workers' compensation. The gap between the current Work Account and Earners would also be significant.
- There might be concerns about delays to claim acceptance and claim payment under privatised arrangements.
- Dealing with claim disputes is a major issue whether the system is public or private, and the combination of internal and external dispute resolution will need to be carefully designed, along with the boundaries of legal representation and court resolution.

*In our view this list of legitimate consumer issues is, in itself, sufficient to establish the case for a strong, specialist scheme regulator. It is important to note that all of these issues are 'market conduct regulation' (rather than 'prudential regulation'), which in the Australian model are not part of APRA's remit.*

## Actuarial Issues

What would the actuary's role be under a privatised accident compensation structure? Potential areas for formal actuarial responsibility include valuation, pricing and assessment of financial condition. Would there be an 'Appointed Actuary' role for insurers writing accident insurance? Will both in-house and external actuaries be accommodated? What sort of actuarial work will be required, and what sort of sign-off? Are there enough NZ actuaries with sufficient long tail experience?

A potential significant challenge for actuaries will be the availability of relevant experience on which to base their assessments:

- Will the historical ACC experience be available to insurers writing accident business?
- Depending on the differences from the current environment, the relevance of the historical ACC experience may be low

- Will there be a central 'scheme' database, which can be used by all insurers to benchmark their own experience and use as a base for future projections if their own experience is sparse? The better Australian schemes maintain central databases which are available to insurers.

NZSA's professional standards would need to respond to changes in the roles played by actuaries in a post-privatisation world:

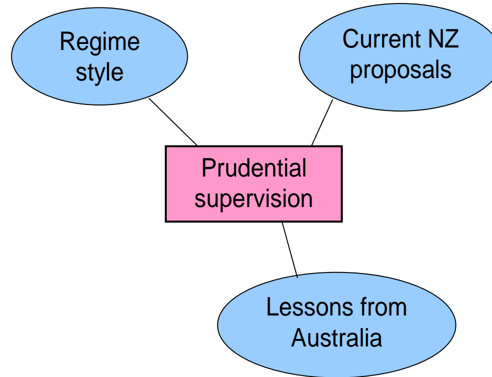
- A valuation standard, similar to the current PS4, which applied to the privatised workers' compensation business in 1999 and which we understand still applies to the valuation of the ACC scheme, would be required
- A pricing standard may also be required.

The decisions around all of these aspects will facilitate the addition of maximum value by actuaries involved with NZ business. The current approach adopted by the Government and the RBNZ is to place strong reliance on the actuarial profession in contributing to prudential regulation, and the environment would indicate a continuation of that approach with accident insurance.

## Prudential Supervision

Our discussion of prudential supervision in this section is covered under the three headings shown in the diagram below.

**Figure 2 – Issues in Prudential Supervision**




### Regime Style

When designing a prudential supervision regime, decisions need to made at the high level between:

- Complexity and simplicity:
  - The advantages of complexity include: more information for the regulator, and (if well designed) lower risk of failure/problems
  - The disadvantages of complexity include higher compliance costs – which has relatively greater impact on smaller insurers
- Prescriptive and principles-based approaches. A principles-based approach allows insurers to focus on the 'spirit' of the regulatory requirements, but of course may lead to quite different interpretations by different insurers – with some moral hazard inevitable.

### Current NZ Proposals

The proposals for prudential regulation of insurers which were current at the time of writing this paper are those contained in Cabinet papers published in December 2007 and August 2008. The stated plan is that legislation will be introduced during 2009 and will be brought into force during 2010.

We note that the NZ market is unusual, with a large proportion of the general insurer market made up of foreign-domiciled companies.

The main features of the proposed regime include:

- A relatively **light-handed approach** to supervision and regulation, which places significant reliance on insurer discipline
- **Minimal reporting requirements** – with strong reliance on published financial statements
- Intention to be **competitively neutral** i.e. smaller insurers not penalised
- **NZSA standards** relating to solvency, valuation and financial strength will be adopted for prudential regulation and will be given the force of law
- **Mandatory financial strength ratings** – except for insurers with premium below $5 million
- Absolute **minimum capital of $2 million**
- For **foreign insurers** - discretion to accept compliance with home regulator's prudential requirements.

Much of the detail of the NZ approach, and in particular the specific solvency/capital requirements, is yet to be fleshed out. In terms of the criteria in the 'Regime Style' section above, it appears so far that:

- The regime will fall at the 'simple' end of the spectrum
- It will be principles-based rather than prescriptive.

In our view there are significant risks in a light-handed approach for long tail insurance. These risks relate to the need for careful monitoring of the experience of long tail business as the financial outcomes emerge. Without careful monitoring, unprofitable business can be written over a number of years - which could put an insurer's solvency position at risk. Given that the beneficiaries of the insurance coverage are 'innocent consumers' it will be unacceptable to leave significant insolvency risks with the insureds or claimants.

Without indications of the content of the relevant NZSA standards, it is hard to comment on the proposed approach to measurement of solvency. In the context of the possible inclusion of bodily injury insurance under this regime, we wonder if bare minimum capital of $2 million is enough. Even for a small insurer writing low risk business, $2 million is not a significant buffer against insolvency.

There are some problematic elements in reliance on financial strength ratings from ratings agencies as a 'proxy' for more rigorous solvency calculations:

- The credibility of such ratings has been dented significantly by the recent financial crisis
- It is unlikely that most consumers of insurance will have any real understanding of what the ratings grades mean – for example, in most people's minds, anything less than an 'A' grade would probably be viewed as a negative.

We argue that it will not be acceptable for accident insurance to be provided by 'just any' insurer. Even if the reliance on rating agencies is continued (in a global environment where the credibility of rating agencies is at a low ebb), should a 'B' rating be good enough to be permitted to write the business? Should an insurer be able to write up to $5 million of premium without any rating?

We also note that at the moment there is no specific guidance relating to requirements for reinsurance – either outwards reinsurance, or reinsurance written by reinsurers.

Finally we wish to observe, with due respect, that there are risks in reliance on the NZSA for the development of solvency standards. In some respects it may be just too difficult for the professional body to make the necessary decisions. We note that in Australia standard setting has been taken back into government in accounting and in life insurance.

The next section looks in more detail at the current NZ proposals, and compares them to the equivalent Australian requirements.

## Lessons from Australia

In Australia, supervision of insurance and banking activity is split between the 'two pillars' APRA (the Australian Prudential Regulation Authority) and ASIC (Australian Securities and Investments Commission). In the insurance context the responsibilities are:

- APRA essentially regulates the **safety of institutions** – insurer licensing, solvency, other prudential supervision
- ASIC is responsible for the **market conduct** aspects, or interactions with consumers – contracts, intermediaries, product standards, code of conduct etc.

For bodily injury insurance, the market conduct regulation is undertaken by specialist regulators in each jurisdiction (see Table 1). The interaction between these regulators and APRA is not always straightforward. While NZ has the benefit of being a single jurisdiction, there will still be complexity in the relationship between prudential and market conduct regulation, whether it is undertaken in a single institution or split between two (e.g. RBNZ and a new ACC).

In this section we focus on APRA's supervisory role in the general insurance market. The key piece of legislation is the Insurance Act 1973, and APRA's requirements are set out in a series of prudential standards (there are currently 15) which are effectively under continuous review by APRA. The key elements of the requirements for general insurers are shown in Tables 2 to 4 below – split (somewhat judgementally) into capital/financial aspects, management/operational requirements and requirements for foreign insurers respectively. For each element, the table also shows the current comparable proposal for NZ (where known); where comparison can be made, shading indicates the 'more stringent' requirement (Australian or NZ).

We note that the APRA regime's design is:

- Complex
- Intended to be principles-based rather than prescriptive, although most would probably view at is as being prescriptive in practice.

The complexity and comprehensiveness of the APRA regime were increased dramatically after the cataclysmic failure of HIH. One of the significant causal factors in the downfall of HIH was large volumes of personal injury liability business which were being written very unprofitably; the regulator was unaware of the extent of the problem. In particular, the introduction of the requirement for an annual Financial Condition Report was a direct recommendation from the HIH Royal Commission.

**Table 2 – Australia vs NZ Supervision – Capital/Financial Elements**

| Area | RBNZ Proposal | Aust (APRA) equivalent |
|---|---|---|
| Solvency | Absolute minimum capital $2m | Absolute minimum capital $5m ($2m for captives) |
| Solvency | Solvency standards will be set out in NZSA standards | Solvency standards set out in APRA's prudential standards |
| Solvency | Details of **approach to calculating required capital** not yet known | Prescribed approach to calculating **risk-based capital,** based on nature of insurer's liabilities and assets. Insurer must hold capital at least 20% above calculated RBC |
| Capital | No equivalent requirement as yet | Restrictions on reducing capital |
| Capital | No equivalent requirement as yet | Limitations on different types of capital (Tier 1, Tier 2) |
| Rating | Mandatory **financial strength rating** unless premium income < $5m | No prudential requirement to have rating from ratings agency |
| Valuation actuary | Must be qualified actuary | Appointed Actuary must be qualified and have >5 yrs' relevant experience, and be resident in Aust |
| Provisions | Not yet specified | Premium liability calc replaces unearned premium - based on expected claim costs + expenses + risk margin |
| Provisions | Not yet specified | Provisions must include allowance for bound but not incepted business - significant impact on QS reinsurers |
| Provisions | Not yet specified | Risk margin must be based on 75% probability of sufficiency |
| Financial Condition Report | Not yet specified. PS4 assessment of "financial soundness" covers similar range of topics - although not currently mandatory | Appointed Actuary must prepare annual FCR considering all factors impacting on, and all risks to, financial condition |

Our comments on these aspects are:

- APRA sets a higher threshold capital level of $5 million than NZ's proposed $2 million
- Most of the solvency and valuation requirements for NZ are yet to be defined – as noted earlier, we believe there is some risk in 'delegating' the solvency standards to the NZSA.

**Table 3 – Australia vs NZ Supervision – Management/Operational Elements**

| Area | RBNZ Proposal | Aust (APRA) equivalent |
|---|---|---|
| Licensing | Different class of business for run-off insurers | Different treatment of run-off insurers |
| Licensing | Nothing equivalent? | Different treatment of captives, branches |
| Non-insurance activities | Not permitted beyond minimal level unless RBNZ grants exemption | No specific restrictions. Practical limitations imposed by complexity of regulatory requirements, and by capital requirements |
| Non-insurance activities | Non-insurance exposures excluded from solvency calculations | No specific exclusions, but dealt with in capital requirements |
| Connected party exposures | CPE above threshold disallowed for solvency calculations | Dealt with in capital requirements |
| Connected party exposures | CPE must be - at arm's length, in interests of insurer, disclosed in director attestations | Dealt with in capital requirements + some specific requirements for arm's length dealings |
| Governance | Fit and proper requirements for directors and specified senior managers | Fit and proper requirements for directors and specified senior managers |
| Governance | RBNZ can veto management appointees or auditor/actuary | APRA can't veto individuals who satisfy fit and proper requirements |
| Governance | No requirements relating to Board membership? | Board must satisfy APRA requirements re size and composition - independence etc |
| Monitoring | Insurers provide **annual financial statements** and **reduced form 6-monthly.** No proposal for regular meetings | Insurers complete **quarterly APRA returns** with full balance sheet and P&L, and capital adequacy assessment. APRA meets annually with each insurer. |
| Monitoring | RBNZ will focus on insurers who are "carrying too much risk" or have "insufficient capital" | All insurers subject to basic review. Insurers who are rated as "riskier" are subject to more in-depth review (largely meetings with APRA) |
| Monitoring | RBNZ has power to perform on-site inspections and initiate 3rd party reviews | APRA has power to perform on-site inspections and initiate 3rd party reviews |
| Monitoring | Auditors required to report major concerns to RBNZ | Whistleblower protection + can't constrain individuals from giving info to APRA |
| Planning and documents | No equivalent requirement | Annual submission of Business Plan, Risk Management Statement, RI Management Statement to APRA |
| Transactions | RBNZ must approve all NZ **transactions** that change ownership of policyholder liabilities | APRA/ASIC approval required depending on nature of transaction |
| Distress management | Similar powers/provisions | |

The striking difference between Australia and the NZ proposals here is the much higher level of monitoring – of financials and insurer management, frameworks and planning - and much more 'hands-on' supervision in Australia. As discussed earlier, we believe that comprehensive monitoring of long tail business is crucial to its management, and hence to insurer security. Monitoring by the prudential supervisor can provide a 'background' motivation for insurers to monitor this business carefully.

**Table 4 – Australia vs NZ Supervision – Foreign Insurers**

| Area | RBNZ Proposal | Aust (APRA) equivalent |
|---|---|---|
| Foreign insurer branches | Home country regulation/supervision must be acceptable to RBNZ | Home country regulation/supervision must be acceptable to APRA |
| Foreign insurer branches | Must meet all NZ licensing, monitoring, prudential requirements EXCEPT THAT (see next point) | Must meet all APRA licensing, monitoring, prudential requirements |
| Foreign insurer branches | RBNZ has discretion to accept compliance with home country requirements | All insurers writing Aust business must be authorised by APRA and meet APRA requirements |
| Foreign insurer branches | Financial strength rating must include consideration of home policyholder preference | n/a |
| Foreign insurer branches | No equivalent requirement | Aust assets not available outside Australia until all Aust policyholder liabilities met |

The Australian (APRA) framework requires that all business written in Australia - with very limited exceptions - meets the full range of prudential requirements. While the NZ proposal includes discretion to accept compliance with home country regulatory requirements, we would assume that this discretion will be exercised only when the home country requirements are at least as stringent (overall) as the NZ requirements. This discretion should not therefore lead to an increase in risk.

Overall, the Australian regime is more complex and comprehensive than the NZ proposals, and even in comparison with regimes elsewhere in the world APRA's requirements are among the most stringent. There is certainly criticism in Australia that APRA's regime is overly complex and has led to 'compliance overload'.

We make the following observations, from the Australian experience, about the complexity (or not) of the prudential supervision regime:

- No matter how complex the system, it can't reduce the risk of failure to zero
- Once the regime heads down the path of increasing complexity, it's very hard to turn back
- Complex rules mean time (and expense) spent by insurers in understanding them and complying with them
- Auditors don't generally cope too well with the subtleties of a complex series of requirements and measurements – particularly where they differ from the requirements of accounting standards
- It's hard to have a single set of rules that make sense for all insurers (e.g. capital requirements for lenders mortgage insurance, 'catastrophe exposure' for non-property portfolios).

A few other general observations in relation to prudential supervision:

- The regulator often needs to look behind the numbers – to get the 'story' – in order to understand what is happening
- The supervision relating to foreign entities can be tricky – e.g. assessing and allowing for the security of offshore reinsurers, foreign insurers writing business not through branches
- It's hard for the prudential regulator organisation to:
  - Keep good frontline staff – they tend to get poached
  - Maintain consistent messages to the industry across all of their staff (e.g. Perth says one thing, Sydney another **or** frontline staff say something different to the policy-makers).

## Our Conclusions

### Introduction of Competition

In our view the characteristics of accident insurance – its long tail nature, and third party beneficiaries – mean that strong regulation and prudential supervision is needed if the business is to be written in the private sector:

- Regulation is needed to protect stakeholders – both insureds and potential claimants
- Strong prudential supervision – with monitoring and management - is required to minimise the risk of writing unprofitable business, which may threaten the security of the insurer
- Strong market conduct regulation is equally important, and does not fit naturally with the mandate of the RBNZ.

The path to a competitive market for bodily injury insurance in NZ would require well thought out decisions in many areas:

- Product design – the unusual nature of the ACC scheme means that the design of the corresponding private insurance product(s) needs to be done carefully
- Market creation – market capacity seems assured, but details of the transition of underwriting to the private sector will need to be worked out
- Consumer issues – both policyholders and potential claimants will have significant concerns about any privatisation. Universal coverage is difficult to achieve in a private market
- Actuarial issues – it will be important to use actuaries in ways in which they can add maximum value.

### Prudential Supervision

The design of NZ's new prudential regime needs to take account of both the unique NZ environment, including the dominance of overseas-based insurers, and the possible privatisation of long tail accident cover. We see that there are dangers in a light-handed approach, especially for the security of insurers writing long tail business. Having said this, we do not believe that full-blown complexity similar to APRA's Australian regime is required.

With respect to both privatisation and prudential supervision, there is a wealth of relevant experience in NZ's history, as well as in Australia and elsewhere in the world. NZ has an opportunity to minimise the risk of 'mistakes' by using that experience.