Draft prudential insurance legislation and risk management

Literature review and submission

Working Paper WP 0070

Prepared for Reserve Bank of New Zealand

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About Risk Management Limited

Risk Management Limited is an independent risk management consultancy established in 2003 to help clients identify, analyse, assess and manage their major risks and to monitor their critical controls over those risks.

Further information about Risk Management Limited is available at www.riskmgmt.co.nz.

About the author of the report

This report was prepared by Chris Peace, the managing director of Risk Management Limited who worked for NGC Holdings Ltd as their risk manager (2000-2003) and who had previously worked for Jardine Lloyd Thompson in New Zealand (1995-2000) and the UK (1990-1995), Marsh & McLennan in New Zealand (1985-1990) and CIGNA (NZ) Ltd (1982-1985). Between 1974 and 1980 he enforced the UK Health and Safety at Work Act 1974 in a wide range of premises.

Chris holds an MSc in Risk Management and Safety Technology and other qualifications in environmental health, air pollution control and occupational safety and health. Chris is also a Chartered Fellow of the Institution of Occupational Safety and Health (UK); details of the charter and fellowship are available from http://www.iosh.co.uk.

Apart from work as a risk management consultant, Chris is Adjunct Lecturer in Risk Management Studies at Massey University and has research interests in risk criteria.

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Executive summary

The Reserve Bank has made available an exposure draft of proposed legislation that will regulate the insurance industry in New Zealand, including captive insurers. We find it hard to isolate prudential regulation of insurers generally and captives specifically without considering risk and the need to manage some of the adverse consequences of insurable risks.

Therefore, the purpose of this working paper is to explore risk and risk management in the context of insurable risk and to review academic research on captive insurers in relation to the exposure draft of the proposed legislation.

We find:

- direct financial advantages to captive owners have not been unequivocally demonstrated in the peer-reviewed literature
- as an indirect mechanism for risk management, captives can have significant indirect non-financial advantages
- substantial direct and indirect economic advantages can accrue to administrations that enable the development of a captive insurance industry.

We understand the Reserve Bank proposes using insurer licensing to limit new captive insurers owned offshore and that do not trade in NZ. We also understand the Reserve Bank proposes to progressively eliminate such captives.

Such a negative approach to captive insurers may not directly impact on NZ registered parents but may limit choices for professional advisors and lead them to seek an alternative captive domicile. This will reduce NZ tax revenues and will not aid economic development.

Conversely, captive-friendly legislation may act to increase tax revenues and aid economic development.

Literature review

Risk, risk management and insurable risk

Risk management

We use the following as the definition of risk management.

> *The coordinated activities to direct and control an organisation with regard to risk (AS/NZS ISO, 2009).*

Risk

We use the following as the definition of risk.

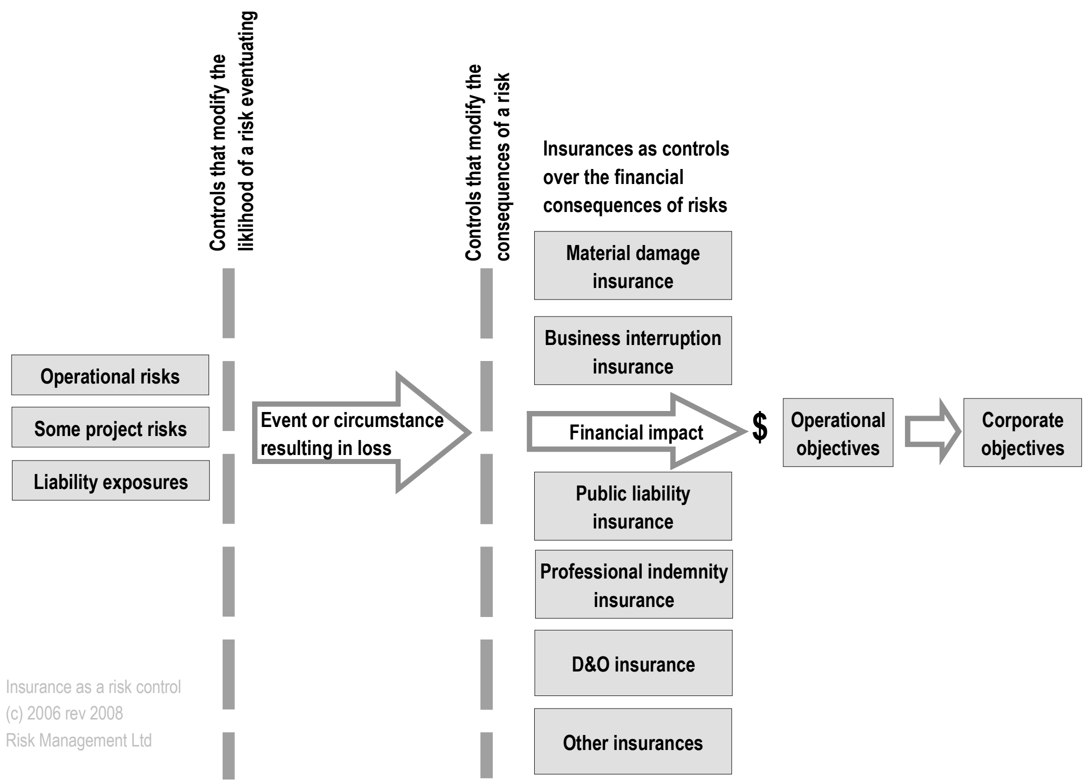
> *The effect of uncertainty on objectives (AS/NZS ISO, 2009).*

Uncertainty may be analysed as follows (Klinke & Renn, 2002):

- variability within the population
- systematic and random measurement errors
- indeterminacy of relationship between cause and believed effects
- lack of knowledge.

Uncertainty around *some* of the financial consequences of *some* risks may be controlled by buying insurance. Such risks are referred to in this paper as *insurable risks*. The application of non-insurance controls and insurance controls to insurable risks is illustrated in Figure 1.

Figure 1. Insurance as a risk control



Not all insurable risks are insured for a range of reasons (cost, frequency of occurrence, likely level of harm, availability of cover, etc).

The financial consequences of insurable risks that are often not insured (eg, due to cost or availability of cover) may be funded using a variety of financial mechanisms, including a captive insurer. Such mechanisms help to reduce uncertainty for the risk-owning organisation.

The definition of risk assumes an organisation or society knows what its objectives are. For New Zealand as a potential or actual captive domicile, this can be interpreted in relation to the key stakeholders as follows.

Objectives of a captive parent

For private sector organisations, objectives normally include the creation and maintenance of shareholder value. For public sector or not-for-profit organisations, objectives may be focused on service delivery to or for stakeholders.

We have reviewed how captives may help achieve such objectives on page 5 (*Advantages and disadvantages of captives for a parent*).

Objectives of the regulator

The regulator will have as objectives compliance with legislation by (in this case) insurance companies; this may be achieved by formal and informal enforcement strategies and self-regulation. For the Reserve Bank, an objective is "to develop a prudential regime for the insurance sector" (page 4, Statement of Intent for 2008-2011).

Objectives of the NZ government

The government has objectives around economic growth, social justice, environmental protection, etc. These were enunciated in Budget 2009 speeches by the Minister of Finance, Prime Minister and other ministers.

Some of the government objectives can be achieved by attracting foreign direct investment (FDI).

With appropriate legislation the assumed objectives of all stakeholders can be achieved.

Draft legislation

Clause 6 of the draft Bill proposes definitions including:

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

carries on insurance business in New Zealand has the meaning set out in section 8

Clause 8 of the draft Bill defines carrying on insurance business in New Zealand thus.

8 Meaning of carrying on insurance business in New Zealand

(1) For the purposes of this Act, a person carries on insurance business in New Zealand if the person—

(a) is—

(i) a body corporate or an association of persons incorporated or formed in New Zealand; or

(ii) an overseas company that is required to be registered or deemed to be registered under the Companies Act 1993; or

(iii) ordinarily 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.

(2) However, a person does not carry on insurance business in New Zealand for the purposes of this Act if the person is—

(a) a Crown entity within the meaning of section 7(1) of the Crown Entities Act 2004 (for example, the Accident Compensation Corporation, the Earthquake Commission, or the Housing New Zealand Corporation); or (b) an entity named in Part 1 of Schedule 1 of the Ombudsmen Act 1975; or

(c) a public entity (within the meaning of section 5(1) of the Public Audit Act 2001) that is declared by regulations to be an entity to which this paragraph applies.

This definition appears to propose prohibition of foreign direct investment in New Zealand in the form captive insurers when the parent operates offshore. If this is the case it will reduce some aspects of economic activity and hinder future growth in export services. This may, in turn, slow the overall growth of the NZ economy.

If this proposed legislation proceeds as drafted it would seem to conflict with government objectives for job creation and economic growth. Specifically, the Minister of Finance in his Budget speech referred to “creating a springboard for strong future economic growth and the jobs it will bring with it”.

In reaching this opinion we have reviewed academic research on captive insurers since 1984.

Literature review on captive insurers and organisational objectives

The USA

The US National Association of Insurance Commissioners (the professional body for insurance regulators) publishes the Journal of Insurance Regulation as a:

> *… forum for opinion and discussion of major regulatory and public policy issues in insurance. It strives to make state insurance departments more aware of the cutting-edge, high-quality research occurring in the regulation arena.* (JIR website).

The Journal has been published four times per year since 1982. Using “captive” as a key word the complete set of 984 articles was searched finding eight citations, including an editorial. This suggests a lack of peer-reviewed evidence on effects (positive or negative) due to captives that has influenced US insurance regulators.

Indeed, the editorial, published in 2008 after the financial crash, commented on the need for a better understanding of recent changes to captive insurer legislation in the USA and the growing diversity of regulatory environments. The editorial noted favourably the paper by Cole & McCullough (2008) examining overall trends in the captive marketplace who noted that “captive insurance companies have long been an important part of the insurance marketplace”. Their study investigated overall trends in the captive marketplace as well as variations in the legislation governing captive formation and operation.

Cole & McCullough suggest there are various factors that may affect the selection of a captive as a domicile. These may include taxation, fee levels, capitalisation requirements, proximity, appeal of the domicile, regulatory freedom, regulatory infrastructure and the knowledge of regulators. They argue a key factor is the domicile of the parent – that is, the captive should be near the parent.

Petroni (1998), presenting an Italian and European perspective on domiciles for captives, also identified:

> *(a) effective insurance legislation and simple administration; (b) highly qualified management services; (c) sufficiently endorsed banking, legal and financial services; (d) non-existence of problems of exchange controls; (e) political and economic stability; (f) good communication infrastructure; (g) acceptability as an insurance centre; (h) optimization of fiscal management; and (i) investment limits.*

Ireland

Research on the emergence of Ireland as a centre for internationally traded services found that, by 2002, FDI in Ireland amounted to €121 billion (Grimes, 2006). This was the highest FDI per capita in the world after Hong Kong. Services exports in the same year totalled €29.9 billion with insurance services being the third largest group accounting for €3.8 billion.

Grimes also quoted data showing the growth in permanent full-time employment in financial and other international services 1993-2003. Insurance-related services appeared to account for growth from about 1,000 jobs to about 10,000 jobs over that period.

Not all of those jobs would have been related to captive insurers. Cole & McCullough (2008) cited work by Geisel, 2006 showing that, in Vermont, 567 captive insurers supported over 1,400 jobs and yielded over US$20 million in taxes. This suggests that each captive might support about 2.5 jobs and generate about NZ$500,000 in taxes; many of these jobs would probably be high-value, professional jobs.

Advantages and disadvantages of captives for a parent

Reasons why a parent may form a captive vary but typically are financial; risk management; strategic; administrative; certainty of future cover (Priest, 1987).

Table 1 summarises some advantages and disadvantages of captives for a parent.

Table 1. Advantages and disadvantages of a captive formation to the parent

Advantages	Disadvantages
Provides negotiating power with insurers – especially if the captive layer insulates underwriters from moderate losses	None evident
Reduces dependency on the direct insurance market and the insurance market cycle	None evident
Participates in underwriter profits	May also need to participate in losses
Avoids underwriter overheads and expenses (possibly as much as 40c in the dollar)	Start up costs and expenses (capital, professional fees, registrations, etc) may mean that this advantage is not achieved immediately
Provides direct access to the reinsurance market	None evident
Creates a long term relationship with reinsurers	None evident
Provides additional capacity in a hardening or hard market	None evident
Avoids alleged failure to properly insure critical exposures (directors and officers might not be covered by D&O insurance for such alleged negligence)	None evident
Provides capacity that did not exist (eg, environmental impairment liability or electricity transmission and distribution lines)	None evident
Improved coverage availability (eg, exposure to terrorism, flooding or other threats that may be or become uninsurable)	None evident
Enables cover to be customised to meet peculiar circumstances	None evident
Adds commitment to and improves loss prevention to the benefit of the parent, captive and insurers or reinsurers	None evident
Increased efficiency in allocating premiums	None evident
Provides investment income on reserves that may help fund losses and smooth the total cost of risk	None evident
Enables control of the investments that matches the parent investment strategy	None evident
Improved cash flow	None evident
Enables retained earnings to be carried forward so as to smooth losses year on year	None evident
Enables provision to be made in the accounts for potential liabilities from past incidents	None evident
Possible increases in share or stock value	None evident

Sources: Cole (1984), Cole & McCullough (2008), Costle & Schauer (2000), Cross et al.(1986), Petroni (1998) Whitehead (2003),

Competitive advantage and shareholder value

An organisation thinking of forming a captive might also consider the extent to which the captive might increase competitive advantage. In assessing possible competitive advantage, management will to consider where significant costs of insurable risk lie in the value chain (Porter, 1998). If those costs can be identified, premiums fairly allocated and loss control improved the organisation may increase its competitive advantage.

Some of the value may lie in a stronger balance sheet if the share price is improved. Cross, Davidson, & Thornton (1986) demonstrated that, for US corporates, formation of a captive insurer resulted in an increase in the value of parent company stock values. They suggested this might be due to a positive response by share analysts. As formation of a captive was not normally announced to the stock exchange there was no correlation between formation of a captive and subsequent increase in share price.

Their research found that:

> *… captive formation impact the security returns of the parent corporations over a time interval from 75 days before the date of captive formation to 30 days after that formation date. Over this time interval, the parent corporations' stock returns demonstrate a positive reaction to captive formation.*

Subsequent research in the UK by Adams & Hillier (2002) suggested that when purely financial considerations were taken into account, single-parent captive insurance solutions were possibly suitable for:

- large, publicly-listed, closely-held companies
- large, non-publicly-listed companies (eg, private companies, mutuals).

They found that single parent captives were suitable for large non-companies (eg, partnerships, public-sector bodies). They also found that in each case there were alternative strategies. Their research did not consider the wider benefits listed in Table 1.

Advantages and disadvantages of captives for domiciles

Cole & McCullough (2008) describe the benefits of captives for the domicile as including increased tax revenue, additional jobs, increased capital deposited in financial institutions within the domicile and an "environmentally friendly source of revenue, an issue that is becoming more important to many domiciles".

The potential rate of growth in captives within a domicile can be considerable, especially for domiciles seen to provide the advantages valued by parents. For example, Utah grew from two captives in 2003 to 92 in 2007 following introduction of captive-friendly legislation and Arizona showed similar growth from four captives in 2002 to 108 in 2007 (table 1, C. Cole & McCullough, 2008). It is assumed the growth in captive-related jobs and tax revenues matched the growth in captive numbers.

Cobb (2001) (Cobb, 2001) researched the growth in the financial services industry in a number of offshore financial centres and noted that, in the Isle of Man, the financial services companies had wide international linkages and that the mix of companies included:

> *… banks, building societies, life and captive insurance companies, fund management companies, law, accountancy and ship-management companies.*

Advantages to New Zealand as a captive domicile

Such diversity in the service industry generally and captive insurance management specifically helps create employment for professional service providers including:

- auditors
- captive managers
- lawyers
- bankers
- investment advisors
- claims managers.

This helps attract and retain qualified and experienced professional staff for the benefit of the wider economy.

Table 2. Advantages and disadvantages to NZ of being a recognised captive domicile

Advantages	Disadvantages
Growth in direct tax revenue from captives and indirect tax revenue from salaries of employees	None evident
Increased capital deposited in financial institutions	None evident
Growth in high-value white collar jobs enhances the attractiveness of the NZ economy as place to invest	None evident
Growth in regulatory jobs	Fees may not cover all the costs of captive regulatory activity
Environmentally friendly source of revenue	None evident
Increased foreign direct investment attracted by NZ professional services	None evident

Captives also generate other income including:

- travel to captive board meetings
- accommodation
- tax income
- captive industry conferences.

They could also contribute to the growth of the knowledge economy in New Zealand (see, for example, research by Ernst & Young, 2008 carried out for the Ministry for Economic Development) that concluded:

> ***Our people are a source of competitive advantage***
>
> *New Zealand companies need to better understand and use the concept of intellectual capital. They need to look at their products, processes and people, and assess and augment the amount of knowledge they possess. They must unlock the value of their hidden assets, such as the talents of their employees, the loyalty of their customers, and the collective knowledge embodied in their systems, processes, and culture. They must learn how to turn their unmapped, untapped knowledge into a source of competitive advantage.*
>
> ***New Zealand at the centre of the global economy***
>
> *In this new view, New Zealand is at the centre of the world. Our white-collar workers can compete on price and quality with those in London or California. New Zealand will be able to retain graduates who until now have emigrated in search of higher salaries. Work-related travel will decline. People will no longer have to live in cities to work; instead, they will be able to work from wherever they choose to live. ICT will enable New Zealand not only to overthrow the tyranny of distance but also to mitigate the disadvantages of our small population and low population density - at 13 people per square kilometre similar to that of Argentina and Finland (Statistics New Zealand, 1994; Collins Concise Atlas of the World). New Zealand is no longer on the edge, but at the edge.*

The possible economic benefits of a captive insurance industry for New Zealand have been estimated as $NZ50 million within 10 years (Routledge & Lowe, 2005). In 2007 members of the Captive Insurance Industry Association:

- wrote gross premiums of $77.6 million
- owned total assets under management of $137.3 million
- had capital and surpluses of $91.0 million
- paid taxes to the New Zealand Government of $7.1 million.

New Zealand has a number of advantages as a captive domicile including proximity to Australia, low cost of establishment, low compliance costs, membership of the OECD and very low corruption (Transparency International, 2008).

Conclusions

There is good evidence that a vibrant captive insurance industry acts to increase tax revenues and contribute to the economic growth of the domicile. The case of Ireland has studied by Grimes who clearly showed the growth in jobs and tax revenues, both contributing to economic development.

Similarly Vermont, Utah and Arizona have shown growth as a result of captive-friendly legislation.

Direct financial benefits to captive parents are not so clear. The two studies located show marginal benefits to US listed companies and dubious benefits in the UK. However, the indirect benefits seem not to have been taken into account in the UK study.

New Zealand has a long-running problem with retention of professional staff. Developing a captive insurance industry will help reduce such losses and increase the regional reputation of New Zealand for professional services.

We welcome the proposals to modernise regulation of the insurance industry and so to reduce uncertainty but urge the Reserve Bank to ensure new legislation does not act to reduce economic activity in one part of the professional services industry.

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