

Regulatory Reform Developments in New Zealand

– Ready, Steady, Jump

1. The story so far – History of Review of Financial Products and Providers

In May 2005 the Government announced a review of the regulation of financial products and providers. This has become known as the RFPP. The key objective of the RFPP was to “develop and effective and consistent framework for the regulation of non bank financial institutions, financial intermediaries and financial products”.¹

The RFPP has been led by the Ministry of Economic Development (**MED**). The MED has worked with an inter departmental working group of officials from Treasury, the Reserve Bank, the Securities Commission and the Ministry of Consumer Affairs.

One of the stated objectives of the review was to bring New Zealand closer into line with international best practice and to provide a basis for closer “co-ordination” with Australia. However, in announcing the review, the Government was at pains to say that any changes made would be appropriate for New Zealand conditions and that “while considering Australia an important part of the review, establishing apra style regulations in New Zealand is not the objective of the review”.

A certain amount of “heavy lifting” had already been done in certain key sectors that would be subject to the review. In November 2004 the Government appointed a taskforce to consider and report on the regulation of financial intermediaries. That taskforce reported back on 29 July 2005 with its final report “Confidence, Change and Opportunity”. Central to the taskforce’s recommendations was the concept of a co-regulatory regime in which the industry stakeholders and professional bodies worked in tandem with a statutory regulator.

Insurance law reform had also been the focus of two reports by the Law Commission. Report 46 “Some Insurance Law Problems” was submitted in May 1988. The report made the bold suggestion of repealing the Fires Prevention (Metropolis) Act which was enacted in 1774 during the reign of George III and was then (and is still today) part of New Zealand law.

More significantly, the 1998 Law Commission Report proposed an Insurance Law Reform Amendment Act which would have significantly reformed the law of non-disclosure, including the introduction of a concept of “blameworthy” non-disclosure.

The draft bill annexed to the report to the 1998 report was optimistically titled “Draft Insurance Law Reform Amendment Act 199-.”

By November 2004, when the Law Commission presented Report 87 “Life Insurance”, the reform that was described back in 1998 as long overdue had still not occurred. However, momentum was gathering, with the 2004 report building on the proposals for reform advance in 1998.

¹ Ministry of Economic Development “Stage 1: Framework, Problem Identification and General Directions for Reform, 2005”

The interface between New Zealand and Australian insurance regulations was a focus for the Law Commission's 2004 Report. Indeed the terms of reference included the following:

Given CER, the unique characteristics of the New Zealand market and the significant input of overseas, particularly Australian, insurers into that market, assess how New Zealand regulation could best accommodate overseas regulation and overseas insurers in order to meet its aims.²

In recommending repeal of the Life Insurance Act 1908 and a new Insurance Contracts Act, the Law Commission's 2004 report stated that the proposed legislation would not form a comprehensive insurance code but would provide a platform that could be built on in the future. The President of the Law Commission, Justice Bruce Robertson, noted:

"Throughout the project we have been conscious of the close relationship between New Zealand and Australia, and the predominance of Australian based life insurers in the New Zealand market. Accordingly we have sought solutions that are primarily suited to New Zealand conditions, but are also compatible with the Australian approach to regulation of life insurance.

Some of the features of the life insurance regime that we are recommending are also found in the Australian regulatory regime, in particular the extension of product disclosure to risk only life insurance policies. However we have concluded that it would not be appropriate or advantageous to adopt the whole of the Australian regulatory model for the regulation of life insurance in New Zealand. It would be inconsistent with the way we regulate most other financial products and providers in this country, and it would have the potential to cause regulatory arbitrage, where providers seek to tailor products in order to avoid certain aspects of the regulatory regime".

In other words, New Zealand, would develop its own indigenous regulation, not simply a scaled down facsimile of the Australian regulatory regime.

The RFPP has been broken down into four stages:

- **Stage 1:** Framework, problem identification and general directions for reform;
- **Stage 2:** Development of draft options for reform;
- **Stage 3:** Release of discussion documents for consultation;
- **Stage 4:** Development of Policy Proposals.

We are now up to Stage 3. On 31 August 2006 the MED released a series of no less than nine discussion papers, each focussed on a different aspect of the proposed reform of the non bank financial sector. Included in this prodigious output from the MED was its "Discussion Document on Insurance".³ It is that Discussion Document which is the focus of this paper.

2. The current landscape

The MED Discussion Document describes the current New Zealand regulatory environment for insurance as being "extremely light handed" yet at the same time describes the industry as "stable and well managed" due to the significant investment made by the market in developing a self regulatory model. It is a market replete with industry bodies including:

² Request under 27(2) Law Commission Act 1985

³ *Review of Financial Products and Providers: Insurance*, MED Discussion Document September 2006

- The New Zealand Insurance Council (**ICNZ**);
- Health Funds Association of New Zealand (**HFANZ**);
- Investment Savings and Insurance Association (**ISI**);
- New Zealand Society of Actuaries (**NZSA**).

The responsible professionalism of these bodies is part of the reason why the industry has been so stable and well managed. Membership of these bodies and adherence to their standards is voluntary. For example, the ICNZ's "Fair Insurance Code" is adhered to by members of that body which comprise nearly all of New Zealand's major fire and general insurers. However, membership is not compulsory and the ICNZ has no "formal" status in the way that say, the New Zealand Law Society has.

The current hooks in the peg board of regulation are:

- **Deposit requirements**

These are currently covered by the Insurance Companies' Deposits Act 1953, Life Insurance Act 1908 and the Mutual Insurance Act 1955. Depending on the year in which the deposit was made by an insurer setting up a non-life business under the Insurance Companies' Deposits Act it would have been required to deposit \$100,000 (1975) and \$500,000 from 1979 onwards.

- **Rating**

Only insurers offering disaster and property insurance in New Zealand are required to obtain a rating under the Insurance Companies (Ratings and Inspections Act) 1994. The rating must be obtained from one of the approved agencies (A.M. Best, Standard & Poors and Fitch Ratings).

The insurer must disclose its ratings to consumers who are entitled to avoid the contract if there is a failure by the insurer to do so.

- **Insurance contracts**

The following quartet of statutes govern the contractual relationship between the insurer and the policy holder:

- The Life Insurance Act 1908,
- The Marine Insurance Act 1908,
- The Insurance Law Reform Act 1977; and
- The Insurance Law Reform Act 1985.

Only the Marine Insurance Act 1908 purports to be a code governing marine insurance law. The other pieces of legislation cover only aspects of Insurance Law in a rather piece meal way.

- **Intermediaries**

The Insurance Intermediaries Act 1994 deals with an insurer's liability on payment to the intermediary of premiums by the policyholder and payment of claims monies by the insurer to the intermediary.

The Insurance Law Reform Act 1977 defines when the intermediary is an agent of the insurer as opposed to an agent of the insured. It does not do so with great clarity.

There are no "insurance specific" formal conduct requirements for insurance intermediaries in any current legislation.

- **Financial reporting**

The level of financial reporting required by an insurer depends on the nature of the insurance product offered by the insurance company. Insurance products that include the issuing of "securities" must comply with the Financial Reporting Act 1993 (FRA).

Corporate insurers who are not issuers of securities for the purposes of the FRA must prepare financial reports and obtain an audit in compliance with the Companies Act 1993.

Certain other insurers, who are neither companies and fall outside the FRA, have specific reporting requirements. Friendly societies and credit unions, must comply with the Friendly Societies and Credit Unions Act 1982.

There are other relatively undemanding financial reporting obligations for life insurance companies under the Life Insurance Act 1908. They must produce annual, audited statements of their revenue account and financial position and lodge returns with the ISU on behalf of the chief executive of the MED.

Insurers are also required to complete a number of schedules included in the Insurance Companies Deposit Act 1953 and/or the Life Insurance Act 1908, depending on which regime they have registered under.

None of these reporting requirements are perceived to be particularly exacting.

- **Exit management**

This is the euphemistic term used to describe the provisions that exist for dealing with a failing insurer.

Under the Life Insurance Act 1908, application can be made to the High Court for appointment of a judicial manager "where it appears that there is a likelihood that the company is, or will be unable to meet any of its liability to policyholders".

This statutory provision has never been used in the nearly 100 years it has been on the statute book.

Under the Corporations (Investigation and Management) Act 1989 (CIMA), a company can be placed in statutory management and the Act applies to any corporation:

- (a) that is or may be operating fraudulently or recklessly; or

- (b) to which it is desirable that the Act should apply:
- (i) for the purposes of preserving the interests of the corporation's members or creditors; or
 - (ii) for the purposes of protecting any beneficiary under any trust administered by the corporation; or
 - (iii) for any other reason in the public interest.

The powerful provisions of CIMA have never been applied to a public insurance company in New Zealand.

3. **So what's wrong with a light handed approach?**

In short, it is relatively easy to establish and operate as an insurance company in New Zealand and stay within the playing field. The problems with the existing regulatory regime which the 2006 Discussion Paper identified include:

- **Lack of merit requirements**

The meagre deposits required under the Insurance Companies' Deposits Act 1953 or the Life Insurance Act 1908 are a quantitative measure and not particularly demanding ones at that. The IAIS⁴ promotes a combination of qualitative and quantitative measures to more effectively assess an entrant's ability to perform its promises both at the point of entry and in the future.

What is more, there is no publicly available centralised register of insurance providers in the finance sector. It is possible to go on to the MED website and obtain a list of current registrations, but as the registration requirements are not all encompassing, this does not give an accurate picture of who is in fact offering insurance product in the New Zealand market.

- **Inconsistent governance requirements**

Depending on whether you are an insurer registered under the Life Insurance Act 1908, or an insurer who is bound to comply with the Insurance Companies Deposits Act 1953, there are different levels of governance and negative assurance requirements. Holders of the same kind of policy from different legal entities may not therefore be afforded the same protection for no reason than the vagaries of registration.

- **Non existence of requirements for expertise in governance**

Those who run insurance companies or hold any statutory function (e.g. directors, officers and senior management) are not required to achieve any particular standard. In that regard New Zealand is out of step with the OECD guidelines, the IAIS principles

⁴ International Association of Insurance Supervisors – Insurance Core Principles and Methodology, October 2003 ICPM.

and FAFT recommendations, all of which require those in responsible positions to meet the “fit and proper person test”.⁵

- **Rating system not comprehensive**

The mandatory rating regime is limited only to those insurers writing disaster and property cover. The MED believes that this creates inconsistency across the sector, does not allow for competitive neutrality due to differing models used by the three approved agencies and permits regulatory arbitrage.

- **Lack of New Zealand policyholder asset ring fencing**

Because New Zealand has no requirement for insurers to only offer certain business lines through separate legal entities “inter class contagion” is a real risk.

A foreign insurer who has assets in New Zealand is not required to keep those assets separate to meet the interests of its New Zealand policyholders. According to the review this is a particular concern where the insurer’s home jurisdiction gives statutory priority to policyholders in that home jurisdiction.

- **Public reporting requirements inconsistent**

Because not all insurers are subject to the Financial Reporting Act 1993, not all report in accordance with that regulatory regime.

The Review does recognise that reporting is not a “costless exercise”, particularly for insurers in New Zealand who have their parent domicile in a foreign jurisdiction. As matters stand, the Regulator cannot accept reports provided in the parent’s home jurisdiction to meet any of New Zealand’s reporting requirements.

- **Insufficient monitoring and enforcement tools**

It is very difficult under the current regime for the Regulator to assess whether an insurer is responsibly managing the risks of its business or assess the underlying financial viability of its business. This is due in part to the time lag in information – currently reporting to the Regulator is nine months following the close of financial reporting period which means that by the time the Regulator gets the report, problems may have already developed and reached a point where they cannot be resolved.

Furthermore the Regulator has only a very limited ability to call for information which has not been volunteered by the insurer.

- **Unsatisfactory Mechanisms - Managing distress**

The powers to manage distress are either described as being extreme, i.e. they are neither non-existent or too strong. The heavy handed regime provided under CIMA is described as not “granulated” sufficiently to provide optimal intervention outcomes – it is too heavy handed and provides for intervention later rather than sooner.

⁵ Financial Action Task Force on Money Laundering – The Forty Recommendations, 20 June 2003

4. **Proposed regulatory reform in three key areas**

So what is the panacea for this myriad of ills? The answer suggested in the Discussion Document is hardly surprising: regulation, regulation and more regulation, but in a restrained way! In looking at the proposals set out in the Discussion Document I want to focus on three areas:

- (i) duty of disclosure and remedies for non-disclosure and mistake;
- (ii) insurance intermediaries and agencies;
- (iii) product disclosure.

5. **Duty of disclosure and remedies for non-disclosure and misstatement**

The Insurance and Savings Ombudsman is on record as saying that non-disclosure complaints represent one of the largest single reasons for consumer dissatisfaction and complaint to the Insurance Ombudsman's Office.

Since 1992 the Court of Appeal has been encouraging the New Zealand legislature to follow the Australian model. In *State Insurance v McHale* [1992] 2 NZLR 399, at page 404, Cooke P said that the case had:

“... shown that the law of this country is in far from a clear or satisfactory state. In 1957 the Law Reform Committee in England recommended legislation as to disclosure adopting the test of what would have been considered material by a reasonable insured. The late Sir Brian MacKenna in *Lambert v Co-operative Insurance Society Ltd* [1975] 2 Lloyd's Rep 485] at 491 expressed his personal regret that the recommendation had not been implemented. Legislation on those lines has since been introduced in Australia. In effect I follow him in suggesting that it appears to be time that New Zealand did the same.”

In *Quinby Enterprises Limited (in liq) v General Accident Limited*, [1995] 1 NZLR 736, at page 740, Barker J observed that:

...uncertainty and possible injustice may be caused by the current state of the law in New Zealand as enunciated”. Legislation along the lines of the Australian Commonwealth legislation on the point was commended by Richardson and Hardie Boys JJ at the conclusion of the joint judgment in the McHale case: No action has been taken by the New Zealand legislature.

In both its 1988 and 2004 reports the Law Commission took up the cause of reform of the law of non-disclosure and proposed that a new Insurance Contracts Act should be enacted. A draft bill was included as appendix “C” to the 2004 report. The Law Commission observed that its Draft Insurance Act did not provide a code for all insurance law but that perhaps expansion in the future was possible, suggesting that something “*along the lines of the Australian Insurance Contracts Act ... would provide a coherent code of laws relating to insurance contracts, and may assist the number of Australian based insurers that must adhere to different regulatory requirements in Australia and New Zealand*”.

In neither of its reports did the Law Commission propose reforming the law in relation to *misrepresentation*. New Zealand's Contractual Remedies Act sets out a code in relation to precontractual misrepresentation but the inter-relationship between the common law in respect of non-disclosure and the statutory regime created by the Contractual Remedies Act has never been an easy one.

The MED Discussion Paper goes one step further than the Law Commission and has proposed reform which would affect both the duty of disclosure and remedies for non-disclosure and misstatement.

The proposed reforms are to apply equally to life and non life insurance.

The essence of the proposal is that the duty of disclosure be retained but the rights of an insurer to avoid a contract of insurance due to non-disclosure or misstatement would be limited to four specific circumstances namely:

- **In the case of fraud:** A misstatement or non-disclosure is fraudulent where, for instance, the insured making the statement or failing to disclose does so intentionally or recklessly.
- **Specific answer to a specific question put by the insurer:** Where the misstatement or non-disclosure is contained in an answer to a specific question expressly put by the insurer, and is essentially incorrect and material. An answer to a question would be substantially incorrect and material where, for instance, the difference between what is stated or failed to be disclosed and what is actually correct would have influenced the judgment of a prudent insurer in fixing the premium or in determining whether the prudent insurer would have taken or continued a risk on substantially the same terms.
- **Where the insurer seeks to avoid the contract within 10 days of the risk first attaching:** This caters for market practice of interim cover to allow time for the insurer to ask questions. The review concedes that the time allowed may need to be longer than 10 days.
- **Where the contract is for reinsurance:** Where the contract relates to reinsurance the parties are deemed to know the duty and have ability to discharge their disclosure obligations.

The challenges an insurer faces in proving fraud on the part of an insured are well known. In practical terms, then, the second of the four circumstances (specific answers to a specific question put by the insurer) is likely to be the area in which there is the most “avoidance” traffic.

To bring themselves within the second type of avoidance circumstance insurers may be tempted take a “kitchen sink” approach and require the insured to complete very detailed questionnaires.

The MED suggests that the proposed approach provides the insurer with the option of how far they wish to go in asking questions. If they wish to cling to the remedy of avoidance on this ground they will need to have specific and detailed questionnaires. The Discussion Paper suggests that other insurers may take the approach of short form questionnaires, accepting that the restitution remedies which are also to form part of the proposed legislation will apply to matters not covered by the questions listed.

Proposed remedies other than avoidance

An insurer’s right to avoid will be stripped away other than in the four circumstances outlined above, but the insurer may invoke a remedy described as “restitutionary” in approach where:

- the insurer is not entitled to avoid the contract, and in the circumstances a reasonable person ought to have known that the undisclosed or misstated fact would have influenced the judgment of a prudent insurer in relation to that insurance contract; or
- for life insurance, an incorrect statement of age of the insured.

The remedies that will be available to the insurer in those circumstances are:

- declining to accept the risk on any terms – i.e. exclude a particular risk prospectively or cancel the policy prospectively;
- accepting the risk only as a higher premium;
- accepting the risk on different terms regardless of the premium; and
- for the life insurance age misstatement, the formula in clause 13 of the draft Insurance Contracts Bill would apply. That formula is:

$$v = \frac{s \times p}{q}$$

where –

v is the amount of the sum insured (including any bonuses) as varied

s is the amount of the sum insured (including any bonuses)

p is the amount that is equal to the premium that has or to the sum of the premiums that have, become payable under the life policy

q is the amount that is equal to the premium, or to the sum of the premiums, that the insurer would have charged if the life policy had been based on the correct date of birth or correct dates of birth.

The restitutionary remedy is dependent on the response the insurer would have made if it had known the undisclosed or correct material. This will sound very familiar to Australians.

Insurance intermediaries and agency

The MED produced a separate discussion document on “*Financial Intermediaries*” which also sets out far reaching proposals in relation to the regulation of that sector of the industry. The two papers need to be read in tandem to gain a full appreciation of the scope of the proposals.

The Insurance Law Reform Act 1977 attempts to set out when an insurer is responsible for the conduct of those who negotiate the sale of their product during the contract formation process. However, there is a distinct lack of clarity around when the intermediary is acting as agent for the insured or insurer due to the wording of section 10 provides:

A representative of the insurer who acts for the insurer during the negotiation of any contract of insurance, and so acts within the scope of the actual or apparent authority, shall be deemed, as between the insured and the insurer and at all times during the negotiations until the contract comes into being, to be the agent of the insurer.

The term “representative of the insurer” is defined to include any person who is entitled to receive a commission from the insurer.

It is clear that this question of agency is one on which the MED received a significant amount of industry feedback which led it to the view that a conclusive system of determining an insurance intermediaries agency status must be included in insurance legislation.

The MED's key proposal is that agency status will be determined on the basis of a written authorisation from a licensed insurer. Where such a written authority is not in place the insurance intermediary will be deemed to be the agent of the consumer. The system anticipates three categories of insurance intermediary:

- **Exclusive agent:** The insurance intermediary is the authorised agent of only one insurer;
- **Non exclusive agent:** The insurance intermediary is the authorised agent of more than one insurer;
- **Consumer agent:** The insurance intermediary is the agent of the consumer.

The intermediary will, depending on the category it falls into, have certain obligations in terms of product disclosure and consumer disclosure and there will be a number of consequences that flow from the status of the intermediary.

- If an insurer provides product information to an insurance intermediary who is a consumer agent then the insurer will be deemed to have fulfilled its obligations, and only the insurance intermediary will be held responsible for any failure to disclose. This means that because the consumer in this instance only has recourse against the intermediary there may not be an ability to recover. This is the current position under the Insurance Law Reform Act 1977, which is being retained. The requirement of intermediaries to disclose their agency status and the effect of the status, is the mechanism for warning consumers prior to dealing with a consumer agent. Since the insurer has not agreed to the intermediary being their agent, and hence have no control over them, they should not be held responsible for the intermediary's actions in this regard;
- If an insurer provides information to an insurance intermediary who is the insurer's agent, it will have the same effect as if the insurer were disclosing to itself. Hence, if disclosure is not made by the insurance intermediary to the consumer, both the insurer and the intermediary will be held responsible. Since the insurer has appointed the agent to act on their behalf they will be held responsible for their actions in this regard.
- Where an insurance intermediary is the insurer's agent, the insurer is liable for the intermediary in relation to product disclosure information only during contract negotiation and formation. Also, where the consumer provides information to the insurer's agent the consumer will have met their duty of disclosure to the insurer. If the insurer's agent fails to disclose this information or misinterprets it to the insurer, the insurer will *not* have the right to remedies for non-disclosure or misstatement caused by the failure of the insurance intermediary; and
- Where an insurance intermediary is the consumer's agent, the insurer is not liable for the insurance intermediary in relation to disclosure of product information during contract negotiation and formation. Also, where the consumer provides information to the consumer's agent the consumer will not have met their duty of disclosure to the insurer if the intermediary fails to disclose or mis-states the information to the insurer.

Thus, the insurer will have the right to remedies for non-disclosure or misstatement against the consumer caused by the failure of the insurance intermediary. The consumer's only recourse for this will be against the insurance intermediary.⁶

Product disclosure

As matters stand, only those life insurance products which include an investment element are required to comply with the disclosure framework in the Securities Act 1978 and the Securities Regulations 1983. There is no insurance specific regulatory product disclosure regime which applies to risk based insurance products.

It is in this area that the views of the MED are most unformed and the Discussion Paper acknowledges that the MED will do further work and consultation in this area in order to provide a more detailed set of proposals.

Should New Zealand move to the type of product disclosure regime which has been the subject of so much discussion in Australia? On the basis of the Discussion Document it would appear that a less exacting regime than that which operates in Australia is contemplated. The desirability of some kind of "consistent format" in which product information is delivered to the consumer is identified. The template headings, the MED suggests, could be similar to those adopted under the Credit Contracts and Consumer Finance Act 2003 but adjusted to reflect insurance product features, for example:

1. Full name and address of insured and any policy beneficiaries (if any);
2. Full name, address and telephone number of insurer;
3. Premium – the amount of the premium to be paid either in one lump sum or by instalments, including the dates and frequency of payment(s);
4. Other fees;
5. Total cover amount – the total amount the policy covers;
6. Term of the contract, including the start and end dates;
7. Renewal rights;
8. Special conditions and exclusions;
9. Cancellation rights and process;
10. Claims process; and
11. any requirement to notify change of circumstances.

It is clear that in relation to this potentially fraught area of product disclosure statements the MED remains open to suggestion, identifying three very broad questions for further submission:

⁶ Para 340 Discussion Document

- Should there be product disclosure requirements for insurance that are contained in legislation?
- Is the product disclosure framework set out above a move in the right direction for the insurance sector, or is a different approach to the framework required?
- What would be the costs and benefits of an insurance product disclosure regime?

Where to from here?

The MED has set 1 December 2006 as the closing date for submissions on the proposals contained in the Discussion Papers. After receiving submissions the MED will evaluate them and seek further comment where necessary before development recommendations for Ministers and then Cabinet to consider in mid-2007.

The suite of reforming legislation that will be required to implement the reforms is targeted will be panoramic. The current plan is for necessary legislation to be passed in 2008. That is an election year in New Zealand and also the 100th anniversary of the Life Insurance Act.

Completing the development of proposals, introducing legislation and then passing that legislation within that timeframe is an enormous challenge. Within the industry there is, generally, an acceptance of the desirability of reform but concern in relation to its practical application. As with all reforms of this type, the devil is in the detail and it is on that detail that the industry must now focus.

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