

# New Zealand Captive Insurance Association

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**WELLINGTON**

## **INSURANCE (PRUDENTIAL SUPERVISION) BILL**

### **Introduction**

1. This submission to the Finance and Expenditure Select Committee on the Insurance (Prudential Supervision) Bill (**the Bill**) is from the New Zealand Captive Insurance Association (**the Association**). Our particular interest in the Bill is the impact that it has on the captive insurance industry. This submission deals with that issue alone.

### **Regulation of the Captive Insurance Industry is Essential**

2. A captive insurance company is set up to underwrite only the risks of its parent and/or any subsidiaries, affiliates and/or related companies of the parent.
3. It is important for it to be understood from the outset that the Association supports regulation of the captive insurance industry. We support the general approach of the Bill in enhancing prudential supervision of the insurance industry, and feel strongly that the Bill should be extended to regulate all captive insurance companies operating in New Zealand.
4. Currently, the Bill's definition of the phrase "*carrying on insurance business in New Zealand*" in section 8 only covers insurers who are liable to New Zealand policyholders. However, there are some captive insurance companies in New Zealand which are owned by foreign parents, and which insure the risks of their parents overseas. The effect of section 8 of the Bill is that these foreign-owned captives do not fit within the Bill's definition of "*carrying on insurance business in New Zealand*", and thus are not required to hold an insurance licence. This is an anomaly within the Bill, which covers all general insurers regardless of the country of ownership. The Bill creates an unregulated industry for foreign-owned captives in New Zealand.
5. The Reserve Bank has stated that this is the intention of the Bill as drafted – it will not prohibit foreign-owned captives, but it will not regulate and oversee them either. We attach as Appendix One a letter dated 20 November 2009 from Toby Fiennes, Head of Prudential Supervision at the Reserve Bank, which confirms this policy.
6. This is not the Association's preferred position. The Association's members should be regulated as licensed insurers in order to participate as responsible members of the New Zealand insurance industry. The standards of compliance should be those confirmed by the International Association of Insurance Supervisors, of which New Zealand is a member. Those standards have been supplied to the Reserve Bank during the Bill's consultation process.

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## **With the Right Regulation, the Industry Could Earn Millions for New Zealand**

7. The industry currently consists of 22 captive insurance companies, which underwrite \$80 million in gross premiums annually, have assets of \$137 million, and pay New Zealand income tax of \$8 million per annum. The industry makes a significant direct contribution to the New Zealand economy; every captive established in New Zealand generates significant taxable revenue and provide other economic benefits such as employment and investment.
8. While most of the captives currently operating in New Zealand are New Zealand-owned insurance companies, a growing number are owned by Australian parents. Geographical proximity, similar legislative and tax systems, and the exchange rate are some of the key attractions for Australian companies looking to set up a captive in New Zealand. The Association is also seeking to attract business from Japan in the future.
9. With the right regulation, the Association estimates that within ten years the captive insurance industry could grow to 150 captives paying \$50 million a year in tax to the Government.

## **New Zealand's Financial Services Reputation**

10. If New Zealand is to secure its reputation as an international financial services centre, and attract international business and investment, it is important to provide an appropriate regulatory environment. The Reserve Bank has stated that it does not want New Zealand regarded as a regulatory "soft touch"; however this is exactly the outcome of its policy in relation to unregulated foreign-owned captives.
11. As mentioned already, the Bill as introduced does not regulate foreign-owned captives, but encourages them to remain operating unregulated; an undesirable policy decision. This is contrary to the regimes in many other jurisdictions, including Australia, Singapore, Ireland, Guernsey and Vermont, all of which regulate captives irrespective of their owner's origin, and to the recommendations of the International Association of Insurance Supervisors.
12. Most general insurance companies in New Zealand are owned by foreign entities. The domicile of the insurer's parent company has no negative financial or legal consequences for an insurance company.
13. The international business community is already taking note of the Bill's negative impact on captives; international insurance publication A.M. Best covered the issue in its 15 December 2009 issue (a copy of the article is attached as Appendix Two).

## **Closer Economic Relations**

14. The Bill's treatment of foreign-owned captive insurance companies is also inconsistent with New Zealand's CER obligations, and the intentions of New Zealand and Australia in moving towards a Single Economic Market (SEM).
15. In particular, creating a different regulatory environment for New Zealand-owned captives and Australian-owned captives is not consistent with the SEM principle of optimising net trans-Tasman benefit.

## **The Bill Does Not Require Much Amendment**

16. Extending the Bill to regulate foreign-owned captives, and taking account of the unique position of the captive insurance industry, would require very little amendment to the Bill, as noted below.

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## A *Definition of "captive insurer"*

The interpretation section of the Bill defines a captive insurer as an insurer that:

- (a) is a subsidiary of an entity that is not an insurer (the *parent*); and
- (b) only insures risks of the parent or of other subsidiaries of the parent (or both).

This definition is too narrow, as most entities large enough to have a captive also have complex structures of subsidiaries, affiliates and joint venture interests. In practice, captive insurers often also insure the risks of related entities. The risks of the subsidiaries and affiliates are the risk of the parent by virtue of being part of the company group.

The definition used by the International Association of Insurance Supervisors has been accepted in many jurisdictions where captives are commonly domiciled, and would suit the needs of the Bill:

*"The captive is an entity that only insures entities that in terms of international accounting standards are:*

- (i) its parent; or*
- (ii) a related entity, i.e. under joint control; or*
- (iii) in joint venture with that entity, or an entity of the type described in (i) or (ii) above".*

## B *Definition of "carrying on insurance business in New Zealand"*

Clause 8(1)(c) of the Bill provides that a person carries on insurance business in New Zealand if the person is liable as an insurer under a contract of insurance *to a New Zealand policyholder*.

This excludes foreign-owned captives who insure their overseas parents from being defined as *"carrying on insurance business in New Zealand"* for the purposes of the Bill.

Therefore, clause 8(1) should be amended so that it covers all insurance companies, including foreign-owned captives. This could be simply done by removing the words *"New Zealand"* from clause 8(1)(c).

## C *Conditions of licence*

Section 20 provides that the Reserve Bank may impose conditions on a licensed insurer, including at subsection (2)(d) a condition that requires a specified amount or proportion of the licensed insurer's insurance business to relate to New Zealand policyholders.

Following the inclusion of foreign-owned captives in the definition of *"carrying on insurance business in New Zealand"*, it should be clarified that the Reserve Bank may not impose a section 20(2)(d) condition on foreign-owned captives, as this will prevent them from obtaining an insurance licence. There is a risk that the Reserve Bank could use its discretion to impose conditions that would prohibit foreign-owned captives from operating as licensed insurance companies.

## D *Solvency standards*

Section 53 of the Bill allows the Reserve Bank to issue solvency standards, and last year it released a standard for non-life insurance for consultation.

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The Reserve Bank's non-life solvency standard is not appropriate for captive insurance companies, due to the unique structure and risk profile of captives. Applying the Reserve Bank's standard to captives owned by some of New Zealand's most iconic companies produces results that indicate the companies are insolvent. Reasons for this include the underlying risk residing with the company group rather than with a third party, and that a captive often invests funds with its parent company (a strategy recognised and supported by the International Association of Insurance Supervisors).

Aside from having to consider the comments of affected parties, the Bill contains no checks and balances on the solvency standards produced by the Reserve Bank; the Reserve Bank is free to produce whatever standards it likes. It is of great concern to the Association that the Reserve Bank would produce solvency standards that are not appropriate for captive insurance companies, and it is clear that adjustments need to be made.

Captive insurance companies should be exempt from the solvency standards issued by the Reserve Bank; in particular, captive insurers should be exempt from the following standards:

- Related Party Assets
- Deductions from Capital
- Asset Risk Capital Charge
- Asset Concentration Risk Charge
- Liquidity Risk Capital Charge
- Catastrophic Risk Capital Charge
- Insurance Risk Capital Charge

## *E Requirement for risk management programme*

Section 73 requires licensed insurers to be subject to a risk management programme, and the Reserve Bank may issue guidelines relating to the categories of risk to be covered in the risk management programme.

Captive insurers have a lower risk profile than most other insurers, which should be taken into account, either by issuing a separate set of guidelines for captives, or by exempting captives from certain requirements where appropriate.

International standard on risk management AS/NZS ISO31000:2009 is soon to be adopted in New Zealand; this standard would be an excellent basis for risk management programmes under the Bill.

## *F Requirement for licensed insurers to have appointed actuary*

Section 76 of the Bill requires a licensed insurer to appoint an actuary. It is not normal practice internationally for captive insurers to have an actuary; most captives have a more identifiable and lower risk profile than a standard insurance company.

Captive insurers should be exempted from section 76 and the related requirements of subsequent sections, in the same way that captives have been exempted from the requirement to have a financial strength rating (sections 61 to 71).

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## G *Related parties*

Several parts of the Bill refer to “*related parties*”; for instance, a consideration in determining whether an insurer is carrying on business in a prudent manner is “the nature and extent of transactions that the applicant or insurer has with, or in respect of, related parties”.

The unique nature of a captive insurance company means that it generally has extensive relationships with related parties. It is important to ensure that the provisions of the Bill in relation to “*related parties*” take into account the particular circumstances of the captive insurance industry, and that captive insurers be allowed to conduct related party transactions.

Furthermore, one of the “*fit and proper matters*” that directors of insurance companies must satisfy under section 34(1)(h) relates to conflicts or potential conflicts of interests, either direct or indirect. By their nature, captives are related companies to, in general, holding companies. Typically, some or all of the boards of directors, and likewise the officers, will have senior management positions within the group, or be directors of related entities. It would be inappropriate for this to be seen as a potential conflict of interest in relation to the directors of captive insurance companies.

## **The Reserve Bank Has Significant Discretion Within the Bill**

17. As we have touched upon above regarding the section 20 conditions of licence, the Bill grants the Reserve Bank extensive discretion with regard to the issue of insurance licences. Furthermore, section 229 contains significant powers for regulation.
18. There is a risk that the Reserve Bank could use its discretion and regulatory powers in the future in a way that will restrict or prohibit foreign companies from operating captive insurance companies in New Zealand. The Reserve Bank does not appear to value the contributions that captives make to New Zealand’s economy; Toby Fiennes described overseas captives to the National Business Review as “footloose” on 13 November 2009 – this article (attached as Appendix Three) is inaccurate.
19. It is important for Parliament to make its policy in relation to foreign-owned captives explicit, so that any action of the Reserve Bank which is contrary to the intention of Parliament will be ultra vires.

## **Conclusion**

20. The Bill and its related solvency standards will increase the cost of business for New Zealand captive insurance owners and cause many captive insurance companies to leave New Zealand. However, if the amendments suggested by the Association are adopted, New Zealand will continue to have a thriving captive insurance industry.
21. The Association requests the right to be heard in person by the Select Committee. We can be contacted through Peter Lowe on 09 920 2997 or by email at [lowepj@willis.com](mailto:lowepj@willis.com).

Yours sincerely

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