POLICY-ONLY LIABILITY INSURANCE AS ALTERNATIVE TO PRUDENTIAL REGULATION IN THE NEW ZEALAND LIFE ASSURANCE INDUSTRY

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I. THE INSURABLE INTEREST

A. *Setting insurers to monitor one another*

THE ADVANTAGES OF USING INSURERS TO MONITOR THE HEALTH OF OTHER INSURERS INSTEAD OF USING REGULATORS TO ENFORCE REGULATIONS DESIGNED TO ENSURE THE SAME THING.

This paper will argue that even recent history is littered with examples of failures by the financial regulators to prevent bank and insurer failures in the UK, the US, Australia and elsewhere. This paper argues that regulators are inherently incapable of performing the task. The theoretical basis for which is investigated below. Evidence will be drawn from the collapse of HIH and the role of the Australian Prudential Regulator (APRA) in that collapse.

Examples of regulatory failure in the United States includes the collapse of the Savings and Loan industry in the early 1990's; and the insolvency of the State Bank of South Australia; Pyramid and the merchant bank, Tri-Continental in Australia. Benston[1] cites the example of the S&L crisis in the USA, where Savings and Loans companies would attract deposits by offering high interest rates, and would then use those funds to make high-risk loans on the philosophy that the S&L could appropriate any gains, while losses would be passed along to FSLIC (The United States Federal Savings and Loans Insurance Corporation):

> Heads, the S&L owner would win; tails, the deposit insurance fund would lose.

The authors continue[2] to argue that by the late 1980s, numerous studies had identified federal deposit insurance as the primary cause of the banking and thrift crises:

> Most of these studies emphasized 'gamble-the-institution' behavior (sic) by depository institutions as the chief culprit...

See also Huertas[3] who asserts further that [initially] restrictions on the ability to pay market rates of interest on deposits and charge variable rates of interest on mortgages effectively forced sav-

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1 G J Benston and G G Kaufman, 'FDICIA After Five Years' (1997) *Journal of Economic Perspectives* 11, (3), 141.

2 Ibid 142-3.

3 T F Huertas, 'A Market Paradigm,' *IFLRev* Special Supplement, 1993, at 97.

ings and loan associations to assume massive amounts of interest rate risk; and further that government's failure to close insolvent institutions further compounded the problem.

See further Calomiris,[4] where the author argues that there exists historical evidence, flowing principally from the savings and loan collapse in the United States, that [government] deposit insurance creates perverse incentives when it is not fairly priced. I argue below that only commercial insurance firms can fairly price insurance, and that government insurance agencies cannot. Principally Calomiris points out that insurance removes the discipline of the market. Moreover he argues that insurance has the potential to encourage excess risk-taking by existing banks, especially those banks that have little capital remaining due to past losses. I would argue that this is equally true for insurers as it is for banks. Furthermore such insurance also encourages unscrupulous or inexperienced entrepreneurs to enter banking in order to finance their risky enterprises. Again I would argue the same would hold true of insurance. This is often the case with one-size fits-all government regulation and guarantees, but would not be the case with insurance fairly priced by a commercial enterprise, and tailored to the specific risk profile of the client bank, in the case of Calomiris' example, or in the case of a direct insurer, in respect of the examples used in this paper.

Whilst these examples relate to the United States and Australia, and not to New Zealand, the reasons why the regulators failed are in my view universal. In addition it is argued that government regulators are not capable of monitoring multi-national insurers. This results in insurers operating across multiple jurisdictions with increasingly sophisticated products. In response to which regulators are most often confined to enforcing regulations enacted in response to prior crises – effectively leaving regulators stuck fighting the last war.

'The traditional approach to financial regulation is bankrupt. It sought to assure stability by providing guarantees ... The result was a system of regulation that increased both risk and cost.'[5]

> Regulation … [is] not the problem …. Government regulation … [is] the problem.[6]

This aspect is of particular concern when one considers how quickly insurance is changing under the impact of electronic commerce and communication. Rupert Pennant-Rea, the Deputy Governor of the Bank of England, quoted in Petri,[7] admitted that regulators are always five years behind, and further that that was good, because according to Pennant-Rea, if regulators tried to stay abreast of technology they would stifle innovation. But the time lag results in regulations which are not only inadequate in evaluating new risks, but because of their anachronistic nature will inevitably distort banking, in the example put forward by Pennant-Rea, or equally in the case of insurance, as put forward by this paper. In fact one could argue that the more anachronistic the regulation, the greater the market-distortion in banking; and similarly, insurance. In view of this writer Pennant-Rea does not adequately address the problem of a failure to regulate other than retrospectively.

Furthermore regulators themselves are not at risk if they should fail. The regulator may suffer political damage and a diminution of credibility, as has been the case with the Royal Commission into the collapse of HIH. But the regulator itself will not suffer financial harm. Whereas the

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4 C W Calomiris, 'Is Deposit Insurance Necessary? A Historical Perspective,' *The Journal of Economic History*, Vol. L, No. 2, June 1990, at 283.

5 Huertas, above n 3, at 97. See also T Petri and B Ely, 'Cross Guarantees: A Horse of a Different Color,' <http://www.ely-co.com/horse.htm>.

6 T Petri and B Ely, 'Cross Guarantees: A Horse of a Different Color,' <http://www.ely-co.com/horse.htm>.

7 Petri, above n 6.

greater efficacy of the market as a regulator was confirmed by the US Treasury Department in a report by Litan and Rauch which states:[8]

> [m]arkets tend to be less forgiving than regulators, who may be more willing to give a troubled institution time to work through its problems.

This paper will instead propose that an off-shore insurer, undertaking to honour the liabilities on the policies written by a direct insurer would stand to lose considerably if that direct insurer became insolvent, and the premiums charged for that insurance had not been accurately priced.

It is more likely that a large multinational insurer will be able to effectively monitor a domestic insurer than would a regulator, as the former would be better equipped and more experienced when it comes to monitoring and understanding the activities of the domestic insurer. Consequently an innsurer would be better able to perform the kind of supervision and risk assessment of the domestic insurer than the regulator would be able to.

Moreover an offshore insurer would operate under a compelling incentive: it will be severely punished if it does not perform the task of insuring the liabilities of the direct insurer efficiently. A failure by the off-shore insurer to properly asses the risk of failure posed by the direct insurer, and a concomitant failure to price the premium correctly, would result in premium income failing to match the amount of the claims levied against the off-shore insurer when the direct insurer covered by the policy failed. This would lead to losses incurred by the offshore insurer.

> The buck will stop with the guarantors.[9]

B. What is being insured? the liability on every Policy written by the direct insurer

Under this proposal, instead of a government regulator monitoring domestic insurers in New Zealand with a view to ascertaining the direct insurers compliance with prudential regulations, private off-shore insurers could fulfil the task of monitoring domestic New Zealand insurers. This they would do as a necessary part of assessing the viability of the direct insurer, in a manner similar to a due-diligence, which in turn they would do in order to determine the quantum of the premium they would charge to insure the direct insurer against its own collapse. The insurable interest would be the liabilities outstanding on the policies written by the direct insurer and still in force at the time of its demise.

In order to determine the quantum of the premium the offshore insurer would seek to determine what the likelihood is of the direct insurer collapsing. To do this the full spectrum of the direct insurer's business would be investigated in order to determine the health of the company, and by implication the likelihood of the direct insurer remaining solvent during the currency of the contract.

It is envisaged further that the offshore insurer would undertake to honour only the direct insurer's liabilities under the policies which the direct insurer had written prior to becoming insolvent, and which are still current at the time it becomes insolvent.

I order to avoid moral hazard which might arise if shareholders are protected, it is important that the off-shore insurer insure only the liabilities on policies current at the time of the direct insurers collapse. It is not envisaged that creditors receive any protection under this scheme. Such

8 R E Litan and J Rauch, 'American Finance for the 21st Century,' The United States Department of the Treasury, November 17, 1997, (no page numbers), <http://www.treas.gov/press/releases/97report.htm> quoted by Ely, above n 6, 1998 at 5.

9 Petri, above n 6.

protections do not apply to creditors of other firms, and crditors of inurers should not receive special treatment. There are important benefits to be gained from creditors exercising a measure of supervision over their debtors which imperative would be removed by creditor's insurance, and would in turn lead to moral hazard. By insuring creditors' funds creditors will be encouraged to extend excessive amounts of credit to insurers in the belief that either the direct insurer will repay them, or failing which the offshore insurer will repay them in the event that the direct insurer becomes insolvent. Secondly New Zealand is possessed of a substantial insolvency law and corporation law jurisprudence, which, it is argued, is sufficient to protect creditors. Moreover creditors have at their disposal a raft of measures which they can use to ensure repayment, including purchasing their own insurance against their debtors becoming insolvent, or ensuring that they are secured creditors, or for instance by obtaining a charge over the direct insurers assets.

Moral hazard is the creation of a situation, which effectively encourages precisely the types of practices, which the measures are meant to combat, by unintentionally encouraging behaviour, which is directly opposite to those intended. So for example if insurance provided to a direct insurer was extended to shareholders funds, then shareholders would be encouraged to take ever-higher risks in the hope of attaining ever-higher returns. Because their funds would be guaranteed by the off-shore insurer, in the event that the direct insurer, in which they hold shares, were to collapse, the shareholders would be encouraged to 'bet the firm.' Put differently if the offshore insurer were to guarantee shareholders funds it would lead to a case of 'heads the shareholder wins, tails the off-shore insurer loses!' This would result in an almost limitless up side, with no downside. The effect would be to encourage behaviour more likely to cause the direct insurer to collapse, instead of discouraging excessively risky behaviour. See further Calomiris,[10] where the author argues that there exists historical evidence, flowing principally from the savings and loan collapse in the United States, that [government] deposit insurance creates perverse incentives when it is not fairly priced. I argue below that only commercial insurance firms can fairly price insurance, and that government insurance agencies cannot. Principally Calomiris points out that [government] insurance removes the discipline of the market. Moreover he argues that insurance has the potential to encourage excess risk-taking by, in the case of his example, banks, especially those banks which have little capital remaining due to past losses. I would argue that the same can be said of the effects of government insurance on the liabilities of direct insurers. This is the case with one-size fits-all government insurance, but would not be the case with insurance fairly priced by a commercial enterprise, and tailored to the specific risk profile of the client direct insurer. The arguments which Calomiris makes in respect of the creation of moral hazard by insuring banks is in my view analogous to that which would apply to insurers.

By failing to protect shareholder's funds, these would then serve as a deductible in the event of the direct insurer's failure.[11] This would have further positive implications in respect of preventing moral hazard.

Policyholders are the least able to protect themselves against the insolvency of their insurer, and the least able to monitor their insurer. Even if they were able to engage in such monitoring their recourse is limited. They are not creditors properly so-called, so creditor's remedies are not available to them. They are not shareholders, and so shareholder's remedies are not available to them. Because of the very nature of insurance, especially life or disability insurance, and unlike

10 See above n 4, at 283.

11 A 'deductible on the policy' and an 'excess on the policy' are synonymous.

shareholders, the policyholder cannot remove the policy to another insurer should they lose confidence in their direct insurer.[12] United States Senator Tom Petri's argument about depositor's inability to monitor banks is in this writer's view equally valid for the inability of policyholders to monitor an insurer:

> For most people, though, and even for many businesses, closely monitoring their bank, and therefore exercising 'depositor discipline' over it, is about as practical as suggesting that people train to perform surgery upon themselves.[13]

C. Why offshore insurers would assume the risk?

Uncertainty and a pooling of risk function are the primary uncertainties with which insurers regularly contend. Every form of insurance includes a measure of uncertainty, including life insurance. Whilst it is a certainty that every person will die, the uncertainty inherent in life insurance is 'when'. The insurer effectively takes a bet that the insured will die later rather than sooner. The insured bets that (s)he will die sooner rather than later. If the insurer is correct the insured will pay a greater amount in premiums for the same death pay benefit. If the insured is correct the insurer will pay out the same amount on death but will have collected fewer premiums. In the case of car insurance the insured bets that the car will be lost, the insurer bets that it will not. If the insurer is correct premiums will be paid and no claim will result. If the insured is correct (s)he will receive a payout far greater than the amount of premiums paid. Insurers make a profit from providing insurance to a pool of people or entities provided that on aggregate more premiums are paid in terms of value than the value of claims lodged against the insurer. It is for this reason that individuals cannot adequately self-insure because there is no spreading of the risk function. For an insurer to remain profitable it must charge an adequate premium to a risk-worthy client, which it may seek in traditional markets; to remain competitive and provide a satisfactory return to shareholders, insurers are compelled to seek out new markets and develop new products.

Whilst providing policy-only liability to New Zealand insurers may involve assessing risks which are difficult to quantify, I would argue such difficulties are no greater than those posed by for example earthquake damage; yet insurers provide such cover regularly.

In order, to provide policy-only liability insurance the off-shore insurer would need to quantify the extent of their liability under the policy, which would in large measure already have been quantified by the direct insurer as part of its normal management function. However that would not preclude the offshore insurer from determining an adjusted level of liability as part of its enquiries into the liability posed by the direct insurer. Determining the value of a direct insurer's policies, which are still in effect, is a routine actuarial function conducted in the insurance industry regularly. Once they have evaluated the extent of their potential liability under the policy they would then want to determine how likely would be a claim under the policy? The off-shore insurer would then be able to charge an accurate premium. The 'policy' referred to here is that provided by the off-shore insurer to the direct insurer, whereby in return for a premium the off-shore insurer would undertake to assume all the liabilities flowing from whatever policies are in force against the direct insurer, at the time when, or if, the direct insurer becomes insolvent. By that it is not

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12 There exists in Australia limited scope to call an insurer to account by engaging in alternate dispute resolution, such as having recourse to an ombudsman. However this still does not allow the insured the ability to remove to another company their policy should they lose confidence in their direct insurer.

13 Petri, above n 6.

Figure 1

meant that the offshore insurer would assume the liability for whatever policies had been written by the direct insurer and against which the insured had made a claim. Rather what is meant is that ALL policies would be ceded to the offshore insurer – those against which claims had been made, and those still running, but against which claims had not been, and arguably may never be, made.

D. How the premium function would work?

Having determined the extent of their liability under the policy,[14] an offshore insurer would then have to determine how likely it is that the direct insurer will become insolvent within the period of the currency of the policy written by the off-shore insurer.

In other words a two stage process: (1) the likelihood of a claim arising, and (2) if a claim arises how much will it be?

In order to determine the answer to enquiry (1), the off-shore insurer would engage in a due diligence of the direct insurer by examining such factors as the company's capital adequacy ratio,[15] its exposure to foreign currencies, and the extent to which those are hedged,[16] quality of

14 See below, n 19.

15 The extent of the company's paid up share capital relative to liabilities.

16 A hedging contract functions by providing a guarantee from the guarantor that if the guaranteed's foreign exchange liabilities increase beyond a certain level due to exchange rate fluctuations, then the guarantor will make good the difference. This guarantee is provided in exchange for the payment of a premium.

management, asset quality and whether those assets are correctly valued, quality of risk assessment procedures and its ability to accurately price the premiums which it charges its clients for cover on the policies which it sells, extent of retained reserves, extent and adequacy of its re-insurance[17] contracts, growth in its premium income, as an indicator of whether the company itself is growing or shrinking. There would be scope for negotiation between the offshore insurer and the direct insurer in respect of extending or even limiting the scope of which factors should be evaluated. Transparency by the direct insurer in its dealings with the off-shore insurer could be rewarded with a reduction in the premium.

It is envisaged that in order to calculate the premium the insurer would investigate many if not most of the factors which a regulator would investigate as part of its normal oversight function. However whereas the regulator would not stand to lose financially if the insurer it was regulating became insolvent, an off-shore insurer would stand to lose in what could be a substantial claim. This provides a powerful incentive for the off-shore insurer to conduct its enquiries diligently.

Somewhat analogous to what the off-shore insurer would be doing is the due diligence that would be conducted by a sponsoring broker prior to the public listing of an insurer - as happens when a mutual life insurer de-mutualises.

The premium function would act to encourage prudent behaviour by rewarding it with lower premiums, and punish imprudent behaviour with higher premiums. It is envisaged therefore that the premium function will encourage better corporate governance than the present system of criminal sanction. Ultimately it is left to the insurer to decide what degree of risk to assume. And the implications of the direct insurer's choice are monetary – in my view a more effective incentive than criminal sanctions. And secondly, increases in premium are easier to implement than obtaining a criminal conviction for breach of the law, which requires proof beyond reasonable doubt. An offshore insurer need not give reasons for its premium levels. The direct insurer can opt to accept the policy and pay the premium, or look elsewhere, whereas a prosecutor is either able to record a conviction or not. A failure to obtain a conviction may be for reasons which relate to the burden of proof. Not necessarily because the direct insurer is innocent of the charges.

In order to gain compliance with this model, each New Zealand direct insurer[18] would be required to obtain a certificate of direct-policy-only insurance. This would apply to all insurance companies operating in New Zealand as direct insurers, whether New Zealand by nationality or not. It may be necessary to require all insurers, which wish to operate in New Zealand as direct insurers to incorporate their New Zealand operations under domestic laws. This has the effect of levelling the playing field so that all direct insurers in New Zealand operate under the same compulsion to procure policy-only liability insurance. That way foreign direct insurers operating in New Zealand are not advantaged by being exempt from this requirement.

Under this system policy-holders would be reassured that in the event that their insurer failed during the currency of their policy, their rights and obligations would be ceded to the off-shore insurer who would take-over those policies, and assume the role played by the failed insurer, as if it had never collapsed.

Direct domestic insurers would only be permitted to obtain insurance from a pre-approved list of 20 of the world's largest insurers by market capitalisation; with a further proviso that none of

17 An examination of re-insurance will be provided below.

18 Direct insurer differentiates an insurer, which writes policies with the direct insured as distinct from a reinsurer, which writes insurance policies covering the risk of other insurers.

them be a New Zealand insurer. This would hopefully prevent the collapse of a domestic insurer causing contagion, and thereby destabilising the entire domestic insurance industry. Put differently, the safety mechanism of requiring the insurer who assumes the policy-only liabilities of the direct insurer to be an off-shore insurer, is designed to prevent contagion, and a situation seen more often in banking, that of a bank run. I acknowledge however that this may not be as serious a risk in insurance as it may be in banking. Bank runs occur because of panic, and evidence themselves in the form of depositors withdrawing their funds from healthy banks en masse, thereby causing healthy banks to fail. However it is not possible, even in times of panic, to withdraw en masse life insurance policies, or claim, en masse, simply because panic has set in, on, for example, car insurance. Either the car has been lost or it has not. The collapse of a competitor insurer would have no bearing on that factual situation. Moreover if the provider of the policy-only liability insurance were adequately managed, there is no reason in principle why that company could not also be a domestic insurer. Provided it has adequately assessed the risk, priced the premium correctly, and obtained adequate reinsurance, there is no reason in principle why the collapse of a domestic direct insurer should lead to the collapse of a domestic policy-only liability insurer. However what this safety mechanism would prevent is a worst case scenario where the domestic direct insurer is poorly managed and collapses, causing a claim to be made against the secondary insurer, which in a worst case is also poorly managed, is unable to cope with the claim made by the direct insurer, and also collapses, thereby causing a doubling-up of distress to the local economy.

E. Why multi-national insurers are the only entities capable of regulating one another

Government regulators are often ill-equipped and under-resourced when it comes to monitoring direct insurers. This was certainly the case with APRA before the collapse of HIH. It presents particularly intractable challenges to a regulator which seeks to regulate an insurer which operates internationally – the off-shore operations may be difficult to monitor due to jurisdictional issues. Whereas an off-shore insurer that itself operates across multiple jurisdictions would be better placed to monitor and understand the nature of a direct insurers off-shore transactions. An off-shore insurer would also be better placed to understand the at times highly complex and sophisticated insurance products which a direct insurer may offer.

Through the mechanisms of risk pooling and re-insurance it may be argued that multi-national insurers are more likely to posses the capacity to absorb potentially large claims than any other commercial entity.

Because policy-only liability insurance is in some ways analogous to re-insurance, it may be argued that insurance companies which are active in the field of re-insurance will posses many of the tools and skills needed to operate in the field of policy-only liability insurance.

Lastly because of the relatively small size of the New Zealand direct insurance market it is a good candidate for such a system of prudential regulation by way of market mechanisms.

II. Potential Shortcomings

A. The cost

This model would represent a potentially sizeable operating expense for direct insurers. This may be mitigated by government recognising the costs to the economy of supervision and the costs to

the economy of an insurer which fails - both economic and social. Having insurers in effect pay the costs of their own supervision, and through policy-only liability insurance in effect insulating the economy from distress in the insurance sector, it may be argued that in return for insurers relieving tax-payers of the risk and cost of insolvency, the government may consider a lower tax rate for insurers, in order to compensate them for assuming the burden and costs of supervision and protection against insolvency. There is an argument, which could be made, that insurers pay taxes, which in turn fund the commons. Maintenance of law and order is a commons, and so in return for paying tax, insurers should be regulated by the state at no additional cost. If this responsibility is then to be sub-contracted to an off-shore insurer at a cost to the direct insurer, then that would constitute a further and indirect tax. If such a further tax is levied only against insurers then it may be argued that that is unfair. This may form the basis of a claim by the insurance industry as a whole to be taxed at a different rate from other commercial entities. A similar argument could be made that a stable insurance industry is a commons – something which we all need, but which only the state can supply by enforcing prudential regulations. Consequently if an insurance company is required to pay tax, then it may reasonably expect the state to provide a regulatory authority. If the state no longer provides such an authority and instead seeks to maintain the commons of a stable insurance sector by shifting the onus – and the costs – for conducting such regulation onto the insurers themselves, then it may be argued that insurers are being taxed twice. Once when they pay tax to the state, and again when they pay for a service, which the state should supply – in this case prudential regulatory enforcement. So the argument could be made that if the state is no longer going to provide for prudential regulation, but is instead going to shift the responsibility – and the costs – for such regulation to the individual participants in the insurance industry itself, that those participants should enjoy a measure of tax relief commensurate with the amount of money the state stands to save by no longer providing a prudential regulator.

For this system of market discipline to work, and in the event of an insurer which cannot afford the premium, it should not receive assistance from the state. It should be compelled to allow itself to be taken over, or alternately forced to cease operating. This forms an important cleansing role, whereby insurers, which are so ill that they are unable to obtain policy-only liability insurance, or cannot afford the premium, must be removed from the economy so that they do not become a contaminant and cause instability if and when they fail.

B. Loss of sovereignty

It is conceded that this system would entail a diminution of sovereignty by the state over the insurance sector.

C. Industrial espionage

It remains a deficiency of this model that it would set competitors to monitor one another. This may make possible industrial espionage.

This may be mitigated in several ways:

> Re-insurers typically have close relationships with direct insurers. Secondly the use of Chinese Walls is common practice in accounting, law and stock brokerage firms. Thirdly if the policy-only liability insurance market grew to be of significant size, then the providers of such insurance would wish to protect their reputation as honest and trust-worthy. A reputation as a sneak would not encourage repeat business.

D. Monitoring the policy

The state's involvement would be limited to verifying that a certificate of policy-only liability insurance had been issued in favour of each direct insurer in New Zealand, and that the certificate was current. This is a fairly simple task and could be performed by the registrar of companies.

It is important that each contract of policy-only liability insurance adequately insures the direct insurer's policy-holders and does not contain exclusion clauses which would essentially render the protection under the policy meaningless. The registrar may wish to ascertain that as a minimum, each certificate of policy-only liability insurance provides an obligation by the off-shore insurer to cover whatever obligations lie against the direct insurer if and when the direct insurer collapses.

A standard form contract to which all offshore insurers who agree to provide policy-only liability insurance must adhere, is another alternative. This would still allow room for negotiation between the direct and off-shore insurer which would impact the premium. What would be precluded from becoming a variable would be the nature of the obligation to provide policy-only liability insurance. But the costs of providing insurance under such a standard form contract would provide fertile ground for negotiation and adjustment of errant behaviour by the direct insurer in return for a lower premium.

III. Why this is Not Re-insurance

A. What is re-insurance?

Direct insurers as part of their normal business re-insure the risks they have assumed under the policies they have written. This involves an arrangement between the direct insurer and the re-insurer such that in return for a premium the re-insurer will make good part of the direct insurers losses in the event of a claim by the policy holder. The re-insurance is paid to the direct insurer, not the policy holder. In so doing re-insurance becomes the process by which direct insurers mitigate their potential losses by themselves purchasing insurance against the policy, which they have written.

Consequently re-insurance operates in the same manner as insurance: pooling of risk. Stenhouse[19] lists these advantages as follows;

- There is a greater independence in the pool of reinsured risks through risk diversification.
- There is further mitigation of risk through a geographical spread of otherwise similar risks. This risk spreading may take place regionally, nationally and internationally.
- There is inherently greater stability by way of a larger scale risk pool.

Reinsurance not only allows insurance companies to spread the risk, which they assume when writing an insurance policy. It also allows them to write more business, because reinsurance has the function, in practice, of substituting capital. The capital substitution argument relates both to volume of business, ie solvency, and volume of risk, ie capacity.[20]

An increase in both volume of risk and volume of business has the function of increasing the capacity of the pooling function.

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19 R Stenhouse, 'Background Paper – Reinsurance,' Submission to the Insurance Council of Australia, for the HIH Royal Commission, January 2002, 4.

20 See Stenhouse, above n 19, at 5.

B. Types of re-insurance

A list of types of reinsurance of relevance to this paper, but not exhaustive includes:

- Proportional covers, where the insurer and the reinsurer share the loss payments in the same ratio as they shared the premium.
- Non-proportional covers, which is determined on a case-by-case basis, with the reinsurer paying all losses above a set deductible to a certain limit.
- Financial reinsurance, described by Stenhouse[21] as having been developed as a response to the insurance market's commercial needs and the growing attention to whole of balance sheet risk management. In Stenhouse's[22] view as the market in financial derivates developed, so too has insurance. An example of which are derivative instruments to hedge interest rate and foreign currency exposures. It is noteworthy that these instruments insure against unforeseen but foreseeable risks which may adversely affect profits. Examples include hedging contracts which insure against currency fluctuations. The timing and extent of the appreciation may be unforeseen, but the concept of free-floating currencies appreciating against one another is not.[23]

C. Activation is the key

The circumstance under which policy-only liability insurance is activated is the most marked point of difference from re-insurance.

Re-insurance is activated by a claim on the underlying policy between the direct insurer and the consumer. Policy-only liability insurance is activated by the insolvency of the direct insurer.

By way of an example: Air New Zealand hedges against a rise in the fuel price. The insurer who provides the cover is reinsured with Swiss Re on a proportional cover of 25 per cent. The direct insurer itself has 100 per cent policy-only liability insurance with Lloyds of London. Lloyds in turn re-insures 10 per cent of that risk with Munich Re.

If the price of jet fuel rises above a certain level the direct insurer will make good the difference, of which it may in turn claim 25 per cent of the payout from Swiss Re. Alternately a situation may arise where the price of jet fuel has not risen sufficiently for a claim to lie against the direct insurer, but rather the direct insurer becomes insolvent. The liability on the policy is then assumed by Lloyds of London, who will now be entitled to collect the premiums payable under the hedging contract.

If at any stage during what remains of the currency of the hedging contract a claim arises, it will then lie against Lloyds. Lloyds would be entitled to all outstanding premiums under the original hedging contract.

Should a claim arise Lloyds may claim against Swiss Re to be reimbursed for part of their loss under the original hedging contract because its' predecessor in title, the direct insurer, paid reinsurance premiums to Swiss Re. Lloyds would be able to claim re-imbursement for part of the loss for which they were responsible from Munich Re, as Lloyds' risk under the policy-only liability contract was in turn re-insured.

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21 Above n 19, at 7.

22 Ibid.

23 A so-called 'hedging contract'.

IV. The Ely-Petri Model

United States Senator Tom Petri and economist Bert Ely propose an analogous system, under which banks guarantee other banks in a cross guarantee model. Banks would then supervise one another, and guarantee one another's depositor's funds.

The proposal for policy-only liability insurance differs from theirs in that I envisage direct insurers being supervised by offshore insurers, not by other direct domestic insurers. This provides my model with two distinct advantages. Firstly mine does not allow a supervisory relationship by direct competitors.

Secondly my model removes the consequences of a bail out to other countries and other economies, by prohibiting the use of a New Zealand insurer as guarantor of policy liability. This insulates New Zealand insurers from one another.

V. Conclusion

This proposal would remove the state as prudential regulator of the insurance industry. As a requirement for operation as an insurer in New Zealand each insurance company would have to be able to display in its head office a certificate of policy-only liability insurance, issued by an approved insurer. Approved insurers would be drawn from a list of the world's 20 largest insurers by market capitalisation, and would not be permitted to be New Zealand insurers.

In this manner the task of prudential regulation is in effect sub-contracted to a group of off-shore insurers. The state's involvement would be limited to ensuring that each direct New Zealand insurer was covered by policy-only liability insurance. In this way the regulator could enforce compliance with this arrangement, without having to enquire into any of the underlying aspects of the direct insurer's health or its' compliance with prudential regulations. That task is left to the off-shore insurer, on the understanding that the off-shore insurer will need to make these enquiries in order to ascertain the financial viability of the direct insurer which is a candidate for policy-only liability insurance.

The incentive for the direct insurer to co-operate with the off-shore insurer is compelling: failure to co-operate will risk an increase in premiums – or worse, a failure to obtain cover. A failure to obtain cover will preclude the direct insurer from continuing to operate.

For reasons of commercial confidentiality the domestic insurer may wish not to make disclosure about certain aspects of its business. Unlike traditional prudential regulation which allows for very little flexibility or discretion, this proposed model would allow the parties to agree on levels of disclosure and adjust the premium accordingly. So the direct insurer will have to determine whether on any given potential factor of investigation it is a greater priority to save on the costs of the premium, or keep the information private.

In practice it is envisaged that in determining the health of a domestic insurer, the off-shore insurer would probably use many if not all of the measures employed by the prudential regulator.

The Australian Prudential Regulatory Authority failed in respect of HIH, in spite of excellent rule of law conditions in Australia, a highly developed commercial, corporate and insurance jurisprudence, a good skills base, and a market economy. I would argue that in large measure these failings belie systemic shortcomings. For example regulators tend to enforce regulations enacted in response to the most recent corporate collapse. In that sense regulators are often stuck fighting the last war. This is in my view one of the reasons why government enforced prudential regulation

is a story littered with reoccurring failures. Tri-continental, Pyramid and the State Bank of SA being but a few examples from Australia.

I would assert further that by removing the state from the function of prudential regulation there is less prospect for distortions of the market, political interference and 'one-size fits all' regulation.

Instead of ensuring compliance through criminal sanctions, and thereby relying on the criminal justice system with its higher burden of proof, compliance under this model will be encouraged by market mechanisms – specifically lower premiums. Disputes may be resolved by recourse to the jurisdiction of civil courts.

Should an insured direct insurer fail the responsibility to make good on the policies still in force would fall to the off-shore insurer, and not the New Zealand government or its taxpayers. It is important to re-emphasise that shareholders funds would not be protected under this scheme, but would instead act as a deductible, which in turn encourages shareholders to exercise control over management.

Whilst this model is not one of re-insurance it should be stressed that whilst claims could be substantial against the off-shore insurer, the off-shore insurer could take steps to mitigate their losses through re-insurance.

Unlike insurance against natural disasters a claim on a policy-only liability policy would not necessarily result in the off-shore insurer having to pay out large amounts immediately, as they would have to do with for example, an earthquake. Whereas with policy-only liability insurance only claims that would have fallen due against the direct insurer at the time of its demise would be an immediate liability for the off-shore insurer.

Premiums paid by a New Zealand insurer to an off-shore insurer would be a legitimate operating expense and would be tax deductible. There exist tremendous opportunities for ways to reduce the premium through negotiation between the parties. For example the off-shore insurer could stipulate higher levels of re-insurance, improved risk assessment, a seat on the board of directors etc.

Whilst this model contains risks, including the risk of being untested, it is also true that the prevailing model of state directed prudential regulation has failed numerous times. Recent experiences in the United States and Australia bear this out. The advantage for New Zealand is that the direct insurers which operate in New Zealand would, it is argued, not represent an insurance market that would be too large to underwrite with policy-only liability insurance. The advantage to New Zealand of a proposal such as this, is that if it succeeds in creating a very stable insurance sector, New Zealand may be spared an HIH type of collapse, which in an economy the size of New Zealand's may economic distress throughout the domestic economy.