Recent developments affecting New Zealand's Life Insurers

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Abstract

New Zealand product range is primarily yearly renewable term with tailored mix of life, total and permanent disability, critical illness and income protection. Insurance with investment is mostly legacy.

Autonomous and tied advisers write most new business, nearly half is replacement. Initial commission is clawed back pro-rata in the first two years whilst most companies offer transfer terms. Thus, persistency in the third and fourth year is poor.

Offices try to reduce twisting by: linking higher commission to persistency; paying higher renewal commission accompanied by lower first year commission; or attempting to lock-in more distribution.

An overhaul of minimal regulation in New Zealand has recently started: appointment of prudential regulator with power to veto directors and officers; directors must maintain minimum solvency margin, obtain credit rating and act in interests of local company; conduct regulator will licence advisers and qualifying financial entities and may require full disclosure of commission.

Dealer groups are growing rapidly, providing comparator and client management tools and compliance framework for advisers of varying quality. Over-ride commissions negotiated by dealer groups have squeezed profit for life offices.

During 2007 and 2008 many Life offices increased initial commission without increasing retail premiums. The Margin on Services valuation method allows higher acquisition costs to be capitalised, so the impact on reported profit emerges slowly.

A new tax regime is expected to start in July 2010, with a five year transition. Taxable profit will be Premiums less Costs rather than Investment income less Expenses. Premiums may have to increase by up to 20% to offset tax. Further premium increases to recoup higher commission could result in loss of market share.

Contents

1. Introduction

2. NZ life insurance market
   - 2.1 Premium split
   - 2.2 Product
   - 2.3 Distribution
   - 2.4 Life Investment business

3. Replacement business
   - 3.1 Stepped increases in premium
   - 3.2 High up-front commission
   - 3.3 Transfer terms
   - 3.4 Predatory behaviour
   - 3.5 Lapses by channel

4. Financial Reporting
   - 4.1 Spreading initial costs
   - 4.2 Low discount rate
   - 4.3 Lapse risk

5. Why regulate?
   - 5.1 Prudential regulation
   - 5.2 Adviser regulation
   - 5.3 Finance Companies

6. Prudential regulation of insurers
   - 6.1 Framework
   - 6.2 Role of actuaries
   - 6.3 Governance
   - 6.4 Consistency with non-life

7. Licensing, disclosure and oversight of distribution

8. Changes to taxation
   - 8.1 Collective investment schemes
   - 8.2 Life office tax

9. Outlook
   - 9.1 Distribution
   - 9.2 Retail pricing
   - 9.3 Role of actuaries

1. Introduction

This paper outlines recent developments affecting the life insurance industry in New Zealand.

Chapter 2 provides a brief overview of the New Zealand market. Regulation is very light, but there have been no major failures for decades in a competitive market. The leading company has nearly twice the market share of the second biggest company. The main product is yearly renewable term with premiums adjusted every year collected by bank direct debit.

Chapter 3 discusses the endemic problem of intermediaries transferring policyholders to a new carrier every three or four years. Life offices pay full introductory commission of up to 240% of the first year premium with partial clawback of commission in the first two years. Replacement business qualifies for full initial commission and is actively encouraged by some life offices who waive stand-down period and medical underwriting.

Chapter 4 considers how financial reporting might disguise the economic cost of acquiring business. The risk free discount rate and best estimate assumptions used to project discounted cash flows do not have a contingency for risk. Furthermore, the old tax basis creates artificial losses that can be offset against high up-front costs.

Chapter 5 sets out the reasons for regulating advisers and insurers.

Chapter 6 discusses the appointment of the prudential regulator and licensing of insurers. Insurers will be required to have a credit rating on their local operation, obtain a financial condition report from an actuary and maintain a risk management framework.

Chapter 7 discusses the expansion of oversight by the conduct regulator and licensing of advisers. Intermediaries will be required to have relevant education attainment, maintain competency through Continuous Professional Development and be a member of a disputes resolution body.

Chapter 8 discusses the rationale and impact of changes to life office taxation.

Chapter 9 outlines the outlook for the industry in light of recent legislative changes, including drivers for aggregation through dealer groups and aligned distribution.

Unless otherwise specified, all numbers relate to New Zealand dollars

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2. New Zealand life insurance market

New Zealand has 4.2 million people and very little insurer regulation. Most of the significant life insurers have an overseas parent.

The Life Insurance (1908) Act returns and financial statements are lodged with Companies Office within 9 months of the close of the financial year.

All life insurers operating in New Zealand must deposit $ 500,000 of New Zealand Government Bonds with the Public Trustee.

There are 42 registered life insurers, comprising 5 reinsurers, 13 direct offices who are members of the Investment, Savings and Insurance Association (ISI), 4 companies run by ISI members and 20 small niche offices that account for less than 2% of total premium.

Almost all Life Insurers maintain segregated capital in excess of the minimum set out in New Zealand Society of Actuaries Professional Standard no. 5. This is not a legal requirement.

2.1 Premium split

In-force retail life and disability premium grew by 42.7% in 5 years ended 30 June 2009. This exceeded the 15.6% increase in the Consumers Price Index. There is also a relatively small amount of group life ($ '000's):

	Individual Life excluding medical				Group Life
Office	30 June 2004		30 June 2009		30 June 2009
1	265,620		411,050		36,910
2	172,702		215,608		
3	154,425		165,612		35,037
4	102,586		128,123		906
5	44,914		99,319		
6	56,986		78,555		8,342
7	29,343		74,665		188
8	42,799		70,139		739
9	55,294		63,143		20,240
10	33,476		54,180		
11	20,442		31,348		
12	6,391		9,913		
13	- -		4,062		
	984,978		1,405,727		102,362
Distribution					
Retail banks	217,631	22%	367,449	26%	
Tied/direct	460,208	47%	586,961	42%	
Autonomous advisers	307,139	31%	451,377	32%	
	984,978		1,405,727		
Coverage					
Traditional	256,993	26%	180,229	13%	
Term Life	470,253	48%	768,867	55%	
Trauma/TPD	114,278	12%	233,419	17%	
Income Protection	143,454	15%	223,212	16%	
	984,978		1,405,727		

(Source: ISI, author's distribution estimates)

2.2 Product

Unlike many developed markets, yearly renewable term (YRT) is the predominant contract in New Zealand and Australia. There are also some level term contracts. The traditional endowments, whole of life and unbundled contracts are mostly legacy business no longer actively marketed.

Under YRT, the premium changes every year in line with prevailing market rates at the current age. Apart from life cover in the 20s or early 30s, premiums tend to go up with increasing age.

Almost all premiums are collected through monthly or fortnightly instalments through direct debit to the policyholder's current bank account where the amount is originated by the life office. The age related increase at policy renewal is automatically collected unless the policyholder cancels the contract.

The accepted wisdom is that savings and risk should be separated, rather than bundled up in a traditional endowment or whole of life assurance. The savings component should be in a transparent vehicle with low entry charges and ready liquidity, such as a unit-trust.

On the risk side, as you get older the need for cover tends to decline. There is no tax on deceased estates in New Zealand and no tax incentives for paying premiums into a life policy. Thus, there is no reason to commit to a fixed amount of cover with a level-premium contract.

A yearly renewable term offers low initial premiums and the flexibility to opt-out when insurance is no longer needed.

A low initial premium leaves more money to be saved from a fixed amount set aside for cover and savings. A low initial premium helps reduce the strain on the family budget at the time when there are more mouths to feed and school fees to pay.

The drawback of yearly renewable risk is that at older ages when the risk is higher, the cost becomes unaffordable. The insurer collects the premiums when the chance of dying is relatively small. Later on, as the chance of dying becomes a probability rather than a possibility, the cost soars and eventually the cover is cancelled.

2.3 Distribution

One-third of business comes from autonomous advisers who write business for several companies. Typically the adviser is a sole-trader or small partnership. There are a few master agents with sub-agents. Autonomous advisers are not described as independent. New Zealand securities legislation prohibits using the phrase 'independent' if an intermediary receives a financial reward from an issuer for placing business. There are a growing number of dealer groups offering autonomous advisers a variety of compliance tools in return for over-rider commissions from life offices.

Most of the tied business comes from aligned advisers who are permitted to write a small proportion of their business with competing companies. Many autonomous advisers were previously aligned advisers. For as long as advisers remain tied, persistency risk is limited to the policyholder changing adviser rather than the current adviser shifting the business around the market.

Most of the bank business is initiated at the time of securing a loan to buy or refinance a house. Banks generally require life insurance cover to be in place particularly for low-equity mortgages. Although banks are not permitted to require customers to buy captive cover, it is convenient to buy cover through the bank. Banks also acquire business through mail-shots and their branch network.

2.4 Life Investment business

The vast majority of retail investment inflows are channelled through unit-trusts or bank deposits rather than life investment policies. Master trusts and wrap platforms that facilitate multi-manager access are popular with aligned advisers.

Most unit-trusts are structured as a Portfolio Investment Entity (PIE) for tax efficiency.

Life investment policies are taxed at source at the standard rate of tax. This is more penal for lower rate tax-payers than a PIE. Higher rate tax does not apply to investment income sourced through a PIE.

Many life offices stopped selling life investment policies during the last 10 years. Investment business is mostly offered by fund management companies many of whom are owned by banks or life insurers.

Unlike most developed countries, there were no tax incentives or compulsion for retirement saving in New Zealand from 1988 to 2007. The number and size of employer sponsored superannuation schemes has declined considerably. Most remaining private sector schemes are defined contribution.

In 2007, the KiwiSaver scheme started. This provides for accumulated contributions to be paid as a lump sum at the age of entitlement for New Zealand Superannuation, currently age 65. Apart from voluntary enrolment, there is automatic enrolment for new employees but with an opt-out provision. Employers have to provide 2% contributions if the employee contributes. A few employers contribute 4% for contributing employees, paying fringe benefit tax on contributions in excess of 2%. The government provides a tax rebate for adult member contributions capped at $ 20 per week. In the first two years, nearly one-quarter of the population has enrolled, but there are a lot of accounts where contributions are restricted to the cap for incentives.

Many advisers who sell unit-trusts or KiwiSaver also sell life insurance policies. They have been subject to increasing regulation with full disclosure of commission on investment business.

Regulations are being expanded in scope and will be extended to life insurance products. The issue of adviser regulation is discussed more fully in chapter 7.

3 Replacement business

Retaining business is one of the biggest challenges facing many life offices, particularly those serviced by autonomous advisers. Typically the responsibility period for initial commission is pro-rated and ends after 24 months. Advisers have less interest in conserving business from the second renewal.

The main factors mitigating the potential loss of business to a competitor are client inertia; contractual or emotional ties binding advisers to the life office; differences in scope of cover for trauma and income protection; and increased difficulty in re-underwriting borderline/sub-standard lives.

3.1 Stepped increases in premium

Life offices have discretion to change premiums on each policy anniversary. Rates change in line with age-related stepped increases, indexation of benefits and experience adjustments.

In recent years, Life and TPD experience has improved, so premium rates at the same age have stayed the same or fallen. Trauma and income protection rates have increased in line with heavier claims experience. Experience adjustments are often chunky rather than gradual. Some adjustments have also been made to recoup higher acquisition costs. A few offices also provide discounts for policyholders whose policies remain in-force for more than 5 years.

Apart from the male accident hump, premium rates increase with advancing age, by around 7% to 12%. Inflation indexing adds around 1% to 5%. With experience adjustments, the overall increase in premium may vary between -5% to +45%, but averages +8% to +15% every year.

The cumulative impact of rising rates provides autonomous advisers with an opportunity to shop around at each policy anniversary. Increasingly advisers are also shifting part of cover from annual stepped to a guaranteed level premium structure.

3.2 High up-front commission

Introductory commission terms vary. New premium may include or exclude sales tax (or 'GST'), policy fees and inflation (or 'CPI' increments). Commission write-back scale for early lapses differs.

Typically, commission will be a multiple of the first year premium (inclusive of pre-set negotiated bonus) plus indirect remuneration (including holidays), variable bonuses and dealer group over-riders.

Three years ago, initial commission ranged from 160% to 200% of the first year premium. Following a commission war, commission peaked last year in a range of 180% to 240%, an increase of roughly 30%.

There are higher headline numbers (e.g. 240% + 30% dealer-group over-rider), but require exceptional persistency or exclude frequency loadings, policy fee, GST and mortality/morbidity loadings. A lot of offices increased commission terms in response to falling sales as advisers shifted allegiance to companies paying more commission. Ultimately, acquisition costs increased for all life offices.

Many companies link part of the commission packages to high persistency. However, advisers can build up a client base over several years before approaching clients to move to another insurer.

Life offices pay renewal commission of between 4% and 10%, with options to exchange some initial commission for a higher renewal. However, the incentives are heavily skewed to the point of sale. Some offices have increased renewal commission for advisers that meet continuing production targets.

3.3 Transfer terms

Many life offices have an overseas parent. The short-tenure of many Chief Executives encourages an emphasis on increasing market share of new business. Winning business from non-tied intermediaries can be facilitated by simplifying the process of acquiring business on competitors' books.

There is some effort involved answering a long list of medical questions, providing a blood sample and visiting a doctor for an insurance medical. This is a necessary inconvenience for someone in good health taking out life insurance for the first time. Answering intrusive health questions again, serving another waiting period or repeating blood tests can be off-putting for existing clients. From their perspective they are not applying for cover, they are applying for cheaper cover. Thus, a simplified acceptance process for transferred business is one less objection for an intermediary.

Typically, limits are placed on underwriting concessions to limit the potential strain from early claims. For example, business must have been accepted at standard rates of premium within the past five years. Acceptance is based on screening by the original accepting office. A signed declaration of health can help remove the most seriously ill from a pool of transferred lives. Reduced even perfunctory questions prevent the worst cases from being transferred. The amount insured may also be capped to limit the non-underwritten exposure on any one life.

Although market share of new business will improve as a result of predatory campaigns, the long-term profitability may not improve. Competitors often respond with their own predatory campaigns to hold onto market-share. Most importantly, intermediary behaviour may be altered by predatory campaigns.

Advisers that change tied network, are often given transfer terms to offer their former clients. Thus, it was Life Offices and their reinsurers that encouraged advisers to approach existing customers with a value proposition to transfer cover away from some other insurer.

3.4 Predatory behaviour

A thriving market is one in which new business comprises new customers for the industry or increased coverage for existing customers. Intermediaries are getting referrals and prospecting for new customers.

A stagnant market has a significant proportion of new business arising from replacing cover that existing customers already had in place somewhere else.

The predatory campaigns, seen in New Zealand in the past decade, encouraged intermediaries to transfer existing business from competitors. Thus, intermediaries are no longer expected to continually look for new prospective customers.

High up-front commission with short write-back period created divergent financial interests. Maximising commission earned by an adviser is inconsistent with maximising profits of a Life Office.

Once an intermediary has tasted the enhanced commission from what is sometimes an easier sale process, the process of shifting existing clients around the market can become established. Where necessary, full medical tests are undertaken and sold to the client as a 'free' medical check-up.

Attempts to restrict twisting of business have been frustrated by competition law that protects advisers from suppliers agreeing to restrict commission on replacement business.

3.5 Lapses by channel

Cancelled premium during the year divided by closing in-force premium varied as follows:

Distribution channel	30 June 2004	30 June 2009
Retail banks	13.99 %	11.51 %
Tied/direct	7.65 %	10.43 %
Autonomous advisers	12.48 %	14.20 %
Overall	10.56 %	11.92 %

Banks used to charge higher premiums than adviser offices on 'captive' insurance plans. This practice has moderated and is partly responsible for the improvement in persistency. Brokers are no longer able to routinely replace any bank policy with a cheaper plan.

Tied sales forces provide a good short-term defence mechanism against advisers twisting business. However, once an adviser changes allegiance, the entire book can be at risk particularly for those life offices that stop paying renewal commission.

The prevalence of transfer terms coupled with short commission responsibility and very high up-front commission is mostly responsible for the up-tick in lapses affecting autonomous adviser offices.

4 Financial Reporting

The Margin on Services valuation method is the standard basis for reporting life insurance liabilities. Life investment policy liabilities are valued in accordance with NZ IFRS.

The Margin on Services method is a prospective valuation of expected future cash flows, discounted at the risk free rate of return. The policy reserve is often negative.

The profit expected to emerge from the sale of a policy is spread across the expected lifetime of a policy. The planned profit margin, usually a percentage of future premiums, is added to the unbiased estimate of discounted cash flows to ensure that no profit is capitalised at point of sale.

The reserve for business written in the year preceding the valuation is the negative of acquisition costs adjusted for part year premiums and claims. The magnitude of the reserve for new business may not exceed the deferred acquisition cost.

A more complete description of the valuation method is described in New Zealand Society of Actuaries Professional Standard No. 3 – Determination of Life Insurance Policy Liabilities.

There are business risks in using the Margin on Services results to measure long-term profitability.

4.1 Spreading initial costs

Initial commission is amortised over 20 years or more.

Thus, the valuation basis dampens the impact on current profit of increasing up-front commission.

4.2 Discount rate

The prescribed discount rate is based on market rates of interest. The 10-year NZX swap rate is often used as a proxy for the risk free rate of return.

The valuation basis tends to inflate negative policy reserves and disguise the true cost to shareholders of high up-front commission.

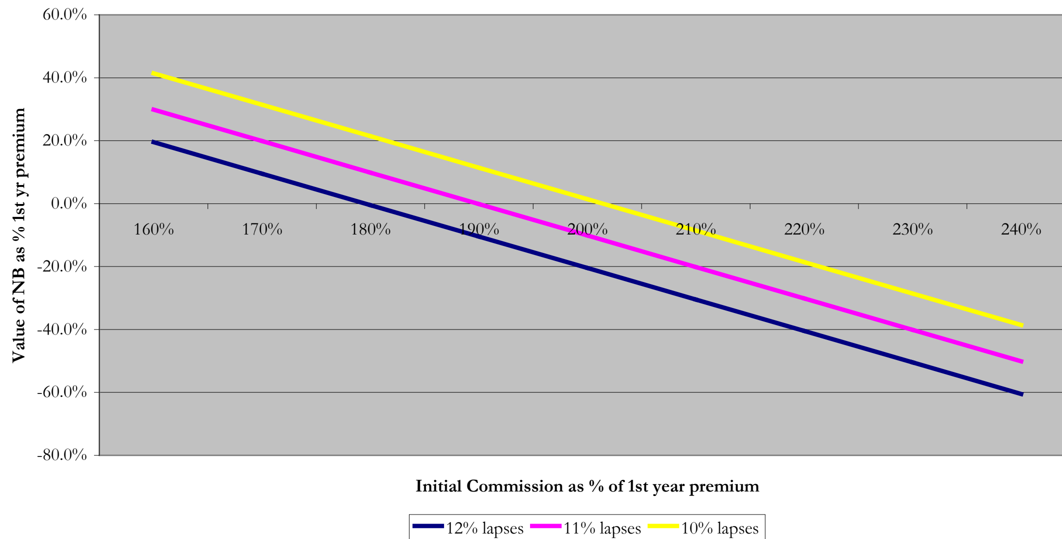
4.3 Lapse risk

An office that is growing rapidly may not notice an increase is lapses for several years.

Predatory advisers will wait until they have served the write-back period on a transferred book before shifting business to another company. Thus, the initial best-estimate for lapses may ultimately prove inadequate.

The valuation method may initially not recognise higher ultimate lapses. Thus, the value of future planned profit margins will be inflated. This means that overseas parents may have been given the impression that business is more profitable than is ultimately achieved.

An example of the impact on value of new business was provided in Smith (2008) and is reproduced below:



The break-even point is sensitive to discount rate and other assumptions. Regardless of assumptions, profitability and expense recovery improves as incidence of lapses declines.

4.4 Taxation

Tax is on the higher of a life office and policyholder basis. In practice, almost all offices pay tax on the life office basis, which can be used to reduce the impact of high commission.

Assessable income under the current life office taxation base =

taxable investment income + capital gains - expenses + underwriting profit + non-life profit

Non-life profit = non-life premium – non-life claims – non-life expenses + non-life investment income

Non-life business comprises disability, critical illness and medical insurance.

The tax basis is applied at the group level; i.e. amalgamating risk and savings business.

Some life offices net down commission for the tax relief afforded by the old tax formula. Thus, the true cost of commission can be disguised.

A new tax basis will take effect from 1 July 2010. Risk and savings business will not be amalgamated. Life insurance will be taxed as disability insurance; i.e. moving from "I –E" basis to "P - C" basis.

Life offices will no longer generate tax losses alongside accounting profit. Thus, high up-front commission may need to be reflected in higher retail premiums or reduced profitability.

5 Why regulate?

Although there have been no major insurance failures in New Zealand for several decades, regulation was seen as inadequate.

5.1 Prudential regulation

In 2005/6 a comprehensive review of financial products and providers was undertaken by the Ministry of Economic Development. A synopsis of the case for reform is reproduced from Smith (2006):

Regulatory intervention is required because voluntary self-regulation cannot ensure all participants adhere to the best standards and because of market imperfections:

5.1.1 Information asymmetries
Insurance products are complex, purchase is irregular and intermediary incentives are not aligned to policyholders. An insured event could be financially ruinous if the insurer does not settle. Without satisfactory disclosure consumers may be left without cover or insurer exposed to unidentified risk.

5.1.2 Transferability
Policyholders whose health worsens are trapped with their existing insurer. Another provider may impose exclusions, higher excess or extra premium.

5.1.3 Unfair conduct
Rules should minimise incentives for parties to act unfairly or fraudulently.

5.1.4 Expectations
Enhanced public confidence and understanding of the limitations of public insurance will help reduce under-insurance. Financial decision making is the responsibility of the individual, not government.

5.1.5 International obligations
Insurance failure may not compromise banking system, but could: damage international reputation; reduce risk mitigation available to entrepreneurs; create regulatory arbitrage; and allow firms to be run by people who fail a fit and proper persons test.

The aims of prudential regulation are to promote public confidence in insurance; encourage soundly managed insurers; and ensure orderly resolution of distressed insurers.

Problems with minimal regulation are:

1. No minimum qualitative standard to assess new entrants abilities
2. The prescribed statutory deposit is a blunt instrument not proportional to policy obligations
3. Inconsistency under different Acts
4. No formal separation of assets to prevent inter-class contagion risks
5. Limited ring-fencing of assets backing some local life investment policies
6. Information lags are long with limited scope to call for extra detail
7. Threshold for intervention high with blunt regulatory tools
8. Unclear guidelines and no remedial graduation for non-disclosure
9. No legally binding enhanced solvency regime for prudential reserving
10. Limited regulation of financial intermediaries

5.2 Adviser regulation

New Zealand has adopted the dual regulator model that separates oversight of prudential strength of product providers and conduct of intermediaries who advise members of the public.

Reserve Bank of New Zealand will supervise all financial institutions not just retail banks.

The Securities Commission will supervise financial advisers and employees of product providers to ensure members of the public receive advice from people who are:

- of good character (without conviction for dishonesty) and member of dispute resolution body
- suitably qualified and keep up-to-date with continuing professional development
- properly understand needs of individual and products recommended to meet those needs
- fully disclose their financial interest and any conflict of interests.

Licensing of financial advisers either directly or indirectly through qualified financial entities is seen as protecting a gullible public from unscrupulous sales people.

Although licensing of advisers is primarily directed towards financial advisers, the provisions of regulation will also affect insurance advisers that do not sell investment plans. Some policy setters are encouraging a shift from commission to fee based remuneration.

5.3 Finance Companies

During 2006 and 2007, over 30 Finance companies in New Zealand went into liquidation or scheme of arrangement. These non-banking deposit-takers "borrowed short and lent long" on a thin capital base.

Common themes that emerged from these failures were:

5.3.1 Connected party lending and complex web of inter-related companies

5.3.2 Concentration of lending on big property developments with little developer capital at risk

5.3.3 Unsuitable directors with history of past insolvency or shallow depth of skills (required to prudently run a financial institution through downturns in business cycle).

5.3.4 Inadequately capitalised without an internationally recognised credit rating (based on the entity's own balance sheet).

Lessons learned will be incorporated into new regulations for insurers. Thus, for example NZSA (2009) recommended that subsidiaries have assets that are: legally owned by the NZ entity, unencumbered without any lien; and realisable only by the NZ entity (not its parent or other related party).

6 Prudential supervision of insurers

A bipartisan approach to legislative in collaboration with industry and the actuarial profession was adopted. There was extensive consultation over several years before publication of a draft Insurance (Prudential Supervision) Bill in April 2009. The new supervision regime will apply to general and health insurers as well as life insurers.

6.1 Framework

Key features of the proposed prudential supervision frame work are:

- Supervision by Reserve Bank of New Zealand (RBNZ) that will not eliminate risk, but provide information to enable the public to make informed decisions about insurance

- Competition on a level playing field will be fostered, that does not duplicate compliance for foreign insurers of a home country regulator with stronger regulation (e.g. Australia).

- Insurers will be required to have sound governance including policies approved by RBNZ for fit and proper directors and officers and an effective risk management policy.

- Responsibility for running companies rests with Directors who will attest to compliance with: minimum solvency margin; approved risk management framework; and appointment of 'fit and proper' directors and officers.

- Insurers will be licensed by RBNZ and maintain a minimum solvency capital defined by RBNZ. The existing NZSA professional standard for life insurance solvency is likely to be adopted with only minor changes.

- RBNZ will be able to investigate insurers and vet the appointment of Directors, Chief Executive Officer, Chief Financial Officer and Actuary.

- Require companies to maintain at least one statutory fund for life insurance.

- Require companies to lodge the year-end and interim financial statements as well as a Financial Condition Report (FCR) prepared by an Actuary approved by the RBNZ. The FCR will be confidential to RBNZ and exempt from Official Information Act disclosures.

- Allow Reserve Bank to exempt foreign insurers from compliance with local regulations if their home jurisdiction has similar or more extensive requirements. This will enable branches of Australian registered insurers to lodge their APRA returns with RBNZ.

- Require a credit rating by an approved credit rating agency for all insurers. The credit rating will take account of any home country priority in case of winding-up. The credit rating will be used in lieu of intrusive site-visits for established well run companies. This is a 'light handed' approach to supervision that minimises the burden of regulatory compliance.

- Require approval by RBNZ of transfers and amalgamations

- Restrict non-insurance activities that would be prejudicial to solvency

6.2 Role of actuaries

For the past four years, the Council of the New Zealand Society of Actuaries has actively engaged the policy setter (Ministry of Economic Development) and new regulator (Reserve Bank of New Zealand) in designing a robust framework.

The profession was guided by the public interest rather than commercial interests in formulating submissions. Whilst submissions would be drafted by insurance practitioners, our colleagues from other fields (Superannuation and Investments) would peer-review submissions.

6.2.1 Responsibility for maintaining minimum solvency margin

One of the biggest changes is shifting the onus for solvency from the actuary to the company.

Under the old regime, an actuary would calculate the solvency margin. The result would normally be published in the statutory annual report. Unfortunately, there was no legal obligation on the company or its directors to maintain sufficient assets to cover the solvency margin.

There was at least one foreign branch that reported a shortfall in branch assets but provided a letter of guarantee from its American parent.

The new regime requires companies to maintain the minimum solvency margin. Directors are held accountable and must include a majority of New Zealand residents.

6.2.2 Standards set by regulator

The new regime has mandatory standards promulgated by the regulator, rather than standards set by the actuarial profession. In practice, the standards will be almost identical.

This was particularly useful for Heath insurers, some of whom needed time to build up capital to meet the desired level of solvency. The Health Funds Association of New Zealand adopted a standard drafted by the NZSA with a 5 year transition.

The actuarial profession could not support a solvency level that was less than the ultimate level. However, the regulator will allow a transition period to enable companies to raise equity and increase prices to bring their funds onto a sound footing.

6.2.3 Governance

Regulatory action when the solvency margin is breached is rather like having an ambulance at the bottom of a cliff. A risk management framework, prohibition on related party investments and positive vetting of directors is rather like having a fence at the top of a cliff.

The new framework adopts a holistic approach. The objective is for companies to be well run, rather than just focusing on capital in excess of the minimum requirement.

6.2.4 Appointed Actuary

All insurers will have to have an appointed actuary, either internal or external, who will confirm that the reserves are adequate and prepare a Financial Condition Report (FCR).

The non-life industry suggested that an FCR could be produced by a Chartered Accountant. This was rebutted in NZSA (2009):

- The FCR will include analysis and commentary on the application of the solvency standard both at the balance date and a forward looking basis.

- An appointed actuary for general insurers is consistent with the approach recommended by the International Association of Insurance Supervisors and Australian practice.

- The requirement for general insurers to have an appointed actuary meets international obligations and convergence towards best practice in developed markets.

- An FCR completed by an Actuary provides a Board with a forward looking assessment which is an actuarial strength.

- A standard may not cover every conceivable situation. Thus, referring some items to the judgement of an appointed actuary is appropriate.

- An actuary will be able to apply statistical techniques to test whether the technical reserves are adequate under a range of scenarios and whether the company is likely to remain solvent taking account of a number of factors including planned new business, adequacy of premium rates, investment policy, reinsurance program and fixed costs.

- Fellows of the New Zealand Society of Actuaries will have passed stringent actuarial examinations, maintain ongoing competence via Continuing Professional Development and prepare reports compliant with our Code of Professional Conduct and Professional Standards.

The challenge for our members in non-life insurance is for their FCR to be more than a compliance report lodged with the regulator.

The experience in Australia suggests that after directors and management of non-life companies have received the FCR prepared by an Actuary they find it very useful in governing their companies.

6.3 Consistency with non-life insurance

Although there is a convergence between life and non-life insurance for financial reporting, it was decided that separate solvency standards will apply. However, the provisions in each standard will not be contradictory.

Work is still ongoing on the definition of the regulatory standards. New Zealand will most likely adopt principles and solvency calculations very similar to Australia, but with less direct oversight.

7 Licensing, disclosure and oversight of distribution

The Securities Markets Act 1988 and Securities Markets (Investment Advisers and Brokers) Regulations 2007 requires disclosure of certain information by investment advisers. This includes details of qualifications, previous convictions, insurance, dispute resolution and remuneration.

Disclosure is likely to be extended to insurance advisers. This may put pressure to reduce high up-front commissions and curtail or restrict soft-dollar benefits.

Under the Financial Advisers Act 2008, authorised financial advisers (AFA) will:

- be licensed by the Securities Commission

- abide by a professional code of conduct and be a member of a disputes resolution process

- have attained educational qualification set out in ETITO (2008) designed for advisers operating without direct supervision and outside a rigid 'template' work process who:
  - Give personalised and specific advice based on needs analysis of a wide range of data,
  - Determine appropriate methods, make recommendations and lead the client, based on this analysis,
  - Have full responsibility for the nature, quantity and quality of outcomes,
  - Possess a broad knowledge base with substantial depth in some areas,
  - Work for the client,
  - May specialise in investment advice, insurance advice or do both.

Providers of financial products may set up a Qualifying Financial Entity (QFE) that includes registered financial advisers (RFA) as well as AFAs. Many banks and life offices with tied distribution are expected to establish a QFE.

RFAs will be required to achieve a level 4 or better under the National Qualification Framework rather than level 5 mandated for AFAs. Levels 1 to 3 are taught at secondary schools. Levels 8 to 10 represents post-graduate qualifications.

RFAs will encompass bank and telephone-sales staff selling less complex products. More complex products can only be sold by AFAs.

8 Changes to taxation

New Zealand undertook radical fiscal changes in the 1980s.

- The rate of tax was lowered but applied to all indirect remuneration.
- Superannuation contributions and investment roll-up was taxed with proceeds at retirement tax-free; a system described as 'TTE'. This replaced an 'EET' system that favoured roll-up of retirement funds that would be taxed in retirement.
- Capital gains tax on directly held investments was abolished as this was an inflation tax. However, capital gains on actively managed funds were treated as income.
- Death duties were also abolished.

Without any tax-incentives, growth of collective investment schemes stagnated whilst employer funded retirement schemes declined. Many New Zealand investors bought rental properties, often with significant gearing.

8.1 Collective investment schemes

In 2007, changes were made to the way investments were taxed.

Actively managed equity funds and life insurance companies are now taxed the same as passive funds.

Capital gains on New Zealand and most listed Australian equities invested via a Portfolio Investment Entity (PIE) are exempt from tax from 1 October 2007. Most New Zealand companies pay a much higher dividend yield than other parts of the world

Under the Fair Dividend Regime (FDR) which came into effect from 1 July 2007, the investment return from international equities held at the start of the tax-year is deemed to be 5% (irrespective of actual capital appreciation or depreciation). This change also applies to life insurance companies.

The rules are quite complex, particularly if forward currency hedging is used or assets are held in trust. Readers who want further details are referred to Chamberlain (2009). It should be noted, however, that options 'O' and 'Q' described in that paper have been shut down by Inland Revenue Department.

8.2 Life Office tax

The case for changing life office taxation was set out in IRD (2007).

This showed an example under the current rules where life office taxable income is negative when accounting income is positive:

	Financial accounting	Life Office Basis Tax
Premiums	100	
Claims (= expected claims)	(50)	0
Investment income	10	10
Expenses	(35)	(35)
Premium loading (20% claims)	.	10
Accounting profit/tax (loss)	25	(15)

Furthermore, when the claims ratio is lower, accounting profit was higher and tax losses even greater.

	Financial accounting	Life Office Basis Tax
Premiums	100	
Claims (= expected claims)	(25)	0
Investment income	10	10
Expenses	(35)	(35)
Premium loading (20% claims)	.	15
Accounting profit/tax (loss)	50	(20)

Term insurance was a minor part of life insurance in 1990 but is now the majority of premium written. Thus, the tax anomaly that arose was not envisaged when the tax regime came into force.

The industry managed to delay the implementation of the new tax regime, in order to mitigate a consequent large increase in premiums paid by policyholders.

From 1 July 2010, life insurers will move from an "I – E" regime to a "P – C" regime, with a five year transition for existing renewable term contracts.

Savings business will taxed independently of shareholder funds and risk business. Thus, any tax losses on risk business can no longer be offset against taxable investment income on savings business.

Furthermore, artificial tax losses on risk business classified as life insurance will not be generated under the new tax basis. This has implications for the viability of current pricing for new contracts and eventually for existing yearly renewable policies.

9 Outlook

There are several concurrent changes affecting the life insurance industry in New Zealand.

Most large offices are already fully compliant with the new prudential regulatory regime. There is likely to be some consolidation as smaller niche companies exit the industry.

The biggest challenges for established life insurers arise from regulation of intermediaries and taxation.

9.1 Distribution

Regulation and supplier positioning will create more segmentation of distribution.

Advisers will have to be licensed. This will involve demonstrating competency, compliance with good practice, ongoing CPD, disclosure of commission and approved dispute resolution.

Initially, tied-agency offices will gain market-share by providing a safe harbour for advisers to be complaint with the new regime.

There has also been consolidation of adviser practices and greater aggregation into groups who can provide standard templates for documentation, guidelines for compliant process, technological tools, product research and ongoing training for non-tied advisers.

Dealer groups will join policyholders, shareholders and advisers as the 'fourth person in the room' getting a slice of the premium. This cost will ultimately fall on policyholders (higher premiums), shareholders (lower profits) or advisers (reduced commission).

Ultimately, many advisers will become comfortable operating under the new conduct regulations, without the controls imposed by dealer groups or tied agencies.

Australia underwent similar regulatory change a few years ago. Over there, some advisers are now leaving dealer groups to restart small practices. Thus, dealer groups that merely 'clip-the-ticket' or focus exclusively on compliance are likely to have a short life-span.

Another trend is life offices acquiring equity stakes in successful dealer groups that advisers perceive as adding value. This is a form of aligned distribution, which is hybrid between tied and independent.

Independence of dealer groups can also be compromised through tendering for life offices to be included on a panel of recommended providers.

9.2 Product

Changes to taxation and financial reporting are encouraging savings business to migrate from life insurers to other forms of collective investments such as unit-trusts.

In Australia, most life offices so not write new savings business. They have sister companies, within a financial services group, that offer retail unit-trusts, retail superannuation and group superannuation with individual member accounts.

Not many offices continue to sell traditional whole of life and endowment assurances with surrender values. The emphasis is on yearly renewable term with a little bit of level term.

9.3 Retail pricing

There is not yet a consensus on what to do about the impending tax changes. However, there is likely to be a shift from chasing market-share to improving profitability.

Some offices may reduce commission or take a lower profit rather than passing everything onto policyholders. A secular improvement in mortality experience, averaging about 3% a year over the past 15 years, may absorb some of the increased outgo.

Some offices have closed some products or increased premium rates by between 15% and 20%. These increases might be designed to recoup higher commission in recent years rather than future tax.

One office has announced that it will increase both life and disability premiums by 2.5% a year for 5 consecutive years and has incorporated this into its illustrations.

Other offices favour a larger one-off increase to new life rates, keeping the old premiums on existing business for as long as possible until the end of the transition.

9.4 Role of actuaries

The standing of actuaries is likely to improve with an appointed actuary regime where the actuary provides guidance to Directors on a range of issues rather than merely calculating policy reserves.

However, with greater disclosure and more professional guidelines on scope of reports, there will be less discretion of actuaries to set charges, premiums and bonuses outside a defined framework.

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