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Submission to the Reserve Bank on the classification of policies as "life policies" under the Insurance (Prudential Supervision) Act 2010

10 February 2012

1. ABOUT THIS SUBMISSION

- 1.1 This submission is made by the Insurance Council of New Zealand ("**ICNZ**") on behalf of the following members:
- (a) Allianz New Zealand Limited;
 - (b) IAG New Zealand Limited;
 - (c) Lumley General Insurance (N.Z.) Limited; and
 - (d) Vero Insurance New Zealand Limited.
- 1.2 Those insurers issue policies that insure death and disablement and are captured by the definition of "life policy" in the Insurance (Prudential Supervision) Act 2010 ("**Act**"), but those insurers do not intend to become life insurers under the Act.
- 1.3 Accordingly, this submission seeks amendment to the Insurance (Prudential Supervision) Regulations 2010 ("**Regulations**") to give effect to a further limited exception to the definition of life policy.
- 1.4 Each of those insurers has contributed to the development of this submission. They have reviewed the drafting of the suggested amendment provided in this submission. In some cases those insurers would still have life policies on their books even if that suggested amendment was made, in which case they plan to run those policies off or otherwise dispose of them before the provisional licence period ends.
- 1.5 The ICNZ understands that any amendment to the Regulations is unlikely to occur before 7 March 2012. Accordingly, insurers are individually seeking conditions in their respective provisional licences that the obligations regarding statutory funds and life insurance solvency standards do not apply to them (as permitted by section 247 of the Act). It is hoped that an amendment to the Regulations can be made during the provisional licence period so that, once full licences are in place, the insurers can continue to issue the policies in question without being considered life insurers under the Act.

2. EXECUTIVE SUMMARY

- 2.1 Some ICNZ members issue consumer credit insurance ("**CCI**") policies and other short-term, low value policies that insure death and disablement ("**relevant policies**"). Those policies are classified as "life policies" under the Act. For the various reasons explained further in Part 4 below, the relevant policies do not fall within the definition of "specified CCI contracts" under the Regulations, and so are not excluded from being life policies.
- 2.2 This means that, because of the relevant policies, those members are treated as "life insurers" under the Act and are required to operate a separate statutory fund and apply different solvency standards in respect of those policies. That is a costly exercise which does not meet the purposes of the statutory fund regime and is not justified.
- 2.3 ICNZ submits that the relevant policies should be excluded from being life policies by amending the Regulations. This further exclusion can be made without upsetting:
- (a) the Act's purpose of promoting public confidence in the insurance sector; or
 - (b) the purpose of requiring "life policies" to be managed through separate statutory funds, which is to protect policyholders of long-term and typically

large value policies from the risk of their insurer's non-life insurance business becoming insolvent.

- 2.4 Indeed, providing this exclusion is consistent with the intention that statutory funds are used to manage long-term and typically high value policies, and with the Act's principles of avoiding unnecessary compliance costs and maintaining competition within the insurance sector.
- 2.5 The remainder of this submission:
- (a) explains the policy underpinning the Act's distinction of life insurance from other insurance, and the other relevant principles of the Act that support the exclusion sought (Part 3);
 - (b) describes the relevant policies, why they are currently classified as life policies, and why they should not be (Part 4); and
 - (c) provides suggested drafting of an amendment to the Regulations to achieve the exclusion sought (Part 5).

3. POLICY UNDERPINNING THE DISTINCTION OF LIFE INSURANCE

Summary

- 3.1 ICNZ submits that further policies should be excluded from being classified as life policies under the Act because:
- (a) the purpose of treating life policies differently is to provide added protection to policyholders of long-term and typically large value policies, and the relevant policies are short-term and insure modest sums;
 - (b) the costs of compliance of establishing a separate statutory fund and applying a different solvency standard to a small part of a general insurer's business is not justified; and
 - (c) not granting the exclusion would mean that these low value products cannot be offered by general insurers (unless they are also life insurers under the Act), reducing consumer choice and competition.

Life policies under the Act

- 3.2 To begin, the Act distinguishes between life policies and all other policies¹ in order to provide additional protection to policyholders of life insurance:
- (a) If a policy is classified as a life policy under the Act, then the insurer that issues or is liable under that policy is a "life insurer" and must maintain a separate statutory fund in respect of its life insurance business (ss6 and 82). The statutory fund ensures that life insurance business is separated from other business, as premiums for life policies must be paid into the fund (s92), and only payments for liabilities under life policies can be paid out of the fund (s94).
 - (b) A life insurer must also apply a different solvency standard in respect of life insurance business.

¹ The Act also defines health insurance, but that definition is only relevant in the Act to s84(1)(d), which distinguishes health insurance from life insurance.

- 3.3 Additionally, a life insurer under the Act would also be classified as a "financial institution" under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 and so would have to also comply with the requirements of that Act (see s5 of that Act).

Why policyholders of life insurance get additional protection

- 3.4 Cabinet papers leading to the development of the Act clearly indicate that the purpose of requiring life insurance business to be separated from other insurance business is to protect against contagion between the two areas of business. In particular, life insurance policyholders should be protected from the risk of their insurer's general insurance business becoming insolvent.

- 3.5 The background material also makes it clear that the reason for protecting life insurance policyholders in this way is because of the long-term nature of life insurance. This means that those policyholders have more funds at stake, which should be protected from the risk of insolvency to an insurer's short-term insurance business. For instance, the Cabinet paper leading to the decision to introduce a separate statutory fund for life insurance stated:²

... this problem is most likely to manifest where short-term general insurance commitments undermine assets required to service long-term liabilities associated with life insurance ...

- 3.6 A feature of all relevant policy discussions of the distinction of life insurance for the purposes of prudential regulation is that life insurance is long-term, not that it simply insures death or disablement. An earlier Reserve Bank consultation paper also noted that:

... the reason for requiring legal separation of life insurance business is primarily to protect the funds required to cover long term commitments on life insurance policies ...³

...

The existence of a statutory fund would underpin the insurer's ongoing ability to meet their [sic] long term promises to policyholders.⁴

- 3.7 That consultation paper also recognised that life insurance generally insures larger amounts than non-life insurance:⁵

Although health insurance can involve long term relationships with policyholders similar to life policies the case for legal separation within its own statutory fund is more finely balanced than for life insurance where the benefit amounts are typically greater than for health insurance.

- 3.8 Finally, the Law Commission's earlier work on the regulation of life insurance only recommend that "quasi-life insurance" (disablement and income protection insurance) be aligned with the regulation of life insurance where that quasi-life insurance is long-term.⁶ It also distinguished general insurance from life insurance on the basis that:⁷

² Office of the Minister of Finance *Review of Financial Products and Providers: Prudential Regulation of Insurance* Cabinet Economic Development Committee Paper (released 22 August 2008) at para 17. See also para 26.

³ Reserve Bank of New Zealand *Review of Financial Products and Providers: Prudential Regulation of Insurance* Consultation Paper (May 2008) at para 10.

⁴ *Ibid* at para 24. See also para 19, last bullet point.

⁵ *Ibid* at para 30.

⁶ Law Commission *Life Insurance* (NZLC R87, 2004) at para 12.17.

⁷ *Ibid* at para 12.28.

The short-term nature of the [general insurance] policy means that policyholders are not "locked into" their policies in the same way that policyholders of life insurance are.

Compliance costs

- 3.9 One of the principles of the Act is the need to avoid unnecessary compliance costs (s4(h)). That is consistent with the Government Statement on Regulation, which requires a strong case to be made for any regulatory proposals that are likely to impose additional costs on business.⁸
- 3.10 The compliance costs would be large for general insurers who have to establish statutory funds and apply different solvency standards to a small part of their business.⁹ That cost is not justified by the benefits to the policyholders of the relevant policies, given that the policies do not involve long-term commitments or insure large sums. Moreover, including those policies as life policies is also inconsistent with the aim of preventing contagion between short-term and long-term liabilities.

Consumer choice and competition

- 3.11 Another principle of the Act is the need to maintain competition within the insurance sector (s4(g)). The Government Statement on Regulation also requires a strong case to be made for any regulatory proposals that are likely to impair market competition.¹⁰
- 3.12 Not granting an exclusion may mean that the relevant policies - CCI insurance and low value policies that insure death and disability - cannot be offered by general insurers (unless they are also life insurers under the Act). This would reduce consumer choice and competition, without a compelling corresponding benefit.

4. THE RELEVANT POLICIES

- 4.1 This section explains why the relevant policies are classified as life policies under the Act and why they are not excluded from being life policies by the Regulations.

Why the relevant policies are life policies under the Act

- 4.2 The relevant policies are classified as life policies under the Act only because they insure death and disablement. In particular, the relevant policies:
- (a) provide for the payment of money on the death of a person (s84(1)(a)) but do not fall within the exception in section 84(3) because they:
 - (i) have a duration of more than one year; and/or
 - (ii) are not limited to death resulting from an accident or a stated condition or disease; and/or
 - (b) provide for the payment of a benefit on the death or disablement of a person, and have a duration of more than one year (s84(1)(d)). (In this submission the

⁸ *Government Statement on Regulation: Better Regulation, Less Regulation* (released by Hon Bill English and Hon Rodney Hide on 17 August 2009).

⁹ Depending on the final definitions of what is classified as a life policy, the value of books of life policies may be more than the \$1.5 million stipulated in the Regulations' exemptions for small insurers. Further, those exemptions for small insurers do not extend to the requirement to comply with the life solvency standard in respect of life insurance business.

¹⁰ Above n 8.

term "**disablement**" is used as shorthand for the insured events described in section 84(1)(d)(ii) and (iii) of the Act.)

- 4.3 While the relevant policies have a duration of more than one year, industry practice still does not consider them to be long-term. Indeed the current exception in the Regulations for specified CCI contracts permits contracts of up to five years' duration to be considered non-life policies, where the policyholders do not need the added protection. ICNZ's submission is that this five year duration should remain the limit of death and disablement policies that are excluded from being life policies.
- 4.4 Importantly, the relevant policies are not annuities, policies with an ongoing obligation to pay premiums, or policies with an investment component (that is, they are not life policies under sections 84(1)(b), (c), (e) or (f) of the Act). Those are policies that industry practice and existing regulation typically treat as life insurance rather than general insurance. As such, they are policies that ICNZ anticipates will only be offered by life insurers and ICNZ does not seek any further exclusion in relation to them.
- 4.5 Almost all of the relevant policies are also "composite policies" under the Act, meaning that they contain multiple benefits:
- (a) some of which are life benefits, being benefits that are paid when the insured person suffers death or disablement as described above; and
 - (b) some of which are non-life benefits, such as benefits that are paid when the insured person suffers redundancy or suspension from employment, bankruptcy or business interruption.
- 4.6 For completeness, ICNZ notes that composite policies may or may not have to be treated as life policies. This depends on the outcome of an actuarial assessment that must be undertaken, based on a method prescribed in section 85 of the Act:
- (a) An insurer must first identify each "insurance product line" that the composite policies fall into. An insurance product line is a group of contracts of insurance that are entered into by the same insurer and have the same, or substantially the same, terms and conditions.
 - (b) For each insurance product line, an insurer's appointed actuary must determine the proportion of premiums for the line that are allocated to life benefits and the proportion allocated to non-life benefits.
 - (c) The insurer can then determine how to treat each insurance product line of composite policies according to the following formula:

Outcome of actuary's assessment	Result
The proportion of premiums allocated to life benefits is less than 25%	All of the contracts of insurance within the product line are <i>not</i> life policies
The proportion of premiums allocated to life benefits is greater than 75%	All of the contracts of insurance within the product line <i>are</i> life policies
Neither of the above applies; the proportion for benefits is between 25% and 75% (inclusive)	Each contract of insurance within the product line must be treated as two separate policies for the purposes of the Act, one that is a life policy and one that is not a life policy

- 4.7 Some insurers have undertaken the actuarial assessment and found that premiums allocated to life benefits exceed 25%, while others have not undertaken the assessment due to difficulty and cost. Under section 85, composite policies may still be life policies or may have to be split in two, which would require further expense. Accordingly, ICNZ seeks an exclusion for the relevant policies.

Why the relevant policies are not excluded from being life policies by the Regulations

- 4.8 Regulation 14 excludes a "specified CCI contract" from being a life policy. There are several aspects of the definition of "specified CCI contract" that the relevant policies do not satisfy.

Connection with a "loan"

- 4.9 The Regulations only exclude policies that are entered into in connection with a "loan", which is defined as a consumer credit contract under section 11 of the Credit Contracts and Consumer Finance Act 2003 other than a home loan (r14(2)(a) and (3)).

- 4.10 However, some of the relevant policies do not meet that requirement because they provide for modest cash payments on the happening of an insured event, such as death or disablement. These policies are often designed to help insured people (or the administrators of their estate) to manage debts, but are not expressly connected with those debts.

- 4.11 Additionally, some policies are connected to debt obligations but not those that are consumer credit contracts under section 11 of the Credit Contracts and Consumer Finance Act 2003. For example, some policies will pay an insured person's obligations to pay rates and electricity bills.

- 4.12 ICNZ submits that such policies, often called lifestyle protection insurance, should not be classified as life policies under the Act. The policies are of low value, providing payments of no more than \$200,000, and do not involve the type of long term commitment that warrants their management through a separate statutory fund.

Amount of benefit

- 4.13 The Regulations only exclude policies that provide payments related to the remaining balance of a loan (r14(2)(b)(iii), (v) and (vi)). As explained above, not all of the relevant policies are connected to a loan. Additionally, those that are connected to debt obligations can also provide for modest cash payments that can exceed the remaining balance. For those same reasons, ICNZ submits that such policies should not be classified as life policies under the Act.

Other benefits

- 4.14 The Regulations only exclude policies that insure death, disablement and/or redundancy, but no other events (r14(2)(c)). The ICNZ notes that this requirement - that for a policy to be a specified CCI contract it cannot provide for any benefits other than those listed in the definition - was not included in the draft regulations that the Reserve Bank consulted on in May 2011.

- 4.15 This requirement has meant that some composite policies cannot be classified as specified CCI contracts, because they also provide for payment in the event of bankruptcy, business interruption, suspension and/or hospitalisation. The definition of specified CCI contract permits payment in the event of redundancy, but not any of these other events. However, none of those benefits are life benefits to begin with (that is, they do not fall within the definition of life policy under section 84 of the Act).

- 4.16 Under the Regulations, the elements of the definition of specified CCI contract must be applied to a composite policy as a whole, not just the life benefits. ICNZ submits that this should not be the case, as it has no sound policy basis. Accordingly, in the suggested drafting provided below:
- (a) the elements of the definition are only applied to the aspects of a contract that are a life policy under the Act; and
 - (b) the requirement that an excluded policy can only insure death, disablement and/or redundancy, but no other events, is removed.

Non-life insurer

- 4.17 Under the Regulations if an insurer issues any life policies that are not "specified CCI contracts" then it cannot obtain the benefit of the exclusion for *any* of its policies, even policies that satisfy all other elements of the definition specified CCI contracts. That is because, for a policy to be a specified CCI contract, it must be issued by a "non-life insurer" (r14(2)(d)), which is defined as (r14(3)):

an insurer that, if contracts that satisfy the requirements referred to in subclause (2)(a) to (c) are disregarded, is not liable under any life policy

- 4.18 Accordingly, if an insurer has a single life policy (as defined in the Act) that does not satisfy all of elements (a) to (c) of the definition of specified CCI contracts, then the insurer is not a "non-life insurer" (that is, it is a life insurer). If an insurer is a life insurer, then none of its life policies can qualify as specified CCI contracts, even if some of those policies satisfy elements (a) to (c) of the definition of specified CCI contract. Put another way, an insurer can only benefit from the exclusion if all of its life policies (as defined in the Act) satisfy all of elements (a) to (c) of the definition of specified CCI contract.
- 4.19 This element creates a problem for insurers who have life policies that are in run-off or about to be disposed of. Such insurers may be "life insurers" under the Act (as they issue life policies that are not excluded by the Regulations) but may not have to establish a statutory fund or apply the life solvency standard due to conditions in their provisional licences, or impending disposals.
- 4.20 ICNZ submits that the requirement that an insurer be a non-life insurer in order to obtain the benefits of the exceptions be removed. Removing that requirement will not affect whether an insurer that issues other life policies has to comply with life insurer obligations in respect of those policies. It only means that the insurer does not have to comply with life insurer obligations in respect of the excluded policies; they would still have to comply in respect of other life policies. This better recognises the purpose of the statutory fund regime, to prevent contagion between short-term and long-term liabilities.

5. SUGGESTED DRAFTING OF AN AMENDMENT

- 5.1 ICNZ submits that the Regulations be amended to broaden the exclusion for CCI policies provided by Regulation 14.
- 5.2 These amendments could be made using the regulation making power under section 237(1)(k) of the Act.
- 5.3 ICNZ has provided suggested drafting below. There is a version showing the changes in tracking, and a clean copy of what the regulation would look like once amended.

5.4 Changes in tracking:

14 Certain consumer credit or low value insurance contracts are not life policies

- (1) For the purposes of section 84(4) of the Act, specified consumer credit or low value insurance contracts are declared to be a class of contracts that are not life policies.
- (2) A contract is a **specified consumer credit or low value insurance contract** if, in relation to the aspects of the contract that are a life policy under the Act, by the terms of the contract, all of the following apply:—
- ~~(a) the contract is entered into in connection with a loan; and~~
 - ~~(b) by the terms of the contract, all of the following apply:

 - ~~(i) the duration of the contract is not more than 5 years:~~
 - (a) the duration of the contract is not more than 5 years:
 - ~~(ii) a lump sum is payable in either or both of the following situations:

 - ~~(A) in the event of the death of an insured person:~~
 - ~~(B) in the event of the disablement of an insured person as a result of accident or sickness:~~~~
 - ~~(iii) the sum insured in respect of the benefit referred to in subparagraph (ii) is limited to the unpaid balance under the loan at the time of the event referred to in that subparagraph:~~
 - (b) any lump sum payable is limited to:

 - ~~(i) the unpaid balance under a debt obligation or obligations of the insured; or~~
 - (ii) no more than \$200,000:
 - ~~(iv) regular payments are payable in either or both of the following situations:

 - ~~(A) in the event of the disablement of an insured person as a result of accident or sickness:~~
 - ~~(B) in the event of the redundancy of an insured person:~~~~
 - ~~(v) the liability of the insurer to make the regular payments referred to in subparagraph (iv) is to be determined by reference to the liability of the insured under the loan:~~~~
 - (c) any regular payments payable are:

 - (i) to be determined by reference to the liability of the insured under a debt obligation or obligations; or
 - (ii) limited to an aggregate of no more than \$200,000:
 - ~~(vi) the maximum period for which the regular payments referred to in subparagraph (iv) may be made does not exceed the remaining term of the loan; and~~
 - (d) the maximum period for which the regular payments may be made does not exceed:

 - (i) the remaining term of a debt obligation or obligations of the insured;
or
 - (ii) the time when the total aggregate of such payments reaches no more than \$200,000.
- ~~(e) the contract does not provide for any benefits other than those referred to in paragraph (b); and~~
- ~~(d) the insurer is a non-life insurer.~~
- (3) In subclause (2),—
loan debt obligation—

(a) means an obligation to pay for goods or services, or an obligation under a consumer credit contract within the meaning of section 44 7 of the Credit Contracts and Consumer Finance Act 2003; but

(b) does not include a credit contract entered into primarily for the purpose of providing finance to enable, or facilitate, the purchase of real property

~~non-life insurer means an insurer that, if contracts that satisfy the requirements referred to in subclause (2)(a) to (c) are disregarded, is not liable under any life policy~~

unpaid balance means the amount owing under a ~~loan~~ debt obligation at a particular time, being the difference between all amounts credited and all amounts debited to the debtor under the ~~loan~~ debt obligation at that time.

5.5 Clean copy of what the regulation would look like once amended:

14 Certain consumer credit or low value insurance contracts are not life policies

(1) For the purposes of section 84(4) of the Act, specified consumer credit or low value insurance contracts are declared to be a class of contracts that are not life policies.

(2) A contract is a **specified consumer credit or low value insurance contract** if, in relation to the aspects of the contract that are a life policy under the Act, by the terms of the contract, all of the following apply:

(a) the duration of the contract is not more than 5 years:

(b) any lump sum payable is limited to:

(i) the unpaid balance under a debt obligation or obligations of the insured; or

(ii) no more than \$200,000:

(c) any regular payments payable are:

(i) to be determined by reference to the liability of the insured under a debt obligation or obligations; or

(ii) limited to an aggregate of no more than \$200,000:

(d) the maximum period for which the regular payments may be made does not exceed:

(i) the remaining term of a debt obligation or obligations of the insured; or

(ii) the time when the total aggregate of such payments reaches no more than \$200,000.

(3) In subclause (2),—

debt obligation—

(a) means an obligation to pay for goods or services, or an obligation under a credit contract within the meaning of section 7 of the Credit Contracts and Consumer Finance Act 2003; but

(b) does not include a credit contract entered into primarily for the purpose of providing finance to enable, or facilitate, the purchase of real property

unpaid balance means the amount owing under a debt obligation at a particular time, being the difference between all amounts credited and all amounts debited to the debtor under the debt obligation at that time.