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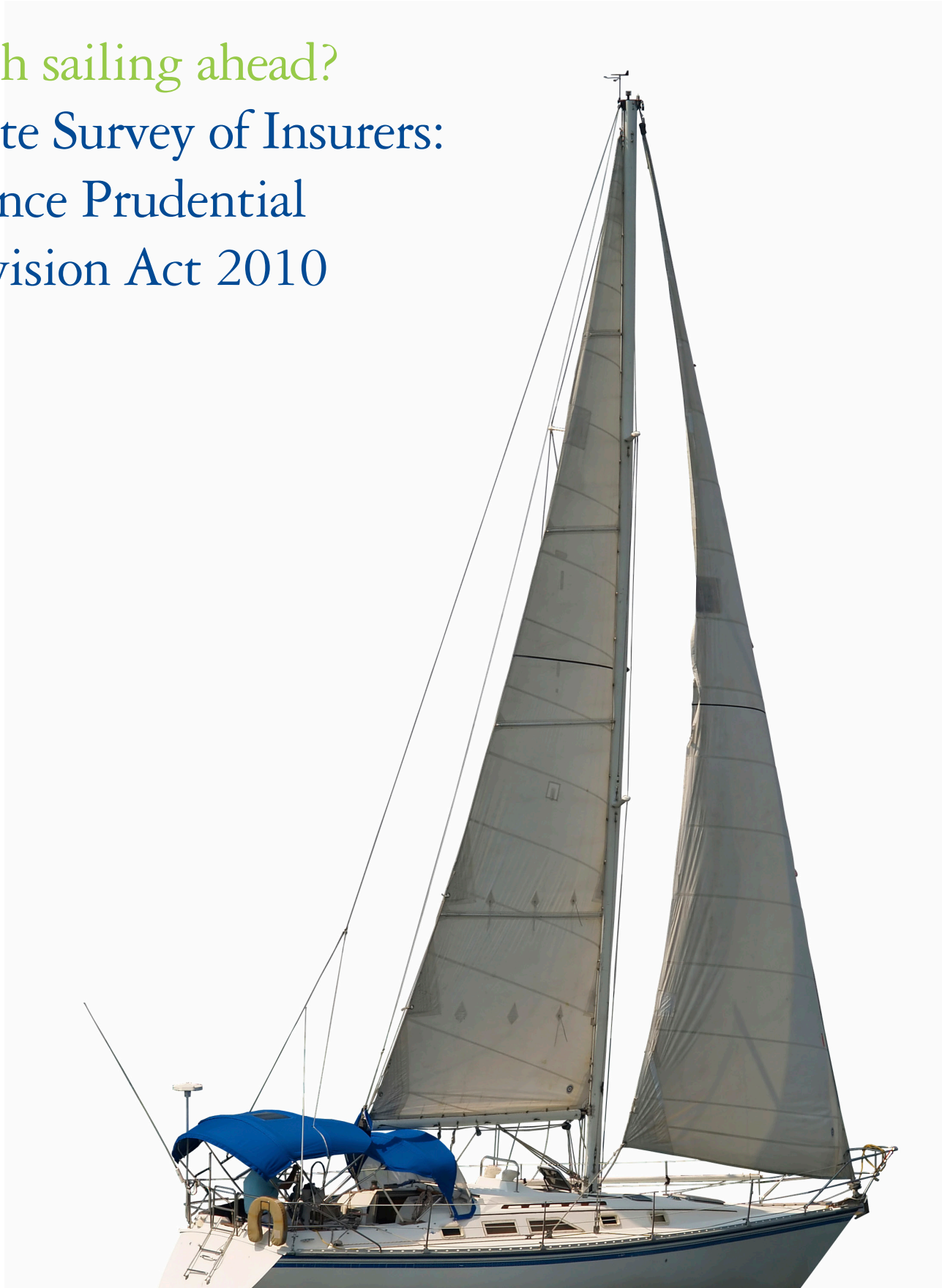
Smooth sailing ahead?

Deloitte Survey of Insurers: Insurance Prudential Supervision Act 2010



September 2014

"Companies have adjusted to the new regulatory seas under the Insurance Prudential Supervision Act. There are still lessons to be learned by the industry and the regulators to bring out the best in the regime and deliver greater confidence and security to policyholders."

Charles Hett, Head of Actuarial Services

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Introduction and highlights

In 2011, Deloitte undertook a survey that covered the Insurance Prudential Supervision Act ("IPSA") as companies applied for their provisional licences. The survey showed companies were confident they would be able to comply with the Act, but there were some areas that stood out as looming issues.

Looking back, those issues included solvency and capital, development of a risk management programme, statutory funds and changes to the board of directors.

Now that the transition is over, and regulation under the IPSA has become "business as usual", Deloitte conducted a follow-up survey to understand how the industry is responding to, and perceiving, the new regulation.

We explored, among other things the:

- impact and costs of compliance, both within companies and industry-wide;
- communicating with the regulator, the Reserve Bank of New Zealand; and
- the role of the Appointed Actuary in the financial management of insurers.

The response to the survey was very good, with 24 companies participating, covering about 50% of the industry (by premium). This included a cross-section of insurers from life and non-life, as well as large and small insurers.

On the whole, companies have adjusted to the new regulatory regime under the Insurance Prudential Supervision Act, with the Reserve Bank of New Zealand ("RBNZ") as regulator being seen generally in a positive light.

There will always be areas for improvement and this survey highlights some of them. It covers some concerns over the knowledge and resourcing of the RBNZ prudential supervision team, the adequacy of risk management programmes, getting the most out of the Appointed Actuary and the overall purpose and effectiveness of statutory funds.

Our view is that these issues represent the start of a journey of continuous improvement for the industry seeking to develop the best possible approach to the regulatory framework.

We would be delighted to discuss these results with you in person and explore how they point to ways to use the process of meeting legislative requirements to build a stronger and more resilient business.

Charles Hett
Head of Actuarial Services

Greg Haddon
Insurance Industry Leader

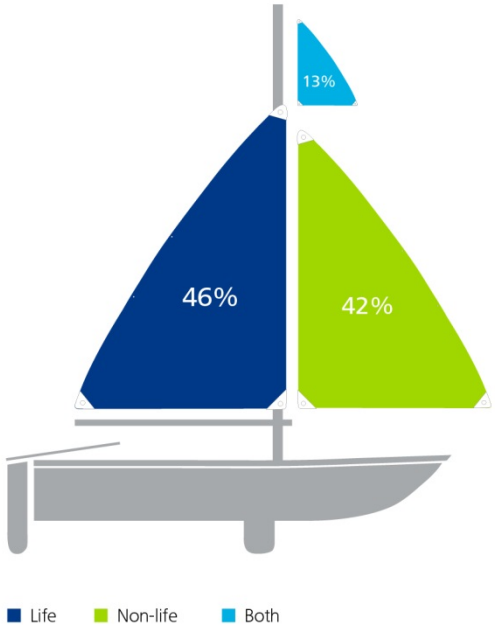
1. Survey participants

The survey covers a good cross section of the insurance market, especially in terms of the medium and larger insurance companies.

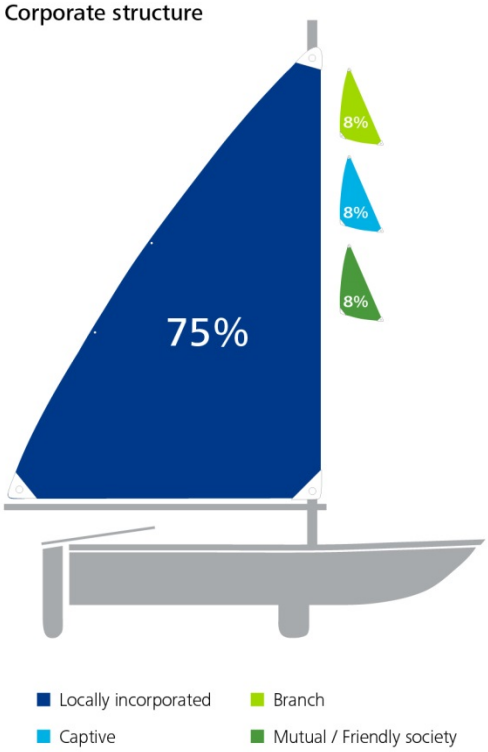
- 24 separate insurance organisations were included in the survey. In the previous survey conducted in 2011, we had 23 participants;
- measured by premium, the participants represent approximately 50% of the market;
- there are **13 large** companies (Annual Gross Written Premium ("GWP") greater than $75m); **5 medium** sized companies (GWP between $5 and $75m) and **6 small** companies (GWP less than $5m). Only 1 respondent to our survey has an annual GWP of less than $1.5m, and is therefore exempt from some aspects of the regulation.
- in terms of IPSA categorisation, 14 companies are classified as life; 10 classified as non-life. For the purposes of this survey, 3 of the life companies that sell both life and non-life insurance have been classified as "both";
- 44% of the companies surveyed sell life insurance; 38% sell general insurance and 19% sell health insurance;
- half of the companies surveyed were headquartered in New Zealand; 29% in Australia and the remaining based in other countries;
- regarding corporate structure, 75% of respondents are locally incorporated and shareholder based; the remaining were equally divided between locally based mutual or friendly societies, branches of overseas companies and captives.

Describing the companies

Type of insurance



Corporate structure



2. Impact on Insurers

For most insurers, these regulatory requirements have added more than just compliance costs. Business decisions, company structures and board meetings have all been affected by regulatory changes.

Cost of compliance

A surprising result from the survey was the average costs involved in qualifying for an insurance licence. Large and medium sized companies (by GWP) have spent an equal amount in dollar terms on average, although there is a wider range of compliance costs for larger companies. Small companies have spent an average of $195,000.

The ongoing costs to meeting regulations are more equitable according to the size of the company. For small companies, the estimated annual costs average around $60,000, while for medium and large companies average annual costs are $100,000 and $250,000 respectively.

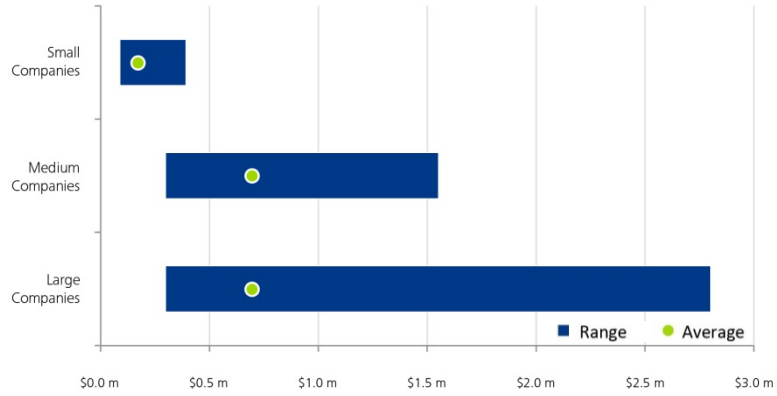
Business Change

Over half the companies commented that IPSA legislation had a moderate to significant impact on their business decisions. Only 3 companies, small in size, indicated that IPSA did not affect any business decisions beyond compliance.

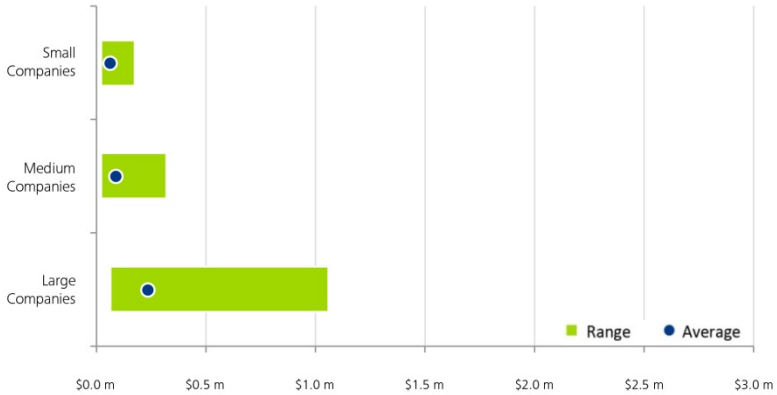
The business decisions primarily affected by IPSA were: the amount of capital held in business; the responsibility for regulatory reporting; business structure; and financial monitoring.

There is some evidence that IPSA has reduced business risk appetite as insurers focus on building capital or changing investment strategy to minimise risk capital charges.

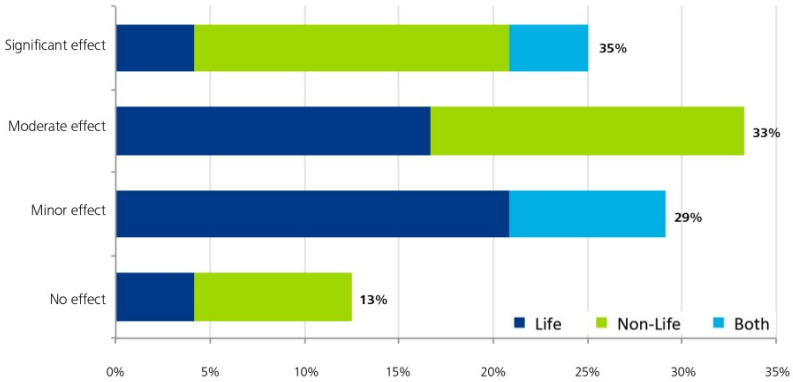
Range of IPSA Compliance Costs (Establishment)



Range of IPSA Compliance Costs (Ongoing, Annually)



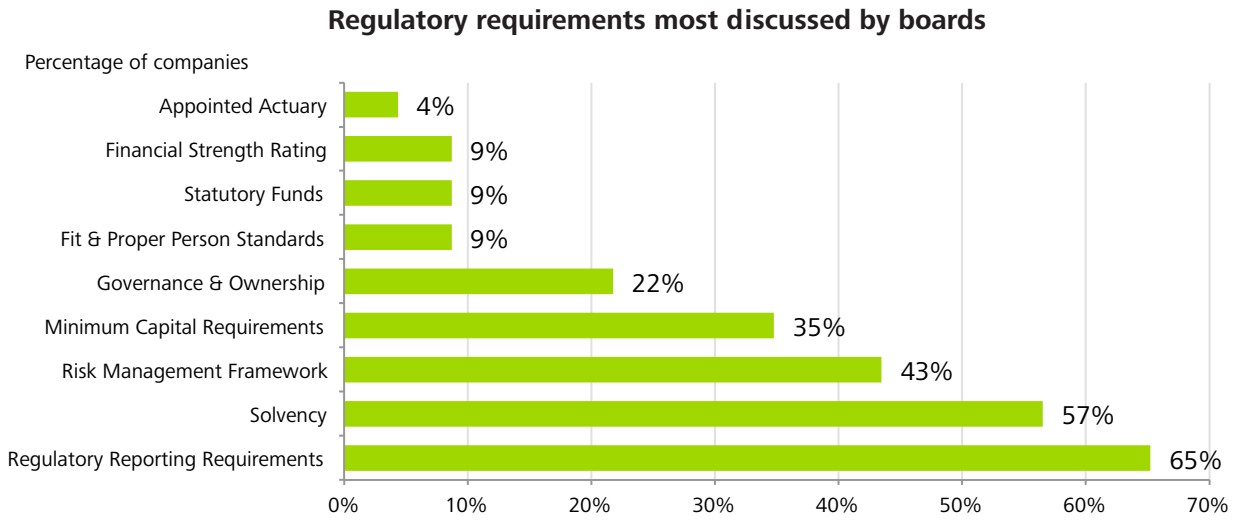
Effect of IPSA legislation on companies by percentage



Board matters

Since the introduction of prudential regulation, nearly all company boards in our survey consider the regulatory impact of business decisions either more frequently or in more detail and depth. Regulatory reporting requirements feature most regularly at Board meetings, whilst Solvency and Risk Management Frameworks also feature strongly.

Many companies have restructured their Boards in recent years and are discussing more technical issues at board level than before. The ability to clearly communicate technical information to the Board is becoming more important, as well as ensuring the focus is not solely on regulation and compliance.

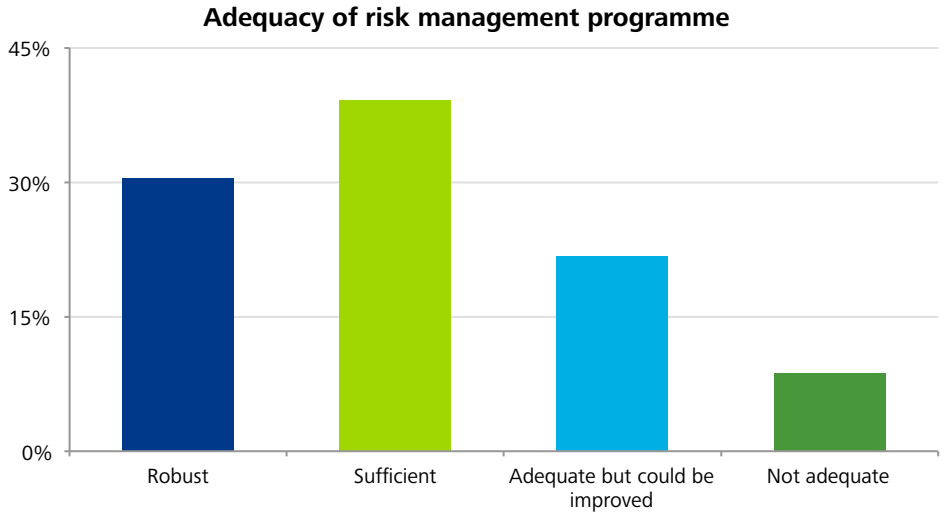


Company structure

17% of the companies indicated they changed their company structure due to IPSA requirements with a further 8% planning to change their structure in the coming 12 months. Changing parent or sister company relationships or merging were the main structure changes with associated changes to directors.

Risk management

Most of the surveyed companies thought their risk management programmes were either "sufficient" or "robust". Interestingly, the companies who thought their risk management programme was "not adequate" or "could be improved" were mainly the large companies.



3. The Regulator

In general, the response from the industry is that working with the RBNZ has been a positive experience, although there are concerns around the knowledge and expertise of some RBNZ team members.

The majority of the respondents in the survey rated the experience of working with the RBNZ Prudential Supervision team as good or excellent while only a couple of respondents thought of their experience as poor or very poor.

A bulk of the respondents took a pro-active approach to raising issues with their advisor within the RBNZ Insurance Oversight team. The few who were cautious thought that regular contact would be seen as a negative by the RBNZ team.

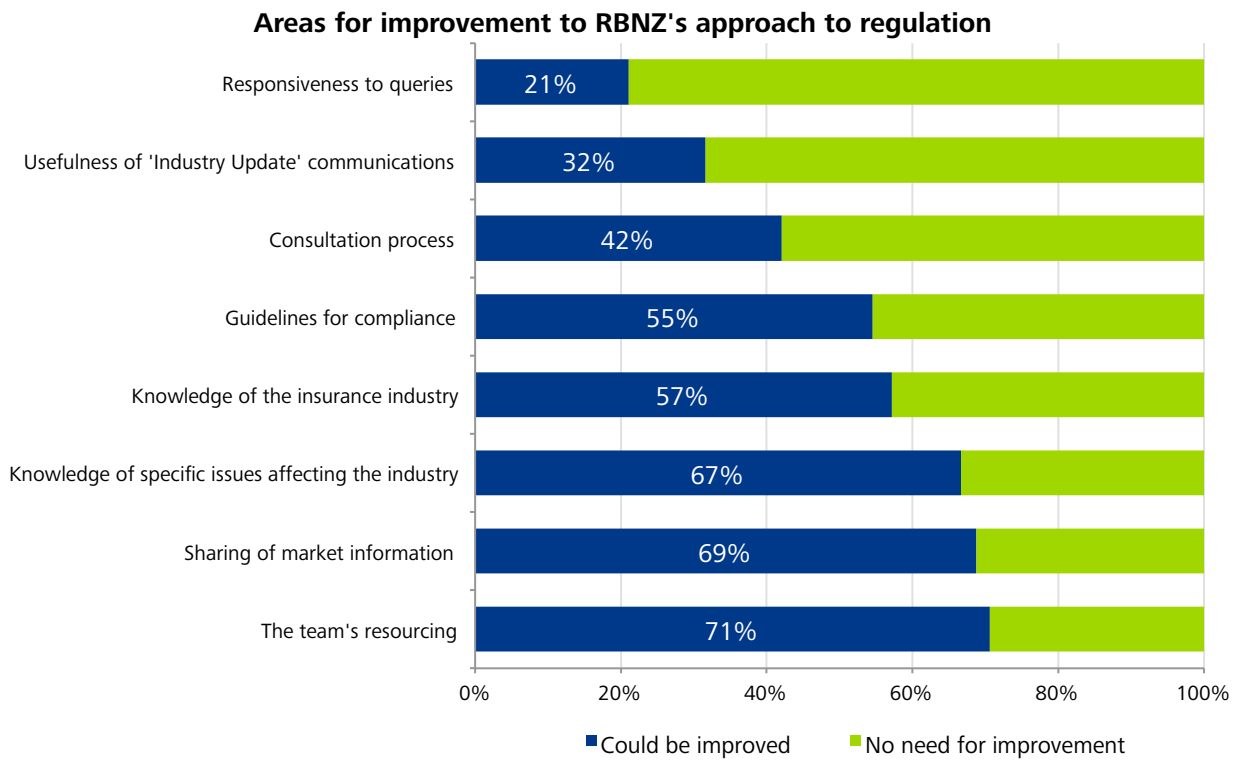
39% of the respondents appointed a Regulation or Compliance Officer to deal with the RBNZ Insurance Oversight team. The other respondents were roughly and evenly divided between the 4 remaining positions of Chief Risk Officer, Chief Financial Officer, Head of Legal and Other. Interestingly, not a single company in our survey used the CEO or the Appointed Actuary as the main contact person with the Oversight team, although it is possible the CFO may also be the AA.

Many respondents praised the RBNZ for maintaining an open and consultative dialogue with their organisation.

> "We are very satisfied with the open style of communication with RBNZ."
>
> -survey respondent

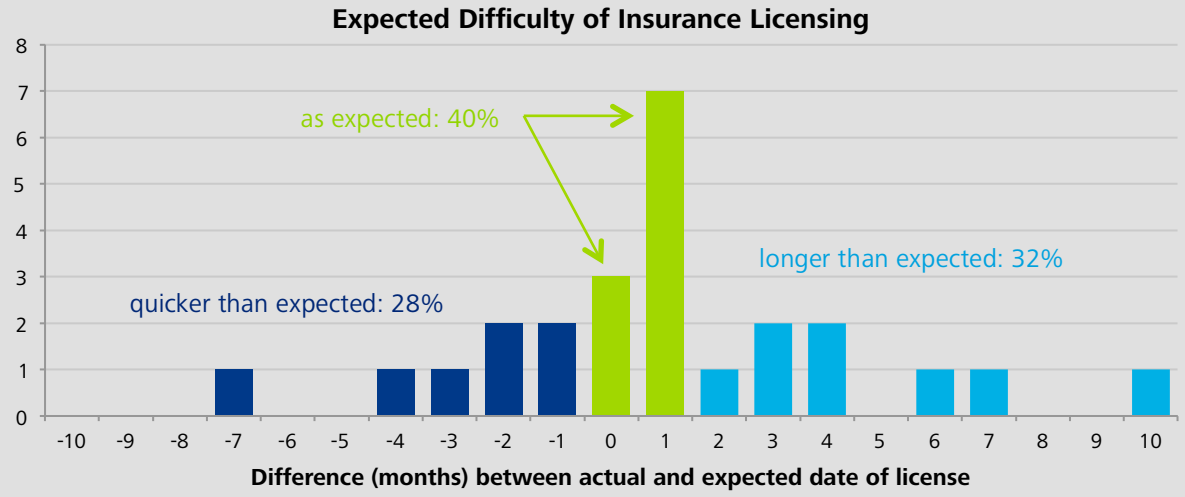
Most of the respondents in the survey were more than satisfied with the performance of the RBNZ Insurance Prudential Supervision Policy team.

A bulk of the respondents thought the RBNZ did an excellent job in their responsiveness to queries and in the usefulness of the industry update communications. However, there appears to be an inverse relationship between the RBNZ's 'responsiveness to queries' and 'the team's resourcing'. Several respondents elaborated that they had concerns around the level of insurance industry knowledge among some team members, particularly in relation to modelling appropriateness. In addition, survey respondents felt a need for the RBNZ to share market information, although the regulator's next steps here are currently open for consultation with the industry.



Communication in the lead up to licensing

In 2011, our survey asked respondents when they expected to achieve their full insurance license. Using data from the RBNZ's license register, we were able to compare this with their actual date of licensing. We can use this as a proxy for the 'difficulty' of the initial licensing process: if a company took longer than expected, we assume that it was somewhat more difficult than expected. As it happens, two-thirds of surveyed companies achieved their license at or before their expected date. To us, this shows that the RBNZ's communication and process in the lead up to licensing allowed most companies to plan well for the introduction of the IPSA regulation.



4. The Appointed Actuary role

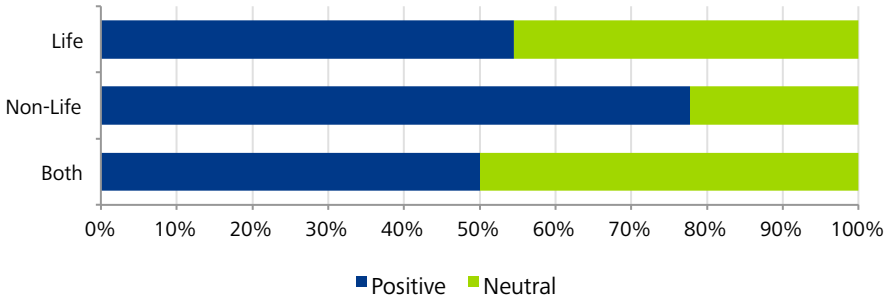
The Appointed Actuary plays a significant role in the management of an insurance company – but our respondents suggest there is room for actuaries to grow further into this role.

All small and medium sized companies surveyed use an external provider to fill the Appointed Actuary role. About half of the companies think that the Appointed Actuary role has been a positive development for the company. However, more than a third of the companies think of the position as a neutral development suggesting that more value could be added by the actuary.

In addition to the above, larger organisations see the role of their Appointed Actuary differently in that they expect him/her to prioritise the **financial security** of the company. Small and medium sized companies expect their Appointed Actuary to be an **advisor** to the company, which makes sense given all small and medium sized respondents hire an external consultant to fill this role. Another difference between the various company sizes is the Appointed Actuaries' role in protecting policyholders. Small and medium sized companies see it as one of the role's lowest priorities whilst large ones rate it high priority.

The Appointed Actuary as a 'watchdog' for the regulator was rated as one of the lowest priorities among all surveyed companies.

Has the creation of the role of Appointed Actuary been a positive or negative development for the company?



Ranking of priorities of the Appointed Actuary			
	Large	**Medium**	**Small**
Financial security of the company	**1**	3	2
Advising the company	3	**1**	**1**
Protecting policy holders	2	4	5
Business support	4	2	3
Watchdog for the regulator	5	5	4

1 = most important priority, 5 = least important priority

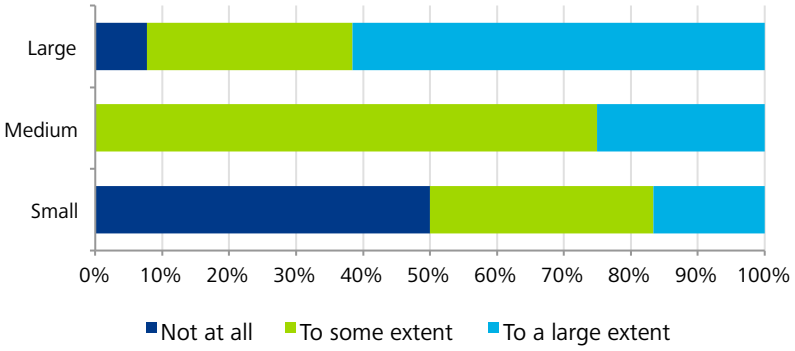
The role of the Appointed Actuary is a significant responsibility. At the very core of the regulation is the requirement for the Appointed Actuary to consider the interests of the policyholder – which may not always be aligned with the interests of the shareholder, or the actuary's employer! As part of the compliance role, an Appointed Actuary must review all actuarial information to be used in the preparation of the financial statements, review the solvency return and write a Financial Condition Report for the company's Board and senior management team. As the results of our survey have shown however, an Appointed Actuary needs to add significant value to the company in their role as a business advisor.

Financial Condition Report

The Appointed Actuary plays a critical role helping senior management and board understand risks to solvency and the capital position of the insurer; the Financial Condition Report ("FCR") plays an important role in this. We expect that the FCR will increasingly be seen as a beacon for the board and senior management, and it is important that actuarial teams focus on clear communication.

In addition to meeting IPSA requirements, the FCR can present a number of important uses: providing the board with a further perspective, as a basis for discussions and training with staff and senior management. In addition, some companies found the FCR useful as part of their business planning. Around two thirds of large companies thought of the FCR as being useful to other parts of the business while less than a quarter of medium and small companies thought of it this way.

Use of FCR outside of CEO/CFO/Board



The FCR can be a big undertaking for companies: large companies take between 2-3 months to produce the FCR while medium and small companies take 2-4 weeks to produce it. However, we understand this is linked to the time taken to finalise the year's financial performance.

Particularly for bancassurers or captives, having an FCR can be a really useful reference document for members of the Board or Leadership team who may be less familiar with the inner workings of an insurance company.

A company's FCR must contain description of the risks that could pose a threat to the insurer's ability to meet solvency requirements, and the steps taken to address or minimise those risks. It must also outline the assumptions made by the AA in the preparation of the solvency margin, and describe how deviations from those assumptions could impact the level of solvency capital in the business.

Talk to us about how you can make your company's FCR less formulaic, and get the most out of it. It doesn't have to be just another compliance exercise.

"The FCR is essential background to business strategy planning and maintaining or improving the financial strength of the business"

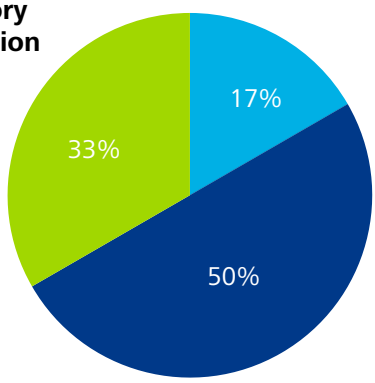
-survey respondent

5. Statutory Funds

Statutory funds add another layer of compliance for life insurers. Our respondents are not convinced that they provide additional protection for policyholders, as intended by the regulator.

Statutory funds became compulsory for life insurers under IPSA. Therefore the results in this section reflect the responses by **life insurance** companies only.

How valuable are statutory funds in providing protection to policyholders?



Two thirds of life insurers thought that additional financial reporting for the statutory fund was a material issue for the company as a result of the IPSA statutory fund requirements. One respondent commented that there was a: "*considerable overheads associated with splitting life and health business when health business is less than 25% of overall business.*" Other areas of concern for insurers were the flexibility around movement of capital and meeting solvency requirements.

Most companies believe that statutory funds provide at least some additional protection to policyholders. One respondent has noted that:

"If the company is solvent then the statutory fund is solvent, and vice versa; therefore the statutory fund is simply an extra level of compliance and cost."

-survey respondent

6. Capital and solvency

Generally, the amount of regulatory capital required to meet solvency standards was seen as being "about right". Perhaps unsurprisingly, it is the smaller insurers and non-life insurers who were more likely to view regulatory capital as "too much".

Regulatory capital

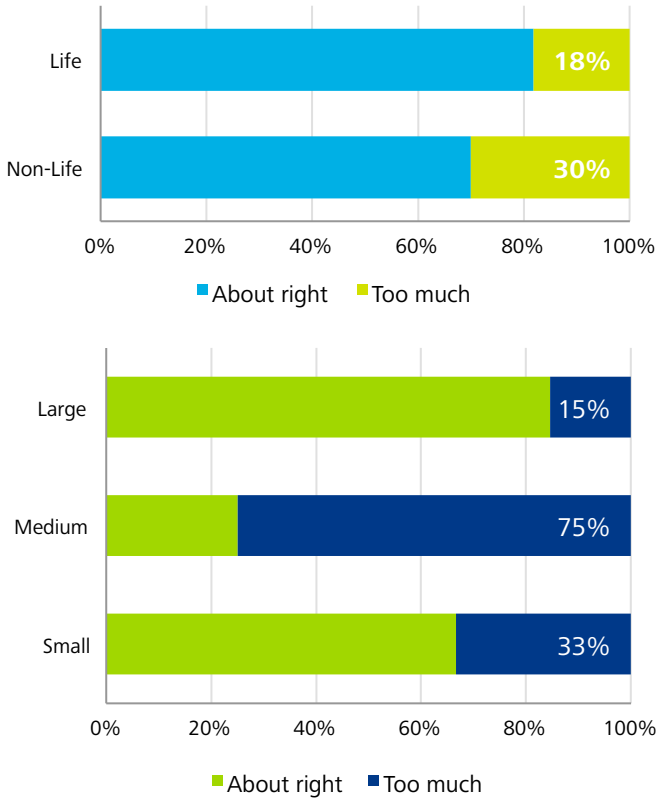
Slightly less than half of the surveyed companies continue to hold the **same overall level** of capital since the implementation of the IPSA regulation. Around the same proportion of companies indicated that they would be holding **more capital**. Around 80% of these companies indicated that this level of capital was permanent.

Small and medium sized insurance companies and non-life insurance companies are more inclined to have increased the level of regulatory capital held by the business.

Attitudes do differ on the amount of capital held and the size of the organization. Most large companies believe they are holding the right amount of capital, while medium sized companies believe they are holding too much. No-one felt that they were holding "too little" capital.

More life than non-life companies believe they are holding the right amount of capital. In addition, life companies were also more inclined to use regulatory capital as a factor in managing the business.

The amount of regulatory capital the company is required to hold



We are now in an environment where there will always be a minimum amount of regulatory capital required for insurance companies, but how can it be managed effectively?

- The insurer could identify capital inefficient portfolios and re-price these or divest from them if they're no longer a core offering.
- Optimise reinsurance levels to minimise the required capital for both insurer and reinsurer, for example this could involve increasing or decreasing the current insurance retention levels.
- Evaluate the current investment allocation to find the ideal mix that matches portfolio and risk appetite of business.
- Design capital-efficient products and ensure cost of capital is included within pricing.

Solvency standards

At the time of our last survey in late-2011, the RBNZ had not yet finalised its guidelines for the solvency standards under IPSA. At the time, we were surprised that only 30% of respondents thought that the solvency standards would be difficult to comply with.

We surmised that the **complexities would be in the detail**, which of course have become more apparent throughout the implementation process. We asked respondents to share what areas of the solvency standards they feel are technically difficult to comply with, and received a range of answers. There are no apparent trends or correlation around a company's size or whether it's a life or non-life insurer, and the types of difficulties the company has with a solvency standard.

Some areas of the solvency standards which our respondents think are technically difficult include:

- Tax, including deferred tax
- Catastrophe risk and associated risk charge
- Complexities and ambiguities due to the ongoing evolution of requirements
- Areas where the actuary can apply his/her discretion – for example, in defining Related Product Groups (RPGs)
- Reinsurance

One respondent commends the recent refinements to the solvency return template provided by the Regulators, and confirms that it is relatively straight-forward to complete.

> "Standards are primarily principle-based with clearly defined risk capital charges."
>
> -survey respondent

7. Industry-wide impact

Not surprisingly, respondents feel that regulation has had a significant impact on the insurance industry.

Almost all (87%) of our respondents said that there has been an increase in business consolidation or M&A activity in the insurance industry since 2011 – although not all activity can be attributed to the introduction of prudential regulation.

A majority of respondents (83%) consider the impact of regulation on the insurance industry, as a whole, as significant. A couple of respondents have noted that the regulation has adversely impacted captive insurers with one respondent noting: "*that Captives are not really understood by the Regulator and offshore markets are now looking more captive-friendly than New Zealand as the compliance and reporting costs are getting higher*."

Most respondents (74%) think that the introduction of prudential regulation has had a slight improvement in the manner in which the industry is run, as a whole.

The RBNZ continues to make adjustments to its requirements of licensed insurers. One area in particular that is undergoing regular review and update are the solvency standards. As at the publication date, consultation was underway on the solvency treatment of guarantees and submissions had recently closed regarding Financial Reinsurance. In addition, the RBNZ is seeking to collect data to better monitor and assess the financial position of all insurers, which has the potential to increase the compliance workload further.

Concluding thoughts…

The results of this survey suggest that while the industry is cruising toward "Regulatory BAU", this does not necessarily suggest smooth sailing up ahead. The initial compliance process was not as titanic an event as some may have predicted, but the New Zealand insurance industry, including the regulator, is still adjusting to the current uncharted waters before reaching the clear water ahead.

Deloitte actuarial and insurance specialists

Charles Hett
Head of Actuarial Services
Wellington
+64 4 470 3866
charleshett@deloitte.co.nz

Adam Follington
Director
Auckland
+64 9 303 0931
afollington@deloitte.co.nz

Richard Korte
Manager
Wellington
+64 4 470 3537
rikorte@deloitte.co.nz

Catherine Edgar
Manager
Auckland
+64 9 303 0903
cedgar@deloitte.co.nz

Greg Haddon
Insurance Sector Leader
Auckland
+64 9 303 0911
ghaddon@deloitte.co.nz

Michael Tang
Financial Services Practice
Auckland
+64 9 303 0799
michaeltang@deloitte.co.nz

Michael Wilkes
Partner - Audit
Christchurch
+64 3 363 3845
mwilkes@deloitte.co.nz

Wendy Lai
Partner - Consulting
Auckland
+64 9 303 0792
wlai@deloitte.co.nz

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- Reserve, liability & solvency calculations
- Compliance with regulations and taxation
- Prudential regulations, IFRS 4 and IFRS 9
- Appointed actuary services and financial condition reports
- Mergers and acquisitions
- Data analytics

Tax

- Compliance with legislation and Inland Revenue requirements
- Tax implications of various transactions
- Policy submissions to officials on new legislation
- Strategic tax review of functions and systems
- Tax planning for income tax and indirect taxes
- Financial reporting and calculation of tax balances
- Assistance with Inland Revenue audits and reviews

Audit

- Accounting opinions and technical issues
- Acquisition examinations and due diligence review
- Corporate governance
- Financial investigation and restructuring
- Initial public offering
- Operational and statutory audits

Strategy and Operations

- Operations excellence
- Business performance improvement
- Cost-down
- Business process change
- Finance transformation
- Business case development
- Change management

Enterprise Management and Information Systems

- Management information and data
- Data warehousing
- Sales and retention analysis
- Underwriting rules
- Claims management

Business Technology Services

- IS strategy and roadmap
- Enterprise architecture
- Strategic sourcing
- Systems integration
- Project management
- QA and benchmarking

Risk and Regulations

- Capital management
- Risk governance and appetite
- Risk management frameworks
- Risk appetite reporting and dashboards
- Asset, liability modelling and management
- Financial risk modelling

Auckland
Deloitte Centre
80 Queen Street, Auckland 1010
Private Bag 115033
Shortland Street, Auckland 1140
New Zealand
Tel: +64 (0) 9 303 0700
Fax: +64 (0) 9 303 0701

Hamilton
Deloitte House
24 Bridge Street, Hamilton East
Hamilton, 3216
PO Box 17, Hamilton, 3240
New Zealand
Tel +64 (0) 7 838 4800
Fax +64 (0) 7 838 4810

Rotorua
Level 2, Pukeroa Oruawhata House
2/1176 Amohau Street, Rotorua
PO Box 12003
New Zealand
Tel +64 (0) 7 343 1050
Fax +64 (0) 7 343 1051

Wellington
Deloitte House
Levels 11-16, 10 Brandon Street
Wellington, 6011
PO Box 1990, Wellington, 6140
New Zealand
Tel +64 (0) 4 470 3500
Fax +64 (0) 4 470 3501

Christchurch
50 Hazeldean Road
Christchurch, 8024
PO Box 248
Christchurch, 8140
New Zealand
Tel +64 (0) 3 363 3800
Fax +64 (0) 3 363 3801

Dunedin
Otago House
481 Moray Place
Dunedin, 9016
PO Box 1245, Dunedin, 9054
New Zealand
Tel +64 (0) 3 474 8630
Fax +64 (0) 3 474 8650