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BILLS DIGEST

Digest No. 1726

Insurance (Prudential Supervision) Bill 2009

Date of Introduction:	29 October 2009
Portfolio:	Finance
Select Committee:	As at 08 December, 1st Reading not held.

Published: 08 December 2009

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Although every effort has been made to ensure accuracy, it should not be taken as a complete or authoritative guide to the Bill. Other sources should be consulted to determine the subsequent official status of the Bill.

Purpose

The aim of this Bill is to reform and extend the present law relating to the prudential supervision by the Reserve Bank of New Zealand (the Bank) of the insurance industry in New Zealand.

Background

"The Bill will replace existing outdated legislation and fill gaps where no prudential regulation currently exists, as well as remove inconsistent legislative application between different insurance sectors"[1].

[1] Insurance (Prudential Supervision) Bill, 2009 No 95-1, Explanatory note, General policy statement, p. 1.

Main Provisions

Purpose

The purposes of the Bill are to:

- promote the maintenance of a sound and efficient insurance sector; and
- promote public confidence in the insurance sector.

The Bill provides that these purposes are to be achieved by:

- establishing a system of licensing insurers; and
- imposing prudential requirements on insurers; and
- providing for the supervision by the Reserve Bank of New Zealand of compliance with those requirements; and
- conferring certain powers on the Bank to act in respect of insurers in financial distress or other difficulties *(Part 1, Clause 3, the "purpose clause")*.

Principles to be taken into account by the Bank in performing its functions under the Bill

The Bill sets out certain principles that the Bank must take into account when acting under this Bill, such as recognising the importance of insurance, the need to maintain competition, the need to avoid unnecessary compliance costs, and the desirability of sound governance of insurers. Amongst the principles is the following:

> *" ... the importance of recognising ... that it is not a purpose of this [Bill] to eliminate all risk of insurer failure ... and ... that members of the public are responsible for their own decisions relating to insurance". (Part 1, Clause 4).*

What is a "contract of insurance"?

The Bill defines, for its purposes, the term "contract of insurance" 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 term "uncertain event" means an event " ... with respect to which there is (from the perspective of the policyholder) an element of uncertainty as to when or whether it will take place ... and ... that is beyond the insurer's control". The following are not contracts of insurance for the purposes of the Bill:

- a derivative transaction (within the meaning of Section 136(1)[2] of the Crown Entities Act 2004);

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[2] Section 136(1) of the Crown Entities Act 2004 includes the following definition of the term "derivative transaction":

(a) a transaction that is a rate swap transaction, swap option, basis swap, forward rate transaction, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option, commodity swap, commodity option, equity or equity index swap, equity or equity index option, bond option, credit protection transaction, credit swap, credit default swap, credit default option, total return swap, credit spread transaction, forward purchase or sale of a security, or commodity or other financial instrument or interest (including an agreement or option that relates to any of these transactions); or

(b) a transaction that is similar to any transaction referred to in paragraph (a) that—

(i) is currently, or in the future becomes, recurrently entered into in the financial markets; and

- a guarantee under which a person agrees to answer to another person for the debt, default, or liability of a third person;
- a repayment waiver (within the meaning of Section 5[3] of the Credit Contracts and Consumer Finance Act 2003);
- a product or service guarantee or warranty in relation to any goods or services that is given or made by the manufacturer or supplier;
- any lump sum, annuity, pension, allowance, refund, or other payment arising from membership of a superannuation scheme (within the meaning of section 2A of the Superannuation Schemes Act 1989) or a KiwiSaver scheme (within the meaning of section 4(1) of the KiwiSaver Act 2006);
- gambling (within the meaning of Section 4(1) of the Gambling Act 2003);
- any other transaction or matter of a class declared by regulations to be transactions or matters that are not by way of insurance *(Part 1, Clause 7)*.

Comment
The explanatory note to the Bill states: "The definition of contract of insurance in the Bill is based on the common law. Accordingly, it includes (for example) house and contents insurance, motor vehicle insurance, life insurance, professional indemnity insurance, health insurance, marine insurance, and reinsurance. The courts have recognised that the concept of insurance is difficult to define with precision (see, for example, *Department of Trade and Industry v St Christopher Motorists Association Ltd [1974] 1 All ER 395*). The definition in the Bill already specifies a list of specific exclusions. However, to recognise this difficulty and to provide certainty, the Bill allows regulations to declare transactions or matters that are not by way of insurance"[4].

Reserve Bank's functions

The Bill provides that the functions of the Bank under this Bill are to

- issue licences to insurers; and
- undertake prudential supervision of licensed insurers; and
- take appropriate action in respect of licensed insurers that are in financial or other difficulties; and
- carry out any other functions and duties and exercise powers conferred on it by this Bill and the regulations.

The Bill requires the Bank to have regard to Government policy that relates to the Bank's functions under the Bill *(Part 1, Clauses 11 and 12)*.

(ii) is a forward, swap, future, option, or other derivative on 1 or more rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, economic indices or measures of economic risk or value, environmental or climatic variable, or other benchmarks against which payments or deliveries are to be made.

[3] The term "repayment waiver" is defined in Section 5 of the Credit Contracts and Consumer Finance Act 2003 as: " ... an agreement between a creditor or lessor and a debtor or lessee under which the creditor or lessor, for an additional consideration, agrees to waive the creditor's or lessor's right to any amount payable under the credit contract or consumer lease in the event of the unemployment of, sickness of, injury to, or the disability or death of the debtor or lessee.

[4] Insurance (Prudential Supervision) Bill, 2009 No 95-1, Explanatory note, clause by clause analysis, p. 3.

Licensing and prudential regulation of insurers

Requirement to be licensed

The Bill provides that it is an offence to carry on insurance business in New Zealand without holding a licence issued under the Bill and it is an offence (carrying maximum penalties, in the case of an individual, of three months imprisonment or a fine not exceeding $200,000 (or both) and, in the case of a body corporate, a fine not exceeding $1,000,000 *(Part 2, Subpart 1, Clause 14)*.

Process for obtaining licence

The Bill makes detailed provision for the process for obtaining a licence. The Bank must make particular consideration as to whether the applicant (which must be a body corporate) is able to carry on its business or proposed business in a prudent manner *(Part 2, Subpart 1, Clauses 16-19)*.

Conditions of licence

The Bill provides for conditions of licence, including conditions requiring an insurer to maintain a solvency margin in accordance with certain solvency standards issued by the Bank. A life insurer is required to maintain a solvency margin in relation to each statutory fund that it is required to maintain under the Bill. An insurer must report to the Bank a future likely failure to comply with the requirements relating to its solvency margin. A failure to comply with a condition is an offence with a penalty of a fine not exceeding $500,000 *(Part 2, Subpart 1, Clauses 20-23)*.

Notification of the Bank where controlling interest acquired or corporate form changed

The Bill requires notification to be given to the Bank before a controlling interest in a licensed insurer is acquired or obtained (for example, the insurer becomes a subsidiary) and before the insurer's corporate form is changed (for example, through demutualisation). The Bank must then consider whether it is still satisfied of the licensing matters. If the Bank is not so satisfied, the licence may be cancelled if, despite that fact, the controlling interest is acquired or obtained or the corporate form is changed. The Bill provides that a person (A) has a controlling interest in an insurer if:

- the insurer is a subsidiary of A; or
- more than half of the voting securities of the insurer, other than voting securities that carry no right to participate beyond a specified amount in a distribution of either profits or capital, are held by A and persons that are associated with A (whether directly or indirectly, but other than in a fiduciary capacity) *(Part 2, Subpart 1, Clauses 25-27)*.

Cancellation of licence

The Bill provides that the Bank may cancel a licence if the insurer has no liabilities under any contracts of insurance in respect of insurance business carried on by it in New Zealand and any of the following applies:

- the insurer has asked the Bank to cancel its licence;
- a controlling interest has been acquired or obtained or the insurer has changed its corporate form in the circumstances referred to in Clauses 25 to 27 (see above);
- the insurer has been deregistered under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 and has not been reregistered within three months;
- the insurer does not or has ceased to carry on insurance business, or the insurer has been wound up or otherwise ceased to exist.

The Bill provides that the Bank must direct an insurer to arrange, subject to the Bank's approval, to assign its liabilities to one or more other licensed insurers in order to allow a cancellation to take place. A failure to comply with a direction is an offence with a penalty of a fine not exceeding $500,000 *(Part 2, Subpart 1, Clauses 28-31)*.

Fit and proper requirements

The Bill provides that an insurer must have a "fit and proper "policy in respect of its directors and relevant officers. This must include such matters as: whether a person has the qualifications and experience reasonably expected for the position; whether a court has made a finding that a person has engaged in serious wrongdoing; and whether a person has at any time been adjudged bankrupt or been convicted of an offence. The policy must also include the processes to be undertaken in assessing whether a person is fit and proper to be appointed to, and hold, a position and must also provide for reassessments. The Bill provides that the Bank may remove a person as a director or relevant officer if the Bank has reasonable grounds to believe that the person is not a fit and proper person to hold the position. The relevant person may appeal to the High Court against the decision, and appeal again to the Court of Appeal on a point of law *(Part 2, Subpart 1, Clauses 32-41)*.

Transfers and amalgamations

The Bill makes detailed provision in respect of transfers and amalgamations. In particular an insurer must obtain the approval of the Bank before transferring all or part of the insurer's insurance business to another person (or, in the case of an overseas insurer, transferring all or part of its New Zealand business) or amalgamating with another person. A failure to comply with the requirement to obtain approval is an offence with a penalty of a fine not exceeding $1,000,000. A failure to comply with any conditions of an approval is an offence with a penalty of a fine not exceeding $500,000. An assignment of liabilities under contracts of insurance for the purposes of an approved transfer has effect as if the contracts were transferred by "novation"[5] *(Part 2, Subpart 1, Clauses 42-51)*.

Prudential regulation of insurers

Solvency standards

The Bill provides that the Bank may issue solvency standards (which have the status of regulations) which may prescribe:

- matters relating to the solvency margin or margins that an insurer must maintain;
- requirements relating to reports about the financial condition of insurers;
- methods for valuing or estimating the assets and liabilities of an insurer;
- the assets of an insurer that must be disregarded for the purposes of valuing or estimating the assets of an insurer;
- any other matters relating to the assessment, or disclosure, of matters relating to an insurer's financial condition;
- matters relating to actuarial reviews *(Part 1, Subpart 2, Clauses 53-60; Schedule 1 of the Bill ("General provisions relating to incorporation by reference)")*.

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[5] "Novation" is a term used in contract law to describe the act of replacing a party. Novation generally requires the consent of all the parties to the contract. see Spiller, *Butterworths New Zealand Law Dictionary*, 6th ed., LexisNexis, Wellington, 2005.

Financial strength ratings

The Bill requires most insurers to have a current financial strength rating that is given by a rating agency approved by the Bank. This rating must be disclosed to a policyholder before entering into or renewing a contract of insurance by the insurer with a New Zealand policyholder. If a licensed insurer's financial strength is downgraded , that fact must be disclosed in writing by the insurer to every New Zealand policyholder under a contract of insurance with the insurer that has a duration of more than one year. A licensed insurer commits an offence if it fails to comply with these requirements and is liable, on summary conviction, to a maximum fine of $500,000. The requirement to have a current financial strength rating that is given by a rating agency approved by the Bank does not apply to:

- friendly societies or credit unions with an annual gross premium income less than an amount to be prescribed by regulations; or
- insurers that exclusively carry on reinsurance business; or
- captive insurers *(Part 2, Subpart 2, Clauses 61- 71)*.

Disclosure of overseas policyholder preference

The Bill requires overseas insurers to disclose, in the manner prescribed in regulations, the nature and the extent of any "overseas policyholder preference" that may apply. An "overseas policyholder preference" is an overseas law or regulatory requirement that relates to the recognition and priorities of claims of creditors in the event of the insurer's insolvency and has the effect of being materially disadvantageous to New Zealand policyholders as compared to policyholders in the insurer's home jurisdiction *(Part 2, Subpart 2, Clause 72; Part 1, Clause 6(1), definition of "overseas policyholder preference")*.

Risk management

The Bill requires insurers to have a risk management programme, the content of which is set out in the Bill *(Part 2, Subpart 2, Clause 73-75)*.

Appointment of actuary and actuarial review

Clause 76 requires an insurer to have an appointed actuary. The actuary must review the actuarial information in, or used in the preparation of, the insurer's financial statements and must have access to information and explanations required to perform these duties. The actuary must give an opinion as to whether the statements comply with the solvency standards in respect of the actuarial information and whether the insurer is complying with its solvency margin obligations *(Part 2, Subpart 2, Clauses 76-80)*.

Supply of financial statements

The Bill provides that an insurer must send to the Bank financial statements and group financial statements prepared under the Financial Reporting Act 1993 and prepare half-yearly interim financial statements and send these to the Bank within five months of the end of the first half of each accounting period *(Part 2, Subpart 2, Clause 81)*.

Statutory funds of life insurers

The Bill provides that a life insurer must have at least one statutory fund in respect of its life insurance business. A statutory fund is a fund that is established in the records of a life insurer and relates solely

to the life insurance business of the life insurer or a particular part of that business. The Bill defines the meaning of the term "life policy" *(Clause 84)* for the purposes of the Bill and deals with contracts of insurance that contain both life insurance and other insurance (if less than 25% of the premium relates to non-life insurance, the policy is to be treated as a life policy). The Bill provides that the assets of the statutory fund are only available for expenditure relating to the business of the fund (for example, to meet liabilities (including policy liabilities) or expenses incurred for the purposes of the business of the fund). A life insurer may invest the assets in any way that is likely to further the business of the statutory fund, subject to certain qualifications (for example, restrictions on investing the assets in associated persons of the insurer) *(Part 2, Subpart 2, Clauses 82-102)*.

Directors, restructuring, termination and liquidation

The Bill places duties on the directors of a life insurer to take reasonable care, and use due diligence, to see that, in the investment, administration, and management of the assets of the fund, the life insurer complies with the Bill and gives priority to the interests of policyholders of life policies referable to the fund. A director that fails to comply with the duty can be liable for any resulting loss. The Bill also provides for the restructure and termination of statutory funds with the approval of the Bank and for additional requirements for transfer of life policies between statutory funds by endorsement. The Bill requires an insurer to allocate the operating profit or loss of a category of business of the fund in the manner prescribed by regulations. In relation to a liquidation, after discharging various liquidation fees and expenses, the assets of a statutory fund are to be applied:

- first in discharge of the policy liabilities of the insurer referable to the fund;
- then in discharge of other liabilities that are referable to the business of the fund;
- then as the High Court directs.

Where a life insurer contravenes Subpart 2 and the contravention causes a loss to a statutory fund and the insurer is in liquidation, the directors are liable for the loss. A life insurer commits an offence if it fails to comply with Subpart 2 and is liable to a fine not exceeding $500,000 *(Part 2, Subpart 2, Clauses 103-117)*.

Prudential supervision of licensed insurers

The Bill contains detailed prudential supervision powers for the Bank to require reports, data, forecasts and other information from insurers, associated persons of insurers, and certain other persons relating to the business, operation, or management of the insurer). Under Clause 123, the Bank can require the information, data, or forecasts to be audited or reviewed. The Bank may exercise this power to require the supply of information or data or to appoint an investigator if it has reasonable cause to suspect that:

- an insurer is not maintaining a solvency margin (as required by the conditions of its licence and the solvency standards); or
- the business of an insurer has not been, or is not being, conducted in a prudent manner; or
- an insurer has been or is operating fraudulently or recklessly; or
- an insurer or an associated person has failed to comply with any requirement to supply information, data, or forecasts; or
- an insurer has failed, or is failing, to comply with any other requirement imposed by or under the Bill or the regulations.

The extensive powers of investigators are set out (including power to enter and search a place for the purposes of an investigation if the occupier consents or the investigator obtains a warrant) and offences relating to investigations are prescribed (for example, hindering, obstructing, or delaying an investigator in the carrying out of an investigation). The penalty, in the case of an individual, is a maximum term of imprisonment of three months or a maximum fine of $200,000 (or both) and, in the

case of a body corporate, a maximum fine of $500,000. *(Part 3, Clauses 118-135; Schedule 2 to the Bill ("General provisions relating to search powers"))*.

Distress management

Recovery plans and directions

The Bill provides that the Bank may direct an insurer to prepare a recovery plan if it has reasonable grounds to believe that:

- the insurer is not maintaining a solvency margin; or
- the business of an insurer has not been, or is not being, conducted in a prudent manner; or
- an insurer has failed, or is failing, to comply with any other requirement imposed by or under the Bill or the regulations.

The recovery plan must set out the actions that the insurer will take to effectively address the matters that caused the Bank to give the direction and be provided to the Bank for approval. After approval, the insurer must take all practicable steps to comply with the plan. A failure to comply with the various requirements is an offence punishable by a maximum fine of $500,000. The Bill also gives powers to the Bank to give directions to insurers and associated persons for similar reasons to those listed above. The penalties for non-compliance with such directions are the same as above for a body corporate and a maximum term of three months imprisonment or a maximum fine of $200,000(or both) in the case of an individual *(Part 4, Subparts 1 and 2, Clauses 136-148)*.

Liquidation or voluntary administration of licensed insurers and statutory management

The Bank is given power to apply to the High Court for the appointment of a liquidator of:

- a licensed insurer (on the grounds that the insurer is unable to pay its debts, the insurer is failing to maintain a solvency margin, the insurer has persistently or seriously failed to comply with any requirement imposed by or under the Bill or the regulations, or that it is just and equitable that the insurer is put into liquidation);
- a person that is carrying on insurance business in New Zealand without a licence.

The Bank is also empowered to apply to the High Court to put a licensed insurer into voluntary administration (on the ground of failing to maintain a solvency margin or on the grounds specified in Section 239L of the Companies Act 1993). *(Part 4, Subpart 3, Clauses 149-167)*.

Statutory management

The Bill makes detailed provision for the statutory management of an insurer. The Governor-General may, by Order in Council, on the advice of the Minister given with a recommendation of the Bank declare that a licensed insurer or an associated person is subject to statutory management and appoint a statutory manager or managers. The Bank may make such a recommendation only if it is satisfied on reasonable grounds that one or more of the following circumstances apply:

- that the failure of the insurer may cause significant damage to the financial system or the economy and that 1 or more of the following apply;
    - the insurer is not maintaining a solvency margin; or
    - the business of the insurer has not been, or is not being, conducted in a prudent manner; or

- the insurer, or a director or relevant officer, has failed, or is failing, to comply with any other requirement imposed by or under the Bill or the regulations; or
- the governance structure of the insurer has significantly changed since its licence was issued; or
- the insurer is an overseas insurer in relation to which an overseas prudential supervisor has taken, or is taking, regulatory action; or
- the insurer is an overseas insurer and the overseas law, requirements, or prudential supervision that applies to the insurer has significantly changed since its licence was issued; or

- that the insurer is, or may be, operating fraudulently or recklessly, and that it is desirable that the insurer be declared to be subject to statutory management.

The Bank may make a recommendation in respect of an associated person of an insurer if it is satisfied on reasonable grounds that:

- the person, or a director or chief executive officer, has failed, or is failing, to comply with any requirement imposed by or under the Bill or the regulations; or
- the circumstances of the person are such as to be prejudicial to the solvency of the insurer or its ability to comply with the Bill or the regulations, or the affairs of the person are being conducted in a manner that is so prejudicial; or
- the business and affairs of the insurer are so closely connected with the associated person that the statutory manager would be unable to exercise effectively the powers conferred by this subpart in relation to the insurer unless the statutory manager is appointed as statutory manager of the associated person; or
- the associated person is, or may be, operating fraudulently or recklessly in a manner prejudicial to the solvency of the insurer or its ability to comply with the Bill or the regulations, and that it is desirable that the person be declared to be subject to statutory management.

However, the Bank must not make a recommendation in respect of an insurer or associated person unless it is satisfied on reasonable grounds that the public interest, the financial system or economy of New Zealand, or the relevant policyholders cannot be adequately protected under the other provisions of the Bill or under the Companies Act 1993 *(Part 4, Subpart 4, Clauses 168-197)*.

Miscellaneous provisions

Provisions relating to Lloyd's

The Bill makes special provision for Lloyd's (being a society of that name incorporated by the Imperial Act known as the Lloyd's Act 1871). In the case of Lloyd's, insurance is underwritten by its individual members. These provisions allow Lloyd's to apply for a licence on behalf of all of its members. Lloyd's underwriters must not carry on insurance business in New Zealand unless Lloyd's obtains a licence. If a licence is issued, its members:

- may carry on insurance business in New Zealand and are each treated as being a licensed insurer;
- must comply with the conditions of the licence, the Lloyd's fit and proper policy, and the Lloyd's risk management programme.

The various requirements of the Bill (for example, those relating to fit and proper requirements and risk management programmes) are modified to fit the particular circumstances of Lloyd's *(Part 5, Clauses 198-208)*.

Other matters

The Bill provides for access of an overseas supervisor to certain information. An overseas supervisor is any authority or body in any country other than New Zealand that performs functions in relation to insurers that correspond with, or are similar to, those conferred on the Bank under this Bill *(Part 5, Clauses 209 and 210; Part 1, Clause 6(1), definition of "overseas supervisor")*. The Bill provides for certain offences (false declarations and representations), the liability of directors and the defences for offences under the Bill *(Part 5, Clauses 211-213)*. The Bill provides that no New Zealand person or overseas company may hold out outside New Zealand that the person carries on insurance business in New Zealand, or that the person is regulated by New Zealand law in respect of insurance business carried on in New Zealand, if the person does not carry on insurance business in New Zealand *(Part 5, Clauses 214-216)*. The District Court is given power to ban certain persons from participating in the insurance business *(Part 5, Clauses 218-224)*. Every statutory manager of a licensed insurer or of an associated person or of a subsidiary of a licensed insurer, every officer or employee of the Bank, every investigator, and every director of the Bank is protected form liability for an act done or omitted to be done in the performance or exercise in good faith of the person's functions, duties, or powers under the Bill *(Part 5, Clause 226)*. The same persons are indemnified by the Crown in respect of any liability that arises from the exercise or purported exercise of, or omission to exercise, any power conferred by this Bill unless it is shown that the exercise or purported exercise of, or omission to exercise, the power, was done in bad faith *(Part 5, Clause 227)*.

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