TE TAI ŌHANGA
THE TREASURY

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

SAFEGUARDING THE FUTURE OF OUR FINANCIAL SYSTEM

Further consultation on the prudential framework for deposit takers and depositor protection

Submission form

To have your say on these important issues, please answer the questions below and send this form by email to rbnzactreview@treasury.govt.nz by 5pm on 23 April 2020.

To get more information on these topics and the wider Reserve Bank Act Review, see the full consultation document at treasury.govt.nz/rbnz-act-review.

Chapter 5

Liability and accountability

In this section we provide general feedback about the proposals set out in chapter 5 of the consultation (regarding directors of deposit takers accountability and liability). By way of background, ICNZ's members are general insurers that insure about 95 percent of the New Zealand general insurance market, including about a trillion dollars' worth of New Zealand property and liabilities. ICNZ members provide insurance products ranging from those usually purchased by individuals (such as home and contents, travel and motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability, business interruption, professional indemnity, commercial property and directors and officers insurance).

Careful attention needs to be taken to ensure any new director accountability regime is clear and rationalised with existing obligations, with a view to avoiding duplication and inconsistencies. In this regard, we note the potential tension between directors' existing duties under the Companies Act 1993 to the company, shareholders and creditors and those under the proposed Deposit Taker regime to the public at large/society.

From an insurance perspective, having clear and properly integrated directors' obligations is important because, in so far as exposures are insurable, insurers need to assess risk before underwriting it and the clearer and more predictable the regime is, the more confidence there will be in underwriting it and pricing it appropriately. Conversely, uncertainty results in insurers being less inclined to write the risk or a premium loading being applied (increasing the price for the insurance). Having a clear and rationalised regime also means it is less likely that parties (including insured parties) will need to initiate expensive and time-consuming litigation to get clarity on matters from the courts.

Insurance response to proposed exposures

For completeness, below we provide details about the potential insurance response to the proposed director and officer liability exposures outlined in this chapter to inform decision-making in this regard. We do so without expressing any particular views on this matter.

Insurance market for Directors and Officers insurance

Directors and Officers (**D&O**) insurance has been undergoing a sustained period of market hardening over recent years, with increasing rates and scrutiny being applied when underwriting this line of business, reflecting increased claims costs and trends.[1] It is expected the COVID-19 outbreak, and the resulting lockdowns and recession, will put further pressure on this line, consistent with what occurred following the Global Financial Crisis in 2007-2008. Accordingly, to the extent these new exposures are insurable, it should not be assumed that D&O insurance will be readily available or affordable in all cases.

Insurability of fines and penalties

While the particular structure of liability insurance policies vary between policy wording and insurer, the standard approach is for insurance for fines and penalties under legislation to be covered under a Statutory Liability insurance, with D&O insurance generally excluding these exposures.[2] Where fines and penalties are covered under Statutory Liability insurance, generally there will also be cover for related legal defence costs incurred.

Cover under Statutory Liability insurance is limited to unintentional breaches of legislation (i.e. those strict liability offences where there is no mens rea or mental element); there is no cover for the intentional or reckless commission of an offence. Obviously, this insurance also excludes cover for penalties and fines uninsurable at law. Other exclusions will apply, the specifics of which will depend upon which Statutory Liability insurance is involved. In the context of this consultation, we assume that the distinction being drawn between 'civil' and 'criminal' penalties, which relate to more serious matters where the offence in question includes a mental element, with 'civil' penalties being less serious and not having the mental element. That is, as opposed to 'civil' action brought by a third party, rather than a 'criminal' prosecution bought by a government agency.[3]

Reliance on the insurance market as an additional layer of scrutiny

In the consultation document reference is made to potentially relying on the insurance market as a layer of external monitoring for the regime. While it is correct that insurers will, in assessing whether to accept the relevant risk, examine what mechanisms are in place to ensure directors and boards are meeting their legal obligations, it would not be prudent for regulators to rely upon this as a layer of protection. Mechanisms directors and boards have in place are only one of numerous factors that insurers will consider in assessing risk and it is possible that risks are not accepted even where such mechanisms are in place (for example, because the risk falls outside the insurer's particular risk appetite, previous claims and/or due to concerns with related parties).[4] It is also possible that the directors elect not to take insurance cover independent of what mechanisms they have in place, and we reiterate the comments made about availability and affordability in this regard.

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[1] D&O market at its hardest in living memory – report, https://www.insurancebusinessmag.com/nz/news/breaking-news/dando-market-at-its-hardest-in-living-memory--report-234587.aspx. See also, https://www.iod.org.nz/resources-and-insights/publications/insights/under-pressure-d-and-o-insurance-in-a-hard-market/#.

[2] For completeness in some cases both Statutory Liability and D&O insurance may be provided in a broader liability suite with other liability covers or as part of a broader insurance package covering physical assets and other exposures (e.g. business interruption). Alternatively, Statutory Liability may be provided as a separate and distinct policy or as a benefit/extension under a separate broad form Public/General Liability policy.

[3] In this context it would be helpful to clarify what the reference to 'financial loss' in the consultation document is referring to. Specifically, is this intended to refer to directors' potential liability to either third parties for damages (civil liability) and regulations (penalties under legislation).

[4] Other matters that may be considered include insurers asking detailed questions around the financial position and performance of a company, solvency, business continuity plans, the pandemic's impact on employees, customers and supply chains, and for listed companies, how disclosures to shareholders are being managed.

Chapter 6

Supervision and enforcement powers

On-site powers

6.A Do you agree that the on-site power for the AML/CFT regime is an appropriate comparator for a similar power for the Reserve Bank's prudential functions?

6.B Should this power be a generic power in the new Institutional Act, or specified in the Deposit Takers Act?

6.C Do you think any additional safeguards are necessary for the on-site power?

6.D Do you think the FMA's on-site inspection power should be expanded in the same way that is proposed for the Reserve Bank?

6.E Should an expanded FMA on-site inspection power apply in all circumstances and to all FMA-regulated entities or only some (e.g. in high-risk circumstances or for dual prudential-conduct regulated entities)?

Introductory comments

This consultation focusses on the prudential framework for deposit takers and depositor protection. Given that, we were surprised to discover that the proposals in this chapter relate to all entities the Reserve Bank, as prudential supervisor, regulates (including licensed insurers). In our view this is something that should have been signalled more clearly and there is a risk that other parties that may have an interest in providing feedback are unaware of it. This ought to be avoided in the future. This same procedural failing is even greater in respect of the proposals to expand the FMA's powers buried in the middle of this consultation document.

The comments below relate to licensed insurers, although it may be that they are also applicable more generally.

6.A Do you agree that the on-site power for the AML/CFT regime is an appropriate comparator for a similar power for the Reserve Bank's prudential functions?

While there are some logical elements that can be drawn on in this regard,[5] we do not agree that the on-site power under the AML/CFT regime is an appropriate model for the proposed on-site power. The most obvious reference point from our perspective would be the Reserve Bank's existing inspection and supervision powers focussing upon any identified deficiencies in these respects.

The AML/CFT and Reserve Bank prudential supervision regimes are fundamentally different with specific focusses and scopes:

- The AML/CFT regime has a discrete and specific crime-related focus, designed to detect and deter illegal criminal activities related to money laundering and terrorism financing.
- Conversely, the Reserve Bank has a broad supervisory role extending to a range of regulated entities, with wide-ranging powers to promote the maintenance of a sound and efficient financial system, with an emphasis on three disciplines (market discipline, self-discipline and regulatory discipline).

[5] For example, the structure and language to be used for providing for an on-site inspection power.

Given the differences, it is not considered that the protections provided under the AML/CFT regime,[6] would be sufficient to prevent misuse, particularly given the Reserve Bank's broad supervisory remit. For example, we would be wary of this power being used to undertake a wide-ranging 'fishing expedition' without any apparent justification. The reference in the consultation document to the on-site inspection mechanism being a 'generic power' and 'pre-emptive' is particularly concerning in this context.

As further outlined in the 'Any other comments' section below, such a heavy handed approach risks undermining the relationship of genuine trust, mutual respect and collaboration which the insurance industry has worked hard to establish and maintain with the Reserve Bank (and vice versa), and there are sound reasons for an on-site inspection power to include a notice requirement, as this ensures the inspection is conducted as efficiently and productively as possible.

6.B Should this power be a generic power in the new Institutional Act, or specified in the Deposit Takers Act?

Whatever powers are considered appropriate, they should be included in the relevant sectoral acts (such as the Deposit Takers Act and Insurance (Prudential Supervision) Act 2010) rather than in the Institutional Act.[7] This reflects that each sector regulated by the Reserve Bank is different and it is important that this is reflected in the relevant regulatory regime, with different and appropriate treatment applied to each.[8] In general terms, in our view, care should be taken not to adopt consistency for consistency sake as this may lead to unintended consequences and mechanisms applying where there is no justification for them or which do not work well in practice. The fact that sectors regulated by the Reserve Bank are so different reinforces our concerns in this regard. If a sectorial approach is adopted, it may be more appropriate to consider the proposed power in so far as it related to insurers in the context of the upcoming review of the Insurance (Prudential Supervision) Act 2010.

We also note that the Institutional Act focuses on the institutional arrangements of the Reserve Bank rather than its prudential supervision powers so this would not appear to be the appropriate place for this power in any event.

In broader terms, as outlined in the 'Any other comments' section below, it is unclear to us what the justification for introducing a without notice on-site inspection power for licensed insurers is. In this regard, we also note that the application of on-site inspection powers agreed to by Cabinet related to deposit takers only.[9]

6.C Do you think any additional safeguards are necessary for the on-site power?

We consider that additional safeguards are necessary for any on-site power considered appropriate, given its broad scope and potential application.

We question how much protection would be afforded by the on-site inspection power being limited to accessing business premises at a 'reasonable time'. We suggest that an additional protection be introduced requiring inspections to be conducted following 'such period of notice as is reasonable in the circumstances' or with reference to a prescribed reasonable minimum timeframe in which notice must be given. Further details about the rationale for including a notice requirement are set out in the 'Any other comments' section below.

[6] For example, a reasonableness test and requirement for the person completing the inspection to be suitably qualified.

[7] Introduced to Parliament as the Reserve Bank of New Zealand (RBNZ) Bill.

[8] Consistent with this, on page 98 of the consultation document, it is indicated that regulated banks, insurers, financial product issuers and crowdfunding platforms each raise different types of risks and are subject to different supervisory and monitoring approaches.

[9] https://www.treasury.govt.nz/sites/default/files/2019-12/prudential-regulation-deposit-takers-dev-19-sub-0346-4223657.pdf.

While we believe it would be highly unlikely that documents would be destroyed upon receipt of any notice of inspection, if there was evidence of this, consideration could be given to introducing an offence equivalent to that recently introduced under the Privacy Act 2020.[10]

If this view is not accepted (and a without notice on-site inspection power is to be progressed):

- In general terms, in framing this power, an evidenced-based approach needs to be taken, drawing upon previous events where it has been determined having such a power would have prevented significant 'social harm'. In particular, the power should be structured in such a way that its usage is limited to those extreme situations where it is clearly established that the supervisory tools are insufficient, noting that in the consultation document it is indicated that general practice is to issue de facto notices of inspection.[11]
- A detailed cost benefit analysis of the proposal should be undertaken, noting the seriousness of the rights and freedoms potentially infringed and the risk of undermining the relationship of genuine trust, mutual respect and collaboration between the Reserve Bank and the entities it regulates.
- Consideration should be given to including a requirement to obtain a court-ordered warrant before any without notice on-site inspection is conduction, acting as a check on the appropriate usage (e.g. when there is evidence of noncompliance).
- Clear guidance should also be prepared by the Reserve Bank setting out their supervisory approach in more detail including the specific circumstances they would look to evoke the without notice inspection power.

It is not possible to meaningfully comment on the proposed safeguards regarding the authorisation/approval of persons carrying out inspections, the requirements for them to be properly authorised and trained, and confidentiality protections, without having more detail about what is specifically proposed in these respects.

6.D Do you think the FMA's on-site inspection power should be expanded in the same way that is proposed for the Reserve Bank?

It is unclear to us what demonstrated problem warrants such a wide-ranging FMA on-site inspection power being introduced. The consultation document refers to FMA's current monitoring and supervision activities, including off-site information requests and on-site visits, which appear to work well. Additionally, the insurance industry has worked hard to foster a positive relationship with the FMA built on mutual trust and respect and there is a risk that the introduction of this power would undermine this. The effectiveness of current arrangements have recently been demonstrated during the culture and conduct review and during the COVID-19 outbreak and resulting lockdowns, with good collaboration between insurers and the FMA occurring, and proactive work being undertaken by insurers to ensure good customer outcomes in this regard.[12]

Additionally, as outlined in the consultation paper, providing notice before inspection aligns with general international practice for market conduct regulators.[13] Also, as indicated in the 'Any other comments' section below, there are practical reasons for providing notice before an on-site inspection occurs. We query whether a without notice inspection of a recently licensed Financial Advice Provider (**FAP**) to verify whether they have processes and compliance staff in place in line with their licensing application, as described in the consultation document,[14] would provide the FMA with any additional benefit. Providing reasonable notice in this case would enable a more meaningful engagement as the FAP will have time to ensure relevant staff and information on

[10] See section 212(d) of the Privacy Act 2020, which provides that a person commits an offence and is liable on conviction to a fine not exceeding $10,000, if they destroy any document containing personal information, knowing that a request has been made in respect of that information under subpart 1 of Part 4 of that Act.

[11] Page 96 of the consultation document.

[12] Specifically, at the outset of the first Government lockdown (in late March 2020), ICNZ and its members promptly announced a set of 10 core principles they have each pledged to use to guide their individual response to support consumers during the COVID-19 crisis. These principles reflected a commitment to respond flexibly and responsibly to those in financial hardship or who were otherwise vulnerable.

[13] See page 98 of the consultation document.

[14] Page 98 of the consultation document.

compliance processes are readily available. In the rare event that a FAP did not have the necessary processes and staff in place, it is highly unlikely that they could rectify this during the notice period. It would also appear to us that such issues would be better dealt with the FAP upfront via the licensing process rather than via without notice on-site inspection.[15]

As a general observation, consistent with our introductory comments above, we consider that, in terms of policy development and regulatory reform, it is highly unusual that such a significant proposal for extending the powers of the FMA is buried in a review of Reserve Bank arrangements for deposit takers and depositor protection. In our view this is something that should have been signalled more clearly or included in FMA specific consultation and there is a significant risk that other parties that may have an interest in providing feedback are unaware of it as they would otherwise have no reason to be considering this review. Many entities regulated by the FMA are not regulated by the RBNZ.

It is important that the FMA's supervisory powers are appropriate to its various roles and we recognise achieving this may require legislative changes in some areas. Consultation of these matters should be explicit, open and subject to a dedicated process, involving engagement with the all the types of entities the FMA regulates.

6.E Should an expanded FMA on-site inspection power apply in all circumstances and to all FMA-regulated entities or only some (e.g. in high-risk circumstances or for dual prudential-conduct regulated entities)?

As outlined above, it is unclear to us what demonstrated problem warrants such a wide-ranging power being introduced. In our view the risk-based approach taken by the FMA on supervisory matters remains appropriate. We are concerned by the reference in the consultation document (FAP example) that: "*…the FMA may not have evidence or reasons to believe the FAP was breaching a regulatory obligation so would not have grounds to obtain a warrant*."[16] Similarly, the reference to the 'flexibility'[17] afforded to the FMA under the proposed without notice inspection power is concerning. Such a cavalier approach risks substantially undermining the constructive working relationships that have developed between the FMA and insurance entities it regulates and the appropriate judicious execution of FMA's supervision powers.

Other supervisory powers

6.F Do you have any comment on the appropriate legislative location of supervisory powers such as information gathering and sharing, on-site inspections, and other related powers? Do you see merit in consolidating similar powers from sectoral Acts into the Institutional Act?

Consistent with our comments above, we consider that such powers (if at all appropriate), should be located in the applicable sectoral Acts, so they can be tailored as appropriate for each regulated sector. As earlier indicated, we do not consider that a one size fits all approach is appropriate. Potentially this could lead to unintended consequences and mechanisms applying where there is no justification for them, or which would not work well in practice. From an insurer perspective, it may be more appropriate to consider this matter in the upcoming review of the Insurance (Prudential Supervision) Act 2010.

Breach reporting

[15] If the FMA had concerns about whether the FAP had the appropriate processes and compliance staff in place surely they should not have been granted the FAP license in the first place.

[16] Page 98 of the consultation document.

[17] Page 98 of the consultation document.

6.G Should a breach-reporting requirement be directly provided for in legislation? Should this be provided for in the Deposit Takers Act, or located in the Institutional Act as a requirement for all entities regulated by the Reserve Bank?

Consistent with the comments made above, to the extent relevant, any breach-reporting requirements should be located in the relevant sectoral Acts so they can be tailored as appropriate to each regulated sector. As earlier indicated, we do not consider that a one size fits all approach is appropriate. Potentially this could lead to unintended consequences and mechanisms applying where there is no justification for them, or which would not work well in practice.

In so far as this matter is relevant to insurers it would be more appropriate to consider this in a dedicated and thorough manner in the upcoming review of the Insurance (Prudential Supervision) Act 2010.

Any other comments?

While we support the objective to protect and promote financial stability, we do not consider that such a wide-ranging inspection power (i.e. a broad warrantless and noticeless on-site inspection power), is warranted in so far as the insurance industry is concerned. In this regard we note the following:

- The Reserve Bank has positive and constructive engagement with licensed insurers under the current Insurance (Prudential Supervision) Act 2010 regime[18] and it is unclear what problems warrants such a significant new power being introduced.[19] On-site engagement with the Reserve Bank already occurs in a regular and routine fashion as part of their prudential supervisory cycle and additionally, by way of a recent example, the culture and conduct and Appointed Actuary thematic reviews for insurance companies. The effectiveness of these current arrangements with insurers has also recently been demonstrated during the COVID-19 outbreak and resulting Government mandated lockdowns, with good collaboration between insurers and the Reserve Bank and insurer reporting occurring.
- Introducing such a significant power suggests that there is a problem that needs solving (e.g. because the Reserve Bank is currently not getting what it needs from insurers or they hold concerns about the veracity of the information provided by them), which is not the case from our perspective or the information as presented in the consultation document. It would be extremely unlikely for an insurer to ever refuse to consent to any engagement, visit or request from the Reserve Bank so in that regard the powers seem not only unnecessary but disproportionate. Introducing such a power also runs the risk of undermining the relationship of genuine trust, mutual respect and collaboration which the insurance industry has worked hard to establish and maintain with the Reserve Bank (and vice versa). Additionally, we do not believe such an approach would be consistent with the commitments in the Reserve Bank's Relationship Charter.[20]
- We do not consider that consistency with overseas jurisdictions in and of itself would be sufficient grounds to warrant this change being made, particularly given (as outlined above) no problem with the current inspection power has been identified. Regard also needs to be had to the unique New Zealand context (e.g. a small economy with generally co-operative market participants). We also note that, as has been indicated in the consultation document APRA in Australia, the closest regulatory jurisdiction to us, does not have any equivalent formal on-site inspection power.[21]
- Additionally, it is important to reflect that the application of on-site inspection powers agreed to by Cabinet related to deposit takers only,[22] and the proposal to now extend this to licensed insurers and other regulated entities appears to be somewhat of an afterthought.

It is also unclear to us what this, and the potential introduction of a wide-ranging inspection power, means for the Reserve Bank's three pillar approach to prudential regulation (market discipline, self-discipline and regulatory discipline), as they seem somewhat inconsistent.

Additionally, there are practical reasons why providing sufficient notice before an in-site inspection is important. Specifically, this ensures that the inspection occurs as efficiently and productively as possible. Expanding upon this, providing sufficient notice allows for the regulated entity to:

- Task the appropriate personnel within the organisation to lead the engagement with the Reserve Bank, to understand the information being sought in broad terms and coordinate the on-site inspection. These

[18] See sections 131 and 132 of the Insurance (Prudential Supervision) Act 2010 which provides for powers to obtain information or documents and enter and search a place, respectively.

[19] For instance, it is unclear to us whether any Reserve Bank request to undertake an on-site visit has ever been declined..

[20] https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/Statements-of-approaches/RBNZ-Relationships-Charter-final.pdf?la=en

[21] We also note that Table 6.1 in the consultation document appears to be referring to on-site activities generally rather than of a specific type.

[22] https://www.treasury.govt.nz/sites/default/files/2019-12/prudential-regulation-deposit-takers-dev-19-sub-0346-4223657.pdf.

personnel will be the officers within the organisation who have a good working understanding of the entity's structure, processes and information repositories, the Reserve Bank's functions, responsibilities and standard lines of inquiry, as well as the formal engagement process. Their involvement also ensures that the entity can provide the Reserve Bank with any wider contextual information and explanation of operational practices in advance of an inspection to help ensure the focus is on the pertinent areas.

- Identify, generate and/or collate the information the Reserve Bank is interested in in one place, noting that this may be spread across different physical offices or computer systems.
- Make relevant individuals with skills and experience in the areas the Reserve Bank is interested in available, noting that they may need to travel from other cities or countries. This issue is particularly pertinent given the trend for people work from home, which has recently been accelerated by the COVID-19 outbreak and the resulting Government mandated lockdowns.

If notice is not to be provided before inspection there is a serious risk that the inspection results in a sporadic, incomplete or at worst an inaccurate picture of the matters the Reserve Bank is interested in.

Where information collected from an on-site inspection is shared with another regulator about a regulated entity, we believe that regulated entity should be advised of the nature of the information shared and who it has been shared with. This is consistent with the Reserve Bank's commitment to honesty and transparency under their Relationship Charter. This would also provide the regulated entity with an opportunity to provide their views to the party who has been provided with this information.

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