

Corporate Advisory Alert

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Insurance (Prudential Supervision) Bill Introduced to Parliament

Introduction

On 29 October 2009 the Insurance (Prudential Supervision) Bill ("Bill") was introduced to Parliament. The Bill, which establishes a licensing regime for insurers with prudential oversight by the Reserve Bank (the "Bank"), is likely to have its First Reading during the week beginning 17 November 2009.

The Bill's introduction has been widely anticipated in the industry, given the release of a draft Bill for consultation by the Bank in April this year. Here we summarise the main features of the Bill, focusing on the key changes made to the draft Bill.

Main features of the Bill

The Bill intends to introduce a prudential supervision regime for the New Zealand insurance sector to ensure policyholders and the general public retain confidence in the financial stability of the sector. Essentially, the Bill requires insurers to:

- (a) obtain a licence from the Bank having met eligibility requirements which include:
 - (i) holding a current financial strength rating;
 - (ii) having the ability to carry on business in a prudent manner; and
 - (iii) having an appropriate incorporation and ownership structure;
- (b) maintain solvency as defined by regulatory standards (to be established);
- (c) establish and comply with a fit and proper policy for directors and officers and an organisation risk management programme (the Bill now allows these to be prepared on a group basis);

- (d) appoint an actuary; and
- (e) prepare financial condition reports as required by the bank and provide financial statements to the Bank.

For life policies, insurers will be required to maintain at least one statutory fund that relates to their life insurance business and is solely for the purpose of meeting life insurance liabilities.

The Bank will be given significant powers to deal with insurers that fail to comply with the Bill's requirements. This ranges from investigations and directions to ensure compliance with licence conditions and the statutory requirements, through to applications for statutory management of insurers in financial distress.

Generally, the Bill has not changed materially from the draft consultation version. However, there have been some changes of note, as discussed below.

Transitional regime

The Bill includes a new transitional regime. The provisions dealing with the process for obtaining a licence will come into force on a date established by Order in Council, which must not be later than 18 months after the Bill receives Royal Assent. The intention is that the date will be after insurers have become familiar with the Bill, the Bank has established processing systems, and the necessary regulations have been made. The remainder of the Bill comes into force 18 months from the date of Royal Assent. There is also a provisional licensing regime. The Bank *must* issue a provisional licence to an insurer if that insurer:

- (a) was carrying on business before commencement of the Bill;
- (b) within 3 months of the Bill receiving Royal Assent, notifies the Bank that it was carrying on insurance business and intends to continue carry on insurance business after the transitional period ends;

- (c) makes an application for a licence within the transitional period; and
- (d) has taken reasonable steps to make the application for a licence and provide a fit and proper policy and risk management programme.

A provisional licence *may* also be issued to an insurer that was carrying on business before the commencement of the Bill, and has notified the Bank that it intends to exit the market within 3 years of commencement of the Bill.

The insurer is required to comply with the Bill to the extent required by conditions in the provisional licence. A provisional licence can last for up to three years.

Definitions

Contract of insurance

A licence is required if a person "carries on insurance business in New Zealand", which, among other things, means that the person is liable as an insurer under a contract of insurance. As expected, the Bill now includes a definition of "contract of insurance", which will also establish a precedent for the (yet to be drafted) Insurance Contracts Bill and other related legislation. A contract of insurance is defined as a contract:

involving the transference of risk and under which a person (the insurer) agrees, in return for a premium, to pay to or for the account of another person (the policyholder) a sum of money or its equivalent, whether by way of indemnity or otherwise, on the happening of an uncertain event.

The Explanatory Note to the Bill acknowledges that it is difficult to define the concept of insurance with any precision. This means the scope of the definition is very broad, and has the potential to capture a number of financial instruments that would not commonly be thought of as insurance in the traditional sense. The definition therefore provides specific carve-outs for particular contracts (such as certain guarantees or gambling contracts), and a power for further contracts to be excluded by way of regulations.

Life policy

The second definition of particular interest is the definition of "life policy", which distinguishes between regular contracts of insurance and contracts of life insurance.

The definition of "life policy" essentially covers contracts of insurance where payments depend on the continuance or termination of human life. Contracts that are less than one year long and where payment is only for death by accident or arising from a specified sickness, are excluded.

In recognition of the range of insurance products that incorporate life insurance elements, the Bill deals with

"composite policies". Policies with less than 25% of the premium relating to life insurance will be treated as standard contracts of insurance, and policies with less than 25% of premiums relating to non-life insurance will be treated as life policies. Policies that sit in-between these two poles will be split into separate life and non-life parts. The proportions of premium allocations will be determined by the appointed actuary.

These provisions are likely to receive close attention from insurers, given the onerous requirements placed on insurers who offer life policies, including a requirement to maintain a statutory fund in respect of any life policy, and various restrictions on the management of such statutory funds (which remain largely unchanged from the draft Bill).

Solvency standards, solvency margins and reporting requirements

The Bill has tidied up the solvency standard provisions and reporting requirements. The key requirements are now as follows:

- (a) the Bank may impose compliance with a solvency margin as a condition of a licence, and may prescribe the methods for establishing or calculating a solvency margin under the general power to establish solvency standards;
- (b) solvency standards can include a range of other matters, such as the methods for valuing assets and liabilities. It is no longer the case that solvency standards can be expressed to apply to the preparation of financial statements and that the solvency standard would prevail to the extent that there was inconsistency with financial reporting standards;
- (c) the appointed actuary must review and report on actuarial information contained in or used for the preparation of financial statements, in accordance with the applicable solvency standard; and
- (d) the solvency standards may also include requirements regarding the provision of financial condition reports by insurers (ie how and when they are to be prepared, and who must prepare them). It will be an offence to fail to comply with the financial condition reporting requirements.

Changes in ownership

The Bill now incorporates an approval process for changes in controlling interests (ie a person is the parent of the insurer or holds more than half of the voting securities), or where there are changes in corporate form (the example given in the Bill is changes as a result of demutualization). This process involves submitting information to the Bank, so that the Bank can determine whether the insurer continues

to be eligible for a licence. The Bank's evaluation is on all the same criteria as must be met when considering an initial application for a licence. The Bank will have 20 working days in which to consider such a proposal. This requirement effectively provides an approval process for any particular acquisition or change in corporate form, in addition to any Takeovers Panel, Commerce Commission or Overseas Investment Office approval that may be required.

The Bill also includes new provisions setting out the consequences of the Bank approving a transfer of an insurer's business to another insurer. For example, if an insurer accepts transfer of liabilities from another insurer, all contracts are treated as being transferred by novation, and the policyholder will have the same rights against the receiving insurer as it did against the transferring insurer.

Acting in best interests of parent companies

The Bill also provides that constitutions of locally incorporated insurers may not allow insurers to act in the best interests of their parent companies (as is currently permitted under the Companies Act 1993). This clause introduces additional considerations for overseas insurers carrying on business in New Zealand. In deciding whether there is any advantage in operating as a branch operation instead of incorporating locally, in addition to general corporate considerations, insurers will need to consider the specific rules governing overseas insurers operating in New Zealand under a branch structure, including:

- (a) the requirement to disclose any overseas policyholder preference (ie a law or regulatory requirement that gives preference to policyholders in the insurer's home country), which the Bank must have regard to when determining the application for a licence; and
- (b) the requirement for the Bank, when determining an application for a licence, to be satisfied that the relevant laws and regulatory requirements and prudential supervision of the insurer's home jurisdiction are appropriate, having regard to whether they are at least as satisfactory as the requirements of New Zealand.

Other changes

The Bill makes a number of other changes that are largely for clarification or to improve the workability of the Bill. Changes include:

- (a) displacing the requirement to obtain a "credit rating" with a requirement to hold a "financial strength rating" from an approved rating agency. Financial strength ratings are specific to insurers, and rate their ability to meet ongoing insurance policy and contract obligations. In addition to being a requirement for obtaining a licence, if the financial strength rating is not disclosed to the policyholder, then the policyholder may cancel the contract of insurance within 20 days of it being entered;
- (b) providing for mutual recognition of fit and proper requirements in overseas jurisdictions;
- (c) requiring the Bank to publish its policies on how it will act in approving licence applications and deciding applications for transfers and amalgamations;
- (d) introducing a range of provisions relating to Lloyd's and its underwriters, including licensing requirements, fit and proper policies and risk management programmes;
- (e) a number of changes to the requirements governing statutory funds for life insurers; and
- (f) the consent of the Minister will no longer be required for the Bank to give directions to insurers and/or to remove and replace directors.

Conclusion

The workability of the Bill has been improved since the draft Bill. The various changes should provide greater certainty and clarity, and in some cases will provide greater transparency in the Bank's decision-making. The more substantive changes in the Bill are likely to receive mixed reactions from stakeholders.

Ultimately, the Bill imposes a comprehensive new licensing regime and gives the Bank extensive powers and responsibilities. Given the additional compliance costs this will create, insurers should be keen to ensure that the Bill imposes a proportionate regulatory response to the risk of financial stress in the industry. Once the Bill is referred to Select Committee, submissions will be sought (likely to be due early in the New Year). This provides stakeholders with an important opportunity to make recommendations to further improve the workability and effectiveness of the Bill.

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