

# New Zealand Captive Insurance Association

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## **Submission by New Zealand Captive Insurance Association**

to Reserve Bank on Exposure Draft of Insurance  
(Prudential Supervision) Bill

22 June 2009

# New Zealand Captive Insurance Association

## Introduction

Thank you for the opportunity to comment on the exposure draft Insurance (Prudential Supervision) Bill (**Bill**). The Association supports the general approach of the Bill in enhancing prudential supervision of the insurance industry, and wishes to engage constructively with the Reserve Bank to ensure that the significant risk management role and economic contribution of the captive insurance industry is continued and enhanced.

As you know, the Association was concerned about a number of signals from officials that the Bill would prohibit over time the operation of New Zealand domiciled captives owned by Australian parents. That was notwithstanding the fact that:

- (a) we saw no basis in Cabinet's consideration of the proposed reform of the insurance sector that mandated this approach for captives;
- (b) such an approach would be inconsistent with the New Zealand-Australia Closer Economic Relations Agreement (**CER**); and
- (c) prohibiting such captives would unnecessarily remove from New Zealand a sector which generates significant revenue and tax.

We were therefore pleased that on analysis, the Bill's apparent policy intent was that such captives would continue to be permitted to operate in New Zealand as licensed insurers, and, therefore, continue to play an important role and to contribute to New Zealand's economy. However, in discussions with you last week to clarify the Reserve Bank's intention around one clause, you made it clear that the Reserve Bank does wish to prohibit the operation of New Zealand domiciled captives owned by Australian parents, with probably a two year transition period where existing captives would be provisionally licensed.

For several reasons, we are not only very surprised, but also disappointed, by the Bank's position. The interpretation which officials argue the Bill requires for this category of captives is not obvious on the face of the Bill. The asserted policy concern that New Zealand is a "flag of convenience" (the wording used by Bank officials) is misleading and is inconsistent with New Zealand's international legal obligations. Finally, we reiterate that even before our discussion with you last week, the Bank's stance was already causing New Zealand businesses to advise reputable and significant overseas corporations which wish to establish captive businesses here that the regulatory outlook is too uncertain, notwithstanding the undoubted economic benefit such businesses would bring to New Zealand.

The Association is, therefore, disappointed by the Reserve Bank's approach. We emphasise that the Association's position is that its members want to be regulated, i.e. they want to be licensed insurers. It is for that reason that this submission does nevertheless engage with and comment on the Bill, because the Association believes that the Bank will benefit from the matters that we raise.

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## **The New Zealand Captive Insurance Association**

The Association represents members of the New Zealand captive insurance industry. The industry currently consists of over 20 captive insurance companies, and these companies underwrite \$80 million in gross premiums annually, have assets of \$137 million and pay New Zealand income tax of \$8 million.

While many of these are New Zealand owned, a growing number of them are New Zealand domiciled companies owned by Australian parents. The industry makes a significant direct contribution to the New Zealand economy, and the potential for growth in the numbers of Australian and other foreign owned captives represents a real opportunity for New Zealand. One Association member was approached in the last week by two significant, reputable overseas corporations wishing to establish captives in New Zealand. Every captive established in New Zealand will generate significant taxable revenue and brings other economic benefits, including employment and other investment.

Since many other jurisdictions (including Australia, Singapore, Bermuda, Ireland, Guernsey and Vermont) do allow foreign owned locally incorporated captives, we consider New Zealand would be disadvantaged by any such restriction.

Also, as you will be well aware, most New Zealand insurers are owned by foreign entities. For example, Vero is Australian owned. This confirms that the domicile of the insurer's parent has no negative financial or legal consequences.

The Association has already submitted considerable evidence to the Reserve Bank about the benefits of New Zealand incorporated and operated but foreign-owned, captives. Similarly, we have submitted evidence to the Bank about their low risk status. The Bank has never shared with us evidence that current legislative empowerment of the operation of such captives is detrimental in any way to New Zealand.

## **Overview of Submission**

This submission is in two main parts.

The Association acknowledges that the Reserve Bank has sought responses on legal, drafting and operational issues.

In the first part we consider specific aspects of the Bill where we think improvements can be made by way of amendment. These are largely confined to definitional issues. One of those issues (relating to the definition of "carrying on insurance business in New Zealand") does, obviously in light of last week's discussion with you, raise concerns about the Government's approach to New Zealand captives owned by foreign companies.

In the second part of our submission we set out our broader thoughts (and remaining concerns) about possible downstream regulatory consequences of the Bill. It is clear that the Bill is a framework for more detailed regulation, the detail and effect of which is at this stage unknown. We therefore think it is important to place these views on the record at this time, but we also look forward to more detailed engagement as regulations are developed, and implementation of the Act occurs.

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## Request for Further Meeting

We acknowledge the Reserve Bank's willingness to date to discuss the Association's issues.

We would appreciate a further opportunity to meet with you at your earliest convenience to discuss the issues raised by the draft Bill and this submission. Peter Lowe, the Association's President, will contact you to discuss.

## 1. Recommendations for Amendment

### 1.1 Definition of "Captive Insurer"

Under the proposed clause 6(1), captive insurer means 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*

It may well be intended that the risks of the parent include the risks of all of its subsidiaries, affiliates or joint venture interests, but it is not clear from this definition.

We consider that this definition is too narrow. Most groups 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 Association notes the definition used by the International Association of Insurance Supervisors (**IAIS**), the international entity for insurance regulators and supervisors.

That definition has been accepted in jurisdictions where captives are commonly domiciled. That definition is that the captive is an entity that only insures entities that in terms of international accounting standards are:

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

In the Australian context the APRA's Prudential Standard GPS 001 defines captive insurers (**Category E insurers**) as follows:

*Category E insurer means an insurer incorporated in Australia that is a:*

- (a) *corporate captive; or*
- (b) *partnership captive.*

*Category E insurers, often referred to as 'sole parent captives', will generally be shareholder companies.*

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*Corporate captive means an insurer that:*

- (a) *is owned by a single company or a group of related bodies corporate; and*
- (b) *exists for the purpose of underwriting risks of the parent company or members of a group of related companies, which may include the risks of joint venture partners and contractors of the members of the group of companies.*

*Corporate captives include insurance group captives.*

*Insurance group captive is an insurer that:*

- (a) *is a subsidiary of an insurer or an authorised NOHC; and*
- (b) *exists for the purpose of reinsuring the risks of the insurer or members of the insurance group, which may include the risks of joint venture partners of the members of the insurance group.*

*Partnership captive means an insurer that:*

- (a) *is owned by a partnership; and*
- (b) *exists for the purpose of underwriting the business risks of the partners and/or the partnership.*

**Association Comment:** It is our recommendation that the definition in the Bill be modified so that it is consistent with other international definitions and is sufficiently broad to cover all intended insurers and insureds i.e. related entities.

## **1.2 Meaning of “carrying on insurance business in New Zealand”**

Currently clause 8(1) provides:

*... a person carries on insurance business in New Zealand if the person –*

- (a) *is –*
  - (i) *a body corporate or an association*
  - (ii) *an overseas company that is required to be registered or deemed to be registered under the Companies Act 1993; or*
  - (iii) *ordinary resident in New Zealand; and*
- (b) *acts, or has at any material time acted, as an insurer in New Zealand or elsewhere; and*
- (c) *is liable as an insurer under a contract of insurance to a policyholder in New Zealand.*

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On reviewing the Bill, Association members formed the view that clause 8(1)(c) would have the effect that New Zealand domiciled captives owned by foreign shareholders which entered into captive insurance policies in New Zealand and which were subject to New Zealand law were “carrying on insurance business in New Zealand”.

That was certainly acceptable to the Association and reflected our understanding of the more recent indications from officials that such captives would continue to operate in New Zealand as regulated licensed insurers. That is the Association’s goal.

However, Association members did note that the wording would benefit from some clarity as it was arguable that under clause 8(1)(c), it is the policyholder that must be in New Zealand rather than (as the Association feels is the more natural wording) the liability/contract of insurance that must be in New Zealand. If it is the former, then (in our view) overseas owned New Zealand captives would be excluded from this entire regime, leaving them largely unregulated. Based on our discussions with the Bank, and based on advice from officials to suspend our Official Information Act request, pending receipt of the Bill, we were confident that this was not the intention. Our understanding of Cabinet’s policy decisions is that the Bill aims to regulate insurers which are New Zealand based. Many will have New Zealand policyholders, but that is not the fundamental criterion for regulation.

However, in our discussion with Richard Dean, Manager, Insurance Policy, on 17 June 2009, Mr Dean stated that:

- (a) insurers have to be licensed to carry on insurance business in New Zealand;
- (b) insurers will not be licensed unless they have a high proportion of New Zealand policyholders. Officials aim to enforce this through a combination of the Bill and licence conditions (clause 21);
- (c) The Bank is looking to achieve this goal over a two year phase out period.

**Association Comment:** The Association does not support the Bank’s interpretation of clause 8(1)(c).

- (a) The Bank’s interpretation as conveyed orally to our legal representative on 17 June 2009 is not the most obvious interpretation. As drafted, the clause is more likely to be interpreted as meaning that the liability/contract of insurance must be in New Zealand;
- (b) The uncertainty around interpretation, combined with the Bank’s asserted intention that it will use the licence condition powers in clause 21 (see below) to achieve the goal of prohibiting foreign owned captive insurers from doing business in New Zealand on the basis that New Zealand regulation is a “flag of convenience”, means that the wording clearly needs to be clarified to mean that it is the liability/contract of insurance that must be in New Zealand;
- (c) The Bank appears to believe that if its interpretation is right, any insurers carrying on captive insurance business in New Zealand will be unlicensed and not permitted to do this. But this is not what the Bill says. Insurers are either licensed or they are not (clause 13). Insurers carrying on insurance business in New Zealand within the meaning of clause 8 must be licensed.

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However, if insurers (including captives) are not covered by clause 8, then so long as they do not represent themselves as being licensed, then they breach neither clause 13 nor clause 14 (criminal offence to hold oneself out as being licensed). Such an approach cannot possibly be the Bank's intention.

We therefore recommend that the meaning of "carrying on insurance business in New Zealand" be modified to ensure that it has the effect of applying to all contracts of insurance issued in New Zealand (e.g. underwriting the risk, or making the decision to grant cover by a principal of a captive in New Zealand such as board or principal agent/officer). We would like to discuss the drafting with you. The Association believes that the Reserve Bank should look at alignment with other developed jurisdictions, including Singapore and Australia, to develop a definition that regulates insurers (including Captives) if they enter into a liability in New Zealand.

The Monetary Authority of Singapore is currently moving its definition towards this framework<sup>1</sup>.

We also take the opportunity to formally remind the Bank that its interpretation (which presumably reflects a policy approach officials have developed but which is either not recorded in writing, or has not been disclosed to us notwithstanding our Official Information Act request of 13 March 2009) is inconsistent with CER. We are still waiting for an explanation from officials as to how New Zealand's CER obligations are being met under the Bill.

### **1.3 Requirement for an Actuary**

We note that clause 74 imposes an obligation on licensed insurers to have an actuary. It is not normal practice for captive insurers to have an actuary. Most captives have a lower risk profile, better risk understanding and underwrite "short tail" business. Short tail business is defined as insurance risk that identifies within a twelve month period. Actuarial reviews cannot assist in developing reserves for this type of risk.

**Association Comment:** We recommend that captive insurers be exempted from the requirement to have an actuary under clause 74 and the related requirements of subsequent clauses, in the same way that captives have been exempted from the requirement to have a credit rating.

### **1.4 Fit and proper matters**

Clauses 30-39 contain a suite of provisions relating to the qualification of the directors and relevant officers of licensed insurers to meet the licensed insurer's fit and proper policy.

Clause 31 sets out the fit and proper matters which the fit and proper policy must have regard to.

In practical terms, the Reserve Bank has the power of approval of the fit and proper policy upon amendment (clause 30(5)). There is also a notice regime for new directors and relevant officers (clause 32) and the Bank has the power to remove directors and relevant officers.

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<sup>1</sup> See MAS *Consultation Paper on Proposed Amendments to Definition of Carrying on Insurance Business* (May 2009).

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The Association acknowledges that under clause 31, the fact that a person through their experience etc. may be assessed negatively on one or more of the fit and proper matters, does not necessarily mean that they will not be regarded as fit and proper by the licensed insurer or indeed the Reserve Bank. However, the Association does wish to draw to the Reserve Bank's attention to one of the fit and proper matters in clause 31 relating to conflicts or potential conflicts of interest, including direct or indirect conflicts of interest (clause 31(1)(i)). The matters in question apply whether the circumstance, conduct, or event is, or occurs, in New Zealand or any other country.

By their nature, captives are related companies to, in general, holding companies. The holding companies may be incorporated offshore. They will be direct or indirect subsidiaries. Typically, some or all of the boards of directors, and likewise the officers, will hold senior management positions within the group, or be directors of related entities. This is less likely to be the case with licensed insurers outside of the captive sphere.

The Association would not wish the Reserve Bank to operate a policy of only approving a captive's fit and proper policy if, for example, it automatically regarded as not fit and proper a director or office holder of the subsidiary captive, simply because they happen to hold a management or director role for the related entity.

## **2. Further Issues**

### **2.1 *The Future of Foreign Owned Captives***

We have already addressed above in respect of clause 8 the ambiguity introduced by Bank officials about the future of foreign owned companies wanting to incorporate and operate a captive in New Zealand, even though there is no explicit prohibition, which would have been the more sensible and appropriate course if officials considered that was Government policy.

We understood Mr Dean to acknowledge in his recent telephone conversation with our legal adviser that the Bill's framework for creating secondary and/or tertiary legislation through regulations, licence conditions and so on is very important in terms of determining which insurers are able to carry on business in New Zealand. Officials intend for example to ensure that, on their view of clause 8(1)(c), New Zealand insurers will have to have a "high proportion" of New Zealand policyholders, with the level being set under clause 21 licence conditions.

Clause 217 understandably and appropriately contains wide and significant powers for detailed future regulation. The Association is not opposed to this type of regulatory framework, which is a well-used model i.e. the primary legislation is neither comprehensive nor entirely prescriptive as to the regulatory regime.

However, we are concerned about the possibility that at some point in the future, these wide powers of regulation and statutory discretions within the Bill could be used in a way that would unjustifiably restrict or prevent overseas companies establishing or retaining captive insurers incorporated in New Zealand. That includes captives insuring the risk of New Zealand parents where much of the parent's operations (and therefore risk) are undertaken offshore, and (if the Bank broadens the definition of "captive" to include other related companies) where the parent undertakes offshore operations through subsidiaries incorporated offshore, which would be quite usual. The Association numbers among its members several New Zealand based multinational companies which fall within this category. Considering the purposes of the Bill, we consider that such a move would be

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contrary to the legislative intent, but our recent communications with the Bank leave this in doubt. As we note above, we look forward to engaging constructively as regulations are developed under the new Act.

In our view care will need to be taken to ensure that implementation in relation to the following matters do not cause inadvertent harm to the captive insurance industry:

- Clause 21(2)(b) of the Bill allows for the imposing of a condition of licence requiring a “specified amount or proportion of the licensed insurer’s insurance business to relate to New Zealand policyholders”. For the reasons set out in detail above, we believe it would be inappropriate for this to be applied to foreign owned New Zealand incorporated captive insurers, which frequently underwrite either exclusively or as a majority proportion the risks of overseas related entities; or to the category of captives described above which insure the risks of related companies in a New Zealand based group but where the related companies are frequently incorporated overseas.
- Clause 18(1)(h) of the Bill provides that an applicant is only entitled to be issued with a licence if the Reserve Bank is satisfied that the applicant’s incorporation and ownership structure, governance structure, and financial structure are appropriate, having regard to the size and nature of the applicant’s business. We note that the appropriate governance arrangements are likely to differ in the case of captive insurers.
- Clause 217(1)(d) (along with clause 18(1)(l)) of the Bill provides for regulations to be made that prescribe additional requirements for an applicant to be entitled to be issued with a licence. The nature of these additional requirements is not stated. An exemption arrangement may be appropriate for captives.
- Clause 217(1)(e) (along with clause 19(2)(g)) provides for regulations prescribing additional matters which the Bank may consider in deciding whether an insurer is carrying on business in a prudent manner (and hence entitled to a licence). The nature of these additional matters is not stated. Depending on the nature of those additional matters, an exemption arrangement may be appropriate for captives.
- Clause 217(1)(f) (along with clause 21(2)(e)) provides for regulations to augment the types of conditions of licences that may be imposed. The nature of these conditions is not stated. Depending on the nature of the conditions, an exemption arrangement may be appropriate for captives.
- Clause 217(1)(u) permits regulations “providing for any other matters contemplated by this Act, necessary for its administration, or necessary for giving its full effect”. The Association wishes to ensure that this very wide power is not used in a way that unfairly discriminates against captives.

## **2.2 Licensing Process and Costs**

The industry will of course be keen to ensure that the financial (and other) costs of the licensing process are kept to the minimum necessary to achieve the regulatory purposes of the regime. To this end, the Association recommends reviewing recognised licensing regimes (such as Singapore) in the context of captive insurance companies. We recommend the establishment of a separate defined licensing process for captives to recognise their lower risk factors and more conservative business structures.

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## **2.3 Solvency Requirements**

Clause 50 of the Bill allows the Reserve Bank to approve solvency standards.

The Association is keen to see that those standards are in line with the recommendations of the IAIS and with comparable jurisdictions that are recognised as captive domiciles such as Singapore. The Association's initial view on this operational issue is that a solvency margin of \$NZ500,000 would be appropriate.

## **2.4 Risk Management**

We note that clause 71 of the Bill requires a licensed insurer to have a risk management programme, and that the Reserve Bank may issue guidelines regarding the risk categories to be covered.

As a general comment regarding the management of risk, the Association notes that captive insurers by their nature have a lower risk profile than most other insurers. Our recommendation is that this is taken into account, perhaps by issuing a separate set of guidelines for captives, or by exempting captives from certain requirements where appropriate. We are very willing to submit a proposed draft based on well-respected overseas guidelines if that approach is regarded as prudent by the Bank.

An international standard on risk management is about to be published and will become AS/NZS ISO31000: 2009 Risk Management – Principles and guidelines on implementation. We commend this standard to the Reserve Bank as the basis for effective risk management of insurers generally and captive insurers specifically.

The predecessor joint standard AS/NZS 4360 Risk Management (on which the international standard is based) is already widely used by large corporate organisations. Citing the new standard will enable an integrated approach to risk management by insureds, captive insurers and "commercial" insurers. We see this as beneficial to the long-term strength of the New Zealand economy.

## **2.5 Financial Reporting**

As in the case of investment restrictions, we understand from previous discussions that the Bank may consider requiring Actuarial standards in relation to financial reporting, auditing and regulatory compliance. The Association recommends that captive insurers be held to accounting standard IFRS 4 in this respect.

## **2.6 Related Parties**

In several places the Bill inevitably touches on issues surrounding related parties. For instance, one 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 Association notes that the unique nature of a captive insurer means that it has extensive, and appropriate, relationships with related parties. It will be important to ensure that any regulations, licence conditions, and the like recognise the particular circumstances of the captive industry.