Competitive provision of ACC in New Zealand

A LEGAL PERSPECTIVE – LESSONS AND LEARNINGS FROM 1999

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NEW ZEALAND SOCIETY OF ACTUARIES BIENNIAL CONFERENCE, TAUPO, 19-21 NOVEMBER 2008

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A copy of Bell Gully's ACC Capability Statement, and other reference information, can be obtained from Bell Gully's ACC Reform Extranet Site. Please contact the author for access details: mark.todd@bellgully.com.

1 INTRODUCTION

The National Party's policy document relating to ACC, released on 16 July 2008, contains the following statement:

"The National Party is committed to the principles of competition and choice as the appropriate means of ensuring efficiency of ACC provision, and increasing incentives for improved workplace safety and better rehabilitation of accident victims. For this reason, we believe that the benefits of competition, and the increased incentives for greater workplace safety, should be investigated in relation to the Work Account."

With the formation of a National-led government, the competitive provision of ACC has become increasingly likely. Although it is not certain that this will occur, or what form it might take, Bell Gully seeks to adopt a "thought leadership" role on this subject.

The purpose of this paper is to identify some of the lessons and learnings derived from New Zealand's experience of competitive ACC provision in 1999. At that time, Bell Gully advised a wide range of industry participants, including accident insurers, trustee companies and employers.

This paper focuses on structural and regulatory aspects of the 1999 experience. Where appropriate, the paper makes reference to the proposed regime under which the Reserve Bank of New Zealand will be appointed as prudential regulator of the insurance industry (**the Proposed RBNZ Framework** or **Framework**).

The paper is unashamedly selective in terms of the issues covered, based on the recollections and experiences of the author. It does not purport to provide a comprehensive overview of the 1999 regime or to identify all of the issues that arose. In particular, this paper does not deal with coverage, boundary issues or claims matters.

My thanks to Mark Weaver of Melville Jessup Weaver for arranging for me to speak at the 2008 Biennial Conference, and for assisting with the presentation.

2 BUSINESS STRUCTURE

Introduction

Under the Accident Insurance Act 1998 (the **1998 Act**) accident insurers were required to be companies incorporated under the Companies Act 1993. This prevented branches of foreign insurers from operating as accident insurers.

However, there was no restriction on accident insurers also undertaking non-accident insurance business. In particular, it was open to an accident insurer to underwrite other general insurance business lines.

The 1999 position in practice

In practice, a mixed approach was taken in 1999 in relation to the establishment of special purpose companies to operate as accident insurers. Four of the six private insurers established special purpose companies for the purposes of conducting accident insurance. The remaining two (Allianz (then MMI) and ACE) used their principal general insurance companies in New Zealand to write accident insurance business.

The Proposed RBNZ Framework

The Proposed RBNZ Framework will be mentioned in a number of contexts in this paper. It is unclear how the Framework might apply in respect of any competitive ACC regime. However, it is nevertheless helpful to consider that Framework in the context of the 1999 experience.

Some observations on the Framework in relation to business structure are as follows:

a) **Non-insurance activities**: The Framework contemplates that RBNZ will have the power to limit the extent to which insurance entities can perform non-insurance activities. This is designed to limit potential contagion of insurance activities by other activities.

b) **Life statutory funds**: The Framework also contemplates that insurers that carry on life and general insurance within the same legal entity will be required to operate at least one life insurance statutory fund. As with (a) above, this is designed to limit potential contagion between business lines.

c) **Foreign insurers**: The Framework contemplates that foreign life and general insurers may continue to operate in New Zealand as branches. Some special requirements will apply in respect of such insurers, including:

- Exemptions from New Zealand requirements may be available where compliance with home country requirements achieves New Zealand regulatory standards.
- The financial strength ratings from credit rating agencies must take into account any home country policy preference arrangements or

other legal issues which would disadvantage New Zealand policyholders.

- RBNZ may require local incorporation in circumstances where either home country regulation and supervision, or the legal or accounting framework, are not of an acceptably high standard.

If ACC competition occurs, it will be interesting to see the extent to which the above principles from the Proposed RBNZ Framework would be applied to private accident insurers. This is likely to be particularly relevant, given the expected interest from existing general insurers and, possibly, a number of overseas new entrants. It is possible that the social policy objectives associated with ACC will give rise to more onerous regulatory requirements than apply to other general insurance business lines.

Factors relevant to business structure

Factors relevant to the choice of business structure will include the following:

a) **Regulatory latitude**: First and foremost, the latitude provided by regulatory requirements.

b) **Contagion risk**: Any commercial benefits from quarantining the assets and liabilities associated with different business lines, and limiting or eliminating potential contagion between business lines.

c) **First ranking charge**: The potential need to provide a first ranking charge over assets to support accident insurance liabilities (as was required in 1999). It may be that insurers will wish to establish a special purpose company so as to limit the operation of that charge.

d) **Costs**: Reducing operational and administrative costs, including those associated with regulatory compliance, through minimizing the number of legal entities involved.

e) **Other**: Other legal, financial, accounting, tax and governance factors.

3 ACCIDENT INSURANCE CONTRACTS

Introduction

From a legal perspective, the key "pillar" of the 1999 regime was the "accident insurance contract". The accident insurance contract was the instrument by which insurers provided ACC entitlements to relevant individuals.

In a number of respects, accident insurance contracts were quite different to normal insurance contracts. This section explores those differences and highlights areas to consider in relation to any new competitive regime.

Role of accident insurance contracts

Under the 1999 regime, the following applied:

a) **Employers**: Every employer was required to enter into, and maintain in force, a single accident insurance contract with an insurer in respect of work-related personal injuries suffered by its employees (section 169(1)).

b) **Self-employed**: Self-employed persons and private domestic workers were entitled to enter into accident insurance contracts, but were not required to do so (sections 176 and 180).

c) **Insurers**: Accident insurers were obliged to offer to enter into an accident insurance contract with an employer, self-employed person or private domestic worker on terms and conditions (including premium) determined by the insurer (section 186).

Implied terms

The 1998 Act implied a number of key terms into accident insurance contracts (mainly under sections 170, 178 and 181). These implied terms included the following:

a) **All employers**: In relation to accident insurance contracts with employers, that the contract applied to every employee of the employer.

b) **All work-related injuries**: Also in relation to contracts with employers, that the contract applied to every work-related personal injury suffered by the employer's employees in that employment.

c) **Enforcement**: Also in relation to contracts with employers, that employees (and other relevant individuals) may enforce the contract.

d) **Claims**: Terms relating to the receipt and determination of claims.

e) **Minimum entitlements**: Terms to the effect that the contract provides no less than the statutory entitlements (as set out in Schedule 1 to the 1998 Act).

f) **Disputes**: Terms relating to disputes.

g) **Compulsory transfers**: Terms relating to the ability of the prudential supervisor to compulsorily transfer the insurer's rights and obligations under the contract to another insurer.

Observations relating to accident insurance contracts

We make the following observations in relation to accident insurance contracts under the 1998 Act:

a) **Compulsion**: Unlike in relation to typical contracts, the 1998 Act placed a restriction on "freedom of contract". As mentioned, employers were required to enter into an accident insurance contract (although they could choose from amongst registered accident insurers).

Similarly, accident insurers were required to offer to enter into accident insurance contracts on request. They could not refuse to offer accident insurance to an employer, self-employed person or private domestic worker.

This requirement was of some concern to insurers because of the possibility that it would prevent them from avoiding unacceptable risks or restrict their ability to target particular sectors or classes of business. However, in practice, due principally to the ability of the insurers to determine the terms of their offer without restriction, our observation is that this requirement did not create significant difficulties.

b) **Limited flexibility as to terms**: Again, unlike for a typical contract, insurers had very limited flexibility to determine the terms and conditions of their accident insurance contracts. This is because the terms implied into the contracts by the 1998 Act covered most of the core components of the contracts. For example, as mentioned above, those implied terms prescribed who was covered, the periods of cover and the entitlements to be provided.

c) **"Low doc" approach**: The fact that most of the core components of accident insurance contracts were implied into the contracts through the operation of the 1998 Act meant that insurers were able to adopt a "low doc" approach. This meant that the contracts themselves would be relatively short, often just a couple of pages long. So long as they expressly identified as an "accident insurance contract under the Accident Insurance Act 1998" they would automatically incorporate the implied terms under the Act.

Despite this, most insurers saw fit to include some additional legal boiler-plate into their contractual documents. This was permitted, so long as that boiler-plate was consistent with the implied terms under the 1998 Act.

d) **Commencement date of contracts**: The 1998 Act contained specific provisions relating to the point in time at which an accident insurance contract was created (section 184). The contract was created as soon as the person to whom the contract was offered had satisfied three conditions:

- Accepted the terms and conditions offered by the insurer.
- Paid any premium that the insurer specified must be paid as part of the acceptance.
- Provided the insurer with the person's insurance number.

This provision overrode the normal contractual approach of specifying the date at which the contract commences.

It was very important to ensure that the contractual terms and the procedures for the acceptance of premiums were such as to create certainty as to when the contract was created. This ensured that there was clarity as to when the insurer's liability commenced.

e) **Minimum entitlements**: The implied terms required that the insurer would be liable for "no less than" the statutory entitlements. This meant that it was open to insurers to provide entitlements in excess of the required minimum.

We understand that this was intended to enable insurers to provide additional benefits or coverage if considered appropriate for competitive reasons. While we were aware of some examples of this, our observation is that this was not a widespread practice in 1999.

f) **Employees could enforce**: The 1998 Act incorporated the concept of "privity of contract" under which a third party who is not a party to the contract is entitled to enforce the contract. This occurred in relation to accident insurance contracts with employers, which were enforceable by the employees of those employers.

g) **Misrepresentation and non-disclosure**: Consistent with the concept of universal cover, an insurer was not entitled to avoid an accident insurance contract because of misrepresentation or a failure to disclose by any person (section 190). However, in certain circumstances, an employer, self-employed person or private domestic worker was liable to an insurer for damages for material non-disclosure.

h) **Termination**: As with any insurance contract, the ability of the insurer to terminate an accident insurance contract needed careful consideration. From a commercial perspective, it was important that the insurer had maximum flexibility to terminate such a contract.

The 1998 Act did not prevent an insurer from including a right to terminate in its accident insurance contracts. However, certain minimum notice periods were required to be met in order to ensure that there was continuity of cover (section 189).

Interestingly, an insurer that had terminated an accident insurance contract was not relieved from the requirement to offer to enter into an accident insurance contract with the person who was a party to that contract. However, as mentioned, in practice, insurers were able to control the persons with whom they entered into accident insurance contracts.

As a general comment, it seems likely that the concept of accident insurance contracts and the statutory provisions relating to them would be applicable to any equivalent competitive regime enacted in the future. Accordingly, the observations outlined above may well be of relevance in the context of any such regime.

4 RISK SHARING ARRANGEMENTS

Section 185 of the 1998 Act stated that:
"An employer or a self-employed person or a private domestic worker may agree with an insurer that the employer, self-employed person, or private domestic worker will carry out certain obligations of the insurer under an accident insurance contract with that person."
From our experience, risk sharing arrangements were an important component of the 1999 regime. Our observations in relation to these arrangements are as follows:

a) **Large clients**: A number of the larger employers, particularly those who had participated in the "accredited employer" regime with ACC, wished to enter into risk sharing arrangements. Given that large employers were generally attractive clients from an insurer's point of view, insurers were generally prepared to accommodate their requirements.

b) **Flexibility**: The 1998 Act gave considerable flexibility regarding the nature and extent of risk sharing arrangements. Some employers wished to take responsibility for the provision of all statutory entitlements, including the provision of rehabilitation services (typically, through trusted contractors). Others took on a portion of the financial risk, subject to various stop-loss limitations.

c) **Captives**: We worked with a number of large employers to explore the possibility of utilising a captive insurance arrangement in conjunction with the 1999 regime. This could either be an existing captive insurer or a new captive insurer established especially for that purpose. One approach that was considered was the possibility of registering a captive insurer as an accident insurer under the 1998 Act. A key factor in relation to this approach was the compliance issues that would arise. Another approach was to combine a risk sharing arrangement with an existing accident insurer and the provision of reinsurance to that accident insurer by the captive. This approach essentially enabled the employer to leverage off the accident insurer's registration under the 1998 Act.

d) **Risk sharing contracts**: Some accident insurers developed a form of template accident insurance contract specifically designed to accommodate risk sharing arrangements. This could be used as a starting point for negotiating risk sharing arrangements with employers. This tended to assist the process of efficiently negotiating risk sharing arrangements.

e) **Residual liability**: Even where a risk sharing arrangement was entered into by an insurer, the insurer continued to have residual liability to provide cover and the statutory entitlements if the employer failed to do so (section 185(3)). This provision was designed to ensure that individuals always had recourse to a registered accident insurer for their statutory entitlements. From an insurer's perspective, it meant that the transfer of liability associated with risk sharing arrangements was imperfect.

5 PRUDENTIAL REGULATION

Introduction

One of the most interesting issues that will arise in relation to any competitive ACC regime will be the arrangements that are established for the prudential regulation of accident insurers. Some aspects of this are touched on above in relation to the business structure for accident insurers.

However, from a broader perspective, it is informative to compare:

a) **Current regime**: The prudential requirements that currently apply to general insurers.

b) **1999 regime**: The prudential requirements that applied to accident insurers under the 1999 regime.

c) **Proposed RBNZ Framework**: The prudential requirements that will come into force under the Proposed RBNZ Framework.

Preliminary comments

Before undertaking this comparison, it is worth noting the following comments:

a) **Limited current requirements**: The prudential requirements applicable to general insurers at the time of the 1999 regime and presently are very limited. The Proposed RBNZ Framework will significantly increase those requirements.

b) **1999 Prudential Supervisors**: In recognition of the social policy aspects of ACC, the prudential requirements applicable to accident insurers under the 1999 regime were significantly increased from those applicable to general insurers. This was principally achieved through the requirement for accident insurers to appoint a trustee company (i.e. a private sector entity) as prudential supervisor under a trust deed (section 201). A number of references relating to the 1999 regime in the following chart relate to requirements that were overseen by these prudential supervisors.

Comparison chart (simplified)

	Current general insurance regime	**Proposed RBNZ Framework**	**1999 Accident Insurance regime**
NZ incorporation	No	No	Yes
Recognition of overseas regulation	No	Yes	N/A
Deposit	Yes	No	Yes
Licensing	No	Yes	Yes
Rating	Yes	Yes	Yes
Fit and proper requirements	No	Yes	No
Prudential Supervisor	No	Yes	Yes
Actuary required	Yes (in practice)	Yes	Yes (in practice)
Insurance specific solvency requirements	No	Yes	Yes
Connected party transaction provision	No	Yes	Yes
Ongoing monitoring	Yes (?)	Yes	Yes
Prevention of non-insurance activities	No	Yes	Limited
Control of mergers etc	No	Yes	Limited
Insurance specific distress management	No	Yes	Yes
Charge over assets	No	No	Yes
Customisation possible	No	Yes	Yes (?)

Observations

Observations in relation to this comparison are as follows:

a) **Similar regimes**: It is clear that there are significant similarities between the 1999 regime and the Proposed RBNZ Framework. Many of the requirements imposed by the 1998 Act are also contained in the Framework. Under the Framework many of the functions undertaken by private sector prudential supervisors in 1999 in relation to accident insurers would be undertaken by RBNZ in relation to general insurers.

b) **Some gaps**: Notwithstanding (a) above, there are several aspects of the 1999 regime that are not contained in the Framework. Most notably, these are the requirement for New Zealand incorporation and the requirement for the prudential supervisor to hold a first charge over the assets of the accident insurer in order to support its liabilities.

   It may be that policymakers designing any competitive ACC regime would consider that the special features of ACC require enhanced prudential regulation over and above that which applies to general insurance. Features of ACC that may lead to this conclusion include the social policy aspects of ACC and its long-tail nature.

   If policymakers take this view then they are likely to seek to "plug" the above gaps. They may go further and seek to establish a special prudential regulation regime for accident insurers with a different structure or further enhancements.

c) **Flexibility**: The 1999 regime contained considerable flexibility for prudential supervisors to recognise the specific circumstances of each accident insurer. This arose because the requirements applicable to each accident insurer were set out in a trust deed that was specifically negotiated between the accident insurer and the prudential supervisor.

   If policymakers sought to apply the Proposed RBNZ Framework (or an enhanced version of it) to a competitive ACC regime, there is a question mark as to whether similar flexibility would be delivered. The Framework does seem to contemplate that some customisation will be possible (through exemptions or otherwise), but the extent of this is uncertain.

d) **Costs**: RBNZ has indicated that it will not be charging fees for its regulatory functions.

Trust Deed Covenants

As mentioned, under the 1999 regime, each accident insurer entered into a trust deed with its prudential supervisor. Under the trust deed, the accident insurer entered into a variety of covenants in favour of the prudential supervisor. These covenants effectively contained many of the prudential requirements applicable to the accident insurer.

The covenants were numerous and examples included:

a) **Solvency**: Covenants placing specific solvency-related requirements on the accident insurer.

b) **Disposal/alteration restrictions**: Covenants preventing the accident insurer from disposing of assets or altering the nature of its business without the approval of the prudential supervisor.

c) **Connected party transactions**: Covenants placing restrictions on the ability of the accident insurer to enter into transactions with connected parties and/or requiring those transactions to be undertaken on an arms-length basis.

d) **Investment restrictions**: Covenants placing restrictions on the manner in which the accident insurer could invest its assets.

e) **Information sharing**: Covenants requiring the accident insurer to provide certain classes of information to the prudential supervisor.

In case it may inform interested parties in relation to any competitive ACC regime that may be established, we attach in the Schedule a comparison of the covenants entered into by the six private accident insurers that operated in 1999. This gives an indication of the specific prudential requirements that were considered to be appropriate at that time.

6 CONCLUSION

It is almost 10 years since a competitive ACC regime was operative in New Zealand. And that regime only operated for a very short period of time.

There is now a possibility that a similar regime may be established in the near future. With the passing of time, it is inevitable that some of the matters that were previously relevant will not remain so. However, equally, it is clear that some of the lessons and learnings from 1999 have the potential to be relevant to any new competitive regime.

SCHEDULE: COMPARISON OF 1999 PRUDENTIAL COVENANTS

Notes:

1. The prudential covenants in the Trust Deeds are detailed and complicated. This Schedule contains a brief selective summary only. Copies of the Trust Deeds are available on Bell Gully's ACC Reform Extranet Site. Please contact the author for access details: mark.todd@bellgully.com
2. At the time of printing, the Trust Deed for Insurer 6 has not been obtained. A complete comparison, including Insurer 6, will be posted on the Extranet Site once available.

Section A – Solvency Covenants

Insurer 1	Minimum capital not less than the greatest of: • $2 million • 20% of Premium Income • 50% of Net Central Estimate of Outstanding Claims Liabilities plus estimate of Non-accident Insurance Contract Claims
Insurer 2	As for Insurer 1
Insurer 3	As for Insurer 1
Insurer 4	As for Insurer 1
Insurer 5	Owners equity not less than $25 million or 25% of Total Premium
Insurer 6	

Section B – General Covenants

	Insurer 1	Insurer 2	Insurer 3	Insurer 4	Insurer 5	Insurer 6
Restrictions on disposal of assets otherwise than in the ordinary course of business.	✓		✓		✓	
Restrictions on the provision of services otherwise than in the ordinary course of business.	✓				✓	
Restrictions on granting security interests.	✓	✓		✓		
Restrictions on connected party transactions.	✓	✓	✓	✓	✓	
Restrictions on the valuation of assets.	✓		✓		✓	
Restrictions on carrying on life insurance.	✓					
Restrictions on incorporating or acquiring a subsidiary.	✓	✓		✓		
Investment restrictions.	✓	✓	✓	✓	✓	
Limitation on investing in unlisted securities.		✓		✓		
Limitation on investing in overseas securities.		✓		✓		
Reinsurance restrictions	✓	✓		✓	✓	
Requirements to provide various classes of information to Prudential Supervisor.	✓	✓	✓	✓	✓	
Requirement to comply with the Accident Insurance Act.	✓				✓	

Restrictions on seeking deregistration or relief under the Act.	✓	✓	✓	✓	✓	
Requirement to maintain rating.	✓	✓	✓	✓	✓	
Requirement to appoint Actuary.	✓	✓		✓	✓	
Requirement to maintain liquid assets.	✓					
Requirement to develop and maintain management policies on certain matters.		✓		✓		
Requirement to comply with actuarial recommendations.		✓		✓		
Restriction on changing the nature of business.		✓	✓	✓	✓	
Restrictions on giving guarantees.		✓		✓		
Restrictions on borrowing.		✓		✓		
Restrictions on loan concentrations.		✓		✓		
Restrictions on changes in shareholding.	✓		✓		✓	
Requirement to allow Prudential Supervisor to attend general meetings.	✓		✓		✓	
Requirement to insure assets.			✓			
Requirement to carry on business in a proper and efficient manner.		✓	✓	✓		
Requirement to comply with all laws.			✓			
Requirement to comply with contractual obligations.		✓	✓	✓		

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