February 2005

Comment on Law Commission Report 87 "Life Insurance"

The current position

The Law Commission's report was sent to the Minister Responsible for the Law Commission (David Benson-Pope) on 18 November 2004. The Minister has 6 months to make a formal response on what the Government proposes to do.

There is wide agreement that change in the legislation relating to life insurance is appropriate. It now becomes a question of priorities, and the decisions made will vary with circumstances. If a life office went down next week, priorities would probably be different. The 201 bondholders and 109 annuitants who were policyholders of ACL Life in 1989 would no doubt feel differently from the rest of the public about how priorities ought to be set.

Although there is no consultation process underway during this hiatus of up to 6 months, we nevertheless thought it useful to comment on some aspects of the Law Commission's report. This is not an attempt to summarise the recommendations of the report, since a list is already available within the first few pages of the publication.

Background

Most of our current NZ life insurance legislation dates from 1873. Those who refer to the legislation almost reaching its centenary are well out of date. Although none of us were around in 1873, there appears to be general agreement that financial markets in general and life insurance in particular have changed dramatically over this period. We expect virtually everything else has as well.

Overall impression

The Law Commission was faced with the difficulty of reconciling the general approach taken in New Zealand for regulation of other financial products, with the acceptance that life insurance policyholders do face clearly identifiable and separate issues.

Our general feeling on reviewing Report 87 "Life Insurance" published by the Law Commission in December 2004 is that it recommends a form of regulation that might be acceptable within a political environment that basically does not want any regulation at all. In our view, given the current political climate, this is the only approach that could sensibly be taken by the Commission.

Our reading of the report gives an overall impression that the Law Commission's recommendation is for layer upon layer of "supervisors".

Alongside the underlying principle that consumers must learn to be responsible for their own financial decisions is a clear expectation that the industry must help them get there.

We also note that while the recommendations regarding product disclosure may be reasonable for prospective clients of life offices, it does little to strengthen requirements that existing policyholders should be treated fairly.

Required: a collective noun for supervisors

Appendix B, para ICP2 of the report lists as "supervisors":

- the Securities Commission,
- auditors,
- actuarial auditors,
- the Accounting Standards Review Board (ASRB),
- a prudential supervisor or policy holder agent, and
- the High Court.

On top of this, ratings agencies and/or market analysts would also be reviewing companies' operations.

What are all these various entities going to do?

The proposed responsibilities of the various nominated supervisors are summarised below.

Securities Commission

- approve audit actuaries, set criteria for their appointment, revoke appointments.
- exempt overseas insurers from the Securities Act disclosure regime.
- inform the public about internet cross border offers.
- exempt overseas insurers from the requirement to incorporate locally (with conditions if appropriate).
- exempt New Zealand insurers from the requirement to incorporate.
- allow exemption from a requirement that contracts must comply with New Zealand law.
- allow exemption from the Financial Reporting Act 1993.
- prohibit advertisements that are misleading etc.
- exempt overseas life insurers from the prudential supervisor / policyholder agent requirement, on criteria set out in legislation.
- approve private sector entities as prudential supervisors.
- monitor the performance of prudential supervisors.

Auditor

- nothing specifically mentioned, so presumably the same as they do now.

Actuarial auditor (appointed by the life insurer, with agreement of the auditor)

- report on actuarial aspects of financial statements, specifically whether or not the stated solvency position is true and fair, and whether assumptions are reasonable and in accordance with standards.

ASRB

- approve (revised) actuarial standards.

Policyholder agent / prudential supervisor

- monitor financial information, obtaining extra information from companies if necessary, commissioning independent actuarial reports at a company's expense.
- take action against the life company in the interests of policyholders.
- monitor (and if necessary oppose) proposals for amalgamations and transfers between insurers.
- take an advocacy role for policyholders.
- instigate liquidation, or apply for voluntary administration or statutory management.
- receive material adverse change notifications.
- act on policyholders' behalf if companies want to modernise policy conditions.

The High Court

- again, the same as it does now.

Ratings agencies

- provide "prospective evaluations of insurers' financial security" to policyholders.

The most interesting aspect in the list is the policyholder agent / prudential supervisor, the advocate of those who are not in a position to act collectively to help themselves. We fully support the general idea. However, we would be more comfortable with the likely effectiveness of such a role in practice if more evidence were available from the privatised workers' compensation scheme set up several years. Had the scheme continued for longer, some real supervising of that business could have had gone on.

Actuarial employment prospects

We make no apology for suggesting that any review involving long term business should involve actuarial input.

As far as we can see, the proposed regime has at least four actuaries involved in working for, or reviewing the work of other actuaries in respect of, every life office in New Zealand:

- the company actuary (internal or consultant),
- the actuarial auditor,
- an actuary contracted by the company's policyholder agent / prudential supervisor for ongoing review work, and
- an actuary employed by a ratings agency.

A fifth actuary may be employed by the agent / supervisor to give an independent opinion in certain circumstances. In addition, the ASRB would require actuarial input, in practical terms from several individuals.

We start to wonder whether the Law Commission is an actuarial employment agency in disguise. We have serious concerns about the ability of the profession in New Zealand, given its small size, to provide the suitably experienced manpower necessary to support the proposed regime.

Looking to (presumably) Australia for resources seems inevitable. Consideration of the costs of using Australian actuarial consulting firms may make local actuarial consultants' rates seem extremely reasonable. Alternatively, we could see overseas actuaries actively recruited into New Zealand.

Ratings

The Law Commission accepts that ratings agencies do not provide a complete picture nor any guarantee of companies' soundness. However, agencies are stated to be a useful comparative tool for financial advisors and consumers, and would seem to play a central role in the proposed regime as an independent source of information.

General insurers have been required to obtain and publish ratings for some time now. In our view, consumers' comprehension and perceptions of ratings need to be better understood before any regime of compulsory ratings for life offices is considered. A consumer education campaign may assist, but we suspect most people would (unfortunately) see life offices' solvency as a problem for the offices rather than for the public.

Our own understanding is that ratings agencies do not see themselves as forming part of a supervisory regime in any way.

Comparison with best practice

International principles of insurance regulation are well established, although not exactly in the best seller class, and part of the Law Commission report contains a comparison of their recommendations to the 28 Insurance Core Principles of the International Association of Insurance Supervisors.

The Commission's stated aim is to ensure that internationally recognised principles are included within a regulatory framework appropriate for the relatively small size of the NZ industry.

The Law Commission suggests that its proposals are compliant with most of the IAIS principles. However there are certain notable exceptions.

- ICP6 requires life and non-life business to be handled separately, i.e. life offices should not underwrite non-life business unless they have satisfactory processes for separate handling of the risks. The proposed regime has no such requirement.
- ICP16 requires a legal framework that gives priority to the protection of policyholders in the event of winding up. The Law Commission does not consider that policyholders should be given any priority, because this disadvantages other creditors.

We disagree with the view of the Law Commission as expressed in the second of these points. It seems to us that members of the public who have a major element of their financial security with a life office are deserving of greater consideration than an unpaid supplier of stationery or staff biscuits. Of course, such suppliers may disagree.

Product disclosure statements

These are the renamed investment statements, to apply to risk products as well as products with a savings element.

Investment statements are described by the Law Commission as "succinct". We do find it difficult to agree with this adjective. While we fully support the principle of greater or clearer disclosure, we see over and over again (in the Insurance and Savings Ombudsman's casebook) comments that policyholders have not read the information they are given. Adding more paper to that information is unlikely to improve matters. Human nature is to require a quick and simple process, regardless of how often consumers are told that they have to protect themselves.

Requiring greater disclosure suggests that companies know how to make matters sufficiently clear for the layman to understand but currently lack the willingness to do so. We do not believe this to be the case. Rather, the maze of conditions that necessarily comprise an insurance contract can be almost impenetrable, even for those who are supposed to be experts in the field.

Policyholder equity

Information in product disclosure statements on how surrender values and bonus distributions are determined would seem to be of limited value, given how little relevant business is now sold by life offices. Making such disclosures available on request does not necessarily improve the treatment of those policyholders who already have contracts.

Guidelines about what information on these matters should be disclosed would be built.

We have looked at some of the public statements of Principles and Practices of Financial Management now required for UK life offices. These are very lengthy, and unlikely to send policyholders scurrying to read actuarial textbooks for fun. We noted mention of a matching rectangle within one statement. The yet to be issued shorter "customer friendly" versions may be an improvement.

Solvency – a simple matter?

The Law Commission states in para 6.8: "it will largely be a factual (non-policy) issue whether or not financial unsoundness is revealed by financial information, and what steps should be taken to protect policyholders".

We do think that this indicates a simplistic view of a very complex matter, and we wonder to what extent the Commission's thinking was coloured accordingly. Assessments of the position of long-term business are necessarily based on estimates of future experience. Making the estimates "best" or "prudent" does not alter the fact that actual experience will inevitably turn out to not exactly fit the estimates. In terms of the numbers that may be involved, we are also reminded of the oft-heard reference to 2 actuaries having 3 (or more) opinions.

It is not clear to us whether the supervisors are to be looking at solvency in a wind-up situation or for an ongoing business. There may be different considerations. In particular, we see no mention of reviewing the premiums being charged.

Definition of "life insurance"

The Law Commission's terms of reference limited it to consideration of life insurance. Nevertheless, we were disappointed to see that the bulk of the report stayed with the very narrow definition currently found in legislation. The much wider range of disability, income protection and trauma products now sold by life offices considered later as "quasi-life" insurance, with the suggestion that these should also be treated as life insurance for regulation purposes.

Other classes of insurance

The Law Commission suggests that the regime proposed for life insurance could be extended to non-life insurance that is offered to the public, such as personal general insurances and health insurances.

Their suggestions are not recommendations, as the topic requires its own thorough review with the opportunity for the market to comment. Nevertheless it is interesting to see their preliminary analysis.

The Law Commission notes that health insurance shares some characteristics with both life and general insurance, and that the regulation of health insurance currently falls between two stools. The health market is dominated by the one large mutual, and there are some significant insurance company players, but otherwise involves many small niche players. Introducing regulation on a standard basis similar to that for life insurance could cause severe disruption. The problems arising if a health insurer fails are not primarily the standard ones of immediate financial loss, but rather the loss of cover for existing conditions if the policyholder wants to continue cover with another insurer.

We do not understand the Commission's primary concern with personal lines, to the exclusion of commercial insurances. The financial soundness of all general insurers is important, and sections of a company's activity cannot be separated in this way. If one class of business is poorly operated, the whole entity can be jeopardised.

Applying different regulations to short-tail and long-tail business could also be difficult in practice, as domestic policies include a public liability component.

Final comments

As noted above, the Minister has until the middle of May 2005 to respond to the Law Commission's report. It seems to us that his response may well be to request a full analysis of the issues that would arise from extending the proposed regime to other classes of insurance business.

For further information please contact:

Linda Caradus or John Melville
Wellington *Phone (04) 499 0277*

Neil Christie
Auckland *Phone (09) 300 7155*