

NEW ZEALAND CAPTIVE INSURANCE ASSOCIATION

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22 February 2006

Hon Lianne Dalziel
Minister of Commerce
Parliament Building
Wellington

Hon Dr Michael Cullen
Minister of Finance
Parliament Building
Wellington

Dear Sir / Madam

Captive Insurers – Developing Appropriate Criteria to Exempt them from Prudential Regulation

We are writing to register an interest, on behalf of captive insurers, to develop appropriate criteria to exempt them from prudential regulation in New Zealand.

The New Zealand Captive Insurance Association is an incorporated society established to represent the captive insurance industry in New Zealand.

An Appropriate Time

We believe this submission is timely since the Australian Treasury is currently calling for submissions on its discussion paper of December 2005 entitled “Regulation of Discretionary Mutual Funds and Direct Offshore Foreign Insurers”, which addresses the position of captives in Australia in paragraphs 67 to 78.

In its paper, the Australian Treasury comments on the proposals contained in Australian Prudential Regulation Authority’s (APRA) paper of 23 February 2005 to exempt captives from prudential regulation in Australia. We support the concept of exemption regimes for captives. However (like the Australian Treasury), we acknowledge that “determining the appropriate criteria for captives to be exempt from regulation exposes a tension between securing appropriate protection for policyholders but defining captives and their service sufficiently broadly to have some practical benefit (see paragraph 72 of the Australian Treasury paper).

We are enclosing a copy of the submission we made to the Australian Treasury on its paper, insofar as that paper applies to captives.

The New Zealand Prudential Regulation Regime

We are aware that financial regulation in New Zealand is under review.

Any regime for exempting captives from prudential regulation will need to be considered in the context of the current reviews, including, in particular:

- (a) the Review of Financial Products and Providers (RFPP); and

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- (b) the Domestic Institutional Arrangements for Financial Sector Regulation Review.

We consider that an exemption regime for captives is consistent with the objectives of these two reviews since there is an implicit acceptance in the RFPP paper of the position taken by APRA, in its February 2005 paper, to the effect that prudential regulation is not required for policy holders who are likely to have an understanding of the financial standing of the insurer and able to make informed decisions on that basis.

Developing an Exemption Regime for New Zealand Domiciled Captives

We therefore urge you to ensure that one of the products of the above reviews is an exemption regime for New Zealand domiciled captives.

In particular, we believe that it will be important for officials, as part of Stage Two of the RFPP Review to analyse captives as a special category under its section dealing with short term insurance, being the insurance category in which captives predominately operate.

We suggest that the only real issue in this area, albeit a significant one, is to decide where to draw the line in deciding what constitutes a captive.

APRA set out a proposed formulation in its February 2005 paper. In our view this formulation:

- (a) is more restrictive than is warranted, even by the policy statements set out in APRA's own paper;
- (b) is now effectively subject to input on the questions that the Australian Treasury has raised in relation to that formulation (in paragraph 67 to 78 of the Australian Treasury's paper.)

We suggest that the core of an appropriate exemption regime should reflect the following part of our submission to the Australian Treasury:

"...a captive...[is]...any entity...that only insures the risks of entities that, in terms of International Accounting Standards, are:

- (a) *its parent;*
- (b) *a related entity (ie under the same control);*
- (c) *in a (jointly controlled) joint venture with that entity, or an entity of the type described in (a) or (b) above;*
- (d) *an associate of that entity, or an entity of the type described in (a) or (b) above.*

*The essence of (a) and (b) is the concept of **control**; the essence of (c) is (obviously) **joint control**; and the essence of (d) is **significant influence** (all of which are defined by relevant international accounting standards)."*

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You will find that this formulation is consistent (in fact slightly more restrictive) than formulations used in other jurisdictions where captives are commonly domiciled.

Other matters that need to be considered in concluding any formulation for an exemption are also discussed in our submission to the Australian Treasury. We would be happy to discuss these matters further with your officials at an appropriate time.

In developing an exemption regime officials will need to be mindful of the developments taking place in Australia. However, in the final analysis, it will be important to establish a framework for exemption of New Zealand domiciled captives that encourages global businesses to domicile their captives in New Zealand. It may be that this leads to a need to establish a less regulated, and more workable regime than the exemption regime currently mooted by APRA for Australia.

As you will appreciate, the main objective of an exemption regime for captives is to confine its operation to situations where, because of the nature of the insured or the insurance, regulation is not required to protect policyholders.

Benefits of a Workable Regime

Our assessment is that the potential significance of captives is not yet fully appreciated in New Zealand or Australia.

Captive insurance tends to be viewed too simplistically as just self insurance, with relatively little thought given to the role it now increasingly has for businesses as they seek to enhance their risk management and financial management programmes.

The decision to "self insure" through a captive involves an assessment of many factors that go to the heart of the business; for instance:

- (a) establishing a captive enables a group to clearly measure its risk management programme within the context of a separate legal entity, ie the captive, that is accountable for its own financial statements;
- (b) instead of insurance premiums being paid direct to an external insurer, they are pooled (initially at least) and placed with the captive which doubles as an insurance company and an investment vehicle;
- (c) the captive (as the group insurer), has control over the collection and investment of those premiums, and therefore the profitability of the group's insurance related operations;
- (d) captives often have an ability to price more competitively than external insurers, since much of a captive's business involves insuring the owner's risks, often with the result that the claims records of captives tend to be better than those of normal insurers;
- (e) captives have greater flexibility to finance risk at all stages of the underwriting cycle, at a more consistent cost, since they tend to insure primarily based on the risks of the group, whereas external insurers tend to insure based on conditions prevailing in the general

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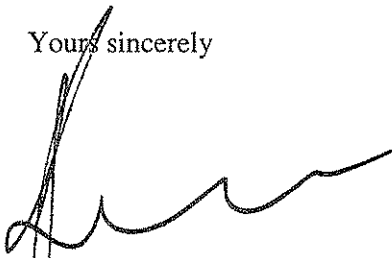
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insurance market, and this affects their ability to insure, and the price at which they insure, at different stages in the underwriting cycle;

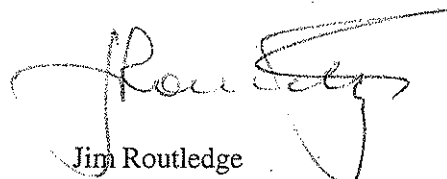
- (f) captives also have the flexibility to price and cover risks that might simply not be available from external insurers, or is only available from external insurers at prohibitive prices;
- (g) captives, because they pool premiums within a group, provide flexibility in the coverage of insured risk, since these funds need not be earmarked for a particular cover;
- (h) captives also provide groups with greater flexibility as to where their premium income is invested than is the case where the group simply pays its premiums to an external insurer;
- (i) captives give a group the ability to reinsure at a lower cost, based on the risk profile of the whole group, and direct the savings appropriately;
- (j) captives also give the components of corporate groups an ability to effectively reinsure based on the risk profile of the whole group, but to absorb a portion of that lower overall cost on a basis that allows individual components of the business to claim based on what may be a lower appetite for risk than is possessed by the group as a whole.

The decision to establish a captive is therefore much more than a decision whether to insure or not insure. It is a decision taken as part of a strategy to manage risk. The input required to establish a captive acts as a catalyst to business to undertake a more rigorous analysis of its risk profile. The decision is often taken in conjunction with an insurance audit of the business. Implicit in the decision to establish a captive, is a move to not simply accept the going rate, but to get the best value. Establishing a captive can lead to greater scrutiny of risk, but at a lower overall cost. We believe that these factors are resulting in an increasing tendency towards the use of captives as a means of managing risk, not only more cheaply, but more effectively.

Yours sincerely



Peter Lowe
President



Jim Routledge
Vice President