cutting through complexity

New Zealand Insurance Update

November 2013

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Foreword

Now, more than ever before, New Zealand's economic prosperity is linked to the performance of our insurers: a strong and robust insurance industry is fundamental to the enduring growth of New Zealand.

Welcome to the KPMG *New Zealand Insurance Update*. Our 2013 issue provides a snapshot of the industry's performance, and canvasses a number of key issues and opportunities currently facing the industry.

The New Zealand insurance landscape in 2013 was again dominated by the effect of the Canterbury earthquakes and associated recovery efforts. In addition, further rationalisation of the sector has occurred as insurers migrated from provisional to full licenses under the Reserve Bank of New Zealand's supervision.

Our 'year in review' on page 2 provides an overview of the industry's performance in the year to 30 June 2013, and tracks the progress of post-earthquake Canterbury recovery efforts and other market developments.

KPMG's global publication, *The Valued Insurer*[1], distils four consistent attributes: focus, efficiency, agility and trust; that a successful and valued insurer should consider embedding in its business model and integrating into its strategy. One overarching characteristic is no great surprise – a consistent orientation or refocus by these firms around their end customer – these four key attributes merit careful contemplation.

On page 18, we explore customer engagement strategies for the future insurer.

The insurer of the future will have to adapt to the changing trends in technology in order to remain competitive, to stay relevant for its customers and to create value for its investors. Two of our articles, on page 10 and page 13, provide insight on creating value from opportunities in a changing IT world, and harnessing data in the digital age.

With an eye to the future, we highlight a number of current tax issues with direct relevance to the insurance sector on page 26, including an update on the latest consultations with the Reserve Bank of New Zealand.

Finally, on solvency and capital management, on page 28 we consider regulatory developments in Asian insurance markets and potential implications for our industry.

On behalf of KPMG New Zealand, we hope you enjoy the read.

1. *The Valued Insurer: Leading the pursuit of sustainable growth KPMG International, 2013*

The year in review

General insurance industry overview: 2013

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The year to 30 June 2013 was one of progress and transition for the general insurance industry in New Zealand. Insurers and their project management teams made substantial progress in completion or agreed resolution of claims relating to the Canterbury earthquakes, underlining the wider residential recovery of Canterbury. The industry also reached a milestone in sector regulation, with insurers migrating from provisional to full licenses under the Reserve Bank of New Zealand's supervision.

Canterbury earthquake update

Three years on from the initial September 2010 Canterbury Earthquake, the importance of the insurance industry as a macro and micro vehicle to mitigate risks associated with catastrophic events is apparent. We have only to look at the July and August 2013 Cook Strait earthquakes to see that New Zealand will always be susceptible to natural disasters. An insurance industry that is robust enough to withstand these disasters is a critical building block to the sustainable success of the New Zealand economy.

Earlier this year, the Treasury revised its estimates on the total cost of the rebuild. This has moved from an estimated cost of $30 billion in 2012, to the current estimate of well in excess of $40 billion. Although this includes costs that are not included in insurance claims – such as planned public and private expenditure on improvements and new property developments[1] – this significant revision only emphasises the inherent uncertainties in the rebuild costs.

The year to 30 June 2013 has also seen some important earthquake claim cases go through the courts, providing greater clarity and a platform from which claims can be settled. The Court of Appeal made an important ruling when it upheld the decision that the Christchurch City Council could not set a higher-than-minimum seismic strength standard for repair to earthquake damaged buildings[2]. This provided certainty around the minimum standards required for the earthquake rebuild, and allowed projects to progress.

During the year, insurers have continued to gain a greater understanding of the drivers of the costs of the Canterbury earthquake rebuild. However levels of uncertainty remain with respect to the quantum of the total costs. This is due to a range of complicated issues, such as: the settlement of multi-unit and cross title claims; complexities in land remediation for Port Hills claim cases; apportionment of costs in relation to land remediation in Technical Category 3 properties; and demand surge inflation on rebuilding costs. International experience would indicate that demand surge inflation can be as high as 25%[3].

Insurers are making good progress with claims settlement – due to an increasing understanding on the factors impacting settlements, clarity coming from court cases, and continual resources invested by insurers. They have committed to having claims settled either through repairs, rebuilds or cash settlements; or in the construction phase by 2015. The Earthquake Commission ("EQC") also has positive news – reporting that apportionment of all over cap claims had been completed, allowing policyholders to proceed with their private insurers for resolution. With respect to their stated goal of completing the largest claims management and settlement exercise in the world undertaken by a single insurer, they have brought the end date forward a year from 2015 to 2014[4].

In the current year we saw a major change in the underwriting of property risk, with most of the industry moving from traditional open-ended replacement cover to fixed sum insured policies. This move was expected, as global reinsurers were unwilling to take on unquantified cover. It has pushed the onus back on the insured to understand the value of their property, and what is (and isn't) included,

During the year, insurers have continued to gain a greater understanding of the drivers of the costs of the Canterbury earthquake rebuild. However levels of uncertainty remain with respect to the quantum of the total costs.

when deciding on the maximum sum insured value.

The industry has been proactive in educating policyholders of the changes. However given the requirements for property owners to now understand the cost of a rebuild – something which most will not be familiar with – insurers and brokers will need to ensure that ongoing education, resources and interaction with policyholders is available to meet their needs. Policyholders want to protect their property through products they understand; and while it will be up to the insurers and brokers to meet their expectations, the decision on the sums insured is now left to the policyholder.

Affordability of insurance for older buildings could also become an issue, when policies come up for renewal. As a result of moving to fixed sum insured policies, the level of information required by insurers where earthquake cover is applicable has increased. As discussed on page 13, the ability for an insurer to use this data along with information from other internal and external sources will be a valuable asset in creating a competitive advantage, allowing more informed decisions on products and services orientated around customer needs.

As of 25 October 2013, approximately 468,004 claims had been lodged with the EQC. Of these, 41,559 had been closed. Total settlements made amounted to $6.30 billion[5].

As at 1 July 2013, figures released by the Insurance Council of New Zealand noted private insurers were dealing with 24,400 over cap residential property claims. Of this, approximately 34% of claims had been resolved, 46% with resolution in progress and 20% with an unsettled claim of which 18% of the 20% had settlement options in place[6].

Industry performance overview

During the year ended 30 June 2013, business across the insurance industry performed well. This was on the back of a relatively benign year of claim events.

Industry statistics across all classes of business for the year ended 30 June 2013, compared to the year ended 30 June 2012[7], highlighted the following:

4% INCREASE IN GROSS WRITTEN PREMIUM (2012: 19% INCREASE)

1 SEE GRAPH 1 – PAGE 5

On a quarterly basis, Gross Written Premium ("GWP") fell quarter on quarter from September 2012 to March 2013, and rose in the quarter to June 2013. This trend is consistent with the comparative period, again indicating the significance of the June quarter renewal period. Overall, on a year-to-date basis, GWP rose 4% – from $4.47 billion for the year ended 30 June 2012, to $4.64 billion in respect of the year ended 30 June 2013.

While Net Written Premiums ("NWP") (after reinsurance costs) have also increased, from $3.51 billion in 2012 to $3.55 billion in 2013, the 1% increase is less than GWP growth over the same period. Increases continue to be ultimately passed on to reinsurers; as insurers continue to restructure their reinsurance programs as a mechanism to reduce volatility risk and to address capital requirements under the Insurance (Prudential Supervision) Act 2010.

On the other side of the Tasman, the trend with premium rate increases is similar, particularly amongst the property classes, as insurers continue to recover higher reinsurance costs[8].

2 SEE GRAPH 2 – PAGE 5

While premium increases have occurred across the majority of classes, it is not surprising that the most significant GWP increase was observed in both the commercial material damage and domestic property classes. This is a result of an increase in costs of reinsurance on catastrophe cover.

Private Motor has seen a decrease in total GWP as a result of pricing decreases. This is in contrast to the previous year, where a large increase in GWP was noted, reflecting a steady implementation of rate increases in recent years.

34% DECREASE IN THE GROSS CLAIMS INCURRED (2012: 67% DECREASE)

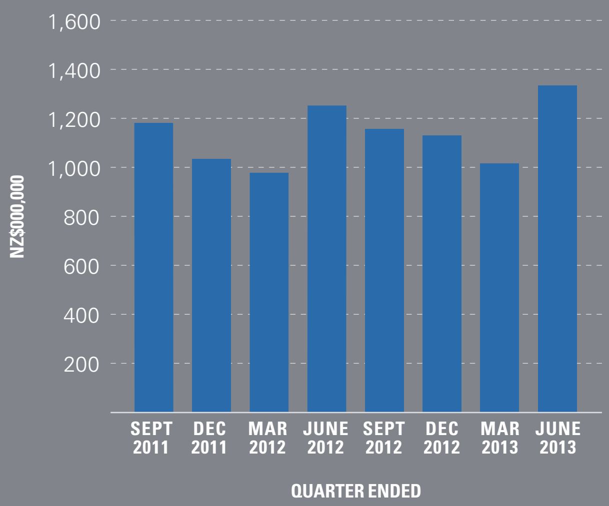
3 SEE GRAPH 3 – PAGE 5

Gross claims incurred decreased 34% on 2012. Results for the year ended 30 June 2013 benefitted from the absence of any large earthquake event or any other severe natural events. There was also a reduction in the ongoing escalation of ultimate claims costs associated with the Canterbury earthquakes compared to what was seen in the prior year. Two events of note in the year ended 30 June 2013 were the April 2013 Nelson/Bay of Plenty storm and floods, and the June 2013 nationwide storms. These events cost the industry an estimated $36 million and $34 million[9] respectively.

Net Claims Incurred ("NCI") also decreased, from $2.21 billion in 2012 to $2.12 billion in 2013. The 4% decrease is less than the decrease in gross claims incurred for the

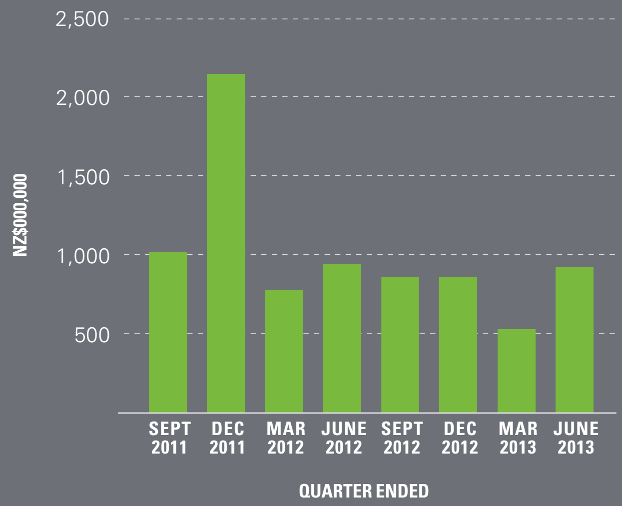
1 GROSS WRITTEN PREMIUM FOR THE QUARTER

Source: ICNZ Quarterly Statistics[7]



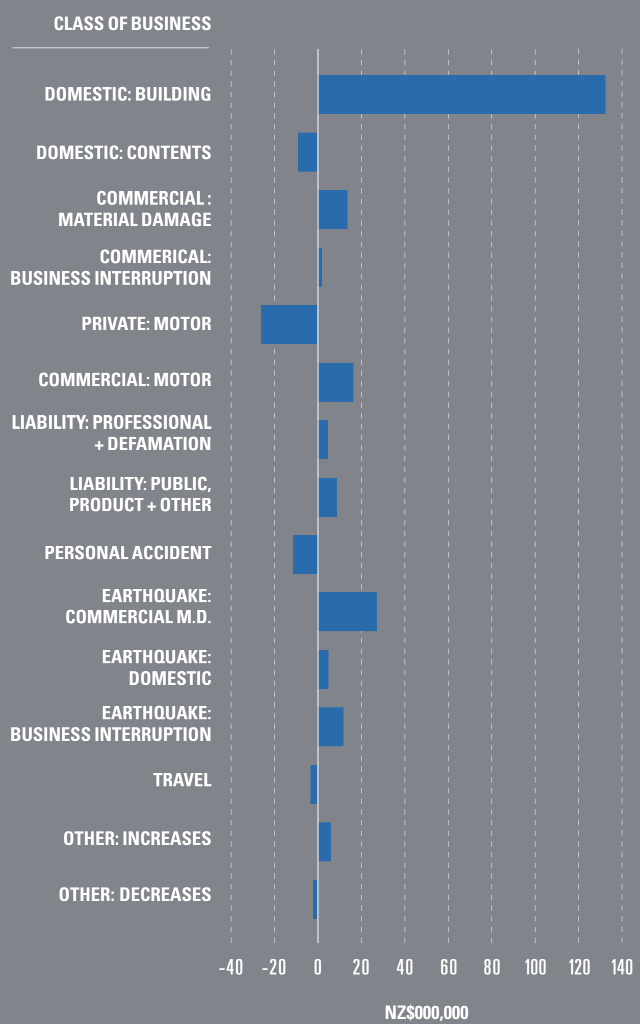
3 GROSS CLAIMS INCURRED

Source: ICNZ Quarterly Statistics[7]



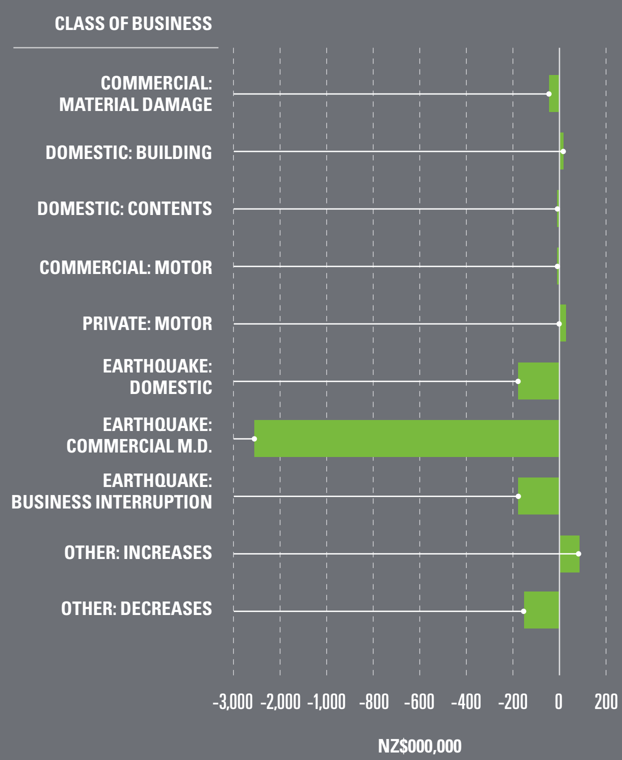
2 MOVEMENT IN GROSS WRITTEN PREMIUM – BY CLASS OF BUSINESS BETWEEN 2012 – 2013

Source: ICNZ Quarterly Statistics[7]



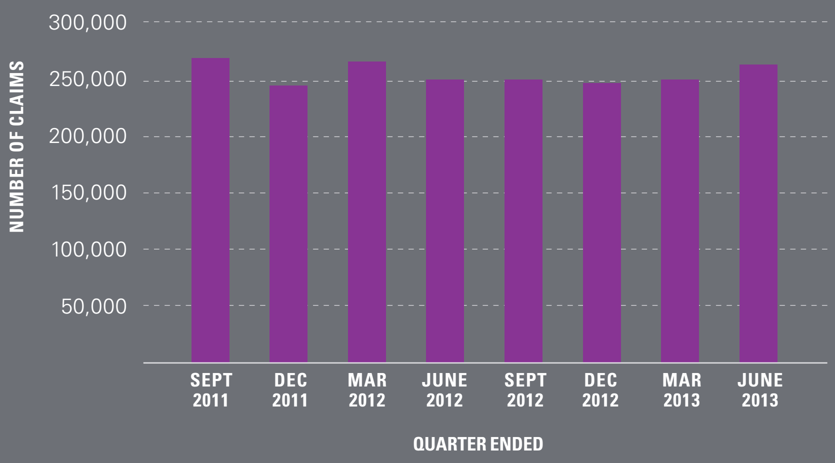
4 MOVEMENT IN GROSS CLAIMS INCURRED – BY CLASS OF BUSINESS BETWEEN 2012 – 2013

Source: ICNZ Quarterly Statistics[7]



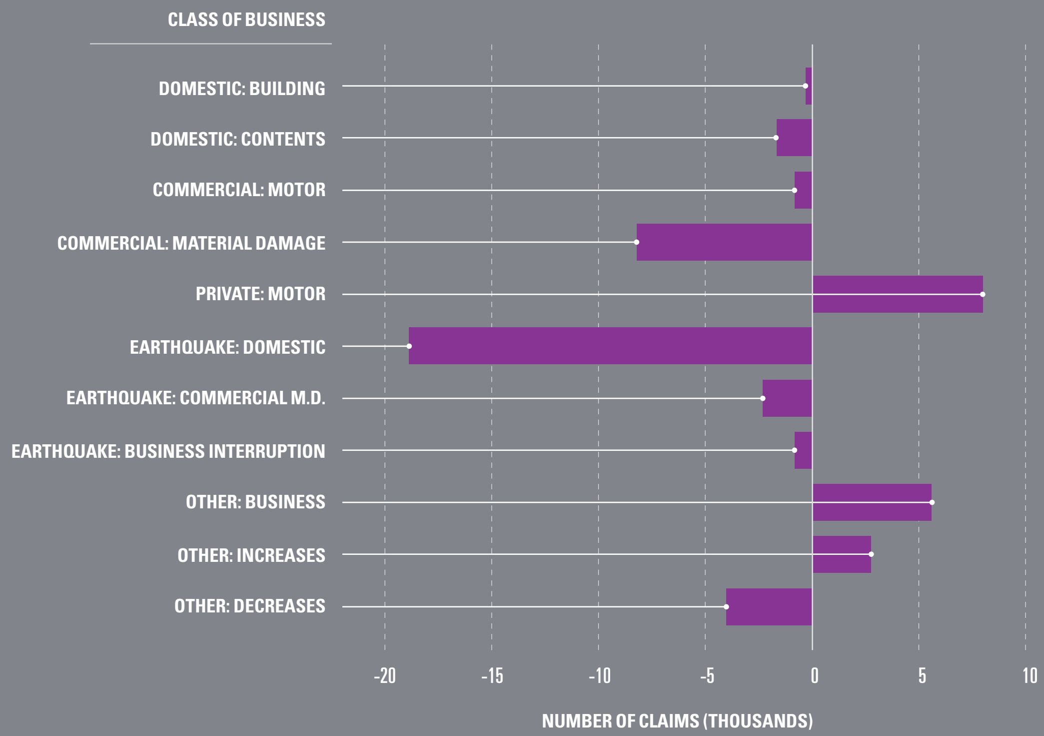
5 TOTAL NUMBER OF CLAIMS RECEIVED

Source: ICNZ Quarterly Statistics[7]



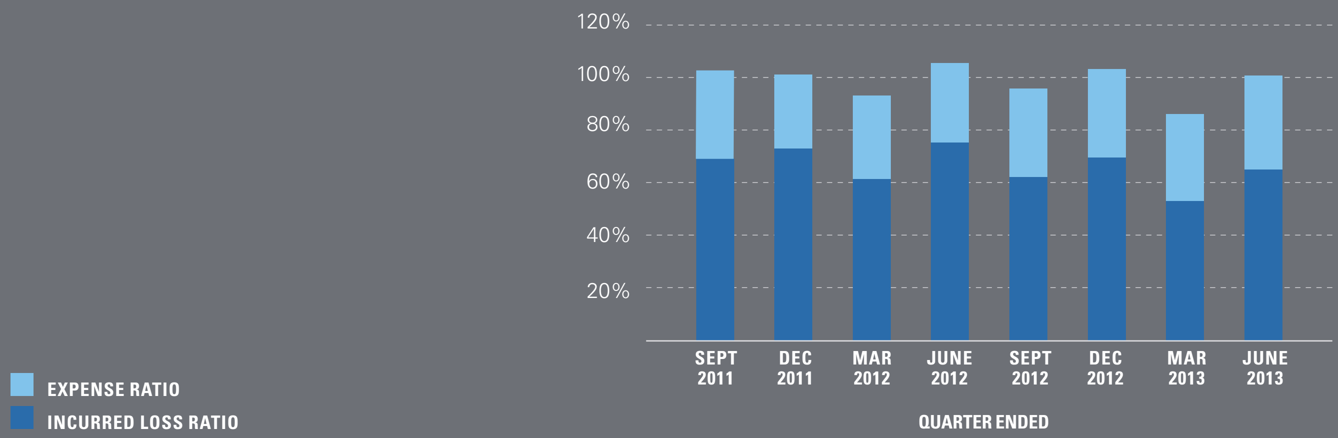
6 MOVEMENT IN TOTAL NUMBER OF CLAIMS RECEIVED – BY CLASS OF BUSINESS BETWEEN 2012 – 2013

Source: ICNZ Quarterly Statistics[7]



7 COMBINED RATIO – INCURRED LOSS RATIO + EXPENSE RATIO

Source: ICNZ Quarterly Statistics[7]



same period, reflecting the higher level of claims in 2012 that were reinsured (primarily relating to Canterbury earthquake claims).

4 SEE GRAPH 4 – PAGE 5

There has been a significant decrease in gross claims incurred within the domestic and commercial property lines of business again, as a result of the absence of any large earthquake event. This compares to the year to 30 June 2012, when claims were impacted by the December 2011 earthquake, plus a larger impact from claims development on costs associated with the earthquakes in the prior year.

Both claims volume and quantum were down on the same period in the prior year.

2% DECREASE IN TOTAL CLAIMS RECEIVED (2012: 12% DECREASE)

5 SEE GRAPH 5 – PAGE 6

The total number of claims has fallen from 1,027,311 in the year to 30 June 2012, to 1,007,387 in the year ended 30 June 2013. Consistent with the 2012 year, there were few severe weather events in 2013.

6 SEE GRAPH 6 – PAGE 6

The number of new claims received decreased across the majority of categories of business. The exceptions were 'Other', and Private Motor which saw marginal increases on 2012. As with last year, the greatest decrease seen is in relation to the Canterbury earthquakes.

5% DECREASE IN THE COMBINED RATIO FROM 101% TO 96% (2012: 50% DECREASE FROM 151% TO 101%)

7 SEE GRAPH 7 – PAGE 6

The net decrease in the Combined Ratio year on year is due to a decrease in the Incurred Loss Ratio from 70% to 62%, and an increase in the Expense Ratio from 31% to 34%.

As noted above, Gross Incurred Claims decreased on the prior year due to the absence of severe natural events and a reduction in the ongoing escalation of ultimate claims costs associated with the Canterbury earthquakes, when compared to the prior year. Combined with a 7% increase in net earned premiums, this resulted in an 11% improvement in the Incurred Loss Ratio.

The increase in the Expense Ratio is largely due to an increase in other costs, commission/brokerage costs and staff costs. Staff costs have increased by 6% on 2012 driven by an increase in full time equivalent staff which has increased 5% on the prior year.

Excluding earthquake claims, the Incurred Loss Ratio is 59% (2012: 60%). Coupled with an annual Expense Ratio of 34% (2011: 31%), this results in a Combined Ratio of 93% (2012: 91%), versus an Incurred Loss Ratio for Australian insurers of 91% (2012: 102%).[10]

Regulatory and other matters

The RBNZ completed its full licensing application process on 9 September 2013. This resulted in 96 full licenses being issued across the general and life insurance industries. Of these, 87 were insurers who were previously granted a provisional license, with three insurers continuing under a provisional license as permitted under certain prescribed circumstances by the RBNZ[11]. During this process, the industry saw 15 transfers of insurance business between insurers, along with insurers exiting the market[11].

With the licensing process now complete, the RBNZ's focus shifts to 'business as usual' supervision. This intention was first communicated by the RBNZ in May 2013 when it advised that it was moving to a more stringent approach to compliance breaches. The RBNZ also listed some examples where improvements in reporting sent to the RBNZ could be made. Examples given included:

- financial reporting being provided late;
- S78 reports not being filed with the Companies Office;
- annual and Half-Year Certification not being completed and/or incorrect wording being used;
- bank approval not being sought for material changes to fit and proper and risk management programs;

- fit and proper certificates provided late – outside the 20 working day timeframe;
- solvency margin disclosure requirements on websites not being present; and
- overseas insurers not advising the RBNZ of new director notifications[11].

With regulatory reporting deadlines looming for insurers with 30 June 2013 balance sheet dates, hopefully lessons have been learnt and the examples given have been addressed.

Policy initiatives – solvency

In June 2013, the RBNZ released a consultation paper on the treatment of guarantees and off-balance sheet exposures for solvency capital purposes. These changes are mainly aimed at providing clarification as to the intended application of the Solvency Standard. The RBNZ invited submissions on its consultation paper by 9 August 2013, and an update is expected shortly from the RBNZ on submissions received.

Financial Reporting Bill

The proposed Financial Reporting Bill is intended to replace the Financial Reporting Act 1993, to be enacted on or no later than 1 April 2015. The proposed Bill includes changes to the deadline of lodgement of statutory financial accounts with the registrar for various entities. In its current reading, the proposed timeframe for insurers is four months after balance date; compared to the current five months and twenty days deadline under the Financial Reporting Act 1993. The RBNZ has indicated that it will be considering any amendments to the Financial Reporting Bill for consistencies with the reporting requirements under the Insurance (Prudential Supervision) Act.

Insurance (Prudential Supervision) Amendment Bill

The Insurance (Prudential Supervision) Amendment Bill received Royal Assent on 3 September 2013. The Bill introduces changes to the timing of half year regulatory reporting (to four months after an insurer's half year balance date) and requires half year financial statements of an insurer's group only (where an insurer has subsidiaries), or an insurer's company accounts (where no subsidiaries are held).

Future outlook

Premium growth has continued throughout the year; however it has decreased compared to the previous five quarters. The importance of keeping high levels of insurance penetration due to the role it plays in the diversification of risk and economies of scale to policyholders, will be a significant force in future pricing decisions.

8 SEE GRAPH 8 – PAGE 9

And as insurers look to retain existing customers and grow their customer base, competitive forces will guide them to look at implementing strategies that enhance the customer experience, and design products that are more flexible to the needs of the customer. This will particularly apply to the issue of insurance affordability, as a result of recent increases in premiums over the last few years. We are already seeing insurers introduce more flexibility in excesses on property cover, in an effort to make insurance more affordable to customers. The use of data analytics, as discussed on page 13, will also be a key tool in understanding customer's needs and tailoring products accordingly.

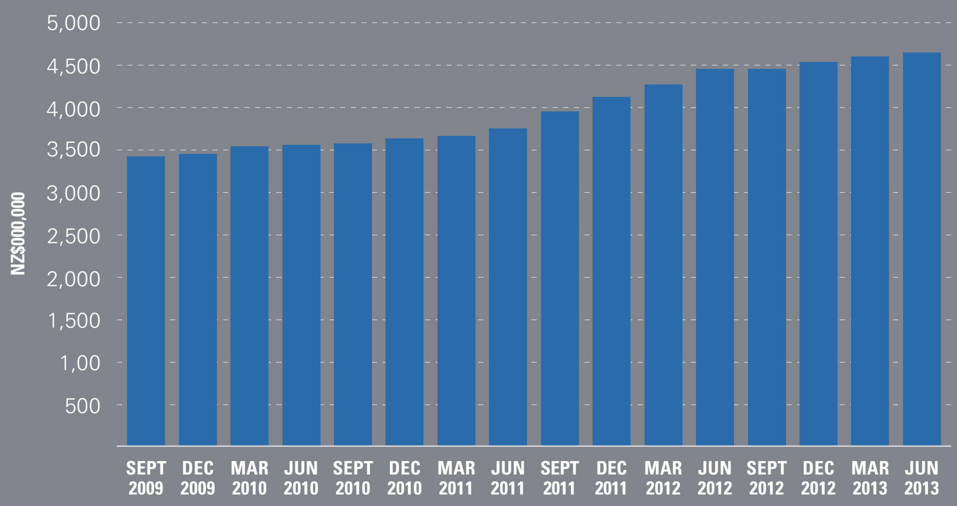
With the licensing process now complete, the RBNZ's focus shifts to 'business as usual' supervision.

1. Reserve Bank of New Zealand: Financial Stability Report, May 2013
2. www.icnz.org.nz/category/press-release/2013/
3. www.icnz.org.nz/issues-submissions/issues/insurance-for-commercial-buildings/
4. www.eqc.govt.nz/third-anniversary-of-2010-quake-brings-major-claim-milestone
5. www.eqc.govt.nz/canterbury-earthquakes/progress-updates/scorecard
6. www.icnz.org.nz/80-percent-of-the-insurer-canterbury-residential-earthquake-claims-completed-resolved-or-in-progress
7. ICNZ Quarterly Statistics – July 2011 to June 2013
8. KPMG Australia "General Insurance Industry Survey 2013", September 2013
9. www.icnz.org.nz/statistics-data/the-cost-of-disaster-events/
10. www.rbnz.govt.nz/regulation_and_supervision/insurers/publications/5483771.pdf
11. Reserve Bank of New Zealand – Insurance Industry Licensing Update May 2013

The importance of keeping high levels of insurance penetration due to the role it plays in the diversification of risk and economies of scale to policyholders, will be a significant force in future pricing decisions.

8 **GROSS WRITTEN PREMIUM** – ROLLING 12 MONTHS

Source: ICNZ Quarterly Statistics[7]



The insurer of the future

Creating value from opportunities in a changing IT world

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The global financial crisis and its aftermath, along with the Canterbury earthquakes here in New Zealand, have created dramatic changes in the environment for insurers. However, other social and economic trends are equally significant. They include:

- The re-orientation of economic growth and business opportunities towards new markets in South East Asia, Latin America and Africa.
- The challenge of meeting new demands in an environment of historically low interest rates and volatile equity markets.
- A range of broader impacts – ranging from extended life expectancy to increasing urbanisation; more extreme weather events to greater use of social media; and an increasingly interconnected world.

Against a shifting macro-economic and political landscape, these forces create both opportunities and threats. The insurer of the future will have to adapt to these megatrends[1] in order to remain competitive – to stay relevant for its customers, accountable to its stakeholders, and to create value for its investors. Here we look at one specific strand of these developments: how the use of technology could be a key distinguishing advantage in this new world.

There has been an under-investment in technology by insurers. The need to streamline and innovate distribution while reinvigorating brands on better technological platforms will be required. One positive for insurers is that new technologies can be developed quickly and at low cost.

Compared to the banking sector, insurers have been comparatively slow and unadventurous when it comes to investing in new technology. However it will be an increasingly important factor in developing innovative new distribution channels, and reinvigorating existing brands on improved technological platforms. The following three developments seem particularly key:

Cloud computing

Cloud computing provides us with a different business model for using technology. It is a model whereby we use third party resources, provided as a service over the Internet, to deliver our computing needs.

Cloud computing affords opportunities to enhance efficiency, flexibility and scalability. It offers potential gains in areas such as speed to solution and widespread accessibility. Transferring applications and processes to the Cloud provides an alternative way of delivering technology services which can move insurers' costs from capital to operating expenditures.

Although initial investment will be needed in order to achieve this, the long-term benefits can be significant.

One of the most desirable approaches is to use an outsourced model that makes full use of a third party's experience, and allows insurers to focus on their core business. Although the level of trust in the 'Public Cloud' offering remains low; adoption of 'Private Cloud', where a higher degree of control is maintained, is much more palatable to stakeholders. This is probably because the synergies with classical outsourcing are much tighter.

The potential benefits are clear – the speedier delivery of technology solutions to market; the increased ability to rapidly establish a presence in new markets; and the promised reduction in technology costs as economies of scale are recognised. At a time of increasing cost pressure and

Greater connectivity and use of social media provide insurers with access to an unparalleled wealth of data. While cloud computing creates the potential to enhance flexibility and reduce cost, many insurers are constrained by legacy systems.

MOBILE TECHNOLOGY

For consumers, speed and security of payment will be the mark of success. The winners will be the insurers that can provide the richest consumer experience with the greatest convenience.

SOCIAL MEDIA

Participating in social media has become an imperative and, regardless of industry group or ownership structure, social media is rapidly moving up the boardroom agenda.

THE CLOUD

The hype around Cloud computing has become reality. One of the next big challenges is catching up with banks regarding the use of mobile technology.

margin constraints, these characteristics are indeed valuable.

The centralised management of Cloud data repositories can also bring collateral benefits. This includes the ability to retire cumbersome and expensive legacy systems more easily, avoiding considerable capital and maintenance expenditures.

Social media

Consumer use of social media – especially by the tech-savvy younger generations who are prime targets for new business development – is growing exponentially. The challenge is to harness this trend to build relationships and to deliver products which meet real consumer needs.

Social media is commonly viewed as an additional marketing channel for most organisations, utilising word-of-mouth-based interactions to advise potential markets of new products and recent campaigns. However, social media also offers the ability to create dynamic two-way communications between insurers and their customers. This can greatly improve an organisation's delivery of customer service.

Social media also provides the platform for customers to self-serve and help each other. By establishing a 'self-help group' that is monitored and managed by the insurers, the cost of customer support can be reduced while its quality is improved.

Social media also provides the potential to gain access to an ever-increasing amount of market data, as social media networks provide trend and market information on the growing online and connected generation. Insurers must keep in mind that their own staff will increasingly be users of social media. Accordingly, they must be the biggest advocates of the organisation's offerings and products which are accessible on these platforms.

Corporate use of social media is increasing rapidly, although it varies significantly by country. In financial services, its use may be limited by regulatory constraints on how financial services firms use new media channels to communicate financial promotions to customers. Such constraints exist in the UK, among other countries. And while the pay-off may seem unclear, companies that have invested in greater use of social media report it is worthwhile.

Mobile technology

Consumer use of smart phones and tablets continues to grow rapidly as convenience, speed of service, and the ability to compare products are increasingly valued.

Mobile payments are gaining an increasing share of the market globally and in New Zealand, with corporate customers adding their voice to calls for more advanced mobile payments solutions. Security of personal data remains a concern. Nevertheless, mobile payments are expected to double each year over the next three years. This is driven by the customer desire to shop in environments that are always on, always fast and always accessible.

Insurers need to understand that their existing and new market offerings need to be 'mobile aware'. This encompasses everything from presentation of form factor, to the speed of provisioning of products on the platform (e.g. just-in-time insurance models), through to enabling payments for policies (e.g. integration with mobile payment technologies).

Insurers that commit to mobile technology have the potential to win two battles – to win the customer, and to cut costs. This is a significant advantage at a time of low investment returns.

For consumers, speed and security of payment will be the mark of success. This means mobile applications have the potential to increase access to entry-level financial services. The winning insurers will be those companies that can provide the richest consumer experience, with the greatest convenience.

Conclusion

The technology theme is just one of four underlying megatrends[1] which will determine the nature of tomorrow's insurance industry. The others are: environment, demographics, and social values and ethics. As yet, there is no clear consensus as to how the technology theme will play out – but it is clear it will have a profound impact. The insurer of the future should be preparing for that impact now.

> The insurer of the future will have to adapt to the changing trends in technology in order to remain competitive, to stay relevant for its customers and to create value for its investors.

1. *The Intelligent Insurer*: Creating value from opportunities in a changing world, KPMG International, 2012

What has data analytics done for you lately?

...and what it should be doing for every insurer

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Do you remember going shopping as a child? The butcher knew you wanted a 1.5 kg roast for Sunday dinner because your relatives were in town. Your pharmacist had your prescription ready when it needed to be refilled. It seemed like they could read your mind and you trusted their recommendations implicitly.

Let's face it, nowadays we're a long way from when people knew their customers and their companies well. So what can you do about it?

In this digital day and age, you and your team are unlikely to ever meet even a fraction of your customers face-to-face. So how can you gain true insights about them? To make them feel understood and valued as a customer? The answer is simple – you have to analyse the data.

Your crystal ball – Data Analytics

If you want to read your customers' minds, data analytics can help. While it can't give you psychic abilities, it will enable you to pick up on their behaviours. The ability to leverage your organisation's internal and external data will allow you to build a much closer relationship with your customers. At its core, data analytics turns masses of data into useful information to help you meet your objectives and add value.

It will allow you to answer some of those questions that keep you up at night – like how can you increase spend from your current customers, and also increase your customer base? How can you reduce your customer churn, and more effectively analyse your risk or customer service KPI's in real time?

"Being locally relevant has always been the core of success in retailing, going back 100 years to the town general store whose owners knew that their customers wanted, liked and would like to try. Social is like the ultimate customisation vehicle, giving us back the local relevance we had lost in trying to get scale and lower cost. It makes that era 100 years ago really possible again."[1]
Stephen Quin – CMO Walmart

Here's an example for the insurance industry. If insurers were to look at your customers' age and gender, or customers of comparable industries or sizes or location, and observed that they typically purchase a particular portfolio of insurance products, could they then identify other customers with the same characteristics to then on-sell these products, with a high success rate and minimal effort?

Alternatively, let's say your data tells you that customer churn is lower for customers with three or more insurance policies. Could you then set up your systems and processes to flag this before you lose your customer?

There is a treasure trove of historical electronic data in your own systems that can be used to effectively analyse and better understand your customer.

1 SEE TABLE 1 – PAGE 14

A good example of the power of data analytics, is the U.S retail company Target. They were interested in proactively responding to the needs of new families. Their customised systems analysed buying patterns and created a "pregnancy prediction score". It successfully deduced that one of its customers was pregnant and sent customised marketing material to her address. So effective was their new system, that it accidentally spilled the beans on the young teenager's situation before she had a chance to inform her parents![2]

While insurance propositions are quite different from retail, these concepts are just as applicable. Insurers can address key factors such as customer loyalty and behaviours by using analytics – giving them the ability to gaze into policyholders' activities, and then suggest a new product or policy limit.

When life gives you data...

Now, after extolling the benefits of data analytics, guess what? There's a shortage of good data analysts. During a forensics

1 WHAT DATA ANALYTICS CAN DO FOR YOU

Source: KPMG, *New Zealand Insurance Update* 2013

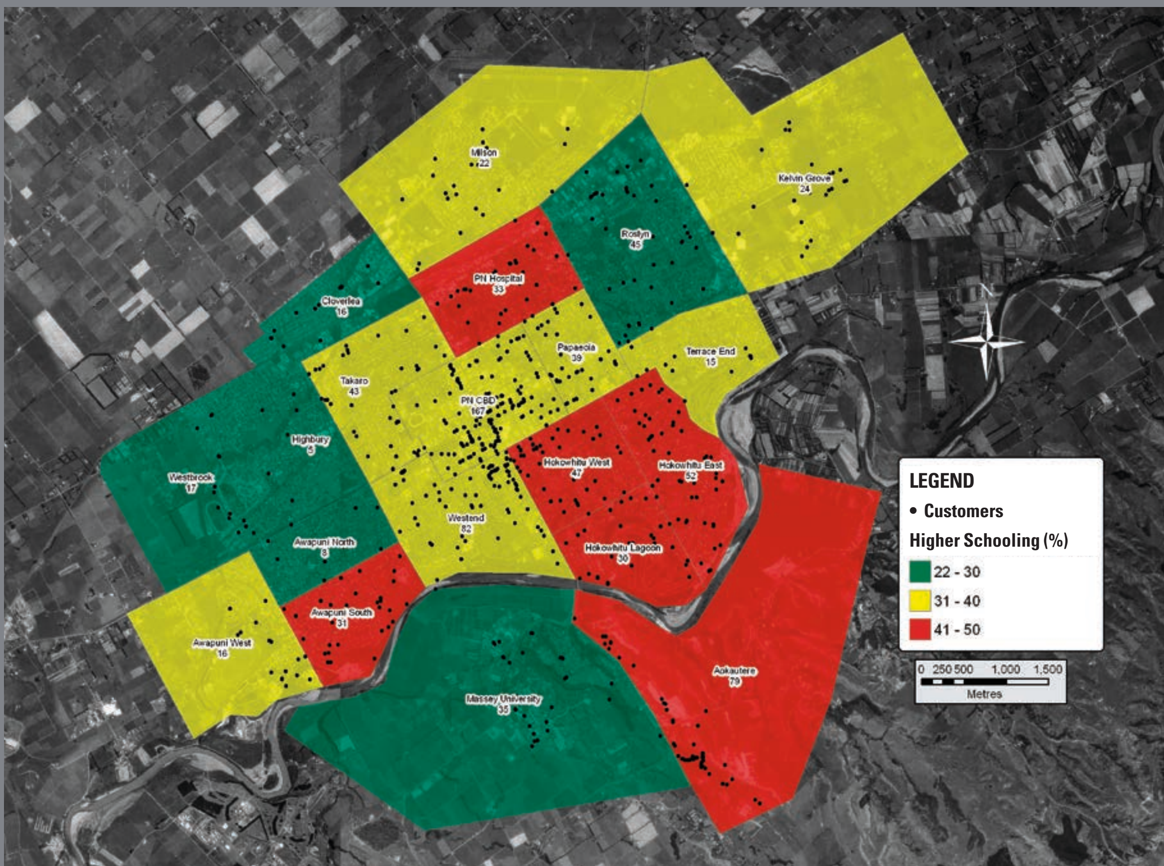
↓ DATA ANALYTICS BENEFITS ↓

FINANCIAL	PROCESS	REGULATORY
• INCREASE REVENUE	• EFFICIENCIES	• LEGISLATION
• DECREASE COST	• PRODUCTIVITY	• POLICIES/STANDARDS
	• CAPACITY	
	• DECREASE RISK	
	• QUALITY	

> "It is a capital mistake to theorise before one has data."
>
> – Sherlock Holmes

2 ILLUSTRATIVE EXAMPLE OF MATCHING INTERNAL CUSTOMER DATA TO EXTERNAL CENSUS INFORMATION

Source: KPMG, *New Zealand Insurance Update* 2013



conference recently, a client who was keen to accelerate their analytics programme asked me how I deal with the shortage of resources.

The response was that 'it's a hard road finding a good data analyst and they would have to consider training analysts in-house.

A recent report from the McKinsey Global Institute says that by 2018, the U.S. could face a shortage of up to 190,000 workers with analytical skills. "Data engineers are already harder to find than search engineers, and that's a sign of the times," says Deep Nishar, head of product at LinkedIn.[3]

There are several strategies to keep in mind if taking the approach of training analysts in-house:

- Attract the best people possible – people with technical, logical, problem-solving backgrounds.
- Consider up-skilling existing team members from other areas if they have the requisite skills, aptitude and 'can do' attitude.
- Once you have obtained the right people, make them responsible for building and training up your team internally.

Data, data everywhere and no way to process it

"It's often said that 90% of the data in the world today has been created in the last two years…" *IBM – What is Big Data?*

The U.S. National Security Agency ("NSA") Prism surveillance program ("Prism") is a perfect example of big data. This massive data and intelligence gathering program – which has been in the news after Edward Snowden blew the whistle – uses all the concepts and technologies that define big data.

Prism processes a variety of data bouncing over the Internet; including emails, GPS coordinates, Facebook pictures and comments, Twitter posts, and YouTube videos. You name it, Prism probably looks at it.

The volumes of data flowing into the program are mind boggling. Imagine all the internet traffic and email going through this system and trying to monitor it.

Now imagine the velocity of data, as it flies in faster than you can read it. Try dealing with 50 million emails in a matter of minutes.

Prism enables the U.S government to identify, correlate, and prioritise events and threats in real time by identifying suspicious electronic behaviour, for example:

- Bob has posted anti-government comments on Facebook; and
- he views a bomb making website;
- he drives to another state and uses his credit card to buy fertiliser;
- his cellphone is used to call high risk individuals about the attack and his location is triangulated using his cellphones GPS feature; and
- on the day of his planned attack he is picked up speeding on a speed camera.

All this allows the U.S government to successfully intercept him before he arrives at his target.

Insurers are beginning to recognise the importance of big data. It is vital to their future strategy and ensuring they stay current and competitive. There is huge power in the ability to collate all this data and turn it into information that can help make fast and informed decisions. It can help you to pacify unhappy customers posting negative remarks on Facebook, or it can help you to on-sell products.

For instance, if you identify that one of your company's Facebook page followers is planning an overseas trip, you may recommend a tailored travel insurance policy which takes into account their claims history. This allows you to put forward a customised solution to your customer instead of simply pushing a product. This approach will immediately result in higher success rates and a better bottom line – and of course, keep your customer happy.

For most insurers, this is uncharted territory. As the first step, insurers should consider using the data they have available now. This can be supplemented with external data, such as credit reference agencies, Census information, Sensible Sentencing New Zealand offenders database, and the New Zealand police stolen vehicle database – all of which is publicly available.

2 SEE GRAPH 2 – PAGE 14

Additionally, you can prepare for the future by setting up a clear roadmap and direction for your analytics team. Develop a blueprint that supports long-term business objectives that can be delivered thorough short-term goals. Concentrate your efforts on cleaning up the data you have now, and rectifying data quality issues as much as possible.

An example of 'bad data' would be not having the right gender information about your customer, and thus targeting inappropriate insurance products for them. There is a real chance of losing that customer if they were offended by you mistaking their gender and providing incorrect premiums that have an immediate financial impact for you.

Nothing will damage the reputation of your analytics team like company initiatives based upon bad decisions, based upon bad data.

Why use a sledgehammer when you can use a sickle.

"If you know the enemy and know yourself you need not fear the results of a hundred battles" *Sun Tzu – The art of war*

If you've only just started (or are yet to start) on your analytics journey, don't worry; everything does not have to rely on external data immediately. Very few insurers, or other organisations for that matter, maximise the value of all their in-house data.

Most organisations have data sets that are either: spread across multiple systems, are not easily available from legacy systems, or are in poor state (the old adage about 'garbage in, garbage out').

You don't have to use a costly, risky, big bang approach. Great returns can be achieved by targeting your efforts towards the low-hanging fruit and easy wins. One insurer I work with has gone from strength to strength, with millions of dollars stopped in fraudulent claims this year alone.

Using an approach of maturing and growing their analysis, increasing automation and lines of communication has helped greatly within a short period of time and improved their Return on Investment. The analytics performed now also feeds into their customer policy information and claims team, to flag potentially fraudulent customers in almost real time. This allows the claims team to ask additional questions and request more paperwork if a high-risk customer makes a claim.

On the flip side, claims with a low fraud risk or valued customers with a good history can now be fast-tracked. This makes the claims process that much easier and pain-free for all concerned.

Another potential example is around the implementation of agreed sums to rebuild homes, as the online calculators cannot always take all variables into consideration. As illustrated in graph 3, an insurer could view all of its customers' sums insured in a particular area. After easily identifying that a number of them appear to be significantly less than the average, the insurer could potentially contact the affected customers and organise for an in-house or preferred surveyor to estimate the sum insured.

This proactive approach means reduced effort and peace of mind for the customer, knowing that their sum insured is more accurate. The insurer ends up with a happy customer paying the right premiums for a solution provided.

3 SEE DIAGRAM 3 – PAGE 17

If you're just starting off or are apprehensive about investing with uncertain returns, you could consider running pilot projects to 'test and learn'. Get those nice easy wins under your belt to get vital stakeholder buy-in and improve return on investment. Then progress with more measured expansion following your successes. Use this approach to continuously develop in-house capability and drive cultural change. At the end of the day, the numbers won't lie.

The opportunities and success rates for cross selling and retention campaigns immediately go up using these smart or predictive data analytics approaches.

Spearheading your future

The situation we face in the digital age can indeed cut both ways. On the one hand, the sheer volume of data can drown a team and an organisation, and results could sit stagnant due to 'paralysis from analysis'.

Or, it can be used powerfully to gain a deeper understanding and insight into your customers, your organisation and its processes. Using your data wisely, your marketing can become more powerful, efficient and effective; thereby reducing costs and increasing success rates of on-sell solutions.

4 SEE DIAGRAM 4 – PAGE 17

The data you have to deal with can be seen as a cost and a hindrance – or as a way to make your customers feel like you really know and understand them. Most importantly, it can ensure the kind of customer satisfaction we once had in the days of face-to-face interaction.

1. Walmart-Forbes.com – www.forbes.com/sites/scottdavis/2012/05/30/368
2. www.forbes.com/sites/kashmirhill/2012/02/16/how-target-figured-out-a-teen-girl-was-pregnant-before-her-father-did
3. www.mckinsey.com/insights/business_technology/big_data_the_next_frontier_for_innovation

3 ILLUSTRATIVE EXAMPLE OF ANALYTICS IDENTIFYING ANOMALIES IN SUM INSURED BY POSTCODE

Source: KPMG, *New Zealand Insurance Update* 2013

4 WHAT DO PREDICTIVE ANALYTICS OFFER?

Source: *The Valued Insurer, KPMG International,* 2013

Better knowledge of your customers	Unearth customer insights by pairing data with customer feedback and market research to better anticipate customers' needs, satisfy their expectations and deliver competitive prices.
Relevant propositions at the right time	Develop tailored products faster, personalised service.
	Identify which customers are most likely to respond to special offers in cross-selling or retention campaigns.
Optimal distribution for each customer segment	Maximize the efficiency and productivity of distribution channels, tracking sales and distribution performance.
Optimal servicing for each customer segment	Use unstructured internal data (complaints and feedback with publicly available external data on consumer behavior – social media, surveys and focus groups).
	Identify claims with potential to develop into large losses or frauds.

→

- **Improve customer experience**
- **Identify risks and opportunities**
- **Increase profitability**
- **Reduce costs**
- **Improve retention**

Customer relationships

A look at customer engagement strategies for the future insurer

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"The sharing economy is hard to define. In my mind, it encompasses a broad range of activities, including worker cooperatives, neighbourhood car-sharing programs, housing cooperatives, community gardens, food cooperatives, and renewable energy cooperatives. These activities are tied together by a common means (harnessing the existing resources of a community) and a common end (growing the wealth of that community). The sharing economy is the response to the legacy economy where we tend to be reliant on resources from outside of our communities, and where the work we do and the purchases we make mostly generate wealth for people outside of our communities."[2]

Insights from *The Valued Insurer*, a report from KPMG Global[1], showed that insurance industry players realise the imperative to be more customer-centric in their engagement with current and potential clients. The report states:

- With the rise of the Millennial generation, insurers are challenged with an ageing population; and a mix of generational aspirations, values, morals and ethics. Cast an eye over some key facts about this generation and the future:
  - Statistics New Zealand[3] forecasts indicate that 26% of the population will be 65+ by 2061, compared to 14% this year. This is the millennial generation of 2013; and
  - By the late 2020s, the 65+ age group will outnumber those in the 0-14 age group and deaths will outnumber births in 2061 (1 in 3 chance). This is the baby boomer generation of 2013.
- The Insurance industry currently has a product-centric customer viewpoint with regards to their data analytics.
- The upcoming and future generations will have a focus on the individual and the new aspirational status of "disownership".[4] This is predicted to challenge the capitalistic consumer base and ownership aspirations of consumer goods and services companies.
- To be customer centric for one's own financial gain and providing a customer with a positive emotional connection associated with asset ownership has now been replaced with an ethical and moral connotation.
- Traditional approaches to being customer-centric – which rely on concepts of financial gain and emotional connections with asset ownership – are being replaced with new ethical and moral considerations.

How will these trends impact our business model? Do we need to re-assess our customer engagement strategies? Are there clues in the touch points?

Let's begin with the following single-minded proposition that applies to Financial Services and is relevant to insurers: Customers don't want to be sold to. They want to be helped.

A scenario to illustrate:

Jen is a 22-year-old in her second year working at a reputable company in Auckland. She has disposable income but is a responsible saver. Jen prides herself in being a savvy and frugal consumer. She really gets the growing collective mind set to re-use rather than buy; it suits her right now and resonates with her personal belief system of only using what you need responsibly.

Forbes estimates the revenue flowing through the share economy directly into people's wallets will surpass $3.5 billion this year with growth exceeding 25%.[5]

"That happy sound was the tune of millennials getting what they want. We'd better get used to it, because it's a song we're going to be hearing a lot more of, as this century rolls along."[6]

Jen is a digital native and uses the internet as a primary source of product and service research. She values peer-to-peer recommendations, sometimes with a grain of salt. Jen is looking for a car on her tablet and has found one that's more or less within her budget. She concludes the transaction using her savings of some months and a generous donation from her parents. She is also aware that it has great fuel economy and resale value, should the need arise, and had a 5-star rating from other buyers of similar models. Jen chooses the general insurance option she has researched for a while. She navigates through the standard questions and responses to finalise the general insurance option suiting her purchase.

Pausing and unpacking the above:

Jen lives the life of a millennial, works in a growing share economy where the new normal values are 're-use, common use, gifting, peer-to-peer transactions, and bartering', to name a few. "Knowing" that Jen is a qualified prospect on the site, Insurer Z has the opportunity to offer:

- pay-as-you-go personal accident insurance top up, if Jen wants to use the car for more than work trips and back home;
- general insurance for loss of personal items; and
- life insurance top-up offer.

These service offerings are relevant and targeted; and they connect with Jen on an emotional, rational level in real-time. Jen does not feel resentment – instead she feels that she has done well with her purchases and places a recommendation on the Insurer's web site. The Insurer is using the entire interaction to improve data quality and integrity about the insured and her assets. Most importantly, they will seize hyper-personalised data about Jen, her life event, and what successfully led to the conversion of a prospect to a client at a granular level.

Andrew Leonard's article *"Millennials will not be regulated"*[6] sounds both a warning and a call to respond to the needs of millennials. In the scenario described above, the Insurer may request, in exchange for a more cost effective premium, data about the individual, location, trip information, distance and speed travelled, personal belongings in transit, age and gender of the insured.

It also provides an opportunity to address the perennial challenge of data quality pertaining to the data at every opportunity and turn it into a "moment of truth".

Of course, customers may opt not to share the details described above, which in turn provides Insurer Z with the opportunity to price this event appropriately, or not at all. However there is still an opportunity to provide a positive customer experience – by demonstrating transparency, which is highly-valued by millennial customers.[7] Providing a clear, upfront explanation to these customer will resonate with them.

Let us consider the wider impact of another millennial value. The share economy emphasises re-use and prolonged use of assets. What will be the impact on the underlying value of a vehicle that is being used post the expected useful life? Will insured consumers be satisfied with just third party and fire cover when the utility value of the vehicle exceeds the book value? What does a meaningful client-centric insurance offering look like in this instance? These questions, are perhaps best left for the actuaries to ponder and answer.

In summary, millennial values of transparency and optimum use of resources/assets may be just the catalyst to provide more current and accurate data, but also opportunities to gain insight into customers, their behaviour and their insured assets. All this information is obtained with a single-minded focus of helping the many Jens and Jacks on an individual level. The return on investment for the insurer manifests in sustainable, socially responsive product strategies; by providing customer-centric service offerings to Jen and many others like her.

1. The Valued Insurer, KPMG International, 2013
2. www.resilience.org/stories/2013-09-16/the-sharing-economy-just-got-real
3. www.stats.govt.nz/browse_for_stats/population/estimates_and_projections/NationalPopulationProjections_HOTP2011.aspx
4. www.venturebeat.com/2013/04/03/disownership-is-the-new-normal-the-rise-of-the-shared-economy-infographic/
5. www.everydayfamily.com/blog/making-the-share-economy-work-for-you-in-business/
6. www.salon.com/2013/09/20/millennials_will_not_be_regulated/
7. www.generationy.com/characteristics/

Project management

Strategic tools to drive critical initiatives

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"First, have a definite, clear practical ideal; a goal, an objective. Second, have the necessary means to achieve your ends; wisdom, money, materials, and methods. Third, adjust all your means to that end."

– Aristotle

"The art of prophecy is very difficult, especially about the future." *Mark Twain*

Like the best astrologers – and understanding that the current pace of change in the insurance industry is unlike anything previously experienced – we should perhaps avoid being too specific while reading the crystal ball. However, it's also been said that the insurance industry has seen more change in the last three years than in the preceding 30, so we can confidently say that 'change is the new normal'. While the level of transformation in the industry is surely unprecedented, it is set to continue for the immediate future.

This gives rise to a number of challenges, including:

- Innovative and disruptive new market entrants applying competitive pressure for the established incumbents, by leveraging lower cost structures and more efficient channels-to-market.
- A growing need to ensure affordability for the end customer, along with the need to stay relevant to them (i.e. trends such as decreasing vehicle use and vehicles that are much safer, raise questions about how insurers price affordably and underwrite risk in a way that is relevant).
- Rapidly-changing expectations for 'e-enabled' customer-services – available 24/7 to allow customers to interact with their insurer however, whenever, and wherever they want. This is challenging insurers to transform not only their technology infrastructure, but also their core business processes.
- In the past, growth in the insurance industry has derived from mergers, acquisitions and joint ventures. However with the market now largely 'fully consolidated' these options no longer exist. In order to grow, insurers need to transform their business.
- A portfolio of legacy systems and products, which are often difficult to reconcile with product strategies and customer demands, is adding a layer of complexity to many insurance operations.
- An increased level of reporting and scrutiny is required, as the industry responds to a vigilant regulatory regime.

It is no surprise, then, that we see a significant number of initiatives being planned and undertaken in the New Zealand insurance domain that are genuinely transformational. At KPMG, we believe passionately that the performance and competitiveness of New Zealand insurers depends on their ability to execute these

The productivity and profits of New Zealand companies were being seriously impacted by their inability to consistently deliver projects well. If those results are extrapolated across New Zealand's insurance industry, they represent a truly staggering waste of resources.

transformation projects well, and reliably deliver the expected results. Effective Project Management is a key strategic tool to drive critical initiatives like these, and reap their full value.

We believe that businesses that understand this – and are committed to improving the quality of their project management – will therefore have a strong competitive advantage.

Earlier this year, KPMG NZ launched our *2013 Project Management Survey*, which examines the real-life experiences of New Zealand businesses who are working on the challenge of improving their project performance. It combines insights and trends from across New Zealand, with detailed analysis by our project management practitioners.

This latest report identifies a number of practices that are helping New Zealand organisations extract more value from their project investments, and to do so more reliably. We believe these insights are of particular relevance to the Insurance sector, given the mission-critical dependence on transformation projects.

The survey also demonstrates that effective project management is an important competitive differentiator, and highlights how some organisations are using it to outperform their competition.

In summary, our survey found:

- The average spend on projects was approximately $15 million in the organisations that we surveyed.
- More than half of the survey respondents did not consistently achieve the intended project results.
- More than two-thirds of organisations surveyed had experienced at least one project failure in the previous year.
- More than half of respondents did not attempt to align their projects with corporate strategy, and only one-third always prepared a business case for projects.
- Almost two-thirds of those surveyed did not attempt to measure the return on their project investments, and more than a quarter did not undertake any form of strategic reviews to track the resulting benefits achieved by the business.

The conclusion we drew from the data was that, for the majority of New Zealand organisations, embarking on any project appeared to be a 'leap of faith', working in the hope, rather than the confident expectation, of delivering the required outcomes. This led us to conclude that the productivity and profits of New Zealand companies were being seriously impacted by their inability to consistently deliver projects well. If those results are extrapolated across New Zealand's insurance industry, they represent a truly staggering waste of resources.

However, some encouraging trends have emerged since our inaugural survey in 2010. We are seeing an increase in the number of projects being commissioned, as well as a renewed focus on accomplishing strategic objectives. We are also seeing more executive-level conversations regarding prioritisation of investment, and systematic ways to achieve forecast benefits from investment.

Our survey also demonstrated the strong correlation between project success, and some specific 'good practices'. Businesses that were using these good project management practices achieved dramatically higher success rates (typically up to 50% better) than those that did not.

The practices that are strongly correlated with increased project success rates include:

1. Consistent use of a Project-management methodology ("PM Methodology") throughout the project lifecycle.
2. Effective use of project risk-management.
3. Use of a Project Management Office.
4. Use of programme and/or portfolio-management techniques, in addition to project management.
5. Ensuring that projects are supported by a high-quality business case, and tracking the associated benefits.

With regard to the first point (PM Methodology), our observation in practice is that it complements (but can not replace) PM capability i.e. success derives from capable Project Managers deploying appropriate methodology in a consistent and effective way. Another point that is very apparent, in our experience, is that many businesses will claim to use a methodology, while paying 'lip-service' to, or worse, abusing the methodology. As an example, some organisation's espouse 'Agile' methodologies (which, used effectively, can deliver powerful benefits), but either misunderstand or misuse the approach, to the point where any available benefits are undermined or sacrificed.

Similar observations apply to risk-management, where the emphasis has to be placed on effective (and active) management of risk by the Project Manager, as opposed to the risk-register as a 'point-in-time' catalogue, which becomes overtaken by events.

The Project Management Office ("PMO") point is very interesting: in detail, we found that although it is strongly correlated with better project outcomes, we also reported that, since 2010 around 30% of our survey had dis-established their PMOs (citing reasons such as "perceived overhead", and "misalignment"). Far from being contradictory, we believe that this highlights the value of PMOs. However, given the diversity of types and roles of PMOs, in practice this also shows that there is no 'one-size-fits-all' model for a PMO. It is critically important to design and optimise the role of the PMO for the specific needs of the organisation.

Highlighting Programme and / or Portfolio techniques demonstrates the value of extending the use of project-management techniques across the whole ecosystem of projects within an organisation. Doing this successfully raises the level of benefit to the business, by allowing executives to manage their project investments (and risks) across the broader business landscape, and exercise effective governance of the project portfolio at that level.

The final point, relating to Project business-cases and Benefits-management, was one of the encouraging highlights of this year's report. It showed a marked increase (44% since 2010) in the number of respondents that are using these tools systematically. Our experience (and a body of independent research) demonstrates a related dramatic improvement in project outcomes from effective use of these techniques.

In summary, then, our survey offers no 'silver bullet', but rather reinforces our client experiences. A minority of our respondents consistently deliver significantly better Project outcomes by implementing a few, well understood project management techniques, while the majority of businesses get far more variable results. Good project-management practice is often well understood in theory, but it is not generally well executed in most organisations. The survey also provides hard evidence that organisations using these disciplines reliably are outperforming the competition.

A common response to these findings (and one we sometimes encounter in practice) would be to accept these sub-standard results with a sense of resignation. At KPMG, we do not accept this. To ignore the potential for positive change is to continue an unnecessary and serious waste of resources. We believe that managers, Boards and shareholders (and, indeed, consumers) should challenge New Zealand businesses to 'raise their game' in project, programme and portfolio management. The potential rewards are simply too significant to ignore.

The tax brief

Key issues coming from the Reserve Bank of New Zealand Consultations

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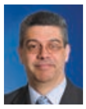

Simply being labelled an "insurance contract" does not mean that a contract will be considered a "contract of insurance" when a regulator, tax authority or legal professional is considering the contract.

Over the next few months, the Reserve Bank of New Zealand ("RBNZ") has advised that it will be undertaking a review of the treatment of taxation within the solvency standards. The RBNZ review is expected to be completed over a relatively short timeframe, with revised solvency standards expected to be published during the first quarter of 2014.

A review of the treatment of taxation in the solvency standards is welcome, as this is an area that has often caused confusion.

KPMG recently considered the tax requirements in the Australian Prudential Regulation Authority ("APRA") released draft capital adequacy standards for Level 3 conglomerate groups.

Broadly, the proposed standards require Level 3 head companies to maintain "Level 3 eligible capital" in excess of the Level 3 "prescribed capital requirement" ("PCR"). For Level 3 eligible capital, deferred tax assets can be offset against a range of deferred tax liabilities, allowing the aggregation of tax balances across tax consolidated groups. For conglomerates with New Zealand and Australian operations, tax balances cannot be offset between Australia and New Zealand.

Under the current New Zealand solvency standards, taxation can be applied to the calculation of the Solvency Margin based on either a net or gross basis. Once identified, any additional current or deferred tax liabilities/assets arising as a result of the capital charge must be arrived at using a prudent assessment. In order to recognise any taxation assets the potential recovery of the assets must be beyond doubt (where the insurer would be wound-up). Finally, the net taxation position is calculated by netting off any taxation assets against any taxation liabilities.

In both cases, the principle is relatively easily stated. However, this hides some of the complexity. In the case of the APRA standards it was not clear at which point the tax assessment is made or whether a gross or net basis is being applied. The New Zealand standard allows a net or gross basis to be used but this can lead to confusion. It potentially leads to double counting of taxation if it is not obvious which method has been used when the position is considered for financial reporting.

From a purely tax and financial reporting perspective, a gross approach (where all non-tax items are calculated and assessed without taking tax into account) and subsequently determining the existence and ability to recognise deferred tax assets

1 DEFINITION OF "CONTRACT OF INSURANCE"

	Legal and Tax	Financial Reporting	Regulatory
General insurance contract	The Income Tax Act 2007 does not provide a definition of a contract of insurance. Therefore, the common law definition – "an insurance contract will be any contract which provides a benefit on the happening of an uncertain event where the purpose of the benefit is to compensate the insured party for loss or prejudice resulting from the event." – must apply.	NZ IFRS 4 defines "Insurance Contract" in Appendix A as: "A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix B for guidance on this definition.) "	Insurance (Prudential Supervision) Act 2010, section 7(1): "(a)means a contract involving the transference of risk under which a person (the insurer) agrees, in return for a premium, to pay to or for the account of another person (the policyholder) a sum of money or its equivalent, whether by way or indemnity or otherwise, on the happening of 1 or more uncertain events; and (b)Includes a contract of reinsurance."
Reinsurance contract	The Income Tax Act 2007 does not provide a definition of a reinsurance contract for general insurance. Section EY 12(1) of the Income Tax Act 2007 defines "life reinsurance" as: "(a)...a contract of life insurance between a life insurer and another person (person C) under which the life insurer is secured, fully or partially, against a risk by person C; (b) does not include a contract that secures against financial risk unless, in the contract, it is incidental to securing against life risk..." Further, "life financial reinsurance" is defined as: "a contract that may be life reinsurance under subsection (1)(a), but is not included under subsection (1)(b)."	Same definition as for general insurance above.	Same definition as for general insurance above.

and liabilities is less confusing. This allows a comprehensive assessment of the tax position using all the assumptions that are used to test solvency rather than a piecemeal approach to determining tax assets and liabilities.

What is a contract of insurance – implications for reinsurance

I am an insurer, I write insurance policies, what's the fuss?

It may be instructive to take a look at what life insurers are facing, based on the RBNZ's most recent consultation, to see what general insurers may soon be faced with.

The characterisation of a contract as a "contract of insurance" is important from a tax, legal, financial reporting and regulatory perspective. However, the definition of what constitutes a "contract of insurance" may differ depending on the purpose for which it is being assessed.

Importantly, simply being labelled an "insurance contract" does not mean that a contract will be considered a "contract of insurance" when a regulator, tax authority or legal professional is considering the contract.

To illustrate, the table above highlights the different definitions used.

The recent *Sovereign*[1] case illustrates the potentially significant difference in treatments. When it entered into the agreement, Sovereign considered it was entering into a "contract of insurance". However, the Court held that it was not a "contract of insurance". In addition, the *Sovereign* case has highlighted the ability for a single contract to be split and the different components to be considered separately (rather than as a single contract).

While *Sovereign* is a life insurance case, it seems general insurers may soon face similar concerns. RBNZ's most recent consultation notes that, for the purposes of life reinsurance, financing defined as "amounts payable" will be required to be separated and treated as a liability. RBNZ has signalled a similar change for general insurers[2].

1. Sovereign Assurance Company Ltd & Ors V Commissioner of Inland Revenue (2012) 25 NZTC

2. Insurance Solvency Standards: financial reinsurance, released on 24 October 2013

Regulatory developments

Asian insurance markets and implications for New Zealand

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With the considerable changes currently taking place in the New Zealand insurance industry, we thought it may be useful to review regulatory developments in Asia and consider whether there are any useful implications for the New Zealand market. We have purposely ignored the Australian market in this article as we expect most readers would already be well abreast of the Australian developments.

Asian market background

With few exceptions, most insurance industries in Asia are bigger than in New Zealand; however the New Zealand market is mature with high levels of insurance penetration and density. The North Asian markets of Japan, Korea, and Taiwan are also relatively mature, and as expected, these markets tend to have modest annual growth rates (typically between 5-10% pa). China, India, and many of the South East Asian countries, are characterised by having strong past and expected future growth rates.

1 SEE GRAPH 1 – PAGE 29

With low insurance penetration, high future growth is expected and increasing infrastructure and industrialisation together with emerging middle classes are key drivers underlying these markets.

(in the graphs opposite we have defined "Penetration" as the ratio of Premium volume to Gross Domestic Product and "Density" as the amount of Premium volume per capita.)

2 SEE GRAPH 2 – PAGE 29

Overview of Regulatory Supervision systems

In recent years, New Zealand has undergone significant regulatory changes and similar trends have occurred in other parts of Asia. Risk based Capital (RBC) prudential solvency regimes have been introduced into a number of countries and these have tended to follow either the Australian APRA model (involving prescribed risk charges), or the more formulaic US systems.

RBC regimes implemented in Singapore in 2005, Malaysia in 2009, and Thailand in 2011 tend to follow the APRA models whilst the Japanese, South Korean, Taiwan and Indonesian systems are closer to the US.

3 SEE GRAPH 3 – PAGE 29

Solvency 2 type regimes (where reliance is placed on individual insurer capital models) are currently not in place. It is doubtful whether these would be practical in most Asian countries in the foreseeable future given the data capabilities and cost constraints of most insurers. In addition most of the countries' regulators would struggle to manage these systems.

Some countries' regulators still however rely on the non risk based (premiums and claim formula) approach in setting capital requirements. A number of these are in the process of reviewing their future solvency requirements including the Chinese regulator (whom we understand is looking at Solvency 2).

Treatment of Insurance Catastrophe Risk

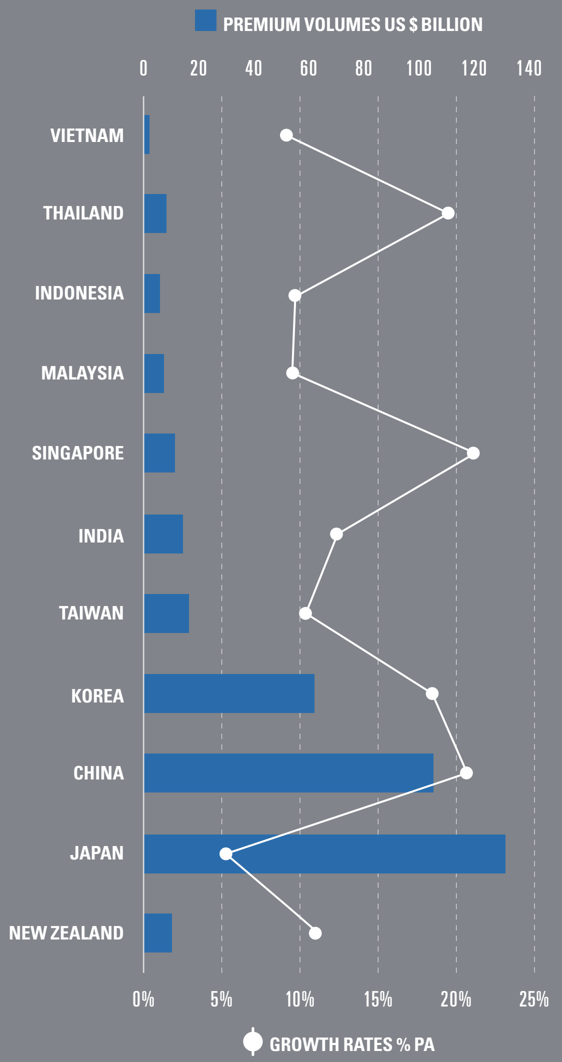
The past decade has seen many natural disasters; including the 2004 Indian Ocean Tsunami, the 2006 Java Earthquake and various destructive typhoons in Taiwan, the Philippines and Vietnam. From an insured loss perspective, the most devastating event was the Thailand Flood in October/November 2010. Swiss Re estimates an insured cost of US$15.3 billion which places it in the top 10 of all time events.

The Thailand Flood has raised the awareness of natural perils amongst most regulators in the region, and many are now asking companies to consider catastrophe scenarios when calculating their RBC.

For example, in a recent consultation paper the Monetary Authority of Singapore

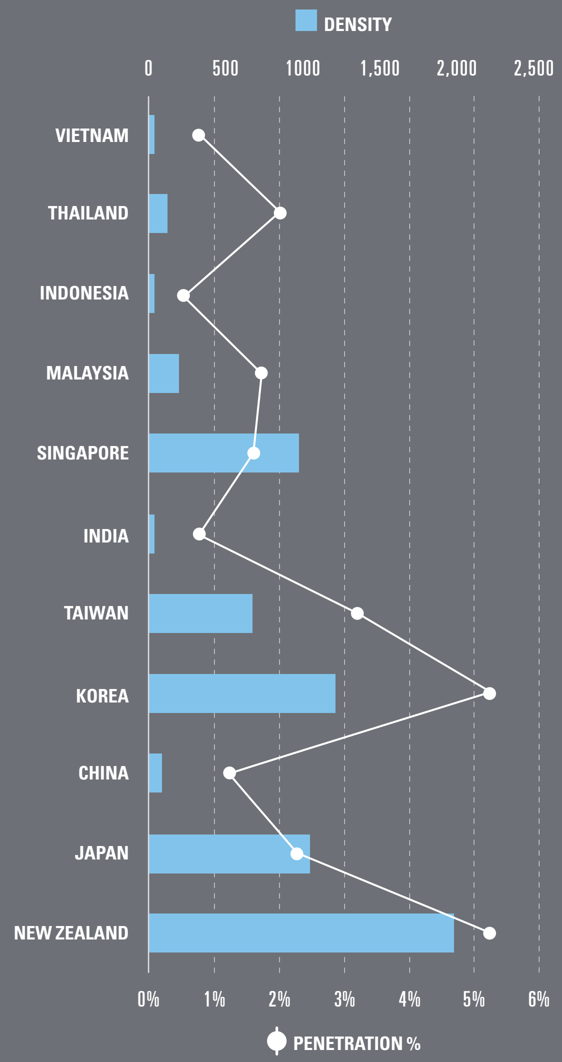
1 PREMIUM VOLUMES AND 2 YEAR GROWTH RATES TO 2012

Source: Swiss Re Sigma Reports



2 INSURANCE PENETRATION AND DENSITY IN 2012

Source: Swiss Re Sigma Reports



3 PRUDENTIAL SOLVENCY REGIMES IN ASIA

US STYLED RBC
Japan, Taiwan, South Korea, Indonesia

APRA STYLED RBC
Singapore, Malaysia, Thailand

PREMIUM/CLAIM BASED FORMULA
China, India, Vietnam, Philippines, Hong Kong

In our experience targeted return periods of 1 in 200 years, or 1 in 250 years, tend to be the norm and there is no differentiation by type or peril. In New Zealand a 1 in 1000 year event has been targeted for the earthquake peril.

("MAS") asked for capital to be determined for a net retention on a 1 in 200 year event. In our experience targeted return periods of 1 in 200 years (or 1 in 250 years) tend to be the norm, and there is no differentiation by type of peril. In New Zealand a 1 in 1000 year event has been targeted for the earthquake peril, and this appears to be stringent compared to other countries.

Enterprise Risk Management ("ERM") trends

For countries employing RBC, there has been a recent tendency for regulators to lead ERM initiatives. Taking Singapore as an example, there has been a steady development of regulation which includes:

- introduction of RBC in 2005 along with a suite of risk management guidelines;
- mandatory stress testing of solvency positions from 2009 onwards. As well as having to fulfil prescribed financial stresses, each company must test their ability to remain solvent in a large loss event that is appropriate to the company's particular circumstances. Additionally a series of events is required to be devised that would stress the company to failure;
- requirements, effective January 2014, for all insurers to establish an ERM framework. These include a documented risk management policy, statements of risk tolerance, a monitoring system to identify breaches in risk tolerance and an Own Risk and Solvency Assessment, ("ORSA"), whereby the insurer will provide an assessment of its own capital needs.

In relation to the new ORSA requirements we understand that many Singapore companies are now committing considerable time and resources into these projects with involvement from Board level down to the various functional areas.

Market outcomes

In Singapore, one of the key benefits that we have noticed is an increasing awareness of risk management throughout many insurance companies' boards, staff and management. This has been achieved via factors such as:

- considerable consultation between the regulator and the industry players;
- "hands on" practical experiences of operating in the RBC system. For example, companies that have chosen to take riskier positions in their investment policy or in their choice of reinsurer understand that this will directly result in higher risk charges; and
- engagement from management from various functions (reinsurance, claims, underwriting, finance) in stress testing, and building ERM frameworks.

The Singapore market as a whole was virtually unscathed from the effects of the Global Economic Crisis in 2008/09. This was due, to some extent, to the prudent risk management practices of many of the companies there.

In our experience of stress testing, many of the incorporated companies have demonstrated highly resilient balance sheets, and stress-to-failure exercises have required very artificial scenarios (depending upon the very unlikely combination of a number of extreme events) to achieve a breach in solvency.

The claims experience of the Thailand Flood event did not cause any Singapore companies to fail; however a number of companies would have failed had they not been able to raise capital. It seems unfair, however, to criticise Singapore's RBC system as failing to predict this event; given that it was amongst the 10 of the most costly world events ever. There was no history of previous floods of this nature, and it involved a set of very extreme accumulations of risk (consisting of few insurers covering most of the industrial companies in the same locations).

We would contrast this event with the Anglo Starlite failure in Hong Kong in 2009. Anglo Starlite was a major insurer of the Territory's taxi fleets; and key factors leading to this failure were underpricing, under-reserving and inadequate management (factors not too dissimilar from those underlying the failure of HIH Insurance in Australia in 2001). It is an interesting question to consider whether such a failure would have occurred had a fully operational risk based capital regime been in place in Hong Kong.

Looking ahead

We think there will be considerable attention paid to ERM in the next 2-3 years in many countries in Asia. This will in most part be regulatory driven, however the better companies have already been embracing ERM regardless of regulatory requirements.

If the New Zealand regulator decided to introduce an ORSA requirement, we would expect there to be similar lessons learned as in Singapore. While the process is expected to be onerous, companies who commit to this should achieve quick wins, including:

- an integrated approach throughout their organisations into managing risks systematically; and
- an enhanced relationship with the insurance regulator.

Going forward, there should be an expectation of better execution of profitability and risk management goals.

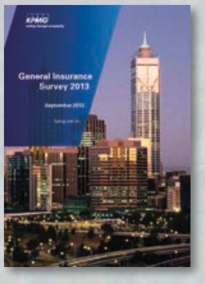
Our thought leadership

The Valued Insurer: Leading the pursuit of sustainable growth

In this publication, KPMG defines four key attributes that a successful and valued insurer should consider embedding, today and in the future, to continuously evolve and provide a better service to their end customers.

Fraud, Bribery and Corruption Survey 2012

This survey analyses the total reported losses from fraud that occurred between 1 February 2010 and 31 January 2012 within New Zealand organisations. Insights from the survey findings from over 140 New Zealand respondents are discussed along with key tools to help manage the risk of fraud, bribery and corruption.



General Insurance Survey 2013

The latest annual Australasian survey includes the financial results of general insurers that represent a significant part of the Australian market. It also examines the market conditions of the last year.

Insurance risk and capital transformation: Moving beyond compliance to value-enhancing performance

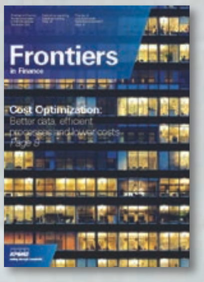
In this article KPMG look at the key drivers required to improve and optimise the risk management function to ensure value-enhancing performance.

Evolving Insurance Regulation

This publication analyses the increasingly wide range of regulatory drivers insurers are facing, ways in which the industry can balance these new demands while creating positive value for enhanced performance, and highlights both the key challenges and opportunities this presents.

Accounting change – what are insurers doing?

This survey highlights what insurers around the world are doing to prepare for the changes in financial reporting in the industry, along with a snapshot of where the participants are with their preparation.



Frontiers in Finance: Cost Optimisation – Better data, efficient processes and lower costs

This paper is one of a series of publications from KPMG's Financial Services practice which explores how financial service firms can grow in difficult times, through improvements to the current business model and rebuilding turnover and profitability by optimising costs. Areas such as the new demands on company board members and potential impacts in the insurance sector from technological change are also covered in this edition.

New on the Horizon: Insurance contracts – A new world for insurance

This publication details the revised proposal for insurance contracts accounting. The details of the proposed changes, models and application of the changes are discussed.

Beyond compliance: Putting an economic capital value on risk

In this article KPMG describes a new approach to articulating how risk management enhances economic capital and helps deliver growth.

If you'd like to receive a copy of any of these publications, please email karlbarker@kpmg.co.nz

Alternatively, you can download these and many more publications from kpmg.com/nz

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