

An Independent Review for the RBNZ of the Supervision of CBL Insurance Ltd

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EXECUTIVE SUMMARY

Introduction

This Review was commissioned by the Reserve Bank of New Zealand (the Bank) following the liquidation of CBL Insurance Ltd (CBL), a subsidiary of CBL Corporation Ltd (CBL Corporation), in November 2018. It is an independent review of the Bank's supervisory processes, best explained through the terms of reference, partially reproduced here:

Background

A major regulatory event in New Zealand has been the failure of licensed insurer CBL Insurance Limited (CBLI). The Reserve Bank of New Zealand (the Bank), in its capacity as prudential supervisor of the insurance sector licensed, supervised, issued regulatory directions, and ultimately applied for the liquidation of CBLI.

The cessation of business by CBLI, its placement into liquidation and the events that led to its liquidation have caused the Bank to review its prudential regulatory and supervisory arrangements for insurance companies licensed by the Bank. The Bank acknowledges the public interest in these events. To this end the Bank has commissioned an independent Review into its supervisory actions and decisions pertaining to CBLI and the associated regulatory framework.

The Review will assess supervisory actions taken and not taken by the Bank, including formal decisions made under the Insurance (Prudential Supervision) Act 2010 (Act) such as the initial licensing of CBLI, directions given and treatment of breaches of licensing conditions and directions.

Purpose of the Review

The objectives of an independent Review are to identify the lessons of this important episode (both the positives and the negatives) by opening the Bank's processes to independent scrutiny and, in doing so, to also provide relevant information to the public and stakeholders.

The purpose is to provide an independent and expert perspective on how best to strengthen the regulatory and supervisory framework for the future, and in particular will:

- Identify any shortcomings and positives in the Bank's supervisory practices and its critical judgements.
- Identify any constraints or areas for enhancement in the legislative and regulatory framework in which the Bank was operating.
- Assist understanding by key stakeholders and the wider public on the Bank's role and activities as a prudential supervisor.

Scope

The Review will cover all phases of the recent history of CBLI from pre-licensing in 2011 through to licensing in 2013, development of the company from 2014 to the listing of its parent company CBL Corporation Ltd in 2015, to substantial and fast-growing specialist

international reinsurer in 2016, followed in 2017 by the unravelling of the company's business and its ultimate liquidation at the instigation of the Bank in 2018.

The full terms of reference are reproduced in Appendix 1 and our direct response to them follows this Executive Summary.

Background context - CBL

CBL had its origins as a New Zealand-based insurer of builders' warranty business but it began to operate overseas in the 1990s. By the time of licensing in 2013, it was already writing the vast majority of its business as offshore inwards reinsurance from Europe, mainly in France. Gross written premiums in the 2013 calendar year were \$165m, less than \$2m of which was New Zealand business.

Most of its business was in building and construction-related classes of insurance and was 'long-tail', with claims reporting periods of 10 years or more. The company expanded rapidly from 2012 to its interim liquidation in February 2018: premiums increased from \$165m in 2013 to \$247m in 2016 and \$313m in 2017. Expansion came about mainly from a range of acquisitions of managing general agents in Europe.

CBL is a wholly-owned subsidiary of a subsidiary of CBL Corporation Ltd, which listed on the NZX and ASX in October 2015.

Interim liquidation of the company came about in February 2018 following a sequence of events beginning in June 2017 when Elite Insurance (Elite), a Gibraltar-based ceding company of CBL, was found by its regulator to be under-reserved. In August 2017, the Bank appointed an investigator (McGrathNicol, a specialist advisory and restructuring firm) to examine CBL and also Milliman and Finity, actuarial firms, to assess CBL's claims reserves.

In February 2018, the reserves were found to be seriously understated, leading to a major breach of CBL's solvency requirement to a level justifying interim liquidation. The Court ordered interim liquidation as a result not of the solvency breach, however, but of a serious breach by CBL of Bank directions regarding corporate transactions. Shares of the parent company CBL Corporation were suspended from trading and, after an interim liquidator was appointed to CBL, the parent was placed in voluntary administration. Full liquidation occurred in November 2018.

Background context - the Bank

The claims under-reserving that was eventually recognised by CBL's Appointed Actuary in 2018 was suspected by the Bank as early as 2013, when a KPMG report commissioned by the Bank during licensing of CBL identified such a possibility.

The Bank attempted to pursue this suspected under-reserving and some other solvency-related issues with CBL to various degrees over the period from July 2014, when the December 2013 solvency return and Appointed Actuary's Financial Condition Report (FCR) were submitted, through to interim liquidation in February 2018. It was a difficult challenge, however, for several reasons:

- On the CBL side:
 - an apparent steadfast and unfaltering belief by CBL in its business strategy and the profitability of its business that was primarily dependent on the level of claims reserves as assessed by the company's Appointed Actuary;

- On the Bank side:
 - limited resources in both scale and insurance experience arising from the introduction of the licensing regime in 2013: there were some 100 companies to license in a limited timeframe, supervisory staff were unaccustomed to their roles and the demands of the Canterbury earthquakes were a critical industry risk and user of resources in this period;
 - the Bank had no evidence that its efforts in 2014 to encourage both CBL and the Appointed Actuary to draw on international actuarial experience were taken up;
 - CBL deflected the Bank's concerns on its claims reserves and solvency in 2014, simply referring them to the Appointed Actuary; and
 - subsequent interest by the Bank in dealing with its doubts about CBL's claims reserving and solvency was not actively pursued by the Bank until 2017 because of a combination of factors including internal legal advice that the Appointed Actuary's opinion on those matters could not be easily circumvented, doubts as to whether its concern about possible under-reserving were a serious problem and competing priorities (the Canterbury earthquakes in particular).

Overall performance of the Bank as prudential supervisor

2012 – 2013: pre-licensing and licensing

During pre-licensing and licensing in 2012 and 2013, when the Act was new and being applied for the first time, the Bank's processes were sound and the Bank made a sound decision in granting CBL a licence despite concerns over some aspects of the company's affairs. These concerns were to be followed up after licensing.

2014 – 2016: "business as usual" supervision phase

Soon after Bank supervision commenced in 2014 following licensing, the Bank had some misgivings about CBL's claims reserves and solvency. Its efforts to resolve these misgivings encountered some difficulties in both 2014 and 2015 that were not resolved during this period, mainly for reasons internal to the Bank. Lessons from this period form the major part of our findings and have resulted in a number of recommendations to strengthen the hand of the Bank in future through some regulatory changes and modifications to the Bank's supervisory arrangements.

2017 – 2018: international interest and insolvency

CBL's largest single source of inwards reinsurance business was Elite of Gibraltar. In mid-2017, the Gibraltar FSC raised the alarm with the Bank on Elite's solvency. The Bank responded strongly at that time, appointing investigators and two firms of actuarial experts to examine CBL's claims reserves and solvency. CBL's Appointed Actuary and the investigating actuaries all saw the need for substantially increased claims reserves at that time (late 2017 and early 2018), demonstrating that CBL was not meeting the Bank's solvency requirements.

During this period the Bank acted firmly and decisively and, in our view, properly within its powers, leading ultimately to interim liquidation in February 2018 and full liquidation in November 2018.

CBL claims reserves and solvency

To expand on the above, we note firstly that CBL's financial and risk management was an issue for the Bank from the time of provisional licensing in 2012 through to interim liquidation in 2018.

The Bank took a number of supervisory steps after licensing, with some critical initiatives taken and judgements made. For example:

- In June 2014, the Appointed Actuary in his 2013 FCR drew attention to the company's low solvency margin, the risks of rapid expansion, the need for careful monitoring of claims development patterns and participation by him in decisions affecting capital management. He advocated a target solvency ratio of 150% rising to 200% (from a statutory minimum of 100%). A consequential internal Bank actuarial report in August 2014 advised possible negative solvency as a result of under-reserving and of incorrect application of parts of the Solvency Standard.

The Bank responded only to the claims reserving and solvency measurement issue and seems to have paid no direct attention to the Appointed Actuary's other recommendations, which in our view warranted investigation with the Appointed Actuary and with CBL.

- The Bank raised its solvency concerns with CBL in September 2014 but CBL did not accept the views of the Bank's internal actuary. The Bank initially concentrated on trying to impose an investigation under s 130. It ultimately concluded, however, on the basis of internal legal advice, that it did not have sufficient information to meet the statutory threshold. It decided to await the results of the work of the new Appointed Actuary, which it required within a shorter timeframe than usual.
- In April 2015, the Bank had a list of solvency issues, most of them carried over from the internal actuarial report of August 2014.

From the Bank's perspective, the new Appointed Actuary's FCR gave no meaningful resolution of the solvency questions. When CBL foreshadowed an Initial Public Offering (IPO) for its parent company CBL Corporation later in 2015, the Bank took the opportunity of the potential IPO to obtain agreement from CBL to make progress on what were now 21 solvency issues. CBL agreed to an increase in the Minimum Solvency Capital of \$20m to \$70m and to inject \$20m of additional capital. There was not, however, any progress on the claims reserves issue and the Bank did not press at that time for further progress.

We can see that the Bank concentrated on seeing a better balance sheet from CBL, which did occur. We also observe, however, that throughout this period the Bank appeared to overlook the potential consequences if CBL, as well as expanding as it intended, were to write future business at a loss. That was the likely situation if the claims reserves were materially understated:

- it was positive that the Bank took the opportunity presented by the IPO to resolve some solvency issues; but
- the Bank was also lenient because important matters were still outstanding at the time, especially the claims reserving position.
- When the Bank was approached by the Gibraltar FSC in October 2016 because of its concerns about possible under-reserving by Elite Insurance, and hence about CBL's financial soundness (as 80% of Elite's business was reinsured with CBL), the Bank should have been more forthright

with the Gibraltar FSC and used the enquiry as an opportunity to gain a better understanding of the CBL portfolios and its European operations.

- When the Gibraltar FSC made further contact with the Bank in June 2017, with preliminary results from an independent actuarial review it had commissioned showing under-reserving by Elite, the Bank decided to take strong action: it appointed an investigator, McGrathNicol, and also two actuarial firms (Milliman and Finity) to make independent assessments of CBL's claims reserves. This strong action was appropriate and the investigations decided upon were sound.
- The Bank applied for interim liquidation of CBL in February 2018. The Court ordered interim liquidation, trading in parent CBL Corporation's shares was suspended and CBL Corporation went into voluntary administration.
- When the Appointed Actuary completed his 2017 liability valuation in March 2018, he increased the claims reserves substantially. When the independent investigators completed their work in March 2018, they concluded that there was additional substantial under-reserving. Irrespective of which set of figures is used, it was now evident that CBL had been consistently under-reserved since before licensing in 2013 and the scale of under-reserving was being exacerbated by continuing growth in the volume of premiums written each year up to and including 2017. In light of the liquidation and the fact that it had taken so long to reach that stage, the Bank asked itself whether there are lessons to be learned for the future from the CBL experience, hence this Review.

Principal findings and recommendations

The matters described above and a range of other relevant matters are elaborated in the full report. We have analysed the events and actions of the Bank to identify matters arising for future attention by the Bank.

We summarise here the principal findings and recommendations of this Review through several main themes relating to supervision and some specific regulatory changes.

Context

We emphasise at the outset the context in which the Bank was operating: it comprised a small team of people operating a new regime, with significant other work arising, in particular, out of the Canterbury earthquakes. Because CBL's business was almost entirely offshore, its impact on the NZ insurance sector and the economy was seen as low and the resources to be allocated to it needed to be balanced against other priorities.

Supervision

In supervising insurance businesses, the Bank should:

- Adopt a pre-emptive stance of being ready to act on doubts and suspicions of lack of financial soundness, rather than waiting for certainty or advisory confirmation of financial risk.

There are many case studies in many jurisdictions that demonstrate that, for long-tail insurance business, early hints of under-reserving frequently are signs of trouble ahead and need to be 'nipped in the bud' by the regulator. Hence the early doubts about CBL should have been taken up with a greater sense of urgency and acted upon as early and as decisively as possible.

- Act forcefully, making full use of the powers available to it, when in doubt about a company's financial soundness.
 - In the CBL case, the Bank made a number of judgements from 2014 to 2016 that gave the benefit of the doubt to CBL. If it had acted more forcefully, CBL's solvency may well have been found to be inadequate in 2014 or 2015; if that had been the case, the scope and complexity of the CBL liquidation would have been much reduced compared to the position in 2018.
- For insurers with high risk ratings or that are under increased surveillance, rely not only on the written word but interact more extensively with boards, senior management and appointed actuaries, including meetings aimed at identifying any activities or behaviours that are contrary to prudent conduct of the business.
- Strengthen the governance obligations of insurers through greater scrutiny and accountability of boards, management and Appointed Actuaries.
 - Revisions to the Solvency Standard (see below) should contribute to stronger financial management, business planning, governance and board accountability.
 - For an insurer with a high risk rating, the Bank should monitor and test the outcomes of the insurer's compliance with the terms of the Governance Guidelines and the Risk Management Guidelines.
- On receiving expert reports, whether by actuaries, auditors, expert consultants or others, examine them in depth for a full understanding of the messages they might contain.
- Ensure that Appointed Actuary engagements work effectively, with unfettered access to any and all of the company chairman, directors and senior executives and also to the Bank. Require full adherence to Solvency Standard requirements, including professional standards.
- Maintain active relationships with international regulators by utilising the Bank's membership of the International Association of Insurance Supervisors.
- Ensure solvency assessments take full account of business plans and recognise the significance of pricing and future profitability as well as balance sheet integrity.
- In order to deliver on all of the above, allocate additional resources to the supervisory team and the policy team to a level consistent with the Bank's goals, priorities and risk appetite.

Regulation

On regulatory matters, there is a case for:

- *Modifying the Solvency Standard* (and, if necessary, the Act) so as to
 - operate as a graduated and flexible set of solvency measures and triggers, in the same manner as the Bank has proposed introducing for licensed banks, with a *prudential capital buffer* and an *escalating supervisory response* as the buffer reduces. Such an approach would not only strengthen the capital management and solvency framework, but would also oblige active participation by, and responsibility of, the board for capital management and business planning.

- Make it less difficult for the Bank to challenge the Appointed Actuary’s advice in determining an insurer’s solvency margin.
 - Introducing, by amendment to the Insurance (Prudential Supervision) Act 2010 (the Act) –
 - *group supervision* for insurance groups using non-operating holding companies and insurance subsidiaries (as in the CBL case), to ensure capital integrity and protection against contagion risk within the group;
 - *outsourcing requirements* for all insurers (especially for underwriting agencies, third-party claims managers and reinsurance);
 - a power for the Bank to issue a *wider range of prudential standards* including governance and risk management standards; and
 - correction of some omissions including the inability to stop an insurer renewing existing contracts when the insurer’s solvency is under question.
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This Executive Summary outlines the background to our review and to the Bank's journey during the CBL story from pre-licensing in 2012 to liquidation in 2018. It also describes in summary form our main findings and recommendations.

The report should be read in its entirety to understand the full extent of our review including the legislative, regulatory and supervisory context of the Bank’s role, our assessment of its actions and performance in supervising CBL during the period and our recommendations for strengthening the regulatory and supervisory framework for the future.

CONSOLIDATED FINDINGS AND RECOMMENDATIONS

Part I: Key Findings and Recommendations

The first part of this section assembles in the one place a summary of our findings and the full set of recommendations made in the following chapters.

Chapter 5: CBL- Licensing and Solvency - 2012–2016

Findings: Pre-licensing 2011 and 2012, licensing 2013

- The pre-licensing process and the Bank's licensing plan were sound.
- The licensing process and the post-licensing plan were sound. The decision to issue a licence was appropriate against the alternative of denying CBL a licence and forcing closure of the business.
- Noting that the Bank had a set of concerns about CBL, the Bank was adequately prepared for the challenge that CBL was bringing into the new regulatory regime following licensing.

Findings: 2014 – dealing with 2013 Year End

- The Bank should have responded differently once CBL declared in October 2014 that it did not agree with the view of the Bank's internal actuary on CBL's solvency. Alternative steps that should have been considered include:
 - an immediate increase in CBL's solvency requirement (probably to 150%);
 - examining in some depth the FCR recommendations and the internal actuarial advice, which would have entailed, as a starting point: interviewing the Appointed Actuary on his own, interviewing the board with and without the CEO present and exploring more closely the Bank's internal actuarial advice; and
 - seeking further information and/or proceeding with an independent review of the internal actuary's advice, given the limited collateral expertise in the Bank at the time, and then proceed with other supervisory initiatives.
- The approach by the Bank, of seeking some kind of confirmation of the internal actuarial advice, had the effect of putting the onus on the Bank to disprove CBL's position. This was an unsatisfactory situation for the Bank.
- Overall the Bank appears to have given CBL the benefit of the doubt on claims reserving and solvency pending subsequent developments and investigations.

Findings on the regulatory system

- The difficulty encountered by the Bank in challenging CBL's solvency assessment illustrated a significant problem that the Bank believed it had with the Act and/or the Solvency Standard regarding the role of the Appointed Actuary. It also illustrated some potential technical limitations of the Solvency Standard.

The Appointed Actuary situation is covered in Chapter 9 and the Solvency Standard is reviewed in Chapter 11.

Findings on solvency and reserving in 2015 with a new Appointed Actuary

- In our view, the Bank acted reasonably in the steps it took, including continuing to give CBL the benefit of the doubt and granting the new Appointed Actuary the time to prepare 2014 reports, noting that it ultimately cost the Bank another six months delay. However, it could well have been more forceful. It could have done more and, in our view, should have done more to see that the new Appointed Actuary was obliged to seek and consider additional information. Absent a satisfactory response, the Bank might have sought the relevant information using its powers under the Act.
- Notably, if the Bank had acted in 2014 to increase CBL's required solvency ratio to say 150%, as supported by both the previous Appointed Actuary and the internal actuary, then the FCR for December 2014 would have presented CBL with a solvency problem: the reported Minimum Solvency Capital at 31 December 2014 was \$49.2m and actual solvency margin \$19.1m, yielding a solvency ratio of 139%. That in turn would have obliged the CBL board to take urgent and immediate remedial action on its financial position and financial management.
- In summary, the Bank was lenient with CBL for almost a year, from mid-2014 to mid-2015 because, throughout that period, it had doubts about CBL's solvency but it gave the insurer the benefit of the doubt in relation to its explanations and the actuarial advice that the Appointed Actuary was producing.

Findings on reserving and CBL's IPO in 2015

- The Bank's cautious approach to investigating CBL more closely when suspecting under-reserving by the company in 2015 was less than prudent by the Bank and contrasts with the approach advocated in this report in Chapter 12. The Bank gave CBL the benefit of the doubt whereas, in our view, the Bank should have persevered as strenuously as possible to resolve its doubts.
- In the context where CBL had indicated to the Bank that the IPO would not proceed unless the Bank's solvency concerns with CBL were satisfied, we believe that the Bank should have considered using its position as prudential regulator of CBL in 2015 to deter CBL Corporation from issuing a PDS and listing on the NZX before the Bank had been fully satisfied on its reserving and solvency concerns (we do not under-estimate the tension that this approach would have created with CBL but our finding stands).
- The Bank gave the appearance to CBL of treating the concerns as resolved because it nominated no further concerns to CBL at the time that we have discerned beyond the wording of the PDS risk statement.

Finding: Solvency Concerns in 2016

- It is fair to say that the Bank was raising important unresolved issues with CBL in 2016 but it was not exerting any particular pressure on the insurer to respond with urgency or comprehensiveness on these issues.

Findings: External knowledge and Bank confidentiality

- One can debate whether AM Best, in upgrading CBL in 2016, should have looked more closely at CBL given its international resources and access, if it had sought it, to financial results for other French DO and DL insurers. The fact was, however, that neither AM Best nor any other external party - not investment analysts, the FMA or the European regulators - was aware that the Bank was in dialogue with CBL over questions of the soundness of CBL's financial condition.
- That was an entirely defensible position for the Bank because we know that the Bank was under obligations of secrecy while matters were still to be tested. We consider, however, that this confidentiality requirement on the Bank supports the case for resolving quickly the Bank's doubts in case they are valid and substantial.

Findings: Enquiry from Gibraltar in 2016

- While this episode indicated that the Bank remained concerned about CBL's claims reserves, in our view the Bank should have engaged more openly and more actively with the Gibraltar FSC. The Bank of course needed to be cautious as it had a limited established relationship with the Gibraltar FSC but, with its participation in the International Association of Insurance Supervisors and an existing set of protocols that can give protection to both regulators and licensed companies, it had every opportunity to do so (see further in chapter 7).

Finding: Bank's position with CBL after Gibraltar FSC intervention

- Notwithstanding all that had transpired in the previous three years, along with continuing concerns over reserves, recoveries, capital management and issues signalled by the Gibraltar FSC with a core ceding company, the Bank continued to be lenient with CBL.

Recommendation

- 5.1 When in doubt about an insurer's financial soundness, the Bank should take steps, in the interests of policyholders and the public, to investigate the company without delay and to resolve the doubts as quickly as possible.

Chapter 6: CBL 2017–2018: International Interest and Insolvency

Findings: June 2017 to Interim Liquidation February 2018

- The Bank became increasingly concerned after PwC UK, engaged by the Gibraltar FSC to investigate Elite's claims reserves, advised severe under-reserving at Elite. That was the trigger for the Bank to take strong action by issuing Directions and appointing investigators in August 2017.
- We consider that the actions of the Bank over this period, including the investigation and various Directions, were fair and reasonable to CBL and its group members in light of the information the Bank had available. We saw no evidence of predetermination by the Bank. Indeed we note that the Bank was hesitant to take critical action until it had a high level of confidence that CBL was materially under-reserved. The Bank had decided that it was not willing to take strong action without independent investigation and advice. The Directions appeared to us to be appropriate and properly authorised, as did the application for liquidation.
- It is difficult to make judgments now on all the circumstances at the time. We also acknowledge that the legislation prevented the Bank from prohibiting renewals. Nevertheless, in summary, we believe the appropriate course was for the Bank to take whatever steps were needed to limit or prevent CBL from writing additional business once

the seriousness of its situation was recognised by the Bank in July 2017. The solvency advice from the Appointed Actuary in November gave further impetus to the need for restriction of business.

Chapter 7: Understanding CBL's French Claims Liabilities

Findings: Reserving

- Under-reserving was always going to be the biggest risk factor under the CBL business model and strategy.
- The three Appointed Actuaries and the Bank were aware of this risk and associated doubts over the levels of claims liabilities: in our opinion the subject should have been pursued vigorously from 2014 onwards in view of the potential commercial and other consequences.
- Based on their reports to the Bank, the Appointed Actuaries did not show signs of pursuing these claims thoroughly regarding either access to comprehensive and reliable data or actuarial techniques and experience applied in Europe for this type of business.
- The Bank did not thoroughly pursue internally its doubts, did not articulate and pursue its concerns with CBL sufficiently and did not consult, as it could have, with home regulators (in France and other European countries) or external experts (until 2017).
- The results of the Appointed Actuary's work in 2017, where he made large increases in CBL's claims reserves, illustrate from within the company that the liabilities had been considerably under-estimated from 2013 and perhaps earlier. Hence it also illustrates the inaccuracy of all previous profit results and measurements of solvency, both of which were over-stated each year.
- Even if one accepts the Appointed Actuary's December 2017 liability assessment and takes an optimistic view by discounting the estimates offered by Milliman, Finity and PwC UK, it now seems indisputable that the doubts held by the Bank from licensing in 2013 were valid.

Findings: a hindsight view?

- We conclude, on the basis of all the above including the expert reports referred to, that by the end of 2017 CBL was not only insolvent against the Solvency Standard but that its net assets were, by the Appointed Actuary's assessment, only 27% of the assets required and, by Milliman's assessment, negative by more than \$100m.
- Although the quantification represents a hindsight view, there was internal Bank actuarial advice from 2014 that claims appeared to be under-reserved then and the doubts that emerged then were revisited a number of times but were not subsequently resolved until 2018.

Findings: relevance to the Bank as supervisor

- Until 2017, the Bank’s supervisors gave more credence than they should have to the confident and persistent assessments by CBL and its Appointed Actuaries of CBL’s financial performance.

Chapter 8: NZ Business and International Business

Findings: Regulatory status in offshore jurisdictions

- The fact that CBL could operate as a reinsurer in Europe and write so much business in France without a local licence and therefore without any local supervisory scrutiny in France is a regulatory gap. This situation created additional regulatory risk for the Bank without the Bank having any obvious way of mitigating the risk, short of precluding the insurer from carrying on the offshore business as a condition of its New Zealand licence or taking a far more intrusive approach to supervising the offshore business.
- With CBL not being regulated in France and not being part of the established market, it is an oversight that the Bank did not follow up assiduously after licensing by consulting with either the French regulator or alternatively an independent expert in that market.
- While one can only speculate on what would have or might have occurred otherwise, some of the possibilities are:
 - earlier awareness of the French reserving code for the DO and DL business;
 - earlier knowledge of the financial results of CBL’s ceding companies and of their competitors in the French market;
 - earlier opportunity to obtain ‘the other side of the story’, as the Bank believed it had been obliged to rely on information supplied by CBL and its Appointed Actuary, which stretched credulity (loss ratios under 40%, expense rates around 30%– 40% and high profit margins at the same time as significant growth); or
 - most significantly, awareness of the concerns of other regulators as soon as those concerns emerged.

Recommendation

- 8.1 The Bank should maintain its international regulator connections and continue to participate when appropriate as lead regulator or home regulator for New Zealand-licensed insurers operating offshore and offshore insurers licensed in New Zealand respectively.

Chapter 9 : The Appointed Actuary Regime and CBL

Findings: Role of Appointed Actuary

- The role of the Appointed Actuary in establishing an insurer's solvency margin is central to the prudential regime and it is valuable. The degree of deference, however, that the Bank considers must be given to the Appointed Actuary's advice by the Solvency Standard is unhelpful in cases where the Bank has concerns over the Appointed Actuary's numbers.
- In practice, where the Solvency Standard allocates the responsibility of determining certain matters to the Appointed Actuary, the Appointed Actuary's advice was believed by the Bank to be unchallengeable and hence a regulatory barrier to be overcome for the Bank.
- We are not convinced of the correctness of this point but in any event we note that, although there are avenues under the Act to test and challenge the Appointed Actuary's opinion, they can be difficult to apply in practice.

Recommendations – expectations of the Bank

- 9.1 The Bank make clear its expectations of Appointed Actuaries, especially in situations where it has doubts about a company's reserves or solvency and, if its expectations are not met when advice or reports are received, it should follow up assiduously and take action according to its assessment of the circumstances at the time.
- 9.2 The Bank also make clear its expectations of insurer boards regarding risks around claims reserves and solvency, standing firmly on a cautious position until all doubts are resolved.
- 9.3 In cases where there are doubts or warning signals, the Bank, as supervisor, act on its concerns while looking for clarity and not wait for clarity before acting.

Recommendations – The Appointed Actuary and the Solvency Standard

- 9.4 We recommend that the perceived barriers to challenging the authority of the Appointed Actuary be reviewed and clarified, and ensure the Bank has the power by amendment to the Solvency Standard or, if necessary, to the Act to impose an alternative opinion of claims reserves or solvency margin on an insurer.
- 9.5 We go no further at this stage, however, in view of the recommendations made in Chapter 11 about modifying the overall structure of the solvency regime for licensed general insurers.

Findings: Scope of Financial Condition Reports

- For CBL, with its fast-growing portfolios, all long-tail and offshore, and writing reinsurance unregulated offshore, we believe there was a pressing need for the Bank to obtain more extensive analysis and understanding of the business than was set out in each year's FCR.
- It can be argued that the Bank should have been questioning the scope and content of each FCR, given CBL's supervisory status as a higher risk insurer. The Bank should have raised a set of pertinent questions each year and should have then insisted that the Appointed Actuary respond to the questions to the satisfaction of the Bank.
- This proposition is not about compliance by the Appointed Actuary with the professional requirements. It is about ensuring the completeness of the Appointed Actuary's work from the Bank's viewpoint and ensuring that both the board and the Bank as regulator gain a full appreciation of the insurer's financial condition. It is also about assisting the Bank to obtain enough information to make its own assessment of the performance and prospects of the insurer without needing to commission extra analysis.

Recommendations – high risk insurers

- 9.6 The higher the Bank's risk assessment of an insurer, the more demanding should the Bank be on the depth of information gathering and analysis contained in the liability valuations and the FCRs.
- 9.7 For higher risk insurers, the Bank should not only require full compliance from Appointed Actuaries with the Solvency Standard and the Society of Actuaries standards for liability valuations and FCRs but should also consider whether the FCR is complete from the Bank's viewpoint and, if not, to raise questions that will lead to the Bank being satisfied with the information provided.

Chapter 10: Structure and Sufficiency of the Act

Findings: Regulatory framework

- The regulatory framework for insurers is dominated by the Act and the Solvency Standard. The Bank also has some guidelines that do not have the force of law, the most important of which are the Governance Guidelines and the Risk Management Guidelines.
- The Act restricts the ability of the Bank to issue new standards for prudential purposes.

Recommendations

- 10.1 We recommend that the powers of the Bank to issue prudential standards and regulations under the Act be reviewed in order to allow the Bank to extend or modify its prudential requirements of insurers in appropriate circumstances including changing business practices within the insurance industry and changing international regulatory developments.
- 10.2 We further recommend that the Bank's ability to issue additional prudential standards be extended to cover as a minimum standards for governance and clearer powers over standards for risk management

Finding: Restriction of business

- The current restriction in s 144(2), which limits the Bank's power to require a licensed insurer to "cease entering into new contracts of insurance" by excluding the renewal of pre-existing contracts from that power, is unqualified and is not, in our view, an appropriate restriction on the Bank.

Recommendation

- 10.3 We recommend that the exclusion of the renewal of pre-existing contracts in s 144(2) from the Bank's power to direct an insurer to cease writing business be amended or deleted so as to give the Bank appropriate powers to limit the exposure of distressed insurers.

Chapter 11 – Solvency Standard: scope and structure

Findings: Specification gaps

The Solvency Standard was found to be lacking on two counts:

- Firstly, the table of asset charges in the Solvency Standard does not mention reinsurance collateral as an asset type and the conditions that assets of this type must meet under the Standard are not clear.
- Secondly, the Standard does not give the Bank adequate discretion to determine the capital charge in situations such as this one (and there are others), where there may be debate or lack of clarity.

Recommendations

- 11.1 We recommend that the Solvency Standard and if necessary the Act be modified to give the Bank discretion when the capital charge for a particular asset is unclear. It will also be appropriate to review the table of asset charges so that it is more comprehensive in its coverage of asset types.
- 11.2 Further, in our view the default position in exceptional cases should be that the Bank can take a view, based on assessments that are disclosed to the insurer, and that the Bank's view stands until it is satisfied by the insurer that a different position should be taken.

Finding: The Solvency Standard measure of solvency is too rigid

- We believe that the approach to capital adequacy represented by the "all or nothing" solvency measure under the Solvency Standard, whereby a solvency ratio above 100% is taken to be adequate and a ratio of less than 100% is taken to be inadequate, is too rigid and should be modified.
- In our view, there is a clear case for a graduated and more flexible approach to determining capital adequacy.

Recommendation

- 11.3 We recommend that the Bank, in working towards its new capital adequacy approach for licensed banks, adapt and apply the same approach for licensed insurers.

Findings: Revenue account to complement balance sheet in understanding solvency

- Most of the documentation we have seen relating to solvency concentrates exclusively on the balance sheet. Yet s 24(1) of the Act can be used to introduce a dynamic approach to solvency matters. This section states "If a licensed insurer has reasonable grounds to believe that a failure to maintain a solvency margin is likely to occur at any time within the next 3 years, the insurer must report the likely failure to the Bank as soon as is reasonably practicable."
- If business plans for three years are prepared each year along with financial projections of revenue accounts and balance sheets, and they are prepared realistically and professionally, taken together they are likely to enhance the other recommendations above about solvency. They would also give both the company and the Bank valuable insights to the progress of the company and can lead to fruitful discussions about pricing, business strategy, market conditions and other matters.

Recommendation

- 11.4 We recommend that the Bank monitor as a matter of course each year the preparation by insurers of 3 year business plans and financial projections so as to be satisfied that insurers have prepared the information they need to be satisfied that they are complying with s 24(1), making them available to the Bank on request. These plans and financial projections will provide a valuable adjunct to other capital management tools being used by insurers and assessed by their boards.

Chapter 12 – Prudential supervision as a Bank function

Finding - resources

- The CBL case provides evidence to support the IMF FSAP report recommendations. It gives cause for the Bank to re-examine its level of supervisory resources and its general approach to both supervision and regulation of insurers. The CBL case clarifies, perhaps in a dramatic way, the potential consequences of inadequacies in prudential regulation and supervision.
 - A case can readily be made for a higher number of supervisory personnel with greater training, higher seniority and preferably a mixture of regulatory backgrounds and industry backgrounds, in order to engage more effectively and more deeply on a regular basis with individual insurers –
 - In considering the level of supervisory resources, it is important also to allocate adequate resources to the making of supervisory policy, for policy development is an integral part of the supervisory process.

Recommendation

- 12.1 In the light of the CBL case and the recommendations in the 2017 IMF FSAP report, we recommend an expansion of the supervisory resources of the Bank for the supervision of licensed insurers and associated policy development. It is a matter, however, for more detailed investigation in the first instance and then review of the philosophy of supervision, Bank policy and perhaps Government policy as to how far the supervisory resources should be expanded.

Findings - culture

- In summary, we find a supervisory culture that before 2017 is less decisive and less anxious about information and advice that it was receiving about CBL than it might have been. Advice and assistance were not sought by CBL or the Bank from offshore experts or regulators.
- There was also a lack of confidence by the Bank to take firm action earlier than June 2017. The reasons appear to be a combination of respecting the “self-discipline pillar”, the limited experience within the Bank at the time of insurance prudential supervision overall as well as the novelty of and unfamiliarity with the type of business activities in which CBL was engaging. Possibly as influential was a reluctance to act where the Bank had limited resources and other priorities, and there was some uncertainty, as there naturally had to be, in the liability measurements for such long-tail business.
- The lack of an international perspective can be seen as both an impediment to investigating the company’s affairs in the early days after licensing and, later, an impediment to taking advantage of the resources of the international regulatory community (which would have been available to the Bank through its participation in the International Association of Insurance Supervisors).
- The outcome of these behaviours can perhaps be described as the Bank generally giving CBL the benefit of the doubt. Doubts arose over questions raised within the Bank on claims liabilities, solvency assessment, business model (specialty lines of reinsurance with long-tail, offshore, fast growth and ownership of distribution and ceding companies), quality of business, data quality, management performance and some other factors.

Overall finding on the supervision of CBL from 2014 to 2016

Recognising all the factors described above, we believe that in the period 2014 to 2016 the Bank could have and, in our opinion, should have acted with more alacrity and a greater sense of urgency in its supervision of CBL.

Recommendations

- 12.2 We make the following supervisory recommendations for the Bank in dealing with high risk insurers or insurers under strong surveillance:
- be clear on supervisory objectives and the goals of any supervisory intervention;
 - ensure that expert reports are examined at senior level, applying a healthy scepticism and a ‘nose’ for nuances, to ensure that the full significance of the reports is understood before deciding next supervisory steps;
 - supervisory personnel should engage actively in problem-solving, searching for insights from available information, especially from experts’

reports and dialogue with them, some brainstorming and wide consideration of possible courses of action;

- rather than rely on written documentation, engage actively with directors and executives to follow through on the substance behind the documentation;
- when in doubt about an insurer's financial soundness, take steps, in the interests of policyholders and the public, to investigate the company without delay and to resolve the doubts as quickly as possible;
- in situations of uncertainty, doubt or concern, as emerged in the CBL case, act with tenacity and persistence to remove doubts and, in the meantime, curtail or even prevent the insurer from increasing its exposures until the doubts are resolved;
- be decisive and firm in seeking and obtaining information from the insurer;
- take firm action including follow-up once a decision is made;
- when an appointed actuary's engagement is ceasing, arrange interviews with both the departing actuary and the board of the insurer;
- in addition to exploring technical actuarial questions where relevant, explore governance issues thoroughly whenever there is evidence of corporate activities that entail high risk;
 - it is imperative that the full supervisory arrangements, including regulatory powers of the Bank, result in the onus being on the insurer to satisfy the Bank;
 - generally the Bank is in a position to keep the onus on the insurer but its supervisory strategy needs to be revisited to ensure the Bank can maintain that position in the future; and
- make full use of the Bank's powers if the insurer is reluctant in any way to support the Bank's interventions.

Chapter 13 – Governance and Risk Management

Recommendations

- 13.1 *Boards of insurance groups:* in group situations where an insurer is owned by a parent company with other material subsidiaries, the Bank should consider from a risk management perspective whether it is satisfied for the insurer and its parent to have coincident boards.
- 13.2 *Bank interaction:* the Bank should ensure that it has and exercises at its discretion the right to meet with selected individuals or groups of executives, directors, the Appointed Actuary and the auditor, as part of the process of understanding the board and management culture of the insurer.

13.3 *Bank correspondence:* the Bank should require of all licensed insurers that all correspondence from the Bank to the company be disclosed to the board and that all correspondence that has a bearing on reserving, solvency and capital be disclosed to the Appointed Actuary.

Findings on Governance

- At present, once directors meet fit and proper tests and the board includes the requisite quota of independent directors, there are no further questions about the competence or effectiveness of the board as a whole or of individual directors, save for the removal power. There is also no obligation on the board to ensure its competence or its performance, simply guidelines for board renewal or refreshing of the board, for competence of the board as a whole and for board committees.
- On governance more generally, in our view there is a need for the Bank to have the power to enforce good governance and effective risk management if for any particular insurer they are found wanting. This matter is covered in Chapter 10 which recommends that the Bank be granted powers under the Act to introduce additional prudential standards, particularly for governance and risk management.
- Our primary governance finding is that the Governance Guidelines contain a suitable set of principles for governance at board level but that the Bank cannot assume that the Guidelines will be followed and therefore needs to establish processes for holding boards accountable for meeting them.
- An initial step in strengthening the effect of the Guidelines and generating more board accountability for meeting them would be to give the Guidelines the force of law (noting that to do so may require amendment to the Act so that the Guidelines could be issued as a standard under the Act).
- Alternatively they may be issued as regulations under s 237(1)(e) or (x), or perhaps as conditions on the licence.
- Additional findings are that fit and proper standards are important but, as acknowledged in the Governance Guidelines, are only part of the story. See recommendations below.

Recommendation: Governance guidelines

13.4 The Guidelines could be usefully enhanced by:

- The nature of the responsibilities of the board being made clearer.
- Sanctions being imposed when a board fails to do its job properly (the Act allows the removal of individual directors but this is an extreme step to take if the Bank could instead mandate a particular course of action by the board).

13.5 Regarding board renewal and board composition, both covered in the Guidelines, the Bank should introduce guidance to insurers for meeting these requirements, so that boards of insurers can develop their own approaches and have them either approved by the Bank or subject to disallowance by the Bank.

13.6 The Bank should modify its supervisory processes to encompass a set of procedures aimed at ensuring compliance by insurance company boards with the terms of the Governance Guidelines (and particularly the terms of clauses 32 to 36 and 44).

Findings: Risk Management

- This approach by the Bank on risk management, based on interviews and documentation, is reasonable but limited as it illustrates a generally “hands off” reporting arrangement subject to occasional review. It is an approach characterised primarily by documentation review and we understand that there is no process for on-site monitoring or for testing of outcomes of risk management programmes.
- Although the Guidelines do not have the force of law, initiatives by the Bank on risk management of the kinds described above in the CBL case show that the Bank can, if it so decides, require insurers to develop substantial risk management programmes and to apply them.

Recommendations: Risk Management

13.7 Given the risk issues that arose in the CBL case and indeed were on foot at the time of the Bank’s 2014 review, we recommend that the Bank take a more pro-active stance on risk management in cases such as CBL which was under ‘Increased surveillance’ at that time and subsequently.

13.8 We further recommend that extension of the Bank’s ability to issue prudential standards, as proposed in Chapter 10 regarding the Act and earlier in this chapter in relation to governance, include as a minimum prudential standard for both governance and risk management.

Chapter 14 – Group Supervision and outsourcing

Findings: Group Supervision

- In the absence of group regulation, contagion risk within a group cannot be understood by the Bank as supervisor.
- An important initial benefit of introducing group regulation is the identification, and then the elimination, of double use of capital. Licensed insurers should never be allowed to count loans as capital but, without group supervision, parent companies can—and often do—indulge in borrowing funds, which are not capital, and using those funds to capitalise insurance subsidiaries.

Recommendation: a way forward on group supervision

14.1 In the modern commercial world, where group structures proliferate and where insurers and lending institutions search for innovative ways of optimising their capital arrangements, it would be timely for the Bank to explore group regulation options. We recommend that the Act be amended so as to introduce a suitable form of group regulation for all licensed insurers.

Findings: Outsourcing

- Outsourcing of various functions is a common part of the business world generally, although usually core business functions are not outsourced. In the case of insurance, however, the outsourcing can include, as we saw in the CBL case, not just some back-office functions but the fundamental insurance functions of underwriting, pricing and claims management.
- The outsourcing of core functions can generate material risks to the insurer and therefore need to be incorporated in a suitable way into the prudential supervision regime.

Recommendation: a way forward on outsourcing

14.2 The Bank consider introducing, perhaps as part of requirements under the Solvency Standard, information and compliance reports on significant outsourcing arrangements. These requirements could include, for example:

- an outsourcing policy approved by the board;
- legally binding agreements for significant business activities that are outsourced, with extra safeguards or controls where the outsourced activities are outside New Zealand (NB This should include all inwards and outwards reinsurance agreements);

- monitoring arrangements for managing significant outsourcing agreements; and
- copies of all significant outsourcing agreements being made available to the Bank on request.

Chapter 15 – confidentiality and disclosure

Findings: Confidentiality and disclosure

- If the Bank is requiring confidentiality by an insurer's board, the board faces a dilemma in respect of its continuous disclosure obligations.
- Assuming that the Bank's confidentiality requirements override continuous disclosure obligations, the Bank needs to accept the onus of resolving expeditiously any matters that are relevant to public disclosure.
- The converse of the Bank holding the power of confidentiality is that, if it has any prudential concerns about an insurer, the Bank is effectively duty bound to resolve those concerns as early as possible. If there is substance to the concerns, the Bank is then in a position at an early time to say so publicly itself, or to request the insurer to do so.
- We conclude that the Bank acted appropriately on confidentiality during the CBL case.

Part II: Abbreviated response to Terms of Reference

Below is our abbreviated assessment of the specific matters set out in our terms of reference. Each item is covered in one or more chapters of this report.

Critical judgments by the Bank

1. To licence CBL in September 2013
Correct decision despite the questions raised during the licensing process
2. To draw attention to problem areas ahead of licensing and prepare a "licensing case management plan"
Sound approach to the licensing process.
3. Following submission of the 2013 FCR, to question CBL on its solvency in September 2014
Correct step. Internal assessments were extensive.
4. Not to follow up thoroughly on the 2013 FCR –
 - a. actuarial aspects were followed up
 - b. non-actuarial aspects were not dealt with
 - advice on solvency margin (set a high target, say 150% rising to 200%)
 - a recommendation by the Appointed Actuary for involvement in decisions relevant to capital*Internal assessments concentrated on solvency and reserves, other matters overlooked.*
5. On being informed of the resignation of the Appointed Actuary in 2014, not to interview him and the company about his departure
Valuable information would have emerged.
6. On lack of engagement from CBL on item 3 (questioning CBL solvency), not to take further action at that time.
Should have considered and utilised options other than a s 130 investigation-continuing concentration on numbers only.
7. On uncovering perceived constraints in the Act and the Solvency Standard in 2014, whereby aspects of the Appointed Actuary's solvency opinion were believed to be effectively unchallengeable, not to act quickly on making the policy response (which has been deferred to 2019)
The Bank remained hamstrung by the belief it had to accept the Appointed Actuary's advice on key matters and in particular the solvency assessment.
8. On the lack of relevant information from the Appointed Actuary's international colleagues in preparing the 2014 LVR and FCR, to take no further action (even though there were options available such as consulting European regulators or consulting experts from Europe)
The Bank should have engaged with European regulators or experts on the French business

9. Regarding meetings generally between CBL personnel and Bank personnel, including the Appointed Actuary and the Bank, the Bank to determine meeting attendees rather than leaving it to the discretion of the company.
The Bank should have taken a firm position to ensure it controlled the communication lines.
10. To pay attention to the rules first (the Act and the Solvency Standard) and as a result to be lenient on behavioural matters of governance and of accountability of the CBL board
The Bank generally gave CBL the benefit of any doubts and missed opportunities to understand the behaviour and tactics that may have been used by CBL to limit deeper scrutiny.
11. On receiving the 2014 LVR, FCR and solvency return in April 2015, not to press CBL strongly on the still unanswered questions of adequacy of claims reserves and other solvency issues
The Bank continued to give CBL the benefit of the doubt and thus to be lenient on CBL. The under-pricing risk seemed to receive little attention.
12. On "negotiation" between CBL and the Bank on solvency issues leading into the IPO in 2015, to accept CBL's proposed capital injections as quid pro quo for resolving outstanding reserving issues
The progress made was valuable (capital injection, increased solvency requirement) but claims reserving was still unresolved and should have been pursued relentlessly - the under-pricing risk was high so business expansion would increase the potential for under-reserving on a larger scale
13. On receipt of the June 2015 solvency return in February 2016, as follow-up after the IPO, to take no direct action beyond setting up a Prudential Consultation Meeting later in the year
The claims reserving problem should have been top of mind, especially as CBL was continuing to grow so that the scale of any under-reserving was likely to increase.
14. On receiving an enquiry from the Gibraltar FSC in October 2016 about the soundness of CBL, not to disclose to the Gibraltar FSC more about the Bank's concerns and questions about CBL at the time.
Opportunity missed: the Bank should have been more forthright with the Gibraltar FSC and used the enquiry as an opportunity to gain a better understanding of the CBL portfolio and its European operations.
15. On receipt of queries in July 2017 from the Gibraltar FSC and receiving advice that PwC UK was investigating Elite's reserves, to set in train important Directions to CBL, particularly a 170% minimum solvency margin, constraints on business transactions and appointment of an investigator and independent experts to review CBL's reserves
Opportunity taken: the Bank took serious steps to rein in CBL and to establish a proper foundation for understanding its claims liabilities. The Directions issued to CBL were strong, lawful in our view, and the Bank acted resolutely.

Opportunity missed: the Bank may have been able to limit the increased exposures that CBL was taking on in 2017.

Scope questions

1. *Whether CBL should or could have been refused a licence in 2013*

No, granting a licence was the correct decision – see Chapter 5.

2. *Whether the Bank should have imposed more or different conditions on the company when granting its licence*

Possibly but the steps taken including preparing a Licensing Case Management Plan and requiring the company to follow up on KPMG's recommendations were appropriate steps at that time.

3. *Whether there were legislative or other constraints on the Bank that limited its ability to conduct investigations and impose conditions on the company that would have led to greater knowledge and assurance as to whether the company was operating soundly as an insurer.*

There were constraints including too much deference to the advice of the Appointed Actuary, the solvency margin being too narrowly structured within the Solvency Standard, lack of governance requirements and lack of group supervision.

It is unclear whether these constraints were critical for the Bank although they were difficult and influenced it in some aspects of its supervision of CBL. Nevertheless, whether they were critical or not in the CBL case, it is appropriate that they now be attended to in order to strengthen the prudential regulatory regime for the future.

4. *Whether the Bank's actions were fair and reasonable to the company (and its group members), in light of the information the Bank was receiving from the company or otherwise had available. This includes the reasons the Bank gave to the company for its actions, such as Directions and the application for interim liquidation, and whether it kept an open mind as to the likely outcome of investigations.*

The actions were for the most part either fair or lenient (where we take 'fair' to mean not hindering CBL's commercial activities when Bank concerns were unresolved and not taking actions prematurely against CBL). Whether they were reasonable depends on how one interprets the significance of the Bank's leniency towards CBL.

On keeping an open mind on the outcome of the 2017 actuarial investigations, firstly the decision to arrange the investigations was predicated on the serious concerns of other regulators on ceding company reserves. Those concerns could not be ignored. Secondly after issuing Directions in July 2017, the Bank took no further actions beyond clarification of or strengthening those Directions pending receipt of draft reports from the independent actuaries. It also chose not to limit CBL's insurance market activities. We see no evidence that the Bank pre-judged the outcomes of investigations beyond being acutely aware of the background to and the need for the investigations.

5. *Whether the Bank's supervisory activities were sufficiently well founded and pro-active after licensing, including identifying risks within the CBL business and putting constraints on the company that would protect its solvency position and ultimately avoid closure and liquidation.*

The Bank was effective generally in identifying the risks associated with CBL's operations but on several occasions it did not act on its concerns as early or as strongly as it might have and, in our opinion, as it should have, given the nature of its concerns about CBL.

6. *Whether the approach taken by the Bank to the confidentiality of its regulatory actions was appropriate.*

The Bank exercised its confidentiality obligations appropriately.

7. *The degree of reliance on the Appointed Actuary and the interactions with the Appointed Actuary.*

- a. In 2014, there was not enough interaction with the Appointed Actuary and consideration of his FCR, leading to over-reliance on the Actuary's sign off without examining his full suite of recommendations, especially those which related to the affairs and conduct of the company as distinct from his actuarial analysis.
- b. In 2014 on resignation of the Appointed Actuary, there was no investigation or dialogue by the Bank with either the Appointed Actuary or the company, representing an important missed opportunity to gain some insights from both the Appointed Actuary and the company into the way the company operated.
- c. In 2014, believing it likely that the Appointed Actuary's quantitative advice was inadequate and at the same time believing that it needed to accept those numbers, the Bank could have and should have looked beyond the numbers and beyond the Appointed Actuary – this was the real supervision task but it was not undertaken.
- d. In 2015, after the engagement of a new Appointed Actuary, the Bank found itself reliant on the advice of the new Appointed Actuary that still left unresolved questions raised by the previous appointee during the previous year.

The Bank had hoped, and quite reasonably expected, that the new Appointed Actuary, who was an actuary in a major international firm, would draw on international resources and experience in assessing CBL's claims liabilities but he did not appear to do so.

This reliance, in the face of suspicions that the Appointed Actuary's advice was not adequately researched, perpetuated an unhealthy situation that the Bank did not resolve until late 2017 when the Appointed Actuary obtained for the first time more comprehensive data that enabled him to take a more informed view than hitherto of the company's claims reserves.

8. *The relevance of supervisory powers at group level as well as at licensed company level:*

- a. If the Bank had had supervisory powers at group level it could have obliged the parent company to protect the quality of CBL's capital and hence the integrity of its solvency (for example there was effectively double use of capital within the CBL group because loan capital was obtained by CBL Corporation and then injected as equity into CBL). It is worth noting that CBL appeared to consider this practice appropriate and the Bank does not appear to have challenged CBL or CBL Corporation on this question. It could have done so even if, as may have been the case, it had been powerless to prevent it without supervisory powers at group level.
- b. With group level supervision, the Bank would also have been able to ensure that contagion risk to CBL Insurance from actions taken by the parent company or in other parts of the CBL group would have been avoided. We consider contagion risk was a real issue following the numerous acquisitions and related party interests within the group regarding the funding and the operations of managing general agents (SFS and EISL), ceding companies (Elite, Alpha Insurance, CBLIE), CBL Corporation and CBL Insurance itself.

PART 1 - BACKGROUND

Chapter 1: Introduction

1.1. Terms of reference

This Review was commissioned by the Reserve Bank of New Zealand (the Bank) following the liquidation of CBL Insurance Ltd (CBL), a subsidiary of CBL Corporation Ltd (CBL Corporation), in November 2018.

The terms of reference for the Review, as published by the Bank on its website, are at Appendix 1.

1.2. The reviewers

The review has been conducted by John Trowbridge and Mary Scholtens QC.

John Trowbridge is a former Member of the Australian Prudential Regulation Authority (APRA) responsible for insurance, as well as an experienced insurance actuary and management consultant.

Mary Scholtens QC is an experienced public and administrative law Queen's Counsel with expertise in regulatory decision-making processes.

1.3. Approach to the Review and structure of this report

The Review concentrates on matters pertaining to the Bank in its role as supervisor and regulator of licensed insurers in New Zealand. It considers regulatory and supervisory matters that have come to light as a result of the Bank's role in licensing and supervising CBL from 2011 to 2018. It therefore explores the history of CBL only insofar as that history is relevant to the Bank as supervisor.

This report, in responding to the terms of reference, comprises four parts as shown on the contents page but preceded by two sections, namely

Executive Summary

Consolidated Findings and Recommendations

The four parts are –

Part 1 – Background

Three chapters comprise this introductory chapter and the context in which the Bank is operating as prudential regulator and supervisor. It records in Chapter 2 the environment in which the Act was introduced and what it is intended to do. Chapter 3 explains the general principles of prudential regulation and the philosophy applied by the Bank in its role as prudential regulator and supervisor of licensed insurers in New Zealand.

Part 2 – Chronology

There are three chapters on chronology. Chapter 4 records the main events that we believe are relevant to this Review. The remaining two chapters explore and analyse these events in the context

of our terms of reference. Chapter 5 covers the period 2012 to 2016 and Chapter 6 from 2017 to 2018 when CBL's finances became the subject of serious independent investigation that ultimately resulted in full liquidation.

Part 3 - Revisiting current arrangements

This part draws on the events described in Part 2 to examine a range of regulatory and supervisory issues that emerge from those events. It opens with an explanation of our approach to CBL's claims liabilities and then considers international matters, the Appointed Actuary regime, the Act and the Solvency Standard. To conclude, it offers a critique of the Bank's supervisory activities and recommends some steps for the Bank to take to strengthen its future prudential supervision of insurers.

Part 4 - Extending the scope of current arrangements

This part deals mainly with matters that we have identified as gaps in the Bank's armoury of supervisory tools (governance, risk management, group supervision and outsourcing). It also covers the Bank's position on confidentiality and disclosure.

1.4. Independence

The Bank has asked for an independent review. We believe our assessments, findings and recommendations fulfil the tests of independence. This report reflects our own work and our own views and, while we have spoken on many occasions to Bank personnel, our findings and recommendations are our own.

We are aware that some of our findings are not consistent with the views of some Bank personnel. The same applies to external interested parties. However we have made every endeavour to ensure that our commentary is factually correct.

1.5. Method

An outline of the process we followed in undertaking the Review at Appendix 2.

We have examined a wide range of relevant documents received from the Bank as well as a limited number of relevant and available public documents. We have interviewed Bank staff who have been involved in the supervision of CBL and raised many questions with them. We are grateful for their input and assistance. They have all been fully cooperative despite the risk of criticism of their own actions or inaction on some matters during the last 5 years or so that relate to the Review.

Dialogue has been aimed at assisting us to understand the full background to the documents we have examined, the events that unfolded and the actions of those staff in their supervision of CBL.

The Review has focussed on identifying lessons to be learned by and for the Bank. It presents them in the form of a range of findings along with some associated recommendations that are described and explained in the report.

We wish to emphasise that this report relates only to matters that are relevant to the Bank as regulator and supervisor of licensed insurers. To do so effectively, in parts it has been necessary to describe actions and events associated with CBL so as to give the relevant background and context to our assessments of Bank actions and positions. It is not our role, however, to make findings about the actions or inactions of persons outside of the Bank, and we do not do so.

Natural justice requirements

During the course of drafting and preparation of this report, we were conscious that some parties associated with CBL may perceive parts of our report as reflecting adversely on them. For this reason we undertook two rounds of correspondence with them. We did so by issuing each individual with excerpts of our then draft report that we considered relevant and potentially adverse to them individually and invited their comments. The first round was in January and the second in March.

On each occasion we reviewed our draft report taking into account the submissions received. The revisions that followed ranged from minor wording changes to movement of our views on some issues of substance. We did not accept all of the input in the submissions but have edited the report to reflect as best we could a fair, balanced and relevant commentary wherever references are made to these parties.

1.6. Reliances and limitations

Because our brief relates to actions and possible inactions by the Bank, we have not interviewed external parties and nor have we used or relied on information that external parties may have had relating to CBL that was not known or provided to the Bank. This has been the subject of some criticism. However, two specific examples illustrate our position:–

- In 2015, CBL Corporation (CBL's parent) issued a Public Disclosure Statement for the purpose of raising funds and listing on the NZX and ASX. KPMG prepared an expert's report to CBL Corporation as part of this process which, by our understanding, examined the financials and other aspects of CBL Corporation and its subsidiaries. The Bank was not privy to this KPMG report. Accordingly we have not considered it relevant to our assessment of the actions of the Bank in relation to CBL.
- CBL's Appointed Actuaries (of whom there were three from 2013 to 2018) all claim to have consulted with international experts to assist them in considering the French DL and DO business in coming to terms with the CBL portfolio in the period 2013 to 2016. Their written reports, however, disclose limited contact with French market operatives and do not refer to any consultations with experts in the assessment of French DO and DL claims liabilities leading the Bank to believe that no material interaction with international actuaries or other relevant experts was undertaken by any of the Appointed Actuaries until late in 2017.

Scope of our investigations

There are hundreds and perhaps thousands of documents altogether on the CBL case but we have relied on a limited number, being documents that we have identified as relevant to the terms of reference on the basis of our own investigations and of responses from Bank personnel to our questions. Our findings and recommendations rely on this selection of documents and the responses of Bank personnel. As noted above, we have also taken account of submissions by external parties.

Chapter 2: The Act: Background and Scheme

2.1. Regulatory scheme prior to the Insurance (Prudential Supervision) Act 2010

The regulatory framework that existed prior to the introduction of the Act was located in a number of different pieces of legislation. It was considered to be a very 'light handed' regulatory regime. Indeed, during the first reading of the Insurance (Prudential Supervision) Bill (Bill) it was noted that, at that time, the Insurance Council of New Zealand had acknowledged that New Zealand was one of the least regulated insurance markets in the world.

The explanatory note to the Bill stipulates that it would replace existing outdated legislation and fill gaps in the prudential regulation scheme, as well as remove inconsistent legislative application between different insurance sectors. The IPSA repealed:

- parts of the Life Insurance Act 1908;
- the Insurance Companies' Deposit Act 1953;
- the Insurance Companies (Ratings and Inspections) Act 1994; and
- the Mutual Insurance Act 1955.

At a high level, the regulatory scheme created by those former Acts operated as follows:

- Insurance companies were required to lodge monetary deposits with the Public Trustee, who held the deposit on trust for policyholders in the event of the insurer's failure.
- Insurers offering disaster and property insurance were required to obtain a rating from one of the approved rating agencies, which had to be registered with the Registrar of Companies.
- Across the industry, insurers were required to lodge returns with the Insurance and Superannuation Unit of the Ministry of Economic Development.
- Life insurers were required to produce annual, audited statements of their revenue accounts and financial position. A court could appoint, upon application, a judicial manager where there was a likelihood that a life insurer would be unable to meet any of its liability to policy holders.
- The Registrar of Companies was granted various powers of inspection in order to determine whether an insurance company was able to pay its debts.

Prior to the enactment of the Act, oversight of the insurance industry was undertaken by a number of government agencies. The Bank's role was limited to data gathering to support the formulation of monetary policy under the Reserve Bank of New Zealand Act 1989.

2.2. The Act and Parliament's Intention

The genesis of the Act can be traced back to a formal review, undertaken by the Government from 2005 to 2008, into financial products and providers. In December 2005, Cabinet agreed in principle that prudential supervision for the financial sector should be consolidated into a single regulator and that that regulator should be the Bank. In 2006, the Ministry of Economic Development released a discussion paper seeking submissions on various options proposed for prudential regulation of insurers, which covered regulatory boundaries, licensing and prudential requirements, and monitoring and supervision.

That paper identified a number of issues with the existing regime that influenced the drafting of the Bill, namely:

- No merit-based licensing procedure;
- Inconsistent approaches to different types of insurers;
- Insufficient monitoring and enforcement tools, including information-gathering tools;
- Tools for managing financially distressed insurers were either non-existent or too strong;
- Exit tools applying to insurers were too blunt (no capacity for the regulator to make directions); and
- No formalised prudential or enhanced solvency requirements.

In addition to addressing the weaknesses identified in the existing regime, a number of external drivers for the Bill can also be identified:

- The purposes of the Bill itself, which as now stated in the Act are to promote the maintenance of a sound and efficient insurance sector, and to promote public confidence in the insurance sector - s 3(1);
- The concern that, although the New Zealand insurance industry was not generally perceived as an industry in distress, the flow-on effects of the Global Financial Crisis (GFC) would have an impact on the value of investment funds;
- The desire to bring the New Zealand insurance industry into line with established international benchmarks and expectations, which would increase the confidence of offshore participants and improve the confidence of the public;
- A concern not to burden the insurance industry with excessive compliance costs, as these would be passed on to consumers; and
- General industry acceptance of the need for the prudential regulation of insurers and support for the Bill.

2.3. Intended Role of the Reserve Bank

The Bank was selected as an appropriate regulator for the regime due to its existing role of prudential regulator of the financial services sector. In that respect, the Act extends the supervisory role that the Bank was already undertaking in respect of banks and financial institutions. The Bill was said to

broaden the ability of the Bank to promote a sound and efficient financial system. *Colinvaux's Law of Insurance* records that this is consistent with a "twin peak" regulatory regime, in which the Financial Markets Authority (FMA) is responsible for regulation of financial markets, while the Bank is responsible for prudential supervision (at s 10.1.2(1)). That noted, the Bill increased the supervisory powers of the Bank in respect of the insurance sector vis-à-vis its supervisory powers in respect of the banking sector. Throughout the Bill's passage through Parliament, Labour MPs urged the Government to make corresponding amendments to the Reserve Bank of New Zealand Act 1989 in order to introduce corresponding extensions to the Bank's other prudential and supervisory powers.

It is clear from the materials relating to the Bill that a "light-handed approach" on the part of the Bank to regulation was desirable. At its first reading, Rt Hon Bill English, then Minister of Finance and sponsor of the Bill, noted that the Bill "is comparatively light-handed in its application, and it is intended to deliver regulation that does not mire the industry in a compliance mentality".

Instead, the emphasis in the Parliamentary debates was on self-regulation by the industry:

- "[The Bill] contains a strong emphasis on director and senior officer obligations and accountability, which are intended to be reasonably self-administering for compliance insurers once implementation is completed" (Rt Hon Bill English);
- "...compliance [is] largely self-administered, while supervision is provided by the Reserve Bank" (Raymond Huo);
- "...although the Reserve Bank has a supervisory role, it is a reasonably light-handed approach. The regulations require the insurers to take ownership for themselves and exercise self-administration and self-discipline" (Hon Amy Adams);
- "the provisions and requirements of the Bill are generally aligned with established worldwide insurance regulatory practice and, despite imposing new requirements on insurers, they are not radical in comparison with other measures internationally" (Hon Bill English); and
- "The regime has generally been designed around a self-managing approach. For instance, insurers are expected to devise and adhere to their own fit and proper and risk management policies, subject to Bank oversight. Alternative approaches, such as prescribed risk management procedures or pre-approval by the Bank of all director appointments, have been rejected. For compliant insurers, ongoing contact with the Bank is expected to be minimal" (Explanatory note p 35).

In addition to a desire to avoid "compliance mentality", the key driver for a light-handed approach appeared to be a concern to maintain a balance between providing a regulatory scheme that was effective, and minimising compliance costs in order to maintain competition and avoid those costs being passed on to consumers.

Indeed, the need to maintain competition and avoid unnecessary compliance costs are principles required to be taken into account by the Bank under s 4(g) and (h) of the Act where relevant to the exercise of powers or performance of functions or duties under the Act.

The analysis undertaken of the likely cost impacts of the Bill would indicate a belief by Parliament that the Bank's most active involvement would be at the licensing stage, with subsequent compliance work largely being left to insurers to self-manage, with the exception of intervention where required:

Once insurers are licensed, [compliance costs] are likely to be routine costs of doing business, and not to represent a material increase in costs over the status quo...the Bank has the power to require information from insurers, which the Bank can require to be audited, at the insurer's expense. There will be costs incurred by insurers, on a case-by-case basis, who breach regulatory requirements. In both cases, the Bank will adopt a risk-based approach to supervision, meaning only non-compliant or at-risk insurers will face the specific costs. [emphasis added]. (Explanatory note, pp 35–6)

The licensing function is something of a gatekeeper role for the Bank, which will ensure that consumers are protected from insurers who do not meet the minimum standards set out in the Act. The Bank is considered better placed than consumers to assess the financial strength of insurers, thus the Bank is not entitled to approve a licence until it is satisfied of each of the matters set out in s 19. Beyond the minimum thresholds established by licensing, however, (and subject to the importance of dealing with an insurer in financial distress or other difficulty, discussed below), the Act recognises that members of the public are responsible for their own decisions relating to insurance and the Bank cannot eliminate all risk of insurer failure (see s 4(d)(i)).

The language associated with the supervision and intervention provisions also points to the anticipated involvement of the Bank at those stages. For example, the explanatory note states that the Bill *obliges* the Bank to supervise insurer compliance, but in the event of non-compliance, the Bank is *enabled* to escalate supervision (but not obliged to do so). Further, although s 120 requires the Bank to undertake prudential supervision, the subsequent provisions in that part of the Act grant the Bank various supervisory powers, but do not require their exercise in any particular circumstances. That approach is consistent with the principles of the Act, which require the Bank to recognise, when exercising its powers and functions, that it is not a purpose of the Act to eliminate all risk of insurer failure.

A regulatory impact statement prepared in 2009, shortly before the Bill's introduction to Parliament, described the scheme in this way:

A relatively light-handed, risk-based approach to regulation and supervision is considered to be the most appropriate response and the preferred approach to regulatory intervention. This would entail establishing minimum standards for insurance providers, both at the point of licensing and on an ongoing basis (including in relation to solvency and capital adequacy), regular monitoring by the Reserve Bank, powers to enforce compliance with regulatory requirements and fit and proper requirements for directors and certain senior management of insurers. Significant reliance would be placed on the directors' ability to manage their businesses, with the Reserve Bank... having a wide range of monitoring and intervention powers, used only as necessary to fulfil its regulatory objectives.

2.4. The Act

The Act contains foundation purposes and principles in ss 3 and 4. These are relevant to the interpretation of all provisions and powers. Section 12 sets out the Bank's functions under the Act, being (primarily) to issue licences, undertake prudential supervision, and take appropriate action when licensed insurers are (or are likely to be) non-compliant or otherwise in financial or other difficulties. Section 13 requires the Bank to have regard to the Government's policy, given by direction of the Minister and presented to Parliament. No directions have been received to date.

The Act then divides into four further parts, covering licensing and prudential regulation of insurers, prudential supervision, distress management and miscellaneous matters.

Where appropriate or ambiguous, the Act can be interpreted in light of this history.

2.5. The Solvency Standard

The primary regulatory instrument (for non-life insurance) is the Solvency Standard for Non-life Insurance Business 2014 (NZRB: December 2014) made under s 55 of the Act. It provides for obligations in calculating any solvency margin, the fixed capital amount to be maintained, and assumptions in solvency calculations.

Chapter 3: Prudential Regulation: Principles and Bank Philosophy

3.1. Introduction

The purpose of this Review is to provide an independent perspective on how best to strengthen the Bank's insurance regulatory and supervisory framework for the future. In order to do so, in this chapter we set out a general framework for the prudential regulation and supervision of insurance companies. This framework serves as a basis for understanding and evaluating the Bank's supervisory practices in relation to CBL and the regulatory arrangements within which the Bank has been working.

3.2. Prudential regulation: the underpinnings

The purpose of *prudential regulation* is to promote and encourage the sound operation of each licensed insurer and to protect the interests of those dealing with the insurer, policyholders (including claimants) in particular. 'Policyholder protection' is the usual mantra for this purpose, although that term is not used in the Act. This purpose and related principles are embodied in ss 3 and 4 of the Act. Their connection with policyholder protection is explained later in this chapter.

The reason that prudential regulation and supervision of insurance companies is important is to give the public confidence that insurers are capable of delivering on the promises they make when they write an insurance policy and accept the premium.

Insurance has an "inverse cycle of production" whereby, in contrast to most other industries, the insurer's revenue in the form of premiums is paid in advance of the insurer's expenditure (and particularly claim payments). Premium revenue, when received, has to be withheld to cover the costs of the risks underwritten by the insurer that emerge over time in the form of claim payments. In some circumstances that can be over many years into the future, with the quantum of liabilities usually subject to uncertainty. Hence it is critical that:

- the *liabilities be properly measured* at all times (and they will always be estimated);
- there be sufficient assets in the company to meet the estimated liabilities; and
- *there be an amount of capital (or, equivalently, solvency margin)* retained by the insurer to protect policyholders (including claimants) against adverse events such as unexpected increases in liabilities, decreases in asset values or changes in the estimated values of liabilities and assets.

These three ideas are the essential underpinnings or foundation elements of the prudential regulation of insurance. There are many other features of prudential regulation that are also commonly applied, most of them involving different aspects of governance and risk management. Their function, however, is to give form and substance to the regulatory framework with a view to ensuring adherence to the three foundation elements.

These foundation elements are recognised in the Act and the Solvency Standard that supports it. They are also recognised by the Bank in planning and undertaking supervisory activities that are aimed at ensuring compliance by insurers with the terms of the Act and the Solvency Standard.

3.3. The liabilities

The most significant liabilities for an insurance company are usually the liabilities for outstanding claims, including IBNR claims (claims incurred but not reported). Because the assessment or valuation of these liabilities is a technical matter, generally requiring actuarial expertise and experience, it is entirely appropriate that the Act and the Solvency Standard specify reliance on actuarial input.

There are also other matters relating to the liabilities that can benefit from actuarial expertise. Other liabilities requiring technical assessment will include premium liabilities (for premiums received but not yet earned). Various aspects of reinsurance recoveries and liabilities may also be relevant to the assessment of claims liabilities and premium liabilities.

The Act quite validly specifies the need for each insurer to have an Appointed Actuary. Both the Act and the Solvency Standard spell out certain responsibilities of the Appointed Actuary.

3.4. The assets

The value of all assets held by the insurer, suitably measured, must exceed the value of its liabilities, also suitably measured. As simple as this sounds, there are many qualifications on the value for solvency purposes that are to be attributed to different kinds of assets.

While externally invested assets can usually be readily valued, for example by marking to market, there are other assets that may not be so readily valued and there are usually assets that are not admissible or not fully admissible for solvency purposes. They will typically include various forms of intangible assets and deferred assets (such as goodwill, deferred tax and deferred acquisition costs), investments in related parties and any other assets not readily available and realisable as might be required for solvency purposes.

In summary, the valuation of assets for solvency purposes is a technical matter, noting also that their measurement needs to be consistent with the measurement of liabilities, and so their valuation can quite properly fall into the ambit of the Appointed Actuary, as they do under the Solvency Standard.

3.5. Capital (or solvency margin)

In principle, the capital or the solvency margin is the difference between the assets and liabilities, both suitably measured.

Capital gives protection to policyholders against adverse events. The greater the margin of assets over liabilities, generally the greater the protection. If adverse events occur and some or all of the capital is needed, it is to be used in favour of policyholders and at the expense of shareholders.

3.6. Prudential supervision: the underpinnings

It is useful to draw a distinction between regulation and supervision, where regulation refers to the rules and supervision refers to the actions of the regulator in applying the rules and monitoring the prudential performance of licensed insurers.

The essence of effective *prudential supervision* lies in the ability of supervisors to identify risky situations within individual insurers and to do so as early as possible before these situations escalate. The supervisors' first goal is to 'catch' the situation before it escalates to the point where the honouring of promises to policyholders is at risk. Their second goal is to take action that will assist or

oblige the insurer, depending on the circumstances, to remedy its position or to cease trading and put its business into run-off.

The price of inaction in a deteriorating insurance business is often a 'slow burn', which can seem innocuous for some time, perhaps years, with management usually in denial, but when it finally becomes inescapable the costs and the losses can be very high.

There are many conditions that need to be met and principles that need to be applied in order to ensure that the supervisors do their job effectively, and that the Act and the Solvency Standard supply the support and the powers that they need.

The ability of supervisors to do their job effectively relies on two key capabilities and the associated resources:

- access to information about each insurer, including its balance sheet (with appropriate assessments of liabilities in particular and also the assets) and hence its capital position; and
- the ability to recognise risk situations when they arise. In the CBL case there were several risk matters to be explored as far back as 2013, when CBL was licensed. They included:
 - long-tail business;
 - rapid growth;
 - offshore business, regulated and unregulated, in unfamiliar markets;
 - inwards and outwards reinsurance; and
 - heavy reliance on a few major underwriting agencies and significant intermediaries.

Supervisors need to be constantly vigilant and alert to risk situations and have the determination to take action against a company when in doubt. Waiting for certainty or even high confidence, thereby giving the benefit of the doubt to the insurer, is unwise and may well run counter to the very reason for the existence of prudential regulation.

3.7. The Bank as prudential insurance regulator and supervisor

With the above introduction, we can examine in respect of the Bank:

- how its three foundation elements of prudential regulation, namely liability assessment, asset integrity, and solvency, are structured; and
- how it applies the basic tenets of supervision: to be alert to insurer risk and, if concerned or even in doubt, to take action firstly to clarify the situation and secondly to protect policyholders.

To give effect to the regulatory foundation elements, the Bank makes use of the Act and the Solvency Standard in the first instance by placing a set of obligations and requirements on the Appointed Actuary.

The Act and the Solvency Standard taken together comprise most of the regulatory structure that licensed insurers are required to work with and that the Bank needs to monitor as supervisor.

To conduct supervision, the Bank relies on a small team of supervisors to monitor the affairs of each insurer for the purpose of evaluating their compliance with solvency and other matters. Some of these matters are financial but there is also a range of other aspects of their affairs including governance and risk management. In the event that there is discernible risk, supervisors will increase the intensity of supervision and may initiate or demand remedial action.

The process that the Bank applies in carrying out supervision is described by the Bank according to the three pillars, which are:

- *self-discipline*: the expectation that boards of licensed insurers will act responsibly and effectively in exercising their functions in accordance with the requirements of the Act;
- *market discipline*: the expectation that disclosure to the market of financial strength and other information about each licensed insurer will create a level of accountability to the community that will contribute to the effective corporate management of each licensed insurer; and
- *regulatory discipline*: the legal structure (principally the Act and the Solvency Standard), according to which licensed insurers are required to operate.

The CBL case presents a set of circumstances that illustrate the limitations of the three pillars as they were executed in the CBL case from 2013 (licensing) to 2018 (liquidation). These limitations are explained in Chapter 13.

Given that the primary vehicles that define for the Bank the regulatory environment and supervisory requirements are the Act and the Solvency Standard; the following questions arise:

- How effective are they in enabling the Bank to fulfil its supervisory obligations?
- How well did the Bank fare in its supervision of CBL between 2013 and 2018? We ask this question so that, as set out in our Terms of Reference, the Bank can learn from its experience and make appropriate adjustments in future.

3.8. Policyholder protection

Most insurance prudential regulators operate under legislation that explicitly states that the primary purpose of, and the rationale for having, prudential regulation is the protection of policyholders. The reason that policyholder protection is regarded by many governments as important is twofold:

- the insurance industry provides an essential service in a market economy; and
- insurance businesses operate with an inverse cycle of production, whereby policyholders pay premiums upfront, before the insurer has provided anything but a promise.

Hence the primary function of the prudential regulator is to influence each insurer to manage its financial affairs such as to arrange for sufficient funds to be held in reserve at all times to enable it to meet all claims entitlements associated with the premiums that have been paid.

That said, there is no explicit comprehensive policyholder protection provision in the Act. Sections 3 and 4 of the Act can be interpreted, however, as requiring the prudential regulator to treat policyholder protection as a primary objective of prudential supervision.

3.9. The primary regulatory requirements: liabilities, assets, solvency

While the Act and the Solvency Standard provide a reasonably comprehensive and, in many respects, powerful framework for the supervision of insurers, those instruments have limitations, some of which emerged in the CBL case.

To satisfy the three foundation elements, the Act places a high level of responsibility on the Appointed Actuary. The Bank considered that the Solvency Standard, which is secondary legislation, effectively obliges the Bank to accept the actuary's advice as to the solvency assessment even if the Bank wishes to challenge the Appointed Actuary's advice. As we set out in Chapter 9, we do not think the Solvency Standard goes so far. Nevertheless, there is heavy reliance on the Appointed Actuary in relation to specifications in the Solvency Standard on some technical aspects of liability assessment and solvency conditions that insurers are required to meet.

The CBL case has brought to light three material issues that we consider should be reconsidered in relation to regulatory effectiveness:

1. over-reliance on the advice of the Appointed Actuary;
2. the solvency and capital requirements specified in the Solvency Standard are too narrow and too rigid for optimal risk management by insurers and effective supervision by the Bank; and
3. the governance requirements in the Act are minimal and for prudential purposes are not effective in holding the board, the management or the Appointed Actuary of a licensed insurer accountable for sound and effective governance of the insurer.

How, when and where did these three issues manifest themselves during the CBL story? And what modifications might now be considered, both regulatory and supervisory, to respond to them? Our response to each of those questions is set out in Chapters 9, 11 and 13 respectively, where the titles are:

Chapter 9: The Appointed Actuary regime and CBL

Chapter 11: Solvency Standard: scope and structure

Chapter 13: Governance and risk management

3.10. The primary supervisory requirement – effective oversight of insurers

Associated with each of the three issues above, which are regulatory in nature, are questions of supervisory stance and behaviour. Supervisory matters are explored in Chapters 5, 6, 12 and 13.

PART 2 - CHRONOLOGY

Chapter 4: Chronology: Licensing to Liquidation 2012–2018

4.1. Chronology – two aspects

This chapter introduces the background to this review by outlining the history of events regarding:

- the introduction of prudential supervision in New Zealand beginning with the passage of the Act in 2010; and
- chronology of the Bank's interactions with CBL during the development of the CBL group from 2011 to 2018 from a prudential supervision viewpoint.

4.2. Introduction of prudential regulation and supervision in 2010

As noted in Chapter 2, the Act was developed in 2008 and 2009 following a decision by the Government that insurance companies in New Zealand should be subject to a more consistent form of prudential regulation and supervision from one regulator.

The Act was passed in 2010 giving the Bank responsibility for its implementation and operation. The Bank's first task was to identify all businesses in New Zealand that might be subject to the Act. This was the pre-licensing phase and there were some 150 businesses that were examined to see whether they were or were not insurance companies according to the definition in the Act.

About 100 businesses were classified as insurers carrying on business in New Zealand. Subject to meeting some conditions, the Bank was obliged to issue provisional licences to qualifying companies. Applications for full licences were required within 18 months of the date of the Act coming into force (that is, by 8 March 2012) and the Bank was required to complete the full licencing process by 8 September 2013. These insurers would be examined to see whether they might be granted licences to continue to operate as insurers or, alternatively, to be denied licences and therefore obliged to cease offering insurance products.

The licensing phase was carried out in 2012 and 2013 and most of the businesses classified as insurers were granted licences in the third quarter of 2013. CBL was one of those companies.

The Act itself does not stand on its own, although it is the centre piece of the regulatory regime. There is more detail required than is in the Act to enable the Bank to implement and operate as prudential regulator and supervisor. To this end there is one significant instrument supporting the Act that is also legally binding. That instrument is the Solvency Standard.

4.3. Significant events in the Bank's supervision of CBL

Below is a chronology in brief of the main events that have been identified as relevant to this Review. They cover the key events from the perspective of prudential supervision of CBL from 2011 to 2018.

Timing	Event
1. Feb 2012	Provisional licence issued.
2. May 2013	Concerns expressed and conditions added to provisional licence (including KPMG report on risk management and other matters).
3. Aug 2013	KPMG report delivered to the Bank.
4. Sep 2013	Full licence issued.
5. Jun 2014	Appointed Actuary's FCR and solvency assessment for December 2013 submitted.
6. Aug 2014	Internal actuarial advice that solvency margin probably not met.
7. Sep 2014	Bank accepted internal solvency advice and issued letter to CBL expressing doubts on solvency.
8. Oct 2014	Company responded expressing disagreement with the Bank's view of solvency.
9. Oct 2014	Internal request by supervisors for s 130 investigation to examine CBL solvency.
10. Oct 2014	CBL engages a new Appointed Actuary.
11. Nov 2014	Bank concerned at difficulty of requiring a review of solvency.
12. Dec 2014	The Bank responds to CBL on industry governance review.
13. Dec 2014	Further internal advice that CBL does not meet the solvency margin.
14. Jan 2015	Bank issues s 121 notice requiring the Liability Valuation Report (LVR), FCR and solvency return for December 2014 by 15 April 2015.
15. Feb-Mar 2015	Meetings between Bank and CBL to discuss Bank's concerns and solvency issues.
16. Apr 2015	LVR, FCR and solvency return received on time but, upon review, concerns remained.
17. Jun 2015	CBL seeks acceptable statement from Bank on solvency for publication of PDS (Product Disclosure Statement) and to resolve live solvency issues.
18. Jul 2015	Internal Bank documentation reviews 21 solvency issues, most of them unresolved at that stage but agreement subsequently reached with CBL.

19. Aug 2015	Endorsement of PDS reference to CBL having met capital and solvency requirement at December 2014.
20. Oct 2015	The IPO for CBL Corporation proceeds successfully.
21. Feb 2016	'Catch-up' meeting
22. Jun 2016	Prudential consultation meeting.
23. Jun 2016	Upgrade by rating agency A M Best.
24. Oct 2016	Enquiry from the Gibraltar FSC on soundness of CBL.
25. Jun 2017	Concerns by European regulators over claims reserves of CBL's ceding companies.
26. Jul 2017	The Bank imposes business restrictions and a minimum solvency requirement of 170 %.
27. Aug 2017	The Bank issues CBL with a s 130 notice to appoint an investigator.
28. Nov 2017	The Appointed Actuary foreshadows increased claims reserves and inadequate solvency at December 2017.
29. Feb 2018	CBL verbally advises the Bank that its solvency ratio is below 100%, confirmed in writing the next day by the Appointed Actuary
30. Feb 2018	CBL put into interim liquidation and CBL Corporation put under voluntary administration.
31. Mar 2018	The Appointed Actuary quantifies his view of additional reserves, increasing them substantially and showing CBL as insolvent at 31 December 2017.
32. Mar 2018	Finity and Milliman reports conclude that there is further substantial under-reserving beyond the Appointed Actuary's December numbers.
33. Nov 2018	CBL Insurance put into full liquidation.

4.4. Elaboration

Below is a brief explanation of each of these events.

1. *February 2012: Provisional licence issued*

A provisional licence issued without conditions but several issues were identified regarding financial soundness, governance, risk management and a provisional supervisory stance of increased surveillance.

2. May 2013: Concerns expressed and conditions added to provisional licence (including KPMG report on risk management and other matters)

A letter from the Bank to CBL in March 2013 nominated licensing questions related to solvency and "carrying on business in a prudent manner", with reference to the predominance of offshore business, ability to identify and manage the risks of a growing offshore business, adequacy of risk management and internal controls, the ability of advisers including the Appointed Actuary to understand international risks and CBL's ability to comply with solvency requirements.

In view of these issues, a "Licensing Case Management Plan" was prepared for the supervision of CBL.

In June 2013, the Bank varied the provisional licence issued in February 2012 by requiring the company to cooperate with the preparation of a report into its affairs by a suitably qualified person appointed by the Bank. The Bank subsequently appointed KPMG to prepare this report.

3. August 2013: KPMG report delivered to the Bank

KPMG prepared its report and delivered it to the Bank in August 2013. The report raised questions regarding a range of aspects of CBL's affairs. At the same time, it offered the opinion that CBL had "a unique business model in a niche market" and appeared to have the capacity to respond satisfactorily to the issues raised by KPMG.

4. August 2013: Full licence issued

A substantial internal actuarial review was completed in August 2013 in relation to the full licence application. The essence of the internal advice was that CBL needed to make progress on many of the issues raised by KPMG, especially reserving and claims management.

An internal supervisory recommendation was made to issue CBL with a full licence. That was done by letter to the company on 4 September 2013. This letter required CBL to address all matters in the KPMG report, to prepare a corresponding plan and to give the Bank monthly reports on progress in implementing the plan.

5. June 2014: Appointed Actuary's FCR and solvency assessment for December 2013 submitted

This FCR (Financial Condition Report) incorporated the Appointed Actuary's solvency assessment and valuation of insurance liabilities as at 31 December 2013.

6. August 2014: Internal actuarial advice that solvency margin probably not met

The Bank's internal actuary prepared advice that drew substantially on the Appointed Actuary's 2013 FCR and the KPMG report. His report was extensive and raised several significant matters that led to the internal actuary referring to "a serious solvency issue for CBL at 31 December 2013 and going forward".

He concluded, among other things, that the solvency margin, instead of being \$7m as reported by the Appointed Actuary, had been incorrectly calculated. He said, "Due to errors in the solvency calculations, the actual 31 December 2013 solvency margin of CBL is clearly below zero, although the correct solvency margin figure is unknown – it is negative by \$ millions to \$ tens of millions".

A meeting between the Bank and the Appointed Actuary relating to the application of the Standard and the ambiguities in the calculation did not resolve concerns.

7. September 2014: The Bank accepted internal solvency advice and issued letter expressing doubts on solvency

After considering the internal actuary's advice, the Bank wrote to CBL on 23 September 2014 saying that "The Bank is not convinced that the 31 December 2013 solvency return for CBL appropriately applies the Solvency Standard". The letter then questioned whether CBL was maintaining a positive solvency margin and referred to other solvency-related issues. The Bank was considering how to resolve its concerns.

8. October 2014: CBL responded expressing disagreement with the Bank's view of solvency

CBL replied on 6 October to the Bank's September letter stating among other things that "We do not agree with your Actuary's view on CBL's solvency". It indicated it would refer the Bank's concerns "along with our clarifications" to its new Appointed Actuary.

9. October 2014: Internal request by supervisors for s 130 investigation

The purpose of the s 130 request was to examine CBL's solvency using an independent actuary. Section 130 provides for the power of investigation and requires a higher threshold than other powers of review. Internal legal advice at the time however said that a s 130 investigation was not feasible as the required threshold for the use of the power was unlikely to be demonstrably met.

The legal advice identified that a further problem with doing a s 130 investigation is that, irrespective of the outcome of the investigation, the Appointed Actuary's advice as to measuring the solvency margin under the Solvency Standard would stand. The legal advice considered that the Solvency Standard gave authority to the Appointed Actuary to determine, as a matter of expert and informed judgement, how the liabilities are measured under the Standard.

10. October 2014: New Appointed Actuary

The appointment of an actuary from a major firm with access to international resources, namely PwC, to replace a local sole practitioner as Appointed Actuary was welcomed because the Bank saw the appointment as offering the promise of better and more complete analysis of the CBL balance sheet and solvency.

Note that this new Appointed Actuary held the role for one year and it then passed to a different actuary in the same firm from November 2015.

11. November 2014: The Bank concerned at the difficulty of forcing a review of solvency

The Bank was concerned at the apparent limitations of the Act and/or the Solvency Standard but it then deferred further action given the engagement of a new Appointed Actuary at CBL.

12. December 2014: The Bank responds to CBL on industry governance review

After conducting a governance review across 17 general insurers, the Bank wrote to CBL expressing a set of concerns tempered by encouragement to proceed. It was intended to cause CBL to take internal actions on the Bank's governance concerns but it was written in terms such that CBL could have interpreted it as a clean bill of health.

13. December 2014: Further internal advice that CBL does not meet the solvency margin

Following receipt of the June 2014 solvency return in November 2014 and some new information relating to the December 2013 position, the Bank's internal actuary updated his earlier advice. In summary, he considered that CBL did fail to maintain a solvency margin - best case being negative \$21m, more likely negative \$81m. However, he reiterated there remained uncertainty given some significant issues were not yet resolved. He considered it likely that CBL also failed to maintain a solvency margin as at 30 June 2014.

Further options were explored within the Bank on how to press CBL further on its reserving and solvency.

14. January 2015: The Bank issues s 121 notice requiring LVR, FCR and solvency return for December 2014 by 15 April 2015

The Bank elected to take no further action pending receipt of the FCR, LVR and solvency return by the new Appointed Actuary as at 31 December 2014. A s 121 Notice was issued requiring CBL to submit these reports early (mid-April instead of June). The covering letter expressed the expectation that CBL will not pay dividends or take any other actions that might weaken its solvency position pending resolution of all solvency-related issues.

15. February-March 2015: Bank/CBL meetings to discuss Bank's concerns

A meeting was held in February to clarify the Bank's concerns and send a clear message to CBL of the Bank's expectations for a licensed insurer. The key concern was the lack of certainty that CBL was compliant with the Solvency Standard. The Bank emphasised the need for good quality information and more in-depth analysis of CBL's risk exposures. A follow-up teleconference was held on 5 March focussing on the concerns outlined in the letter of 23 September 2014 and seeking resolution of the issues, ideally in the December 2014 solvency return and FCR due 15 April.

16. April 2015: LVR, FCR and solvency return received on time but, upon review, concerns remained

While the Bank had expected more substantial analysis from the new Appointed Actuary, including consultation with European colleagues who have experience in estimating liabilities for the French business being reinsured by CBL, it found the analysis and the advice on claims liabilities were barely different from the advice of the previous Appointed Actuary. It considered the scope of reporting was superior but not the scope of experience analysis and techniques for liability assessment.

17. June 2015: CBL seeks acceptable statement from Bank on solvency for PDS publication and to resolve live solvency issues

The Bank and CBL met, 21 outstanding or new solvency issues were identified and further information was sought by the Bank. CBL responded in a letter of 15 June 2015 addressing each of the 21 matters. The Appointed Actuary confirmed and co-signed the response. CBL was keen to resolve live issues, noting it could not market an IPO if the Bank held serious questions as to whether its solvency requirement was met.

18. July 2015: Internal Bank documentation reviews 21 solvency issues, most of them unresolved at that stage but agreement subsequently reached with CBL

The Bank again considered what approach it should take to prudential supervision of CBL. It noted that resources were continually being diverted to deal with CBL when supervisors were contending with continuing heavy demands regarding other insurers' liabilities from the Canterbury earthquakes,

and it had made its concerns on solvency clear. CBL was anxious to complete its planned IPO and pressed the Bank to reach agreement firstly on the outstanding solvency issues and secondly on the wording in the PDS recording the Bank's position.

CBL agreed to revise upwards its Minimum Solvency Capital under the Solvency Standard to allay some of the Bank's concerns. It also agreed to inject \$10m into the company before the IPO and undertook to inject a further \$10m after the capital raising.

19. August 2015: Endorsement of PDS reference to CBL having met capital and solvency requirement at December 2014

The Bank accepted as satisfactory an increased solvency requirement conceded by the company and, with the capital injections promised before and after the IPO, agreed to the terms of a risk caveat to be included in the CBL Corporation's PDS.

20. October 2015: The IPO proceeded successfully

CBL Corporation raised \$125m and injected \$10m into CBL as agreed in addition to \$10m injected in July.

21. February 2016: 'Catch-up' meeting

A discussion with the CBL Quality Assurance Manager was held in February 2016 which included preliminary arrangements for the first Prudential Consultation Meeting at a time to be agreed.

22. June 2016: Prudential consultation meeting

Solvency issues were raised again after the Bank's internal actuary reviewed the December 2015 solvency return and FCR. The meeting was followed by a letter from the Bank stating, among other things, "As discussed, it is still the Reserve Bank's view that reserving risk remains the most significant risk to CBL."

23. June 2016: Upgrade by rating agency A M Best

Rating agency A M Best upgraded CBL from bbb+ (Good) to a- (Excellent).

24. October 2016: Enquiry from the Gibraltar FSC on soundness of CBL

The Gibraltar FSC had identified reserving concerns at Elite and approached the Bank for its overall assessment of CBL as a business and CBL's claims reserves.

The Bank indicated no major concerns to the Gibraltar FSC although both agreed that claims reserving was the biggest risk factor for both CBL and Elite. The Gibraltar FSC offered to provide information on the French business and French regulatory requirements.

25. June 2017: Concerns by European regulators over claims reserves of CBL's ceding companies

The Gibraltar FSC raised concerns over Elite's reserves and questioned the Bank on the strength of CBL as a quota share reinsurer to Elite. It had engaged PwC UK to undertake an actuarial review. The review

showed Elite as materially under-reserved and it was then evident to the Bank that CBL was likely also to be under-reserved.

The Danish regulator Danish Financial Services Authority (DFSA), regulator of Alpha Insurance, and the Central Bank of Ireland (CBI), regulator of CBLIE, were both also concerned about CBL's strength as a reinsurer. The European Insurance and Occupational Pension Authority (EIOPA) was therefore also involved (see Chapter 7). The dialogue between the Bank and European regulators was extensive from June to August.

Dialogue between CBL and the Bank was also extensive at that time.

26. July 2017: The Bank imposes business restrictions and a minimum solvency requirement of 170%

The Bank issued CBL with a s 143 notice that it was not to undertake a range of expansionary transactions without prior written permission of the Bank and its minimum solvency requirement was to increase from 100% to 170%.

The rationale for the increased solvency requirement was related to several factors, including some of the Bank's own analysis, concerns about under-reserving and "CBL's unwavering approach in the face of serious and mounting concerns expressed by authoritative bodies about its French business".

27. August 2017: The Bank issues CBL with a s 130 notice to appoint an investigator

Under the s 130 notice, the Bank appointed McGrathNicol as investigator and then also Finity and Milliman as expert actuaries to examine the claims reserves of CBL's French construction business.

28. November 2017: The Appointed Actuary foreshadows increased claims reserves and inadequate solvency at December 2017.

In a brief statement of advice to the Bank the Appointed Actuary foreshadowed increased claims reserves and inadequate solvency at December 2017, as required under s 24 of the Act. No quantification was offered at that stage.

29. February 2018: CBL verbally advises the Bank that its solvency ratio is below 100%, confirmed in writing the next day by the Appointed Actuary

This advice followed up the position foreshadowed in November, of solvency less than 170% at December 2018. At less than 100%, the position is more serious than falling short of 170%.

30. February 2018: CBL Insurance put into interim liquidation and CBL Corporation put under voluntary administration

The Bank was preparing to seek a court order for interim liquidation based on CBL's financial position including substantial under-reserving. CBL then breached formal directions from the Bank which caused the Bank to apply, successfully, for interim liquidation on account of the breaches.

March - November 2018

To complete the picture, we note that when the Appointed Actuary completed his LVR for December 2017 in March 2018, the reserve increases, which were substantial, showed CBL as failing to meet the solvency requirement at 31 December 2017.

The increased reserves, as assessed by the Appointed Actuary in March 2018, resulted in CBL's solvency ratio showing as 29% and Actual Solvency Capital at \$44m at 31 December 2017, which was \$108m below the Minimum Solvency Capital of \$152m.

At about the same time the Finity and Milliman reports concluded that there was even further substantial under-reserving. The Milliman advice related to the underlying insurance portfolios reinsured by CBL. The Finity advice converted the Milliman advice to CBL's portfolios.

The advice contained in these two reports indicated an alarmingly high level of under-reserving by CBL, beyond the Appointed Actuary's numbers.

The High Court placed CBL into full liquidation in November 2018.

Chapter 5: CBL 2012–2016: Licensing and Solvency

This chapter offers a commentary on the Bank’s actions in respect of the significant events in the period from provisional licensing in 2012 through licensing to ‘business as usual’ in 2016 including during the listing of CBL Corporation and capital raising in 2015. These significant events are as described in the previous chapter.

5.1. Licensing – provisional licence in 2012 and full licence in 2013

The steps taken by the Bank and the analysis it carried out were appropriate:

- The pre-licensing process in 2012 was undertaken diligently and professionally.
- The Bank recognised the unusual features of the CBL business, namely long-tail, rapid growth, offshore in unfamiliar markets and the associated risks.
- In preparing for licensing, the Bank prepared a “Licensing Case Management Plan” for CBL; it gave CBL written warning on meeting compliance requirements; and it required a report from KPMG on risk management and other matters as a condition of considering a full licence.
- Although there were concerns within the Bank about CBL, it was a reasonable decision to issue a licence in order to have CBL ‘inside the tent’: it was a genuine insurance business and properly warranted being regulated rather than closed down (which was the only alternative to licensing).
- The Bank recognised the need for strong follow-up action on the concerns identified.

When the full licence recommendation was made on 30 August 2013, a list of issues was prepared by the Bank.

Findings: Pre-licensing 2011 and 2012, licensing 2013

- The pre-licensing process and the Bank’s licensing plan were sound.
- The licensing process and the post-licensing plan were sound. The decision to issue a licence was appropriate against the alternative of denying CBL a licence and forcing closure of the business.
- Noting that the Bank had a set of concerns about CBL, the Bank was adequately prepared for the challenge that CBL was bringing into the new regulatory regime following licensing.

5.2. 2014 – first solvency return and initial follow-up on licensing concerns

Analysis of the first solvency return following licensing, received in June 2014 for December 2013, led to serious doubts within the Bank over CBL's solvency but internal efforts to investigate thoroughly the CBL position were not successful:

- In his 2013 FCR, the Appointed Actuary at the time recommended, among other things, that CBL should operate to a solvency ratio of at least 150% and work towards a target of 200% (against a statutory minimum of 100%).
- The Bank's internal actuarial advice included, among other things, a proposal to increase CBL's minimum solvency ratio (and added the suggestion, as an example, that it be 150% to 200%).
- The Bank accepted its internal actuarial advice that the solvency return was at best suspect and that CBL may have been insolvent. This advice, that the solvency margin was likely to be overstated, was given sufficient credibility and weight for the Bank to take action at senior level.
- The Bank expressed its concerns to CBL and asked the company to review its position on claims reserves and solvency and to adequately explain solvency-related issues in the FCR.
- CBL deflected the Bank's concerns on solvency ("We do not agree with your Actuary's view on CBL's solvency") but indicated it would refer the Bank's concerns "along with our clarifications" to its new Appointed Actuary.
- Given the lack of information and range of uncertainties over the solvency position, the Bank supervisory team recommended internally that a s 130 investigation be imposed on CBL. Section 130 authorises investigations which include powers of entry and search. It has a higher threshold for exercise than other powers which require, for example, information and/or reports and/or audits to be provided or carried out.
- The Bank sought internal legal advice that effectively concluded that, even if it had an investigation under s 130 which resulted in a solvency opinion different from the Appointed Actuary's opinion, the Bank did not have the power to circumvent that opinion: independent results could not take precedence over the opinion of the Appointed Actuary in calculating a solvency margin, and in particular the Outstanding Claim Liability Adjustment, because the terms of the Solvency Standard required the calculation to be determined "in the opinion of the Appointed Actuary".

In other words, the Bank concluded, on the basis of legal advice, that even if it imposed an independent investigation on CBL, the Bank could not use the results to circumvent the advice of the Appointed Actuary on matters where the Solvency Standard gave the Appointed Actuary the authority and responsibility to make the determination.

While this advice and hence the Bank's conclusion may not have been beyond question, the Bank acted on this advice.

There is no record of this opinion or conclusion being conveyed to CBL or its Appointed Actuaries.

- Further internal legal advice considered six options for obtaining further information and testing CBL's position on solvency, based variously on ss 121, 125, 126 and 130 of the Act.

Given the perceived primacy of the particular opinions of the Appointed Actuary, the appointment of a new Appointed Actuary and the imminence of an updated solvency return at the end of November which was expected to take into account the Bank's concerns, the Bank decided to take a 'wait and see' stance.

Overall the Bank concluded that its regulatory position was constrained with the result that, at that time, it took no further supervisory action beyond requiring, via a s 121 notice sent in January 2015, a claims liability valuation, the solvency return and the FCR for December 2014, all to be submitted by 15 April 2015.

The Bank did follow up the s 121 notice with a number of meetings with CBL and the Appointed Actuary, early in 2015. These are discussed further below.

5.3. The supervisory position

Although the Bank, rightly in our view, determined that there were insufficient grounds for a s 130 investigation at that stage, there were avenues open to the Bank to put pressure on CBL to deal with the reserving and solvency doubts held by the Bank. Possible initiatives were:

- On actuarial matters, to seek more comprehensive information from CBL, including following up on claims reserving questions in the KPMG report and on the justification for the Appointed Actuary's reserving approach given KPMG's assessment and the French industry run-off tables in the KPMG appendix. Indeed, we see no reason why its objectives could not have been achieved with the use of ss 121 and 125.
- On non-actuarial matters, to insist on receiving proper and timely details of, for example, ceding company reinsurance agreements, underwriting agency agreements and ceding company reserving numbers to be compared with CBL's reserves (and the timeliness issue here is important because the Bank believed that CBL had frequently backdated various reinsurance and other agreements).
- In the interim (pending receipt of the information and analysis above), to increase the required solvency ratio for CBL from 100% to a higher number by recognising, in part if not in full, the Bank's internal actuarial and supervisory advice on the points of doubt in the solvency return. This step would have been straightforward for the Bank to take and would likely have had a significant influence on subsequent financial management of CBL and dialogue between the Bank and the insurer.
- On governance and risk management, to examine and follow up on the Appointed Actuary's recommendations in his 2013 FCR because:
 - the FCR indicated that the Appointed Actuary was not satisfied with some aspects of his dealings with CBL; and
 - the Appointed Actuary indicated he sought or planned to resign from his role.

Both the FCR and the Bank's internal actuarial report appeared to be well founded overall, taking into account the inherent uncertainties at the time, apart from some questions on the reserving work undertaken by the Appointed Actuary (these reserving questions are considered further in Chapter 7).

The Appointed Actuary's position

The Appointed Actuary made several clear and important recommendations to the CBL Board. Despite some perceived shortcomings in his actuarial work and abbreviated reporting, in our view the Actuary's recommendations in the FCR were sound and should have been followed up by the CBL Board and also by the Bank. His recommendations included:

- on risk exposures and claims reserving: references to the need to monitor more closely and better;
- on solvency: to operate to a 150% solvency ratio and target 200%;
- on rapid expansion: to proceed with a significant degree of caution given the risks;
- on deposits with ceding companies: to pursue because they raise issues for CBL's solvency;
- on consultation by management with the Appointed Actuary: to involve the Actuary in advance in decisions that affect capital management, including growth initiatives and dividends; and
- on foreign exchange: the arrangements to be part of a continuous strategy, not just a half-yearly technique to meet reporting requirements.

The Bank's position

Our interest is in how the Bank responded to these recommendations on receiving the FCR. We make no comment on how the CBL Board responded to these recommendations because that is not our concern.

Taken together, these are a powerful set of recommendations and two of them were serious matters to which the Bank could have, and indeed should have, reacted immediately:

- On solvency: all matters taken together (all his other recommendations and also the internal actuarial report) should have led more or less immediately to the Bank setting a hard minimum solvency ratio of say 150%, at least as an interim measure. Given the support of the Appointed Actuary and the concerns generally over solvency, this was an obvious place to start to mitigate any solvency issues.
- On utilising the Appointed Actuary: the Actuary's view that CBL failed to consult him on matters affecting capital and solvency was, if correct, a transgression or series of transgressions of some magnitude. Whether valid or not, the recommendation was an open invitation for the Bank to take the Board to task on this subject (and, incidentally, to obtain in a stress situation some intelligence on the effectiveness of the Act in legislating the Appointed Actuary role to gain the benefits of an independently minded professional expert standing between the company and the regulator).

These observations on supervisory matters raise some questions about the Bank's approach at the time:

- Did the Bank recognise the importance and the opportunity presented by the Appointed Actuary's departure, being the governance issue concerning the Appointed Actuary?

- Did the Bank explore with the Appointed Actuary and with CBL the reasons for his departure?
 - For example, did the Appointed Actuary's engagement cease for reasons unconnected with his relationship with CBL, because CBL wanted to replace him or because professionally he was uncomfortable with CBL's response to some of his recommendations and excluding him from involvement in important financial issues?
- After CBL declined to revisit its solvency position in October 2014 following the Bank's letter of 23 September expressing dissatisfaction with CBL's solvency return, why did the Bank only explore the viability of a s 130 investigation, instead of pressing CBL on other fronts, including the FCR recommendations and the internal recommendation to set an increased minimum solvency requirement?

The authority believed by the Bank to be vested in the Appointed Actuary has emerged as an issue that needs reconsideration. After a PwC actuary became the Appointed Actuary in 2014, the Bank concentrated on what it saw as the Actuary taking a position on claims reserving and solvency in 2015. The Bank wished to see this position reviewed but it was grappling with its perceived inability to challenge that position. Yet the Bank seems to have had, in June 2014, useful ammunition in the then Actuary's recommendations to the company in his FCR, as explained above.

These matters were essentially governance issues. It appears, however, that the Bank continued to look for actuarial advice on claims reserves and solvency calculations as a means of contesting CBL's numbers. It did not look beyond that to questions of governance including the performance of the management and the Board.

Findings: 2014 – dealing with 2013 Year End

- The Bank should have responded differently once CBL declared in October 2014 that it did not agree with the view of the Bank's internal actuary on CBL's solvency. Alternative steps that should have been considered include:
 - an immediate increase in CBL's solvency requirement (probably to 150%);
 - examining in some depth the FCR recommendations and the internal actuarial advice, which would have entailed, as a starting point: interviewing the Appointed Actuary on his own, interviewing the board with and without the CEO present and exploring more closely the Bank's internal actuarial advice; and
 - seeking further information and/or proceeding with an independent review of the internal actuary's advice, given the limited collateral expertise in the Bank at the time, and then proceed with other supervisory initiatives.
- The approach by the Bank, of seeking some kind of confirmation of the internal actuarial advice, had the effect of putting the onus on the Bank to disprove CBL's position. This was an unsatisfactory situation for the Bank.
- Overall the Bank appears to have given CBL the benefit of the doubt on claims reserving and solvency pending subsequent developments and investigations.

5.4. The regulatory situation

The fact that, in practice, on matters where the Solvency Standard allocates the responsibility of determining the matter to the Appointed Actuary, the Appointed Actuary's advice was believed to be unchallengeable is a regulatory barrier to be overcome for the Bank.

More generally, if the Bank is right, then too much authority appears to be assigned to the Appointed Actuary by the Solvency Standard. This situation should be revisited. We do not agree that the Appointed Actuary can have this pivotal role under the legislation which confers regulatory and supervisory powers and responsibilities on the Bank. The point (central to the solvency of the insurer) is too important to be delegated or assigned solely to the Appointed Actuary, if indeed it could be. However this was the interpretation of the Solvency Standard by the Bank and we understand how it was arrived at. The Bank appreciated it was a significant regulatory block and needed to be remedied. But it was not and has not yet been remedied.

Findings on the regulatory system

- The difficulty encountered by the Bank in challenging CBL's solvency assessment illustrated a significant problem that the Bank believed it had with the Act and/or the Solvency Standard regarding the role of the Appointed Actuary. It also illustrated some potential technical limitations of the Solvency Standard.

5.5. 2015 first half – with a new Appointed Actuary

When a PwC actuary succeeded the previous Appointed Actuary, a sole practitioner, in October 2014, initial meetings with Bank staff gave promise of deeper and more thorough analysis along with more comprehensive reporting of CBL's liabilities and financial condition.

Part of the Bank's expectations was access to international expertise through PwC. As a result, the Bank decided to wait for actuarial reports as at December 2014 despite its anxiety about CBL's solvency.

As noted above, the Bank issued a s 121 notice to respond to its continuing concerns about CBL, requiring certain information by 15 April 2015. This decision effectively gave CBL a further four to six months to respond to the Bank's solvency concerns.

At the same time, the Bank pursued its concerns with CBL and the Appointed Actuary, meeting on two occasions in February and March 2015 to emphasise the need for good quality information and deeper analysis of CBL's risk exposures. Issues outlined in the Bank's letter of 23 September 2014 were discussed with a view to assisting resolution of the issues in the December 2014 solvency return and FCR. Consensus was achieved that in future CBL would provide a lot more detail in the FCR and solvency documentation. It was expected that this would be reflected in the reports to be provided in April 2015.

In the meantime, internal work at the Bank continued on solvency because the Bank had received the June 2014 solvency return. The internal work was completed in March 2015. This June 2014 return gave little comfort to the Bank and the internal advice essentially reiterated many of the same concerns as were held about the December 2013 solvency return.

CBL was anxious to resolve all outstanding issues as its parent CBL Corporation was to go down the track of an IPO to raise additional capital and to gain listing on NZX and ASX. In a letter following

provision of the April 2015 reports, the CEO advised he considered these reports would resolve those concerns, and provided a table prepared by the Appointed Actuary which referred to each of the issues outlined in the Bank's 23 September 2014 letter. He expressed some concern that the Bank had not been clear about its issues in the past. The 23 September 2014 letter simply asked CBL to "pass on" the letter to the new Appointed Actuary so he could "take them into account". He observed that that is what happened and CBL thought it was the end of the matter, although he accepted it would have been sensible to provide the Bank with the Appointed Actuary's report addressing each of the matters.

As a result of the subsequent teleconference on 5 March 2015, the consensus was that the Bank would review the FCR and solvency documentation to see if any items remained to be resolved.

The Bank concluded that the new Appointed Actuary's FCR gave no meaningful resolution of the solvency questions. The claims reserves were again based, as for 2013, on what, on its face, was input from CBL without evidence of corroborating analysis or input from actuaries or other relevant experts experienced in the analysis of French DL and DO portfolios; i.e. persons that might validate the Appointed Actuary's analysis. His reports give no indication that the Bank's expectation, which was entirely reasonable, that he would take advantage of PwC's international resources was realised or explained. At the same time there is no evidence that, on receiving the Actuary's reports, the Bank raised this issue with the Actuary or the company. We find it surprising that the Actuary and the Bank did not enter into any dialogue on the topic. The Bank ought to have pursued this matter.

To be specific, the 2014 FCR contained, under the heading 'Claims reserving and management':

Status in KPMG report 2013

The overall reserving processes do not provide adequate challenge to the underwriting/pricing functions and are more led by the underwriting assumptions when setting reserves

CBL will benefit from engaging local market specialists that can appropriately challenge reserving and underwriting assumptions

PwC FCR 2014 – then current status

Industry information is available, but is high level and out of date. Efforts by all parties to get more granular and up-to-date statistics from other industry participants, including competitors, have been unsuccessful. CBL, correctly, strongly relies on its local experts (with CBL oversight) to help ensure successful underwriting results.

CBL has appointed an experienced Technical Manager in France based in Paris to enhance the level of its expertise in this area of its business.

Action: Continue working with local experts to closely monitor CBL results as well as industry performance.

This segment of his FCR indicates that the Appointed Actuary –

- acknowledged KPMG's suggestion about "engaging local market specialists that can appropriately challenge reserving and underwriting assumptions";
- sought some French industry information but found it unhelpful because it was "high level and out of date";

- noted that CBL “strongly relies on its local experts (with CBL oversight) to help ensure successful underwriting results”; and
- stated that he would have future support from a new Technical Manager and in future would be “working with local experts to closely monitor CBL results as well as industry performance”.

The last point refers to future actions so had no direct bearing on the 2014 results.

Our reading of the KPMG reference is that the Appointed Actuary understood he should consult with actuarial or other experts with experience in the assessment of claims liabilities for French DL and DO portfolios. That is as the Bank expected and what is needed for a foreign portfolio of long-tail business.

The FCR, however, indicates that the experts relied upon by CBL were of a rather different kind: they were local operational personnel involved in underwriting and they were overseen by CBL personnel. The indication in the FCR is that these personnel were relied upon for the success of the business, without any suggestion that they were expert or experienced in the assessment of claims liabilities on a portfolio basis or whether they played any part in the assessment of the liabilities. Accordingly the Bank, having not received what it was expecting in terms of consultation by the Appointed Actuary with appropriate experts, could and should have followed this matter up with the Appointed Actuary.

This situation demonstrated again the difficulty of relying exclusively on the Appointed Actuary for claims reserving and solvency assessment. Now the Bank was no further advanced than it had been in August 2014 when it already had concerns about CBL solvency.

Findings on solvency and reserving in 2015 with a new Appointed Actuary

- In our view, the Bank acted reasonably in the steps it took, including continuing to give CBL the benefit of the doubt and granting the new Appointed Actuary the time to prepare 2014 reports, noting that it ultimately cost the Bank another six months delay. However, it could well have been more forceful. It could have done more and in our view should have done more to see that the new Appointed Actuary was obliged to seek and consider additional information. Absent a satisfactory response, the Bank might have sought the relevant information using its powers under the Act.
- Notably, if the Bank had acted in 2014 to increase CBL’s required solvency ratio to say 150%, as supported by both the previous Appointed Actuary and the internal actuary, then the FCR for December 2014 would have presented CBL with a solvency problem: the reported Minimum Solvency Capital at 31 December 2014 was \$49.2m and actual solvency margin \$19.1m, yielding a solvency ratio of 139%. That in turn would have obliged the CBL board to take urgent and immediate remedial action on its financial position and financial management.
- In summary, the Bank was lenient with CBL for almost a year, from mid-2014 to mid-2015 because, throughout that period, it had doubts about CBL’s solvency but it gave the insurer the benefit of the doubt in relation to its explanations and the actuarial advice that the Appointed Actuary was producing.

5.6. 2015, second half – continuation of solvency concerns and a successful IPO

Internal assessment by the Bank of CBL's solvency position had continued during the first half of 2015. Once the December 2014 reports were received, attention turned to them. In June 2015 the Bank still had a list of 21 solvency related issues to be investigated or resolved, some of them very material. Fourteen were issues raised in September 2014 correspondence; seven were issues not previously identified.

At the same time that these 21 solvency issues were on the table, in June and July 2015, CBL's CEO was seeking an urgent resolution to the Bank's solvency concerns. CBL's parent company was preparing to list on the NZX and ASX and the CEO advised the Bank that CBL Corporation could not proceed unless CBL at least met the minimum solvency conditions of its licence. If the Bank considered it could not accept that, then CBL believed that disclosure of that fact would be a deal breaker for CBL. Thus there was some pressure to deal with issues as quickly as possible.

On 5 June 2015 a meeting between the Bank, CBL and the Appointed Actuary was held to discuss these solvency issues. The CEO responded to each of the issues in a letter of 15 June 2015 containing the company's view of the position on each issue and including a statement from the Appointed Actuary as to his satisfaction with CBL's IBNR reserves and with the CEO's response on each item in the letter.

The prudential supervision team at the Bank considered the response, set out in a memorandum from the supervisor of 24 June 2015. It first noted the request by CBL for confirmation as to whether the Bank still had material solvency concerns, given the link to the finalisation of the Product Disclosure Statement as part of the IPO. It noted there were still outstanding solvency issues. It then set out internally its future possible supervisory approaches for CBL, noting as relevant to the decision (and we quote):

- Reputational risk to the Bank should CBL be or become insolvent.
- The vast majority of CBL's policyholders are not NZ policyholders.
- It is the FMA's responsibility to protect potential IPO investors in CBL [Corporation].
- [The team's] resources are continually deflected to deal with CBL.
- The Bank has highlighted its solvency concerns to CBL. CBL has responded to those concerns. CBL's new Appointed Actuary, from a reputable firm has now ratified CBL's solvency at two reporting dates. Is this sufficient discharge of our obligations?

Possible approaches noted were whether a voluntary or imposed increase in the solvency margin would be sufficient to satisfy the Bank and/or whether to initiate an investigation of CBL's solvency using an independent actuarial firm, or a combination of both.

There were further communications between CBL and the Bank. A letter from CBL of 16 July 2015 set out its latest position and appeared to record agreement. A file note from the supervisor dated 22 July recorded the agreement from the Bank's perspective. The Bank agreed to deal with the reserving uncertainty "by looking to see CBL increase its solvency buffers". CBL Corporation would inject \$10m into CBL ahead of the IPO. CBL calculated that with the agreed adjustments, it still maintained just over 100% solvency ratio as at 31 December 2014. The Bank asked for a resubmitted solvency return.

Between the confident assertions and arguments of CBL on the one hand and, on the other hand, the Bank's diffidence and perceived difficulties in dealing with the doubts and uncertainties that inevitably formed part of its own analysis, it decided to accept a risk disclosure in CBL Corporation's PDS and not

impose additional terms or requirements on CBL. The PDS affirmed, on p44 as one of 12 risk issues, the following -

RBNZ queried CBL Insurance's and its Appointed Actuary's interpretation of clauses of the applicable IPSA standards and the resulting calculation of CBL Insurance's Regulatory Capital at December 2014.

RBNZ accepts that despite it having had some differences with CBL Insurance regarding certain applications of the IPSA standard, CBL Insurance met the minimum solvency condition of its IPSA licence. In addition, on 28 July 2015, CBL Insurance increased its Regulatory Capital by the issue of \$10 million of additional equity (sourced intragroup).

Further, the Board of CBL Insurance has in place a Capital Management Plan which has been filed with RBNZ and to which the Board remains committed to, where CBL seeks to operate at a Regulatory Capital surplus of between 135% and 165%.

We can now ask the questions:

Was the Bank fair in its response to CBL and should it have acted more forcefully on its solvency assessment before giving CBL enough 'elbow room' to draft a PDS in terms acceptable to the Bank?

Should the Bank have attempted to find a way to more formally ensure resolution of the solvency issues before seeing the IPO proceed?

In our view, the Bank was eminently fair with CBL and could be said to have acted leniently in terms of not pressing CBL vigorously on the Bank's reserving concerns and thereby risking standing in CBL's way on the IPO. We acknowledge that the Bank did not have the legal power, in the absence of group regulation (see Chapter 10), to mandate or veto any of the content of the PDS. Nevertheless CBL made it clear that if the Bank was not satisfied on the solvency condition, CBL believed that the IPO would not proceed.

In this context, we believe that the Bank should have used its powers over CBL, and perhaps over "associated persons" (which includes CBL Corporation), for example by compelling the provision of information or obtaining reports to oblige a more complete picture of matters relevant to the reserving and solvency issues. This would have led either to resolution of the matters or further and more intrusive regulatory action, such as directions and/or investigation. That would have been the natural progression if the Bank as supervisor had been operating as advocated in Chapter 12.

There are two further issues to consider here. One is the fairness to existing policyholders and investors with the Bank's acceptance of the IPO process. The other is pricing or profitability of future business. Both issues were dependent on whether CBL's claims liabilities were understated –

- On the one hand, if CBL was adequately reserved and was writing business at break-even or a profit, raising more capital to expand its business would have been positive and of no concern to the Bank as prudential regulator.
- On the other hand, if CBL's claims reserves were under-stated, CBL Corporation was going to raise funds from investors to meet claims that had already occurred and, to the extent that CBL was writing business at a loss (i.e. under-pricing the business), to subsidise future business. In other words, some of the capital would be used to make good existing liabilities and would not have earned a return for investors. Instead it would have diluted the losses

already incurred by existing shareholders. It would also mean that some or all of the extra capital to be injected into CBL may subsidise future business and not, as promoted, support further growth of the CBL business.

This situation represented a dilemma for the Bank: it was not certain that CBL was under-reserved or writing business at a loss and, accordingly, it was reluctant to interfere in the commercial affairs of the insurer that it was still assessing.

In our opinion the Bank should have pursued its assessment of CBL further to resolve the under-reserving question: if the Bank's doubts had been justified (and ultimately we discover in 2018 that they were, as explained in Chapter 7), the outcome would be inequitable for subsequent policyholders and investors, would bring benefit to the pre-existing shareholders despite the company making losses that had not been identified, would likely mean that the company was under-pricing its business and, if CBL continued to grow rapidly, any losses to policyholders would likely be magnified relative to the 2015 position.

Findings on reserving and CBL's IPO in 2015

- The Bank's cautious approach to investigating CBL more closely when suspecting under-reserving by the company in 2015 was less than prudent by the Bank and contrasts with the approach advocated in this report in Chapter 12. The Bank gave CBL the benefit of the doubt whereas, in our view, the Bank should have persevered as strenuously as possible to resolve its doubts.
- In the context where CBL had indicated to the Bank that the IPO would not proceed unless the Bank's solvency concerns with CBL were satisfied, we believe that the Bank should have considered using its position as prudential regulator of CBL in 2015 to deter CBL Corporation from issuing a PDS and listing on the NZX before the Bank had been fully satisfied on its reserving and solvency concerns (we do not under-estimate the tension that this approach would have created with CBL but our finding stands).
- The Bank gave the appearance to CBL of treating the concerns as resolved because it nominated no further concerns to CBL at the time that we have discerned beyond the wording of the PDS risk statement.

5.7. 2016 – 'Business as Usual' after the IPO

The main supervisory events that occurred in 2016 were items 21 to 24 in the previous chapter.

February 2016: 'Catch-up' meeting

The Bank had initiated regular annual prudential consultation meetings for its list of some 20 Designated Insurers, commencing in 2016. Ahead of the first meeting with CBL, a discussion was initiated by CBL's Quality Assurance Manager and followed up by an email from the Bank setting out its outstanding solvency issues. According to the Bank's file note and email, claims reserving was not raised as one of the remaining issues.

Subsequently the internal actuary reviewed the December 2015 solvency return and FCR and raised a number of concerns including the accuracy of the solvency margin. This information was fed into the Bank's preparation for the Prudential Consultation Meeting (PCM).

June 2016 – Prudential Consultation Meeting

The PCM took place in June 2016. Our impression from the minutes is that it comprised a discussion like many others with CBL, where the Bank's representatives raised numerous questions based on past doubts about many aspects of CBL's affairs and the insurer responded with strong assurances about the many positive initiatives it was taking.

The Bank issued a follow-up letter providing what it referred to as "feedback" which indicated, albeit in very polite terms, some residual concerns and recorded agreed actions on three major issues, namely reserving, claims recoveries and capital management. CBL replied, noting their new IT system would continue to enhance the granularity and robustness of the claims data, the Appointed Actuary was looking at differing claims valuation models, and repeating its confidence that it was conservatively reserved.

Finding: Solvency Concerns in 2016

- It is fair to say that the Bank was raising important unresolved issues with CBL in 2016 but it was not exerting any particular pressure on the insurer to respond with urgency or comprehensiveness on these issues.

June 2016 - Upgrade by rating agency A M Best

The specialist international insurance rating agency AM Best's assessment of CBL at this time led to a ratings upgrade from bbb+ (Good) to a-- (Excellent). This was largely based on financial information from the insurer, reviewed and audited, and assessment of forecasts from company management, in accordance with AM Best's normal practice.

Findings: External knowledge and Bank confidentiality

- One can debate whether AM Best, in upgrading CBL in 2016, should have looked more closely at CBL given its international resources and access to financial results for other French DO and DL insurers. The fact was, however, that neither AM Best nor any other external party - not investment analysts, the FMA or the European regulators - was aware that the Bank was in dialogue with CBL over questions of the soundness of CBL's financial condition.
- That was an entirely defensible position for the Bank because we know that the Bank was under obligations of secrecy while matters were still to be tested. We consider, however, that this confidentiality requirement on the Bank supports the case for resolving quickly the Bank's doubts in case they are valid and substantial.

October 2016 – Enquiry from the Gibraltar FSC on soundness of CBL

The Gibraltar FSC had identified reserving concerns at Elite and approached the Bank for its overall assessment of CBL as a business and CBL's claims reserves.

The Bank indicated no major concerns to the Gibraltar FSC although both agreed that claims reserving was the biggest risk factor for both CBL and Elite. The Gibraltar FSC offered to provide information on the French business and the French regulatory requirements.

The Bank did, however, raise an important reserving question with CBL's Quality Assurance Manager and the Appointed Actuary in a discussion to follow up the Bank's dialogue with the Gibraltar FSC. The question related to the French reserving code for DO and DL business. While both parties understood that CBL was not obliged to follow this code, CBL did not know whether Elite followed it and the Appointed Actuary suggested it was not applicable or not fully applicable to CBL. The Actuary agreed, however, to explore the code further as part of the review he had undertaken to make of reserving methodologies for CBL's French portfolio.

Regarding the Bank's response to enquiries from the Gibraltar FSC in October 2016:

- It seems that the Bank was not fully open in its communication with the Gibraltar FSC. Correspondence suggests that the Bank was so circumspect that it passed on very little information and advice beyond input it had received from CBL. It did signal that it had had and still had some reserving and other concerns with CBL but it seems to have given no indication that these concerns might be serious ones.
- It seems then that the Gibraltar FSC enquiries, which were made because the Gibraltar FSC was not satisfied with Elite's financial condition, became a lost opportunity for the Bank as the Bank did not engage actively with the Gibraltar FSC.

Findings: Enquiry from Gibraltar in 2016

- While this episode indicated that the Bank remained concerned about CBL's claims reserves, in our view the Bank should have engaged more openly and more actively with the Gibraltar FSC. The Bank of course needed to be cautious as it had a limited established relationship with the Gibraltar FSC but, with its participation in the International Association of Insurance Supervisors and an existing set of protocols that can give protection to both regulators and licensed companies, it had every opportunity to do so (see further in chapter 7).

Finding: Bank's position with CBL after Gibraltar FSC intervention

- Notwithstanding all that had transpired in the previous three years, along with continuing concerns over reserves, recoveries, capital management and issues signalled by the Gibraltar FSC with a core ceding company, the Bank continued to be lenient with CBL.

This topic (of interaction with foreign regulators) is discussed more fully in Chapter 8. The attitude that appeared to cause this level of caution and diffidence in engaging with the Gibraltar FSC is explored in Chapter 15.

5.8. Escalations and possible escalations of supervisory activities before June 2017

This chapter has offered a number of observations regarding potential opportunities that the Bank had to escalate its efforts to examine and understand properly the affairs of CBL in the period from 2014 to 2016.

Prominent were internal discussions within the Bank about requiring the Appointed Actuary to undertake more comprehensive investigations and give more complete advice to CBL and the Bank. It seems however that the Bank made limited efforts to pursue these discussions with CBL or the Appointed Actuary. The Bank did not take concerted action to elicit information or obtain other reports, partly because it had reservations about the efficacy of doing so. It also elected not to draw on the resources of international regulators or external experts. It could have done so informally in the first instance (see Chapter 8 for elaboration).

We note again the context: the Bank comprised a small team of people operating a new regime, with significant other work arising, in particular, out of the Canterbury earthquakes. Because CBL's business was almost entirely offshore, its impact on the NZ insurance sector and the economy was seen as low and the resources to be allocated to it needed to be balanced against other priorities. Furthermore there was the dampening effect of the legal risks identified as associated with stronger regulatory action and possibly, we assume, the concern by the Bank of legal challenge and the engagement of resources that that would involve (people and funds).

These aspects are explored in Chapter 12 (Prudential supervision as a Bank function).

Recommendation

- 5.1 When in doubt about an insurer's financial soundness, the Bank should take steps, in the interests of policyholders and the public, to investigate the company without delay and to resolve the doubts as quickly as possible.

Chapter 6: CBL 2017–2018: International Interest and Insolvency

This chapter offers a commentary on the Bank’s actions in respect of the significant events in the period from commencement of active interactions with the Gibraltar FSC in June 2017 to the Court hearing in November 2018 that put CBL into full liquidation. These significant events are outlined in Chapter 4 and reproduced below.

25. Jun 2017	Concerns by European regulators over claims reserves of CBL’s ceding companies.
26. Jul 2017	The Bank imposes business restrictions and a minimum solvency requirement of 170% using s 143 of the Act.
27. Aug 2017	The Bank issues CBL with a s 130 notice to appoint an investigator.
28. Nov 2017	The Appointed Actuary foreshadows increased claims reserves and inadequate solvency at December 2017.
29. Feb 2018	CBL verbally advises the Bank that its solvency ratio is below 100%, confirmed in writing the next day by the Appointed Actuary
30. Feb 2018	CBL put into interim liquidation and CBL Corporation put under voluntary administration.
31. Mar 2018	The Appointed Actuary increases reserves substantially, showing CBL as insolvent at 31 December 2017.
32. Mar 2018	Finity and Milliman reports indicate very substantial under-reserving beyond the Appointed Actuary’s numbers
33. Nov 2018	CBL put into full liquidation.

6.1 Expanding on the above items

2017 June – Concerns by European regulators over claims reserves of CBL’s ceding companies

There were five European regulators with a strong interest in CBL:

- Gibraltar FSC – for Elite;
- DFSA (Danish Financial Services Authority) – for Alpha Insurance;
- CBI (Central Bank of Ireland) – for CBLIE;

- ACPR (Autorité de contrôle prudentiel et de résolution) French prudential regulator – for the French market; and
- EIOPA (European Insurance and Occupational Pensions Authority), as part of the European System of Financial Supervisors working in conjunction with the country supervisors.

Elite, Alpha Insurance and CBLIE were the ceding companies writing French DO and DL business and reinsuring most of it with CBL.

The Gibraltar FSC queried the Bank about CBL in October 2016 (see end of previous chapter) but nothing more transpired between them until June 2017. At that time, the Gibraltar FSC raised concerns over Elite’s reserves and questioned the Bank on the strength of CBL as quota share reinsurer to Elite. It had engaged PwC UK to undertake an actuarial review. The review, given to the Bank as a draft, showed Elite as materially under-reserved and it was then evident to the Bank that CBL was likely also to be under-reserved.

The Danish regulator DFSA, as regulator of Alpha Insurance, and the Central Bank of Ireland, as regulator of CBLIE, were both also concerned about CBL’s financial strength as a reinsurer.

The Central Bank of Ireland imposed collateral requirements on CBL as reinsurer to CBLIE.

After it saw the PwC UK draft report, the Bank issued two s 121 notices seeking information from CBL, one relating to the Elite and Alpha businesses, the other on CBL’s group solvency position.

2017 July – The Bank imposes business restrictions and a minimum solvency requirement of 170%

Elite entered run-off (i.e. ceased to write any further business) and Alpha’s reserves were required to be strengthened. CBL then sought to acquire Elite’s retained share of the business.

To prevent this increased exposure, the Bank issued CBL with a s 143 Direction that it was not to undertake a specified range of expansionary transactions without prior written permission of the Bank and that its minimum solvency requirement was increased from 100% to 170%.

The grounds for the s 143 Direction were as noted in the letter accompanying the Direction, that “CBL may not be carrying on its business in a prudent manner”. The rationale was related to several factors including some of the Bank’s own analysis, concerns about under-reserving and “CBL’s unwavering approach in the face of serious and mounting concerns expressed by authoritative bodies about its French business”.

The final PwC UK report on Elite was also made available.

The Bank issued further notices under s 121 seeking documents and enhanced financial and solvency reporting.

Finding

- The Bank became increasingly concerned after PwC UK, engaged by the Gibraltar FSC to investigate Elite’s claims reserves, advised severe under-reserving at Elite. That was the trigger for the Bank to take strong action by issuing Directions and appointing investigators in August 2017.

2017 August – The Bank issues CBL with a s 130 notice to appoint an investigator

Under the s 130 notice, the Bank appointed McGrathNicol as investigator, then also appointed Finity and Milliman as investigators in the capacity of expert actuaries to examine claims reserves for CBL's French construction business.

Two s 121 notices were also issued by the Bank and market data from the French regulator was received by the Bank during August.

The Bank's internal actuary prepared a comprehensive 90-page report on CBL's claims reserves by drawing on the extensive analysis and conclusions of the PwC UK report on Elite. His primary conclusion was that, if the PwC UK numbers were correct, CBL's reserves were likely to be understated by an amount of the order of \$350m (which was a surprisingly high number).

Also in August, CBL Corporation indicated to the FMA that it was planning a \$75m–\$100m bond issue.

In October CBL requested the Bank's approval to acquire Elite's 20% retention of business it had written and not reinsured with CBL. The Bank declined this request.

2017 November – The Appointed Actuary foreshadows increased claims reserves and inadequate solvency at December 2017.

On 15 November 2017, the Appointed Actuary advised the Bank that he foreshadowed increased claims reserves and consequent inadequate solvency at December 2017.

CBL had previously notified the Bank that its estimated solvency ratio at 30 September 2017 was 176%. The Appointed Actuary explained, however, that extensive work was being done on historical data for CBL's French business. Analysis of the data was indicating a need to strengthen reserves to December 2017 such that the solvency ratio would fall below the required 170%.

2018 February – CBL Insurance put into interim liquidation and CBL Corporation put under voluntary administration

The Bank was contemplating the next steps including preparing to seek a court order for interim liquidation if, on receipt of the expert actuarial reports, CBL's financial position showed substantial under-reserving. CBL then breached the formal Directions from the Bank which caused the Bank to apply, successfully, for interim liquidation in light of the breaches.

2018 – post interim liquidation

A number of factual matters in the period between interim liquidation in February and final liquidation in November are relevant for context.

In March 2018 the Appointed Actuary submitted his December 2017 LVR which detailed substantially increased reserves and showed CBL as insolvent at 31 December 2017. The opening paragraph of his Executive Summary stated –

The net outstanding claims provision for CBL Insurance Ltd (CBL Insurance) has increased by \$144.1m to \$341.2 million in the half year to 31 December 2017. The major reason for the increase was a significant strengthening in loss ratios on the French construction business after substantially revised historical data was obtained and cleansed, which, compared to previous valuations, revealed claims are developing for longer and at a higher average amount than previously anticipated.

The increased reserves as assessed by the Appointed Actuary in March 2018 were substantial and resulted in CBL's solvency ratio showing as 29% and Actual Solvency Capital at \$44m at 31 December 2017, which was \$108m below the Minimum Solvency Capital of \$152m.

At about the same time, the Finity and Milliman reports also concluded that there was even further under-reserving. The Milliman advice related to the underlying insurance portfolios of French DL and DO business reinsured by CBL. The Finity advice converted the Milliman advice to CBL's portfolios. The advice contained in these two reports indicated an alarmingly high level of under-reserving by CBL:

- At 31 December 2017 CBL's reserves for the French construction business were \$244m whereas Milliman's corresponding figure was \$430m, a difference of \$186m (beyond the increase of \$144m already noted above).
- Both figures are uncertain but the magnitude of the Appointed Actuary's increases and the scale of the additional reserves required according to the Milliman analysis leave little doubt of a serious problem on the CBL balance sheet.

The application for liquidation was opposed and the hearing adjourned, ultimately taking place in November.

In November 2018 CBL was put into full liquidation by the High Court, ultimately unopposed. The judgment explains the predicament of CBL and various facets of the affairs of CBL and CBL Corporation that justify the liquidation of CBL.

We note incidentally the qualifications on the judgment submitted to us that, because the application by the Bank was ultimately unopposed by CBL, the judge's findings were based on untested evidence. It is not necessary, however, for us to consider the accuracy or otherwise of the Court's observations but nevertheless they are a public record of conclusions Her Honour drew from extensive evidence before her in a matter that had been vigorously opposed by CBL for some months.

The subject of CBL's French claims liabilities is elaborated upon in Chapter 7.

6.2 Commentary on the engagement of third parties in August 2017

The report by PwC UK on Elite's claims reserves and associated discussions with the Gibraltar FSC and other European regulators were alarming and prompted decisive action by the Bank.

The engagements of McGrathNicol, Finity and Milliman in August 2017 were important steps.

CBL had agreed to an independent investigation by actuarial experts in French DO and DL business and sought to engage Milliman. The Bank decided, however, to engage Milliman itself, in order to ensure that the Bank had full control of the terms of reference, management of the engagement and access to the work. The Bank might have both retained control and passed the cost to CBL had it determined to use ss 125 and 126, combined with requirements to provide information under ss 121 and 124. However, it was of the view that a s 130 investigation, with its amplified powers, was appropriate and we agree. The use of s 130 meant the Bank would maintain control of the exercise but also meet any costs.

Of course as at August 2017 the Bank did not know:

- what advice Milliman would give;

- what the Appointed Actuary's position would be in November 2017 (when he notified the Bank under s 24 of the Act of CBL's expected failure to meet its 170% solvency requirement at 31 December 2017);
- what the Appointed Actuary's position would be in March 2018 (when his LVR included a recognition of substantial previous under-reserving of \$144m, causing a major shortfall in CBL's solvency margin; or
- that it would take so long (until March 2018) to receive the Milliman and Finity reports.

6.3 The Bank was very active from June 2017

The above events indicate a very substantial escalation by the Bank in the intensity of its supervision of CBL beginning in June 2017 and its willingness to take strong action once it became clear to the Bank that such action was justified.

Directions issued by the Bank

The Directions issued by the Bank under s 143 in July 2017, some additional restrictions on the company in succeeding months and then the Bank calling a high-level December meeting with the CBL Board were certainly appropriate escalations by the Bank.

On 25 July 2017 the Bank took its first significant step under s 143 limiting certain transactions without the Bank's consent and increasing CBL's required solvency ratio to 170%. These steps had to meet a threshold of "reasonable grounds" that the insurer was not carrying on business in a prudent manner – and these are set out in the covering letter signed by the Deputy Governor. The letter explained, as required, why a recovery plan was not more appropriate, being that it required more information before this was considered. At the same time the Bank commissioned the section 130 investigation.

On 22 November 2017 a further direction was given under section 143, this time requiring CBL to consult with the Bank prior to entering into any transaction or series of related transactions over NZ\$5m in value. It had, at this stage, the advice of the Appointed Actuary that CBL was unlikely to meet its solvency margin in December and it was expecting the Milliman and Finity reports in the short term.

In the circumstances these were reasonable steps to take on the information available. CBL was given clear reasons. A similar direction was given to the parent company under section 145 and covered any of its subsidiaries. The scope of the Direction appeared to be properly within the terms of s 146. Later, on 11 February 2018, after discussions about CBL's intention to make a payment of €25m to Alpha, the Bank issued immediate Directions to prohibit this transaction without written consent of the Bank. Again, the grounds were clearly set out. On 21 February, a s 121 notice requiring information on any recent payments and/or asset transfers over NZ\$1m was issued. The Bank issued further Directions, this time requiring consent for any transactions over NZ\$100,000. It was, at that point, aware of the draft Finity and Milliman reports and held very significant concerns about CBL's solvency. At the end of 21 February the Bank learned that CBL had made some NZ\$55m in payments since 1 February, in breach of specific Directions. The Bank applied for interim liquidation on 22 February.

Finding

- We consider that the actions of the Bank over this period, including the investigation and various Directions, were fair and reasonable to CBL and its group members in light of the information the Bank had available. We saw no evidence of predetermination by the Bank. Indeed we note that the Bank was hesitant to take critical action until it had a high level of confidence that CBL was materially under-reserved. The Bank had decided that it was not willing to take strong action without independent investigation and advice. The Directions appeared to us to be appropriate and properly authorised, as did the application for liquidation.

6.4 But there was an omission – restriction of insurance business

Steps that the Bank took in August 2017 were to appoint investigators under s 130 and, as explained above, to use a Direction under s 143 to limit certain financial transactions of CBL. It did not, however, seek to place any restrictions on CBL's insurance exposures or insurance transactions. CBL continued to write more business, mainly in Europe, during the remainder of 2017 and through to interim liquidation in February 2018. According to the 2017 FCR CBL increased its premium income during 2017 by some \$66m or 27% and took on some substantial new risk exposures.

We also note advice from CBL and the Appointed Actuary of 15 November 2017 that CBL was unlikely to maintain its required solvency ratio for the subsequent three years. Taking into account all that had already happened, including the interventions of the Gibraltar FSC, CBI and DFSA, this statement from the Appointed Actuary and CBL should have been enough authoritative information to allow the Bank to take the strongest action available to it to minimise or prevent further insurance exposures.

We therefore need to examine whether the Bank had any options to limit or stop CBL from writing business in July 2017 or later and, if so, whether it should have done so.

Regarding options for the Bank, s 144(1)(b) empowers it to require a licensed insurer to “cease entering into new contracts of insurance” but s 144(2) excludes the renewal of pre-existing contracts from that power.

We regard this restriction on the Bank as a flaw in the Act: one of the first steps that is normally available and often drawn upon by the prudential regulator in situations like this one—of questionable ability of a company to survive and maintain solvency—is to prevent it writing any further business, whether new business or renewals. See further in Chapter 10 on the Act: structure and sufficiency.

If we accept that the Bank could have limited CBL's offshore business to renewals only and may have been able to find a way to prevent further exposures altogether, should it have done so?

We consider that that would have been the prudent course. There are two reasons, one relating directly to policyholders and the other to incentives on CBL as an insurer in a tight position.

Policyholders

To elaborate, we note initially that the Gibraltar FSC concerns, informed by receipt of the PwC UK report, gave weight to the likelihood that CBL was not only under-reserved but also writing business in France at a loss. Hence any further premiums accepted by CBL were likely to reduce further an already questionable solvency margin. This is disadvantageous to existing policies because it

potentially reduces the assets available to meet their claims, thereby weakening their position. It is also disadvantageous to new and renewing policyholders because they are seeking insurance protection from an insurer who may be unable to honour its promises to meet their claims in due course.

Incentives on CBL as an insurer

The second problem is that, in allowing the company to continue to trade, there is a temptation for the company to "gamble for resurrection" by taking on as much business as it can find as quickly as possible. It may do so in the hope that it can extricate itself from its predicament by somehow writing this additional business profitably even though the past business has been loss-making. Limiting the business to renewals only would ameliorate this problem if full run-off is not practicable.

This problem constitutes a perverse incentive that is likely to exacerbate the company's problems.

We understand that the Bank considered some options of this nature but decided against them on two grounds. Firstly it was expecting the Milliman and Finity reports much earlier than they eventuated. Secondly it believed that such steps may interfere with or compromise the goal of securing CBL's co-operation in obtaining the necessary information to determine whether there was indeed significant under-reserving and put the Bank in the best possible position to exercise, if appropriate, very significant powers as an application for liquidation. These were proper considerations in their decision-making over this period.

Finding

- It is difficult to make judgments now on all the circumstances at the time. Further we acknowledge that the legislation prevented the Bank from prohibiting renewals. Nevertheless we believe the appropriate course was for the Bank to take whatever steps were needed to limit or prevent CBL from writing additional business once the seriousness of its situation was recognised by the Bank in July 2017. The solvency advice from the Appointed Actuary in November gave further impetus to the need for restriction of business.

PART 3 – REVISITING CURRENT ARRANGEMENTS

Chapter 7: Understanding CBL'S French Claims Liabilities

7.1 Introduction

From 2013 through to interim liquidation in 2018 the Bank was faced with a company that appeared to believe at all times that it was financially sound while the Bank had persistent concerns about its claims reserves and its solvency. CBL's responses to queries from the Bank were -

- on claims reserves and solvency, assertions that CBL's business model was good, its business was profitable and its Appointed Actuary's advice was appropriate; and
- the Appointed Actuaries' positions, consistently held, were that their numbers and in particular their assessments of claims liabilities and solvency were sound.

CBL consistently exhibited confidence in its business while it appears that the nature and strength of the Bank's concerns about CBL's reserves and solvency were not consistently conveyed and not always evident to CBL.

We note that CBL did not accept at any stage, even after the Milliman and Finity reports issued in March 2018 and the Appointed Actuary's FCR also issued that month, that it had been chronically and seriously under-reserved for five years or more. If that was right, then there was nothing for the Bank to pursue and find – its suspicions would have been ill-founded. We do not accept that position for reasons given in the remainder of this chapter.

Hence the purpose of this chapter is to lay out the background to the debate around CBL's claims liabilities and reserves and to explain the various figures. It also explains the consequences of these figures including showing why the CBL business from 2012 or earlier to 2018 can now be seen, whether on the basis of the Appointed Actuary's 2017 numbers or the Milliman and Finity numbers, to have been built on optimistic measures of financial results (claims reserves under-stated, profits and solvency over-stated).

7.2 The claims liability problem

A critical part of assessing the Bank's supervision of CBL is the role played by estimates of claims liabilities and the setting of claims reserves. It is critical because:

- If the level of an insurer's claims reserves is adequate, the insurer's accounts will usually give a commercially sound picture of the insurer's business. This is because claims reserves, when added to claim payments already made, indicate total claims costs and they, in turn, when compared correctly against premiums, determine profitability and also indicate the adequacy of prices;
- If the level of claims reserves is inadequate, or too low, they will give a false measure of profitability which is an overstatement of profits and simultaneously, if used for pricing purposes, may lead to under-pricing.

The degree of difficulty in estimating claims costs in short tail classes of insurance, such as home and motor, is low. Hence the prospect of having inadequate claims reserves generally matters little. However, it matters greatly for long-tail business such as was written by CBL: the longer the tail, the longer do insurers have to rely on estimates of the levels of future claim payments and the less they can rely on past payments.

Under-reserving of claims, which usually arises from under-estimation of the claims liabilities (through under-estimating the length of the tail as well as the timing of the reporting of claims and the payments to be made on them), has been the greatest source of insurance company failure throughout history, over not just decades but centuries.

Hence the problem of determining realistic estimates of future claims costs and then setting adequate reserves to meet those costs is the single most important financial factor in managing a portfolio of long-tail insurance such as CBL's.

7.3 Opinions on the CBL claims liabilities and reserves

From 2013 onwards CBL consistently claimed, on the basis of Appointed Actuary advice, that it was fully reserved for all outstanding claims. On the other hand, the Bank had suspected from the outset that the insurer was under-reserved. We consider the Bank's concerns were validated in 2018 by the Appointed Actuary's 2017 FCR, the work of Milliman and Finity completed in March 2018 and the PwC UK report on Elite in July 2017.

This dichotomy of views and apparent validation of the under-reserving in 2018 warrants exploration, as does the difference between the views of the Appointed Actuary in his 2017 FCR and those of Milliman and Finity, because the stances taken on claims under reserving are central to the CBL case, from licensing to liquidation. What is the reality regarding CBL's French claims liabilities?

Before responding to this question, it is instructive to bear in mind the relevant numbers. According to the Finity report of March 2018, the claims reserves and ultimate loss ratios for CBL in 2016 and 2017 on the French business were as follows –

Valuation Date	Reserves (\$m)*	Reserves \$(m)*	Loss Ratio	Loss Ratio
	CBL AA	Milliman	CBL	Milliman
31 Dec 2016	100	356	25%	70%
30 Jun 2017	122	411	27%	71%
31 Dec 2017	244	430	45%	71%

*CBL reserves are as adopted in the CBL accounts, Milliman reserves are better referred to as estimated claims liabilities.

The first point to note is the substantial uplift in the CBL Appointed Actuary's figures during 2017 (claims reserves up 144% or \$144m, net loss ratio up from 25% to 45%). The figure of 25% at December 2016 was not greatly different from earlier years, 2013 to 2015.

The second point is the residual difference at 31 December 2017 between the CBL Appointed Actuary's numbers and those of Milliman. Despite the large increase at the end of 2017, the CBL loss ratio at 45% is still well short of Milliman's 71%. The reserves at December 2017 were \$186m less than the Milliman figure.

The Finity report also shows loss ratios for the Elite portfolio, which was a significant component of the portfolio of CBL's French construction business. They were –

Source	Ultimate Loss Ratio	Effective Date
CBL	28%	30 Jun 2017
PwC UK	80%	31 Mar 2017
Milliman	79%	30 Jun 2017

These ratios are consistent with the previous table and also show a consistency between the PwC UK numbers and the Milliman numbers.

In our view it is plain that this is not just a quibble over detail but one can ask: could it be no more than a difference of professional opinion in a class of insurance that is notoriously difficult to assess, as the tail is not only long but also heavily 'back-ended'? It is not uncommon for one actuary to differ from another by say 10% and sometimes more, which can readily be the case in actuarial professional assessments using the same data and the same valuation techniques but applying different judgments. Here, however, we have a difference on a large scale and at an extraordinary level. As Finity states in its report, even if one took a sceptical view of the PwC UK and Milliman reports and deducted even 20% or 30% from their numbers, the CBL reserves at 31 December 2017, already increased by \$144m, would still be lower.

For the purposes of this report, it is not of great significance which of the actuaries' assessments will ultimately prove to be closest to the actual liabilities when they are measured some years from now. What we can conclude, however, with a good degree of confidence, is that the ultimate liability is unlikely to be lower than the Appointed Actuary's numbers and could well be much higher.

7.4 Explanation for the differences

There are nevertheless some material factors noted in the PwC UK and Finity reports which relate to their respective estimates of liabilities and indicate a number of issues associated with making their estimates.

By way of explanation of the large differences between the PwC UK numbers for the Gibraltar FSC on the Elite business and the 2016 Appointed Actuary's numbers, the Executive Summary of the PwC UK records the following -

Key findings for French construction business

- The company's systems are not able to provide data triangles and other reports usually required for actuarial review;
- The data used by management and the external actuaries for reserving makes no use of case estimates and has not distinguished between 1 year and 10 year contractor's liability business, which have fundamentally different characteristics;
- In the approaches to reserving adopted by management and the external actuaries there has been no explicit consideration of the material future exposure period for contracts written with a 10 year term;
- Our estimates suggest a material deficiency in the held reserves net of reinsurance of 27m EUR; and

- Our estimates suggest a deficiency in the held reserves gross of reinsurance of 147m EUR, which highlights the reliance of the company on the performance of its quota share reinsurer.

Because CBL was reinsurer to Elite, its data suffered from the same shortcomings because Elite was the source of CBL's data on the Elite portfolios.

The Finity report offers this commentary under the heading in its report "Why are the Milliman results higher?"

There are many reasons discussed in the Finity and Milliman reports. Among the significant reasons are:

- Serious inadequacies in the data used by CBL and its AA for reserve estimation, including poor data reconciliations and insufficient visibility of the underlying product cover.
- CBL has never had sufficient data quality to allow a robust estimate of the reserves. Since 30 June 2017 CBL has invested considerable effort in cleansing its data. As a consequence, CBL's reserves materially increased at 31 December 2017 and data cleansing remains a "work in progress".
- Underestimation of the 'tail' of claims for the decennial covers through (at least prior to 31 December 2017) the incorrect application of French construction benchmarks. These claims reporting benchmarks were applied in a manner that is inconsistent with the attachment year basis from which they were derived, and were also used inappropriately to form payment development factors.
- Overly optimistic assumptions about the average size of claims and improvements in loss ratios over recent underwriting years as a result of using claims information from an immature portfolio.

7.5 Principles for estimating claims liabilities and setting claims reserves

The numbers shown above and the deficiencies described above in the work of CBL and its Appointed Actuaries before December 2017 indicate why we believe that the advice of Milliman and Finity, along with the Appointed Actuary's advice at 31 December 2017, validated the Bank's suspicions from as early as 2013 that CBL was under-reserved, and why in retrospect it is disappointing that the Bank was not more proactive and assertive earlier in pursuing its suspicions earlier.

We elucidate below how and why the differences in views on claims reserves have emerged and what we see as the relevant issues regarding the Bank's actions and considerations in dealing with them.

In some circumstances, such as those of CBL, it can be a vexed issue for actuaries, directors and regulators alike as to whether to believe or accept that claims liabilities may ultimately be higher, perhaps much higher, than had been recognised hitherto.

With the 'tail' of CBL claims being as long as it is for the French DO and DL business, where the claims notification period extends for 10 years or more and claim payments are not made until after a notification, it is possible to persuade oneself that future claims costs—the payment tail—will not be at the level that others believe.

This problem, which is a form of rationalisation, appears to us to be at the heart of both the under-reserving itself at CBL and the simultaneous and steadfast views of the company that its claims reserves were adequate.

In this vein, we quote from EIOPA's recent "Opinion on non-life cross border insurance business of a long-term nature and its supervision" of December 2018:

EIOPA has identified potential obstacles in relation to the calculation and supervisory assessment of the solvency position of undertakings carrying out non-life cross border insurance business of a long-term nature. These activities are typically more uncertain than the majority of non-life business and require both knowledge of the local market specificities and actuarial skills for the calculation of the technical provisions and the management of the activity. Experience has shown that, because of their distinctive features and their long-term nature, these activities may appear more attractive to players that do not possess the knowledge and the skills required, potentially leading to localised under-pricing, which can be to the detriment of policyholders if undertakings are ultimately unable to meet their liabilities.

The full EIOPA opinion uses French DO and DL business as a case study to illustrate the above proposition, indicating that assessing this kind of business has been a difficult issue in France for the whole market.

Full recognition of liabilities needs to be made as early as possible, ideally in the same year that premiums are earned (and that is the usual prudential regulatory requirement). Thus, provision is made in advance for the estimated level of future claim payments that ultimately emerge. Then, when the need for payments does emerge, the funds are in place to make the payments.

It is sometimes suggested that claims reserving is a matter of opinion by the actuary. That is so once the actuary has completed all the data gathering and analytical steps that are needed to make well researched estimates of claims liabilities. The opinion, however, has to be well founded. And it therefore needs to be understood that -

- Claims liability work is essentially a truth seeking exercise. The claims liabilities, i.e. the total future payments to be made on claims already incurred, whether reported or not, are essentially matters of fact not opinion *but* the facts have not emerged at the time of valuation.

The difficulty, therefore, and the reason for actuarial involvement, is that the facts are unknowable because the payments as to both timing and amount for these outstanding claims are in the future and uncertain. Hence an estimation process is required to quantify the liabilities. It is the role of the actuary to make the estimates of what those liabilities will ultimately be. In long-tail portfolios such as CBL's, there will always be significant elements of judgment.

- Having made such an estimate, the actuary then needs to determine or advise the insurer on the level of claims reserves that the insurer will or should hold on its balance sheet to meet these liabilities.

For NZ insurers, the Solvency Standard requires that claims reserves be set at a level that corresponds to the Appointed Actuary's central estimate of the ultimate liabilities (on a present value basis taking account of interest and inflation) supplemented by a risk margin which is intended to lift the probability of adequacy of the claims reserves from a central estimate level, which is 50%, to a more confident level which is 75%.

7.6 The CBL situation – establishing claims reserves from 2013 to 2017

The comments below are intended to give context to the matters that the Bank found itself having to deal with regarding CBL's reserves and solvency up until the second half of 2017.

Claims reserves were always going to be a major issue with CBL because of the long-tail business being written, the high profits being recorded and the rapid growth. This was evident from the 2013 KPMG report where meaningful statements were made about the claims liabilities and claims reserving. That report also contained some valuable industry information on loss ratios for French construction insurance.

The Bank's internal actuary considered that the Appointed Actuary in 2013 used unrealistically low loss ratios. The Appointed Actuary claimed in his 2013 FCR to take account of the KPMG work but he did not take full account of the long-term industry loss ratios included in the KPMG report, which were significantly higher than his own assumptions, for the reasons nominated in his report.

In 2015 the new Appointed Actuary appeared to follow essentially the same path as his predecessor. His reports make no reference to consulting actuarial colleagues or other experts experienced in assessing the liabilities of portfolios of French construction business.

While Bank personnel believe they expressed the Bank's expectations reasonably clearly to CBL and the Appointed Actuary in the second half of 2014, there was no apparent follow-up by the Bank with the Appointed Actuary as to why he had not consulted with external actuaries or other experts experienced in assessing liabilities for French construction businesses. Whether he did or not, the Bank was entitled to see it referred to in the documentation.

The essential position regarding the Appointed Actuaries and CBL's claims reserves, which is elaborated in Chapters 4 and 5, is that:

- There is little in any of their reports or discussions with the Bank that indicates any of the three Appointed Actuaries took full account of the French industry experience by drawing on the assistance of actuaries or other experts experienced in estimating liabilities for these portfolios. They all referred to data deficiencies, and rightly so, but there appear to have been no substantial advances in data scope and quality until 2017. Their analyses, based as they were on only a few years of claims development in expanding portfolios with a very long-tail, appeared to take no account of the longer term experience of this French business.
- While this French business had a much higher level of uncertainty than most other forms of long-tail business, exacerbated by the data deficiencies and slow reporting and payment patterns, none of the Appointed Actuaries applied large risk margins to their liability estimates when determining claims reserves (the 2013 Appointed Actuary did suggest that a 50% risk margin should be considered but did not apply such a margin).
- The 2017 year end work of the Appointed Actuary and the work of PwC UK, Milliman and Finity demonstrate, as noted above, that the Appointed Actuaries had made favourable loss ratio assumptions from as far back as 2013. The Bank was aware of this as a result of its internal actuarial advice but, as observed in earlier chapters, did not act on this concern.
- Despite these factors being recognised by some within the Bank, the Bank gave CBL the benefit of the doubt from 2014 to mid-2017.

The Appointed Actuaries had been obliged to use deficient data as a foundation for claims reserving from 2013 until December 2017. They were aware of this and attempted to take it into account in their work but they also suggest in their reports that they used the original work of the first Appointed Actuary as a reference point.

Findings: Reserving

In summary, we find that –

- Under-reserving was always going to be the biggest risk factor under the CBL business model and strategy.
- The three Appointed Actuaries and the Bank was aware of this risk and associated doubts over the levels of claims liabilities: in our opinion the subject should have been pursued vigorously from 2014 onwards in view of the potential commercial and other consequences.
- Based on their reports to the Bank, the Appointed Actuaries did not show signs of pursuing these claims thoroughly regarding either access to comprehensive and reliable data or actuarial techniques and experience applied in Europe for this type of business.
- The Bank did not thoroughly pursue internally its doubts, did not articulate and pursue its concerns with CBL sufficiently and did not consult, as it could have, with home regulators (in France and other European countries) or external experts (until 2017).
- The results of the Appointed Actuary's work in 2017, where he made large increases in CBL's claims reserves, illustrate from within the company that the liabilities had been considerably under-estimated from 2013 and perhaps earlier. Hence it also illustrates the inaccuracy of all previous profit results and measurements of solvency, both of which were over-stated each year.
- Even if one accepts the Appointed Actuary's December 2017 liability assessment and takes an optimistic view by discounting the estimates offered by Milliman, Finity and PwC UK, it now seems indisputable that the doubts held by the Bank from licensing in 2013 were valid.

Additional comments

No-one can actually prove, in a scientific sense, that the Appointed Actuary's numbers were wrong (because the liabilities relate to future payments that can only be estimated) but, at the same time, statistical and actuarial analysis properly undertaken can demonstrate the likely scale of the liabilities. Experienced actuaries using the right techniques and understanding well the data limitations that they have to accept can usually arrive at realistic estimates, as we believe ultimately occurred in 2017.

However it is a complicating feature of the CBL story that the Bank did not detect any concern or question by CBL or its Appointed Actuaries that there could be major deficiencies in CBL's claims reserves.

These are serious matters because the business of CBL was built on these previous profit and solvency figures but CBL itself did not know that, the Appointed Actuaries did not discover it until 2018 and the Bank, while suspecting it, was unable to confirm it until 2018. As a result there are adverse consequences for many parties today.

All of the above is relevant analysis and commentary because it made the task of the Bank as supervisor considerably more difficult and demanding over the five-year period than would have been

the case if CBL's Board and senior management had had relevant data and expert input from Europe of the kind it finally obtained in late 2017 and 2018.

Findings: a hindsight view?

- We conclude, on the basis of all the above including the expert reports referred to, that by the end of 2017 CBL was not only insolvent against the Solvency Standard but that its net assets were, by the Appointed Actuary's assessment, only 27% of the assets required and, by Milliman's assessment, negative by more than \$100m.. Although the quantification represents a hindsight view, there was internal Bank actuarial advice from 2014 that claims appeared to be under-reserved then and the doubts that emerged then were revisited a number of times but were not subsequently resolved until 2017.

Findings: relevance to the Bank as supervisor

- Until 2017 the Bank's supervisors gave more credence than they should have to the confident and persistent assessments by CBL and its Appointed Actuaries of CBL's financial performance.

Chapter 8: New Zealand Business and International Business

8.1. Introduction

CBL Insurance had its origins as a New Zealand-based insurer of builders' warranty business, but it began to operate overseas in the 1990s. By the time of licensing in 2013, it was already writing the vast majority of its business as offshore inwards reinsurance. Gross written premiums in the 2013 calendar year were:

Region	Premiums (\$m)
Australasia	12.8
Europe	142.8
Other	<u>9.7*</u>
Total	<u>165.3</u>

*South America, Mexico and Southeast Asia

The Australasian business was direct insurance and the remainder was inwards reinsurance. The Australasian business comprised less than \$2m of New Zealand business, with the remainder from Australia. The majority of the European business was French DO and DL business.

There are four separate dimensions to the prudential regulatory and supervisory role of the Bank when international business is involved. They are:

- The position of New Zealand policy holders vis-à-vis offshore policyholders;
- CBL's regulatory status in offshore jurisdictions;
- CBL's offshore business: the risk level; and
- The Bank's engagement as supervisor with offshore supervisors.

8.2. The position of New Zealand policyholders vis-à-vis offshore policyholders

The offshore CBL business created a quandary for the Bank. The natural interest of the Bank, when promoting the soundness of the insurance sector and public confidence in it, is to want to protect New Zealand policyholders first and then offshore policyholders.

The Act gives the Bank the power in s 21(2)(d), in the form of a licensing condition, to nominate the amount of business that relates to New Zealand policyholders. The Bank did not avail itself of this option and would have seen no particular reason to do so at the time of licensing of CBL.

However, almost all of CBL's business was offshore, which meant that almost all of the Bank's actions in supervising CBL affected only a very small number of policyholders in New Zealand.

In considering international policyholders' interests versus NZ policyholders' interests, we note that when the Bank licensed CBL, it was enabling the insurer to write insurance and reinsurance business anywhere in the world without restriction. Arguably then, if the Bank wished to see New Zealand policyholders of CBL protected, it needed to be mindful of all the risks to their interests from all of the activities of CBL, which would of course include all of its offshore business activities.

8.3. CBL's regulatory status in offshore jurisdictions

The Bank understood that CBL was unregulated in offshore markets where it acted as a reinsurer, which was the case for most of its business. This situation arguably put a greater onus on the Bank to supervise the financial integrity of CBL's offshore business than would have been the case had those activities been regulated offshore.

It is unusual for there to have been no regulatory requirements on CBL from foreign regulators. The reason is that it was a reinsurer and not a direct insurer (noting that reinsurer regulation in most jurisdictions is less demanding than for direct insurers and in some cases not required).

The topic of licensing offshore reinsurers has been controversial, partly because for many years European reinsurers were completely unregulated in Europe but were heavily regulated in the United States, beginning with a significant collateral requirement.

Finding

- The fact that CBL could operate as a reinsurer in Europe and write so much business in France without a local licence and therefore without any local supervisory scrutiny in France is a regulatory gap. This situation created additional regulatory risk for the Bank without the Bank having any obvious way of mitigating the risk, short of precluding the insurer from carrying on the offshore business as a condition of its New Zealand licence or taking a far more intrusive approach to supervising the offshore business.

8.4. CBL's offshore business: the risk level

Reliance by CBL on underwriting agents in France has to contribute risk. Underwriting agents add specialist market knowledge and understanding but at the same time they usually have incentives to grow the business and also to see that it is profitable. Because of the long-tail, however, everyone is working on speculation as to the eventual profit outcomes - see previous chapter - so the precise nature of the underwriting agency agreements will determine whether financial incentives for the agents are aligned or in conflict with CBL's interests. Special care is needed here because of the potential for conflicts of interest.

By way of example, French and other European-licensed insurers needed to follow French regulations regarding claims reserving. Firstly CBL argued to the Bank that, because it was not licensed in France, it was not obliged to follow these conventions or regulations and secondly, the CBL Appointed Actuary, although aware of these regulations and free to consider applying them, did not follow them and did not refer to them in his FCRs. This approach of appearing to disregard foreign regulatory requirements, even if not directly applicable, without analysis or explanation should have been regarded by the Bank

as a topic to be pursued fully so as to understand the level of risk associated with this approach from a solvency and capital management perspective.

Although the obligatory nature of the French code changed from 2016, as a result of EU regulatory changes, the validity or usefulness of the code has continued to be endorsed by ACPR, the French regulator.

Some of the internal analysis by the Bank at the time of licensing in 2013 drew attention to these risks. Ultimately, however, for licensing purposes the Bank was prepared to rely on a range of explanations and assurances from CBL that it was indeed capable of successfully managing a "unique business model in a niche market" (to quote KPMG's 2013 tagline).

8.5. The Bank's engagement as supervisor with offshore regulators

The Bank could have engaged with offshore regulators at any stage. It chose not to do so, however, until the CBL situation became critical in July 2017 when the Gibraltar FSC became actively involved with the Bank. As explained further below, the Gibraltar FSC contacted the Bank in 2016 with some reserving concerns but the Bank elected not to initiate any subsequent dialogue until 2017.

The international prudential regulator community for insurance has been well established for some years. Its primary mechanism for interactions that include international standards, debate on prudential regulatory and supervisory issues, and other matters is mainly through the auspices of the International Association of Insurance Supervisors (IAIS). Its headquarters are in Basel, Switzerland. The Bank is a member of the IAIS. Also, regarding Europe, EIOPA is now established as an EU-wide regulator – see previous chapter.

That the Bank did not engage with international regulators in respect of CBL before 2017 appears to be because the Bank decided to expend its energies over its concerns about CBL by attempting to influence firstly the approach to be taken by the new Appointed Actuary in 2014 and secondly use by the new Actuary of his firm's international connections to explore CBL's affairs more deeply. That this did not appear to eventuate was unexpected and left the Bank with a dilemma as to how to proceed. Following the efforts by the Bank at resolution of outstanding matters leading up to the IPO of CBL's parent company in 2015, the Bank then appeared to let matters lie during 2016 and until mid-2017 when the Gibraltar FSC intervened in the affairs of Elite Insurance and contacted the Bank about that in June 2017.

It is acknowledged by the Bank that there was some ambivalence within the Bank towards devoting material resources to supervising portfolios that had no connection with New Zealand policyholders. That debate is understandable and might be said to be consistent with the principles to be considered when making decisions under the Act, including where the Bank's resources and priorities should lie. Nevertheless, in deciding to license CBL, the Bank arguably assumed responsibility for supervising the totality of CBL's business, wherever located. It also needed to recognise the emerging risks to New Zealand policyholders if the offshore business were not being operated prudently.

Before June 2017

A previous contact in October 2016 from the Gibraltar FSC, regulator of Elite, raised questions with the Bank on the standing and soundness of CBL. That engagement did not develop as the Bank, while acknowledging that it regarded claims reserving as an important risk issue, indicated no major concerns to the Gibraltar FSC about CBL at that time. Active engagement did not occur until June 2017, when the Gibraltar FSC raised questions about CBL again and notified the Bank that it had appointed

PwC UK to undertake an investigation into Elite's claims reserves (noting that CBL reinsured some 80% of Elite's business in France).

The hesitation of the Bank to make contact and initiate dialogue with one or more European regulators can now be seen, especially with hindsight, as a significant omission that should have been seen as such as early as 2014. Further, when the new PwC Appointed Actuary's first FCR of April 2015 made reference to information from France but dismissed it as unhelpful and decided instead to rely on CBL's data and management input about its business, the Bank had even more reason to consult European regulators.

In summary, it had always been open to the Bank to discuss the CBL position with other regulators, especially as the Bank was not receiving the information and assessment it expected from both the Appointed Actuary and the insurer in its attempts to delve more deeply into CBL's affairs, and particularly its French insurance exposures, as early as 2014. Hence there was good reason for the Bank to do so well before 2017, given the scale and scope of CBL's international operations and its specialty reinsurance exposures.

Findings

- With CBL not being regulated in France and not being part of the established market, it is an oversight that the Bank did not follow up assiduously after licensing by consulting with either the French regulator or alternatively an independent expert in that market.
- While one can only speculate on what would have or might have occurred otherwise, some of the possibilities are:
 - earlier awareness of the French reserving code for the DO and DL business;
 - earlier knowledge of the financial results of CBL's ceding companies and of their competitors in the French market;
 - earlier opportunity to obtain 'the other side of the story', as the Bank believed it had been obliged to rely on information supplied by CBL and its Appointed Actuary, which stretched credulity (loss ratios under 40%, expense rates around 30%– 40% and high profit margins at the same time as significant growth); or
 - most significantly, awareness of the concerns of other regulators as soon as those concerns emerged.

After June 2017

Once dialogue commenced with the Gibraltar FSC in June 2017, telephone meetings and some other interactions with the European regulators quickly escalated to active and frequent dialogue and exchanges of information.

It took the Bank some time to 'get its eye in' on these international connections in 2017 and its role as the lead regulator. The matter was also complicated by the fact that CBL was reinsurer to ceding companies and the other regulators were concerned in the first instance with these ceding companies and not with CBL itself.

In any event, we see that, from June 2017, the Bank did accept international responsibility for the supervision of CBL and the impact on it of all of its tentacles.

Recommendation

The Bank should maintain its international regulator connections and continue to participate when appropriate as lead regulator or home regulator for New Zealand-licensed insurers operating offshore and offshore insurers licensed in New Zealand respectively.

Chapter 9: The Appointed Actuary Regime and CBL

9.1. The actuarial role – general

As explained in Chapter 3 (principles of prudential regulation), it is valid for the Act to require an insurer to appoint an actuary whose primary task relates to measurement of solvency. The task requires firstly an assessment of the **actual capital** of the company, being assets less liabilities properly measured. The Solvency Standard refers to this figure as the Actual Solvency Capital.

The adequacy of this Actual Solvency Capital then needs to be assessed against solvency requirements specified by the Bank as representing the **minimum required capital**. The Solvency Standard refers to this figure as the Minimum Solvency Capital.

In principle, capital adequacy is a measure of whether the Actual Solvency Capital exceeds the Minimum Solvency Capital and, if so, by what margin (**the solvency margin**).

Under the Act and the Solvency Standard, the ‘Appointed Actuary’ is the person who has the responsibility for performing or reviewing all aspects of the solvency margin calculations to ensure they are complete and accurate.

The above statements are made here simply to reiterate the relevance and importance of actuarial involvement in the financial affairs of an insurance company. As noted at the end of Chapter 3, the CBL case has brought to light three material issues that need to be reconsidered in relation to regulatory effectiveness; one of those issues is the degree of deference by the Bank to the Appointed Actuary’s opinions, as understood by the Bank at the relevant time.

This level of deference to the advice of the Appointed Actuary and associated questions is explained below, followed by a description and evaluation of what occurred in the CBL case.

NB: Some parts of this chapter repeat some material from Chapter 5 on CBL’s solvency. In Chapter 5, the emphasis was on solvency, whereas in this chapter it is on the role of the Appointed Actuary and on the interactions between the Bank and CBL’s Appointed Actuaries.

9.2. Formal role of the Appointed Actuary

By way of summary, it appears that, under the Act and the Solvency Standard as presently written and interpreted by the Bank:

- the insurer appoints the Appointed Actuary and the Appointed Actuary is responsible to the Board for ensuring his or her calculations on solvency are complete and accurate;
- the Solvency Standard gives the Appointed Actuary considerable authority when exercising his or her judgement in determining the insurance liabilities (premiums and claims) and the solvency margin; and
- the insurer is effectively obliged to accept the Appointed Actuary’s opinion on the solvency margin and certain other matters.

Under the Solvency Standard the Appointed Actuary has the responsibility for determining aspects of the insurance liabilities (premiums and claims) and the solvency margin. The Bank's view in 2014 was that this legislated responsibility created difficulties for the Bank, if it has any concerns about an insurer's claims reserves or solvency margin, because it limits the Bank's ability to impose a different opinion on solvency.

This summary is elaborated below.

Under the Act and the Solvency Standard, the Appointed Actuary has considerable responsibility and authority

The Act requires the Appointed Actuary to review all the "actuarial information" in accordance with the Solvency Standard and report as to whether, "in the Appointed Actuary's opinion and from an actuarial perspective", the insurer is maintaining the solvency margin condition of its licence. The obligations of the Appointed Actuary are set out in more detail in part 5 of the Solvency Standard, which is secondary legislation under s 55 of the Act.

The role of the Appointed Actuary is one where the holder is expected to bring his/her experience, expertise, professionalism, judgment and knowledge of the business of the insurer to bear in determining matters relevant to the solvency of the insured. He or she will use other experts wherever necessary. It is clearly important that the Appointed Actuary take an independent and objective approach to the task, which is critical to whether the Bank can ascertain if the insurer is complying with the Solvency Standard.

The importance of the role is supported by the centrality of the solvency margin to the prudential regime.

The centrality of the solvency margin to the prudential regime is important to understanding the Appointed Actuary's role

The importance of the solvency margin is seen in the scheme and provisions of the Act. For example:

- To obtain a licence, an insurer must satisfy the Bank that it holds and has the ability to maintain a minimum amount of capital that is specified in the Solvency Standard. The maintenance of the solvency margin is a condition of the licence.
- There are obligations on the insurer, the Appointed Actuary and the insurer's auditors to report to the Bank if they have reasonable grounds to believe that a failure to maintain a solvency margin is likely to occur at any time within the next 3 years.
- Reasonable cause to suspect failure (or likely failure) to maintain the solvency margin is a basis for various escalations under the Act, for example investigations under s 130, the requirement for a recovery plan under s 138, directions including to cease to carry on business in accordance with the direction under ss 143 and 145. Failing to maintain solvency is a ground for application by the Bank for liquidation of the insurer under s 151.

Thus, many of the prudential functions and powers of the Bank depend, at least in part, on its understanding of the insurer's solvency margin.

The relationship between the Board and the Appointed Actuary

The insurer appoints the Appointed Actuary under s 76 of the Act. The Solvency Standard provides that the Appointed Actuary is responsible to the insurer for performing or reviewing all aspects of the solvency margin calculations to ensure they are complete and accurate. The insurer remains responsible for meeting the licence conditions, including the solvency margin. Thus, the Board is responsible for ensuring the Solvency Standard is met.

Para 112 of the Solvency Standard recognises that a Board may adopt a policy of accepting the advice of the Appointed Actuary in relation to the solvency margin and certain other matters. There are also some provisions, such as para 42, which require the Board to follow the Appointed Actuary's advice on matters relating to business with long term characteristics. That provision recognises that the Appointed Actuary, having considered the significance of the risk and the materiality of the business, may judge that no adjustments are needed. This is a good example of the type of assessment by the Appointed Actuary (that no adjustments are needed) that the Bank identified as difficult to challenge.

Some provisions appear to put the obligation on the Appointed Actuary to decide on matters relevant to the insurer's insurance liabilities and the solvency margin. Examples are paragraphs 117 (relating to the liability adequacy test) and 120 (relating to solvency margin calculations).

It appeared to the Bank in 2014 that, under the Act and the Solvency Standard as presently written, the Bank may be obliged to accept the company's figures to the extent they incorporate the expert opinions of the Appointed Actuary on matters specifically assigned to the Appointed Actuary in the Solvency Standard. This was the legal advice to the Bank in 2014.

We note incidentally that we have found no records at the Bank that communicate this understanding or view about the standing of the Appointed Actuary's advice to CBL or its Appointed Actuary.

What if the Bank has concerns about aspects of the Appointed Actuary's advice?

Such concerns arose in the CBL case as described in Chapter 5: the Bank concluded, on the basis of legal advice, that even if it imposed an independent investigation on CBL, the Bank could not use the results to circumvent the advice of the Appointed Actuary on matters where the Solvency Standard gave the Appointed Actuary the authority and responsibility to make the determination.

We find it difficult to accept that the effect of the Solvency Standard is to create a situation where the insurer, via the opinions of the Appointed Actuary, is in an unchallengeable position in relation to the determination of the solvency margin and certain other matters. In our view it would frustrate a central purpose of the Act if the Bank could not examine and challenge opinions as to solvency and their basis, including expert opinion inputs from the Appointed Actuary.

We note the Appointed Actuary's opinions may be tested, for example, by requiring further information, and/or having information reconsidered by someone else. In this way the Appointed Actuary's views are subject to review and dispute in appropriate cases. Discussion may achieve a resolution. We note this was also the legal advice to the Bank in 2014. Concern was expressed that, if the Appointed Actuary did not accept an alternative view, then a stalemate would result. However, an alternative independent actuarial view that is not accepted by the insurer may nevertheless give the Bank proper cause to take further regulatory action, such as to issue directions that limit the activities of the insurer. In such cases it is foreseeable that action based on the different actuarial views held by the Bank may be challenged by way of judicial review. The Bank would need to have clearly articulated reasons for taking a different view from an Appointed Actuary and its position should be sufficiently robust to withstand judicial review.

For the purposes of this Review, we note that the Bank's legal advice in 2014 was that, on particular matters of informed, expert opinion and judgment under the Solvency Standard, the Appointed Actuary's opinions would have primacy over alternate views. However, it was recognised that that did not prevent the seeking of further information to test those opinions.

We acknowledge that the question of whether, under the Solvency Standard, the Appointed Actuary's views have primacy over other views is a difficult one but not one we consider necessary or appropriate to try to resolve here. Save to say that we consider that notwithstanding this view, there were a range of options open to the Bank in 2014 to 2016 which it did not pursue. However, in 2017 it did, quite properly, take decisive action, without apparent concern to any obstacle that the primacy of the views of the Appointed Actuary might raise. We note its means of doing so were to rely on CBL carrying on business in an imprudent manner rather than failing to maintain the required solvency margin, as the appropriate statutory threshold.

The question of possible bias

The introduction of the Appointed Actuary role within the Act was a major step forward from the historical position before the Act. This statutory role was introduced in the expectation that all Appointed Actuaries would have the independence or impartiality and also the experience and competence to make sound and proper assessments of liabilities and hence the solvency margin. For the Appointed Actuary role to be effective, it is important that the Bank can rely on every Appointed Actuary meeting these criteria.

The Appointed Actuary is, in some respects, the agent, in the sense of being required professionally to be impartial, of both the insurer's board and the Bank in assessing the financial condition of the insurer. Both parties need to be able to rely on the Appointed Actuary's impartiality and competence in undertaking this role.

This situation is not always straightforward for the Appointed Actuary because:

- not all executives and boards are above attempting to influence or persuade the Appointed Actuary to produce numbers that suit the insurer;
- not all actuaries are immune from this influence; and
- not all actuaries are adequately experienced and competent to accept and discharge the responsibilities of an Appointed Actuary.

These factors indicate the importance of the selection of appointed actuaries through the fit and proper process and the monitoring of their performance (as part of the processes for directors and senior executives – see further in Chapter 13 on Governance).

We note too that the board and management of any insurer have a natural short-term conflict of interest in these situations and it is a responsibility of the Appointed Actuary to stand against that conflict and to avoid becoming complicit in it. The conflict arises because any increases in the claims reserves cause a reduction in profit which is not only uncomfortable for shareholders but also, especially for listed companies, suggests financial under-performance. In other words, it is usually in the interests of the board to see the claims reserves at a level with which they are comfortable and that might be a lower number than is being advised by the Appointed Actuary.

While reliance on actuarial advice is common and indeed wise, some checks and balances are usually applied when there is an actuary appointed by the insurer. Some examples, which are not all mutually exclusive, are:

- requiring peer review—internal or external—either as a matter of course or else only in cases where the regulator calls for it;
- using the Appointed Actuary's results as advice to the board or management, in which case the board or management can diverge from the actuary's advice but would be obliged to explain to the regulator any decisions taken that do not accord with that advice;
- giving the regulator the right to call for a second opinion and/or obliging the insurer to set different reserves from those advised by the Appointed Actuary in appropriate circumstances; and
- specifying a set of stress tests and requiring the Appointed Actuary to apply them so that the regulator can use them in examining and consulting with the Appointed Actuary and the board on the financial and solvency risks of the insurer.

Some of these ideas are aimed at protecting or strengthening the independence of the Appointed Actuary, while others constitute ways to challenge his or her findings if the insurer or the Bank has any doubts about the quality or scope of the Appointed Actuary's advice.

Challenging the Appointed Actuary's advice

There needs to be an effective method by which the Bank can challenge the Appointed Actuary's views in the event that the Bank suspects that the Appointed Actuary or the board is not operating effectively and/or with full competence.

The need for an effective form of challenge is heightened in a situation where there are doubts about any aspect of the insurer's operations that may affect its ability to meet its promises to policyholders (including claimants). It is further emphasised if there are any concerns for the Bank about whether the board is attempting to influence the Appointed Actuary's advice. The need is also evident if there are any doubts about the genuineness of the Appointed Actuary's impartiality, independence and/or competence when preparing his or her professional advice.

Findings

- The role of the Appointed Actuary in establishing an insurer's solvency margin is central to the prudential regime and it is valuable. The degree of deference, however, that the Bank considers must to be given to the Appointed Actuary's advice by the Solvency Standard is unhelpful in cases where the Bank has concerns over the Appointed Actuary's numbers.
- In practice, where the Solvency Standard allocates the responsibility of determining certain matters to the Appointed Actuary, the Appointed Actuary's advice was believed by the Bank to be unchallengeable and hence a regulatory barrier to be overcome for the Bank.
- We are not convinced of the correctness of this point but in any event we note that, although there are avenues under the Act to challenge the Appointed Actuary's opinion, they can be difficult to apply in practice.

Recommendations – expectations of the Bank

We recommend that -

- The Bank make clear its expectations of Appointed Actuaries, especially in situations where it has doubts about a company's reserves or solvency and, if its expectations are not met when advice or reports are received, it should follow up assiduously and take action according to its assessment of the circumstances at the time.
- The Bank also make clear its expectations of insurer boards regarding risks around claims reserves and solvency, standing firmly on a cautious position until all doubts are resolved.
- In cases where there are doubts or warning signals, the Bank, as supervisor, act on its concerns while looking for clarity and not wait for clarity before acting.

Recommendations – The Appointed Actuary and the Solvency Standard

- We recommend that the perceived barriers to challenging the authority of the Appointed Actuary be reviewed and clarified, and ensure the Bank has the power by amendment to the Solvency Standard or, if necessary, to the Act to impose an alternative opinion of claims reserves or solvency margin on an insurer.
- We go no further at this stage, however, in view of the recommendations made in Chapter 11 about modifying the overall structure of the solvency regime for licensed general insurers.

9.3. CBL as a case study for the Appointed Actuary role

It is not our role to inquire into or opine upon the adequacy of work of the three Appointed Actuaries in relation to CBL. However, a key aspect of our assessment of the Bank's efforts was that at times it did not press the Board of CBL on the validity of its concerns, particularly in relation to claims reserving, and did not convey its concerns directly to the Appointed Actuary. This limited communication is an important aspect of the prudential supervision of CBL over the relevant period.

We propose to consider several aspects: the nature of the Bank's concerns, what it did and did not do in relation to those concerns, how effective its actions were and whether the action or lack of action was appropriate given those concerns.

Pre licensing and KPMG's advice in 2013 on claims reserving

Questions arose in 2012 and 2013, during licensing, about CBL's insurance reserves and solvency as determined by the Appointed Actuary at the time. The Bank was uncomfortable with CBL's insurance reserves and hence had questions about its solvency. The questions and the discomfort contributed towards the commissioning of the KPMG report at that time.

The advice contained in the KPMG report quoted below forms the starting point of the Bank's (and our) understanding of the claims reserving position at CBL. The KPMG summary was -

We have examined the data and assumptions used in setting loss ratio assumptions for reserving. The evidence used to support the selection of loss ratios is limited.

The adoption of actual versus expected analysis and engagement of local market expertise in the countries where CBL has significant business (that can provide market benchmarks and challenge assumptions) will strengthen this process considerably.

The documentation supporting the selection of risk margins applied to central estimate loss ratios is limited.

The full KPMG statement follows –

Obtained evidence to support the selection of loss ratios

- For DO and DL business, evidence used is limited. While recognising this business began to be written in 2006 the majority has been written in the last three years, necessitating external benchmarks. References have been provided to specific industry websites. KPMG France has confirmed that the websites themselves contain no obvious data that would support the setting of specific valuation assumptions (except for incidence rates), but that, from time to time, these industries may provide data. CBL noted that they received claims data from Alpha for example, however no further detail was provided.
- It is not clear that the business or Appointed Actuary (AA) have access to or have referenced benchmark information for the various international portfolios. Benchmarking is particularly valuable, and important for new lines of business and for small portfolios where the insurer's experience can be volatile and inconclusive as to reserving trends. Research into local conditions appear to be inhibited by a valuation process that is constrained to New Zealand. For example, we understand that for insurers based within France there is a minimum reserving basis for DO business and that it is common for quota share reinsurers to follow the reserving basis of the insurer. Given the niche position CBL has in this market the reserving basis applied by French insurers may or may not be an appropriate benchmark. CBL confirmed that this basis does not apply to Alpha. That the minimum reserving basis for French DO insurers did not seem to be within the knowledge base of the business or the AA before our discussions is an illustration of the increased difficulties in maintaining relevant market knowledge from the New Zealand base. Going forward, there is merit in examining the cost benefit of involving international actuarial expertise for material international operations to support the management of reserving and underwriting risk.
- The valuation report does not set out the data used. Noting the discussion in the two dot points above, it will [sic] beneficial going forward for the valuation report to confirm the data, including benchmarks, referenced by the AA.
- It is clear that the AA has worked closely with management in setting reserving assumptions. There is little variance in assumptions from those used in underwriting and internal monitoring. The process of review, challenge and reliance, where made by the AA, has little documentation. Variation from underwriting input is limited. Typically we would expect some variation from the internal and external view indicating a degree of challenge and the incorporation (as regards the comparison of underwriting and claims assumptions) of the influence of claims experience to date.
- Claims documents provided to the AA do not show market loss ratios for DO and DL which have tracked at a significantly higher rate than those assumed by CBL. This reflects CBL's view that these market loss rates are not an appropriate benchmark for the niche CBL operate in.

- Accordingly claims development patterns (where used), ultimate loss ratio assumptions and recovery rates have been based off a very limited dataset.
- The documentation supporting the selection of risk margins applied to central estimate loss ratios is limited.

This input from KPMG was a major alert at the time to the then Appointed Actuary, to CBL and to the Bank. While there were other parts of the report that caught the attention of the Bank, this segment on claims reserving appears to have been the most potent and in our view was highly significant.

First FCR and solvency return in 2014 and initial follow-up on licensing concerns

Analysis of the first solvency return following licensing, received in June 2014 for December 2013, led to serious doubts within the Bank over CBL's solvency but internal efforts to thoroughly investigate CBL's position were not fruitful:

- In his 2013 FCR, the Appointed Actuary recommended, among other things, that CBL should operate to a solvency ratio of at least 150% and work towards a target of 200% (against a statutory minimum of 100%).
- Internal Bank actuarial advice also proposed, among other things, an increase in CBL's required solvency ratio (and added the suggestion, as an example, that it be 150% to 200%).
- The Bank took no direct action on the internal actuarial advice but instead tried, unsuccessfully, to arrange an independent actuarial investigation of CBL's solvency. At this time, CBL was standing firm on the Appointed Actuary's assessment of its insurance liabilities and solvency margin.
- One significant reason that the Bank was unsuccessful is that it believed, on the basis of legal advice, that its ability to circumvent the advice of the Appointed Actuary was limited even if it had alternative advice that was different.

The position to September 2014

In 2014, after the KPMG report had been prepared and the Appointed Actuary at the time had reconsidered his earlier advice in the face of both the KPMG report and questions from the Bank, the position from the Bank's perspective was:

- The Appointed Actuary, in presenting his December 2013 FCR in June 2014:
 - noted the risks associated with CBL's rapid growth, the uncertainties over claims reserves and other factors;
 - recommended that, although the Solvency Standard required a minimum solvency margin of 100%, CBL should operate to at least 150% with a target of 200%; and
 - commented on his need to be more closely involved in matters of capital management and dividend decisions before commitments were made by the Board.

This written advice from the Appointed Actuary was highly significant. Furthermore its wording might suggest some tension and areas of disagreement between the Actuary and CBL that should have been followed up by the Bank.

- In August 2014, an internal Bank actuarial report concluded that CBL was unlikely to be meeting the solvency requirement. In that report, the uncertainties and concerns expressed by the Appointed Actuary in his FCR were acknowledged but there were additional concerns expressed about the loss ratios applied by the Appointed Actuary that were perceived to be unrealistically low (and hence also unrealistic profit numbers).
- In September 2014, the Bank wrote to CBL enumerating its concerns about its solvency. CBL expressed disagreement with the Bank's view of solvency.

Before any action could be taken by the Bank, in the third quarter of 2014 the Appointed Actuary's role with CBL ceased.

Internal work at the Bank continued on CBL's solvency as the Bank had received, in November 2014, the June 2014 solvency return. The internal work was completed in March 2015. This June 2014 return gave little comfort to the Bank, and its internal advice essentially reiterated all the same concerns as were held about the December 2013 solvency return.

The position in late 2014 and 2015 first half – with a new Appointed Actuary

When, in September 2014, a PwC actuary succeeded the previous Appointed Actuary, a sole practitioner, initial meetings between him and Bank staff gave promise of deeper and more thorough analysis and more comprehensive reporting of CBL's liabilities and financial condition.

The Bank considered there were a number of shortcomings in the work of the previous Appointed Actuary, being the perceived lack of independent analysis and his perceived acceptance of the loss ratios and other claims-related information supplied by CBL. Information presented by CBL had been relied upon heavily by the Appointed Actuary in determining assumptions and deriving figures for claims liabilities.

There was an expectation by the Bank that the change of Appointed Actuary, from a local sole practitioner to a major firm, with greater resources and ready access to international capabilities, could and would see the Appointed Actuary delve more deeply into the claims experience and examine it more widely. The new Appointed Actuary might be expected to deliver analysis and results that would give greater confidence to CBL and the Bank as to the adequacy of the claims reserves.

As a result of this expectation, rather than take any alternative action, the Bank decided to wait for actuarial reports as at December 2014 despite its anxiety about CBL's solvency.

The Bank did take one further step to respond to its continuing concerns: it issued a s 121 notice that required an LVR to be completed and provided to the Bank by 15 April 2015, and the FCR and solvency return to be completed early, also by 15 April 2015.

This decision effectively gave CBL a further four to six months to respond to the Bank's solvency concerns. During that time the Bank met with CBL and the Appointed Actuary to emphasise its concerns.

We consider this expectation by the Bank of more comprehensive and internationally supported analysis by the new Appointed Actuary to be entirely reasonable and it was important. But the Bank did not consider it was realised.

The Bank found that CBL's own loss ratios, recovery rates and expense rates from earlier years continued to be used in the main by the new Appointed Actuary. There was no evidence in the

Appointed Actuary's FCRs or LVRs of consultation with international PwC expertise or other experts in liability assessments for the French portfolios of CBL (although he did seek out some market data which he dismissed as unhelpful – "high level" and "out of date" - and provided a chart showing some industry loss ratios accompanied by a CBL statement, not verified or tested by the Actuary, as to why CBL experience will be superior to the market), and no indication of material additional reserving margins to take account of the risks and uncertainties in the CBL portfolios. This was the case notwithstanding the rapid growth of the portfolios and the lack of familiarity of the Appointed Actuary with French DO and DL business. Instead, as far as the Bank could tell, he continued to rely solely on information and advice supplied by CBL management. The reporting in both the LVRs and the FCRs was more extensive, yet while the 2014 LVR suggested some areas where claims reserves might be increased, no increases were recommended.

To put this situation in perspective, we can observe that loss ratios used by the Appointed Actuary each year to 2016 were generally less than 40%. Yet in KPMG's 2013 report there is an appendix from the FSSA (French Federation of Insurance Companies) with claims development tables showing ultimate loss ratios approaching or exceeding 100%. This difference was stark and, even if CBL's French portfolios were clearly superior to the rest of the market, such a huge difference in loss ratios was not credible without supporting analytical information and explanation. The Bank assumed, and it appeared to be the case, that this approach was the result of reliance by the Appointed Actuary on CBL input. There is nothing in the 2014, 2015 or 2016 LVRs that indicates any materially different approach to establishing claims reserves, whether in the scope of the data collected, the depth of analysis or the assumptions used.

A technical limitation may be the availability of adequate reliable data but, when that is the case, the actuary is expected to explain the problem fully in his work and either allow in some way for the data problems, for example by adding an extra risk margin, advocating a higher solvency margin or, in some cases, refusing to carry out the valuation pending better data or better knowledge about the limitations.

Hence the Bank considered there to be very limited independent examination or research by the Appointed Actuary into the appropriateness of the main valuation parameters. It should have pursued these points with the Appointed Actuary.

The consequences of the above can be seen as central to the supervisory difficulties that the Bank has had with CBL. During the PwC Appointed Actuary period, it appears that there was considerable debate within the Bank as to whether the work was genuinely independent and well founded. At the same time there is no evidence that the Bank pursued this question directly with the Appointed Actuary, which it should have done. Yet until 2017, when international regulators began raising questions, the Bank found itself reluctant, owing mainly to perceived regulatory impediments, some uncertainties about the CBL numbers and other priorities, to take action on its questions.

This situation demonstrated again the difficulty of the Bank's belief that it had to defer to the Appointed Actuary for claims reserving and solvency assessment. Now the Bank was no further advanced than it had been in August 2014, when it already had serious concerns about CBL solvency.

The position in 2016

There was limited interaction with CBL in 2016 compared with previous years, in the aftermath of the IPO which raised additional capital for CBL Corporation. There was, however, dialogue on reserving in October 2016 regarding the French reserving code with questions asked by the Bank about this code and the Appointed Actuary's approach to this code. The questions arose after discussions between the Bank and the Gibraltar FSC regarding Elite's reserves.

As noted in Chapter 5, the Actuary was not applying this code or considering it but agreed to explore it further as part of the review he had undertaken to make that year of reserving methodologies for CBL's French portfolio.

The Appointed Actuary strengthens claims reserves greatly for 2017

As noted in Chapter 7, in March 2018 the Appointed Actuary submitted his December 2017 LVR which detailed substantially increased reserves and showed CBL as insolvent at 31 December 2017. The opening paragraph of his Executive Summary stated –

“The net outstanding claims provision for CBL Insurance Ltd (CBL Insurance) has increased by \$144.1m to \$341.2 million in the half year to 31 December 2017. The major reason for the increase was a significant strengthening in loss ratios on the French construction business after substantially revised historical data was obtained and cleansed, which, compared to previous valuations, revealed claims are developing for longer and at a higher average amount than previously anticipated.”

The increased reserves resulted in CBL's solvency ratio showing as 29% at 31 December 2017 with Actual Solvency Capital of \$44m, which was \$108m below the Minimum Solvency Capital of \$152m.

Later, in the FCR submitted in June 2018, these figures were further revised to show a Minimum Solvency Capital of \$181m so the Actual Solvency Capital of \$44m was now short by \$137m.

The shortfall estimated at \$181m was against the original 100% requirement. Under the revised 170% requirement, however, the Minimum Solvency Capital became \$308m, yielding a shortfall of \$214m.

The shortfall would have accrued progressively over previous years.

These results show two things. One is a dramatic change in the financial position of CBL, discussed further below, and the other a major shift in the assessment by the Appointed Actuary away from his position of previous years.

Noting that CBL was already in interim liquidation when these assessments were made, on page 5 of the 2017 FCR the Appointed Actuary states:

“CBL Insurance's financial difficulties have stemmed from significant reserve strengthening on the French construction business primarily with Elite and, to a lesser extent, Alpha and CBLIE.”

On pages 7 and 8 of the FCR, he concludes:

“CBL insurance has had a severe deterioration in its financial circumstances following a significant reserve strengthening on its French construction business and the impact of intervention from regulators, both in Europe and here in New Zealand. CBL Insurance does not meet the solvency margin required by the Reserve Bank.

“As a result we reported to the Reserve Bank in November 2017 that CBL Insurance was unlikely to maintain the required solvency ratio continuously over the next three years. In February 2018, we further reported that CBL Insurance was failing to maintain a 100% solvency ratio based on the actual December 2017 solvency position.”

The quote above from the LVR attributes the revised assessment to the availability of substantially improved data in the second half of 2017. Two questions arise relevant to our review -

- Why did it appear that the Appointed Actuary did not press for and obtain this kind of data much earlier, whether by his own initiative or under encouragement or direction from the Bank? and, in response,
- Why did the Bank not respond earlier to the repeated qualifications in the Appointed Actuaries' reports regarding data shortcomings by insisting that the Actuary and the company resolve the shortcomings?

The quoted statements above are important because they demonstrate firstly that CBL's difficulties were only visible to the company for the first time through the reserve strengthening on the French construction business in 2017. Secondly, they represent a belated recognition by the Appointed Actuary of consistent under-reserving and probably under-pricing through all the years that the company wrote French business.

Hence the reserve strengthening was simply the demonstration of emerging and better estimated financial performance, being well below the previously published performance which had hitherto not been visible because of under-reserving.

The "serious deterioration in its financial circumstances" was clearly a reference to the balance sheet position only and not a sudden change in financial circumstances. The financial position had always been less healthy than CBL's accounts had shown each year but the position had simply gone unrecognised by the company from as far back as 2013 or earlier.

We see then that the Appointed Actuaries did not discover the under-reserving until the end of 2017. The Bank, indirectly through the reserves determined by the Appointed Actuaries, and faced with the confidence of CBL and its Appointed Actuaries in the insurer's position, did not elect to use its powers to oblige some form of remedial action within CBL. The Bank had found itself in the difficult position of suspecting but not readily able to confirm its suspicions.

The perception that the Appointed Actuary's advice had primacy under the Solvency Standard contributed to discouraging the Bank from acting more forcefully and more quickly on its solvency concerns and its suspicions about CBL's business from 2014. However we find that the Bank could have and should have done more to test CBL's position.

9.4. Scope of Financial Condition Reports

Under the Solvency Standard, the Appointed Actuary is required to prepare an FCR (paras 125–126). The FCR should provide significant detail as to the Appointed Actuary's understanding of the business and approach to his or her review (for example all assumptions must be detailed and the impact of key sensitivities quantified). The results of the calculation or review of "all aspects of the Solvency Margin calculations" must be documented (para 120), along with a number of other specific matters (paras 121–124). The Appointed Actuary's view of the risks over the next three years must also to be addressed. The insurer is required to provide the Appointed Actuary's FCR to the Bank (para 98(d)).

The FCR is a relatively new concept (of the last 20 years in general insurance and pioneered in Australia), but LVRs have been around for many decades.

The introduction of FCRs is usually designed to give board and management an annual overview of the financial condition of the company, as their name suggests, and in doing so also to give the regulator valuable information. The FCR will draw on the valuation report and, using its results and other data to analyse such matters as company profits (bearing in mind that the valuation report and solvency calculations deal only with balance sheet items), expense rates, reinsurance arrangements, changes to business mix and volumes, risk issues and so on.

The FCR would usually contain a set of recommendations that the board should consider in preparing business plans and strategy. The CBL FCRs did contain such recommendations. They are not prepared for the regulator but the regulator can use them to test the board on its business plans and its responses to the Appointed Actuary's recommendations.

The Bank considered the CBL FCR from the first Appointed Actuary in 2013 to be limited in scope and requested the new Appointed Actuary for 2014 to extend the reporting. He and his successor did that so there is rather more information in subsequent FCRs. They provided more detail, quantitatively and qualitatively, but the extra detail was essentially a set of descriptions and tables on business written and results from the valuation reports. They also contain numerous qualifications on the limitations of available data and state their reliance on information provided by CBL. They effectively disclaim, however, on industry and external expert information and, given the scope and complexity of the CBL business, they contain very little analysis of such matters as pricing, profitability by year of account, expense structure and other material that could have given the reader insights into the business and how it was developing through its various ceding companies and underwriting agents.

In our view, the Bank could and should have asked for more information, especially given the repeated qualifications on data quality, the apparent lack of meaningful international consultation and the reserving risks that were of concern to the Bank.

In preparing an FCR, it is a matter of discretion and judgment on the part of the Appointed Actuary as to how extensive should be the scope of analyses undertaken and also the scope of reporting on these analyses. The Solvency Standard and the Society of Actuaries professional standard specify the scope but the requirements are guidelines and each company's circumstances are different and can change from year to year.

In the CBL case, where the Bank had questions and concerns over reserving and solvency, it was always open to the Bank to call on the Appointed Actuary in any year to extend his analysis or to respond to questions about his FCR. The Bank may or may not think that the Actuary has fully met all the requirements but, for a higher risk insurer such as CBL, the key issue is whether, by the Bank's assessment, all relevant information has been sought by the Actuary, all relevant investigations and analyses have been undertaken and all relevant reporting has been done.

The commentary above is intended to illustrate that there were some gaps from the Bank's viewpoint in the content of the CBL FCRs and also gaps in following up by the Bank with the Appointed Actuary. By our assessment, the CBL FCRs offered limited insights into the insurer's affairs despite more extensive reporting from 2014. While this assessment may be a matter of opinion, in our view, the Bank could have and should have been active in identifying these gaps and asking for more information, especially given the repeated qualifications in the FCRs on data quality and reserving methods, the apparent lack of meaningful international consultation and the reserving and solvency risks that were of concern to the Bank.

Finding

- For CBL, with its fast-growing portfolios, all long-tail and offshore, and writing reinsurance unregulated offshore, we believe there was a pressing need for the Bank to obtain more extensive analysis and understanding of the business than was set out in each year's FCR.
- It can be argued that the Bank should have been questioning the scope and content of each FCR, given CBL's supervisory status as a higher risk insurer. The Bank should have raised a set of pertinent questions each year and should have then insisted that the Appointed Actuary respond to the questions to the satisfaction of the Bank.
- This proposition is not about compliance by the Appointed Actuary with the professional requirements. It is about ensuring the completeness of the Appointed Actuary's work from the Bank's viewpoint and ensuring that both the board and the Bank as regulator gain a full appreciation of the insurer's financial condition. It is also about assisting the Bank to obtain enough information to make its own assessment of the performance and prospects of the insurer without needing to commission extra analysis.

Recommendation

The higher the Bank's risk assessment of an insurer, the more demanding should the Bank be on the depth of information gathering and analysis contained in the liability valuations and the FCRs. For higher risk insurers, the Bank should not only require full compliance from Appointed Actuaries with the Solvency Standard and the Society of Actuaries standards for liability valuations and FCRs but should also consider whether the FCR is complete from the Bank's viewpoint and, if not, to raise questions that will lead to the Bank being satisfied with the information provided.

Chapter 10: Structure and Sufficiency of the Act

10.1. Introduction

Overall we consider the Act is well structured for the purpose of prudential regulation and supervision. It gives the Bank sufficient powers to deal with most circumstances that might be encountered in dealing with insurers that are not operating in a prudent manner, that show some signs of getting into difficulty or are otherwise failing to serve the community in a way that is envisaged by the Act.

There are, however, some gaps that limit the ability of the Bank to carry out its mandate successfully in some circumstances. The gaps are identified below.

10.2. Limited powers to issue standards

The Act gives the Bank the power to issue solvency standards (s 55) that are binding on insurers. They may apply to all, some or only one individual insurer. The Bank must have regard to relevant overseas standards to ensure that the proposed standard does not apply in an unreasonable manner to a particular insurer as compared to others. This appears to envisage that New Zealand regulation should not be significantly out of step with similar regulation overseas.

Section 56 sets out the matters that may be prescribed by solvency standards. It permits a wide range of prescribed standards for matters relating to the financial condition or solvency of the insurer, the disclosure of that information to the Bank and others, and matters relating to the s 77 review of actuarial information.

There are limited other powers, however, to issue standards for prudential purposes. It would be beneficial for the Bank to be able to issue standards for other prudential purposes that do not relate directly to solvency. An important example is governance, for the reasons explained in Chapter 13.

We note there are significant powers to make regulations in s 237. It may be that some matters can be made binding by regulation.

Findings: Regulatory framework

- The regulatory framework for insurers is dominated by the Act and the Solvency Standard. The Bank also has some guidelines that do not have the force of law, the most important of which are the Governance Guidelines and the Risk Management Guidelines.
- The Act restricts the ability of the Bank to issue new standards for prudential purposes.

10.3. Governance

As discussed in Chapter 13, there is no framework for monitoring or enforcing the expectations set out in the Bank's Governance Guidelines, other than the drastic powers to direct officers and employees to step down in certain circumstances (ss 143 and 144(f)) or to remove a director

altogether (ss 39 and 149). We consider this to be a gap in the prudential supervision toolbox. Standards that bind the insurer and thus give the Bank authority to test governance arrangements where appropriate would be the preferable tool in our view. This topic is covered more extensively in Chapter 13.

10.4. Risk Management

We note that an insurer must prepare and comply with (“take all practicable steps”) a risk management programme for its particular business (s 73). This covers procedures to identify and manage the key risks. It is an offence to fail to comply with s 73.

We understand that CBL’s programme did not feature in the regulatory action by the Bank beyond a “Risk governance review – final feedback letter” to the insurer in December 2014.

The CBL input to the Bank and the Bank’s response seem to indicate a preoccupation on both sides with form (the written risk management material), without the Bank examining or knowing how much substance was behind the documentation.

Risk management and governance are closely linked because effective governance is an essential component of effective risk management. The Bank has a set of Risk Management Guidelines for licensed insurers. They have some regulatory force, in contrast to the Governance Guidelines, but that force is expressed obscurely in s 73 of the Act and it is not clear how comprehensive are the Bank’s powers on risk management.

The Guidelines themselves contain a wide range of provisions and principles that insurers are encouraged to follow and, if applied conscientiously by insurers, would represent an extensive risk management programme.

Recommendation

- We recommend that the powers of the Bank to issue prudential standards and regulations under the Act be reviewed in order to allow the Bank to extend or modify its prudential requirements of insurers in appropriate circumstances including changing business practices within the insurance industry and changing international regulatory developments.
- We further recommend that the Bank’s ability to issue additional prudential standards be extended to cover, as a minimum, standards for governance and clearer powers over standards for risk management

10.5. Group regulation and supervision

In 2008 and 2009, when the policy behind the Act was being formulated, group regulation and supervision was a relatively new topic across the international regulatory community. However, in the decade since, it has become well established—and for good reason: if the Bank had had the opportunity from the outset to regulate both the parent company CBL Corporation, as happens in some other jurisdictions, as well as the licensed insurer CBL, a number of benefits would have flowed and may well have given greater protection to policyholders and also to investors.

Licensing of parent holding companies can have the effect of minimising contagion risk to an insurer that is part of a larger corporate group including strengthening its capital position.

The "associated persons" provisions in the Act allow the Bank to demand supply of information from the parent company and from other companies within the group that owns the licensed insurer. These powers are, however, limited and do not protect against contagion risk.

This topic is covered more extensively in Chapter 14.

10.6. Power to direct restriction or cessation of business

As noted in Chapter 6, options for the Bank to restrict or prevent an insurer writing business are dealt with in s 144(1)(b) which empowers it to require a licensed insurer to "cease entering into new contracts of insurance". However, s 144(2) excludes the renewal of pre-existing contracts from that power.

We regard this restriction on the Bank as a flaw in the Act. One of the first steps that is normally available to and initiated by the regulator in situations like CBL's in 2017 — of questionable ability of a company to survive and maintain solvency — is to prevent it writing any further business, whether new business or renewals. See, for example, the much broader powers of APRA in s 104(3) of the Insurance Act 1973 (Aus).

There are circumstances where it may be inappropriate for a distressed insurer to cancel or fail to renew a policy. It may be disadvantageous to the policyholder in some situations (for example some guaranteed renewable life insurance policies). There may also be other contractual conditions that need to be considered, such as reinsurance arrangements (and they may have become relevant in the CBL case if the Bank had attempted to direct CBL to accept no new exposures).

Finding: Restriction of business

- The current restriction in s 144(2), which limits the Bank's power to require a licensed insurer to "cease entering into new contracts of insurance" by excluding the renewal of pre-existing contracts from that power, is unqualified and is not, in our view, an appropriate restriction on the Bank.

Recommendation

We recommend that the exclusion of the renewal of pre-existing contracts in s 144(2) from the Bank's power to direct an insurer to cease writing business be amended or deleted so as to give the Bank appropriate powers to limit the exposure of distressed insurers.

Chapter 11: Solvency Standard: Scope and Structure

11.1. Introduction

The Solvency Standard is issued pursuant to s 55 of the Act and gives the Bank wide powers to determine its details.

The Solvency Standard is a comprehensive document that specifies in good detail many aspects of the financial management of an insurer that are provided for in the Act.

The primary function of the Standard is to set out the rules and arrangements for an insurer to assess its Actual Solvency Capital and its Minimum Solvency Capital. The insurer's solvency margin is the difference between the two (a dollar amount) and the solvency ratio is the ratio of the ASC to the MSC (a percentage) - see also Chapter 3.

When the ASC is equal to the MSC, the solvency margin is zero and the solvency ratio is 100%. The Standard requires insurers to maintain a positive solvency margin or, equivalently, a solvency ratio of at least 100% at all times. In s 24, the Act provides that an insurer must notify the Bank if it believes that solvency will fall below the minimum at any time in the next three years.

The Standard deals at length and in valuable detail with such matters as the role and obligations of both the Appointed Actuary and the insurer, the reporting requirements within the Appointed Actuary's FCR as well as a full specification of the way that assets and liabilities are to be assessed or measured for solvency purposes.

11.2. Lessons from the CBL case

During the course of this review, we have identified three particular features of the Solvency Standard arising from the CBL case that represent constraints for the Bank in handling the solvency of insurers. They are:

- Some gaps in the specifications of individual asset types and liability measures that can cause "jurisdictional" disputes between insurer and the Bank when measuring solvency.
- The rigid approach to capital adequacy implied by the Standard, whereby a positive solvency margin, or equivalently a solvency ratio of 100% or more, is treated as adequate and a lesser margin or ratio is treated as inadequate.
- A preoccupation by supervisors with the balance sheet of an insurer with limited attention to the revenue account, profitability and pricing matters.

There is also the perception of the primacy of the opinions of the Appointed Actuary as to the solvency margin and certain other matters, resulting in inappropriate deference to his or her advice. This topic is covered separately in Chapter 9.

11.3. The specification gaps for classes of assets and liabilities

The specification gaps were manifested in the various solvency issues identified by the Bank and debated at length with CBL in 2014, 2015 and 2016. See Chapter 5.

An example is the problem of reinsurance collateral, where CBL had deposited funds with Elite in Gibraltar as collateral for claim payments that Elite would make over time and which, for Elite, were in the nature of future reinsurance recoveries.

Initially CBL claimed that the collateral was freely available to CBL at its option to be repatriated to CBL. It was therefore in the nature of a bank deposit, which would attract a capital charge of just 0.5% of its value. The Bank sought evidence of the availability of this collateral and, in the absence of documentation from Elite that fully clarified its status, the Bank claimed a full capital charge of 100% of the value (equivalent to giving no credit to CBL for the collateral amount). Ultimately, in the lead up to the IPO in 2015, both parties accepted a capital charge of 40%.

Whether or not this 40% charge was an appropriate result – and it may have been — we make the following findings:

Findings: Specification gaps

The Solvency Standard was found to be lacking on two counts:

- Firstly, the table of asset charges in the Solvency Standard does not mention reinsurance collateral as an asset type and the conditions that assets of this type must meet under the Standard are not clear.
- Secondly, the Standard does not give the Bank adequate discretion to determine the capital charge in situations such as this one (and there are others), where there may be debate or lack of clarity.

Recommendations

- We recommend that the Solvency Standard and, if necessary, the Act be modified to give the Bank discretion when the capital charge for a particular asset is unclear. It will also be appropriate to review the table of asset charges so that it is more comprehensive in its coverage of asset types.
- Further, in our view the default position in exceptional cases should be that the Bank can take a view, based on assessments that are disclosed to the insurer, and that the Bank's view stands until it is satisfied by the insurer that a different position should be taken.

11.4. A rigid definition of capital adequacy

The “all or nothing” approach to capital adequacy (over 100% is satisfactory, under 100% is not) is not very helpful from a capital management viewpoint. This problem is recognised implicitly in the Act where, under s 55(2), the Bank may set a minimum solvency ratio specifically for one insurer (or even for all insurers) that is higher than 100%. The Bank took this step with CBL in July 2017, when it

mandated a minimum solvency ratio of 170% as an amended condition of its licence. The minimum ratio had previously been the normal industry requirement of 100%. Yet this is still an “all or nothing” approach because the insurer either meets the requirement or it does not meet the requirement. There are no other measures.

Finding: The Solvency Standard measure of solvency is too rigid

- We believe that the approach to capital adequacy represented by the “all or nothing” solvency measure under the Solvency Standard, whereby a solvency ratio above 100% (or any alternative regulated figure) is taken to be adequate and a ratio of less than 100% is taken to be inadequate, is too rigid and should be modified.
- In our view, there is a clear case for a graduated and more flexible approach to determining capital adequacy.

11.5. A desirable alternative

Three highly relevant examples of this kind from other jurisdictions are:

- The European Central Bank (ECB), which has a graduated approach to capital adequacy that it refers to as ICAAP or “Internal Capital Adequacy Assessment Process”.
- The Australian Prudential Regulation Authority (APRA), which operates its own ICAAP that is very similar to the ECB approach.
 - These ICAAP approaches utilise what we might refer to as a “ladder of intervention”, where there is more than one level of capital requirement. The different levels are managed by the company under the supervision of the regulator. Each different level represents a trigger point or point of intervention where the closer the trigger point is to the minimum capital requirement, the greater the level of supervisory intensity or intervention.
 - Note that both the ECB and APRA ICAAP approaches apply equally to banks and insurers (with of course different definitions of capital and points of intervention that are tailored to banks and insurers respectively).
- The Bank itself in respect of licensed banks in New Zealand.

In December 2018, the Bank released a discussion paper entitled “Capital Review Paper 4: How much capital is enough?” This paper describes an approach for New Zealand banks that is similar to the ICAAP approaches referred to above. Relevant extracts from the paper are quoted on the next page. The centrepiece of the proposal is a *prudential capital buffer* that sits above the Minimum Solvency Capital and which itself has some trigger points that are each used to trigger an escalating supervisory response.

In our view, this approach, which is still under development, could be applied to New Zealand-licensed insurers in the same way as for licensed banks. Not only would it be a progressive and valuable development for the capital management of licensed insurers, to create a graduated approach to capital adequacy, but it should also be a very useful piece of harmonisation of regulation and supervision for the Bank across the two industries.

It is noteworthy that each of these three approaches (and they are all conceptually the same) is a blend of regulatory and supervisory requirements that operate in a principles-based environment rather than a prescriptive environment. They place responsibility on the company's board for developing and operating the process subject to approval and regular monitoring by the regulator. In that way, they also contribute to better governance and stronger board accountability for capital management. It is instructive in this context to read the first page of APRA's guidance note on the topic, which is reproduced below as Supplement B to this chapter.

Recommendation

We recommend that the Bank, in working towards its new capital adequacy approach for licensed banks, adapt and apply the same approach for licensed insurers.

11.6. Revenue account to complement balance sheet in understanding solvency

Findings: Revenue account to complement balance sheet in understanding solvency

- Most of the documentation we have seen relating to solvency concentrates exclusively on the balance sheet. Yet s 24(1) of the Act can be used to introduce a dynamic approach to solvency matters. This section states "If a licensed insurer has reasonable grounds to believe that a failure to maintain a solvency margin is likely to occur at any time within the next 3 years, the insurer must report the likely failure to the Bank as soon as is reasonably practicable."
- If business plans for three years are prepared each year along with financial projections of revenue accounts and balance sheets, and they are prepared realistically and professionally, taken together they are likely to enhance the other recommendations above about solvency. They would also give both the company and the Bank valuable insights to the progress of the company and can lead to fruitful discussions about pricing, business strategy, market conditions and other matters.

Explanation

CBL was obliged to report under s 24(1) in November 2017 when it became evident to the company that it would not have a solvency margin at December 2017.

The revenue account, which brings into play pricing and profitability, provides the evidence for where the balance sheet and hence the solvency margin of an insurer are heading. If they are not heading in the right direction, the regulator needs to instigate action by the insurer to minimise the likelihood of losses to existing policyholders and to protect prospective future policyholders from promises that may not be met.

Analysis of financial projections that include revenue accounts, i.e. a dynamic assessment of financial position as distinct from the static position shown in a single balance sheet, is an important tool to use as part of capital management and solvency assessment.

These projections also facilitate the application of stress tests on insurers, where either the insurer or the Bank can nominate the stress assumptions to be applied.

In the CBL case, when the PDS was being prepared in 2015, a request from the Bank to CBL to demonstrate that it would meet solvency requirements over the next 3 years could have generated a valuable dialogue relating to solvency, claims reserves, pricing and the potential for CBL to be making losses not profits in the period ahead.

Consideration of the likelihood and the possible consequences of writing future business at a loss is an important supplement to the examination by the Bank's supervisors of balance sheet integrity and capital adequacy.

Recommendation

We recommend that the Bank monitor as a matter of course each year the preparation by insurers of 3 year business plans and financial projections so as to be satisfied that insurers have prepared the information they need to be satisfied that they are complying with s 24(1), making them available to the Bank on request. These plans and financial projections will provide a valuable adjunct to other capital management tools being used by insurers and assessed by their boards.

Supplement A

“Capital Review Paper 4: How much capital is enough?”

- Released by RBNZ on 14 December 2018
- Quoted extracts relevant to capital adequacy for insurers
- Italics represent our emphasis

Minimum requirements

80. It is important to note that we are proposing a much larger role for prudential capital buffer in this Consultation Paper, compared to the current capital framework. The current framework includes a *capital conservation buffer*, set to 2.5 percent, and *countercyclical capital buffer*, currently set to 0 percent. We are now proposing a *prudential capital buffer* of 10 percentage points.
81. The important change in what we are proposing is in how we allocate the Tier 1 requirement between a regulatory minimum – which if breached means a bank is in breach of its Conditions of Registration – and prudential capital buffer. The consequences of entering into the prudential capital buffer vary in significance because, as will be explained below, we propose *escalating supervisory responses* and dividend restrictions when banks breach the buffer. Entering into the prudential capital buffer would not be a breach of a condition of registration in and of itself.

...

Operational aspects of prudential capital buffer

90. There are important differences between prudential capital buffer requirements and the regulatory minimum capital ratios. Take, for example, the minimum Tier 1 requirement of 6 percent. This is a minimum requirement in that a registered bank will be in breach of its Conditions of Registration if its Tier 1 capital ratio falls below 6 percent of RWA. In contrast, a buffer requirement means banks are expected to be above the buffer level of capital but would not be in breach of its conditions if it were to operate inside it (all else equal), for example following a large loss event.
91. The current capital framework requires banks to maintain a conservation buffer... Banks can enter into this buffer without being in breach of their conditions of registration. However, once in the buffer they face limits on their ability to distribute their earnings, for example through dividends, and must provide a plan for the Reserve Bank’s approval setting out how the bank will rebuild its buffer.
92. A bank will not be in breach of its Conditions of Registration if it enters into our proposed *prudential capital buffer*. However, we propose they will be subject to automatically triggered restrictions on discretionary payments and an increasingly intensive supervisory response (for example, preparation of a capital plan, as is the case with the current conservation buffer). These two policies are quite separate in that they may be triggered at different levels within the prudential buffer.

...

94. The escalating supervisory response (ESR) to a bank entering the prudential buffer will vary depending on the extent to which a bank has entered into the prudential buffer. We are not

yet in a position to consult on a fully developed suite of supervisory responses, but we can illustrate the policy with indicative responses as outlined in Figure 7.

95. An important aspect of the proposed buffer policy is that it complements and coexists with the 'business-as-usual' supervision of banks that is undertaken by the Reserve Bank. It is not a substitute for the monitoring and engagement with banks, supplemented by enforcement action where necessary that we are currently undertaking. However, together with the proposed output floor on IRB models, it should facilitate less detailed scrutiny over risk models, and to some extent may alleviate the need for the Reserve Bank to significantly intensify our supervision activity.

...

Figure 7: Stylised escalated supervisory response

97. The high level concept is that as banks go further into the prudential capital buffer, the nature and consequences of the supervisory response are increasing severity. In bad times especially, capital is a lagging indicator and the escalating nature of the intervention is designed to stop and reverse deterioration to the extent possible.
98. The details of the nature of the supervisory response, the precise trigger points, the timeframes and obligations on banks to respond, and so on are important details, which warrant a standalone consultation with stakeholders. For the purposes of this Consultation Paper, we merely wish to introduce the concept of an Escalating Supervisory Response, and to illustrate the sorts of response we have in mind.
99. Currently the Reserve Bank has an array of possible supervisory responses, so in this regard we are not proposing new tools or powers. What we are proposing to do is to develop a framework of escalating supervisory responses based on objective triggers that can provide clarity and much more certainty about the circumstances and conditions under which we would expect to use our tools.
100. Examples of the current tools and powers available to the Reserve Bank under existing legislation are information gathering powers, such as section 94, 95, and 99 of the Reserve Bank of New Zealand Act, powers to issue directions (section 113), or the power for a bank to be placed into Statutory Management (section 117).
101. The intention, following a consultation process on the details of the escalating supervisory response is that the Reserve Bank would produce a set of guidelines, principles, and/or requirements to formalise and clarify when we expect existing powers to be used and under which circumstances (noting that the Reserve Bank will always need to reserve the right to exercise its financial stability powers as appropriate to emerging circumstances).
102. On the other side of the ledger, when banks are operating above the prudential capital buffer, ... the Reserve Bank will look to continue to give banks the discretion they currently enjoy, imposing relatively less of a regulatory burden on banks.

Supplement B

APRA Guidance Note - Extract

Board ownership of the ICAAP

1. Under the capital standards, the Board of a regulated institution has primary responsibility for the capital management of that institution. This obligation goes beyond the need to ensure compliance with regulatory capital requirements and requires the Board to ensure that each regulated institution holds capital resources commensurate with its risk profile.
2. Consistent with that overarching responsibility, the capital standards require each regulated institution to have an ICAAP that has been approved by its Board.
3. While the ICAAP may be developed by the regulated institution's senior management with input from relevant areas and experts across the organisation (including the Appointed Actuary where relevant), the capital standards require the Board to be actively engaged in the development and finalisation of the ICAAP and the oversight of its implementation on an ongoing basis.
4. APRA expects the Board to robustly challenge the assumptions and methodologies behind the ICAAP and the associated documentation. APRA expects the Board to understand and to be able to explain the key aspects of the ICAAP and why it is considered appropriate for the institution.
5. APRA expects the ICAAP to be integrated into the decision-making processes of the regulated institution and considered in strategic and business planning.

Risk appetite and risk management framework

6. The Board is responsible for the risk appetite of a regulated institution and for ensuring that the institution has an appropriate risk management framework. Risk appetite is a fundamental part of both risk management and capital management.
7. An ICAAP involves an integrated approach to risk management and capital management, based around assessing the level of, and appetite for, risk in the regulated institution and ensuring that the level and quality of capital is appropriate to that risk profile. APRA expects these processes of risk and capital considerations to have clear linkages, and be consistent with one another and with the business planning process. The processes will also be embedded in the institution's operations and be key inputs into decision-making.
8. APRA expects that the risk appetite and risk management framework of a regulated institution will address all material sources of risk for that institution. This will include risks that are covered by specific regulatory capital requirements and risks that are not, regardless of whether those risks are able to be quantified.
9. Since a regulated institution is required under the capital standards to have an appropriate ICAAP in place at all times, it follows that material changes in its risk profile or risk appetite would prompt a reconsideration of capital needs and a review of the ICAAP.

Chapter 12: Prudential Supervision as a Bank Function

12.1. Background

Prudential supervision is a specialist field and, while there are many similarities between the prudential supervision of insurers and of banks, there are also some important differences.

The most significant difference is that, in the banking system, when a bank gets into difficulty, there is often a reverberation throughout the system that can occur with great speed (as quickly as one day) and it may generate a monetary crisis and threaten economic activity. The regulator needs to act swiftly by taking urgent and perhaps sweeping steps to protect the system.

On the other hand when an insurer is getting into difficulty, the insurer board and management may not realise it or may not believe it - see also discussion and the EIOPA quote in Chapter 7 – and, in the short run, it will not affect the insurance system or the economy. It may even take years to manifest itself fully. This “slow burn” characteristic, however, while not requiring action this day or the next, still requires decisive action as early as possible to protect existing policyholders and to avoid exposing potential future policyholders to the non-payment of claims.

With this background in mind, we can assert that an essential feature of the supervisory capability and culture within the prudential insurance regulator is that the regulator firstly can identify any insurer that may be getting into difficulty, even if the company itself does not see it or denies it, and secondly, in the context of doubt and uncertainty, will take steps aimed at clarifying the insurer’s situation and then taking appropriate supervisory steps.

This chapter builds on the above ideas in the context of the Bank’s publicly stated approach to insurance supervision and the experience of the CBL case. The chapter covers –

- the *three pillars* used by the Bank to describe its supervisory approach;
- the adequacy of supervisory resourcing at the Bank;
- the insurance supervisory culture within the Bank;
- the International Monetary Fund’s Financial Sector Assessment Programme report (IMF FSAP report) of May 2017.

12.2. Three pillars

The Bank describes its supervisory approach according to 3 pillars, which are –

Self-discipline – the expectation that boards of licensed insurers will act responsibly and effectively in exercising their functions in accordance with the requirements of the Act.

Market discipline - the expectation that disclosure to the market of financial strength and other information about each licensed insurer will create a level of accountability

to the community that will contribute to the effective corporate management of each licensed insurer.

Regulatory discipline - the legal structure (principally the Act and the Solvency Standard) according to which licensed insurers are required to operate.

The CBL case presents a set of circumstances that illustrate the limitations of the three pillars as they were applied in the CBL case from 2013 (licensing) to 2018 (liquidation).

Self-discipline:

... the expectation that boards of licensed insurers will act responsibly and effectively in exercising their functions in accordance with the requirements of the Act.

It is plainly in the best interests of an insurer for its board to act responsibly, effectively and in accordance with the law. Accordingly, there is a presumption that it will do so. Further, the Act requires that directors be “fit and proper” for the task of governance. This is the foundation of the expectation described above.

Two questions arise about this expectation in the CBL case. The first question is whether the Bank knew if the Board met the expectation – this is a supervisory question – and the second is whether in fact the Board did meet the expectation – this is a governance question.

On the second question, quality of governance, CBL always claimed in its written and verbal interactions with the Bank that it did meet the expectation. This much is clear from correspondence and records held by the Bank. We are not able to make any findings about this.

The first question is the more important in the CBL case, however, as the self-discipline pillar has generally been treated historically by the Bank as a matter that it can leave to the licensed insurers themselves. As noted above, the essence of this position is that self-interest and legal responsibilities will lead to the expectation being met.

Because the Bank did have some questions at the time of licensing about CBL’s governance, it required, as explained elsewhere, that CBL submit to a risk governance review carried out by KPMG before being granted a licence. The KPMG report raised a number of questions but effectively advised the Bank that CBL had the competence, the intent and the incentive to meet the self-discipline expectation. The Bank quite correctly wished to test this after licensing and prepared an internal “Licensing Case Management Plan”.

The Board gave the appearance of sound governance and it was confident of its positions. The Bank had no substantial information, however, as to how or how well the Board functioned and did not know whether it could rely on the Board of CBL to meet this self-discipline expectation.

It is this lack of accountability of the boards of licensed insurers to the Bank as prudential supervisor which, in our opinion, leads to the self-discipline pillar being ineffective from a supervisory viewpoint in some cases. While most boards act competently and diligently, some do not, whether knowingly or unknowingly. The Bank needs to be vigilant to identify them.

In summary, the CBL case may provide an example of the limitations of the self-discipline pillar. If it were effective, it is reasonable to expect that many of the issues arising in the CBL case should not have arisen and some of the findings and recommendations expressed in this report would not be important.

Market discipline:

... the expectation that disclosure to the market of financial strength and other information about each licensed insurer will create a level of accountability to the community that will contribute to the effective corporate management of each licensed insurer.

Generally when an insurer is not in a sound financial position or may not be so –

- if it is not listed, the only effective way of understanding its financial soundness is through supervisory activities of the regulator;
- if it is listed, in due course the share price and share market reputation will likely reflect its financial condition (although not necessarily accurately or in a timely way but there will usually be some impact).
- The CBL case is unusual because, during and after listing of the parent company from 2015 right up until suspension of trading in its shares in 2018, the share price did not on the whole reflect any actual or potential distress or lack of financial soundness of the company. We note that CBL was the main operating subsidiary of the parent. Associated observations are - Published statements of the company always expressed high confidence in the business
- In 2017, when international regulators began publicly questioning the solvency of insurers regulated in Europe who were reinsuring most of their business with CBL, the company's share price did not show any continuing weakness or decline (it fell about 20% in August 2017 but remained more or less static from then until suspension in February 2018).
- A M Best, the International specialist insurance rating agency, continued to give CBL high ratings right through to 2017.

It appears to have done so by relying on the company's annual reports, media releases and other published information, along with some dialogue with the company, which at all times exhibited, as already noted, high confidence in the business model, strategy and financials of the CBL group.

- There were some relevant disclosures by CBL Corporation, although in our view they were limited and down-played by the company, notably a press release in August 2017 following some reserve strengthening by CBL as at 30 June 2017 and intervention then by the Gibraltar FSC that was in the public domain.

Also the PDS prepared by CBL Corporation in 2015 contained a brief disclosure, within a list of a dozen risk issues, that the Bank had been investigating CBL Insurance's solvency and had queried the company's claims reserves but had accepted that CBL met its solvency requirement at December 2014. The directors commented on the reserving risk: their assessment was that under-reserving was a low risk issue.

In summary, the evidence suggests that the market did not respond to indications of business risk within CBL Corporation and CBL Insurance.

Regulatory discipline:

... the legal structure (principally the Act and the Solvency Standard) according to which licensed insurers are required to operate

As to regulatory discipline, this Review draws attention to a number of aspects of both the powers of the Bank and its actions as supervisor which indicate that regulatory discipline (accompanied by supervisory action) can be effective but, in the CBL case, it was not fully effective throughout the period from 2012.

It is of course, however, the primary purpose of this Review to make an assessment of the regulatory discipline pillar by drawing attention to matters of regulation and supervision that may need to be reconsidered in the light of the CBL case. That is the subject matter of most of this Review.

12.3. Risk-based supervision

Risk based supervision or regulation is the preferred approach among regulators across industries. It seeks to achieve public policy objectives by targeting activities that pose the highest risk to the public wellbeing, and in turn lowers burdens for a variety of lower-risk firms. By directing resources towards highest risk areas, risk-based approaches make the most of limited public resources.

The Bank is a risk-based supervisor. It assesses both the risk that an insurer might fail to meet policyholder promises and expectations, and the potential impact that a failure is likely to have. More attention is paid to the higher risk and higher impact insurers than those at lower risk or with low impact.

However being 'risk-based' is about the allocation and priorities of available resources and little about the total level of resources. It does not indicate the overall scale or level of intensity, capability and seniority of the individuals dedicated to insurer supervision.

CBL created a question of priorities for the Bank regarding allocation of supervisory resources on the basis of an internal Bank rating that takes account of both the risk and the impact of failure.

On the one hand, the CBL exposure in New Zealand was small so the local impact of failure was always going to be minor. On the other hand, the growing scale of CBL's offshore business and the long-tail of the business were leading towards an accelerating impact of failure if failure occurred, and many offshore policyholders would be left without cover or with claims unpaid.

At the same time that CBL's solvency was under question, the impact of the Canterbury earthquakes on some insurers was very high. Also there are provisions in the Act, particularly s 4, which may influence or encourage the Bank to give priority to local policyholders over offshore interests. As a result it was legitimate for the Bank to give CBL less than maximum attention at the time. The question then was how much and what kind of attention it should give to the offshore policyholders of CBL when it was stretched dealing with the local policyholders of insurers with major volumes of earthquake claims.

We accept this was properly a matter for the discretion of the Bank, working with the resources it had at the time.

12.4. Adequacy of supervisory resourcing

Adequacy of supervisory resourcing is clearly relevant to the capacity and capability of the Bank to carry out its supervisory responsibilities. It also gives context regarding decisions and actions taken by the Bank in respect of CBL.

A recent document that refers to the adequacy of supervisory resources is the IMF FSAP report of May 2017.

Supervisory resourcing relates to the numbers of people, their background and training, their suitability for supervisory work and their roles within the supervisory division of the Bank.

Supervisory resourcing is ultimately the outcome of the goals of the supervisory institution, in this case the Bank, along with the techniques it chooses to use for supervision and the level of intensity of supervision that it decides is appropriate.

The philosophy that was reflected in the design of the Act and adopted by the Bank is to operate a low intensity supervisory approach whereby most of the responsibility for husbanding the affairs of an insurer is in the hands of the company and its board.

Notwithstanding this low intensity approach to supervision, the level of regulation, particularly as set out in the Act and the Solvency Standard, is quite comprehensive and gives the Bank extensive powers in the event that it should choose to use them (notwithstanding that there are limitations and gaps in those powers).

The 2017 FSAP report

The IMF conducts reviews of the financial regulatory system country by country on a rolling basis under its Financial Sector Assessment Programme (FSAP). The NZ system was the subject of an FSAP assessment in 2017.

The low intensity supervisory approach of the Bank has been very deliberate and contrasts with the situation in most other prudential supervisors around the world. The 2017 FSAP report explains the situation in some detail and advocates a greater level of supervisory resources:

The approach of the RBNZ to supervision should be strengthened by increasing the weight of regulatory discipline in its three-pillar framework. The RBNZ approach to supervision relies on three pillars: self, market, and regulatory discipline. The authorities have strengthened regulatory discipline since the last FSAP, but the three-pillar framework should be improved by adopting a more intensive approach to supervision. This would increase the ability of supervisors to be proactive to exercise regulatory discipline and obtain reliable information to enforce self- and market-discipline. The RBNZ is encouraged to issue enforceable supervisory standards on key risks, review the enforcement regime to promote preventive action, and initiate on-site programs targeted on areas of high risk. In addition, clarifying the responsibilities of the Treasury and RBNZ on financial sector issues and reinforcing the role and autonomy of the RBNZ as prudential regulator and supervisor would enhance the ability of the RBNZ to respond swiftly to ongoing and emerging risks.

Increasing supervisory resources for all financial sectors is key. This would support the highly qualified RBNZ staff in improving the effectiveness of the supervisory process, enhancing their knowledge of financial institutions' operations, and deepening risk assessment of supervised entities—and strengthening their ability for early preventive action.

Finding: Resources

- The CBL case provides evidence to support the IMF FSAP report recommendations. It gives cause for the Bank to re-examine its level of supervisory resources and its general approach to both supervision and regulation of insurers. The CBL case clarifies, perhaps in a dramatic way, the potential consequences of inadequacies in prudential regulation and supervision.

- A case can readily be made for a higher number of supervisory personnel with greater training, higher seniority and preferably a mixture of regulatory backgrounds and industry backgrounds, in order to engage more effectively and more deeply on a regular basis with individual insurers –
- In considering the level of supervisory resources, it is important also to allocate adequate resources to the making of supervisory policy, for policy development is an integral part of the supervisory process.

Observation

It is acknowledged that it is a matter for the Government as to how far it wishes to invest in stronger supervision and regulation including how much regulatory overlay the Government believes is appropriate for the purpose of protecting policyholders and the financial system. We advocate an approach that takes account of the Bank's goals, priorities and risk appetite.

Recommendation

In the light of the CBL case and the recommendations in the 2017 IMF FSAP report, we recommend an expansion of the supervisory resources of the Bank for the supervision of licensed insurers and associated policy development. It is a matter, however, for more detailed investigation in the first instance and then review of the philosophy of supervision, Bank policy and perhaps Government policy as to how far the supervisory resources should be expanded.

12.5. The Bank's interactions with CBL

There were extensive interactions between the Bank and CBL from as early as 2011 and through to 2018. Below we identify the main factors or actions between CBL and the Bank and lessons to be learned.

Mitigating circumstances: the apparent character of CBL

We preface these comments by noting that our observations and impressions are taken from the documents we have considered, including correspondence and notes of meetings between the Bank and CBL, and discussions with Bank personnel. We have not interviewed any of the officers of CBL, nor the Appointed Actuaries. We make these observations because the experience and prudential response of the Bank appears to us to have been impacted by the Bank's perceptions of CBL's responses to its efforts to clarify matters. We do not opine on the accuracy of those perceptions.

It is our impression that, throughout the prudential relationship beginning in 2011, CBL Insurance and CBL Corporation have been difficult in their dealings with the Bank. They have given the appearance of cooperating with the Bank and genuinely did so on many occasions but, whenever challenged on matters of financial importance, were steadfast in standing by their numbers and the advice of their Appointed Actuary until the Gibraltar FSC intervention in 2017. They regularly defended their own numbers and continued to assert their confidence in the CBL business model and commercial success. We also perceive they have not understood well the real nature of their own business activities and in particular the claims tail risk and potential for substantial upwards revision in the future of claims liability estimates (see also comments in Chapter 7).

We note in this context part of the judgment of the High Court following interim liquidation in 2018. The judgment outlines alleged irregular activity where the CEO, and in some cases the other executive director, acted dishonestly in their dealings with the Bank (and others), thereby misleading the Bank on certain matters that had a material bearing on CBL's solvency from time-to-time. In particular, the executive directors were alleged to have provided some misleading information to the Bank and failed to disclose some material relevant information.

This behaviour contributed to the very significant challenges for the Bank as supervisor and is part of the relevant context for the Bank's approach.

The Bank's supervisory approach

There are several features of the events from 2013 to 2017 that indicate or characterise the supervisory approach of the Bank during that period. They are, by our assessment -

- (a) A cautious approach to invoking the Bank's powers under the Act and the Solvency Standard, for example –
 - in the pre-licensing period (to 2013), the Bank identified and agreed internally on concerns or weaknesses within CBL and determined that they were to be followed up after licensing but, after licensing, the Bank can be seen to have exhibited a mixture of timidity or great caution on the one hand and leniency or lack of commitment on the other hand to getting to the bottom of each of the items of concern and acting on them.
- (b) Limited scrutiny of and circumspection around experts' reports at senior level, for example –
 - the 2013 KPMG report contained some warning signals within a report that overall seemed favourable to CBL (one is the tagline "CBL – a unique business model in a niche insurance market" - could this really be so? – and another is the section on claims reserving, discussed elsewhere in this report)
 - the 2013 FCR, submitted in July 2014, contained several recommendations from the Appointed Actuary that were also warning signals that were not followed up by the Bank, as discussed in Chapter 5.
- (c) The Bank displayed in the CBL case a propensity to rely on written documentation of procedures within CBL with limited willingness to engage actively with directors and executives to follow through on the substance behind the documentation.
 - while this is essentially a supervisory matter, it seems to indicate a reliance by Bank supervisory staff on the regulatory structure (the Act and the Solvency Standard) with insufficient dialogue and hands-on assessment of insurer operations. We say insufficient because active dialogue and understanding of insurer operations is fundamental to a supervisory assessment of an insurer's risk management framework and outcomes.
- (d) Correspondence and interactions with CBL that were not firm enough for the Bank as supervisor to disturb the insurer or to instil a fear of forced curtailment of business, for example:
 - correspondence and interaction on the Governance Review that took place in 2014: the Bank expressed concerns but CBL may have interpreted the message as a clean bill of health;

- dialogue and negotiations over solvency at the time of the IPO in 2015 left the claims reserving problem unresolved; and
 - correspondence and interactions from June to August 2016 on the Prudential Consultation Meeting that took place in June and follow-up that concluded with a “good intentions” letter from the company in August.
- (e) Limited sensitivity to the dangers and risks in the CBL business model:
- the risks were evident on licensing in 2012 and 2013; although the company was rather smaller then, the Bank had major resource constraints and some other priorities (especially the Canterbury earthquakes) that limited its ability to dedicate the right resources to CBL; and
 - the limited familiarity of Bank personnel with prudential supervision of insurance generally and with the risks of long-tail business, rapid growth and offshore business may have limited the depth of attention to CBL’s affairs and understanding of the risks that were present (although the internal actuary was alive to these issues).
- It is clear enough that there were some legislative or regulatory impediments to the Bank doing everything that it may have wanted to do to circumscribe CBL’s activities – see Chapters 10 and 11 - but also it seems that the supervisory culture was not well enough developed to respond in a way that many senior insurance supervisors from other prudential regimes would have seen as imperative.
- (f) Lack of awareness that regulators in other jurisdictions may have been relevant and helpful, along with the absence of engagement by either CBL or the Bank of any experts from outside New Zealand:
- there was a strong case for the Bank to look beyond New Zealand in 2015 but it did not do so: the case was made when, after the new Appointed Actuary from PwC was appointed in 2015 and was encouraged to draw on relevant international expertise, he did not record doing so in his FCR and LVR beyond dismissing as unhelpful some limited information on the French DO and DL portfolios .
- (g) A willingness to take strong and decisive action, as it did from July 2017, once it was confident of its position.

Findings: Culture

- In summary, we find a supervisory culture that before 2017 was less decisive and less anxious about information and advice that it was receiving about CBL than it might have been. Advice and assistance were not sought by CBL or the Bank from offshore experts or regulators.
- There was also a lack of confidence by the Bank to take firm action earlier than June 2017. The reasons appear to be a combination of respecting the “self-discipline pillar”, the limited experience within the Bank at the time of insurance prudential supervision overall as well as the novelty of and unfamiliarity with the type of business activities in which CBL was engaging. Possibly as influential was a reluctance to act where the Bank had limited

resources and other priorities, and there was some uncertainty, as there naturally had to be, in the liability measurements for such long-tail business.

- The lack of an international perspective can be seen as both an impediment to investigating the company's affairs in the early days after licensing and, later, an impediment to taking advantage of the resources of the international regulatory community (which would have been available to the Bank through its participation in the International Association of Insurance Supervisors).
- The outcome of these behaviours can perhaps be described as the Bank generally giving CBL the benefit of the doubt. Doubts arose over questions raised within the Bank on claims liabilities, solvency assessment, business model (specialty lines of reinsurance with long-tail, offshore, fast growth and ownership of distribution and ceding companies), quality of business, data quality, management performance and some other factors.

Overall finding on the supervision of CBL from 2014 to 2016

Recognising all the factors described above, we believe that in the period 2014 to 2016 the Bank could have and, in our opinion, should have acted with more alacrity and a greater sense of urgency in its supervision of CBL.

Principles of prudential supervision

In view of the above, it is worth repeating here the following statements made in Chapter 3 on the principles of prudential supervision:

The essence of effective *prudential supervision* lies in the ability of supervisors to identify risky situations within individual insurers and to do so as early as possible before these situations escalate. The supervisors' first goal is to 'catch' the situation before it escalates to the point where the honouring of promises to policyholders is at risk. Their second goal is to take action that will assist or oblige the insurer, depending on the circumstances, to remedy its position or to cease trading and put its business into run-off.

The price of inaction in a deteriorating insurance business is often a 'slow burn', which can seem innocuous for some time, perhaps years, with management usually in denial, but when it finally becomes inescapable the costs and the losses can be very high.

The ability of supervisors to do their job effectively relies on two key capabilities:

- Access to information about each insurer, including its balance sheet and hence its capital position.
- The ability to recognise risk situations when they arise.

Supervisors need to be constantly vigilant and alert to risk situations and have the determination to take action against a company when in doubt. Waiting for certainty or even high confidence, thereby giving the benefit of the doubt to the insurer, is unwise and may well run counter to the very reason for the existence of prudential regulation.

The recommendations below are intended to set out the main steps that we believe the Bank should take in order to operate in future in accordance with these principles.

Recommendations

We make the following supervisory recommendations for the Bank in dealing with high risk insurers or insurers under strong surveillance:

- be clear on supervisory objectives and the goals of any supervisory intervention;
- ensure that expert reports are examined at senior level, applying a healthy scepticism and a ‘nose’ for nuances, to ensure that the full significance of the reports is understood before deciding next supervisory steps;
 - supervisory personnel should engage actively in problem-solving, searching for insights from available information, especially from experts’ reports and dialogue with them, some brainstorming and wide consideration of possible courses of action;
- rather than rely on written documentation, engage actively with directors and executives to follow through on the substance behind the documentation;
- when in doubt about an insurer’s financial soundness, take steps, in the interests of policyholders and the public, to investigate the company without delay and to resolve the doubts as quickly as possible;
- in situations of uncertainty, doubt or concern, as emerged in the CBL case, act with tenacity and persistence to remove doubts and, in the meantime, curtail or even prevent the insurer from increasing its exposures until the doubts are resolved;
- be decisive and firm in seeking and obtaining information from the insurer;
- take firm action including follow-up once a decision is made;
- when an appointed actuary’s engagement is ceasing, arrange interviews with both the departing actuary and the board of the insurer;
- in addition to exploring technical actuarial questions where relevant, explore governance issues thoroughly whenever there is evidence of corporate activities that entail high risk;
 - it is imperative that the full supervisory arrangements, including regulatory powers of the Bank, result in the onus being on the insurer to satisfy the Bank;
 - generally the Bank is in a position to keep the onus on the insurer but its supervisory strategy needs to be revisited to ensure the Bank can maintain that position in the future; and
- make full use of the Bank’s powers if the insurer is reluctant in any way to support the Bank’s interventions.

PART 4 – EXTENDING THE SCOPE OF CURRENT ARRANGEMENTS

Chapter 13: Governance and Risk Management

13.1. Introduction

There are numerous features of the CBL story that relate to governance and risk management. The most significant feature overall is that, while there is a range of governance and risk management requirements in the Act and Solvency Standard, and the Bank also has a set of Governance Guidelines and Risk Management Guidelines for licensed insurers, the Bank was not effective in holding the board of CBL to account under these guidelines until interim liquidation in 2018. This situation is explained in this chapter and some associated changes are recommended.

Governance

We regard the governance question as important because it has an overarching influence on many of the issues that arose between the Bank and CBL during the period from 2012 to 2018. The Act makes it clear that insurers have a responsibility to the public as well as to shareholders: the nature of insurance means those who are most vulnerable to governance failure rely on prudential supervision for their protection.

The supervisory structure used by the Bank relating to governance can be characterised as follows:

- Under the Bank's "three pillars" description of its supervisory approach (see Chapter 12), the Bank has relied heavily, across the industry, on the self-discipline pillar. This pillar comprises the expectation that boards of licensed insurers (which comprise persons who have met the "fit and proper person" requirements) will act responsibly and effectively in exercising their functions in accordance with the requirements of the Act and sound governance of the insurer.

There is no framework for monitoring or enforcing these expectations, other than directing officers and employees to step down in certain circumstances (ss 143 and 144(f)) or by removing a director altogether (ss 39 and 149).

- The Bank's Governance Guidelines have two important limitations from a governance viewpoint:
 - The first is that the Guidelines are predominantly about process and have little content that relates to behaviour and to how the board is accountable for meeting its responsibilities.

To the extent that the Guidelines relate to performance, the Bank has no process for monitoring compliance with the Guidelines (largely because, as we understand it, of the importance attributed to the self-discipline pillar referred to above).

- The second is that, as guidelines, they have no regulatory or legislative force. Although not tested by companies directly, this non-legislated nature of the Guidelines may inhibit the Bank in seeking to oblige compliance by insurance company boards.

There are also other features of the Act and the Solvency Standard that do not impose responsibilities on the board of the insurer within the prudential regime.

One is the way that the solvency requirement of the Solvency Standard operates: it is a mechanical matter whereby if the solvency ratio exceeds 100%, companies are effectively 'safe' from further supervisory scrutiny and, if it is less than 100%, then action needs to be taken.

In Chapter 11 we explain this shortcoming in the approach to solvency and offer a recommendation on modifying it. The recommendation is aligned to the Bank's approach to supervision of licensed banks and their solvency, so as not only to give a graduated and more useful approach to solvency but also to engage insurance company boards actively in solvency management.

Upgrading the Solvency Standard in this way will contribute to the increased accountability of boards.

13.2. The CBL Board situation

On licensing, the CBL Board's members all met the fit and proper requirements of the Act and its composition met the independence requirements. These requirements are formalities which relate to board membership and not board governance, performance or culture, which are matters that the Bank can choose to influence and monitor as supervisor if it so decides.

The membership of the Boards of CBL and CBL Corporation were coincident, so there was no voice on the CBL Board that could question the Corporation board or vice versa. In some corporate situations, that is of no consequence but in a case where there are significant transactions being made by the parent company that can have a bearing on the affairs of the insurer, such a voice can be valuable.

This observation is not a criticism of CBL but it is a matter that the Bank as prudential supervisor should consider in future when an insurer has a parent company that owns other businesses.

It is also useful to note that the Bank's records indicate few meetings in five years where Bank supervisors met with the Appointed Actuary without the presence of the CEO or the CFO. There were no meetings between the Bank and the Board of CBL without the CEO present. Such meetings can be valuable to test the understanding and influence of the board on the company and of the CEO on the board.

Regarding Bank supervision, this situation indicates a diffidence on the part of the Bank to understand the board and management culture of the insurer. Insisting on meetings with the Appointed Actuary on his own as well as with management present, and also with the board or selected board members with and without the CEO present, can be useful means of understanding the governance and risk culture of the insurer.

There was also no mechanism that enabled the Bank to know whether all correspondence from the Bank to CBL reached the Board. If it had been a requirement that all correspondence did reach the Board, there would have been an additional layer of interaction with the Bank that contributed to some accountability of both the Board to the Bank and the CEO to the Board.

In these circumstances, the self-discipline pillar is not effective without close monitoring by the Bank and some strenuous efforts by the Bank to generate accountability of the board in a way that could meet the purposes and the principles of the Act.

Recommendations

Boards of insurance groups: in group situations where an insurer is owned by a parent company with other material subsidiaries, the Bank should consider from a risk management perspective whether it is satisfied for the insurer and its parent to have coincident boards.

Bank interaction: the Bank should ensure that it has, and exercises at its discretion, the right to meet with selected individuals or groups of executives, directors, the Appointed Actuary and the auditor, as part of the process of understanding the board and management culture of the insurer.

Bank correspondence: the Bank should require of all licensed insurers that all correspondence from the Bank to the company be disclosed to the board and that all correspondence that has a bearing on reserving, solvency and capital be disclosed to the Appointed Actuary.

Additional comments

The circumstances described above raise some further questions for the Bank as supervisor beyond the above three recommendations:

- How effective are the current fit and proper standards for licensed insurers?
 - The fit and proper standards relate to the initial appointment of directors and senior executives but they are static in that they apply on initial appointment only. Is it appropriate that they are then left to the insurer to advise the Bank of any changes over time?
 - Are the powers to side-line officers or employees from involvement in certain business, or to remove directors, useful?
- How does the Bank monitor the governance performance of an insurer when it has doubts about the quality of governance, including the functioning of the board, its capabilities as a whole and its oversight of the role and performance of the CEO?
- How suitable are the Governance Guidelines regarding oversight of the affairs of licensed insurers, including the establishing and functioning of board committees? And how useful are those committees in contributing to the good governance and effective risk management of licensed insurers?

Findings on Governance (I)

- At present, once directors meet fit and proper tests and the board includes the requisite quota of independent directors, there are no further questions about the competence or effectiveness of the board as a whole or of individual directors, save for the removal power. There is also no obligation on the board to ensure its competence or its performance, simply guidelines for board renewal or refreshing of the board, for competence of the board as a whole and for board committees.
- On governance more generally, in our view there is a need for the Bank to have the power to enforce good governance and effective risk management if for any particular insurer they are found wanting. This matter is covered in Chapter 10 which recommends that the Bank be granted powers under the Act to introduce additional prudential standards, particularly for governance and risk management.

13.3. Boards that are uncooperative or where doubts are raised about board performance

The Bank, if in doubt about the governance, culture or performance of an insurer's board and concerned about corporate risk, needs to be willing to assume the worst and then test the board using techniques such as:

- overall, adopting a tough stance—remaining sceptical and risking cooperative relationships if necessary;
- using the Act and regulations to their full extent, in a manner that is more strict than usual because of the perceived risk, until the doubts are resolved;
- being precise and demanding about timeliness, quantity and quality of information, issuing notices and/or directions — for example under s 121 if required — and then scrutinising carefully all input from the insurer and its advisers; and
- being confident to act decisively on unconfirmed suspicion in advance of being certain one way or the other, in order to bring the Bank to the required level of certainty or resolve doubts.

13.4. The Governance Guidelines – Content

To assist governance, the Guidelines need to contain behavioural standards or responsibilities that give them substance. By way of example, Clause 6 includes “The governing body will continue to have ultimate responsibility for the governance of the licensed insurer” and the six clauses quoted below are also particularly relevant:

32. The governing body should demonstrate independence and exercise objective and impartial judgment. It is expected that at least half of the directors will be independent, and the licensed insurer should disclose in its governance statement which directors are considered ‘independent’. Guidance on independence is provided in the following section.

33. It is expected that at least two directors will be ordinarily resident in New Zealand. Where the licensed insurer is a branch of an overseas person, the New Zealand chief executive officer should be ordinarily resident in New Zealand. 'Ordinarily resident in New Zealand' is defined in section 6(4).
34. Directorships should be reviewed periodically. Where individuals have been directors for a long time, it should be considered whether the length of the director's service means they may reasonably be perceived as no longer able to act in the licensed insurer's best interests or be independent.
35. It is expected that the licensed insurer will have a formal conflicts of interest policy, and a procedure to resolve any potential or apparent conflicts of interest that may arise. This policy should be disclosed to the Reserve Bank.
36. There should be a formal procedure for assessing the performance of the governing body relative to its objectives. The chair should be responsible for these assessments, which should be at the level of individual directors as well as the governing body as a whole. The licensed insurer should have a formal policy on the renewal of the governing body, to ensure the retention of skills and expertise.
- ...
44. Collectively, it is expected that the governing body will have a full range of skills, knowledge, and experience to run the licensed insurer and its operations, and avoid a concentration of particular skills and experience. In addition, directors should regularly undertake relevant training.

The principles set out in these clauses are entirely appropriate. However, they are not monitored by the Bank as supervisor and, under the self-discipline pillar and without regulatory force, the Bank has little understanding of the degree of influence to date of the Guidelines in ensuring good governance of insurers.

Findings on Governance (II)

- Our primary governance finding is that the Governance Guidelines contain a suitable set of principles for governance at board level but that the Bank cannot assume that the Guidelines will be followed and therefore needs to establish processes for holding boards accountable for meeting them.
- An initial step in strengthening the effect of the Guidelines and generating more board accountability for meeting them would be to give the Guidelines the force of law (noting that to do so may require amendment to the Act so that the Guidelines could be issued as a standard under the Act). Alternatively they may be issued as regulations under s 237(1)(e) or (x), or perhaps as conditions on the licence.
- Additional findings are that fit and proper standards are important but, as acknowledged in the Governance Guidelines, are only part of the story. See recommendations below.

Recommendations: Governance Guidelines

The Guidelines could be usefully enhanced by:

- The nature of the responsibilities of the board being made clearer.
- Sanctions being imposed when a board fails to do its job properly (the Act allows the removal of individual directors but this is an extreme step to take if the Bank could instead mandate a particular course of action by the board).

Regarding board renewal and board composition, both covered in the Guidelines, the Bank should introduce guidance to insurers for meeting these requirements, so that boards of insurers can develop their own approaches and have them either approved by the Bank or subject to disallowance by the Bank.

The Bank should modify its supervisory processes to encompass a set of procedures aimed at ensuring compliance by insurance company boards with the terms of the Governance Guidelines (and particularly the terms of clauses 32 to 36 and 44).

Risk management

Risk management and governance are closely linked and effective governance is an essential component of effective risk management.

The Bank has a set of Risk Management Guidelines for licensed insurers and, as with the Governance Guidelines, they have no direct regulatory or legislative force. Their opening and closing paragraphs are:

Purpose of this guideline

1. This document sets out the Reserve Bank of New Zealand's (Reserve Bank) guidelines in relation to the risk management programme licensed insurers are required to have. This programme is required under sections 18 and 73 – 75 of the Insurance (Prudential Supervision) Act 2010 (the Act).
2. The objective of this guide is to clarify how the risk management requirements of the Act should be interpreted and to provide indicative examples of the issues to consider in the risk management programme. This guide should not be regarded as a prescriptive list of issues to address as each insurer will need to identify and address risks specific to their situation and reflect the outcome of such an exercise in documentation.
3. When assessing risk management documentation the Reserve Bank will focus on the substance of the programme and the extent to which there is evidence that the risk management programme is real and is reflected in operational activity.

Concluding comments

43. The Reserve Bank offers this guide in the context of helping an insurer consider their risk management programme in relation to the requirements of the Act. The guide is not intended to be an instruction manual for preparing a risk management programme and an insurer wanting help in relation to establishing a risk management programme should seek professional advice.

The Guidelines themselves contain a range of ideas and principles that insurers are encouraged to consider and adopt in accordance with their particular risk characteristics. If applied conscientiously by an insurer, these would represent an extensive risk management programme.

13.5. Applying the Guidelines

Insurers are required under s 73 of the Act to have a properly prepared risk management programme and to comply with it. Whenever there are material changes, the Bank's approval is required.

In the case of CBL, an independent risk management review was commissioned by the Bank ahead of licensing, as explained in Chapters 4 and 5 and carried out by KPMG. That review set a framework for both the company and the Bank at that time.

As further described in those chapters, the Bank carried out an industry wide survey of insurer risk management programmes in 2014 and, in CBL's case, gave the company a 'final feedback letter' in December 2014. That letter stated among other things that -

We are of the view that CBL is moving in the right direction in establishing a Board that promotes, through actions and words, an organisational culture that expects integrity and a prudent approach to risk.

Vulnerabilities and areas for improvement

There are, however, several areas that emerged from our review, where improvement is needed.

After explaining those areas for improvement, the letter finished with -

Conclusion

During our meetings we asked you to rate progress being made towards full implementation of an effective risk management framework on a scale of 1 to 10. Your response to this question was 7 or 8 out of 10. This question was intended to gauge the perceptions within CBL Insurance Ltd of the maturity of the risk management framework, noting that we are focusing on desirable risk behaviours as the best indication of how progress is tracking.

As explained in our feedback, our view of the maturity of your risk framework would be lower than those scores. We will be closely monitoring developments going forward.

There is nothing exceptional about this CBL assessment at the time but these quotes indicate the approach that was being taken and we understand continues to be taken by the Bank to risk management. We have seen subsequent correspondence that indicates that CBL was following up over time on issues raised by the Bank. The Bank noted the developments through correspondence and discussion.

Findings: Risk Management

- This approach by the Bank on risk management, based on interviews and documentation, is reasonable but limited as it illustrates a generally “hands off” reporting arrangement subject to occasional review. It is an approach characterised primarily by documentation review and we understand that there is no process for on-site monitoring or for testing of outcomes of risk management programmes.
- Although the Guidelines do not have the force of law, initiatives by the Bank on risk management of the kinds described above in the CBL case show that the Bank can, if it so decides, require insurers to develop substantial risk management programmes and to apply them.

Recommendations: Risk Management

Given the risk issues that arose in the CBL case and indeed were on foot at the time of the Bank’s 2014 review, we recommend that the Bank take a more pro-active stance on risk management in cases such as CBL which was under ‘Increased surveillance’ at that time and subsequently.

We further recommend that the extension of the Bank’s ability to issue prudential standards, as proposed in Chapter 10 regarding the Act and earlier in this chapter in relation to governance, include, as a minimum, prudential standards for both governance and risk management.

Chapter 14: Group Supervision and Outsourcing

14.1. Introduction

This chapter relates to the regulation and supervision of those parts of a licensed insurer’s affairs that are external to it but that are integral to its operations:

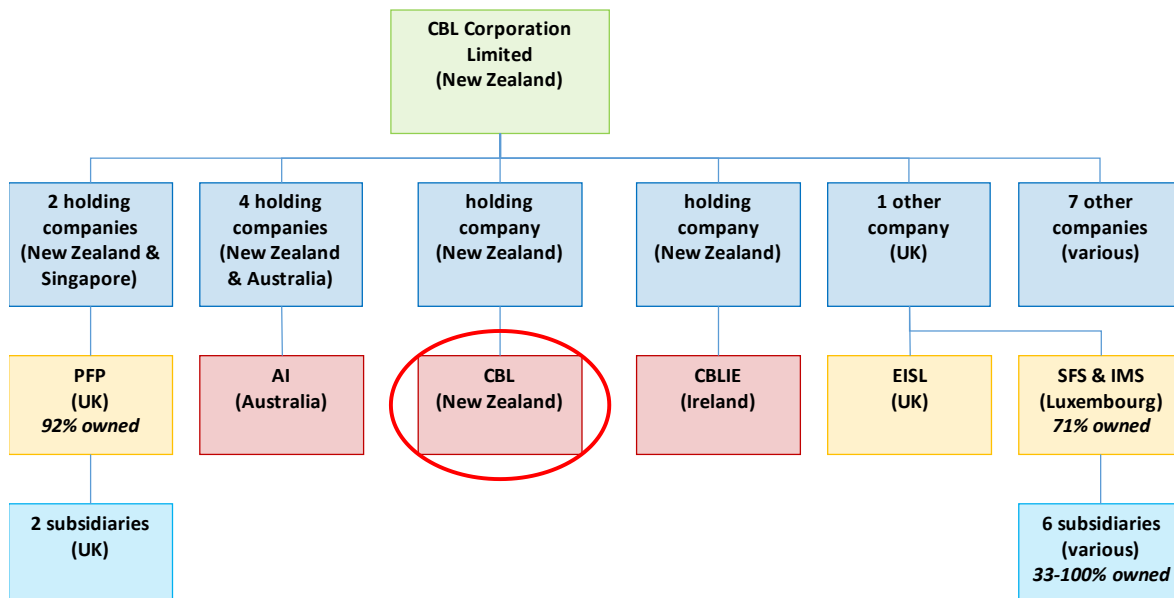
- *Group regulation supervision* relates to parent companies of licensed insurers: a parent company is an *upstream* entity that can have a major bearing on the licensed insurer.
- *Outsourcing* relates to functions of a licensed insurer that are delegated to an external third party: such third parties are *downstream* entities which, if not well managed, can adversely affect the licensed insurer’s operations (and vice versa but the regulator’s interest is the potential for adverse outcomes).

14.2. Group regulation and supervision

Insurance groups

It is common for insurance groups to be structured with a parent non-operating holding company that owns one or more insurance and other subsidiary companies. CBL is an example.

CBL Group simplified structure



14.3. Summary

As outlined in Chapter 10, group regulation and supervision was a relatively new topic when the Act was passed. Now it is well established internationally but not in New Zealand.

We conclude, for the reasons outlined below, that it would be timely for the Bank to explore group regulation options and to introduce a suitable form of group regulation for all licensed insurers.

Explanation

The primary goal of group regulation is to prevent contagion risk for the licensed entity from activities in other parts of the group. It includes protecting the integrity of the licensed entity's capital structure and hence its solvency.

If the Bank had had the power to regulate and supervise the group parent, and actually used that power, what would have been different in CBL's case?

If CBL Corporation had been licensed as a non-operating holding company (a NOHC), the Bank would have had:

- transparency of relevant transactions of the parent;
- the ability to supervise the capital integrity of the whole group, not just the licensed insurer;
- a more direct interest in the PDS in 2015;
- a direct interest in the other (offshore) insurance subsidiaries of the parent;
- a greater ability to give directions under the Act to the parent as well as to the licensed insurer; and
- for unregulated subsidiaries, access through the NOHC to all information that may be relevant to the licensed insurers in the group (and, as a result, the Bank may also have engaged earlier with offshore regulators).

The second item above, capital integrity, is pivotal: licensing of the parent company CBL Corporation would have given the Bank the ability to ensure that none of the capital and other transactions of the parent would adversely affect the capital position or the risk exposure of any licensed operating insurance subsidiaries including CBL.

Of course the regulator cannot interact directly with any unregulated subsidiaries, but under group regulation it can ensure that actions of the parent company or its unregulated subsidiaries do not adversely affect the licensed entities.

The bank has powers to issue directions on information gathering and other matters across a group under the "associated persons" provisions. That is different from group regulation whereby both the insurer and the parent company of the insurer are licensed and supervised by the regulator.

Under the Act, the Bank can demand information from "associated persons" which include the parent company. While it is a useful power, it is limited relative to the potential of full group supervision.

Findings: Group Supervision

- In the absence of group regulation, contagion risk within a group cannot be understood by the Bank as supervisor.
- An important initial benefit of introducing group regulation is the identification, and then the elimination, of double use of capital. Licensed insurers should never be allowed to count loans as capital but, without group supervision, parent companies can—and often do—indulge in borrowing funds, which are not capital, and using those funds to capitalise insurance subsidiaries.

14.4. Background and potential

The subject of group regulation and supervision has perhaps been the most significant area of attention and new regulation in the last decade, following the GFC, for both banking and insurance. The most famous case during the GFC was AIG, which was the largest insurance group in the world at the time, with a market capitalisation of more than \$1,000bn. It was brought to its knees by one rogue unregulated subsidiary. There were also numerous other insurance-related examples at that time including ING, Aegon and Dexia in Europe.

All of these cases, including AIG, had one or more licensed banks or building societies as well as one or more licensed insurers in the group and also some unregulated entities. There are other examples including HIH in Australia whose holding company, like CBL's, owned insurers and unregulated entities but no banks.

All of these examples are cases where major difficulties occurred because there was no group regulation or supervision in place at the time that solvency and capital problems emerged.

At the time of the GFC, the Australian Prudential Regulation Authority was one of the few regulators around the world that had already established a system for group regulation. Other jurisdictions, including the European Union, have since introduced various forms of group regulation and supervision in both banking and insurance.

The CBL case is a clear example of what can happen without group supervision. One could envisage an earlier and less damaging failure or cessation of business of CBL if, for example, both CBL Corporation and CBL Insurance had been licensed. The effect could have been, by Bank oversight, to limit contagion risk for the insurer within the group and to ensure integrity of capital management across the whole CBL group.

Recommendation: a way forward on group supervision

In the modern commercial world, where group structures proliferate and where insurers and lending institutions search for innovative ways of optimising their capital arrangements, it would be timely for the Bank to explore group regulation options. We recommend that the Act be amended to introduce a suitable form of group regulation for all licensed insurers.

14.5. Outsourcing

Outsourcing refers to the functions of a licensed insurer that are delegated to an external third party.

CBL's use of outsourcing

One of the features of the CBL business model as we understand it was the extensive outsourcing of most of its base insurance functions. These functions are sales and distribution, underwriting, pricing, administration and claims management.

Regarding sales and underwriting, CBL relied almost exclusively on managing general agents operating as underwriting agents writing business that was sourced from brokers and placed with insurers who then reinsured most of it to CBL. The claims function was also outsourced to third party claims specialists. This outline relates to how CBL managed its French business, comprising more than half its total business (most of its other business was managed in a similar way with some variations).

14.6. CBL's underwriting arrangements

CBL's ceding companies used underwriting agents extensively. This practice is common for specialist lines of business because many insurers, especially multi-line insurers, often do not have the in-house expertise to write such lines of business.

It is not uncommon for underwriting agents to be partly or wholly owned by an insurer. Also many are independent so as to preserve the option of changing insurer from time-to-time if they see the need.

For much of CBL's French business, being the majority of the CBL portfolio, it seems that the chain of events for underwriting was:

- A broker brings the business to one of two underwriting agents owned by CBL (EISL and SFS).
- The agent insures the business with insurers with some connections to CBL (Elite, Alpha Insurance or CBLIE).
- CBL "fronts" for the insurer by accepting a major proportion of the business by way of quota share reinsurance, often 80%.

The two underwriting agencies, EISL and SFS, were purchased by CBL, EISL in 2011 and SFS in 2016.

Normally an insurer will accept business from an underwriting agent on the one hand and on the other hand make reinsurance arrangements that are not directly connected with the business of individual underwriting agents. In the CBL case, however, there was a clear practice of "fronting", with the insurer acting as a front for the reinsurer who is the real underwriter of the business. In some jurisdictions it is not possible to do this because the regulator requires insurers to take genuine underwriting risk when they accept business. This may be the case in France and may be the reason why CBL had quota shares that were mostly of the order of 80% (full-scale fronting would mean 100%).

When "fronting" occurs, it is often for regulatory arbitrage purposes. In the CBL case, where CBL operated as a foreign reinsurer and not as a locally licensed insurer, CBL was able to operate in France like a local insurer but without being regulated there.

The fact that CBL was operating in France as an unregulated foreign reinsurer while really fronting in competition with local licensed companies suggests that the Bank should have taken a closer interest than it did in these French underwriting arrangements.

Reliance on underwriting agents, along with the untested effectiveness of the ability of internal staff to manage them and their underwriting, noting also some inherent conflicts of interest, is something that arguably warranted deeper investigation by the Bank and regular monitoring.

14.7. CBL's inwards reinsurance arrangements

The insurance and quota share reinsurance arrangements described above may have been intended to align the interests of the underwriting agents, the insurers involved and CBL as reinsurer. How and whether they did so, and indeed whether that was the intention, is not entirely clear but they did have the potential of aligning the interests, which would be beneficial.

We note, however, from the 2013 KPMG report, that "CBL is prepared to pay higher reinsurance commissions to ensure that the relationships with insurers and underwritten risks are acceptable and ... risk underwriting remains robust". Cause and effect are assumed here but conflict of interest is likely: this is an example of the relevance of the supervisor becoming fully informed and then making its own judgment as to the prudence or otherwise of the arrangement.

14.8. Managing the outsourcing

To manage successfully this train of transactions over time requires the reinsurer, in this case CBL, to:

- have full knowledge of the business that the ceding companies are writing;
- because the managing general agents (MGAs) are underwriting agents (ie have authority to bind the insurer), specify fully and then monitor compliance with the underwriting and pricing authority given (irrespective of whether the MGAs were owned by CBL or independent);
- ensure that complete and accurate records are kept of all business written;
- be satisfied that reinsurance arrangements with its ceding companies and remuneration arrangements for the MGAs to not include features that could incentivise the ceding companies or the MGAs to place their own interests ahead of policyholders or of CBL as the reinsurer; and
- have full knowledge of how claims are being managed to ensure that the claims agents are diligent not only in record keeping but in making fair decisions for all claimants and at the same time protecting the financial interests of the underwriting companies and hence of CBL as reinsurer.

These functions had even more importance in CBL's case than in many others because CBL was not regulated in the markets that were the sources of most of its business (most of its offshore business was being written without any prudential regulation other than by the Bank back in New Zealand – see Chapter 6).

Throughout the period from pre-licensing in 2011 to liquidation in 2018, the Bank did not have line of sight of CBL's execution of these functions. The Bank did not seek copies of all of the information that CBL should have had (and may have had) in a situation like this, such as:

- reinsurance treaties with ceding companies;
- terms of the agreements with the MGAs;
- terms of the agreements with the claims agents; and

- copies of regular reports containing management information and compliance information that CBL was or should have been receiving from these parties and monitoring closely.

The Bank did seek copies of some of this information from time to time but did not appear to recognise it as important enough in monitoring CBL's affairs to ensure that CBL itself kept timely, complete and accurate records of all of this information.

The Bank was aware that the Appointed Actuary at CBL endured a significant shortage of comprehensive and reliable data on CBL's insurance portfolios, for several reasons including the low quality of record keeping and associated systems both within CBL and as received from its business partners (ceding companies and the MGAs). Relevance to the Bank as supervisor

Taking account of all of the above, there is a case for the Bank to introduce outsourcing requirements or standards for licensed insurers.

Findings: Outsourcing

- Outsourcing of various functions is a common part of the business world generally, although usually core business functions are not outsourced. In the case of insurance, however, the outsourcing can include, as we saw in the CBL case, not just some back-office functions but the fundamental insurance functions of underwriting, pricing and claims management.
- The outsourcing of core functions can generate material risks to the insurer and therefore need to be incorporated in a suitable way into the prudential supervision regime.

Recommendation: a way forward on outsourcing

The Bank consider introducing, perhaps as part of requirements under the Solvency Standard, information and compliance reports on significant outsourcing arrangements. These requirements could include, for example:

- an outsourcing policy approved by the board;
- legally binding agreements for significant business activities that are outsourced, with extra safeguards or controls where the outsourced activities are outside New Zealand (NB This should include all inwards and outwards reinsurance agreements);
- monitoring arrangements for managing significant outsourcing agreements; and
- copies of all significant outsourcing agreements being made available to the Bank on request.

Chapter 15: Confidentiality and Disclosure

15.1 The issue

Our Terms of Reference ask that we consider whether the approach taken by the Bank to the confidentiality of its regulatory actions was appropriate.

Following the interim liquidation of CBL in February 2018, there has been public commentary over the fact that neither the Bank nor CBL Corporation disclosed earlier that CBL's financial soundness was under question by the Bank. The commentary has included criticism from some quarters, particularly CBL shareholders, because it became obvious at the time of the interim liquidation that the Bank had knowledge of potential problems within CBL well beforehand.

We first consider the obligations on the Bank in relation to regulatory actions generally, and then how they applied to the Bank's actions in relation to CBL.

15.2 The relevant provisions governing confidentiality and disclosure

Section 135 limits the ability of the Bank to publish or disclose information to a number of prescribed circumstances. The section covers a very broad range of information held or obtained by the Bank or an investigator, including information derived from information obtained. It also covers information relating to the exercise or possible exercise of powers under the Act.

Circumstances where disclosure or publication *may* be made (and the decision is one for the Bank if the circumstances arise) include, relevantly, for the purpose of any function or power conferred by any other enactment, and to any person the Bank is satisfied has a proper interest in receiving that information, if satisfied that appropriate provision exists to protect the confidentiality of that material. The Bank may also disclose with the consent of, here, CBL. Further obligations are imposed under s 136. Under s 137, no other Acts can override these provisions, save the Official Information Act 1982 and Local Government Official Information and Meetings Act 1987, which have their own protections for information that is the subject of investigation.

The confidentiality obligation on the Bank is an onerous one. Officers and employees of the Bank, and investigators, are liable on conviction to up to three months' imprisonment and/or a fine up to \$200,000 if they do not comply with this provision.

Note too under s 150 that it is a specific offence to disclose that a direction has been given under subpart 1 or 2 of Part 4 (Distress management). That is subject to permitted disclosure to any director or relevant person to which the direction relates; with the written consent of the Bank for the purposes of the sale or other disposition of all or part of the capital or business undertaking of the insurer or associated person; or by the Bank, or with the Bank's written consent, to any person with a proper interest in knowing of the direction, or to the public.

Two points can be made: first, as noted above, the confidentiality obligations on the Bank are onerous. This is understandable given its very broad powers to obtain vast amounts of commercially sensitive information in order to carry out its functions. In that way it is perhaps analogous to the Inland Revenue Department, and the very strict confidentiality obligations not to disclose taxpayer's

information. Second, the Bank has a discretion in certain circumstances to disclose, notwithstanding its obligations.

15.3 The Bank's actions in relation to CBL

In June 2017, when the Bank became aware of the PwC UK report relating to Elite, it issued a s 121 Notice requiring certain information from CBL. Shortly after, the Bank issued a Direction that CBL maintain a solvency ratio of 170%, and not to enter into certain transactions without the Bank's permission. There were further s 121 notices seeking information, and on 21 August 2017, the s 130 investigation by McGrathNichol was commissioned. The various Directions issued are discussed in Chapter 6.

It was appropriate to maintain confidentiality over these steps. Matters were at a fact-finding stage. The Bank had serious concerns that warranted action, but it had not yet gathered the relevant information, tested it with CBL, and arrived at a sufficiently informed position. Obviously public disclosure of the fact of an investigation or initial concerns that have not yet been tested would be highly damaging to the reputation of CBL and to the value of its parent.

The public interest in preserving secrecy in relation to such matters is well recognised both by statute and the common law. The Court of Appeal has emphasised the need for investigations to be carried out away from the glare of publicity and risk of trial by media: "It is not in the public interest that such mechanisms are by passed or subverted" (*Vickery v McLean* [2006] NZAR 481 (CA) at [19]).

On 2 February 2018, confidentiality in relation to the Directions and the s 130 investigation was lifted by the Bank at the request of CBL, for the purposes of market disclosure under the listing rules. In its letter advising CBL of its agreement, the Bank noted its purpose to date in keeping the matters confidential was to protect CBL from speculation in advance of the findings of the investigation and to allow the Bank and CBL to maintain open communication. It noted that CBL needs to be able to make market announcements in order to plan for capital raising. The Bank considered it would be appropriate for CBL to disclose the investigation at this time.

CBL did so, and trading of CBL Corporation shares was halted on both the NZX and ASX.

15.4 Observations

The primary reason for confidentiality is that the Bank, quite correctly, is cautious about releasing information on any licensed insurer (or licensed bank) that may affect public confidence in the licensed company until the Bank is sure of its position. The confidentiality requirement, however, creates a quandary for the boards of listed companies who have a continuous disclosure obligations under NZX rules/Corporations Act 2001 (AU) rules.

In the CBL case, the position is also confounded to some extent by the fact that CBL Insurance is a subsidiary of the listed entity, CBL Corporation, which itself is not licensed.

Given the risks to public confidence in a licensed insurer if the Bank is carrying out an investigation or otherwise querying the credentials of an insurer before anything is proven, it is entirely appropriate for the Bank to maintain confidentiality by not making any public disclosures itself and also exerting control over any potential disclosures by the insurer.

Expressed another way, it is important that the Bank retain the power to intervene at any time in the affairs of an insurer. The Bank has to be able to recognise and choose to act early on any potential risk issue that it identifies and it also has to be able to stand back, without adversely affecting public confidence in the insurer, if the potential risk is not realised.

The Bank's actions in relation to confidentiality and disclosure in 2017–2018 were appropriate.

We do not consider there was any earlier occasion when it would have been appropriate for the Bank to make public disclosures.

The lack of disclosure at the time of interim liquidation can be said to have been awkward for shareholders because, with no prior disclosure by the Bank or CBL, they were deprived of information that they may well have judged to be relevant to their position as investors. Arguably it was also awkward for policyholders, but that is a secondary matter in the eyes of investors.

On that point we note that CBL Corporation issued two relevant press releases in August 2017. In the first, on 18 August 2017, it disclosed concerns by the Gibraltar FSC over Elite's claims reserves, the Gibraltar FSC's reference to possible inadequacy of CBL's claims reserves, and announced a reserve adjustment. The CBL Corporation share price reacted at the time, falling some 30%, but a week later there was a second press release that promoted the company's prospects and gave a purported explanation for the claims reserving adjustment. The share price recovered by around 10% and then remained more or less static until suspension of trading in February 2018.

It is the policyholders, however, to whom the Bank owes its responsibility, not the investors. The Bank's essential prudential concern always must be that policyholder promises can be honoured, irrespective of the fate or views or fortunes of shareholders.

Findings: Confidentiality and disclosure

- If the Bank is requiring confidentiality by an insurer's board, the board faces a dilemma in respect of its continuous disclosure obligations.
- Assuming that the Bank's confidentiality requirements override continuous disclosure obligations, the Bank needs to accept the onus of resolving expeditiously any matters that are relevant to public disclosure.
- The converse of the Bank holding the power of confidentiality is that, if it has any prudential concerns about an insurer, the Bank is effectively duty bound to resolve those concerns as early as possible. If there is substance to the concerns, the Bank is then in a position at an early time to say so publicly itself, or to request the insurer to do so.
- We conclude that the Bank acted appropriately on confidentiality during the CBL case.

Appendix 1 - Terms of Reference

An Independent Review for the RBNZ of the Supervision of CBL Insurance Ltd Terms of Reference

Background

A major regulatory event in New Zealand has been the failure of licensed insurer CBL Insurance Limited (CBLI). The Reserve Bank of New Zealand (the Bank), in its capacity as prudential supervisor of the insurance sector licensed, supervised, issued regulatory directions, and ultimately applied for the liquidation of CBLI.

The cessation of business by CBLI, its placement into liquidation and the events that led to its liquidation have caused the Bank to review its prudential regulatory and supervisory arrangements for insurance companies licensed by the Bank. The Bank acknowledges the public interest in these events. To this end the Bank has commissioned an independent review into its supervisory actions and decisions pertaining to CBLI and the associated regulatory framework.

The review will assess supervisory actions taken and not taken by the Bank, including formal decisions made under the Insurance (Prudential Supervision) Act 2010 (IPSA) such as the initial licensing of CBLI, directions given and treatment of breaches of licensing conditions and directions.

Purpose of the Review

The objectives of an independent review are to identify the lessons of this important episode (both the positives and the negatives) by opening the Bank's processes to independent scrutiny and, in doing so, to also provide relevant information to the public and stakeholders.

The purpose is to provide an independent and expert perspective on how best to strengthen the regulatory and supervisory framework for the future, and in particular will:

- Identify any shortcomings and positives in the Bank's supervisory practices and its critical judgements.
- Identify any constraints or areas for enhancement in the legislative and regulatory framework in which the Bank was operating.
- Assist understanding by key stakeholders and the wider public on the Bank's role and activities as a prudential supervisor.

Scope

The review will cover all phases of the recent history of CBLI from pre-licensing in 2011 through to licensing in 2013, development of the company from 2014 to the listing of its parent company CBL Corporation Ltd in 2015, to substantial and fast-growing specialist international reinsurer in 2016,

followed in 2017 by the unravelling of the company's business and its ultimate liquidation at the instigation of the Bank in 2018.

The review will examine and consider questions associated with the Bank's supervision of the company during each of these phases. It will include, but not be limited to—

- Whether CBLI should or could have been refused a licence in 2013
- Whether the Bank should have imposed more or different conditions on the company when granting its licence
- Whether there were legislative or other constraints on the Bank that limited its ability to conduct investigations and impose conditions on the company that would have led to greater knowledge and assurance as to whether the company was operating soundly as an insurer
- Whether the Bank's actions were fair and reasonable to the company (and its group members), in light of the information the Bank was receiving from the company or otherwise had available. This includes the reasons the Bank gave to the company for its actions, such as directions and the application for interim liquidation, and whether it kept an open mind as to the likely outcome of investigations.
- Whether the Bank's supervisory activities were sufficiently well founded and pro-active after licensing, including identifying risks within the CBL business and putting constraints on the company that would protect its solvency position and ultimately avoid closure and liquidation.
- Whether the approach taken by the Bank to the confidentiality of its regulatory actions was appropriate.
- The degree of reliance on the Appointed Actuary (AA) and the interactions with the AA.
- The relevance of supervisory powers at group level as well as at licensed company level.

The litigation processes leading to the appointment of interim liquidators in February 2018 and permanent liquidators in November 2018 are outside the scope of the review.

Reviewers

The review will be conducted by:

- John Trowbridge, former Member of the Australian Prudential Regulation Authority (APRA) responsible for insurance, and experienced insurance actuary and management consultant; and
- Mary Scholtens QC, experienced public and administrative counsel with expertise in regulatory decision-making processes.

Process

The reviewers will investigate the Bank's processes over the relevant period. They will have access to any documents they require, and all Bank staff will co-operate with their requests for information.

The reviewers will act in accordance with the principles of natural justice where these apply. In particular, it is anticipated that any proposed adverse findings will be made available to affected persons for submission and consideration before a final view is determined by the reviewers.

The reviewers will deliver a final report to the Bank outlining their findings by 28 February 2019.

Publication

The results of the review will be made public by the Bank. The reviewers will be available to address media queries on their report at that point, but will not take media queries before then.

November 2018

Appendix 2 - Review Process

A summary of the process undertaken by the reviewers, including reference to development of draft reports for consultation with the Bank and the external parties, was as follows -

Establishment of the Review

- October 2018: reviewers appointed
- November 2018: terms of reference finalised.

Phase 1: fact finding – November 2018 to January 2019

Review of relevant Bank actions and information from 2012 to 2018 –

- Review of documents held by the Bank and interviews with Bank personnel involved in the supervision of CBL, in order to understand the documentation and the chronological sequence of events.
- Review of relevant material from among the public information presented to the court in preparation for the Interim Liquidation hearing in February 2018
- January 14 – Discussion draft provided to the Bank
- Further interviews, questions and requests for further documents and revision of discussion draft.

Phase 2: testing preliminary views – End January and February 2019

- The consultation process was prepared and counsel engaged to assist.
- External parties potentially adversely affected were listed and contacts ascertained.
- Preliminary draft report was completed on 30 January.
- On 29 January letters were sent inviting the external parties to receive relevant extracts on a confidential basis. Confidentiality undertakings were attached and any comments on extracts sought by 20 February (as the reporting date for the Review was then 28 February).
- Extracts of the preliminary draft report that may adversely affect those parties were identified, plus sufficient context for them to understand the point or points made. These points related to parts of the report only.
- In early February, the selected extracts were provided to the parties on receipt of undertakings.
- On 12 February, following a query from one external party, counsel assisting explained that the full report was not provided because it was not relevant to their position (i.e. there was nothing new that potentially adversely affected them) and the reviewers considered the extracts provided sufficient context. The affected parties were invited nevertheless to identify

particular additional information that they considered they should be provided with in order to respond.

- On 15 February, Counsel assisting sent each party a letter that -
 - noted concerns expressed regarding whether the draft report had kept within the terms of reference and indicating that the reviewers would carefully examine the draft with this in mind; and
 - recorded that the reviewers declined to provide the full draft because it was a work in progress, was primarily about the Bank and the substance of any adverse commentary was contained within the extracts.
- Draft extracts were also sent to other organisations that might have had relevant input (they were the FMA, the Gibraltar FSC and EIOPA)
- Some additional email correspondence with questions or input from some of the external parties occurred.
- Comments were received in the third week of February.

Phase 3: reviewing preliminary draft report - end February to mid March 2019

- The reviewers:
 - considered further feedback from potentially affected persons, from others providing input and from the Bank
 - undertook further review of the text considering comments and information received.
 - sought and obtained from the Bank an extension of the reporting time to 17 April.
- On 27 February, the reviewers decided to provide draft extracts of the next version of the report, given changes to text and requests received, and to provide more text by way of context.
- Counsel assisting sent an email to potentially adversely affected parties advising that the reviewers proposed to do this second round of consultation, that they were aiming to provide further draft extracts on 15 March and wished to receive any further comments by 29 March.
- On 15 March further draft extracts were provided, this time with significantly more contextual material.
- Certain parties asked for and were given further time to respond for particular reasons.
- Comments were received in late March and early April.

Phase 4: completion – April – May 2019

- On 11 April, in response to requests for notice and with the agreement of the Bank, the reviewers agreed that 5 calendar days' notice would be given of their intended date of final reporting to the Bank. Counsel assisting advised all affected parties accordingly, as well as informing them of the Bank's indication that it will provide the final report to potentially affected persons and give 5 working days' notice of intended publication.
- The reviewers considered all comments and finalised their report.

- On 29 April the reviewers, through Counsel assisting, gave the external parties notice of their intention to report to the Bank on 6 May 2019.
- The reviewers submitted their final report to the Bank on 6 May 2019.