

# Ratings and Deposits (Insurance) Regulatory Impact and Business Compliance Cost Statement

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# **Regulatory Impact Statement**

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## **Statement of the Problem and the Need for Action**

Consumers of insurance products are particularly vulnerable to an insurer's insolvency. Assessment of an insurer's financial position is technical which makes it difficult for ordinary consumers to make a reasonable and informed choice regarding the financial strength and viability of their insurance provider. Insurers themselves are vulnerable to the risk of unusual or unpredicted liabilities and require rigorous records and a considerable level of technical competence to accurately assess their future risk and liabilities and calculate premiums.

The failure of an insurer can have disastrous consequences for policyholders, for people who have claims against policyholders and for the economy as a whole. These include: policyholders face potential financial losses as their claims may not be fully met; loss of confidence in the insurance market; and increased pressures on social welfare systems and government reserves. The collapse of HIH in Australia was a reminder of how real those risks are and of how serious the consequences of an insurer's failure can be.

The existing Ratings Act and the Deposits Act both attempted, in different ways, to protect consumers against the insolvency of an insurer. There are however issues with the current application of both these statutes. The Deposits Act no longer fulfils its original purpose of providing a realistic pool of funds to compensate policyholders in the event of an insurer's insolvency and the financial reporting requirements it imposes are outdated and inadequate. The Ratings Act, which requires insurers to obtain and publicise annual ratings of their financial positions, generally works well but does not apply to all types of insurance products. A rating, given by an approved ratings agency, provides a professional, expert and independent assessment of an insurer's financial strength and allows policyholders to compare insurance companies that provide the same or similar products and services.

## **Statement of the Public Policy Objective**

The objective of the proposal is to promote good business practice in the insurance industry by requiring all insurers to get an annual rating and file standardised financial returns. This will ensure that consumers get better information about their insurers and their ability to meet future obligations. These measures will go some way to improving consumer protection and will enable consumers to make an informed choice of their insurance provider.

## **Statement of Feasible Options to Achieve the Desired Objective**

The following five options were considered:

1. The level of deposits required for unrated insurers could be increased.
2. The Deposits Act could be repealed and no new requirements imposed.

3. An annual rating could be required from all insurers and deposits could be refunded (preferred option).
4. A rating could be required for any insurer that has not yet lodged a deposit.
5. The existing deposit requirements for unrated insurers could be continued.

In addition, all insurers (except captive insurers<sup>1</sup> and overseas reinsurers<sup>2</sup>) will be required to file statements complying with the relevant New Zealand financial reporting standard (“FRS”) instead of the current requirements in the Deposits Act. These will be audited and filed for public inspection at the Companies Office.

## Net Benefits of the Proposal

The advantages and disadvantages of the five options are summarised below:

	Option 1	Option 2	Option 3 Preferred option	Option 4 existing/future		Option 5
Encourages good practice			***		***	
Discourages weak insurers from entering the market	***		***	***		*
Discourages weak insurers from staying in the market	***		***			
Allows existing sound insurers to continue	*	***	*	***		***
Low compliance costs		***	*	***	*	***
Competitive market	*	***	*	*		***
Protection on liquidation	***			*		*

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<sup>1</sup> A captive insurer is an insurance company, controlled by a single company or a single group of companies, which provide insurance only to that single company or group.

<sup>2</sup> Reinsurers are insurance companies that accept risk transferred from other insurance companies in a reinsurance transaction.

Equal treatment of similar insurers	*	*	***		*
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\*\*\* indicates a strong effect

\* indicates a weak effect

an empty box indicates no effect

split cells under option 4 indicate different effects for existing and future insurers

## Preferred Option

Option 3: that all insurers should be required to have ratings and deposits should be refunded would:

- promote good business practice by increasing the rigour that both ratings and an improved financial reporting requirement would impose on insurers' financial systems;
- discourage unsound insurers from entering the market by requiring them to first meet certain standards and requirements;
- remove some at-risk insurers from the market who would be unable to comply with the new regime; and
- provide a logically consistent system for rating non-life insurers which would allow consumers to compare like insurance companies.

### Further Benefits Include:

- standardised financial reports would require insurers to adopt good accounting practices which would demonstrate to them whether they are conducting sound business and are capable of meeting potential claims. This would enable insurers to identify and deal promptly with potential problems;
- ratings would give consumers the benefit of an external, independent and professional assessment of an insurer's financial status;
- consumers would be better able to assess insurer's financial positions and to compare different insurers;
- all insurers who have lodged deposits would get their money back (over \$50 million is currently held), allowing them to put the money to more efficient use and offsetting the increased compliance costs;
- costs for insurers who already have ratings would be reduced since they would no longer be required to lodge a deposit;

- at-risk insurers unable to meet the increased costs and comply with the new regime are likely to be a high-risk business and, therefore, their removal from the market will reduce risks to policy holders;
- unnecessary compliance costs associated with specially preparing financial returns under the Deposits Act would be removed; and
- the Registrar of Companies will keep a register of insurers and will have an enforcement function under the new regime.

There may be some minimal costs associated with establishing a register. Further there may also be enforcement costs relating to potential prosecutions of insurers who carry on business without a current rating. These are also likely to be low as there may be only 1 to 2 cases a year for potential prosecution.

## **Consultation**

Between December 2000-December 2001, two rounds of consultation were conducted. These targeted key stakeholders and all unrated insurers. The second round, which was in the form of a discussion paper, focused on the specific proposals set out in this paper.

In addition to the public consultation, the following parties have also been consulted: Department of Prime Minister and Cabinet, Treasury, Ministry of Consumer Affairs, Te Puni Kokiri, Ministry of Justice, Public Trustee and the Insurance and Savings Ombudsman.

# **Business Compliance Cost Statement**

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## **Source of the Compliance Cost**

Compliance costs would arise from the requirement of unrated insurers to obtain an annual rating and may arise from operating changes to their financial reporting systems.

## **Parties Likely to Be Affected**

Approximately 33 unrated insurers offering health, liability, income, mortgage and consumer credit insurance will be affected by the requirement to obtain a rating. Many of these are small companies with estimated net premiums ranging between \$4,000 and \$22,621,000. There are approximately 45 currently rated general insurers, include all major market players, with an estimated range of net premiums between \$447,000 and \$326,974,000. These companies will not be affected by the proposed regime.

Over 90% of insurance companies, both rated and unrated, currently comply with the FRS 35. Therefore, less than 10% of insurance companies would incur costs by improving their financial reporting systems.

## **Estimated Compliance Costs of the Proposal**

AM Best and Standard & Poor's are the two ratings agencies currently approved to supply ratings to New Zealand insurers. The annual cost of a rating from AM Best is between US\$8,000 and US\$15,000. Standard & Poor's charges A\$28,000 for a new rating and A\$3,000 for a rating of a company branch. There may also be some one-off costs (e.g. hiring accounting specialists) associated with establishing improved financial reporting systems.

## **Longer Term Implications of the Compliance Costs**

The annual cost of obtaining a rating, combined with the low rating that a small company may get because of its size and the initial costs of setting up or improving systems to satisfy the ratings authority's requirements, could well drive some small insurers out of business. It can be argued that any insurer unable to meet the increased costs and comply with the new regime should not be participating in an industry such as insurance, which requires a high degree of prudence and the ability to spread and absorb financial risk. The new regime would improve business practice across the industry and would raise consumer confidence in the insurance market.

## **Level of Confidence of Compliance Costs Estimates**

The cost of ratings were quoted by the two rating agencies. Costs associated with setting up or improving a firm's financial reporting system cannot be accurately quantified as they largely depend on the state of the company's current financial reporting system and what adjustments would need to be made.

## **Key Compliance Costs Issues Identified in Consultation**

No concerns were raised regarding compliance costs that may be incurred by replacing financial returns requirements under the Deposits Act with the relevant FRS. Unrated insurers opposed the ratings regime as they will face an increase in annual costs associated with obtaining a rating.

## **Overlapping Compliance Requirements**

Any overlapping compliance requirements would be removed by repealing the requirements to prepare financial returns under the Deposits Act.

## **Steps taken to Minimise Compliance Costs**

Replacing the reporting requirements under the Deposits Act with the relevant FRS would promote good financial reporting which may reduce compliance costs in the long term. Unrated insurers will be allowed a transitional period of two years before the new requirements are imposed. This will allow them to evaluate their position and put in place any new arrangements required to bring them within the ratings regime.