

Corporate Alert

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Prudential regulation of the insurance sector

Introduction

A new regime for the prudential regulation of the insurance sector in New Zealand was proposed in a recent Cabinet Paper. This Cabinet Paper proposes a new Insurance (Prudential Supervision) Act to be introduced during 2008 to provide a "relatively light-handed approach" to regulation of the insurance sector, with the Reserve Bank being the prudential regulator and supervisor for the sector. This article sets out the key features of the Cabinet Paper.

Objectives

The insurance sector in New Zealand is currently subject to minimal regulation, which is not in accordance with international practices. The key objective of the proposed new regime is "to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence".

Who will be subject to the new regime?

The regulatory regime will apply to all providers of insurance with a physical presence in New Zealand (including via an agent). It is proposed that a comprehensive definition of both "insurance" and "insurance provider" will be contained in the new Act. The definition of "insurance" will include both the common law concept of insurance and also additional definitions of life, general and health insurance, so as to capture all arrangements that may be considered insurance activity. The definition of "insurance provider" will be a substance test and will not be dependent on the form of the entity providing insurance. All insurance providers will need to be licensed, unless a specific exemption is obtained.

The role of the Reserve Bank

The Reserve Bank will be the single prudential regulator for the New Zealand insurance sector. The Reserve Bank will have the authority to:

- licence and de-licence insurers;
- prescribe and enforce compliance with the regulatory requirements;
- apply "fit and proper" requirements to directors and senior managers of insurers;
- intervene in a situation of distress or potential failure of an insurer;
- obtain information from insurers, for example, regarding risk management strategies and financial strength; and
- exempt any institutions or products which may fall within the definition of an insurance provider or insurance but which are not intended to be captured by the legislation.

Licensing requirements

The licensing criteria which will be used by the Reserve Bank will be applied both at the time of initial licensing and on a regular and ongoing basis. The criteria for licensing will cover the following:

- a minimum capital requirement for all insurers, it is anticipated that this will be initially \$2 million;
- that each insurer has sufficient financial strength (demonstrated by compliance with solvency and capital adequacy calculations) to meet all claims/liabilities;
- a requirement for a credit rating from an approved rating agency, although it is not proposed that there is a minimum rating requirement in order to be licensed as an insurer. An exemption for insurers with annual gross premium income of less than \$5 million is proposed on the basis of minimising compliance costs, although

this exemption will not apply to disaster and property insurers;

- insurers will be required to have appropriate risk management and reporting policies and limits on their levels of risk (eg, insurance and investment risk);
- directors and certain senior management (ie, CEO, CFO and the actuary) are to meet "fit and proper" requirements;
- suitable ownership, corporate form and governance arrangements;
- appropriate actuarial and accounting arrangements. It is proposed that the Reserve Bank will have the power to disapprove an insurer's auditor or actuary if there is significant concern about their professional competence or integrity;
- arrangements that provide separation between different types of insurance business, in essence, so that in the event of insolvency of an insurer, one set of policyholder funds will not be at risk of being undermined by unrelated policyholder claims; and
- for foreign insurers, evidence of their home supervisor's prudential requirements and legal and accounting requirements which are considered satisfactory by the Reserve Bank. The proposed regime will seek to rely on foreign insurer's home regulatory requirements to the extent possible in order to minimise compliance costs.

Disclosure by insurers

It is also proposed that there should be increased public disclosure by insurers to provide greater publicly available information and also to promote the strengthening of insurers' internal financial disciplines. Such disclosure will include:

- annual audited financial reporting by all insurers;
- six monthly financial reporting and director attestation statements that will state that the insurer is in

compliance with its conditions of licence, has satisfactory risk management systems, an appropriate level of risk and that the reports have been prepared in accordance with New Zealand actuarial standards;

- a requirement to publish key financial strength indicators on the insurer's website; and
- details of the financial strength rating of the insurer.

The Reserve Bank will have the power to monitor these disclosures and will be able to obtain additional information from an insurer, if it believes appropriate.

Distress management

If an insurer enters into financial difficulties, it is proposed that the Reserve Bank will have the power to take necessary corrective action to safeguard policyholders' interests.

These powers will include:

- the right to require an insurer in actual or potential distress (or if the Reserve Bank has other concerns) to prepare and implement a recovery plan;
- the power to appoint an investigator and give directions, eg, to remove directors and management or cease specific businesses;
- the right to recommend statutory management to the Minister.

Penalties and sanctions

In order to encourage compliance with the new regulatory regime, appropriate penalties and sanctions are to be introduced in the new Act which will be consistent with current penalties in the Reserve Bank of New Zealand Act. These will be applicable to insurers, and criminal sanctions may also be imposed on individual directors and senior officers.

Proposed reforms to insurance market conduct

Introduction

A recent Cabinet Paper has recommended the introduction of a new Insurance Contracts Act to provide “a consolidated statutory framework in respect of insurance contracts, insurance intermediaries’ agency status and the registration of assignments of life insurance policies.” This article sets out the key issues arising from this Cabinet Paper.

Duty of disclosure

Current law and practice requires a policyholder to disclose all material circumstances to an insurer prior to entering into an insurance contract. The remedy of the insurer for failure of the policyholder to do so, is avoidance of the contract from its inception (ie, there is simply no insurance contract). This is often unduly harsh on a policyholder as the remedy of contract avoidance may be disproportionate to the actual breach by a policyholder. The Cabinet Paper recommends that the new Act will provide the following:

- codification of the policyholder’s duty of disclosure of information to insurers;
- a requirement on insurers and insurance intermediaries to inform policyholders of their duty to disclose and the consequences of non-disclosure;
- recommended “safe harbour wording” for the disclosure warning that will be required to be contained in policy application forms, policy documents, changes in cover forms, renewal forms and claims forms;
- a 5 day “cooling off” period following the disclosure warning in which the policyholder can cancel the insurance contract and receive a full refund of any money paid; and
- penalties and civil remedies to apply on the failure of an insurer or insurance intermediary to provide the disclosure warning.

The Cabinet Paper also proposes a new regime specifying the remedies for non-disclosure or mis-statement by a policyholder. Under the new regime, the insurer would only be able to avoid the insurance contract:

- for fraudulent non-disclosure / mis-statement (including “intentional” or “reckless” non-disclosure / mis-statement);
- for the policyholder providing substantially incorrect answers to specific questions from the insurer which are material to that insurance contract;
- within 30 working days of risk first attaching under the contract (which reflects the market practice of providing interim cover whilst questions are asked); and
- for non-disclosure / mis-statement in relation to reinsurance contracts.

If the above do not apply, then the insurer will not be able to avoid the contract. In place, the proposed remedies include reducing the amount of claim payments (or declining a claim), cancelling the policy prospectively, adjusting the premium prospectively or continuing the policy on amended terms.

Insurance intermediaries

Insurance intermediaries (eg, brokers) play an important role as a link between insurers and policyholders. At present, there is little clarity as to whether an insurance intermediary is the agent of the insurer or the agent of the policyholder. This is significant in that the status will affect the policyholders’ rights of recourse for failure by the intermediary to take reasonable skill and care.

The new Act will provide that for the purposes of contract negotiation, formation, renewal, changes in cover and claims where an insurance intermediary is involved, the agency status of the intermediary will be determined on the basis of written authorisation from an insurer or policyholder.

By specifying the status of the insurance intermediary, it will be easier to determine whether the policyholder has recourse to the insurer and the insurance intermediary (which will be the case if the intermediary is the insurer’s agent) or just the insurance intermediary (which will be the case if the intermediary is the policyholder’s agent) for actions by the insurance intermediary during contract negotiation, formation, renewal, changes of cover and claims. Such actions which may give rise to liability include failure by the insurance intermediary to warn the policyholder of disclosure requirements, the incorrect relaying of disclosures by the intermediary to the insurer, or failure to exercise a reasonable standard of care and skill in assessing the needs of the policyholder or giving advice to the policyholder.

For an insurance intermediary to be the agent of the policyholder, this must be confirmed in writing between

the intermediary and the policyholder. If there is no such written confirmation or a written confirmation is in place from both the insurer and the policyholder, the law will benefit the policyholder and the intermediary will be deemed to be the agent of the insurer.

There will accordingly be three categories of insurance intermediary, namely:

- “single insurer agent”, who is the agent of only one insurer;
- “multi insurer agent”, who is the agent for more than one insurer. In such case, the authorising insurer is only responsible for the conduct of the insurance intermediary in relation to that insurer’s products; and

- “policyholder agent”, where the insurance intermediary is the authorised agent of the policyholder.

Registration of assignments of life insurance policies

The Cabinet Paper also proposes a modernised regime for the assignment of life insurance policies (by way of mortgage or transfer). The new regime will do away with paper policies and the mortgage, transfer and discharge documents being required to be sent to the insurer for registration and will replace this with a system of electronic notice and storage.

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