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Inquiry into Regulatory Institutions and Practices
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REGULATORY INSTITUTIONS AND PRACTICES

The Insurance Council of New Zealand (Insurance Council) appreciates the opportunity to comment on the New Zealand Productivity Commissions' Issues Paper regarding the review of Regulatory Institutions and Practices. This review provides an important opportunity to fundamentally reassess the regulatory framework and standards of New Zealand.

1. Insurance Council

The Insurance Council is the industry representation body for fire and general insurance in New Zealand. The Council aims to assist members in key areas affecting their business through effective advocacy and communication.

The Council currently has 29 members who would collectively write more than 95 percent of all fire and general insurance in New Zealand. Insurance Council members, both insurers and reinsurers, are a significant part of the New Zealand financial services system. Our members currently protect more than $0.5 trillion of New Zealanders' assets, including over $170 billion of home mortgages.

The Insurance Council plays an active role in representing the insurance industry. Our members are licensed under the Insurance (Prudential Supervision) Act 2010 and are signatories to the Fair Insurance Code that requires insurers to act ethically. Our members are also subject to numerous other regulatory regimes, including regulation of market conduct by the FMA, regulation of competition and pricing by the Commerce Commission and regulation of health and safety by MBIE. We also perform an important role in informing and educating consumers about key insurance issues and risks.

2. Role of Insurance Sector in the Economy

Insurance plays a fundamental role underpinning economic activity. As a risk management tool it encourages increased investment by reducing the capital businesses need to operate. It enables higher risk/return activities to support growth and through the investment of premium it supports capital growth in the wider economy. It also provides access to

offshore funds through reinsurance, as evidenced following the Canterbury earthquakes, and saves taxpayers and the Government from provisioning entirely for catastrophe events.

It is essential that insurance is well understood as the implications of ineffective regulation can be significant for not only insurers and their consumers, but also the wider New Zealand economy. The Productivity Commission's review provides an important opportunity to reassess the current regulatory regime for the insurance industry.

3. Improving the Operation of Regulatory Regimes

Q1 What sort of institutional arrangements and regulatory practices should the Commission review?

The Commission should undertake a broad review of institutional arrangements and regulatory practices, but with a focus on both new and existing regulatory regimes.

The Commission's paper is very forward looking, focussing primarily on the design and establishment of new regulatory regimes and regulators. However, as noted in the paper, it is at least equally as important to look at current regulatory regimes and processes. As set out in the Terms of Reference, the Productivity Commission has been charged with developing, "*system-wide recommendations on how to improve the operation of regulatory regimes over time [and] how to both build on strengths and address weaknesses in current practices.*"

Our submission focuses largely on the strengths and weaknesses in current regulatory practices, particularly with respect to the insurance industry. We believe that learnings from current regulatory practices relating to the insurance industry could help to identify wider issues around the regulation of financial services in New Zealand.

3.1. Over-Stringent Regulation

The Commission's Paper begins by considering a number of the common design and operational failures of regulatory regimes. With respect to issues around design failure, we agree there needs to be very careful consideration of, "*over-stringent regulation which reduces the possibilities for innovation or imposes excessive compliance costs*."

Over-stringent regulation can act as a significant impediment to productivity and economic growth. For the insurance industry, the risk of over-stringent regulation primarily comes from the Reserve Bank through prudential supervision. However, insurers are also at risk of over-stringent regulation by the FMA with respect to market conduct supervision, by the Commerce Commission for competition and pricing, and by MBIE for health and safety.

Throughout this submission we identify a number of specific issues faced by the insurance industry with respect to over-stringent regulation, specifically around duplicate regulation, limited accountability and transparency, inappropriate consultation and excessive discretion. Over-stringent regulation directly affects the cost of conducting business for various industries in New Zealand.

It's essential that excessive compliance costs are avoided as these will ultimately be transferred through to consumers, creating market attractiveness and affordability issues. Market attractiveness issues will ultimately have a direct impact on competition, to the detriment of industry innovation and efficiency, by affecting the productivity of existing

market participants and by creating entry barriers for potential market participants. This will inevitably exacerbate affordability issues for consumers.

In the insurance industry context unaffordability ultimately leads to under- and non-insurance. This means increased exposure for the government in times of catastrophe and related social issues as well. It is essential that over-stringent regulation of the insurance industry be avoided.

Excessive or poorly designed and executed regulation can also have serious implications for access to, and provision of, capital. It can reduce the profitability of an industry, making it more difficult to raise capital. But it can also discourage international providers from investing capital into the New Zealand economy, particularly if that capital can be more efficiently allocated elsewhere.

Poorly designed and executed regulation can also lead to efficiency distortions. For example, solvency standards that are poorly designed can lead to distortions in insurance policy pricing, by unnecessarily increasing the cost of capital. They can also discourage insurers from undertaking certain legitimately low-risk asset investments, by introducing inappropriate capital charges, ultimately affecting the insurer's balance sheet structure.

For the insurance industry this issue around access to, and provision of, capital is played out through the Reserve Bank's solvency standards. Regulators should be careful to avoid introducing regulation that does not properly fit the New Zealand context and which doesn't have a clear net economic benefit. If regulators demand more capital than is strictly necessary, e.g. through overly strict solvency standards, then this will inevitably cause market attractiveness issues. This should be carefully considered by any regulator. The onus of proof should be on government to prove beyond reasonable doubt that the benefits of intervention will exceed the costs, including unintended costs.

It is also important to note the risks inherent in regulators being new to their role, as with the Reserve Bank in its role as the prudential supervisor of the insurance industry. As noted in some detail below, it is essential to have appropriate external scrutiny and oversight of regulators.

3.2. Duplicate Regulation

> *Q11 Can you provide examples where two or more regulators have been assigned conflicting or overlapping functions? How, and how well, is this managed?*

The insurance industry provides a good example of where two regulators have been assigned very similar functions and where it would make far more sense to confirm one single entity as the regulator for that specific activity.

FMA v Commerce Commission

The Financial Markets Conduct Act 2013 (FMCA) transferred the oversight of misleading and deceptive conduct for financial services from the Commerce Commission, under the Fair Trading Act 1986 (FTA), to the Financial Markets Authority (FMA). However, the Commerce Commission has still retained the ability to bring prosecutions for the same market conduct matters under the FTA if leave is granted by the FMA, essentially duplicating the regulatory oversight of misleading and deceptive conduct.

In practice, the FMA will be the primary regulator of these fair trading conduct matters and a memorandum of understanding will be signed between the two entities to affirm this. However, there will still be the possibility for duplication if leave is granted by the FMA for the Commerce Commission to bring proceedings.

It is therefore possible that proceedings could be bought against an insurer under the FTA or the FMCA, for the same matter. This would obviously lead to ineffective duplication of resources and could also prove unjust if different outcomes were likely to be derived through the different regulators for essentially the same issue.

Financial Adviser Act duplication

Furthermore, insurers and their agents are also subject to similar misleading and deceptive conduct provisions under the Financial Advisers Act 2008 (FAA). Sections 34-35 of that Act prohibit financial advisers from engaging in misleading or deceptive conduct when providing a financial adviser service. The misleading and deceptive conduct provisions in the FMC Act effectively cover this same territory. This duplication exists for all financial advisers.

In practice, the FMA would likely bring actions under the FMCA, not FAA. However, theoretically, proceedings could be bought under either Act, creating potential regulatory inconsistency, especially given the different penalties under each Act.

One single market conduct regulator

Even if financial advisers are only required to deal with the FMA regarding misleading and deceptive conduct matters in practice, they would still be required to deal with the Commerce Commission regarding any unfair contract term matters if the Consumer Law Reform Bill is passed. There should be more consideration given to the need for a single market conduct regulator.

Australia has two distinct towers of regulation – the so-called "twin peaks" model. There is a clear tower for prudential regulation via APRA (just like via the Reserve Bank under our Insurance Prudential Supervision Act 2010) and a clear tower for market conduct through the Insurance Contracts Act 1984 (administered by ASIC).

If some elements of regulatory oversight remain with the Commerce Commission (i.e. for unfair contract terms) then this will lead to further entrenched regulatory fragmentation, inefficiency and uncertainty. There would be clear benefit in amalgamating knowledge within one market conduct regulatory body, as in Australia, so that insurance conduct matters could be dealt with consistently and effectively.

Having a single market conduct regulator also encourages a better working relationship between government and stakeholders, as market participants are not required to commit resources across a number of different bodies. It would also reduce the risk of inconsistent policy and regulatory practice between the agencies, which is a risk under the current framework.

It is ineffective and inefficient to have two distinct market conduct regulators assigned to oversee similar matters.

3.3. Accountability and Transparency

Q56 What types of accountability or transparency arrangements are appropriate for different types of regulatory regimes?

As noted in the Issues Paper, "*Together, accountability and transparency act to sharpen the incentives on regulators to perform well.*"

It's crucial that regulators are held to account for their conduct, particularly when it comes to demonstrating how standards or regulations will be implemented and how certain decisions have been made. The following questions from the issues paper relate specifically to how greater accountability and transparency can be promoted amongst regulators.

Q26 How effective and consistent are the review and appeals processes provided for in New Zealand regulatory regimes?

Q27 Can you provide examples where the review and appeals processes provided for are well-matched or poorly suited to the nature of the regulatory regimes?

Q28 What are the advantages and disadvantages of a general merits review body like the Australian Administrative Appeals Tribunal?

The New Zealand regulatory regime could be strengthened by requiring much greater accountability of the entities which implement and/or develop regulation.

One particular initiative that should be considered by the Commission is the establishment of a merits review framework. In Australia such a framework was established under the Administrative Appeals Tribunal Act 1975. The Act established the Administrative Appeals Tribunal (AAT), which reviews a wide range of administrative decisions made by Australian Government ministers, departments and agencies.

This judicial arrangement enables an affected party to apply to the AAT to review and potentially overturn an administrative/regulatory proposal by a government agency. The AAT considers the material before it and decides what the correct or preferable decision is. For example, it might affirm, vary or set aside the decision under review.

This initiative would help strengthen the accountability and transparency of regulators. It would encourage decision-makers to make better and more careful decisions and would promote much greater confidence in regulators. It is also likely to induce a more considered and meaningful consultation process than occurs currently by the RBNZ, FMA and other regulators.

The Government should also consider other potential initiatives, such as establishing an independent Office of Regulatory Review to review proposed regulation and report on proposals at an early stage, in order to avoid unnecessary and over-burdensome regulation.

This office should be responsible for either preparing or reviewing cost/benefit analyses, to provide greater scrutiny to Regulatory Impact Statements. The current quality of cost benefit analyses and Regulatory Impact Statements is inadequate and is biased because they are produced by the agency that is proposing the new regulation. The Regulatory Reform Minister could be made responsible for this office, in order to bring independent oversight

to proposed regulations and legislation, separate from the Minister promoting the regulatory or legislative proposal.

Similarly, The Treasury, or the Audit Office, should be tasked with undertaking periodic independent reviews of regulators and their supervision arrangements, and also conducting performance audits. These regular external reviews could be five yearly and would involve input from regulated entities and other parties. The results of the review would be made public.

The Treasury should play a much more active role in developing and overseeing regulation. For example, The Treasury recently released a document under the Official Information Act which outlined a number of concerns with the decision-making model of the Reserve Bank with respect to setting the official cash rate. In the letter, senior Treasury officials noted that the Bank's single-decision-maker model is no longer appropriate given the Governor's expanded mandate to include the regulation and supervision of insurance and non-bank deposit takers. This point has as much relevance to prudential regulation and supervision as it has to all other functions of the Reserve Bank.

This recommendation highlights the obvious benefit in having an organisation like The Treasury identifying potentially ineffective decision-making within a regulatory body. We would like to see more of this. Our sense is that the Treasury is currently under-resourced to effectively monitor and scrutinise the Reserve Bank and proposals coming from the Bank. We believe a much more focused and better-resourced effort is needed by the Treasury in this area; much more akin to that in Australia and the UK. Greater accountability and transparency of regulation would ultimately help to ensure better quality decision-making by regulators.

This whole area of accountability and transparency requires serious consideration by the Productivity Commission as developments in this space have the potential to positively affect a number of different industries.

3.4. Discretion and Consultation

Q42 Can you provide examples of where a regulator has too much or too little discretion in enforcing regulations? What are the consequences?

Q45 Can you provide examples of where regulatory regimes require too much or too little consultation or engagement? What are the consequences?

Linked to the above points around improving 'checks and balances' is the need to ensure broad discretion is not given to regulators to implement standards and regulations without appropriate third party consultation or guidance.

Unintended consequences of poor regulation could be better countered by requiring more effective consultation. There should be enhanced requirements for regulators to consult on regulatory proposals, particularly with industries such as the insurance industry, where the issues in question are highly technical in nature.

The regulatory impact (cost/benefit) assessment framework should be strengthened to ensure effective consultation does take place. For example, the legislation should require a minimum time for consultation, should require that any consultation papers are subject to formal review by Treasury before being released for consultation, and the Reserve Bank

should have to issue a response paper that sets out, specifically, what its responses are to comments made, with a second round of consultation required if the proposed changes are significantly different from those in the first paper.

When the Reserve Bank was in the initial stages of drafting the Solvency Standards it held public presentations with various industry bodies. These were extremely useful as it enabled the Reserve Bank to provide context around the intention of the wording within each Solvency Standard.

However, regulatory consultation around the most recent proposed Reserve Bank solvency changes has led to a lot of uncertainty for insurers. The standard would create significant concern for insurers by significantly broadening the definition of off-balance sheet exposures, in turn significantly increasing the level of complexity in solvency return calculations.

If there had been greater consultation between the Reserve Bank and insurers on this standard then there would have been a much better understanding of the intention behind the definition and the significant uncertainty/concern created by this document could have potentially been avoided.

The Commission's Issues Paper identifies that, "*regimes that give regulators wide discretionary powers may require stronger obligations to engage with stakeholders*." This is even more so in a technical industry. Without becoming an obtrusive process, we would encourage the Government to continue to look at ways to ensure effective consultation is made mandatory.

3.5. Resourcing

Q36 Where are there gaps in regulator workforce capability? Can you provide examples?

It is important to have appropriate workforce capability in any regulatory regime. However, this is particularly true of a technically demanding industry such as insurance. Regulators develop knowledge over time so it is critical to engage with industry early on in any regulatory undertaking.

For example, the majority of our members had positive experiences during the recent Reserve Bank licensing process. However, there were a number of lessons also learnt during this exercise. A number of resourcing issues were identified around speed of response in certain circumstances and appreciation of complex insurance/reinsurance arrangements. Primarily resourcing was an issue in the early stages when the regulator was still gearing up.

Having clearly defined guidelines, transparency around decision-making and consistency of regulatory decisions is critical to ensuring workforce capability.

3.6. Regulatory Funding

Q30 Can you provide examples of where the mix of funding sources contributes to the effectiveness or ineffectiveness of a regulatory regime?

Funding mechanisms can have a direct impact on the effectiveness of a regulatory regime by creating excessive compliance costs. In order to have an effective regulatory regime there should be an appropriate funding mechanism in place.

With any 'user-pays', levy-based system there should be a correlation between regulator interaction and the contribution sought from those regulated. If certain groups are charged a disproportionate amount, compared to their limited interaction with the regulator, then the 'user-pays' concept becomes ineffective.

For the insurance industry, there is serious concern around the way in which the FMA is currently funded. The FMA levy has been targeted towards financial market participants because they are the 'end-users' of FMA services. However, the focus in setting levies seems to have little correlation to how the FMA's resources will likely be concentrated.

Insurers do not pose the same risks as banks, financial companies or insurance brokers. However, some insurers are required to contribute up to $150,000 towards the funding of the FMA despite having very little interaction with the Authority. Insurer contributions are arbitrarily calculated and seem to be based on who is perceived to have the deepest pockets.

The basis for such a significant contribution seems to be that insurers benefit from a sound financial sector. While this is undoubtedly true, this is just as true for of any other market participant. Funding mechanisms should not work to further exacerbate compliance costs for potential and existing market participants.

Funding of the Fire Service

We have similar concerns with respect to the way in which the Fire Service is funded and, in particular, the way in which it oversees the collection of levies from insurance companies.

The Fire Service is directly funded through a levy applied to insurance policies. Collection of the levy is undertaken directly by insurance companies and is complicated and expensive. There are difficulties in interpreting the Act and calculating correct contributions.

In particular, there are significant difficulties with respect to broker written business. For intermediated business, insurance companies will only receive payment between 80 to 90 days after the month the policy is finalised, yet will have to pay Fire Service Levy within 45 days after the month the policy is incepted – i.e. for a policy effective and finalised in January, an insurance company will receive the money no earlier than 20 April, yet have to pay FSL by 15 March, GST by 28 Feb, and claims immediately from inception date. It would make far more sense to align payment of the levy to when payment is received.

What is even more alarming is the significant discretion given to the Fire Service to independently collect, audit and enforce penalties relating to the levy. The Fire Service takes a hard line on interest and late payment penalties. The penalty interest rate is excessive (1.5% per month) and there is no independent process to appeal penalty decisions. There is an inherent conflict of interest at play here and there needs to be some form of independent review introduced.

The Fire Service Levy is inherently inequitable, unsustainable, avoidable and inefficient. This whole area needs review, as not only is administration around the levy inappropriate, but the whole concept of funding a public good through insurance is inappropriate.

3.7. Review of Wider Insurance Industry Regulation

Despite the significant regulatory changes imposed on insurers over recent years, and other financial advisers, brokers operating in the intermediated insurance market have remained relatively lightly regulated. We believe this is in large part due to a general misunderstanding of the insurance industry.

There has been an active approach by Government and regulators to encourage insurance companies to self-regulate the intermediated insurance industry. This can be seen in the way Government has refused to implement remuneration or financial strength rating disclosure requirements in previous years. Repeatedly comments have been made by Government and regulators that insurers should be responsible for dealing with these issues.

Not only is this commercially unrealistic, it is inappropriate. For example, there would be significant issue with the Commerce Commission if insurers were seen to be colluding on industry-wide remuneration or premium-retention changes. Also, insurers would not be able to ensure consistent change for all consumers in the same way regulation or legislation would.

Insurance brokers have a significant presence in New Zealand, are independent of insurance companies, and should be regulated as such. If the Government's intention is to have a sound, reputable and unbiased intermediated market then it should ensure proper market conduct regulation is put in place, as it is inappropriate to expect insurers to regulate the intermediated insurance market themselves.

This would have been realised had a number of the recommendations noted above been in practice – i.e. better consultation with stakeholders, better resourcing/understanding of the industry and more effective regulatory review processes.

4. Conclusion

Thank you again for the opportunity to provide input on the Issues Paper. We trust the Productivity Commission's draft report will include specific recommendations on aspects of regulation that should be further investigated and/or new institutional arrangements that should be introduced.

The proposals are of significant interest to our members and we look forward to the next stage of this review. Please contact Simon Wilson on (04) 495 8008 or at simon@icnz.org.nz if you have any queries.

Yours sincerely

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