8 March 2018

Hon. Grant Robertson, Minister of Finance
Cc Associate Ministers of Finance:
Hon. Shane Jones; Hon. David Parker; Hon. David Clark; Hon. James Shaw
Parliament Buildings
Wellington

Dear Ministers and Panel,

Re: Reserve Bank Act Review Terms of Reference

Tower is a New Zealand-based NZX listed insurance company providing general insurance products to New Zealanders and, through its subsidiaries, in Pacific Island countries including Fiji, Samoa, Tonga, and Papua New Guinea. Tower's foundation dates back to 1869 when the New Zealand Government provided the capital for the creation of the New Zealand Government Life Insurance Department. It became Tower Corporation in 1987 and in 1999 Tower Limited was listed on the New Zealand Stock Exchange.

As an independent, listed, general insurance underwriter and brand, Tower has a unique position in the New Zealand market and financial services sector. Tower Insurance currently underwrites approximately 10% of New Zealand's Home, Contents and Motor Vehicle insurance product market by premium. It is New Zealand's third largest general insurer and the largest locally owned insurer. 75% of Tower's shareholders are New Zealand resident.

Scope of Reserve Bank Act Review

We understand that the panel is currently undertaking the first phase of its review of the activities of the Reserve Bank, with a focus on the Reserve Bank's role in monetary policy management, and is presently also undertaking preparatory steps in scoping a second phase of this review.

Tower recommends to the panel that the Reserve Bank Act Review includes within its scope a comprehensive appraisal of the insurance prudential regime overseen by the Reserve Bank.

Further, via the process and recommendations arising from this review, the Government is faced with a unique opportunity to reform the Reserve Bank and either consider re-structuring and re-allocating the roles and responsibilities in New Zealand's regulatory model or, as a minimum, re-positioning the Reserve Bank as an appropriately purposed and resourced regulator that sufficiently protects the people of New Zealand.

Key reasons for ensuring that insurance prudential regulation is included in the scope of this review include:

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- The economic and social perils that give rise to New Zealand's unique exposure to risk and therefore its reliance on the insurance industry to protect the country's sustainable future.
- The Reserve Bank's performance as a prudential regulator by reference to the International Monetary Fund (IMF) report in the 2017 Financial Sector Assessment Program (FSAP) report on New Zealand.
- The evident gaps in the Reserve Bank's prudential regulation approach.
- Systemic risk relating to the large Australian headquartered multi-nationals having a high concentration and market share in the New Zealand general insurance industry.

We provide more detail on these key points below.

The New Zealand risk profile

The New Zealand general insurance industry is characterised by vulnerabilities that generate a unique risk profile for the industry, the economy and the government. Relative to larger insurance markets in other countries, we see:

- the relatively small scale of the economy, leading to a lower ability to spread risk across the country,
- a unique risk profile from natural disasters arising from high earthquake risk in major urban centres (as witnessed by the 2010 and 2011 Canterbury earthquakes),
- exposure of the government to the risk of bailing out insurers or claimants in the event of insurer failure (which exacerbates the government's exposure beyond the EQC, which itself exposes the government to risk as was seen in 2010 and 2011, including through the collapse and subsequent government bailout of AMI), and
- The need for competitive neutrality between locally domiciled and offshore insurers (covered in more detail below.)

Insurance is an inherently complex business based on the management of risk. We take on and manage the risk transferred to us by businesses, organisations and individuals. They do so to reduce their own risk. Tower believes that the effective operation of prudential supervision and the regulation role is more than just critical for individual policy holders, it is fundamental to the underpinning of the economy and prosperity of New Zealanders. New Zealand's risk profile creates a systemic risk for New Zealand that warrants not only very good regulation but also a pre-emptive approach by the RBNZ to supervision. Such an approach is different from the RBNZ's current "hands off" approach to supervision (as distinct from regulation).

This risk has been further highlighted through the recent collapse of CBL Corporation, an NZX listed corporation, with a wholly owned subsidiary, CBL Insurance which is a New Zealand domiciled and licenced insurer. It may be that if the RBNZ had taken a more proactive and public role in monitoring CBL's insurance entity, it may have been possible to avoid the progression to voluntary administration and the subsequent shock experienced by CBL Corporation shareholders and CBL Insurance policyholders.

IMF Review

The International Monetary Fund (IMF) issued its Financial Sector Assessment Program (FSAP) report on New Zealand in May 2017, available here:

https://www.imf.org/en/Publications/CR/Issues/2017/05/08/New-Zealand-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-44886

In this report the IMF criticised the Reserve Bank's idiosyncratic light handed regulatory approach as standing in contrast to international supervisory principles. We understand that the report would see New Zealand ranked near the very bottom if analysed by reference to the FSAP reports prepared by the IMF across all jurisdictions in the world. The report included no less than 24 recommendations across the 26 areas assessed, with a particular focus on the need for increased resources to be applied to improve supervisory activities across a number of key areas. Key recommendations included:

- Increase RBNZ resources for the supervision and regulation of banks, insurance companies, and Financial Market Infrastructures
- Clarify responsibilities of the Treasury and RBNZ on financial sector issues to reinforce the role of RBNZ as prudential regulator and supervisor
- Issue enforceable standards on key risks, governance, risk management, and controls to make RBNZ's supervisory expectations more transparent and support supervisory preventative action

The Reserve Bank's response to these findings has been to accept them as an expected outcome and, while we continue to await any meaningful change in course by the Reserve Bank in response to these recommendations, the attention merited by the severity of the shortcomings identified by the IMF has not been evident. By way of direct comparison, the approach adopted in Australia has been recognised, including by the IMF, as one of the leading regulatory frameworks internationally. Post-GFC the international regulatory and supervisory community has instigated many instances of significant reform, including for example of the Bank of England in the United Kingdom and other European jurisdictions. The approach in New Zealand therefore places the Reserve Bank significantly out of step with international standards both now and seemingly indefinitely in to the future.

Gaps in the Reserve Bank's current approach

Tower provided the Reserve Bank with its assessment on prevalent gaps in the Reserve Bank's current approach in our submission to the IPSA review in July 2017, available here:
https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Insurers/IPSA-review/submissions/Tower-IPSA-review-submission.pdf?la=en

This submission demonstrated that the approach currently taken by the RBNZ to regulation and supervision of insurers had specific shortcomings with regard to:

- the RBNZ position that pro-active supervision is not undertaken by the RBNZ as a matter of policy
- policyholder protection (where there are limitations for all policyholders and where the limitations are greater for the policyholders of foreign insurers and for some local insurers than for other local insurers), and
- competitive neutrality (where foreign insurers, whether branches or subsidiaries, enjoy some regulatory concessions over local insurers).

The Reserve Bank advised in October 2017 that it has commenced Phase 2 of this review in which the submissions from Tower and others in the insurance industry will be considered over the next 12 to 18 months.

Systemic risk from large Australian insurers

The RBNZ should consider policyholder protection as a key strategic imperative, it currently holds great reliance on foreign regulators without a corresponding insistence on local policyholders having the same capital and other protections as are available to policyholders of local companies. There is a foreseeable scenario where if a catastrophic event were to take place in Australia and New Zealand simultaneously, the Australian insurers may be required by Australian regulators to ring-fence their capital base for Australian market requirements, and to prioritise the interests of Australian policyholders ahead of those in New Zealand.

Specifically, Australian insurers (including IAG and Suncorp) are required by the APRA reinsurance standard to nominate their "peak" event (i.e. single largest risk) and reinsure to that level. We understand that in IAG's case this is an earthquake in Sydney and in Suncorp's case it is a Brisbane cyclone. Therefore, if a catastrophic event were to occur in Australia and New Zealand simultaneously, the Australian insurers would potentially not have sufficient cover for the New Zealand event.

As detailed in our submission referenced above, Tower also believes that more extensive guidance to insurers along with supervisory programs that aim to hold insurers accountable for meeting RBNZ's prudential requirements should be introduced by the RBNZ. To make this protection more effective, this could be coupled with the implementation of stronger regulatory requirements for safeguarding capital held for the protection of New Zealand policyholders.

Competitive neutrality

As a locally domiciled general insurance company, Tower believes that the RBNZ's approach to regulation and supervision discriminates against local insurers relative to foreign insurers, as a result of the different regulatory treatment by RBNZ of foreign insurers and local insurers. The competitive discrimination arises essentially from the different regulations that apply to local and foreign insurers, whether companies or branches. It arises from the RBNZ's willingness to rely heavily on the home regulators of foreign insurers while applying more stringent requirements to local companies. The most significant consequences relate to branches of foreign insurers which can operate with lower effective capital requirements than local companies. The main factors are:

- the 1 in 1000 year requirement for local insurers versus a more common 1 in 200 requirement by other regulators,
- use by the RBNZ of Section 59 of IPSA to exempt branches of some foreign insurers from meeting full solvency requirements in New Zealand, and
- no requirement to maintain assets in New Zealand to support their solvency and capital position.

Furthermore, subsidiaries of foreign insurers are in a similar position regarding assets in New Zealand because there are no restrictions on the levels of reinsurance that they can use to move both assets and liabilities to another jurisdiction.

These factors enable a lower cost of capital and lower operating costs for foreign insurers, leading to pricing and/or profitability advantages for those insurers. Tower also submits that the RBNZ's "hands off" approach to supervision discriminates against conscientious and diligent local insurers who invest seriously in complying with the RBNZ's governance, risk management and other requirements relative to both local insurers who do not so invest and to foreign insurers who are not obliged to so invest.

Conclusion

Noting the considerations outlined above, we believe it is imperative that the Government ensure that the second phase of the Reserve Bank Act review includes a comprehensive appraisal of the insurance prudential regime overseen by the Reserve Bank.

Once the scope is confirmed, and for the same reasons outlined above, we recommend that through this review the Government must consider at the least increasing the resourcing and capacity of the Reserve Bank, but also seriously consider adopting a fundamental redesign of the existing system. This redesign may suitably result in adopting the model seen in many other jurisdictions (including Australia) where prudential regulation is separated from central bank responsibilities including monetary policy. This would make sense given the two functions are quite different and require different skills and capabilities. It is imperative that through this change, New Zealand adopt a supervisory model that enables active enquiry, investigation, challenge, issue identification, guidance and support for the betterment of the insurance industry, to the benefit of policyholders.

Further, it is noted that the extended timeframe for completion of the IPSA review by the Reserve Bank already extends in to mid-2019. It is also unusual that the Reserve Bank has been tasked with overseeing review of the regulatory regime which it itself administers. The Government therefore may consider an opportunity to combine the review of the Reserve Bank Act with the in progress review of IPSA to ensure the objectives of both reviews are undertaken independently of the Reserve

TOWER Insurance

Bank and that the reviews are completed in an effective and timely manner. This would result in consistent and aligned outcomes that respond to the risks outlined both in the FSAP report, and in the submissions made to the IPSA review.

If you would like to discuss this matter further, please contact me or Tower's Chair Michael Stiassny directly, or alternatively contact Tower's Chief Risk Officer David Callanan by emailing
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Yours sincerely,

Richard Harding
Chief Executive Officer
Tower Insurance Limited
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