Australian Proposals for the future Regulation of Foreign Insurers – London Market Seminar: 5 April 2006

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1. Introduction – the Australian market and the HIH Royal Commission

1.1 The Australian market

The Australian general insurance market is a significant part of the Australian financial services system. Recently published statistics show that the private sector insurance industry generates direct premium revenue of some A$26 billion per annum and has assets exceeding A$80 billion. The industry employs around 25,000 people. Approximately 100 companies are authorised to carry on insurance business in Australia by the Australian prudential regulator, the Australian Prudential Regulation Authority (APRA). (This is about 58 percent of the number of authorised insurers at the peak in 1998 of over 170 and follows from the consolidation of the Australian market.) Those figures exclude insurance business written in statutory classes such as workers’ compensation and compulsory third party motor vehicle liability.

Most classes of business are represented. Operators range from branches of global reinsurers to locally incorporated monoline insurers such as title insurers and lenders’ mortgage insurers. The Insurance Council of Australia (ICA) is the representative body of the general insurance industry in Australia. ICA membership represents more than 90% of total premium income written by private sector general insurers. ICA members issue more than 41 million insurance policies annually and deal with some 3.5 million claims each year.

There has been a very strong performance in the general insurance industry in Australia over the past three years. Profit growth followed a strong premium income, well performing investment markets, lower claims costs (not only in the public liability area where tort law reforms have had an impact) and a lower frequency of claims across almost all classes of general insurance. This allowed a strengthening in reserves so that almost all APRA regulated general insurers hold capital well above their Minimum Capital requirements.

The London market and Lloyd's in particular have historically had very close links to the Australian market. Lloyd’s underwriters are in fact automatically authorised to carry on business here in Australia under our Insurance Act by virtue of special provisions of the insurance legislation. That favoured status is not extended to London market companies generally. Nevertheless, overseas insurers, including the London company market are a significant source of capacity for Australian risks. This is particularly the case in niche and difficult to place classes.

1.2 The Australian legal and regulatory environment

There is no doubt that the Australian legal and regulatory environment for insurers is complex. Part of the complexity stems from the existence of separate federal and state jurisdictions which undoubtedly give rise to duplication and inconsistency of outcomes in some respects. A detailed analysis of the regimes is outside the scope of this paper although reference, where relevant to the issues canvassed in the paper, is made to the legal and regulatory environment later on.

The Australian insurance industry has had its fair share of woes over recent years. Australia is a litigious place – it has been said that, per capita, New South Wales is the second most litigious place on the planet, ranking only behind California. There have been improvements in the common law and statute based legislation in relation to legal liability recently. This was driven partly by the HIH collapse and the consequential lack of capacity in the market, but also driven by a
sense that the state of tort law in Australia had swung too far in favour of plaintiffs. There has been a raft of liability reform in Australia over the last 3 years involving significant implementation of new legislation and changes to existing legislation relating to liability. Most significant has been the introduction of a range of provisions designed to reduce the frequency and quantum of personal injury claims. This has undoubtedly led to a more benign claims environment in Australia. However, the pendulum appears to be swinging back in the other direction with recent calls from senior members of the Australian judiciary to strip back the recent reforms for fear of adversely affecting individual rights. The industry will need to monitor these developments very closely so that the gains made are not quickly eroded.

There is also the sense that the Australian market, particularly for liability covers (especially professional indemnity and D&O covers) is softening. A number of underwriters we have recently spoken to have all bemoaned the developments. This is partly due to the cycle; partly as a result of memories fading quickly after the harsh lessons learned from the HIH collapse; but also as a result of the sometimes aggressive rate cutting approach adopted by overseas insurers writing business into Australia.

1.3 The HIH Royal Commission

The current debate in Australia and the proposals for the future regulation of overseas insurers under Australian law can be traced back to the aftermath of the collapse of the HIH Group in 2001. Following the collapse, the Australian Government established a Royal Commission chaired by the Hon Justice Neville Owen to examine the circumstances surrounding the collapse. In his report on the collapse issued in 2003, Justice Owen made a number of observations and recommendations as to the future regulation of general insurance in Australia.

Those recommendations and observations included an analysis of the way in which the Australian legal, regulatory and prudential framework operates in relation to local domestic Australian operations. A number of observations were also made as to the extent and the reach of the Australian regime to overseas insurers which although not incorporated and regulated in Australia, nevertheless provide cover for Australian risks and/or to insureds domiciled in Australia. There are no accurate and reliable statistics as to the amount of general insurance and reinsurance which is written overseas in relation to Australian risks, although it is generally understood that a significant volume of business is placed in overseas markets, including in particular, into the London company market. The current best "guesstimate" is that between 5 – 10% of Australian commercial lines premium on direct business goes overseas; the figure is likely to be significantly higher for reinsurance, much of which is placed into the London market – but the figures are not accurate by any means.

It is important to note that there is currently no per se prohibition on an Australian insured obtaining insurance cover from an overseas insurer, and neither are foreign general insurers prohibited per se from issuing policies to Australian insureds. It is entirely legal for them to issue, and for Australian insureds to insure themselves under policies issued by unauthorised foreign insurers.

From our perception, there has been a growing and substantially increased use of overseas insurers as providers of insurance protection within the Australian community and these insurers have a reasonably significant presence at the retail level through underwriting agencies or brokers. In this regard, we note, there seems to be a particular emphasis on liability protection products.
It also appears to us that people choose these products primarily by reason of price without a particularly sophisticated analysis (or any analysis at all) of the different legal regimes that may protect their interests. To some extent the demand for these products has increased because of the unavailability of traditional insurance product from locally authorised insurers. Part of the attraction would also appear to be price differentials arising from the fact that insurance related taxes are avoided.

Another factor that may affect the use of these products is the requirement by various organisations (eg. landlords, the hirers of venues etc.) that tenants and users hold various forms of liability cover. In these circumstances, the prospective insured may be more focused on obtaining insurance at an attractive rate rather than on its terms or enforceability.

Justice Owen made a number of observations in relation to offshore foreign insurers and in respect of discretionary insurance products, such as discretionary mutual funds which are functionally similar to insurance products but nevertheless have a different legal character to insurance products, and as such are not presently the subject of insurance regulation.

The focus of this paper will be on the proposals which flow from the HIH Royal Commission and the subsequent Potts Report (of which more later) in relation to direct offshore foreign insurers (DOFIs), although we will touch on certain aspects relating to discretionary insurance-like products.

Discretionary Insurance Products

Chapter 8 of the Report of the HIH Royal Commission deals with the regulation of general insurance. Recommendation 42 states:

*I recommend that the Commonwealth Government amend the Insurance Act 1973 to extend prudential regulation to all discretionary insurance-like products – to the extent that it is possible to do so within constitutional limits.*

This recommendation arises out of the well known problems of medical defence organisations and their failure to properly recognise their future liabilities and to price their products. His Honour observes (at page 243 of the Report):

"*The discretionary structure of such arrangements, however, avoids the application of the Insurance Act. A consequence of this is that the provider can avoid the costs of complying with the requirements of the Act. This may result in a cheaper product but leaves consumers without Insurance Act protections.*"

His Honour notes that one approach to deal with the issue is disclosure but, of course, disclosure to the insured does not ultimately protect a third party where the cover being provided is a liability cover.

Offshore Foreign Insurers

Following upon his Recommendation 42, His Honour then makes some observations about insurance underwritten offshore. These observations may be summarised as follows:

- In many instances it is unnecessary to regulate insurance written offshore because it involves large commercial insurance contracts where a purchaser is well able to judge for itself the risks involved in the transaction. Prudential regulation of these products is only justified if it involves a systemic risk to the Australian economy.
• His Honour then observes that there are a number of disclosure requirements in relation to offshore insurance which are imposed on agents and brokers under the Insurance (Agents & Brokers) Act 1984 (this legislation has since been repealed). More importantly, His Honour observed that depending on the level of knowledge of an agent or broker, those persons may be involved in the commission of an offence of carrying on insurance business in breach of the Insurance Act by being concerned in a contravention by the offshore principal (see sections 9 and 10 of the Insurance Act). Alternatively, the agent may be carrying on business incidental to insurance business in which case, the agent itself may be carrying on insurance business within the meaning of that term (see section 3 of the Insurance Act).

• The proposed policyholder support scheme which would relate to onshore products may make offshore insurance less attractive – in this regard, there is presently no formal Australian policyholder or depositor protection scheme in place, although that issue is currently the subject of debate and review by the government. However, His Honour did not make any particular recommendations in relation to DOFIs.

2. The Potts Review

As a consequence of the Royal Commission report, the Treasurer commissioned a review, headed by Mr Gary Potts, the former Executive Director of the Markets Group in the Department of Treasury to consider the appropriate regulatory framework for discretionary mutual funds and DOFIs.

The Terms of Reference for the review set out the scope of the review. They provided:

1. The review shall examine the extent and nature of discretionary mutual funds (DMF) and direct offshore foreign insurers (DOFI) operations in Australia and their contribution to overall insurance capacity.

2. In undertaking this examination the review should have regard to:

   (a) the reasons why DMFs and DOFIs choose to do business in the manner they do; and

   (b) the level of financial and organisational resources available to DMFs and DOFIs operating in Australia.

3. The review shall have regard to the systemic risk associated with the failure of a DMF or DOFI to meet its obligations.

4. The review shall examine the adequacy of existing protection arrangements for consumers of products supplied by DMFs and DOFIs and provide options for improving protection arrangements.

   (a) in providing options, the review will have regard to the different characteristics of DMFs and DOFIs.

5. The review shall report to the Government on its findings by 30 January 2004.

The term "direct offshore foreign insurer" or DOFI is explained in the Terms of Reference as being:
“Foreign insurers can still sell insurance to Australians via an insurance agent or broker licenced in Australia, without establishing a subsidiary or branch in Australia. These foreign insurers, known as DOFIs, are not subject to the provisions of the Insurance Act.”

3. Key findings of the Potts Review

The key findings of the Potts Committee Review were released in May 2004. The full findings were not made public due to confidentiality issues. The committee made a number of recommendations for change concerning the regulation of DMFs and DOFIs. The government has committed to implementing the recommendations.

In respect of DOFIs, the key findings were as follows:

- allow DOFIs marketing insurance in Australia to be exempt from prudential regulation in Australia if they are domiciled in a country APRA considers to have comparable prudential regulation, subject to a market significance threshold to prevent established authorised insurers moving offshore. DOFIs not meeting this test would be able to market insurance in Australia as an authorised insurer, through a branch or subsidiary.

- give APRA enhanced enforcement and investigative powers to establish whether the nature of a DOFIs operation is such as to require authorisation under the Insurance Act, subject to satisfactory safeguards.

- APRA to assume a data collection role in relation to offshore insurers.

In reaching its recommendations the Committee rejected other options which had been canvassed including an option to require foreign insurers operating in Australia either directly or through intermediaries to become APRA authorised branches or to establish locally incorporated operating subsidiaries. The option ultimately preferred by the Committee was selected on the basis that the Committee believed it would deal effectively with the foreign insurer issue without relying on a rigorous across the board approach which would be disruptive to a market which was at the time generally accepted to be “under strain”. Significantly however, there was very little guidance or discussion of the key component of the preferred model – namely, what activities would constitute the “marketing of insurance in Australia”.


There followed an 18 month period of public inactivity from the government while it pursued other more pressing legislative programs and had to deal with a general election.

Not until December 2005 was the DOFIs issue publicly revisited with the publication of the Treasury discussion paper in which further industry submission was sought by the Treasury in relation to DMFs and DOFIs. The discussion paper sought comments from interested parties on the implementation of the key findings of the Potts review.

In many respects the discussion paper raises far more questions than it answers.
5. **Why is the regulation of discretionary mutual funds and direct foreign insurers linked?**

The linkage of these two products comes from:

- the question as to whether prudential regulation should be extended to the providers of products (i.e., should Government take steps to ensure that the promises made have a high likelihood of being honoured); and
- the degree to which non-prudential regulation in the nature of licensing and disclosure should be applied to the providers of these products and in particular, the degree to which the differences from locally sourced insurance should be highlighted.

Prudential regulation and disclosure regulation can operate side by side as they do currently for authorised Australian insurers or they can be alternate forms of regulation. In considering these issues, different approaches may be taken depending on:

- the nature of the provider;
- the nature of the product; and
- the nature of the recipient of the product.

**Reason for Prudential Regulation**

In the HIH Report, there is a summary in Chapter 8.2 of the reasons for prudential regulation. These being:

- Market failure which essentially describes the need for customers to be able to make an informed choice about the likelihood of the insurer being able to meet a future claim and balancing that against other factors such as price, coverage etc.
- Contagion – this is the underlying justification for the regulation of banking being the threat of contagion or systemic risk to the wider financial markets within the country. Clearly, the collapse of an insurer the size of HIH has demonstrated the potential for some degree of contagion where a significant insurer collapses.
- Third party risks – that is the role of general insurers in providing protection for third party risks under liability coverage including workers compensation and compulsory third party personal injury. In the case of liability insurance, it extends to the interests of third parties.

The recommendations of the HIH Royal Commission were mainly upon prudential regulation.

**Reasons for Non-Prudential Regulation**

Non-prudential regulation is primarily concerned with:

- disclosure;
- market efficiency;
- ensuring that product providers are adequately trained, qualified and are able to be clearly identified;
- the establishment of core requirements in relation to the contractual relationship between the parties and, in particular, the entitlement of the customer. In the case of liability insurance, this extends to the interests of third parties.
In a sense, prudential regulation is pre-emptive whereas non-prudential regulation is normally enforced after there has been a failure although the increasing use of compliance and audit supervision through a licensing mechanism creates a greater degree of pre-emptiveness in non-prudential regulation.

6. The legal framework

The Australian Federal Government regulates insurance principally through:

- The Insurance Act 1973;
- The Insurance Contracts Act 1984;
- The financial markets and services provisions of the Corporations Act 2001 where Chapter 7 and related provisions have replaced the Insurance (Agents & Brokers) Act 1984; and

6.1 Insurance Act 1973 (the Act)

The Act provides the prudential regime which must be complied with if a person carries on insurance business in Australia. Insurance business is defined in section 3 of the Act as follows:

*Insurance business means the business of undertaking liability, by way of insurance (including reinsurance) in respect of any loss or damage, including liability to pay damages or compensation contingent upon the happening of a specified event, and includes any business incidental to insurance business defined ....*

The Act then identifies matters which are not taken to be insurance business for the purposes of the legislation. These classes include life insurance business, friendly society or trade union benefit business carried on for members or for their dependants; and health benefit insurance business (which is regulated under the Australian National Health Act).

There has long been uncertainty as to the exact scope and application of the carrying on of insurance business test. Unlike in England and Wales however, there has not been a significant amount of litigation in Australia on the issue. Clearly, the undertaking of liability by way of insurance under contracts which are entered into in Australia and activities incidental to that such as performing underwriting assessments, engaging in claims handling and payment of claims in Australia would certainly constitute carrying on of insurance business. For the purposes of the present analysis it is sufficient to note that the uncertainty surrounding the application of the test is further compounded in the case of DOFIs which do not have a permanent establishment and presence in the jurisdiction but which may use a range of marketing strategies and distribution methods in order to contract with Australian insureds.

What is clear however is that presently there is no prohibition on an Australian entity proactively seeking cover from an overseas unadmitted insurer where the negotiations for and the contract are undertaken and concluded respectively outside of the jurisdiction.

The Insurance Act, in that sense could be said to seek to regulate local offerings to Australian insureds which take place within the jurisdiction. Where that happens and it amounts to carrying on an insurance business, the insurer must be appropriately authorised and subject to prudential regulation by APRA.
The Insurance Act requires an insurer to be a body corporate and it may be authorised whether the body corporate is incorporated in Australia or whether it is incorporated overseas. In the latter case it is authorised as a branch. Authorised insurers are required to meet certain requirements in relation to the valuation of liabilities, the maintenance of assets and the maintenance of a minimum capital requirement as well as meeting other requirements under the Act.

In the case of a branch one important distinction from a locally incorporated company is that all assets supporting liabilities and the minimum capital requirement must be held in Australia. In the case of locally incorporated companies only assets matching Australian liabilities are required to be held in Australia.

The importance of the assets in Australia test lies in the requirements of section 116 of the Act which gives a priority in a winding-up to Australian liabilities in respect of Australian assets. In other words overseas policyholders may rank second behind Australian policyholders in respect of assets in Australia. The operation of section 116, particularly before it was amended by the General Insurance Reform Act 2001 is currently the subject of litigation and we expect the Australian High Court (the ultimate Australian appellate court) to determine the matter in the case of AssetInsure v New Cap Re later this year.

There is one other important difference in the way in which the Australian regulatory regime works where it applies to underwriters at Lloyd's who are authorised insurers for Australian law purposes. Lloyd's is required to maintain trust funds in Australia which hold assets which generally equate to what would be required of a locally authorised insurer and which are available to meet any failure by a Lloyd's underwriter to meet liabilities under a Lloyd's policy.

The regulation of Lloyd's in Australia provides an interesting alternate approach to permitting the authorisation of foreign insurers on the basis that assets are deposited in Australia in support of their liabilities.

In addition to the prudential requirements there are also reporting requirements that apply equally to locally incorporated companies, branch offices and Lloyd's where they are authorised to conduct insurance business in Australia.

6.2 Insurance Contracts Act 1984

The Insurance Contracts Act (the IC Act) is an extremely consumer friendly piece of legislation. It codifies the law in relation to insurance contracts and the insurer/insured relationship. It does not supplant common law and there is a great deal of, in some cases conflicting, case law in relation to the application and operation of the legislation. In particular it is important to note that it applies equally to retail and commercial lines of business. However it does not apply to reinsurance, marine insurance, health benefit insurance or statutory classes of workers compensation and compulsory third party motor vehicle insurance.

The IC Act contains extremely important controls on the way in which an insurer may exercise rights to refuse or reduce a claim or to avoid, cancel or vary a policy. This regulatory framework is significantly different from that applying in many countries overseas.

The IC Act applies to a contract of insurance whose proper law is that of a state or territory of Australia or, disregarding any explicit selection of proper law, would be governed by the proper law of a State or Territory of Australia. Therefore, contracts governed by this legislation include those
where the proper law is that of Australia and is specified in the contract or, alternatively, where the contract has its closest connection to Australia.

A policy issued by a foreign insurer may be subject to the legislation if the contract has its closest connection to Australia for the purposes of Australian law but unless that insurer submits to the jurisdiction of Australian courts and/or has assets in Australia, there may be serious problems in enforcing the IC Act in proceedings in overseas jurisdictions. For example the overseas court may not give recognition to the Australian legislation as overriding a selection of proper law contained in the contract itself or overriding the rules for the determination of proper law under the law of the jurisdiction in which the matter is heard.

This difficulty is overcome in relation to Lloyd's underwriters who are authorised to carry on insurance business in Australia by agreement that Lloyd's policies will be subject to Australian law and that the underwriters will submit to the jurisdiction of the Australian courts. This is then further bolstered by assets secured under the trust arrangements required under the Insurance Act 1973.

The key elements of the IC Act which are relevant for consideration in this context are as follows:

**Duty of Good Faith**

Sections 12 to 15 of the IC Act reinforce the principle that the duty of good faith is a contractual condition applying to both parties to the contract. It should be noted that insofar as the duty imposes a duty on a prospective insured to make disclosure or not misrepresent the risk, this is dealt with under the provisions set out in Part IV of the IC Act. The residue of the duty of good faith most often arises where it is alleged that an insurer is acting improperly in breach of its duty to the insured by relying on certain terms of the contract which, for example, may allegedly have been misrepresented as to their effect by the insurer or in other ways.

**Non-disclosure and misrepresentation**

Non-disclosure and misrepresentation relates to the provision of information prior to the contract being formed. This is to be distinguished from acts or omissions which might arise after the contract is formed and which are dealt with under section 54 of the Act. The impact of the risk to the insurer is substantially changed in Australian law by Part IV of the IC Act in sections 21 to 33. Section 33 makes it clear that the remedies available to an insurer contained in this Part are exclusive of any other remedy and the insurer may not seek to rely on other remedies such as those which may arise out of the common law rules or under statute. This is extremely important as an insurer will not be able to rely upon the various statutory provisions giving relief where a party engages in misleading and deceptive conduct.

Moreover, it needs to be particularly noted that an insurer’s rights under the IC Act are rights in respect of conduct by the insured. As a consequence, it is only a non-disclosure or misrepresentation by an insured or their agents (which are in the control of the insured) to the insurer that will give rise to a right. An insurer may seek to protect itself further by exclusions in the policy but the protection will only extend to the actual policy terms and not give rise to any general entitlement.

In summary, if an insurer wishes to rely on a non-disclosure other than in the case of fraud, the insurer is required to clearly inform the insured in writing of the general nature and effect of the duty of disclosure as described in section 21. The duty of disclosure itself varies from the common law duty in that it provides a more objective assessment of the types of matter that must be disclosed.
A failure to disclose or a misrepresentation cannot, under Australian law, result in avoidance of the contract ab initio. In fact, the remedy available to an insurer is significantly different from the common law remedy even where avoidance is not sought. The insurer may only reduce the claim to the amount that would place the insurer in a position in which it would have been if the failure had not occurred or the misrepresentation had not been made. In simple terms, this means that unless the insurer could demonstrate that it would not have underwritten the risk if it had been aware of the matter not disclosed or had been aware of the correct position in relation to the matter misrepresented then the only remedy available to the insurer would be to recoup any additional premium that the insurer would have otherwise charged or otherwise adjust the claim to reflect the extent to which the insurer would have agreed to insure the loan had it been aware of the true facts in relation to the matter not disclosed or the correct position in relation to the matter misrepresented.

In the same circumstances, an insurer, under section 60 of the IC Act may cancel a policy where there has been a failure to comply with the duty of disclosure or where there has been a misrepresentation.

The case law demonstrates that as a practical matter, an insurer needs to demonstrate by fairly explicit evidence a non-disclosure where the relevant notice has been given or a misrepresentation before it is entitled to exercise these remedies. Even where an insurer may be entitled to avoid the contract by reason of fraud, under section 31 of the IC Act a court may exercise a power to disregard that avoidance.

**Unusual Terms**

Section 37 of the IC Act provides that an insurer may not rely on unusual terms in a contract unless it has drawn those terms to the attention of the prospective insured. Given the fact that the Australian LMI insurers deal regularly with particular ADIs in Australia and often under master policy agreements, it is unlikely that this provision would have any significant implications for LMI policies in Australia in that context. However, it does operate importantly to stop unusual terms being introduced into the contract without proper notice being given to the insured.

**Variations**

Section 53 of the IC Act makes void a provision in an LMI contract of insurance which would authorise or permit the insurer to vary to the prejudice of a person other than an insurer the LMI contract terms. In other words, the terms of the policy cannot be varied if, for example, the credit risk increases after the issue of the policy.

**Reliance on conditions and exclusions**

Most importantly section 54 of the IC Act provides substantive protection to claimants under insurance policies. Where an insurer seeks to rely upon a provision of the contract of insurance to refuse a claim, either in whole or in part, that may only be done where the relevant provision is in relation to an act or omission by the insured or another person after the contract commenced if that act or omission could reasonably be regarded as being capable of causing or contributing to a loss in respect of which the insurance cover is provided. In any other case, the insurer is only able to reduce the claim by an amount that fairly represents the extent to which the insurer's interests are prejudiced as a result of that act.
This is best illustrated by an example. If, under a contract, an insured failed to meet the conditions relating to claim notification, an insurer would be extremely hard pressed to rely on that to refuse or reduce a claim but in grosser cases, it may be able to demonstrate actual prejudice and in that case, may reduce the claim by the extent of that prejudice. But a failure to report will not as such be an act that could be reasonably taken to cause or contribute to the loss.

**Interest on delayed payments**

Section 57 of the IC Act protects insureds in the event that an insurer is liable to pay an amount under an insurance contract or under the IC Act and fails to do so by prescribing that, in those circumstances, interest at the rate of 11% per annum is payable during the period in which it was unreasonable for the insurer to have withheld payment.

**Cancellation**

Section 60 of the IC Act deals with the cancellation of contracts of insurance and permits cancellation where there is a failure by the insured to comply with the duty of good faith, where there is a breach of the duty of disclosure by the insured, where there is a misrepresentation by the insured prior to the contract being entered into, where there is a breach of a condition under the contract including a provision with respect to the payment of premium or where there is a fraudulent claim and, in that case, a contract may be cancelled where there is a fraudulent claim under some other contract of insurance with the same insured. Where an insurer cancels a contract it is required to give reasons under section 75 of the IC Act if requested to do so. Insurance contracts may waive all or some of these cancellation rights.

There are therefore a number of key areas where a policy issued by an Australian prudentially regulated insurer and an overseas insurer differ. These are:

- in relation to rights of enforcement;
- in relation to prudential regulation; and
- access to assets in Australia.

The issues are inter-related because ultimately the enforceability of a contract depends on being able to access an insurer's assets for the purposes of enforcing the contractual promise. However, before that issue is reached it needs to be noted that policies are subject to the IC Act where the proper law of the contract is that of Australia or where the insurer who issued the policy is within an Australian jurisdiction. Section 8 of the IC Act provides that, notwithstanding a selection of proper law contained in the contract, the proper law of the contract will be that state or territory with which the policy has the closest connection. Where a policy is issued by an Australian insurer in respect of an Australian risk to an Australian ADI there is little or no doubt that the proper law of that contract will be that state or territory to which the contract has the closest connection and Australian courts will have jurisdiction to enforce the contract.

Where the policy is issued in Australia by a Lloyd's underwriter, such a policy is normally issued on the basis that Australian law applies and that the underwriter submits to Australian jurisdiction. In addition to this, the Lloyd's trust arrangement provides assets within Australia against which the policy can be ultimately enforced.

However, where the policy is issued by an overseas insurer, the matter may become more complicated. If the overseas insurer chooses to specify that the proper law will be that of Australia
and that it will make payment in Australia and submit to the jurisdiction of the Australian courts, then the Australian courts can determine any dispute under the policy but any judgement may need to be registered or enforced in another jurisdiction in order to get direct access to the assets of that overseas insurer.

Where the overseas insurer does not specify Australia as the proper law of the contract and where that insurer has no presence in Australia, then the Australian insured will need to take proceedings in an overseas jurisdiction in order to bring about enforcement of the contract and in order to have access to the assets of the insurer for payment. An overseas court may not apply the IC Act in relation to the policy of insurance. This will have the important consequence that the protection of the IC Act will not apply and the rights under the policy may be significantly different from the rights that arise under an Australian policy.

The second matter relating to prudential regulation in Australia ultimately comes down to whether or not there are assets in Australia available to meet the liabilities under the policy. An Australian insurer, including a Lloyd's underwriter, must maintain assets in Australia to meet its liabilities together with various additional amounts in the form of capital. From an enforcement point of view this results in the Australian courts not only having jurisdiction to determine any contractual dispute but it also gives direct access to assets in Australia for the purposes of enforcing a policy.

If the policy has been issued by an overseas insurer then notwithstanding that it may be prudentially regulated in another overseas jurisdiction there may be issues in that overseas jurisdiction as to the priority the Australian insured has in respect of that insurer's assets.

Within Australia, section 116 of the Insurance Act 1973 provides that Australian assets of an Australian prudentially regulated insurer must firstly be applied to meet Australian liabilities. Similar and other provisions may apply overseas. For example in England and Wales the Policyholders Protection Scheme, now administered by the FSA, provides priority of access to an insurer's assets in the event of an insolvency to local policyholders and overseas policyholders rank second.

6.3 Insurance (Agents & Brokers) Act 1984

The Insurance (Agents & Brokers) Act 1984 (IABA) which has now been repealed under the reforms made by the Financial Services Reform Act 2001. However, the IABA introduced legislation that imposed direct liability upon an insurer for the acts of agents in arranging insurance and required the registration of brokers. It also required importantly that agents of foreign insurers must be registered and brokers and agents who arrange or place insurance with unauthorised foreign insurers are required to obtain an acknowledgment in an approved form and in the approved manner within the required time of the placement of the business with that unauthorised foreign insurer.

6.4 Financial Sector (Collection of Data) Act 2001

The Financial Sector (Collection of Data) Act 2001 requires the provision of data by various financial sector entities to regulators and in particular in the context of insurance to APRA. It is to be particularly noted that this Act has been amended so that the reporting entities now include medical defence organisations who provided medical indemnity cover to health care professionals before 1 July 2003 under arrangements which were not contracts of insurance ie. DMFs.
6.5 Corporations Act 2001

The Corporations Act has been amended by the Financial Services Reform Act 2001 to treat insurance as a financial product and to regulate it in the same way as other financial products. This requires various providers of those products to be licenced and also requires licences to be held by various classes of advisers.

(a) Extra Territorial Reach

The regime has extra-territorial reach. Under s911A(1) of the Corporations Act, an offshore entity who carries on a financial services business in Australia requires an Australian Financial Services Licence covering the provision of the financial services, unless they are an authorised representative of a license holder or otherwise exempt from the requirement.

An entity will be carrying on a financial services business if it:

• provides one or more of the 5 particular types of financial services;
• carries on a business when providing the financial service; and
• satisfies the jurisdictional nexus.

To summarise each of these requirements.

(b) Are you providing a financial service?

You will be providing a financial service if you do any of the following.

1. provide financial product advice;
2. deal in a financial product (including contracts of insurance);
3. make a market for a financial product;
4. operate a registered managed investment scheme; or
5. provide a custodial or depository service;

in Australia.

Each of these services has a special meaning but relevant to insurance activities, an insurer may provide financial product advice and will certainly deal in financial products by issuing policies.

(c) What is the financial product advice?

Financial product advice is a recommendation or statement of opinion that is intended to influence (or could reasonably be regarded as being intended to have such influence) a person in making a decision in relation to a financial product.

Financial product advice does not include:

• factual information;
• information about the price or rate of return on a product; or
• conduct which occurs in the course of work of a kind ordinarily done by clerks and cashiers (for example, distribution of product information, collecting payments, assisting with the completion of application forms and general administrative functions).
(d) **What is dealing in a financial product?**

A person will be dealing in a financial product if their work requires them to **acquire, issue, vary or dispose** of a financial product. Generally, anyone who has the authority to sell or arrange for the sale of a financial product to a client will be **dealing** in that financial product.

**Financial Products** relevantly include general and life insurance products.

(e) **What is making a market for a financial product?**

This means that the entity stands in the market place prepared to offer a bid and sell price for a financial product. For example, offering futures to a client for a price.

(f) **What is providing a custodial and depositing service?**

This involves an entity holding assets on trust for, or on behalf of, a client.

(g) **Do you carry on a business in Australia?**

Whether an entity is carrying on a business will be a question of fact. An entity is **more likely** to carry on business if it:

- Provides a financial service in Australia with system, repetition and continuity (that is, not a one-off service). This is a similar test to that included in the Insurance Act.
- Has a place of business in Australia.
- Administers, manages, or otherwise deals with property situated in Australia whether by employee or agent or otherwise.
- Uses local representatives/agents or employees.

An offshore entity is **less likely** to carry on a business if it is merely:

- A party to legal proceedings.
- Holding meetings of directors and shareholders in Australia.
- Maintaining a bank account in Australia.
- Effecting sales through an independent contractor.
- Conducting an isolated transaction not being one of a number of similar transactions conducted from time to time.
- Investing any of its funds or holding any property.

(h) **Jurisdiction**

Without limiting the circumstances under which an entity will be taken to be carrying on a financial services business **in this jurisdiction**, the Act provides that for licensing purposes the **jurisdictional nexus** is satisfied if the entity engages in conduct that is:

- intended to induce people in Australia to use the financial services provided by the offshore entity; or
- is likely to have that effect;

whether or not the conduct is intended, or likely, to have that effect in other places as well.
Generally therefore, if an offshore insurer actively markets or issues its products in Australia it will be caught by the regime unless one of the exemptions, which I will address shortly, applies.

(i) Exceptions / Exemptions

There are certain exemptions to the licensing requirement which may apply.

(i) Intermediary Authorisation (s911A(2)(b)(ba))

This exemption applies to an entity which only issues, varies or disposes of a financial product, and does not provide any other financial product advice service or custodial services. An example may be an entity that organises a direct debit request from a client in order to pay for financial services or products.

(1) Subject to this section, a person who carries on a financial services business in this jurisdiction must hold an Australian financial services licence covering the provision of the financial services . . .

(2) However, a person is exempt from the requirement to hold an Australian financial services licence for a financial service they provide in any of the following circumstances: . . .

(b) the service is the issue, variation or disposal of a financial product by the person (the product provider) pursuant to an arrangement (an intermediary authorisation) between the product provider and a financial services licensee under which:

(i) the financial services licensee, or their authorised representatives, may make offers to people to arrange for the issue, variation or disposal of financial products by the product provider; and

(ii) the product provider is to issue, vary or dispose of financial products in accordance with such offers, if they are accepted;

provided that the offer pursuant to which the issue, variation or disposal is made was covered by the financial services licensee’s Australian financial services licence;

(ba) the service is the entry into of an intermediary authorisation referred to in paragraph (b);

(ii) Wholesale Regulated Bodies (s911A(2)(h))

This exemption applies where:

- the entity is regulated by an ASIC-approved offshore regulatory body (note that ASIC is currently developing their policy on when they will approve offshore regulatory authorities – they have only released a draft paper at this stage); and

- the entity provides financial services to wholesale clients only (see s761G of the Corporations Act).

The exemption applies only to services provided in the course of carrying on the business or undertaking that causes the foreign regulation to be required.

(1) Subject to this section, a person who carries on a financial services business in this jurisdiction must hold an Australian financial services licence covering the provision of the financial services . . .
(2) However, a person is exempt from the requirement to hold an Australian financial services licence for a financial service they provide in any of the following circumstances: . . .

(h) all of the following apply:

(i) the person is regulated by an overseas regulatory authority;

(ii) the regulatory authority is approved by ASIC in writing for the purposes of this paragraph;

(iii) the service is provided in the course of carrying on the business or undertaking which causes that regulation to be required;

(iv) the service is provided only to wholesale clients; . . .

This exclusion would not be available where personal line products are issued to individuals or small businesses. Such products are more particularly described in the Corporations Regulations 2001 (Cth) (the Corporations Regulations), but include, for example, motor, home buildings, home contents, consumer credit and sickness and accident policies. Life policies would also fall outside the scope of the exemption.

(iii) Offshore Dealers (Regulation 7.6.01(1)(n))

This applies where an Australian licensee with a relevant licence arranges for a foreign provider to deal in a financial product or class of financial products for a person in Australia. An example may be an offshore insurance company which provides a policy to someone in Australia where the arrangement is facilitated by an Australian intermediary which holds an appropriate licence to undertake the arranging.

(1) For paragraph 911A (2) (k) of the Act, the provision of the following services is covered by an exemption from the requirement to hold an Australian financial services licence:

(n) a financial service provided by a person (person 1) to another person (person 2) in the following circumstances:

(i) person 1 is not in this jurisdiction;

(ii) person 2 is in this jurisdiction;

(iii) the service consists only of dealing in a financial product or class of financial products;

(iv) a financial services licensee whose financial services licence covers the provision of the service arranges for person 1 to provide the service to person 2; . . .

(iv) Mere Referral (Regulation 7.6.01(1)(e)/(ea))

A licence is not necessary if all that is done is a referral to an entity which is providing a financial service in Australia. An example may be the distribution of brochures containing contact details for a licensee. However, the financial services provider would itself need to be licensed or bring itself within the scope of a relevant exemption.

(1) For paragraph 911A (2) (k) of the Act, the provision of the following services is covered by an exemption from the requirement to hold an Australian financial services licence:

(e) a financial service provided by a person (person 1) in the following circumstances:
(i) the service consists only of:

(A) informing a person (person 2) that a financial services licensee, or a representative of the financial services licensee, is able to provide a particular financial service, or a class of financial services; and

(B) giving person 2 information about how person 2 may contact the financial services licensee or representative;

(ii) person 1 is not a representative of the financial service licensee, or of a related body corporate of the financial services licensee;

(iii) person 1 discloses to person 2, when the service is provided:

(A) any benefits (including commission) that person 1, or an associate of person 1, may receive in respect of the service; and

(B) any benefits (including commission) that person 1, or an associate of person 1, may receive that are attributable to the service;

(iv) the disclosure mentioned in subparagraph (iii) is provided in the same form as the information mentioned in subparagraph (i);

(ea) a financial service provided by a person (person 1) in the following circumstances:

(i) the service consists only of:

(A) informing a person (person 2) that a financial services licensee, or a representative of the financial services licensee, is able to provide a particular financial service, or a class of financial services; and

(B) giving person 2 information about how person 2 may contact the financial services licensee or representative;

(ii) person 1 is a representative of the financial service licensee, or of a related body corporate of the financial services licensee;

(v) Related Body Corporate (s911A(2)(i))

Another exemption is the related bodies corporate licensing exemption (s911A(2)(i) Corporations Act), which may be relevant in circumstances where the offshore entity provides a financial service only to one of its related bodies corporate in Australia. An entity will be related to another body corporate if it meets the test set out in the Corporations Act (that is, it is the holding company for that body corporate, it is a subsidiary of that body corporate, or it is a subsidiary of the holding company of that body corporate).

(1) Subject to this section, a person who carries on a financial services business in this jurisdiction must hold an Australian financial services licence covering the provision of the financial services . . .

(2) However, a person is exempt from the requirement to hold an Australian financial services licence for a financial service they provide in any of the following circumstances: . . .

(i) the person provides the service only to related bodies corporate of the person; . . .

This might, for example, have some application in relation to the activities undertaken by captives depending on how the corporate group is structured.

(vi) Australian Entity Dealing With Offshore Clients (Regulation 7.6.01(1(f)))
This exemption allows an offshore financial service provider to arrange for an Australian licence holder to deal in a financial product with someone outside of Australia.

(1) For paragraph 911A (2) (k) of the Act, the provision of the following services is covered by an exemption from the requirement to hold an Australian financial services licence:

(f) a financial service provided in the following circumstances:

(i) a person (person 1) is a person that is not in the jurisdiction;

(ii) person 1 arranges, on behalf of another person (person 2), for a holder of an Australian financial services licence to deal in a financial product;

(iii) person 1 believes on reasonable grounds that person 2 is not in the jurisdiction;

(j) Product Disclosure

Under the FSR regime, those who provide financial products or financial services to retail clients have to follow disclosure rules.

The main requirements are:

Under s941B of the Corporations Act, when financial services are offered to a retail client, they have to be provided with a financial services guide (FSG). However, an FSG does not need to be given in relation to a financial product by the issuer of that product where it is not also providing financial product advice. There are prescribed requirements as to the form and content of an FSG (for example, regarding commissions).

When retail clients are provided with personal financial advice, they have to be given a statement of advice (SOA) (s946A Corporations Act) in accordance with prescribed requirements.

When recommending or offering products to a retail client, they must be given a product disclosure statement (PDS) and any information that the person recommending or offering knows might materially influence the client’s decision to buy. The PDS must give specific information about the product, such as what benefits the holder can expect and taxation liabilities. There are also ongoing disclosure requirements under s1017B (Corporations Act), where if there are material changes to, or significant events that affect, any matters specified in the PDS clients should be notified. This should happen before the change or event occurs, or as soon as practicable afterwards, and must happen within 3 months.

It is important to note that under Regulation 7.9.15, more detailed information must be included in a PDS that relates to a financial product issued by an unauthorised foreign insurer. This includes

(a) a statement that the product issuer is:

(i) an unauthorised foreign insurer; and

(ii) not authorised under the Insurance Act 1973 to conduct insurance business in Australia; and
(b) a statement that an insurer of that kind is not subject to the provisions of the Insurance Act 1973, which establishes a system of financial supervision of general insurers in Australia; and

(c) a statement that the person should consider whether to obtain further information, including:

(i) the country in which the product issuer is incorporated, and whether the country has a system of financial supervision of insurers; and

(ii) the paid up capital of the financial product; and

(d) which country’s laws will determine disputes in relation to the financial product.

6.6 Other Legislation

It is also important to note that there is a vast range of legislation at Federal and State level which depends upon a particular product being insurance. If the product is not insurance, then the beneficial effects of this legislation are lost. Some illustrative examples of this are:

- provisions in the Corporations Act dealing with the insolvency of parties which allow direct cut throughs to insurance providers for the benefit of third parties;

- provisions which have similar impact such as the Law Reform (Miscellaneous Provisions) Act 1946 of the State of New South Wales which provides for a charge on insurance moneys under various types of liability insurance;

- a comprehensive federal regime designed to protect the privacy of Australian individuals, including limitations on the way in which personal information about those individuals may be collected, held, used and disseminated;

- additional consumer protection legislation in our Trade Practices and Australian Securities and Investments Commission Acts respectively which prevent numerous types of conduct including engaging in misleading and deceptive conduct in the course of a business; and

- proposed new anti-money laundering and terrorism financing legislation.

6.7 Special Common Law Rules

In addition to this, and apart from statute, the common law provides special rules in respect of the relationships and duties between parties to insurance contracts.

6.8 Tax

Many taxation statutes treat insurance and insurers in a different way from other taxpayers. For example, an insurance product may be liable to significant stamp duty whereas a functionally similar product which was not insurance may not be liable to duty. Fire service levies are imposed upon insurance products but not necessarily on the products which are functionally similar. A New Tax System (Goods and Services Tax) Act applies GST rules in relation to insurance in a significantly different way from other transactions. There may be significant issues as to the deductibility of premium where the premium is paid for an insurance product as opposed to a payment to a trust or to some other mutual entity. Similarly, pay outs from these vehicles may have a different tax treatment.
7. Enforcement issues – DMFs and DOFI's

In the case of a mutual discretionary fund the consumer will be depending upon the proper exercise of a discretion and will either have the benefit of trust law to support the customer's rights or alternatively will be depending upon the proper exercise of discretion by a board of a company and will have the benefit of fiduciary principles and the law relating to companies to assist the process.

However in the case of liability insurances the third parties will have no similar rights to the rights that third parties have to cut through to the "insurer". Similarly the terms of the trust and the terms of the constitution of the relevant company may significantly regulate the rights of the parties and those rights will not be overridden by the protective measures of the type found in the Insurance Contracts Act 1984.

In the case of an offshore foreign insurer or offshore discretionary mutual fund the rights of enforcement may depend significantly upon whether that foreign insurer or fund has assets in Australia or upon whether the jurisdiction in which that foreign insurer or fund has assets is a jurisdiction in which there is a developed legal system which will protect the Australian customer.

In the case of major corporates and similar bodies who buy insurance overseas they will often be familiar with operating extraterritorially, will better understand the risks and may have significant countervailing power in the event that an offshore company fails to meet its obligations.

However an Australian customer without these advantages may well need to bring proceedings in an overseas jurisdiction and have to meet the cost and expense of that in order to enforce the obligations of the insurer or fund and have access to its assets. In the case of insurance it will also depend very much on the degree of prudential control and other policyholder protections that may exist in the jurisdiction in which the overseas insurer is located. It should be noted here that most policy protection schemes do not extend to protect foreign insureds. The consumer and small business customer will not necessarily have the relatively cheap and easy methods of enforcement offered by the general insurance industry in Australia through Insurance Enquiries and Complaints Limited.

If the proper law of the contract is not Australian law then the insured may be exposed to the vagaries of insurance law and contract law in the other jurisdiction in which the foreign insurer or fund is located.

We could expand upon these comments in relation to the enforcement but we believe the above sufficiently makes the point that there is a significant difference between dealing with a discretionary fund provider and an insurer and secondly between an authorised insurer and an offshore foreign insurer or fund.

Where the foreign insurer is located in a jurisdiction where there are equivalent prudential controls and a viable and efficient legal system then so long as there is adequate disclosure of the relevant risks the customer does not have as great a risk as in the situation where the customer is dealing with an insurer who is regulated in a jurisdiction where the prudential controls are light or non-existent and where the law relating to the enforcement of insurance contracts is undeveloped, vague or problematic.

Clearly consumers and the small business sector have a greater potential exposure to not understanding the risks.
8. Foreign Insurers

We now turn to consider more particularly the issues relating to foreign insurance. There have been a number of instances in recent times where the Australian Securities and Investments Commission has found it necessary to take steps against schemes involving foreign insurers. These examples illustrate some of the issues that need to be addressed in the context of considering foreign insurers but at all times it must be remembered that a large amount of insurance is in fact placed by brokers on behalf of Australians and others who have Australian exposures (e.g., overseas owners of property within Australia) with foreign insurers or a mix of foreign insurers and local insurers.

In many instances the foreign insurers with whom this business is placed operate out of jurisdictions which have equivalent regulatory regimes to that found in Australia and also many cases those foreign insurers are part of international institutions who have substantial reputations and quite often very good credit ratings.

However the prudential regulatory regime in Australia does not make any distinction other than the relatively crude distinction based on whether or not an insurer is carrying on insurance business in Australia.

However we will see that in relation to the Corporations Act and the application of the licensing regime introduced by the Financial Services Reform Act 2001 the application of the licensing and disclosure regime on foreign insurers is somewhat broader than the requirements for submitting oneself to prudential regulation.

Bosnian Insurance

A recent example of a situation which illustrates why concerns have been expressed as to the adequacy of regulation of DOFIs arises from ASIC’s intervention against 4 Australian companies with the AMCO group which had purported to write insurance on behalf of a Bosnian based insurer Grand Osiguranje AD Zvornik (Grand) for Australian insureds. The policies covered a variety of risks including the insurance of high performance motor vehicles. Grand had not in fact authorised any of the AMCO companies or their representatives to act on its behalf.

Although perhaps atypical, the Grand matter illustrates the risks which Australian policy holders face in dealing with DOFIs and their agents (or in the case of AMCO, entities which purport to act as their agents). In that particular case ASIC obtained enforceable undertakings against AMCO and ultimately obtained consent orders winding up the AMCO companies. However, the policy holders will be fortunate to recover the premiums paid, and it is highly unlikely that Grand will honour any claims under any of the policies purportedly issued by AMCO on its behalf.

Triton

There are other recent episodes involving other overseas insurers of possibly dubious standing in other exotic jurisdictions including for example the Cayman Islands. ASIC recently obtained injunctions against Triton Underwriting Insurance Agency Pty Ltd (Triton) and Trans Pacific Insurance Corporation (Trans Pacific), an insurer registered in the Cayman Islands. The injunctions prohibited Triton and Trans Pacific from taking or sending any money or property belonging to them out of Australia.
The court further ordered that two directors of Triton and Trans Pacific as well as insurance brokers Aradlay Insurance Brokers Pty Ltd (Aradlay), be restrained from taking or sending money or property belonging to Triton or Trans Pacific out of Australia. The court found that Triton and Trans Pacific were in contravention of the law for carrying on a financial services business without holding an Australian Financial Services licence (AFSL).

In addition to concerns about Triton and Trans Pacific conducting a financial services business without an AFSL, ASIC is concerned that Triton, Trans Pacific and Aradlay may have made, or published statements and/or disseminated information that is false, misleading or deceptive.

Aradlay gave undertakings to the Court that it would remove from the Aradlay website all references to Triton and Trans Pacific and all types of insurance products or financial services offered by them. The action is still underway.

Essentially therefore the issue to be addressed concerns the adequacy of the current prudential and regulatory regime and its extension to DOFIs – at its simplest the question is whether there is sufficient robustness in the current regime to ensure an adequate level of protection for Australian insureds who obtain insurance cover from DOFIs.

9. Carrying on Business Test

The Australian test which focuses on the carrying on of insurance business activities within the jurisdiction is different from the regulatory trigger which is used in many other jurisdictions. Many other regulatory regimes look at the location or situs of the risk insured rather than at the activities undertaken by the insurance provider – that is, the test looks at whether the relevant risk insured is either located in the jurisdiction (eg in the case of property covers); or whether the insured activity and/or claims are made in the jurisdiction (eg liability covers). If so, then the authorisation/licensing trigger is operated with the result that the insurance provider requires appropriate authorisation in the jurisdiction.

Insurance Act 1973

The trigger which requires insurers to obtain an authority under our Insurance Act 1973 looks at whether the insurer is carrying on insurance business in Australia. The concept of carrying on business has been the subject of much common law interpretation both in the general commercial context under corporations legislation and on an insurance specific basis.

However, what can be distilled from the cases is that in order to be carrying on a business in Australia the element of continuity must be present. That is, single instances of an insurer issuing general policies to Australian insureds will not necessarily in themselves trigger the requirement to become authorised under the Insurance Act. However, it has been held that a single transaction may present sufficient evidence of "carrying on business". Also, in England a similar prohibition in the Insurance Companies Act was contravened by the negotiation of a single prospective insurance contract without the "arranger" holding the appropriate authorisation.

Legal advisers are often consulted on the question of whether or not an offshore foreign insurer may be carrying on business in Australia. The traditional answer to this question is based on where the contractual steps are taken. On the assumption that the DOFI has no other connection with Australia if it accepts an offer from an Australian insured in an overseas jurisdiction, it is clearly not carrying on business in Australia. It is also probably not carrying on business in Australia.
where it merely makes an offer to an Australian insured, particularly where that offer is made by the entity from an overseas jurisdiction.

Where an Australian broker seeks quotes from offshore foreign insurers and places business with those offshore foreign insurers, in its capacity as agent for an Australian entity, the offshore foreign insurer is not carrying on business in Australia.

However, the matter becomes less clear where the offshore foreign insurer:

- sends representatives to Australia to seek out customers;
- appoints an agent in Australia to seek out customers; or
- appoints an agent in Australia, who is an underwriting agent with a binder under which the agent can accept and bind cover.

Where offshore insurers have executives who travel to Australia to discuss matters of common interest with the broking community and existing customers it is doubtful that this constitutes the carrying on of business in Australia.

However, in our view, where the offshore insurer appoints an underwriting agent who acts under a binder then there must be a strong argument that in those circumstances the offshore foreign insurer is in fact carrying on business in Australia.

However, APRA does not seem to have taken the view that offshore foreign insurers in these circumstances are carrying on business in Australia. They may take the view that it is difficult for them to assert and enforce Australian criminal law against those offshore insurers because they have no presence in the jurisdiction. However, the HIH Royal Commission pointed out that the underwriting agency located in Australia is likely to be knowingly involved in, and otherwise participating in a contravention of our law, and just as ASIC has taken proceedings against underwriting agencies for a failure to hold an Australian financial services licence it would appear that it is feasible for APRA to take proceedings against those same underwriting agencies in relation to breaches under the Insurance Act.

One other matter which the Royal Commission noted and which is important in this context is that insurance business is defined in a traditional common law fashion but includes "any business incidental to insurance business as so defined". The scope of these words is somewhat uncertain. Clearly, they are there for the purpose of ensuring that claims handling functions and the like which are incidental to the actual undertaking of liability are caught within the concept of insurance business. If this was not the case then companies in run-off may not be required to be authorised. But is it correct, as is suggested by the Royal Commission, that this could also capture underwriting agents who are doing those things such as accepting risk and the like which are incidental to the carrying on of insurance business, ie incidental to the actual undertaking of a liability on a balance sheet.

Although this view may be attractive, we think on balance the words probably do not have such an extension and that the real issue is the issue we have raised and that is whether or not enforcement action can be taken in relation to local activities of offshore foreign insurers where they operate through underwriting agencies under binders.

One obvious step that could be taken in this regard without a substantial change in the law would be to give some better guidance as to what activities are considered to be the carrying on of
insurance business for the purposes of the Insurance Act. For example, if a view is taken that underwriting agents operating under binders should result in the offshore foreign insurer carrying on business in Australia it would help if the Act particularly described those activities as being within the bounds of the legislation. This could clarify the policy intent.

**Life Insurance Act 1995 – A Comparison**

The position in Australia with regard to life insurance is somewhat different. The relevant trigger under the *Life Insurance Act 1995* is far more stringent than the test which currently applies to general insurers. The test under the Life Insurance Act requires that a company must be registered under that act to issue a life policy or undertake liability under a life policy. Consequently, and in contrast to the general Insurance Act, the issuing by an insurer of just one life policy to an Australian insured will trigger the requirement to be licensed under the Life Insurance Act.

**10. Overseas Tests**

The issue of regulation of overseas insurers is dealt with in a number of different ways in various other jurisdictions. For example the UK approach is essentially similar to that adopted in Australia in the sense that under the *Financial Services and Markets Act 2000* (*FSMA*), an insurance company must obtain an authorisation from the Financial Services Authority (*FSA*) (or be an appointed representative or exempted) to carry on an insurance business in the UK. Under FSMA, the activities of effecting and carrying out contracts of insurance are treated as being carried on in the UK on the basis of legal tests under which the location of the risk is only one factor. If the risk is located in the UK, then the activity will, in most cases, also be viewed as carried on in the UK. There are exceptions, however, and overseas insurers may insure risks in the UK without carrying on business in the UK and so without requiring to be regulated. However, the financial promotion regime may apply (under s21(1) of FSMA there are restrictions on communicating an invitation or inducement to engage in investment activity in the course of business by a person who is not authorised). A different regime operates for insurance companies that are authorised by another EU member; reflecting the EU goals of mutual recognition and harmonisation of insurance regulation between member states.

At the other end of the spectrum is a jurisdiction such as the Peoples Republic of China, where it is illegal to offer insurance unless licensed under Chinese legislation. In China, substantial capital, experience and other requirements must be satisfied in order to obtain a licence. The licence application process has a number of stages and takes some time. In addition, the regulator has been inconsistent in the granting of licenses to foreign insurers although there are recent signs that the attitude of the Chinese government, and the China Insurance Regulatory Commission (CIRC) is relaxing in that regard.

The Thai insurance market is also tightly regulated – foreign insurers are subject to both geographic and equity participation restrictions. Two classes of person are permitted to hold licences to engage in the provision of insurance: Thai companies incorporated for the purpose of engaging in the relevant insurance business; and foreign insurers (who may apply for a foreign branch office licence, although no new applications are being accepted at the moment). Holders of a foreign branch office licence are restricted to operating from a single location in Thailand.
Foreign insurers may also operate a joint venture partner in a Thai insurance company. Foreign investment in a Thai insurance company is limited to 25% of shares.

By way of contrast, in the Commonwealth jurisdiction of Canada, foreign companies can enter through a branch licensed in Canada as well as through a separately capitalised subsidiary. Foreign insurers with branches in Canada must vest assets in Canada and also meet requirements regarding a successful track record in the home country, proven expertise and an acceptable corporate name. Canadians are also permitted to purchase insurance from insurers not licensed in Canada. However, the extent to which these unlicensed insurers can solicit business in Canada from Canadians is limited and monitored by the regulatory authorities.

11. Options for Reform

We have identified a number of legal policy issues and our observations in respect of those issues are as follows:

(a) What does the existing prudential regulatory regime cover? Or, more generally, how is the consumer of insurance protected?

It is clear there are strong prudential and other regulatory regimes in place for a consumer purchasing an insurance product from an Australian authorised insurer. Under the FSR regime there will be reasonably strong non-prudential regulation for retail customers purchasing product from offshore suppliers.

The Federal Government has stopped the supply of discretionary insurance-like products to medical practitioners but there is no prudential regulation of other providers of discretionary mutual product or of offshore foreign insurers.

Some of the disclosure requirements applying generally to insurance sourced from DOFIs under the Insurance (Agents & Brokers) Act have been lost in the transition to the FSR regime.

(b) Has the existing prudential regulatory regime been fully enforced?

We would suggest that this is not the case and that in particular, the requirement for authorisation by an insurer carrying on insurance business does not seem to be fully enforced but, as we have noted, those provisions may need to be strengthened in order to clarify their intent.

(c) Do these concerns give rise to a need for further or more extensive prudential regulation?

In our view, care needs to be taken in balancing the interests of the Australian economy in being able to access the wider world insurance markets particularly in the business sector against the need to protect local consumers. We have indicated that we do not believe that the carrying on of business tests in the Insurance Act 1973 has been fully enforced or explored. We have suggested that some strengthening of this test may be necessary.

However, there is a more important question that needs to be asked and considered and that is why does the test for non-prudential regulation differ from that of prudential regulation? If the FSR require bodies who are providing insurance products and who are not prudentially regulated to be licensed or to operate through other licensed entities then
there must be a major issue as to why the prudential controls do not apply in a similar way. Who has got it correct, ASIC or APRA?

It appears to us that there must be a strong argument that the Insurance Act 1973 should be strengthened by providing that an entity carries on insurance business if it makes inducements in Australia to use its products. In other words, an equivalent provision to section 911D of the Corporations Act should be introduced. However that leaves aside a further issue and that is, what exemptions should then be granted to the requirement to have a prudential authorisation. These exemptions may differ from the exemptions provided under the Corporations Act because of the different issues that arise between prudential regulation and other regulation. The exemptions in turn may depend upon relevant disclosures being made particularly where the exemption was based upon a right to sell product through a licenced entity in Australia. Of course, the question of foreign insurers goes far beyond prudential regulation and extends to questions relating to enforcement. Other possible exemptions could be structured in terms of agreements to submit to the jurisdiction of Australian courts and the designation of a proper law of the contract.

Of course, this issue only addresses the question of persons actually providing insurance and does not address the question as to whether discretionary mutual fund products should be treated as insurance. The FSR may treat the mutual discretionary fund product as a financial product but the further question is should they then be treated as insurance? This leads to a question as to whether or not all discretionary mutual fund products should be treated as insurance. It appears to us that that may be an extremely difficult task and could have unfortunate unintended consequences. At the very least, where these products are providing liability protection particularly in relation to personal injury and death, it seems to us there is a strong argument that they should not be permitted. This is the same argument which has lead the Government to prohibit the provision of these types of products to medical practitioners. There is no reason in principle why this approach should only be taken in respect of liability products purchased by the medical profession.

However, in determining the ultimate scope of prudential regulation, care will need to be taken to ensure that product remains available to the Australian community and that the local insurance market or the newly regulated foreign insurance market will continue to provide the product required for our economy. In the initial stages the Government may need to be prepared to provide some support to ensure that product is made available. This is not necessarily monetary support but rather ensuring the legal environment is such that insurers believe that they can price the product and that the price will be relatively affordable. It is for this reason that the completion of the task of tort reform is so important.

Are other types of regulation required to ensure that purchasers fully understand the decision they make when choosing between the different types of product or sources of product.

The FSR is relatively new and its effect has not been fully tested. However, there are some gaps in that regulation particularly in respect of the adequate disclosure of insurance products or insurance-like products that are sourced from offshore. Critical issues for Australian purchasers are whether or not:
• the proper law of the contract is Australian law;
• whether the underwriter will submit to the jurisdiction of Australian courts; and
• whether there are adequate treaty arrangements between Australia and the jurisdiction in which the underwriter operates so as to allow the easy enforcement for judgments.

It is also important to understand the prudential controls and regulations that may apply to the product issuer.

(e) What options does the Government have in respect of dealing with the issues raised?

**DOFI Options**

Possible options for DOFIs are:

• Strengthening the application of the current carrying on insurance business test? – the present regime provided for in the Insurance Act may be adequate in its current form but may require to be enforced and monitored more aggressively and vigorously than has been the case to date. In particular, as noted above, we believe close consideration should be given to introducing a provision along the lines of section 911D of the Corporations Act into the Insurance Act 1973 and then providing for appropriate exemptions to be granted. This could be by reference to the type of business undertaken, the type of customer, the way in which the business is conducted in Australia and what other agreements the insurer has agreed to be bound by.

• A Life Insurance Act model? – as noted previously the existing licensing trigger in the Life Act is stricter than the carrying on business test and if adopted in the context of general insurance would require authorisation to be sought for any DOFI issuing general insurance policies to Australian insured.

• A Lloyd's-type authorisation approach? – the concern which has been expressed in relation to DOFIs is essentially a concern over the financial soundness of DOFIs and their ability to pay claims and the ability of Australian policy holders to enforce their rights in a convenient way. That objective may be achieved for example, by requiring foreign insurers who issue policies to Australian insured or in respect of Australian property to lodge appropriate funds in Australia sufficient to meet claims. Some form of appropriate trust arrangement could be entered into with facilities to ensure that in the event of default by the insurer the Australian insureds could enforce the rights against the assets in Australia. The arrangements might be modelled on the Lloyd's trust arrangements contained in the Insurance Act.

• Applying the choice of law provisions in the Insurance Contracts Act to the carrying on business test? – this would provide that for Insurance Act authorisation and prudential regulatory purposes, contracts subject to Australian law under the ICA would constitute the carrying on of insurance business in Australia.

• The FSR licence exemption approach? – as discussed previously the FSR regime includes relief from the licensing requirements in a number of ways which may be applicable to, and suitable for use in the case of DOFIs. This approach could for example align the authorisation, and exemption regime in the Insurance Act with the
approach adopted under FSR. Firstly, the mutual recognition of overseas regulatory agencies approach may be suitable in cases where APRA is satisfied that the DOFI is subject to a comparably robust regulatory regime in its home state. Alternatively an Insurance Act exemption may be available where the DOFI arranges its contracts with Australian insureds via the agency of a regulated Australian insurance intermediary. As an extension to this approach funds may be required to be lodged in Australia for and on behalf of the DOFI by the local agent so that assets are available in Australia to meet any default by the DOFI. A similar model, as we understand it, is currently adopted in New Zealand.

- Policyholder Protection Fund for DOFIs - A further possible option might involve the establishment of a policyholder protection fund for insureds insured by DOFIs. There are some obvious practical difficulties in this proposal including for example, how the fund would be levied and collected and the basis of distribution in the event of default by DOFIs of their policy obligations. A possible fund collection mechanism could include the levying of a charge on Australian policy holders who choose to insure with DOFIs. The collection mechanism might, for example, operate in the same way that the present withholding tax regime for overseas insurers operates which requires the insured to account as agent for the DOFI of the DOFI's tax liability.

Of the possible options it is our view that the model ultimately adopted should seek to achieve the following:

- Ensuring that prospective policy holders are advised as to the risks of obtaining cover with DOFIs – this might, for example, be achieved by adopting and extending the disclosure requirements regarding overseas insurers previously contained in the repealed insurance agents and brokers regime.

- Ensuring, insofar as possible, that Australian policy holders (or appropriate classes of Australian policy holders) are able to enforce their rights under policies issued by DOFIs, ideally in Australia, against assets located in Australia, otherwise in a convenient and accessible forum which is at least as insured-friendly as the Australian legal environment.

- Ensuring that the model adopted does not significantly adversely reduce overseas insurers' willingness to participate in the Australian insurance market.

- Ensuring that the model adopted does not adversely discriminate against the Australian insurance industry.

12. The Treasury Discussion Paper

The December 2005 Treasury discussion paper sought submissions to be lodged by 24 February 2006. It identified 59 questions on which comment was particularly sought. A number of submissions were made and have been made public. A summary of the publicly available submissions is attached at Appendix 1. The questions are preceded by background material and indications of the current thinking of Treasury, some of which has advanced beyond the recommendations in the Potts report.
Proposals relating to DOFIs

The paper seeks by way of question to invite further consideration of the policy position that was accepted by the Government following the Potts report. One of the more controversial aspects of the Potts report was the statement that DOFIs comprised only 2.5 per cent of the Australian insurance market overall while acknowledging that they provide significant capacity in specialised lines. We understand there has been a great deal of conjecture as to the source of this view and doubt as to whether the role of DOFIs was not significantly larger. This of course will depend on how a DOFI is defined and, because of this, the debate can quickly become circular. The fact that any grant of relief to DOFIs as now proposed is associated with a condition to provide information regarding the levels of activity in Australia reinforces the fact that there is probably little information on the levels of activity either overall or in particular spheres of insurance business. However, as noted earlier, APRA’s current best estimate is that between 5 – 10% of commercial premiums go offshore.

The issues identified in the discussion paper insofar as it relates to DOFIs include the following:

- defining marketing insurance in Australia;
- eligibility for and assessment of the exemption for comparable regimes;
- data to be collected from DOFIs;
- other possible exemptions for DOFIs;
- determining and implementing the market significance test;
- transitional issues;
- appropriate enforcement powers for APRA; and
- the need for additional consumer protection measures.

Marketing Insurance

The proposal – that marketing insurance be taken to be carrying on insurance business – reflects the existing test found in the financial services licensing provisions of the Corporations Act 2001 (Cth) and would extend the meaning to include:

where a person engages in conduct that is intended to induce people in this jurisdiction to obtain insurance cover from that person or is likely to have that effect, whether or not the conduct is intended, or likely, to have that effect in other places as well.

However, the discussion paper states that it is not intended to capture persons in Australia purchasing insurance directly from foreign insurers over the Internet where those insurers do not seek to market their products in Australia directly or through agents or brokers. In other words, the marketing activity seems to require some physical presence in Australia rather than being activity conducted through the Internet. For example, the emailing of an offer of insurance to Australian motor vehicle owners would be considered marketing insurance in Australia.

It is proposed that the definition of insurance business be broadened to capture entities or individuals engaged by domestic insurers and DOFIs to do a range of things including:

- undertake risk assessments and to decide, on behalf of the insurer, whether to accept the risks;
• enter into contracts of insurance on behalf of the insurer;
• claims management;
• making payments to insureds; and
• holding records relating to the insurer's insurance activities in Australia.

Firstly, the comments in relation to marketing of insurance imply a clear broadening of the scope and application of the Act. Secondly, the replacement of the current ambiguous test of carrying on of insurance business by another equally, if not vaguer test of marketing insurance is not to be commended unless there are very clear parameters placed around what activities constitute the marketing of insurance.

Further, the proposed expansion of the definition of insurance business contemplates the capture of a wide range of activities which cannot on any sensible interpretation be worthy of prudential regulation. The activities would for example capture a wide range of third party service providers such as claims managers, law firms, loss adjusters, data warehousing service providers, and banks on the basis that they may be used as conduits for which payments are made to insureds.

The proposals in relation to the new definition of insurance business have met with almost universal criticism in the submissions made in response to the discussion paper.

**Exemption for comparable regimes**

The review recommendations require that any DOFI carrying on insurance business in Australia without APRA authorisation obtain an exemption from APRA, which would only be granted where the DOFI:

• writes authorised insurance business in a comparable jurisdiction;
• allows APRA to collect relevant data about the DOFI; and
• reports to APRA on changes relevant to its exemption.

In order to assess whether a DOFI's home prudential regime is comparable to Australia's, it is proposed that APRA would compare the broad objectives of each regime, rather than consider whether each imposed precisely the same requirements. The paper suggests that APRA will review each application for exemption to ensure that the applicant is operating under appropriate governance standards, maintains adequate risk-based minimum capital and solvency standards, makes appropriate use of reinsurance and can meet any additional criteria imposed by APRA. Significantly, the paper contemplates that each and every DOFI would need to submit an application for approval to APRA – that is, there will be no automatic passporting of DOFIs on the basis that they operate out of a comparable regulatory regime.

Importantly the paper does not suggest that a DOFI which is exempt is required to maintain assets in Australia in order to protect policy holders in the event of non-payment or insolvency.

The proposed extension of the Act would apply equally to insurers and reinsurers, although captive insurers may be exempt if they do not provide insurance to parties outside the corporate group and do not issue statutory classes of insurance. In order to obtain an exemption the DOFI would also need to agree to comply with APRA's data collection powers under Australian legislation and to report to APRA any change to its circumstances relevant to its exemption. The conditions are intended to facilitate the collection of information about DOFIs operating in Australia and to ensure
that it is the DOFIs responsibility to inform APRA of any change in circumstances that may affect its eligibility for the exemption. APRA would be given power to vary or revoke an exemption to reflect conditions placed on the insurer in their home jurisdiction, including where it is suspended or placed into run-off.

In determining the comparability of the relevant overseas regulatory regime it is proposed that APRA would consider the appropriateness and sufficiency of the following:

• conditions for effective supervision such as policy, institutional and legal framework for supervision, a well developed effective financial market infrastructure and efficient financial markets;
• operational structure and administrative powers of the regulator;
• monitoring and supervisory activities of the regulator including that they be ongoing, and involve minimum on-site reviews, information analysis and risk assessments; and
• sanctions and powers available to the regulator to enforce corrective action and behaviour.

The insurer would also be required to:

• be licensed and actually writing business in the relevant jurisdiction;
• be subject to group wide supervision in situations where the insurer is part of a corporate group;
• operating under appropriate governance standards;
• subject to risk based minimum capital adequacy and solvency standards and be meeting those standards;
• be able to meet claims when and if they arise; and
• be making appropriate use of reinsurance.

The review recommended a market significance test be adopted so that if an exempted DOFI becomes a significant player in the Australian market, it would be required to establish a branch or subsidiary in Australia and become formally authorised under the Act. The task of developing an appropriate mechanism for this test will be difficult because of the lack of data on DOFI business in Australia and also a need to introduce flexibility into the model. That is, an unexpected volume of business may cause an exempted DOFI to exceed the market significance threshold and be required to obtain an authorisation. Alternatively, a significant fall in business may provide an opportunity for an authorised insurer to seek to alter its status and become an exempted DOFI because it now falls below the threshold.

Once the review recommendations are implemented, new entrants into the Australian market will be required to comply immediately. A transition period of two years is proposed for unauthorised DOFIs who are currently marketing insurance in Australia. For authorised foreign insurers who may wish to revoke their authorisation and seek exemption as a DOFI, the situation is made more complex because the Act only allows the revocation of an authorisation where the insurer has no liabilities in Australia. As a consequence, an authorised insurer may be able to write new business through an exempted DOFI, but may need to place the business already written into run-off and either run that business off itself or transfer the portfolio to some other authorised insurer in Australia.
The discussion paper queries whether APRA will have sufficient powers to enforce regulatory requirements on DOFIs, but does not attempt to answer the question. APRA currently has arrangements with some foreign regulators for information sharing. APRA might need to obtain a more comprehensive agreement with those foreign regulators on enforcement issues before declaring that their respective regimes are comparable.

To enhance consumer protection, it is proposed that persons marketing insurance on behalf of DOFIs in Australia be required to disclose certain information to consumers, which would reflect – but expand upon – the existing retail client disclosure requirements of the Corporations Act.

### 13. Submissions

As could be expected, there were a wide range of submissions made by different interest groups. These ranged from overseas insurers, domestic Australian insurers, the Australian general insurance peak industry body the Insurance Council of Australia; the Australian Broking Association body NIBA, a range of underwriting agencies and underwriting agency industry bodies, private individuals, government bodies and other professional industry associations including law societies.

While most were generally supportive of the proposals to clarify the position regarding the regulation of DOFIs, not all submissions were universally supportive of the proposals. Many were critical of the lack of prescription in the proposals, fearing that they would lead to continued, if not greater, uncertainty as to outcomes in the future.

Most of the submissions agreed that the capacity DOFIs provide, particularly in niche and hard to place classes of business are critical to the Australian market. It seems to be accepted that the continued availability of DOFI capacity in these areas is necessary to enable Australian businesses and consumers to access specialist and complex lines which would not otherwise be available in the Australian market.

However there were significant concerns expressed by local insurers as to competitive neutrality – that is, that DOFIs should not be allowed to operate in Australia from regimes where the cost of business and capital and solvency requirements were lower than those which apply in Australia, thereby giving those insurers the ability to undercut Australian insurers on rates. Indeed the main object of the Insurance Act is expressed to be to protect the interests of policy holders and prospective policy holders under insurance policies (issued by general insurers and Lloyds Underwriters) in ways that are consistent with the continued development of a viable, competitive and innovative insurance industry. Submissions from local insurers and from the ICA have voiced concerns about the impact on competitive neutrality and the achievement of the main object of the Insurance Act in allowing DOFIs from poorly regulated and capitalised regulatory regimes to enter the Australian insurance market. No doubt that debate will continue.

Concerns were also expressed in relation to consumer protection. Australia's prudential and consumer protection regime is extremely robust – in some respects it is world's best practice. Following the HIH collapse there are concerns that Australian businesses and consumers might be exposed to insurers who have no ability or inclination to pay claims when they fall due.
In that regard a number of submissions made reference to the need to distinguish between high risk and well regulated DOFIs – this means essentially differentiating those from robust regulatory environments from DOFIs operating out of loosely regulated jurisdictions.

Some of the main concerns / suggestions submitted were:

- There should be **no competitive disadvantage** for DOFIs as compared to Australian insurers.
- Regulation should take into consideration the **type of client** likely to obtain a certain insurance (retail or wholesale distinction).
- APRA should put more emphasis on **international credit ratings** than trying to set up and administer a set of onerous criteria which are costly to enforce. (Dexta, Dominion, MIPS, WPI, Marsh (for non comparable regimes))
- **Levels of disclosure** to retail or wholesale clients should not necessarily vary. (Dominion, NIBA, QBE, UAC)
- **Disclosure requirements** of Corporations Act could be extended by the requirements of the repealed *Insurance (Agents and Brokers) Act*. (Marsh)
- A number of **amendments to the definition of "marketing insurance in Australia"** have been suggested. (Dexta, Dominion, NIBA, NZCIA, UAC)
  - Instead of "marketing insurance", the test should be the **existence of an insured risk in Australia**. (NZCIA)
  - Many submissions point out that the **proposed definition is too broad and would capture an number of persons working with foreign insurers and their insurance related activities**, which are mostly post contractual. (Dominion, Marsh, NIBA, UAC)
- Proposals would **capture all DOFIs which cover Australian risks**, even though the insurance is not arranged in Australia. (NIBA)
- NIBA suggest, an **offence** should be created for "marketing, arranging and issuing insurance in Australia as or for a DOFI other than from a comparable jurisdiction", not including other functions like claims handling, or activities of brokers when acting on behalf of a client in post sales activities.
- A wide range of submissions suggest that **APRA should prescribe countries with comparable regimes**. (Dexta, Dominion, Marsh, NIBA, UAC)
- Dominion see a **potential problem** in not acknowledging a comparable jurisdiction for countries with whom Australia has **free trade agreements, closer economic relations agreements and other international agreements**.
- QBE suggest, when examining a company for exemption due to a comparable regime, APRA should also look at the fitness and propriety of its directors and to "environmental factors" like the stability of government and economy in the comparable jurisdiction.
- The acceptance of comparable regimes should be **negotiated on a mutual basis**, granting similar access for Australian authorised insurers to the foreign regimes. (NZCIA)
- Exempt DOFIs should be **subject to regulation by ASIC, Australian Financial Services licensing requirements and the general insurance Code of Practice**.
• NIBA suggest, for a DOFI once exempted as being from a comparable jurisdiction, to be required to appoint a **single local agent** who would certify certain requirements to APRA. – Only sanction required by APRA should be to delist a DOFI which does not meet undertakings or the undertakings of its agent. There is a similar suggestion from WPI.

• There could be an **unfair burden placed on the first DOFI** from a particular jurisdiction to establish that this jurisdiction is comparable, further applicants could get a "free ride".

• If APRA was to individually assess each DOFI from a comparable regime, there is a potential for different conclusions. (UAC)

• It should still be possible for DOFIs from other than comparable regulatory regimes to apply for exemption, prescribing eg. minimum credit ratings from internationally accepted credit rating agencies, minimum capitalisation requirements. (Marsh, UAC)

• NZCIA suggest, that DOFIs operating in comparable jurisdictions should be able to fulfil the requirements to become an authorised insurer in Australia, otherwise consumer protection should prevail.

• NZCIA suggest, it might be preferable to exempt certain (desirable) lines of business instead of the whole business of DOFIs.

• QBE suggest, that APRA should have access to all material correspondence between the home regulator and the DOFI and annual audited and statutory accounts.

• **No distinction** in criteria for offshore and domestic captives. (Marsh, NIBA, NZCIA)

• There is a lot of criticism of the **proposed criteria for exemption of captives in para 73** of the Discussion Paper (which had been previously suggested by APRA), extensions of the criteria are particularly required with respect to the requirements of providing insurance only to other wholly owned companies within the group; not to insure third parties; and not to write statutory classes. (Marsh, NIBA, NZCIA)

• **Incentives for local insurers to move offshore** would be limited, as commercial clients use DOFIs limited to situations where the disadvantages of dealing with foreign insurers are outweighed by cost savings or the inability to source comparable cover in Australia, but otherwise prefer to deal with Australian insurers. (Marsh, WPI)

• **Differential tax treatment or enforcement** is more likely to drive insurers offshore than prudential regulation (Dominion) and might provide DOFI's with a competitive advantage for DOFIs to local insurers (NZCIA, QBE).

• The **Market Significance Test** is mostly seen as too problematic and inflexible (eg to address fluctuating policies (Dexta), possible problems with different definition of different business (Dominion), Marsh, MIPS, level of risk in Australian market should be considered (QBE), what happens if limit is reached? (UAC), who track the threshold (UAC), would only deal with perceived problems (WPI).

APRA lodged a submission with Treasury after the deadline for submissions had passed. APRA’s position is very clear – it should have no direct involvement in the regulation of DMFs and DOFIs. APRA has expressed itself to be uncomfortable in performing an assessment role as regards the comparability of overseas prudential regimes. In particular:
• APRA believes that involving it in the regulation of DMFs and DOFIs may expose APRA and the government to moral hazard – that is, APRA and the government would be accountable if APRA is perceived to undertake a role in the regulation of those entities regardless of the level of supervision actually provided.

• The proposed assessment functions will be very resource intensive. APRA says it will require additional, significant funding to undertake this role.

• APRA believes that the assessment function could have considerable international implications – that is, APRA's refusal to certify overseas jurisdictions as comparable regimes might well create wider inter governmental/diplomatic problems.

• APRA makes the point that it is possible for a bad insurance company to base itself in an otherwise sound regime, particularly where the company does little business in its home jurisdiction.

• APRA believes that such a process is likely to result in considerable dislocation of industry practices. By way of example APRA notes that information suggests that somewhere between 10-15% of catastrophe reinsurance placements by authorised Australian insurers are with Bermuda based reinsurers. On past evidence, APRA notes, Bermuda would have been a highly unlikely comparable prudential regime.

APRA notes that the stated objectives for the proposed regulation of DMFs and DOFIs which are to provide effective but fair completion in the Australian insurance market while providing protection for consumers of insurance products can conflict. On balance, and in summary APRA considers that the desired policy objectives would be best met by a market based solution to deal with an alternative exemption mechanism. This alternative would involve requiring each DOFI to be rated by at least one of the four global ratings agencies at least at the investment grade (typically S&P BBB or better) level for claims paying ability. APRA's view is that a ratings based approach removes the requirement for APRA to perform subjective and resource intensive assessments and deals with the wider moral hazard concerns that it has.

14. Conclusion

Unfortunately, Treasury has not indicated what the next steps are and what the timetable for the preparation and release of draft legislation will be.

Although the government has publicly committed to introducing legislation to implement the recommendations made by the Potts Committee, it may well be some time in the making.

Our sense is that London market entities regulated by the FSA are more likely than not to ultimately be considered to reside within a comparable regulatory regime, and be given the benefit of an exemption from the need to become authorised under the Insurance Act. However, as things presently stand, to obtain that exemption it will be necessary for each individual entity to make a specific application for exemption to APRA, and agree to abide by the information and data collection proposals which are set out in the Treasury discussion paper.

There may well be some change to the exemption application process – for example with APRA being persuaded to automatically exempt all insurers regulated by the FSA. That however is unlikely to happen without intervention from the FSA, or at a governmental level.
However, the concerns expressed by APRA as to its role in the exemption assessment and determination process may cause the government to rethink the approach. There is some benefit to a ratings based approach in terms of certainty of outcomes and removing APRA and the Australian government from the moral hazard arguments identified by APRA. However, our sense is that an exemption process based solely on ratings is a somewhat blunt measurement instrument. It also gives rise to some potentially unintended outcomes (in this regard note the example given by APRA of Bermuda domiciled entities which, although they may be appropriately rated by the ratings agencies nevertheless in APRA’s view are based in what has historically been an unacceptably comparable local regulatory environment). Also, it is not the case that a claims paying ability rating is a direct proxy for the risk based capital and solvency requirements which apply under the Insurance Act. Further, it would not address the difficult jurisdictional and other consumer protection measures which have been touched upon elsewhere in this paper.

Ultimately, we think that the two critical drivers which will determine the approach to be adopted are effective and fair competition in the Australian market and ensuring that Australian consumers are appropriately protected. On the latter issue we believe that the focus will be very much on retail (ie personal lines) business. We think that there is a strong possibility that commercial lines business will be able to be underwritten by DOFIs provided that they are based in a comparable regulatory regime or meet an appropriate rating agency rating level.

As for retail business, if DOFIs are to be exempted then we believe that in addition to meeting the exemption criteria, whatever they may be, there may well be increased disclosure required – for example this might involve a widening of the information required to be given to those customers in relation to DOFIs, and to the inherent risks of doing business with DOFIs. Those outcomes may be able to be achieved by imposing disclosure obligations on Australian intermediaries (whether brokers or agents) and this could for example be done by way of amendments to the FSR regime and/or imposing conditions on the AFSL licences of such brokers and agents.

If our predictions are correct then the legislative changes will facilitate the entry of London market companies into the Australian insurance market. Importantly, it will in our view serve to legitimise the status of DOFIs and may well serve to overcome some of the concerns and scepticism which has been demonstrated by Australian brokers and consumers as to the levels of security offered by DOFIs.

What it may effectively mean for your businesses is a passport to access the Australian insurance market and to legitimately and openly market your products to Australian businesses and consumers.

In the meantime it is important that London market entities are aware of the current prohibition on the carrying on of insurance business in Australia and structure any Australian product distribution arrangements which they have so as not to fall foul of that prohibition.
Appendix 1

Summary of Submissions to Treasury Discussion Paper regarding DMF’s and DOFIs

1. **Ansell**
   - Addressing issues concerning captives only.
   - Considerations for exemption need to take into account that the use of a captive might be a more secure alternative to high self insured retentions [p2-3].
   - If providing insurance (or reinsurance) to an APRA regulated institution, it should be matter for this institution to ensure it is satisfied with financial security of captive; it is not unusual for reinsured to request the captive provide either a parental guarantee or LOC to protect them [p3]
   - Q17 no reason why not.
   - Q18
     - If captive is only providing cover which would otherwise be assumed by the parent or related business, this should warrant exemption, particularly if company is financially secure.
     - Exemptions for offshore captives in line with other insurers from same domicile under comparable regime test.
     - Additional point - captives in run-off: there should be a point at which outstanding liabilities are such that they might be secured by parental guarantee or LOC; captive should then be exempt from additional forms of prudential control (in APRA submissions they suggest $5 million as the line)
   - Attaching their submissions to APRA re captives and exemption from prudential regulation

2. **Dexta Corporation**
   - Qs 1,2 and 3:
     - Dexta, like most entities which provided submissions, distinguishes between three different types of DOFIs. These are:
       1. Reputable DOFIs, which tend to operate in specialist markets and are well known to the major insurance broking and underwriting intermediaries which often underwrite special classes that are typically more complex risks; and usually have a strong international reputation backed by technical capabilities and financial strength;
       2. Captive insurer DOFIs which are risk retention and pooling vehicles established by typically large international companies and in some cases large organisations,
which will provide insurance to companies within the corporate group and reinsure the risk that the group does not want to retain;

3. DOFIs which often enter the Australian market to take advantage of a short term specific need and/or opportunity, such as the withdrawal of an Australian insurer from a specific type of liability.

- Distinctions between these three classes of DOFIs should be reflected in regulations and not place the first category of DOFIs at a competitive disadvantage to that of Australian insurers.
- Conditions attached to DOFIs should also take into consideration the nature of the client in which they deal, as wholesale clients are by their definition sophisticated and must be presumed to be commercially understood and to have the benefit of their own legal advice and also the benefit of advice from insurance brokers.
- The wholesale market often requires insurance in specialised fields, the participation of DOFIs should be encouraged to sure up competitive pressure and to ensure wholesale consumers having continuing access to the global insurance market.
- If a DOFI has a strong international credit rating, the risk of that DOFI not having financial organisational resources available to meet its obligations to Australian clients does not exist.

- Qs 4 to 9 - "Carrying on Insurance Business"
- Business should be described as being carried on by one of the following three mechanisms:
  1. An underwriting agency that writes insurance on behalf of an authorised insurer (either from APRA or a regulator in a comparable regime);
  2. An insurer is authorised to write insurance in Australia through APRA; and
  3. An insurer that is authorised to write insurance in Australia through APRA, recognising that insurer is regulated by a comparable jurisdiction and does not require a potential regulation in Australia.
- More appropriate functions which should be caught in the definition are:
  1. risk assessment; and
  2. determination as to whether such risk should be accepted; and
  3. the entry into contracts of insurance.
- These would not capture offering of insurance to clients residing in Australia through such mechanisms as the internet or telephone, however the proposal in the discussion paper would also not address these concerns.
- Real issue with foreign based entities offering insurance to Australians by internet and telephone is the difficulty in enforcing regulatory standards on such entities.

- Qs 10 to 13 - Comparable Regime
• A number of jurisdictions considered as having comparable regimes, such as the UK and Ireland, should be legislated as having met APRA’s requirements without the need for DOFIs regulated in that regime to actually provide those details to APRA.

• Legislation should specify what features of the Australian legislation need to be included in another regime’s regulatory regime for that regime to be considered comparable; concerns should be prudential only.

• Qs 25 to 29 - Market Significance Tests
  • Problems are identified as: the administrative costs for both APRA and DOFI in determining whether the DOFI continues to satisfy that test; and how to ensure that such test has the flexibility to address fluctuating policy volumes.

• Q37 – Consumer Protection
  • Noting that DOFIs generally operate through underwriting agencies that are licensed in Australia by ASIC and are therefore regulated both by the Insurance Contracts Act and the Corporations Act.

3. Dominion Underwriting Agents

• Expressing view that about one third of the total DOFI market represents captives [p3].

• Q3
  • Dominion believe, specialist lines will become unavailable at a reasonable cost and without economically viable insurance a large number of small to medium size enterprise clients will be out of business.

• Q4
  • Proposed definition could for example extent to claims managers, banks or other financial institutions as they "make payments to insurers" or to storage warehouses where they "hold records relating to an insurer's insurance activities in Australia", a solicitors where they "act on behalf of the foreign insurer in dealings between the insurer and registered insurance intermediaries in Australia".

• Q7
  • Questions, whether a distinction between active marketing and passive marketing can be successfully or logically be drawn (referring to accessing insurance by an Australian over the internet is okay if no previous calls or emails to promote the product occurred but exclusion of a sale of that product promoted in Australia).

• Issue of consumer protection for retail insurance products is dealt with in a way that will preclude DOFIs from dealing with the more commercially savvy or professionally advised business markets.

• Q9
  • Issue could be adequately addressed through an externally prepared ratings report, rating the insurer and adequate disclosure to the professional markets and their business based
clients (under Q2, a turnover measure against which the level of capitalisation can be measured was also suggested).

- **Q10**
  - It is more appropriate to concentrate on the comparable regulatory regime and focus on the structure of the regime rather than the company itself; if there is independent external rating then the jurisdictions may not be as relevant.

- **Q14**
  - The proposed exemption mechanism unfairly places a financial burden on the first applicant to seek to have APRA approve jurisdiction and any other applicant gets a "free ride".
  - APRA's potential refusal to recognise a jurisdiction may have implications for free trade agreements, closer economic relations agreements and other international agreements.

- **Q15**
  - In addition there should be a recognition of the type of insurance being promoted, ie. whether it is to retail or professional markets or whether it is direct or through professional licensed brokers and advisers.

- **Q21**
  - This would require the amendment of the definition of insurance business by "offering reinsurance to insurers" and the definition of marketing insurance would need to be extend to "marketing reinsurance": this would lead to a withdrawal offering insurance facilities from the Australian market with its significant implications for all insurers.

- **Q23**
  - The decision for insurers to move offshore is more likely to be driven by differential tax regimes rather than regulatory regimes; tax regimes would need to be significantly different to pursue such a change.

- **Q26 – Market Significance**
  - Suggesting an overall test based on total premium; once the premium limit is reached in any one financial year, a company should have a period of time to apply for a licence to become regulated or go into run-off.
  - A test that requires a measure of the size of a particular market can suffer from definitional issues, as different companies might have different classifications for business.

4. **Kim Mettam**

- Submissions with respect to DMFs only.

5. **Law Society of SA**

- Qs 5 and 6
• The proposed extension of the definition of insurance business does not change the character of insurance business, rather it seeks to expand the range of activities to be regulated and can capture activities outside the scope of regulation.

6. Marsh

• Marsh expressly support NIBA's submissions in many respects.

• Q2
  • Many of the recommendations will have an unfocussed and unnecessarily wide impact on the ability of Australians to access DOFIs which are not of concern; consumer protection aims may be appropriate with respect to retail clients but will not be appropriate for wholesale clients who are able to assess for themselves the appropriateness of use of DOFIs.

• Q3
  • The implementation of the recommendations would raise real barriers to access to overseas markets for commercial buyers of insurance who have demonstrated a need for such access in order to obtain affordable insurance of large and difficult to place risks.

• Q4
  • DOFIs from countries with adequate regulatory regimes should not be captured; further it is suggested to limit the proposed controls to DOFIs which seek to market insurance in Australia to retail clients.
  • There is no useful purpose for capturing insurance related activities such as claims management, loss assessment and the like. These are post contractual activities and such regulation could operate as a disincentive for insurers to provide claim support for their insureds.

• Q6
  • The current proposal could capture accountants, actuaries, banks, lawyers and loss assessors, for example, that carry services ancillary to the insurance contract between the insured and insurer.

• Q10
  • Supporting NIBA's recommendations, in order to achieve simplicity and efficiency, APRA should nominate comparable regulatory regimes.
  • A further alternative criteria should be acceptable where a DOFI is not operating from a specifically identified comparable jurisdiction; DOFIs with a minimum investment grade credit rating from an internationally accepted credit rating agency combined with a minimum capitalisation requirement should also be exempted. (This is an objective criteria that will separate low risk and high risk DOFIs).

• Q14
• The cumbersome nature of the proposed mechanism and accompanying increased regulatory costs in obtaining an exemption would actively deter participation by DOFIs in the Australian market.

• Q16

• The type of data collected should be limited to classes of insurance, premium, claims paid and country of origin of DOFI.

• Q17

• Offshore captives like other DOFIs, are not subject to the provisions of the Insurance Act because they are not considered to be carrying insurance business in Australia, and in stark contrast to other DOFIs: they do not market insurance.

• Captives are primarily established by large and sophisticated insurance buyers as a means to reduce or stabilise their insurance costs, access reinsurance capacity and provide flexibility in terms of how they choose to finance their risk; their principle aim is to reduce the parent company's reliance on the external insurance market as it cannot always meet the specific needs of large and sophisticated buyers.

• Captives do not seek to underwrite third party business, they are mainly confined to insuring their parent company's risks; they may extend to include related parties such as joint ventures or other associated parties which is usually because the parent has a contractual obligation, can offer risk management expertise or provide a cost benefit to the related entity or persons.

• Proposed criterias for exemption are so restrictive as to be obsolete.

• Q18

• Proposing some modifications to the criteria for exemption of captives originally explored by APRA (para 73 of the Discussion Paper):

• Providing insurance only to other companies which are wholly owned within the corporate group:

Criteria should be expanded to allow the exempted captive to write business for related parties in line with the definition of a body corporate under section 50 of the Corporations Act, because otherwise related entities which are not wholly owned would be disadvantaged as they would be required to purchase insurance from third parties and would lose the benefit of being part of a larger buying group for such insurances.

• No third parties are insured:

Arranging of multiple party insurance policies could prove difficult. A limited exemption from this criteria was proposed: an eligible captive may issue insurance which includes as named insured or third party beneficiaries

(a) entities which are not wholly owned by the parent company; and

(b) such financiers, contractors, subcontractors, joint venture entities;

only where such intending insured parties have been given notice that their interest will be insured under a captive policy and have provided their permission in writing in advance.
Without this extension, this criteria would greatly reduce the classes of risk that could be written, even though such risk is related to the organisation as a whole.

- A further criteria explored by APRA was mentioned: Not to provide reinsurance to any other party:
  
  This is seen as particularly detrimental to captives who have arrangements with fronting insurers to enable them to provide insurance to business units in countries where direct writing of insurance by a captive is prohibited.

- Q19
  
  Proposing, criteria should not vary between domestic and offshore captives provided that Treasury would adopt an approach similar to that outlined in response to question 18, otherwise offshore captives should be exempt for reasons outlined in relation to question 17.

- Q20
  
  There is no reason why foreign reinsurers should be caught; retail purchasers of insurance do not purchase insurance from reinsurers whether or not they are domiciled in Australia or offshore.

- Q21
  
  This would restrict access to the reinsurance market which would reduce the supply of insurance in Australia and increase cost whether retail or wholesale.

- Q22
  
  This would not be consistent with international practice.

- Q23
  
  Incentives for established insurers to move offshore would be limited as commercial clients use DOFIs primarily limited to situations where the disadvantages of dealing with a foreign insurer are outweighed by cost savings or inability to source comparable cover within Australia.

- Q25 – Market Significance Test
  
  Most appropriately determined by premiums written.

- Q29
  
  Complexity of designing and managing the market significant test, both for APRA and the insurer would outweigh any benefits it may have for Australian policy holders as DOFIs that could build a reasonable market share are not high risk DOFIs in unacceptable jurisdictions.

- Q36
  
  Considering the current requirements under the Corporations Act as relevant but not adequate for retail clients; suggesting that the provisions of the now repealed Insurance (Agents and Brokers) Act identified some of the more relevant risks of insuring with a DOFI.
7. Medical Indemnity Protection Society

- Q6
  - It is not clear whether the effect of such changes would capture a number of current non-broker intermediaries such as sporting associations and clubs. Many intermediaries may be involved in providing opinions that are used to "underwrite" a risk, such intermediaries include doctors, engineers, architects, loss adjusters, etc.

- Q25 – Market Significant Test
  - Enforcement of such concept would be too problematic.

Also raising the issue that it would be costly, inefficient and difficult for APRA to attempt to regulate DOFIs in the same manner as Australian domiciled financial institutions and that a comparison by APRA of the methodology and effectiveness of regulators in various overseas jurisdictions combined with other information such as that provided by the various rating agencies might allow APRA to draw conclusions as to DOFIs security.

Also suggesting to take into account the sophistication of policy holders.

8. NIBA

- Q2
  - "Marketing insurance in Australia" should include persons arranging or issuing in Australia insurance contracts as an agent of an insurance company that is not authorised to conduct insurance business in Australia.
  - It could also be extended to include persons marketing an insurance company that is not authorised to conduct insurance business in Australia – focus should be on preventing poorly capitalised DOFIs from "marketing in Australia".

- Q3
  - Under NIBA’s minimalist approach, Australians, through insurance brokers or otherwise, would have full access to the world’s insurance market by going directly overseas to insurers; however, a DOFI from other than a comparable regulatory regime would be prevented from arranging or issuing insurance contracts in Australia or advertising their products in Australia, ie any DOFI, whether from a comparable regulatory environment or not that does not market or arrange insurance in Australia directly or through agents would remain accessible to any Australian insured.
  - If the changes were directed not only at high risk DOFIs but all DOFIs and include activities such as claims management, risk assessment, making payments to insureds and insurance brokers acting on behalf of clients, the implications would be significant, as Australia needs the expertise and specialist insurance cover offered by DOFIs far more than the world’s DOFIs need the Australian insurance business. Some DOFIs may choose not to meet even the most basic Australian requirements, preferring instead to withdraw from insuring Australian risks which would have a significant effect on the supply of insurance to Australia by DOFIs.
The proposals envisage regulating professionals such as lawyers, loss adjustors, financial institutions, actuaries, accountants and risk managers that are paid to perform professional services in Australia for overseas insurers that are not directly related to the arrangement of insurance.

Suggesting creation of an offence to market and arrange or issue insurance in Australia as or for a DOFI from a country that does not have insurance regulations comparable with Australia; other functions than arranging or issuing or marketing, such as claims handling, or the activities of insurance brokers when acting on behalf of a client (ie post sales activities) should be ignored.

The definition in para 44 of the Discussion Paper for "conducting insurance business in Australia" is similar to that used in section 911(d) of the Corporations Act, which ASIC determined was too broad and as a result released class order 03/824 providing an exemption in certain cases for wholesale clients.

The proposal would capture all DOFIs that cover Australian risks as they are likely to require some form of claims handling expertise in Australia at some time (at the very least a loss adjustor would be involved). Accordingly all DOFIs are likely to be caught by the proposed definition including DOFIs approached directly by individuals and overseas insurers writing global business that is not arranged in Australia but which covers Australian risk.

The list of activities proposed to be captured is far too broad: it would capture banks, lawyers, accountants, actuaries, risk managers, loss adjusters and a host of other professionals simply performing their normal services – the proposal effectively means the regulation of all people that carry out almost any function for an insurance company; for example persons making payments to insureds on behalf of both local and overseas insurers would be seen as conducting insurance business; and banks in order to be able to make the payments would first need to become authorised insurers under the Insurance Act of the agent of such an insurer.

There are significant implications for people who perform insurance type functions (claims management, risk management and banking etc) for organisations such as quasi insurers that are not authorised, for instance workers compensation claims managers, self insurers, overseas captive insurers and large corporations that administer insurance claims.

APRA should instead consider the countries which have comparable insurance regulations as for instance the UK, USA, AU, Canada and Singapore.

A DOFI coming from one of the comparable jurisdictions should be able to ask APRA to include them in a list of exempted DOFIs. The DOFI would then need to appoint a single
agent in Australia for regulatory purposes. The agent in Australia would make the request for the DOFI and would need to certify that:

(a) they have authority from the DOFI to act as agent;
(b) the DOFI was regulated in a specifically identified comparable jurisdiction to write the type of insurance business that it intended to write in Australia;
(c) the agent would inform APRA of any change in agent, the agent's address, the type of insurance it would write in Australia and the DOFIs regulatory status in its home jurisdiction;
(d) basic statistical information as required by APRA would be forwarded to APRA in a timely manner;
(e) the DOFI would inform all clients that it was not regulated under the Insurance Act and that APRA did not supervise it.

- APRA would merely need to accept requests, list them on its website, collate statistical returns and periodically check with the home jurisdiction that the DOFI has authority to conduct insurance business. There would be no need to assess individual DOFIs against standards outlined in the discussion paper.
- The only sanctions required by APRA would be to delist a DOFI which does not meet an undertaking and to take action against the agent in Australia for failing to satisfy undertakings given.

- Q12
  - Pointing out that the users of DOFIs are, by and large, sophisticated buyers of insurance.

- Q16
  - The type of data to be collected should only be basic statistics about premiums, claims paid, class of the insurance, and the home jurisdiction.

- Q17
  - Overseas captives do not market insurance in Australia. They do not require any supervisions by APRA, should automatically be exempt and should not even be required to meet the tests for a domestic captive.

- Q18
  - Indicating difficulties with proposed third party exemption criteria, as many third party beneficiaries linked with the captive group are automatically covered under such captive arrangements pursuant to section 48 of the Insurance Contracts Act. This practice should be allowed to continue, even though it may be appropriate for notices to be provided to the relevant third party beneficiaries regarding the captive's non APRA regulated status.

- Q20
  - There is no reason why foreign reinsurers should be caught by the proposed regulations as reinsurance is only purchased by sophisticated buyers and APRA's supervision of insurance companies includes their reinsurance arrangements.
• Q22
  - Regulation of DOFI reinsurers would not be consistent with international practice.

• Q23
  - There would be little incentive for insurers to move offshore as Australians have in the past tended to steer away from overseas insurers for all but large commercial and difficult to place risks.

• Q25
  - Market significance test should be based on premium income.

• Q30
  - Pointing out an inconsistency: the adoption of option 1 in paras 93 to 95 would be inconsistent with the current legislative arrangements and the principle that APRA would not supervise DOFIs as APRA should not allow insurance liabilities to be transferred to organisations that it does not have responsibility for.

• Q36
  - Brokers should warn their clients of the risk involved in dealing with DOFIs; DOFIs should make it clear what, if any, supervisory role APRA plays;
  - DOFIs should not be given equal standing in the Australian market with authorised insurers; a way of achieving this in the past was by a notification requirement.

• Q37
  - As the degree of sophistication of the purchasers of insurance can vary widely including in relation to wholesale purchasers, all clients of brokers should be warned of the risk involved in using a DOFI no matter whether they are classified as retail or wholesale in comparison all wholesale buyers of foreign securities are sophisticated purchasers.

9. Northern Territory Government
   - Pointing out that there may be a need to make complementary amendments to statutory insurance provisions under Territory legislation to ensure that appropriate levels of consumer protection apply, relevant Territory legislation includes:
     - Agents Licensing Act; Building Act, Commercial and Private Agents Licensing Act; Commercial Passenger (Road) Transport Act; Consumer Affairs and Fair Trading Act; Health Practitioners Act; Legal Practitioners Act; Professional Standards Act; and Work Health Act.

10. NZ Captive Insurance Association
    - Q17
      - Off-shore captive insurers should obtain the benefit of any exemptions provided to domestic captive insurers.
• Q18

• The criterias suggested in paragraph 73 should only apply to captives in relation to insurance written in Australia for Australian insureds. They should not prevent a captive from writing insurance in Australia in accordance with the Australian criteria, simply because the captive also writes insurance in other jurisdictions in accordance with criteria that differ from the Australian criteria.

• A captive should not need to apply to APRA for an exemption; it should be automatically exempted if fulfilling the criteria, otherwise the key objective, facilitating business that does not require regulation, would be defeated.

• The first two criteria restrict captives to wholly owned companies within corporate groups and that provide insurance only to other companies that are wholly owned within the group. These criteria restrict the definition of a captive to arrangements that are comparable to self insurance within a corporate entity.

• Suggesting that captives should be defined using the words appearing in the APRA proposal: "policy holders of an eligible captive which would be exempt are "wholesale" and are part of the same corporate group. They are therefore likely to have an understanding of the financial standing of the insurer (being part of the same of the corporate group) and are able to make informed decisions on this basis".

• Submitting that a captive meeting these descriptions would be one that is defined as including any entity as long as that entity is one that only insures the risks of entities that in terms of international accounting standards are:
  1. its parents;
  2. a related entity (ie control);
  3. in a (jointly controlled) joint venture with that entity, or an entity of the type described in 1 or 2 above;
  4. an associate of that entity, or an entity of that type described in 1 or 2 above.

The essence of 1 and 2 is the concept of control; the essence of 3 is joint control; and the essence of 4 is significant influence. Associates, while not part of a group, must be subject of significant influence by the group to count as an associate, and therefore, should be regarded as "wholesale" policy holders, "likely to have an understanding of the financial standing of the insurer", and "able to make informed decisions on this basis".

• In relation to the third criteria suggested in paragraph 73 it was submitted that:
  1. this criteria should not extend to jointly controlled joint ventures as they have an understanding of the financial standing of the captive insurer and are able to make informed decisions on this basis;
  2. assigned beneficiaries should not be deemed to be third parties since the primary contract is between the third party and a person insured by the captive. In that situation a third party can be assumed to know that it is being offered the benefit of an "as is, where is" contract that has already been negotiated with someone else.
and that such benefit is something different from an insurance contract that is targeted directly at a third party.

- In relation to the fourth criteria mentioned in paragraph 73 it was submitted that this criteria was too restrictive and unnecessary and that it should be left to the legislator to specify in each particular instance whether it wishes to limit who can provide the particular insurance.

- In relation to the fifth criteria mentioned in paragraph 73 it was submitted that this criteria is too uncertain and potentially too restrictive and unnecessary and it was suggested to address the objectives of this criterion on a case-by-case basis in provisions governing the particular situations at which the criterion is directed.

- Reference was further made to an additional criterion explored by APRA (but not in the discussion paper) providing that a captive should not provide reinsurance to any other party (unless the reinsurance is to another captive insurer that meets the criteria 1 to 4 as set out in paragraph 73 of the discussion paper and submitting that this criterion should be deleted and that reinsurance should be included within the definition of insurance for the purposes of the exemption.

- Q19
  - There is no need for different criteria between domestic and off-shore captives, reiterating the importance of a sufficiently broad definition of captives and their services.

11. Promina

- Taxation issues:
  - Prudential and taxation matters should not be considered independently, as the different tax treatment of DOFIs and DMFs provides them with a competitive advantage to insurers authorised under the Insurance Act 1973.

- Presenting the view that, as most DOFIs operate out of comparable regulatory regimes, it should not be onerous for most DOFIs to meet the requirements for authorisation. If a DOFI cannot meet these basic requirements, consumer protection should not be compromised to avoid market disruption.

- If the government is going to compromise consumer protection to ensure the availability of certain insurance products, then exemptions from prudential regulations should be made on a line-of-business basis rather than simply by exempting DOFIs.

- Supporting the ICA proposal, that rather than attempting to define "marketing insurance", a more appropriate test for prudential regulation is the existence of an insured risk in Australia.

- Suggesting that acceptance of any comparable regime should be negotiated on a mutual basis, granting similar access for Australian authorised insurers into the foreign regime, as this will assist Australian insurers to compete more effectively on the global stage.

- exempt DOFIs should be subject to regulation by ASIC and the Australian Financial Services licensing requirements, as well as the general insurance industry Code of Practice.
12. **QBE Insurance Group**

- Pointing out that there is a place for DOFIs in the Australian market in order to meet those gaps that local insurers are unable or unwilling to meet, but the prudential framework should ensure a level playing field for all market participants. It should not place local insurers at a competitive disadvantage and should welcome reputable and secure DOFIs such as QBE London from jurisdictions with comparable prudential regulation.

- **Taxation Issue:**
  - DOFIs writing Australian risks must be subject to the equivalent collection of taxes on their business written in Australia. While a number of state and federal taxes are imposed on Australian insurance business written offshore by DOFIs there is disparity in relation to collection of such taxes both from the DOFI and the insured (including income tax, stamp duty, fire services levy, GST, withholding tax and the NSW insurance protection tax).
  - Acknowledging the difficulty to control the risk to Australian policy holders purchasing insurance directly from a DOFI over the internet, QBE suggest that this risk might be mitigated through a highly visible education campaign by the Australian regulators.
  - When deciding whether to grant a DOFI an exemption due to the comparable regulatory regime in their home country, APRA should not only examine the company but the fitness and propriety of its directors.

- **Q3**
  - Suggesting that the availability of some speciality commercial lines of insurance may be affected initially (only) while DOFIs assess whether they wish to continue offering insurance under the new regulatory regime, however, the impact should be minimal.

- **Q5**
  - Expressing the view that it is not intended to extend the regulatory regime to those insurers which are not marketing their products directly or through local agents or brokers, but from whom Australian consumers can purchase insurance. Noting, that it would be difficult for APRA to monitor activities as such emailing of an offer of insurance to Australians.

- **Q7**
  - There is a question as to the enforceability and extraterritoriality of all provisions relating to DOFIs, unless:
    - (a) there is a specific agreement from the DOFI to be subject to prudential supervision in Australia by applying for authorisation under section 12 of the Insurance Act, or for an exemption to be domiciled in a country with a comparable regulatory regime; or
    - (b) there is a strengthening of the arrangements APRA has with some foreign regulators, extending to information sharing and enforcement of APRA’s prudential standards in those jurisdictions; or
    - (c) the DOFI is required to meet minimum capital requirements, for example retain premium in Australia for a set period based on the level of business underwritten in...
Australia, which would be held through a local subsidiary or branch and available to Australian policy holders in the event of insolvency.

- Q9
  - Interestingly, suggesting that if APRA was able to reach agreement with the regulator in the DOFIs home country, it may be possible to impose restrictions on the DOFIs home licence if they were to breach any of the conditions for the exemption granted in Australia.

- Q11
  - Suggesting as further necessary conditions:
    1. to hold assets in Australia; and
    2. to meet minimum capital requirements relative to the amount of risk being underwritten in Australia.
  - Such tests should not apply to a DOFI such as QBE London, which has an established and licensed non operating holding company and other operating subsidiaries within the Australian financial services market.

- Q12
  - QBE points out that APRA has sought to extend Australian standards to its overseas subsidiaries, some of which are not writing insurance business in Australia, APRA needs to ensure that local insurers are not placed at a competitive disadvantage by incurring significant compliance cost to which their overseas competitors operating in the Australian market will not be subjected to;

- Q13
  - APRA should consider "environmental factors" affecting the DOFI's operation in a comparable regulatory regime such as the stability of government and its economy.
  - A primary criteria for assessment must be the working relationship between APRA and the home regulator and the commitment of the home regulator to enforce its "comparable regulatory regime" if and when required.

- Q16
  - Suggesting that APRA should have access to any material correspondence between the home regulator and the DOFI and be provided with a copy of annual audited and statutory accounts.

- Q21
  - If offshore reinsurers were forbidden to market insurance in Australia unless they are domiciled in a comparable regime, this could have severe impact on reinsurance capacity during periods of unfavourable insurance conditions and the ability of local underwriters to write general commercial business affecting the average policy holder in those lines of business possibly residing with under insurance or no insurance.

- Q25
• Market significance test should be based on a combination of the factors listed in paragraph 83 of the discussion paper but of greater significance is the level of risk being carried by the DOFI in the Australian market and to ensure that sufficient reserves are available to meet such risk.

• Q38

Any amendment to the disclosure provisions under the Corporations Act should include a requirement upon the local agent or broker to state why a particular DOFI was recommended to the policy holder, irrespective of whether general or personal advice is being provided.

13. **QLS Insurance**

• QLSI is a wholly owned subsidiary of Queensland Law Society INC which since July 2001 has provided professional indemnity insurance to lawyers practicing in Queensland from its base in Singapore.

• Q18 [P4]

Supporting the contention that exemptions from regulations should properly be expanded as per para 75 in the discussion paper so it is a matter for the relevant legislator, in their case the Queensland State Government, to put in place whatever safeguards it considers appropriate in relation to the type of insurer to provide the statutory insurance.

Interestingly, QLSI does believe that it doesn't carry on an insurance business in Australia nor that it markets insurance in any way in Australia or elsewhere as its activities are solely confined to providing professional indemnity insurance to solicitors practicing in Queensland.

14. **Underwriting Agencies Council**

• Q6

The proposed definition may capture those engaged on behalf of insurers to manage claims or make payments to insureds and will extend the scope of those deemed to be involved in insurance business to loss adjustors, lawyers and banks through whom payments to insureds are made; it will extend to such people even though the insured may not be in Australia and the insurance was arranged outside Australia (for example, a lawyer managing a claim on behalf of an overseas insurer for an overseas company sued in Australia). Further problems could arise where otherwise acceptable insurers who have not sought an exemption, are unable to pay out a claim or their intermediaries in Australia to manage a claim. Further examples are representatives of overseas insurers who currently come to Australia on "marketing visits" to talk to underwriting agents, brokers and large commercial insureds or potential insureds.

• Q9

Defining "carrying on insurance business" by reference to the activities of:

1. undertaking risk assessments;
2. deciding whether to accept risks;
3. entering into contract of insurance;
either as insurer or on behalf of the insurer. (This would not capture insurers selling insurance to Australian insureds over the internet.)

- **Q14**
  - APRA should state which regimes it considers to be comparable, in making that assessment APRA should only have regard to prudential criteria – it would then be sufficient for the individual DOFI to establish that it is in fact authorised and writing business in that regime and that it will comply with the other suggested conditions for an exemption in paragraph 49.
  - The proposals place an unfair burden on the first DOFI from a particular jurisdiction to apply for an exemption. Subsequent DOFIs from the same regime would not have to bear such costs.
  - If it was envisaged that each DOFI authorised under a particular regime would have to individually establish that the regime is comparable, then there is potential for different conclusions to be reached in relation to the same regime and there would also be considerable duplication of costs both on behalf of each DOFI and on behalf of APRA.
  - Suggesting there could still be a discretion for individual DOFIs to apply for an exemption where they operate under a less common regime which had not been declared by APRA to be comparable. There should be a requirement that APRA must consider the application and provide an answer within a certain time, otherwise an exemption is deemed approved.

- **Q25**
  - There would be significant practical difficulties in deciding and implementing a market significant test.
  - Commercial implications: What happens when a DOFI reaches its limit? – The law would suggest that it needs to be authorised, but authorisation is a costly and lengthy process. The DOFI would have to pull out of the market until it obtains an authorisation or enough contracts have expired to take it back below the threshold.
  - Further, if a DOFI has several entries in Australia via several agents and brokers, it would have to keep track of the amount of business effected, the intermediaries would have to report business placed to APRA and it could be APRA who alerts the intermediaries to the fact that a threshold has been met if the insurer does not.

- **Q30**
  - The proposed definition of "marketing insurance business" includes managing claims on behalf of the insurer (UAC submits that this activity should not be included). This raises transitional issues in relation to claims under liability policies where the period of insurance may have expired some years ago and the insurers under those policies may not wish to seek an exemption particularly if they no longer write business in
Australia, but without some transitional relief the insurers would be prevented from dealing with claims.

- Q36
  - The current requirements under the Corporations Act with regard to DOFIs should apply to all insured not just retail consumers and the requirements should be expanded to standardise the form of disclosure in a way that is easily understood by all intending insureds and include a description of ramifications of placing the insurance business with a DOFI.
  - It was further submitted that all insurance contracts covering Australians insured should be subject to Australian law and hence the Insurance Contract Act.

15. Western Pacific Insurance

- Qs 9 to 11
  - Suggesting that a DOFI should only be able to transact any kind of insurance business in Australia through a nominated licensed Australian entity with the appropriate AFSL. The onus should then be on the Australian entity to satisfy APRA that the DOFI meets certain (published) fundamental criteria. The performance of the DOFI can be monitored through the reports of the Australian entity.
  - APRA might fear criticism for having exempted a rogue DOFI, which might cause that conservative criteria for "exemption" will emerge – both official and/or unofficial criteria which will be virtually along the lines of requirements for an Australian insurance company.
  - Before an Australian entity can undertake insurance business on behalf of a DOFI in Australia it must file data with APRA to support a claim that the DOFI meets the published criteria and through ongoing filing of such data showing that the DOFI continues to meet the criteria.

- Qs 12 and 13
  - Criteria under which a DOFI can operate should include the following:
    1. the DOFI must be registered and operate (including writing business) from an approved comparable prudential regime;
    2. the DOFI must obtain within 12 months of commencing business in Australia and then maintain, a rating from an approved international rating agency (APRA to publish from time to time approved international rating agencies);
    3. the DOFI must accumulate and retain in Australian sufficient securities to provide funds to meet a base level of potential claims,
    - these criteria would avoid the need for APRA to undertake exhaustive enquiries from prospective individual DOFIs in its own right and thereby avoiding all the associate costs and the risk mentioned above.

- Qs 14 and 15
• Concern, whether the exemption mechanism will work without the process becoming "bogged down" with detailed criteria to protect APRA from unacceptable risk.

• Q16

• Suggesting that issues such as maintaining minimum capital adequacy standards, reserving standards, acceptable reinsurance arrangements, acceptable corporate governance, proper actuarial advice, regular performance reviews etc. in respect of DOFIs can be adequately handled by the ratings process of international recognised ratings companies, as such companies have the resources and expertise to properly assess these aspects. Direct supervision and data collection by APRA should be kept to a minimum.

• The nominated Australian entities for which the DOFI is operating should be responsible for filing the appropriate data, such data to include copies of all reports, financial statements, etc required to be filed in the home jurisdiction of the DOFI and perhaps a specific annual report on its financial operations in Australia.

• Q29

• The complexity in designing and managing a market significant test to deal with only perceived problems (as in majority of cases market significance will only be achieved by being an Australian insurer), outweighs any benefits to Australian policy holders.