New Zealand Law Society
Te Kāhui Ture o Aotearoa

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Prudential Policy – Financial Policy
Reserve Bank of New Zealand
Wellington

By email: ipsareview@rbnz.govt.nz

Re: Review of the Insurance (Prudential Supervision) Act 2010 – omnibus consultation

1 Introduction

1.1 The New Zealand Law Society Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on the Reserve Bank of New Zealand (**RBNZ**) omnibus consultation paper *Review of the Insurance (Prudential Supervision) Act 2010* (**consultation paper**). The consultation paper builds on five previous consultations to lay out a complete set of proposals for amending the Insurance (Prudential Supervision) Act 2010 (**IPSA**).

1.2 This submission has been prepared with input from the Law Society's Commercial and Business Law Committee.[1]

2 Purposes, scope and regulatory boundaries

2.1 The Law Society has previously commented on the policy questions underpinning the IPSA, and whether they were adequately reflected in the statement of the purposes of that Act.[2] However, those comments focussed on questions about whether some kinds of businesses with insurance-like characteristics required prudential supervision under IPSA. The consultation paper appears largely to address those questions within section 2.3, 'Definition of insurance contracts'.

2.2 Whilst the Law Society considers the clarity and fitness for purpose of IPSA's core purposes is important, we are of the view that even if any change is a matter of nuance, it will likely be industry participants who are best-placed to express views and provide the feedback sought by RBNZ. That said, we offer the following brief comments.

[1] More information about this Committee can be found on the Law Society's website, here.

[2] See the Law Society's submission on the *Review of the Insurance (Prudential Supervision) Act 2010 Options Paper 1: Scope of the Act and Overseas Insurers* (24 March 2021), copy available here.

Definition of "contracts of insurance"

2.3 The Law Society supports leaving the current definition of "contract of insurance" unchanged, in order to maintain flexibility.[3]

2.4 The Law Society also supports the proposal to amend the IPSA to include a 'declaration power' deeming that certain types of transactions or matters are insurance contracts for the purpose of IPSA. It is our expectation that such a power will be coupled with adequate guidance about its proposed or intended use. Where possible, we also recommend undertaking public or targeted consultation on any specific proposals to declare certain transactions or matters as insurance contracts.

Definition of "carrying on insurance business in New Zealand"

2.5 We understand this proposed change to the definition in section 8 is intended to manage the risk of locally incorporated insurers falling into a 'regulatory gap' as result of being excluded from regulation in any jurisdiction, and the resulting reputational risk for New Zealand's insurance sector.

2.6 While there may be policy reasons for excluding overseas captives from the prudential supervision regime,[4] we note that some overseas captives are likely to have a level of administrative support in New Zealand. Therefore, we remain concerned about boundary issues affecting any proposed exclusion.

2.7 As noted in the Law Society's 2021 submission,[5] certainty is important. However, we do not have a fixed view as to whether this is best achieved by:

(a) a blanket statutory exception, which runs the risk of having a definition which is too narrow; or

(b) having greater clarity surrounding the exercise of RBNZ's declaratory powers under section 9 of IPSA (which allows RBNZ to declare that a person is not carrying on insurance business in New Zealand).

2.8 Any guidance about the exercise of the section 9 power could be coupled with additional guidance about how those powers ought to be exercised in relation to overseas captives. Whilst the use of the powers under section 9 must be made on a person-by-person basis (and not, for example, on a class basis), such guidance would enable RBNZ to make necessary declarations in an efficient and consistent manner.

2.9 We acknowledge RBNZ is awaiting stakeholder feedback on the proposal to exclude overseas reinsurers from New Zealand's licensing regime.[6] Our view is that the approach to overseas reinsurers should be broadly similar to that for overseas captives – that is, whilst there

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[3] We note that the Law Society's March 2021 suggested deleting the phrase "unless the context otherwise requires" from the definition of "contract of insurance". However, we have now carefully considered the additional information provided by RBNZ in this consultation paper (including the problems identified by other stakeholders in previous consultations), and revised our position on the definition of "contract of insurance".

[4] Consultation paper, at 2.4.19.

[5] Above n 2.

[6] Consultation paper, at 2.4.20.

appear to be sound reasons for exclusion, the interests of visibility and certainty may be better served by the use of declaratory powers on a case-by-case basis.

Group supervision – licensing non-operating holding companies

2.10 The Law Society continues to support the introduction of comprehensive group supervision for the reasons set out in the consultation paper (i.e., as a means of group-level risk management in accordance with international practice).[7]

2.11 The reasons provided in the consultation paper for having a separate licensing regime for non-operating holding companies, and for specific provisions for groups, also seem logical.

3 Solvency and ladder of intervention

Setting solvency requirements and supervisory adjustments

3.1 We note that the first proposal, to automatically apply the prescribed capital requirement to non-exempt insurers, without the need for a specific licence condition, does not appear to have been resisted by industry participants.[8]

3.2 The second proposal, to enable RBNZ to impose supervisory adjustments to the way the solvency calculation is carried out (overruling the insurer's judgement, including actuarial judgement, as to balance sheet risk) is important. Marginal cases will be at risk of legal challenge, so there is a need for both a clear legal power, and clear guidelines as to how and when that power may be exercised.

4 Recourse to directors following a breach of statutory duty

4.1 Noting that:

(a) directors currently have personal liability in relation to statutory funds, where their failure to comply with statutory fund rules has led to a loss (section 105 of the IPSA); and

(b) RBNZ does not consider it appropriate for directors to have exposure to unlimited liabilities for losses from an insurer's assets as a whole,[9]

the proposal to give the courts the power to impose civil pecuniary penalties for a breach of the proposed due diligence duty (which is also proposed to be extended to the appointed actuary) may lead to a significant escalation of exposures.

4.2 Because this proposal is framed as a means for the court to consider whether the penalty should be paid to policyholders, we would need to have more information to hand before commenting on the suggestion that it would not alter directors' potential liability, but would alter who penalties were paid to. This proposal raises questions as to whether it might make

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7 This feedback was previously provided to RBNZ in the Law Society's 2021 submission (above n 2).

8 Consultation paper, at 4.2.8.

9 Consultation paper, at 5.4.28.

a more appetising target for, say, a litigation funder.[10] Further consultation and consideration of this issue is required at the stage of an exposure draft.

5 Governance, risk management and relevant officers

Fit and proper regime

5.1 We note the proposal to introduce a requirement for licensed insurers to notify RBNZ where an insurer obtains information that could reasonably lead them to form the opinion that a relevant officer is no longer a fit and proper person, as well as the arguments for and against imposing such an obligation.

5.2 Rather than comment on the international standard cited in support of this proposal,[11] or whether it is broadly in line with requirements imposed by the Australian Prudential Regulation Authority, we raise concerns about how this obligation would be applied in practice. We anticipate that, without careful legislative drafting and suitable guidance to identify some sort of threshold test, the proposal is likely to put insurers and their directors in a difficult position.

5.3 Whilst we would express a preference for insurer self-governance, if there is a clear and compelling case for something more, we invite officials to consider whether routine certification (i.e., that the fit and proper test continues to be met) might be a clearer and simpler risk management tool.

Directors' duties

5.4 The Law Society supports the proposal to introduce, in a prudential supervisory context, a positive due diligence duty for directors of New Zealand-incorporated licensed insurers, to ensure the insurer complies with its prudential obligations under the IPSA regime.

5.5 We also note the proposal to backstop that duty with a civil pecuniary penalty. This joint approach to both responsibilities, and the consequences of non-compliance, is likely to be more effective. Of the available options, an approach similar to that under the Deposit Takers Act 2023 (**DTA**), rather than the very broad approaches taken in some other jurisdictions, appears to be more suitable for managing the concerns regarding uncertainty around the scope of the new duty.

5.6 It also follows that we are broadly supportive of a similar approach to New Zealand branches of overseas licensed insurers, by imposing a due diligence duty on the chief executive officer.

Actuarial advice and the appointed actuary

5.7 The consultation paper reports a level of market support for an actuarial advice framework, but notes concerns about imposing a corresponding due diligence obligation in relation to the performance of the duties required under the proposed actuarial advice standard.[12]

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[10] The Law Society does not express a view on this point, but it is a matter RBNZ should consider.

[11] Consultation paper, at 6.3.11.

[12] Consultation paper, at 6.5.6 - 6.5.7.

5.8 In this regard, a new liability for actuaries, even if capped in the manner proposed, is still a new liability exposure that does not appear to be replicated in other jurisdictions, and the Australian example cited[13] does not readily appear to serve as a benchmark. Consequently, we anticipate this proposal will continue to be a cause for concern amongst the actuarial profession.

6 <u>Supervisory powers and approval processes</u>

<u>Supervisory powers</u>

6.1 We make the following brief observations about some of the new supervisory powers proposed in the consultation paper:

(a) The extension of investigative powers: while stakeholders appear to be generally comfortable with the proposed extension,[14] further information is needed about the specific wording of the proposed extension, in order to provide considered and meaningful feedback.

(b) Wider information gathering powers: we acknowledge there are benchmarks under the DTA and the Financial Markets Conduct Act 2013 (**FMCA**), but note that additional information about the proposed threshold is also needed in order to provide useful feedback.

(c) On-site inspection powers: similarly, further information about the wording of the proposed powers is needed in order to provide feedback. However, we agree in principle with the suggestion to apply the same safeguards in the DTA to the proposed on-site inspection powers.

<u>Supervisory approval processes</u>

6.2 We agree it is important for RBNZ to provide enhanced guidance about how the proposed new approvals process will work in practice. We are also pleased to note this proposal addresses some of our previous concerns about IPSA's current definition of when there is a change of "control" being out of step with that in other regulatory frameworks (such as the Takeovers Code).[15]

6.3 We also note the comments in the consultation paper which confirm that, where a change meets the new threshold but is unlikely to have an impact on insurer governance, RBNZ approval is likely to be a straightforward process. Guidance on this more straightforward process could be taken from the examples provided by the Takeovers Panel in the use of its exemption powers (as well as the equivalent regime under the DTA).

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13 Consultation paper, at 6.5.11.

14 Consultation paper, at 8.2.4.

15 See the Law Society's submission on the *Issues Paper: Review of the Insurance (Prudential Supervision) Act 2010* (30 June 2017), copy available here.

7 Enforcement tools and penalties

Publication of written warnings

7.1 The Law Society has fewer concerns about the proposal to require insurers to disclose written warnings, than those voiced by stakeholders.[16] In addition to the safeguards discussed in the consultation paper, the work undertaken by other regulators in broadly similar circumstances[17] should provide an adequate check on issues such as proportionality (particularly when coupled with the circumstances in which this power is proposed to be used). The consultation paper also indicates this power would likely be exercised in cases of suspected contravention of prudential requirements where an insurer has failed to respond adequately to earlier warnings – this signals the power is not to be used lightly, or in relation to matters other than those which are very material.

Infringement notices

7.2 For the reasons set out in the consultation paper, we consider there is a sound basis for a regulator to have the power to issue infringement notices for low-level administrative breaches. This is both in the interests of administrative efficiency, and as a suitable incentive to encourage repeat offenders to 'tidy up' their compliance, or risk reputational damage for repeat offences.

Safeguards

7.3 We are also satisfied that the safeguards which surround the use of enforcement powers will help ensure the powers are exercised reasonably and proportionately. The publication of RBNZ's enforcement framework also provides added transparency. Nonetheless, we will await the wording of the proposed legislation before providing any further feedback about these powers.

Penalty levels

7.4 We do not seek to comment on the proposed adjustments to the penalty levels at this stage. As previously noted,[18] with appeals pending on the *CBL Insurance* case, it is difficult to comment further on the structure of criminal penalties generally. Nonetheless, we consider there is merit in seeking to replace lower-tier criminal penalties with civil pecuniary penalties, or, in the case of low-level administrative type matters, an infringement offence regime.

8 Distress Management

Statutory management

8.1 The proposed changes to the statutory management regime may have a chilling effect on the willingness of overseas insurers to enter into, or remain in the New Zealand market. The

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16 Consultation paper, section 9.2.

17 For example, the public notices required by the Financial Markets Authority Act 2011, and the New Zealand Markets Disciplinary Tribunal

18 Above n 2.

application, or potential application of, the statutory management framework under the Corporations (Investigation and Management) Act 1989 (**CIMA**) does not appear to be well understood overseas, and its application beyond banking and insurance regulation (where there is not the same risk of significant damage to the financial system) is open to question.

8.2 We acknowledge the reasons provided in the consultation paper for the proposed changes to the trigger mechanism for statutory management. However, the consultation paper does not address why it is appropriate to include a reference to "avoid[ing] significant damage to the financial system or the New Zealand economy" in the purpose statement for distress management, when it proposes to remove the same type of systemic risk from the trigger for statutory management.

8.3 In addition, we are not sure the absence of the 'financial system' requirement in either CIMA or DTA is particularly relevant, when arguably, neither of the statutory management regimes under those enactments necessarily involve businesses under prudential supervision with the type of system-wide significance.

8.4 For the avoidance of doubt, the Law Society is not suggesting these matters are by any means decisive, but identifies them as matters which require careful policy consideration. We recommend RBNZ give further thought to these potential unintended consequences of the proposed changes.

9 Other issues

9.1 We acknowledge the reasons in the consultation paper for not altering the existing exemptions for small insurers, and agree there is no compelling case for a *de minimis* compliance regime for small competitors.

9.2 Similarly, we acknowledge the reasons provided in the consultation paper for not responding to calls to alter the holding out and restricted words provisions. In the absence of any evidence of behaviour which points to a pattern of activity, or the exploitation of a regulatory gap that puts consumers at unnecessary risk, there are other avenues for addressing instances of misleading and deceptive behaviour (such as raising the matter with the Commerce Commission).

Coordination with other agencies

9.3 We understand that implementation of the Financial Markets (Conduct of Institutions) Amendment Act 2021 will mean insurers who are subject to prudential supervision will also be licensed under the FMCA. This addresses questions about whether consultation with the Financial Markets Authority (**FMA**) would be necessary if the relevant entity was not also under the jurisdiction of the FMA.

9.4 We also acknowledge the reasons given in the consultation paper for the distinction between:

(a) consulting the FMA before issuing or revoking a licence under the IPSA; and

(b) not mandating formal consultation with the FMA when making decisions under the proposed statutory approval process for significant transactions.

9.5 The Law Society is generally supportive of these reasons for differentiating between the two-types of decision-making processes. However, we emphasise the need for certainty as to:

(a) how RBNZ and FMA would consider significant transactions in a coordinated way; and

(b) the process timeline, evidential requirements and relevant considerations for the approvals process for significant transactions.

9.6 In the absence of an alternative solution, it may be appropriate to provide more certainty by addressing these matters in the enhanced guidance about the proposed new supervisory approval processes (referred to in section 8.3 of the consultation paper).

10 Next steps

10.1 We hope this feedback is useful. Should you have any questions, or wish to discuss this feedback further, please do not hesitate to get in touch via the Law Society's Senior Law Reform & Advocacy Advisor, Nilu Ariyaratne (Nilu.Ariyaratne@lawsociety.org.nz).

Nāku noa, nā

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