ICNZ Insurance Council of New Zealand

Submission by

The Insurance Council of New Zealand

on

Governance Guidelines – Licensed Insurers

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Terry Jordan
Manager, Finance & Regulation

Telephone:	**04 495 8002**
Fax:	**04-473 3011**
Email:	**terry@icnz.org.nz**

A SUBMISSION IN RESPONSE TO GOVERNANCE GUIDELINE ISSUED JANUARY 2011

Introduction

1. The Insurance Council of New Zealand (the **Council**) is pleased to make this submission to the Reserve Bank of New Zealand (**RBNZ**) on the Governance Guidelines – Licensed Insurers issued in January 2011 (the **Guideline**).

General Comments

2. The Council generally welcomes the guidance which will be of considerable assistance as insurers prepare their applications for licensing and move to submit those applications in 2011.

3. Having said that, we interpret the Guideline as a set of guiding statements which are not intended to be applied inflexibly to all licensed insurers. We assume instead that the diversity of the insurers operating in the New Zealand market will be recognised (in keeping with the principles in section 4 of the IPSA) and that Board composition considerations, in particular, will form only part of the overall assessment made by the RBNZ in assessing an applicant's corporate governance arrangements.

4. We also note the philosophy and approach underlying the Guideline is consistent with that taken by regulators in a number of overseas jurisdictions. The Council notes, in particular, the similarities in approach between the draft OECD Guidelines on Insurer Governance (issued as a public consultation document in September 2010, although still in draft at the time of this note to the RBNZ)[1], the Guidelines on Corporate Governance for Banks, Financial Holding Companies and Direct Insurers incorporated in Singapore (issued by the Monetary Authority of Singapore in December 2010)[2], and Prudential Standard GPS510 issued by APRA in November 2009.[3]

5. While we note these similarities in approach we also record our concern in relation to the Guideline's aspiration to reflect moves by regulators of financial institutions in other jurisdictions to treat insurers on a basis similar to banks (in terms of corporate governance). We consider that corporate governance expectations applicable to institutions operating in markets outside New Zealand should not be automatically applied to insurers operating in this market.

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[1] OECD *(Draft revised) OECD Guidelines on Insurer Governance* Public Consultation (September 2010).
[2] Monetary Authority of Singapore *Guidelines on Corporate Governance for Banks, Financial Holding Companies and Direct Insurers which are incorporated in Singapore* (9 December 2010).
[3] Australian Prudential Regulation Authority *Prudential Standard GPS 510 "Governance"* (November 2009).

Is there any need for regulatory intervention in governance processes?

6. We submit that care should be taken in designing the regulatory interventions in governance processes relating to insurers, for the following reasons:

   (a) the insurance market in New Zealand has proven stable (and withstood financial shocks) over a long period of time in a lightly regulated environment;

   (b) governance regulations for banks should not be applied to insurers because insurers are fundamentally different in nature from banks (especially in relation to the risk that they pose to the overall health of the financial sector); and

   (c) there are a large number of foreign insurers operating in New Zealand that are already subject to extensive "home" jurisdiction governance requirements.

7. We expand on these points in the paragraphs below:

Historical stability of the Insurance market

8. The New Zealand insurance market has been described as "stable and well managed over time".[4] The industry has been praised as being pro-active in its promotion and facilitation of an effective self regulatory environment under a light-handed regulatory model.[5]

9. Despite the stresses created by the global financial crisis in 2008 - 2009, the New Zealand insurance market has withstood financial shocks well. There has been nothing to suggest that the governance frameworks for insurers operating in New Zealand have been deficient or ineffective.

Differences between Banks and Insurers

10. We also note that:

    (a) In an environment that is historically stable and has never seen *bancassurance*, banking regulatory principles should not automatically translate to the insurance sector. The basis of insurance (where the receipt of money is not automatically tied to a return of money to a consumer) is very different from the basis of banking (where the only reason for receiving money from a consumer is to lend it out to another consumer).

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[4] Ministry of Economic Development *Review of Financial Products and Providers: Insurance* Discussion Document (September 2006) at page 13.
[5] Ibid, at page 13.

(b) There is extensive research confirming that the systemic and market risks to which insurers are exposed, and the degree of interconnectivity between insurance institutions, is significantly lower for insurance institutions when compared to banks. As a result the risk profiles of insurers and banks differ fundamentally. [6]

(c) Commentators have identified at least four key differences between the insurance and banking sectors: differences in business models, differences in risk profiles, differences in their respective roles in the economy, and differences in systemic relevance, and have concluded that the imposition (on the insurance sector) of regulatory reforms applicable to the banking sector is the wrong regulatory approach, and risks permanently weakening the insurance business model and the stabilising role that insurance plays in the economy.[7]

(d) In relation to systemic risk in particular, other commentators have concluded that insurers do not create systemic risk in the economy; rather they suffer from systemic events caused by failures in other financial sectors. Insurers, therefore, do not require the same level of regulation that is necessary to protect the financial sector as a whole from systemic failure.[8]

(e) Therefore, reforms which may have been considered in relation to banks in the period following the global financial crisis are not, in the Council's opinion, appropriate for application to insurers.

Offshore insurers in the New Zealand market

11. The Council also notes the high number of foreign-based insurers operating in New Zealand. These organisations typically have substantial financial resources, robust and well proven risk management policies, immense pools of experience within the group, and brands, reputations and business operations which span multiple markets. They understand that a failure of the business in any single market could have broad reputational and financial consequences on the organisation as a whole, and they manage their businesses to avoid risks to policyholders and other stakeholders. Finally, they are typically extensively regulated in their "home" markets and governance frameworks throughout the organisation reflect those "home jurisdiction" requirements.

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[6] See, for example, the following papers: CEA *Insurance: a unique sector - why insurers differ from banks* (June 2010); and Mary A Weiss *Systemic Risk and the US Insurance Sector* (Center for Insurance Policy & Research, National Association of Insurance Commissioners, 23 February 2010).
[7] CEA Paper, at page 6
[8] NAIC Paper, pages 34-35.

Summary

12. Against this background we believe that there is no pressing argument for reform of governance arrangements affecting insurers operating in the local market. There is no "problem" which needs "fixing" in the local insurance industry. Rather, the IPSA forms part of a financial services reform program that is desirable and important to garner local and international business confidence.

Legislative background

13. It should be noted that insurers operating in New Zealand are already subject to the following generic legislative requirements:

    (a) sections 131-145 of the Companies Act 1993 codify the duties owed by directors. The core duty owed by directors (section 131) is to act in good faith and in what the director believes to be in the best interests of the company.

    (b) In addition, under section 135, a director of a company must not agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors (which would, in the case of insurance companies, include policyholders).

    (c) section 131(2) of the Companies Act permits a director of a company, if expressly permitted to do so by the constitution of the company, to act in a manner which he or she believes is in the best interests of the company's holding company, even though it may not be in the best interests of the company.

    (d) However, section 221 of the IPSA negates the ability for directors to act in the best interests of the holding company, thereby requiring a focus solely on the best interests of the company.

    (e) As a result, Boards of insurance companies licensed under the IPSA will be under a clear and unequivocal duty to act solely in the best interests of the company, and not in the best interests of any other member of the corporate group of which the company may form part.

14. It is also relevant to note the robust prudential requirements introduced through the IPSA, and the extent to which such requirements will provide effective protection for policyholders and will limit the exercise of directors' discretions and powers. These prudential requirements include:

(a) solvency standards, prescribing the maintenance and reporting of minimum capital requirements;[9]

(b) mandatory financial strength rating requirements and duties to disclose changes in ratings to policyholders;[10]

(c) risk management programmes to assess risk;[11]

(d) actuarial requirements that create broad powers of review and access to information;[12] and

(e) wide monitoring and enforcement powers by the RBNZ as the prudential regulator.

15. The combined effect of focusing directors' duties on the company alone (rather than any other member of the corporate group), and application of robust prudential requirements, is that policyholders' interests will be thoroughly protected.

Status of the Guideline

16. We assume that the RBNZ will assess, in relation to each insurer, the nature and size of the insurer's business, the size and type of insurance business to be written, and the type of risks to be insured (see paragraph 7 of the Guideline), when considering whether the expectations outlined in the Guideline are appropriate for application to that particular insurer.

17. We are however concerned to note the indication (in paragraph 50 of the Guideline) that "all" persons intending to carry on insurance business in New Zealand "should ensure that their arrangements comply with the Guideline". This statement could be interpreted as indicating that the RBNZ is intending to apply a "one size fits all" approach to application of the Guideline, which would be inconsistent with the more flexible indication contained in paragraph 7 of the Guideline.

18. We request that the precise status of the Guideline, including whether it will be rigorously applied in every case or applied having regard to the circumstances of each applicant insurer, be more clearly indicated when the final version of the Guideline is issued.

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[9] For example, sections 55-59 of the IPSA.
[10] Sections 60-71 of the IPSA.
[11] Sections73-75 of the IPSA.
[12] Sections 76-80 of the IPSA.

Flexible application of the Guidelines will be essential

19. In our view it would not be appropriate to adopt an inflexible "one size fits all" approach to the application of governance expectations to individual insurers operating in this market, either in terms of criteria and controls which have been developed and applied to other financial institutions such as banks, nor by applying (to the New Zealand insurance market) standards developed in overseas jurisdictions.

20. A flexible approach to the application of governance principles would also reflect the IAIS Principles - particularly the focus on designing regulatory frameworks for insurers that are specific to the domestic context, rather than simply implementing a set of global standards.[13]

21. This theme is evident in the principles outlined in section 4 of the IPSA. Those principles clearly envisage a "balancing exercise". The standards and expectations necessary to achieve sound governance (section 4(i)) need to be judged in the light of the other principles outlined in section 4 including, in particular: the need to avoid unnecessary compliance costs (section 4(h)), the need to maintain competition within the insurance sector (section 4(g)), the importance of maintaining the sustainability of the New Zealand insurance market (section 4(b)), the importance of recognising that it is not a purpose of the IPSA to eliminate all risk of insurer failure (section 4(d)) and (importantly) the desirability of consistency of treatment of **similar** institutions, while recognising that the insurance market in New Zealand comprises a diversity of institutions (section 4(f)).[14]

22. Viewed in this light, we do not believe that it is necessary or appropriate, that **all** of the expectations outlined in the Guideline be imposed on locally incorporated insurers who are members of large, well resourced, and well governed, groups that are subject to extensive regulation in their "home" markets.

23. We do recognise however that a greater degree of intervention might be warranted in relation to less well resourced, and less experienced insurers who may not have the internal disciplines and experience to accurately assess and manage risks. Even then we doubt that governance intervention will be sufficient (on its own) to prevent failures in such insurers.[15]

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[13] International Association of Insurance Supervisors *Insurance Core Principles and Methodology* (October 2003), at page 6.

[14] Section 4 of the IPSA.

[15] See Janet Lockett "The General Insurance Market in New Zealand - Developments since 2002" Paper presented to the New Zealand Society of Actuaries Conference (Queenstown, November 2006) at page 10.

Governance structure

24. We agree with the observation (paragraph 22 of the Guideline) that each licensed insurer's governance structure needs to be sufficiently sophisticated to ensure effective oversight of its activities, while taking into account the size and nature of its business. We fully endorse the suggestion that there should also be processes in place to provide the governing body of each insurer with information to identify, monitor and manage risks (paragraph 23 of the Guideline). Finally, we endorse the suggestion that governance arrangements should be transparent to shareholders through the inclusion of a corporate governance statement in the annual report, and agree that information about the directors and how the governing body of the insurer operates (including any committees) should be outlined in the insurer's annual report.

Board composition

25. We note the proposals in paragraphs 26 and 27 of the Guideline to the effect that the number of directors and their skills and background, should reflect the size and nature of the insurer's business. It makes sense that larger and more complex insurers may require larger boards which draw on a broader base of expertise than is necessary or appropriate for smaller insurers, or insurers that focus only on particular categories of risk.

Independence

26. Our key concern is the proposal (in paragraphs 29 and 30 of the Guideline) that the chair (or equivalent of the governing body of an insurer) should be an independent, non-executive director, and that at least half of the directors should also be "independent" (we address the criteria for "independence" below).

27. We note that the proposed requirements for establishing "independence" reflect the OECD Guidelines on Insurer Governance (Public consultation version - September 2010) and the approach taken by APRA and MAS.[16]

Policy

28. We assume that, consistent with the principles set out in section 4 of the IPSA and the purpose of the Guideline (especially as evidenced in paragraph 7 of the Guideline), the "expectations" outlined in paragraphs 29 and 30 of the Guideline will be applied, or waived (as appropriate) as the circumstances require. We particularly note that:

[16] See footnotes 1, 2 and 3.

(a) There is debate in the academic literature as to whether a fixed requirement for "independence" on the Board actually enhances corporate governance, particularly where entities operate in well regulated or public markets.

(b) A further issue identified in the New Zealand context is New Zealand's relatively small pool of qualified and experienced directors. If all of the insurers operating in the New Zealand market (which is understood from previous discussions to be at least 140) were rigidly required to give effect to the guidance contained in paragraphs 29 and 30 of the Guideline, at least 280 suitable persons would have to be found to be appointed as independent directors of the insurance companies operating in the New Zealand market. In this market, finding suitably qualified and experienced insurance directors could be problematic.

(c) Given the broad requirements for determining "independence" (see below), cross directorships could also be challenging.

(d) Publicly available information shows that similar issues were identified in Singapore, during the consultation process in relation to the "Insurance Corporate Governance Regulations and Guidelines".[17] The New Zealand market is significantly smaller again and it can be expected that the impact of this issue in the New Zealand context would be magnified.

(e) As a result, there is a real question as to whether this requirement, if rigorously implemented, is practical and achievable in a New Zealand context.

29. More fundamentally, we do not believe that any requirement for "independent" participation on an insurer's board is necessary where the insurer meets local solvency requirements and is a wholly owned subsidiary within a sophisticated and well resourced multi-jurisdictional group. We invite discussion on the extent to which the RBNZ is interested in supervision of offshore parents by offshore regulators and the raft of controls and liaison which cascade to the local operation from an offshore parent.

MAS Example

30. We refer to the Insurance (Corporate Governance) Regulations 2010 in Singapore and submit that this “flexibility” factor has been recognised by MAS. These regulations require "significant insurers" (being life insurers who are incorporated in Singapore and

[17] Monetary Authority of Singapore "Response to Feedback received on Corporate Governance Guidelines and Regulations" (September 2005) at page 6.

who have total assets in excess of $5 billion) to ensure that a majority of the directors on the board of the entity are "independent". Insurers who are not "significant insurers" are subject to the Guidelines on Corporate Governance promulgated by MAS. Those Guidelines **recommend** that "direct insurers" have at least 1/3 of their directors comprised of independent directors. However, **this requirement is not mandatory** for insurers who are not "significant insurers".

31. The approach taken by MAS indicates a degree of flexibility and a recognition that "one size does **not** fit all" in terms of the application of the independence model recommended in that market.

Flexibility

32. We consider that the final version of the Guideline should specifically recognise this dynamic, and should indicate the RBNZ's willingness to consider, on a case by case basis, whether the independence guidance is necessary or appropriate in relation to particular insurers.

33. If RBNZ's intention is (as we submit above) that the need for "independent" directors will be assessed on a case by case basis, and if the RBNZ accepts the above suggestion that it be made clear that insurers which are locally incorporated subsidiaries of well resourced and well regulated offshore insurers will not be required to appoint independent directors to the Board, we would accept the criteria for independence as suggested by RBNZ in paragraph 36 of the Guidelines. If however, the RBNZ intends to invoke the independence requirements without exception, the criteria for determining independence will need to be re-assessed.

34. As an alternative, it is submitted that it may be sufficient for insurers who are locally incorporated in New Zealand and which operate as part of a multi-jurisdictional group, to appoint "non-executive" directors to the New Zealand Board. This could include executives of other group entities, thus providing "external" scrutiny and review of the local operation (particularly with regard to compliance with policies and standards which have been mandated across the organisation as a whole).

35. We note the indication (in paragraph 38 of the Guideline), that a director who is an independent member of the governing body of the licensed insurers parent may, depending on the circumstances, still be considered to be "independent" on the governing body of the licensed insurer. While this indication is welcome, we believe that the suggestion in paragraph 35 above would provide significant additional, and appropriate, flexibility to governance in general for insurers in New Zealand.

Qualifications and committee structures

36. Save as set out below, we are broadly comfortable with the guidance provided in paragraphs 40 to 48 of the Guideline.

37. The “flexibility” proposition set out in the concluding paragraphs 33 to 36 above, along with the underlying rationale set out in this paper, should also extend to paragraph 45 of the Guideline (and by extension, paragraphs 46 to 48 as well).

Conclusion

38. The Council welcomes the guidelines issued by the RBNZ and generally agrees with its provisions.

39. We believe the regulatory regime promoted by the IPSA stems from being part of a financial services reform programme that is desirable and important in garnering local and international business confidence, rather than stemming from the need to fix problems in the local industry.

40. The guidelines should be applied by the RBNZ in a flexible manner rather than in an inflexible “one size fits all” approach.

41. We have particular concerns about an “across the board” requirement for the chair of the Board of Directors and at least half of the directors to be independent. We believe the Guidelines should allow the RBNZ to consider on a case by case basis whether the independence guidance is necessary or appropriate in relation to individual insurers.

Terry Jordan
Manager Finance & Regulation
Insurance Council of New Zealand
Ph: 04 495 8002 Email: terry@icnz.org.nz