Bulletin

An overview of the life insurance sector in New Zealand

Vol. 83, No. 1, January 2020

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Reserve Bank of New Zealand *Bulletin*

Subscribe online: www.rbnz.govt.nz/email-updates

For back issues visit: www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin

Copyright © 2019 Reserve Bank of New Zealand

ISSN 1177-8644

An overview of the life insurance sector in New Zealand

Jinny Leong and Adrian Allott

Executive summary

This article provides an overview of the life insurance sector in New Zealand and highlights issues in the sector. It provides a range of indicators relating to New Zealand's life insurance sector, and where possible, compares them to international peers. The purpose of this article is to support market discipline by sharing some of the data collected by the Reserve Bank in recent years.

The insurance sector plays an important role in the financial system by spreading the costs of risk events through time, across the population and, via reinsurance, internationally. Life insurance coverage softens the financial impact of events such as death, disablement and major illness, allowing insured individuals and their families to maintain their living standards. It may also support mechanisms for long-term saving and provision for retirement, although the sale of new insurance policies that provide this facility has largely ceased in New Zealand.

Life insurance policies currently available in New Zealand mainly provide coverage for personal risk, most commonly in the form of insurance that provides cover for a specified term. They are predominantly distributed through financial advisers and banks. New Zealanders have relatively low coverage compared to residents of other OECD countries.

New Zealand life insurers are more profitable than their peers in many developed OECD countries, with return on equity higher than the median and a low claim ratio. They also have high costs relative to their international peers due to high commission rates and relatively high operating expenses. These characteristics may indicate poor value for money for some potential and existing policyholders as high expenses can drive up premiums. Additionally, high upfront commission rates and policy replacement activity, where policyholders replace an existing policy with a new one during the year, may undermine public confidence in the sector. Consequently, the level of insurance for personal risk may not cover actual financial vulnerability for some individuals in New Zealand, and some individuals may be priced out of the life insurance market altogether.

Insurers hold solvency capital to withstand a range of possible adverse events such as natural catastrophes, insurance losses, credit events and market movements. The solvency ratio is a measure of capital strength and resilience. The aggregate solvency ratio for the life insurance sector has declined in recent years and is low relative to other countries. Some life insurers operate with low solvency margins over the regulatory minimum, raising questions about their ability to comfortably meet the minimum requirements in the event of an adverse shock.

New Zealand life insurers make greater use of reinsurance than their international peers, partly due to differences in product mix. Life insurers primarily reinsure to reduce the volatility of profit and transfer risk to reinsurers. Recently, there has been a greater use of reinsurance as an alternative to holding solvency capital.

The Reserve Bank began regulating and supervising insurers from 2011, after the Insurance (Prudential Supervision) Act 2010 (IPSA) came into force. The purposes of IPSA are to promote the maintenance of a sound and efficient insurance sector, and to promote public confidence in the sector. Alongside the forthcoming review of IPSA, the Reserve Bank will review solvency standards and consider the case for solvency buffers, with the aim of improving resilience in the sector.

The Reserve Bank and the Financial Markets Authority (FMA) conducted a thematic review of the conduct and culture of the life insurance sector in 2018, and found “extensive weaknesses in life insurers’ systems and controls, with weak governance and management of conduct risks across the sector and a lack of focus on good customer outcomes”.

The Government recently announced a new financial conduct regime in response to the issues identified in the review, and gaps in existing regulation. The proposal aims to address conduct issues and promote fair treatment of customers in the sector. Life insurers will be required to obtain a conduct licence from the FMA. The FMA will regulate the new regime and will have a full range of licensing and enforcements tools under the Financial Markets Conduct Act 2013.

Steps have also been taken to enhance the regulation of financial advice in New Zealand. For example, the Financial Services Legislation Amendment Act 2019 will be supported by new regulations and a revised code of conduct for advisers.

Introduction

The importance of the life insurance sector

The insurance sector plays an important role in the financial system by spreading the costs of risk events through time, across the population and, via reinsurance, internationally.[1] A resilient insurance sector facilitates efficient allocation of resources across the economy through the pricing and redistribution of risk.

Life insurance coverage softens the financial impact of events such as death, disablement and terminal illness, allowing insured individuals and their families to maintain their living standards. Some life insurance policies support mechanisms for long-term saving and provision for retirement. However, these are primarily policies that are no longer available to new policyholders in New Zealand.

The development of life insurance in New Zealand

Life insurers began operating in New Zealand in 1854, and the first sector-specific legislation, including a requirement to establish a statutory fund, was enacted in 1873.[2,3] For the next hundred years or so, the life insurance sector was dominated by branches of large Australian mutuals and by Government Life Insurance, which was established in 1869 with initial capital from the New Zealand colonial government. These insurers used tied agents to offer products such as widows' pensions, term insurance policies and whole-of-life policies.[4]

The latter half of the twentieth century saw a range of changes in the sector such as the introduction of unit-linked and group policies. Unit-linked policies allowed policyholders to choose their own investment portfolios and bear investment risk. Group policies allowed firms to insure all of their employees at cost-effective rates and with minimal underwriting. Distribution channels diversified into banks and independent financial advisers, and the large insurers demutualised to access capital markets. Subsequently, tax advantages for saving through life insurance products were removed, which caused participating and investment insurance policies to decline in popularity.

The Reserve Bank's role

The Reserve Bank began regulating and supervising insurers from 2011, after IPSA came into force. The purposes of IPSA are to promote the maintenance of a sound and efficient insurance sector and to promote public confidence in the sector. Prior to this, there was very limited prudential supervision of the insurance sector. The Reserve Bank monitors insurer compliance with the requirements of IPSA.

Under IPSA, the Reserve Bank also addresses insurers in distress but the Bank does not aim to eliminate all risk of insurer failure. Individual insurer failures can still occur, and failures that lead to unstable or missing insurance services are likely to constrain the ability of individuals to transfer risk, which can result in significant harm to policyholders and less efficient outcomes for the economy. The failure of an individual life insurer in New Zealand is unlikely to significantly reduce the ability of the life insurance sector as a whole to provide coverage, as the life insurance market is currently not particularly concentrated, and the failure of one insurer is not likely to lead to the failure of another insurer.

1 See Vucetich, Perry and Dean (2014) for more discussion on the insurance sector in New Zealand.

2 See Henderson (2010) for more details.

3 Statutory funds are designed to protect the assets backing life insurance business, and to provide policyholders a higher ranking than most other creditors on wind-up.

4 Tied agents are individuals who promote the products of a single insurer, and are managed by the insurer.

The Reserve Bank began collecting insurance sector data in 2013, and with improvements in data quality since, it has become more suitable for analysis.[5] The Reserve Bank's *Quarterly Insurer Survey* (QIS) data covers the 28 largest insurers (out of a total of 88 licensed life, general and health insurers), accounting for just under 90 percent of assets and premiums of the regulated insurance sector as a whole.[6] QIS data is published quarterly.[7] 10 of the 28 QIS insurers are life insurers and their data is analysed in this article.

This article provides a high-level overview of the life insurance sector. Life insurers operate a variety of different business models and provide a range of products. We are unable to portray all of the nuances in the data, particularly for comparisons between countries. The observation periods used and point in time comparisons may not accurately reflect longer-term trends in the life insurance sector.

Recent developments in regulation

Events in Australia and New Zealand have shone a spotlight on conduct in the life insurance sector.

In Australia, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry made a series of recommendations specific to the sector and provided feedback on culture and regulatory practices.[8] In New Zealand, the Reserve Bank and the FMA conducted a thematic review of the conduct and culture of the life insurance sector, and found "extensive weaknesses in life insurers' systems and controls, with weak governance and management of conduct risks across the sector and a lack of focus on good customer outcomes".[9]

The Government recently announced a new financial conduct regime in response to the issues identified in the review, and gaps in existing regulation. The proposal aims to address conduct issues and promote fair treatment of customers in the sector. Life insurers will be required to obtain a conduct licence from the FMA. The FMA will regulate the new regime and will have a full range of licensing and enforcements tools under the Financial Markets Conduct Act 2013.

Steps have also been taken to enhance the regulation of financial advice in New Zealand. For example, the Financial Services Legislation Amendment Act 2019 will be supported by new regulations and a revised code of conduct for advisers.[10]

A review of IPSA and its supporting solvency standards will be recommenced in 2020. The review will consider necessary changes identified by recent reviews of New Zealand's financial sector and of the Reserve Bank's supervision of CBL Insurance (in liquidation).[11,12] It will also take into account the Reserve Bank's supervisory experience and public submissions.

5 *Quarterly Insurer Survey* data has been collected from 2015, with data from 2016 available for analysis.

6 Reinsurers are not covered.

7 See www.rbnz.govt.nz/statistics/j10-insurance-income-statement and www.rbnz.govt.nz/statistics/j20-insurance-balance-sheet

8 See The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2018).

9 See Life Insurer Conduct and Culture (2019).

10 See Regulation of Financial Advice.

11 See Financial Sector Assessment Programme (2017).

12 See An Independent Review for the RBNZ of the Supervision of CBL Insurance Ltd (2019).

Characteristics of New Zealand's life insurance sector

Life insurance products

A relatively narrow range of life insurance products is currently available in New Zealand, with most new life insurance policies only providing personal risk insurance. Historically, some life insurance policies provided a savings mechanism (e.g. participating, unit-linked and annuity policies), but the sale of new insurance policies that provide this facility has largely ceased. Given the long-term nature of policy liabilities, there remains about $8 billion of savings currently under insurers' management (although they only make up 1 percent of total household financial assets). These legacy products include investment-linked policies and policies that participate in the profits of the insurer.

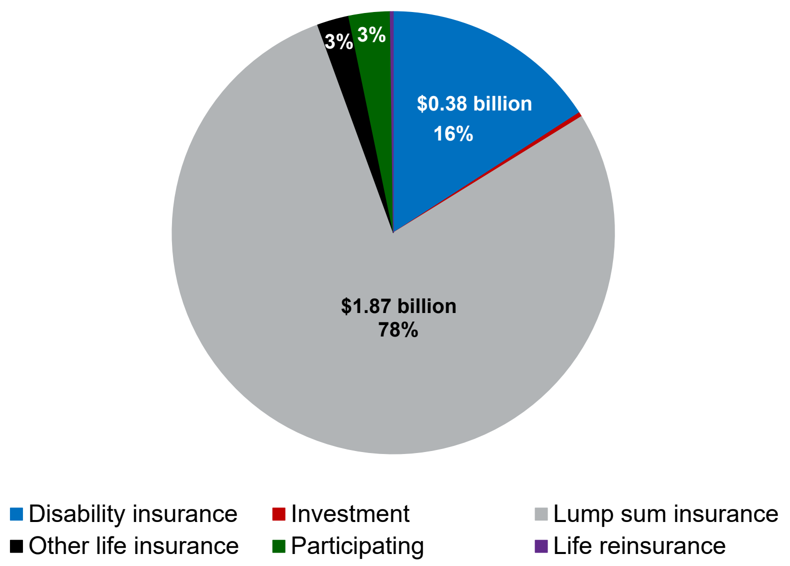
Personal risk insurance benefits include coverage for death, critical illness, permanent disablement, accident, and disability income.[13] Lump sum insurance pays the insured amount upon death, permanent disablement or critical illness (e.g. cancer, heart attack, stroke) within the period set out in the policy. Disability income (income protection) insurance pays a regular income to replace a proportion of the insured person's income when they cannot work due to sickness or disability.

The Accident Compensation Corporation (ACC) offers no-fault cover for disability and death due to accidents in New Zealand. These benefits partially substitute some forms of personal risk coverage provided by life insurance policies in other countries, which may discourage some New Zealanders from taking out life insurance.

13 Only one insurer is currently offering for sale insurance policies that provide a savings mechanism.

Lump sum insurance dominates the sector and accounted for 79 percent of gross premiums in the year to June 2019 (figure 1). Disability income insurance accounts for most other premium income.

Figure 1
Life insurance products in New Zealand by gross premium
Year to June 2019



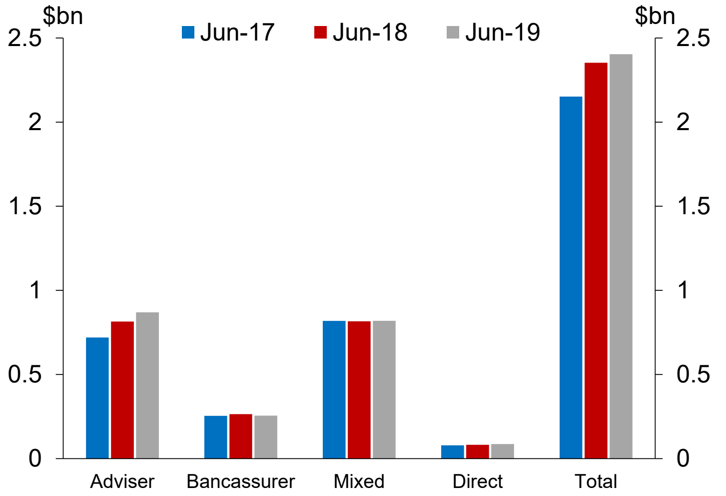
Source: RBNZ QIS.

Note: Lump sum insurance includes term life insurance, guaranteed acceptance, trauma, lump sum disablement, accidental death and group life insurance.

Distribution channels

Life insurers in New Zealand primarily acquire customers (policyholders) via independent financial advisers or through banking relationships (figure 2). Bancassurance is an arrangement between a bank and an insurer allowing the insurer to sell its life insurance products to the bank's client base. A few other channels are also used, such as outbound call centres and online distribution.

Figure 2
Gross premium revenue by distribution channel
Year to June



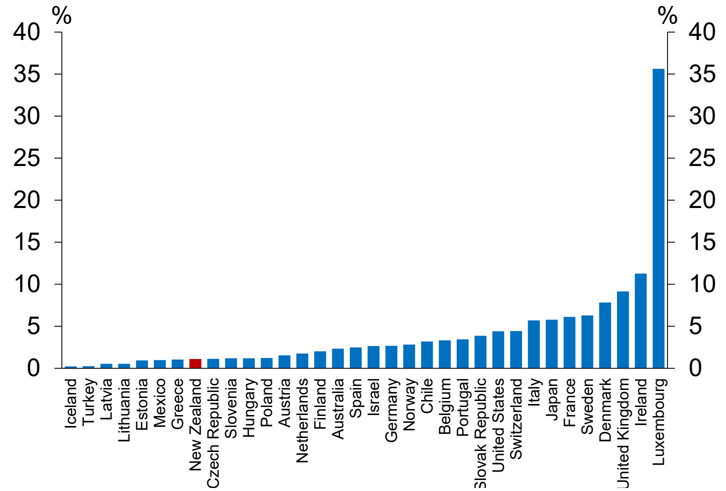
Source: RBNZ QIS.

Note: For the purposes of this chart (and similar charts in this article), each life insurer has been allocated to its primary distribution channel. Some insurers sell insurance policies via independent financial advisers as well as banks, and are categorised as "mixed" in the charts. Life insurers that primarily provide savings policies have been excluded from this chart.

Life insurance penetration

Life insurance penetration (the ratio of gross premiums to GDP) and density (gross premiums per capita) in New Zealand are well below the OECD average (figure 3). These metrics indicate that the New Zealand life insurance sector is relatively small and may be partly explained by the low proportion of savings products in New Zealand and New Zealanders' reliance on the government (ACC cover) to mitigate some risks that would otherwise be in the purview of the life insurance sector.

Figure 3
Penetration
2017



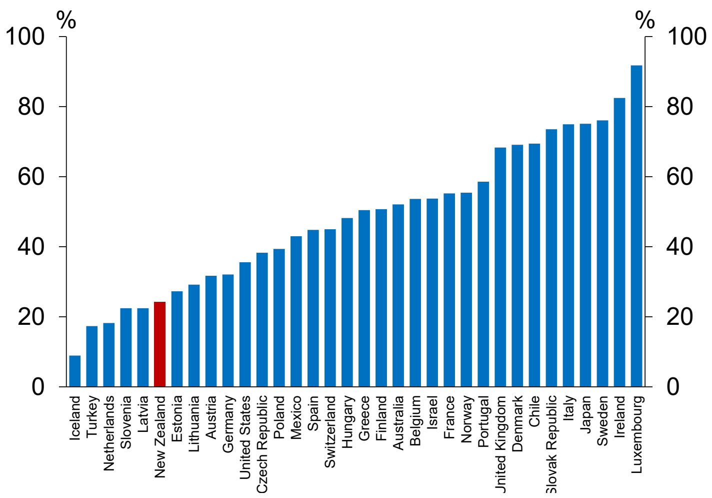
Source: RBNZ QIS, OECD Insurance Indicators.

Note: Ireland and Luxembourg have particularly high life insurance penetration due to specialised legislation that is attractive to cross-border financial services firms.

Life insurance share of total premiums

At 24 percent, life insurance premiums make up a much smaller share of total insurance premiums in New Zealand than in many other OECD countries (figure 4). In addition to the aforementioned factors, the coverage and premiums for some non-life insurance policies are relatively high in New Zealand, given its particular risk profile, contributing to the relatively small share of life insurance premiums.

Figure 4
Life insurance share of total insurance premiums
2017



Source: RBNZ QIS, OECD Insurance Indicators.

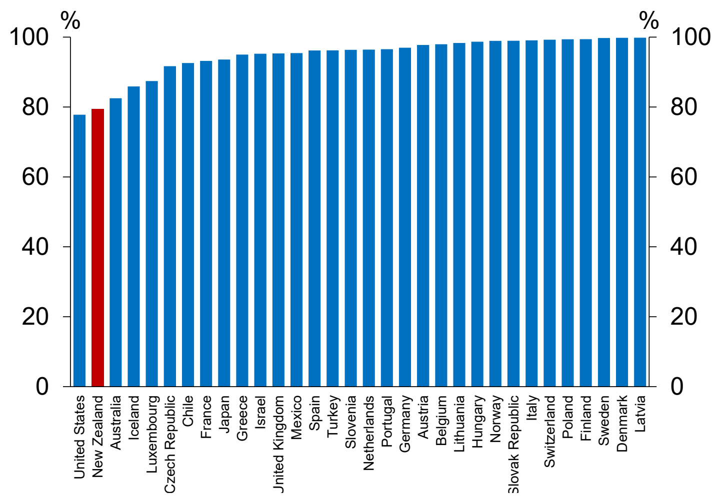
Retention ratio and reinsurance

The retention ratio reflects the overall underwriting strategy of insurers and their risk management policies; it shows the portion of risk that is not passed on to reinsurers. A lower retention ratio indicates a higher portion of risk passed on to reinsurers.

The New Zealand life insurance sector has a relatively low retention ratio of 79 percent, compared to the OECD average of 95 percent (figure 5). This indicates that New Zealand life insurers make greater use of reinsurance than their international peers. Life insurers in New Zealand are relatively small and focus on insuring personal risk as opposed to providing savings products, contributing to greater use of reinsurance.

New Zealand life insurers primarily reinsure to reduce the volatility of profit and transfer risk to reinsurers. Recently, there has been a greater use of reinsurance as an alternative to holding solvency capital.

Figure 5
Retention ratio
2017

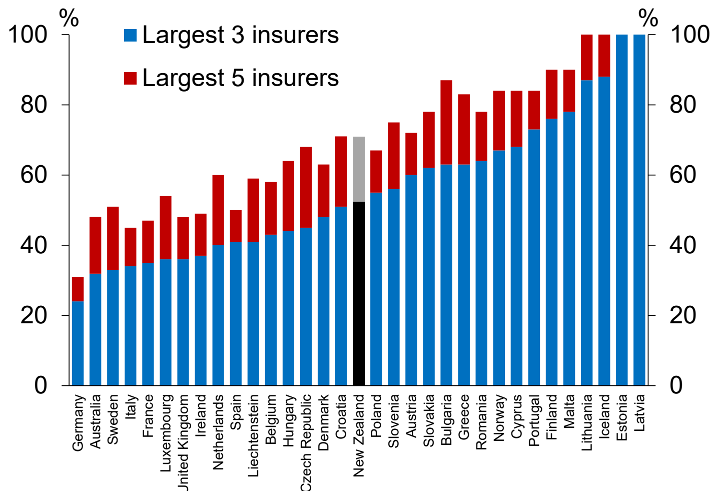


Source: RBNZ QIS, OECD Insurance Indicators.

Market concentration

The largest three and five life insurers in New Zealand account for 54 percent and 72 percent of life insurance premiums respectively. By these two market concentration measures, the life insurance sector in New Zealand is not particularly concentrated and is close to the average (figure 6).[14] However, the life insurance sector is seeing some merger and acquisition activity. It is expected that the sector will become more concentrated.

Figure 6
Market concentration ratio for the 3 and 5 largest life insurers
2018



Source: RBNZ QIS, EIOPA Insurance Statistics, APRA Quarterly Life Insurance Performance Statistics.
Note: Smaller markets generally have fewer insurers and tend to be more concentrated.

14 The Herfindahl-Hirschman Index is 0.14, which indicates a low degree of market power and significant competition within the sector, where 0 indicates perfect competition and 1 indicates a monopoly. The index was calculated using gross premiums as a measure of market share.

15 The Financial Services Council is an industry body whose members include the major insurers in life, disability and income insurance, fund managers, KiwiSaver, professional services and technology providers to the financial services sector. Members of the Financial Services Council account for 95 percent of the life insurance sector in New Zealand.

16 See Exploring Underinsurance Within New Zealand (2013).

17 See Risking Everything (2019).

Underinsurance in New Zealand

Underinsurance (where insurance cover does not correspond to actual financial vulnerability) exposes New Zealand households to risks. Some households may experience financial difficulty if an earner, especially the main earner, is unable to work due to serious illness, disability or death. Furthermore, inefficiencies arise when risk has not been transferred through the use of life insurance policies to those who are more willing and able to bear it. New Zealanders may be underinsured for several reasons such as the high cost of insurance relative to the expected benefit; low discretionary household income to spend on insurance; a lack of trust in insurance providers; misinformation or lack of information; and a reliance on the government (primarily ACC cover).

A 2013 Massey University study commissioned by the Financial Services Council (FSC) found that New Zealanders were underinsured for personal risk, namely total and permanent disability, income protection, trauma and life cover.[15] It was estimated that over half of all households would suffer a fall in consumption of more than 40 percent if the main earner died.[16]

More recently, the FSC commissioned a survey which found that the majority of New Zealanders had not considered the adverse financial impact if they were to lose their income due to illness or serious injury.[17] Additionally, two-thirds of those surveyed thought that there was a moderate to high risk of experiencing major financial difficulty should a significant event happen, such as a serious injury or being unable to work. Respondents cited three main reasons for being underinsured – just under 40 percent cited an inability to afford life insurance premiums, for a quarter of them life insurance is not a priority and around 17 percent did not feel that life insurance represented value for money.

Some individuals are willing and able to take on or manage risks without the use of life insurance policies. For example, 37 percent of respondents said they have sufficient savings to manage risk events and maintain their (or their family's) standard of living.[18] In this case, underinsurance may not be a concern.

Some individuals may be underinsured because the cost of insurance is high for the expected benefit, and others may be priced out of the life insurance market altogether. Improving premium affordability relative to the expected benefit may improve life insurance penetration and coverage in New Zealand.

As other factors contribute to underinsurance, improving premium affordability is not the only solution. If individuals are underinsured due to a lack of awareness or misinformation and do not have suitable levels of life insurance coverage then they (or their families) may experience adverse financial impacts should a risk event occur. For example, there may be misplaced confidence in ACC coverage. Although it provides relatively generous benefits for disability and death due to accidents, ACC does not cover illnesses. In a poll conducted by the FSC in 2015, about 20 percent of New Zealanders think that ACC covers long term illnesses that prevent employment, which is incorrect.

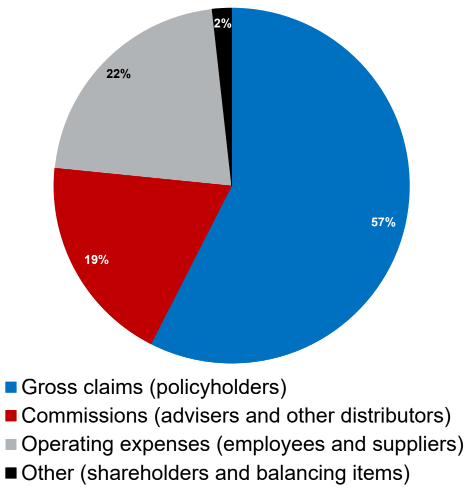
18 They have sufficient savings to cover their home loan or rent if they were off work for three months.

Indicators of profitability

For a life insurer to be broadly profitable, the premiums it collects should cover claims as well as expenses. Figure 7 shows how premiums are allocated, and that New Zealand life insurers are generally able to make a profit.

Claim and expense ratios are indicators of insurer profitability. However, a number of other items must also be considered for life insurers. Principal among these is investment income, which can be large relative to premiums due to the presence of significant assets supporting legacy participating business. Other drivers of profit include the movement in technical provisions, reinsurance cash-flows and taxes on profit.

Figure 7
Stakeholders' claims on gross premiums
Year to December 2018

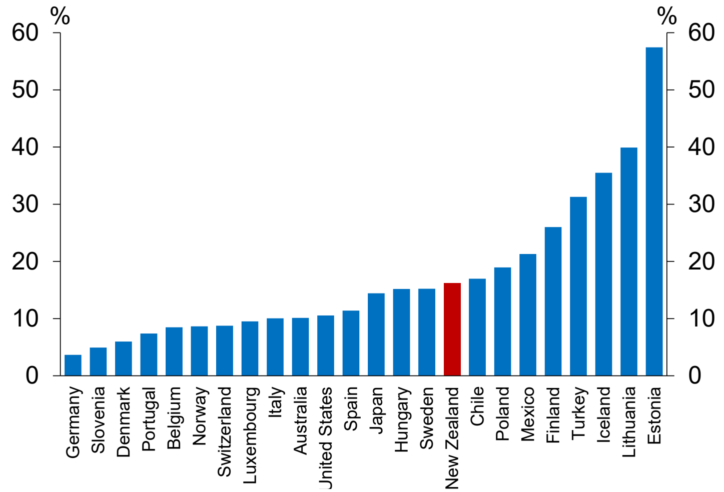


Source: RBNZ QIS.

Notes: The chart only includes gross premium revenue; investment revenue and movements in technical items have been omitted. This chart includes insurers open to new business and insurers in run-off; insurers in run-off tend to have higher claim ratios and expense ratios.

New Zealand life insurers are relatively profitable compared to their peers in many developed OECD countries. In 2017, boosted by strong investment returns, the return on equity for New Zealand life insurers was 16.2 percent, which was higher than the median of 12.9 percent (figure 8).

Figure 8
Return on equity
2017



Source: OECD Global Insurance Market Trends 2018 Report (OECD Global Insurance Statistics).
Note: ROE was calculated by dividing net income in 2017 by average shareholder equity in 2016 and 2017.

There is considerable variation in profitability within the life insurance sector. Pure bancassurers, who make up 13 percent of the sector (figure 2), are the most profitable (figure 9) and have the lowest expenses (figure 12).[19] Banks have existing distribution networks that allow bancassurers to reach their customers more easily.

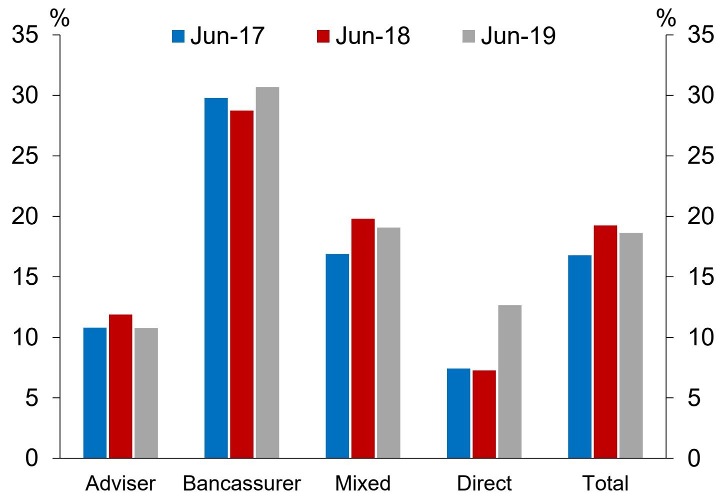
19 Bancassurers are insurers that distribute insurance products largely through banks.

Life insurers that distribute their policies primarily via independent financial advisers make up 43 percent of the life insurance sector (figure 2) and have relatively low profitability (figure 9). This is due to high commission expenses, driven by high upfront commission rates and policy replacement activity, and relatively high operating expenses, possibly due to lack of scale (figure 12).

Some life insurers sell their policies through multiple channels (categorised as “mixed” in the chart below). These life insurers account for 40 percent of the sector (figure 2) and are relatively profitable (figure 9).

Life insurers that sell insurance directly to customers (policyholders) have the lowest profitability (figure 9) and the highest costs (figure 12), possibly due to a lack of scale, as they only account for 4 percent of the sector (figure 2).

Figure 9
Profit after tax as a share of gross premium
Year to June



Source: RBNZ QIS.
Note: Life insurers that primarily provide savings policies have been excluded from this chart.

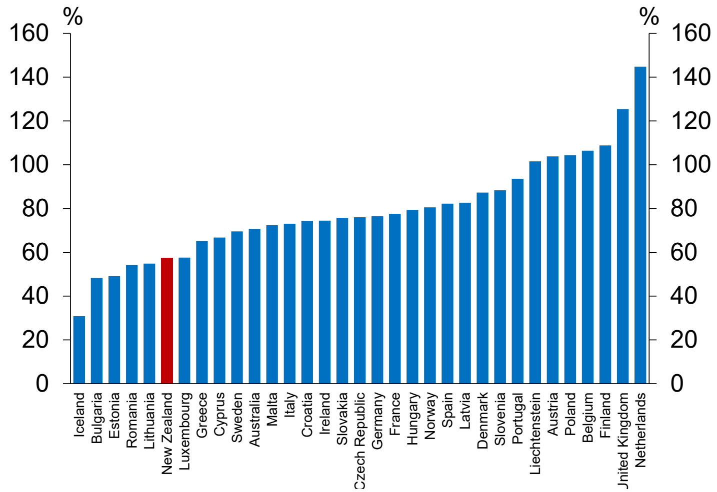
Claim ratio

The gross and net (of reinsurance) claim ratios for New Zealand life insurers are relatively low (figure 10). This means that a relatively small proportion of premiums are paid out as claims. New Zealand's life insurers' gross claim ratio is 58 percent (or 47 percent if insurers that primarily offer savings products are excluded). This is well below the OECD average of 79 percent.

A low claim ratio may imply that the life insurance sector as a whole is relatively inefficient in returning money to policyholders and can indicate that insurance products are unsuitable. The life insurance conduct and culture review found evidence of certain products that provide poor value for policyholders. Some of the indicators of poor value products included low claim ratios, high rates of claims being declined and limited coverage. A low claim ratio also supports life insurers' profitability.

However, it is important to note that the claim ratio is an imperfect measure of the performance of life insurers as it includes claims on both risk and savings products, as well as intertemporal effects. There is a narrower range of life insurance products currently available in New Zealand, compared to other countries, which partly explains the differences in claim ratios. The claim ratio depends on the size and maturity of life insurers' savings business, where higher claim ratios are expected for more mature markets, as more policyholders pass away or retire and draw down their savings. Countries with more savings and investment products tend to have higher claim ratios compared to New Zealand, where lump sum risk insurance policies dominate the life insurance market.

Figure 10
Gross claim ratio
2018



Source: RBNZ QIS, EIOPA Insurance Statistics, OECD Insurance Indicators.
Note: 2017 data for Australia.

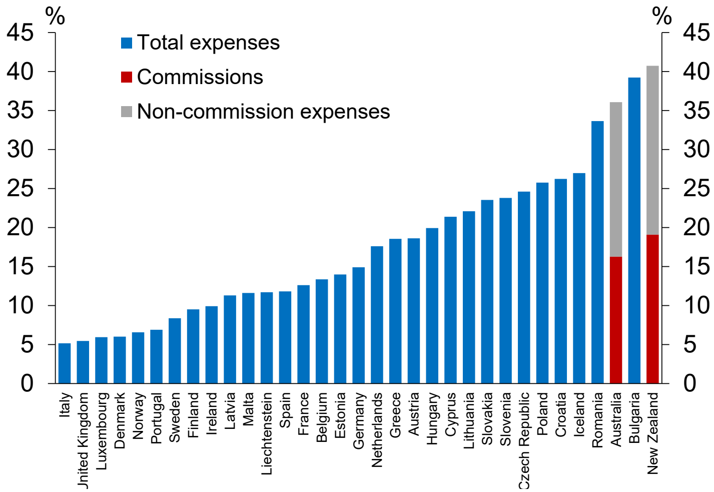
Expense ratio

Expenses are a key determinant of profitability for an insurer or a sector. New Zealand life insurers have high costs relative to their international peers, with a total expense ratio (the ratio of commission and operating expenses to gross premiums) of 41 percent (figure 11). The commission ratio is 19 percent and the operating expense ratio is 22 percent.

The high commission ratio reflects high upfront commission rates and some policy replacement activity, where policyholders replace an existing policy with a new one during the year. The relatively high operating expense ratio partly reflects a lack of scale and the inclusion of insurers in run-off.

These characteristics may indicate poor value for money for some potential and existing policyholders as high expenses have a detrimental impact on the affordability of premiums. Some individuals may have been priced out of the life insurance market in New Zealand, contributing to underinsurance.

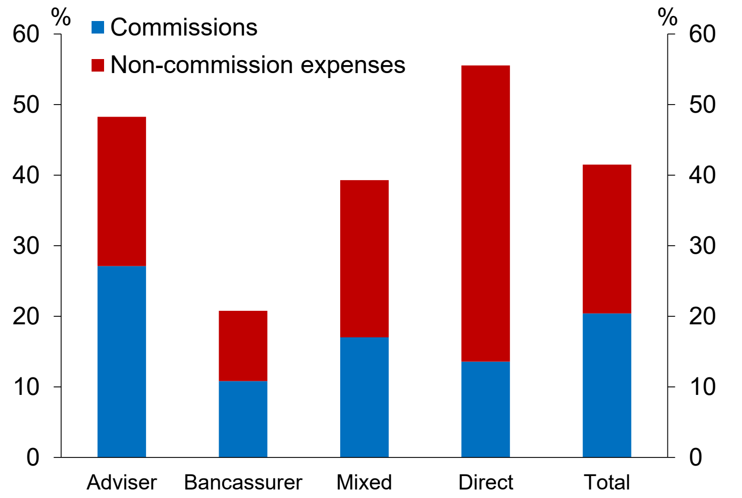
Figure 11
Total expense ratio
2018



Source: RBNZ QIS, EIOPA Insurance Statistics, APRA Quarterly Life Insurance Performance Statistics. Note: Total expenses include commission expenses and investment management expenses.

Life insurer expenses and commissions vary across the sector, depending on their primary distribution channels (figure 12).

Figure 12
Expenses as a share of gross premiums
Year to June 2019



Source: RBNZ QIS.

Note: Life insurers that primarily provide savings policies have been excluded from this chart.

Commissions

The commission ratio (the ratio of commission expenses to gross premiums) for the New Zealand life insurance sector is 19 percent and is high relative to international peers.[20] A higher commission ratio indicates a greater proportion of premiums paid as commissions and generally reflects greater inefficiency in the sector. Commissions are particularly high for some life insurance products, such as credit life insurance, with a commission ratio of 29 percent.[21]

The high commission ratio in part relates to incentives and conduct of advisers in the life insurance sector. The life insurance conduct and culture report highlighted the presence of sales incentive structures such as upfront commissions that promote replacement activity and create risks of sales volumes being prioritised over policyholders' interests.[22,23] The review found that a few life insurers saw the advisers – not the policyholders – as the customers. In some cases, upfront commissions paid to advisers cost the insurer twice the amount of the annual premiums for the first year. High upfront commission rates can act as a barrier to new entrants because substantial funding is required to compete with existing insurers' payment of upfront commissions to advisers.

FMA reviews found high levels of life insurance replacement policies in New Zealand, where policyholders replace an existing policy with a new one during the year.[24] Lump sum insurance policies account for 79 percent of the life insurance market in New Zealand and are currently experiencing lapses of just over 12 percent per annum, which is similar to Australia but relatively high by international standards. Combined with strong sales of new lump sum insurance policies prior to 2018, this indicates a relatively high rate of replacement of insurance policies.

In addition to monetary commissions, soft commissions had been prevalent in the life insurance sector.[25] Soft commissions are usually rewards for meeting sales targets, where insurers pay for overseas trips and other benefits-in-kind for advisers. A review by the FMA found that nine insurers spent $34 million (approximately 1 percent of their gross premiums) on soft commissions over two years.[26] 9 percent of the insurers' revenue from new product sales was shared with advisers in the form of soft commissions. The review suggested that the overall financial benefit to insurers from providing soft commissions is small but that insurers have incentives to maintain their market share and competitive positions against other insurers. These practices may undermine public confidence in this sector. More recently, many life insurers announced that they will stop offering overseas trips in response to pressure from the FMA and the Reserve Bank.[27]

The Government recently announced a new financial conduct regime in response to some issues with bank and insurer conduct, and gaps in existing regulation.[28] The new regime will prohibit sales incentives based on volume or value targets and require licensed institutions, such as life insurers, to meet a fair treatment standard. The proposals aim to address conduct issues and promote fair treatment of customers in the sector. Life insurers will be required to obtain a conduct licence from the FMA. The FMA will regulate the new regime and will have a full range of licensing and enforcements tools under the Financial Markets Conduct Act 2013.

20 See November 2018 Financial Stability Report.

21 Credit life insurance is a type of life insurance policy designed to pay off a borrower's outstanding debts if the borrower dies or becomes disabled. It accounts for about 1 percent of the market in New Zealand.

22 See Life Insurer Conduct and Culture (2019).

23 A review of retail life insurance advice in Australia found a correlation between high upfront commissions and high lapse rates. See Review of retail life insurance advice (2014).

24 See QFE insurance providers' replacement business practices (2018).

25 See Insurers spend $34 million on soft commissions (2018).

26 See Conflicted Remuneration (Soft Commissions) in the Life and Health Insurance Industry (2018).

27 See Life Insurer Conduct and Culture (2019).

28 See Regulation of Financial Advice.

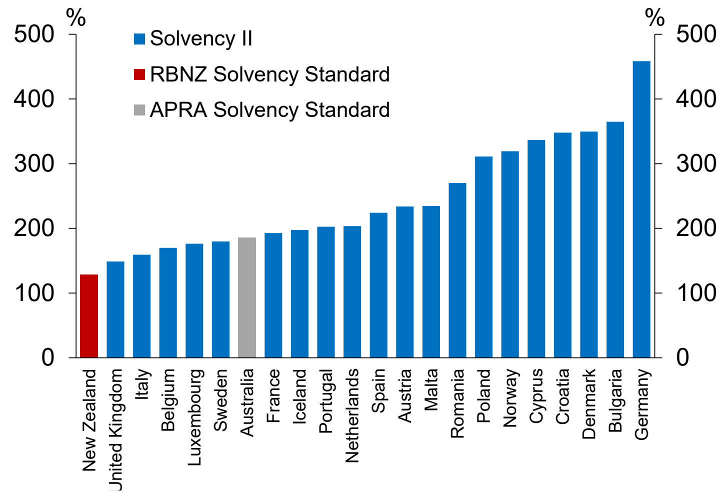
Solvency ratios

Insurers hold solvency capital to withstand a range of possible loss events and meet obligations to policyholders. The solvency ratio is a measure of an insurer's capital strength.[29] Generally, a higher solvency ratio reflects greater capital strength and greater resilience to loss events.

International solvency ratios

The aggregate solvency ratio of life insurers in New Zealand is low relative to many European countries and Australia (figure 13). It should, however, be noted that these measures are not directly comparable across countries due to country-specific factors. Many life insurers in New Zealand are subsidiaries of overseas entities that prefer to retain solvency capital in their home jurisdiction, contributing to a relatively low aggregate solvency ratio in New Zealand. Furthermore, some insurers choose to maintain a relatively low solvency margin as they believe New Zealand's requirements to be more conservative than other jurisdictions.

Figure 13
Solvency ratios
2018



Source: RBNZ Insurer Solvency Return, EIOPA Insurance Statistics, APRA Quarterly Life Insurance Performance Statistics.

Solvency ratios in New Zealand

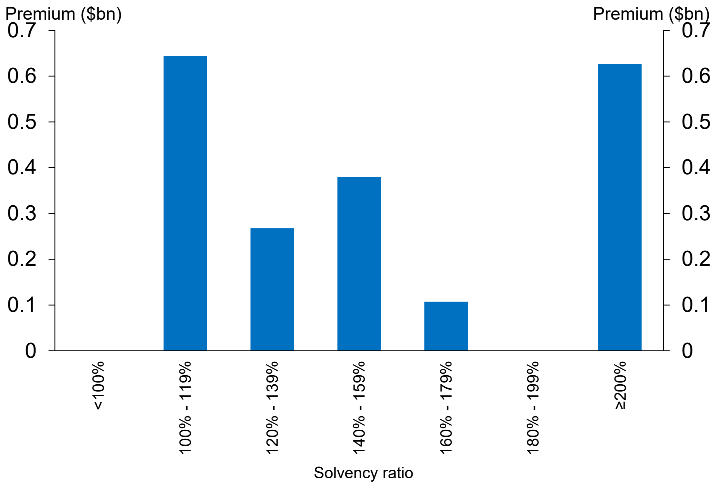
The solvency ratio for the life insurance sector as a whole has declined in recent years, from 151 percent in March 2013 to 129 percent in March 2019. Low solvency ratios raise questions about insurers' ability to comfortably meet the minimum requirements in the event of an adverse shock or a major loss event.

29 Calculated as actual solvency capital/minimum solvency capital, adjusted for any additional capital required under a licence condition (if applicable).

There is significant variation in solvency capital strength across the life insurance sector, with some life insurers having low margins over the regulatory minimum solvency ratio of 100 percent (figure 14). Furthermore, recent sharp falls in long-term interest rates are putting further pressure on some life insurers' solvency margins. This highlights the potential need for more robust solvency standards to be incorporated within the supervisory framework.

Alongside the forthcoming review of IPSA, the Reserve Bank will review solvency standards and consider the case for solvency buffers, with the aim of improving resilience in the sector. Solvency buffers would provide the Reserve Bank with a greater range of supervisory options prior to insurers breaching minimum requirements.

Figure 14
Solvency ratios for groups of life insurers in New Zealand
March 2019 quarter



Source: RBNZ Insurer Solvency Return.

Note: Only those life insurers that are subject to the RBNZ Solvency Standard are included in this chart. The bars represent the total premium revenue for all life insurers in each solvency ratio range shown on the horizontal axis.

Conclusion

The life insurance sector in New Zealand appears to be relatively inefficient and there is relatively low coverage of New Zealanders' death and disability risks. Some risks are not transferred through life insurance policies to those who are more willing and able to bear them. Consequently, some households in New Zealand that are not covered by life insurance may experience adverse financial impacts due to events such as death, disablement and terminal illness.

New Zealand life insurers have a return on equity higher than the median, even after allowing for high expenses. The high expenses are driven by high commission rates, soft commissions, some policy replacement activity and a lack of scale. High expenses have a detrimental impact on premium affordability and value for money for policyholders. Some individuals may be priced out of the life insurance market altogether.

The aggregate solvency ratio for the New Zealand life insurance sector has declined in recent years and is low relative to other countries. Some life insurers have low solvency margins over the regulatory minimum, which raises questions about their ability to comfortably meet the minimum requirements in the event of an adverse shock or a major loss event.

Appendix

Metric	Calculation or definition
Penetration	Gross premiums/GDP
Density	Gross premiums (in USD)/population
Life insurance share	Life insurance gross premiums/total gross premiums
Retention ratio	Net premiums/gross premiums
Return on equity	ROE was calculated by dividing net income in 2017 by average shareholder equity in 2016 and 2017
Gross claim ratio	Gross claims incurred/gross premiums earned
Net claim ratio	Net claims incurred/net premiums earned
Total expense ratio	Total expenses/gross premiums Note: total expenses include commission expenses and investment management expenses
Commission ratio	Total commissions/gross premiums
Solvency ratio	Actual solvency capital/minimum solvency capital, adjusted for any additional capital required under a licence condition (if applicable)

References

Financial Markets Authority. (2016, June). *Replacing life insurance - who benefits?* Retrieved from Financial Markets Authority: www.fma.govt.nz/assets/Reports/160629-Replacing-life-insurance-who-benefits.pdf

Financial Markets Authority. (2018, May). *Conflicted remuneration (soft commissions) in the life and health insurance industry*. Retrieved from Financial Markets Authority: www.fma.govt.nz/assets/Reports/Conflicted-remuneration-in-the-life-and-health-insurance-industry.pdf

Financial Markets Authority. (2018, May). *Insurers spend $34 million on soft commissions*. Retrieved from Financial Markets Authority: www.fma.govt.nz/news-and-resources/media-releases/insurers-spend-34-million-on-soft-commissions

Financial Markets Authority. (2018, July). *QFE insurance providers' replacement business practices*. Retrieved from Financial Markets Authority: www.fma.govt.nz/news-and-resources/reports-and-papers/life-insurance-replacement-business

Henderson, A. (2010, March). *Insurance - Early life insurance*. Retrieved from Te Ara - The Encyclopedia of New Zealand: teara.govt.nz/en/insurance/page-1

Ministry of Business, Innovation and Employment. (2019). *Regulation of financial advice*. Retrieved from Ministry of Business, Innovation and Employment: www.mbie.govt.nz/business-and-employment/business/financial-markets-regulation/regulation-of-financial-advice

Naylor, M., Matthews, C., & Birks, S. (2011). *Exploring Underinsurance Within New Zealand*. Retrieved from Research Documents: www.fsc.org.nz/site/fsc1/files/Insurance%20Gap%20Files%202013//Massey-FSCReportFinal-20%207%2012.pdf

New Zealand Parliament. (1873). *Life Assurance Companies Act 1873* . Retrieved from New Zealand Acts As Enacted: www.nzlii.org/nz/legis/hist_act/laca187337v1873n18347

Reserve Bank of New Zealand; Financial Markets Authority. (2019, January). *Thematic Review of Life Insurer Conduct and Culture*. Retrieved from Reserve Bank of New Zealand: www.rbnz.govt.nz/regulation-and-supervision/insurers/regulation/thematic-review-of-life-insurer-conduct-and-culture

Vucetich, A., Perry, R., & Dean, R. (2014). *The insurance sector and economic stability*. Retrieved from Reserve Bank of New Zealand: www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/2014/2014sep77-3.pdf?revision=5f43c319-e13b-402f-b997-d7aecf7fcf94