



Australian Government  
The Treasury

Treasury discussion paper

# Regulation of Discretionary Mutual Funds and Direct Offshore Foreign Insurers

December 2005

TREASURY DISCUSSION PAPER

REGULATION OF DISCRETIONARY MUTUAL FUNDS  
AND DIRECT OFFSHORE FOREIGN INSURERS

DECEMBER 2005

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## Making a submission

### Confidentiality of submissions

Where possible, Treasury would prefer written submissions on this discussion paper, in electronic format. It will be helpful if your comments address the specific questions and refer to the numbered paragraphs in the discussion paper.

In the interests of informed public debate, non-confidential public submissions will be available to any person or organisation upon request. Treasury will publish these public submissions on its website at [www.treasury.gov.au](http://www.treasury.gov.au).

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In the absence of a clear indication that a submission is intended to be confidential, Treasury will treat the submission as non-confidential and public.

Should you wish to make a submission, please send it by 24 February 2006 to e-mail [dmfreview@treasury.gov.au](mailto:dmfreview@treasury.gov.au), or post to:

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## INTRODUCTION

1. Treasury is seeking comments from interested parties on the implementation of the key findings of the Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers, headed by Mr Gary Potts (the review).
2. Discretionary mutual funds (DMFs) and direct offshore foreign insurers (DOFIs) currently provide some level of insurance cover or insurance-like risk management in the Australian market. However, these entities are not subject to the same level of prudential regulation by the Australian Prudential Regulation Authority (APRA) as Australian authorised insurers.<sup>1</sup>
3. The Treasurer released the report of the HIH Royal Commission into the failure of the HIH Insurance Group on 16 April 2003 ([www.hihroyalcom.gov.au](http://www.hihroyalcom.gov.au)). Recommendation 42 proposed that the Australian Government amend the *Insurance Act 1973* (the Insurance Act) to extend prudential regulation to all discretionary insurance-like products, to the extent that it is possible to do so within constitutional limits.
4. The HIH Royal Commissioner made no recommendation about regulating DOFIs, but noted that in many instances it is unnecessary to regulate insurance written offshore because it involves large commercial insurance contracts.

### The review of discretionary mutual funds and direct offshore foreign insurers

5. In response to the HIH Royal Commissioner's recommendation, the Government commissioned the review of DMFs and DOFIs on 12 September 2003. The purpose of the review was to consider the appropriate level of prudential and consumer regulation for DMFs and DOFIs. The review made a number of recommendations to change the regulation of DMFs and DOFIs.

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1 Throughout this paper, references to 'authorised insurers' or 'APRA – authorised insurers' refer to insurers authorised under section 12 of the *Insurance Act 1973* to conduct insurance business in Australia. Depending on context, the phrase may also be used to refer to Lloyd's underwriters authorised under special provisions in the Insurance Act. Implementation of the review recommendations does not entail changing current arrangements for Lloyd's underwriters.



## Regulation of discretionary mutual funds and direct offshore foreign insurers

6. The Treasurer accepted the recommendations of the review and released the key findings on 27 May 2004. These are available from the DMF and DOFI review website at [www.dmfreview.treasury.gov.au](http://www.dmfreview.treasury.gov.au). The full report of the review has not been publicly released as it contains a significant amount of commercial-in-confidence information.
7. Since the release of the key findings of the review in May 2004 Treasury has undertaken additional consultations with a range of key stakeholders to consider options for implementing the findings of the review.
8. Treasury is now seeking to consult more broadly on options for implementing the review's recommendations.

## Recent general insurance reforms

9. In recent years, several significant improvements to the regulation framework for general insurance have been implemented.
10. Significant prudential reforms have been achieved through the passage of the *General Insurance Reform Act 2001* (the General Insurance Reform Act) and the implementation of the recommendations of the HIIH Royal Commissioner.
11. The General Insurance Reform Act amended the Insurance Act to increase minimum entry-level capital for general insurers from \$2 million to \$5 million and to tailor capital adequacy requirements more closely to the risk profile of individual insurers.
12. Risk management standards have also been strengthened to ensure general insurers are well managed. In particular, the 'fit and proper' tests have been expanded to apply to both the board and senior management.
13. Reforms were also introduced to enable APRA to make prudential standards, thus building greater flexibility into the legislative framework. Greater flexibility will allow the prudential regime to accommodate market developments more easily over time.
14. Considerable progress has also been made in implementing the HIIH Royal Commissioner's recommendations. APRA's internal governance arrangements and front-line supervisory capacity have been enhanced. The Government's Corporate Law Economic Reform Program (CLERP 9) reforms to corporate governance and audit requirements came into force in July 2004. Other agencies, such as the Australian Accounting Standards Board and the

Australian Stock Exchange, have also made significant progress in addressing the recommendations for which they are responsible.

15. The Government's reforms to the prudential regulation of general insurance are complemented by the reforms to enhance consumer protection, introduced by the *Financial Services Reform Act 2001*. These reforms include implementing a single, harmonised licensing regime for providers of financial services and advice to consumers, a consistent and comparable disclosure regime, as well as uniform arrangements for regulation of financial markets.

16. In combination, these reforms have addressed significant gaps in the regulatory framework and improved the consistency of financial markets regulation. More importantly, they have helped enhance public confidence in the general insurance industry and the financial sector more broadly.

### Structure of this paper

17. This discussion paper is in two main sections covering DOFIs and DMFs separately. Each section comprises:

- background;
- the review recommendations;
- the objectives of the recommendations; and
- issues to consider before implementing the recommendations, including questions requesting further input from stakeholders.

## KEY ISSUES

18. Implementing the review recommendations for DOFIs requires the extension of the scope of the Insurance Act to capture a broader range of activities. DOFIs seeking to market insurance in Australia from comparable prudential regimes may then be exempted from the application of the Act.

19. However, regulating DOFIs raises a number of matters to address, including:

- 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 for offshore insurers seeking or revoking authorisation;
- appropriate enforcement powers for APRA; and
- any need for additional consumer protection measures to be placed on exempt DOFIs and their intermediaries.

20. In relation to DMFs, implementing the review recommendations would allow DMFs to continue to operate only if they can do so without retaining any contingent risk. DMFs that cannot do so would no longer be permitted to write discretionary cover.

21. Outstanding matters to address before regulating DMFs include:

- a mechanism for prudentially regulating DMFs;
- defining 'contingent risk';
- the structure of an exemption for no contingent risk;
- determining eligibility for a no contingent risk exemption;
- data to be collected from DMFs;
- transitional arrangements and APRA enforcement powers; and
- any need for additional consumer protection measures to be placed on exempt DMFs.

22. The focus of the HIIH Royal Commission recommendation, the review of DMFs and DOFIs, and this discussion paper is the appropriate prudential and consumer protection regulatory framework for DMFs and DOFIs operating in the Australian market. No examination is conducted or recommendations made in relation to taxation of DMFs and DOFIs.

23. While there are some differences in taxation treatment between DMFs, DOFIs and authorised insurers, it is not appropriate for taxation matters to drive prudential policy.

24. Consistent with the recommendation of the HIIH Royal Commissioner, the Treasurer has written to his counterparts in the States and Territories, urging the removal of all State taxes and levies on insurance contracts.

25. The removal of these taxes would allow the more efficient operation of the insurance market.

## DIRECT OFFSHORE FOREIGN INSURERS

### Background on DOFIs

26. Foreign insurers wishing to conduct authorised insurance business in Australia must establish a subsidiary or branch in Australia and apply to APRA for licensing under the provisions of the Insurance Act. However, foreign insurers can still sell insurance to Australians via an insurance agent or broker licensed in Australia without establishing a subsidiary or branch. These foreign insurers, known as DOFIs, are not subject to the provisions of the Insurance Act because they are not considered to be carrying on 'insurance business in Australia' under sections 9 and 10 of the Insurance Act. However, these DOFIs may be subject to prudential and consumer regulation in their home jurisdiction.

27. The review found that the 'carrying on insurance business in Australia' test lacks clarity, is unnecessarily restrictive and does not reflect the implications of the internationalisation of insurance services.

28. The review concluded that DOFIs comprise approximately 2.5 per cent of the Australian insurance market overall, but provide significant capacity in specialised lines. The review also noted that DOFIs largely operate out of comparable regulatory jurisdictions and write much of their business for large corporate entities.

### Review recommendations

29. The key findings of the review in relation to DOFIs are 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, in accordance with Insurance Act requirements.
- Give APRA enhanced enforcement and investigative powers to establish whether the nature of a DOFI's operations is such as to require authorisation under the Insurance Act.

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

## Objectives of the recommendations

30. The review noted that the profile of DOFIs and the insurance capacity they provide in the Australian market underline the importance of not implementing regulatory changes of a magnitude or a time frame that could prove disruptive.

31. The recommendations are intended to improve current prudential regulatory arrangements. They seek to avoid prohibiting commercial arrangements that have worked satisfactorily to date and to target areas of the highest risks such as foreign insurance companies operating out of less stringent regulatory jurisdictions.

32. In considering the regulation of DOFIs, the Government would be seeking to balance an appropriate level of stability and policyholder protection against any significant adverse impact on the availability and affordability of insurance. The recommendations recognise the need for a competitive, freely-contestable insurance market, with appropriate prudential and consumer protection.

33. The recommendations do not seek to place insurance provided by DOFIs on an identical footing with insurance written by authorised insurers. When the recommendations are implemented, Australian creditors could be placed at a disadvantage compared to creditors in the insurer's home jurisdiction in the event of a wind-up.

### Question 1

Treasury invites comments on whether the objectives of the review recommendations are appropriate.

### Question 2

If the objectives are appropriate, are the review recommendations the best means of achieving the objectives?

### Question 3

What will be the implications for the supply of insurance in Australia of implementing the recommendations?

## Issues for clarification

34. Implementing the review recommendations for DOFIs raises a number of issues in terms of interpreting each of the criteria involved. Issues for resolution include:

- 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 for offshore insurers seeking or revoking authorisation;
- appropriate enforcement powers for APRA; and
- any need for additional consumer protection measures to be placed on exempt DOFIs and their intermediaries.

## Marketing insurance in Australia

35. The existing Insurance Act would require a number of changes to capture all insurers marketing insurance in Australia and to clarify the activities captured by the definition of 'insurance business in Australia'.

36. Implementation of the recommendations would require that insurers 'marketing insurance' in Australia, as opposed to the current 'carrying on insurance business' in Australia, be subject to the Insurance Act. This implies a broadening of the scope of the Act.

37. The review did not propose extending the regime to situations where Australian consumers sought out and bought insurance directly from foreign insurers (over the internet, for example) where those insurers did not seek to market their products in Australia, directly or through agents or brokers.

38. That is, the regime would not apply if an Australian decided to seek out insurance overseas (either in person, by telephone or over the internet), but would apply if a DOFI targeted insurance business in Australia by, for example, offering (either directly, through agents or brokers, or via the internet) insurance to Australians. The e-mailing of an offer of insurance to

Australian sports car owners would be considered marketing insurance in Australia.

39. There are a number of possible ways of broadening the scope of the Insurance Act to capture all insurers marketing insurance in Australia and clarifying what activities constitute 'carrying on insurance business in Australia' for the purposes of prudential regulation.

### *Insurance business*

40. It is proposed that the definition of insurance business be broadened to capture entities or individuals engaged by domestic and foreign insurers to:

- 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;
- manage claims on behalf of the insurer;
- act on behalf of the foreign insurer in dealings between the insurer and registered insurance intermediaries in Australia;
- make payments to insureds; or
- hold records relating to the insurer's insurance activities in Australia.

41. It is proposed to amend the definition of 'insurance business' to clarify that an insurer is carrying on such business whether the acts are performed directly by the insurer or through a representative of the insurer (for example, an agent or broker). An entity that falls within this broader scope would need to be either an authorised insurer or acting on behalf of an authorised insurer.

42. This broadening of the scope of the definition of insurance business would capture any insurer (including a DOFI) that uses persons in Australia to procure, market or administer insurance business, whether or not these activities occur as stand-alone activities or in conjunction with undertaking the insurance liabilities.

### *In Australia*

43. To clarify the description of 'in Australia', it is proposed that a provision similar to section 911D of the *Corporations Act 2001* (the Corporations Act) be introduced, defining when insurance business is taken to be carried on in Australia.



## Regulation of discretionary mutual funds and direct offshore foreign insurers

44. For the purpose of implementing the review recommendations, the provision would state that conducting insurance business in Australia would 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.

45. Such conduct would include targeting Australian consumers via the internet or telephone.

46. These arrangements would not apply to the provision of ongoing services in relation to a product acquired while the policyholder was outside Australia. For example, they would not apply to an insurance contract purchased by an Australian while living in Scotland.

### Question 4

Are the proposed amendments to the Insurance Act to capture DOFIs marketing insurance in Australia the most effective means of implementing the recommendation?

### Question 5

Will the proposed extension of '*insurance business*' capture all DOFIs?

### Question 6

Will the proposed extension capture activities or entities that should not be caught?

### Question 7

Is the definition of what is taken to occur 'in Australia' enforceable?

### Question 8

Would these proposed amendments have unintended implications for currently authorised insurers, including subsidiaries and branches?

### Question 9

Are there alternative means of extending prudential regulation to DOFIs marketing insurance in Australia?

### Exemptions when operating from a comparable regime

47. DOFIs marketing insurance in Australia without APRA authorisation would need to apply to APRA for an exemption.

48. In order for the exemption to be implemented, it is necessary to determine:

- the conditions for exemption;
- how to assess an overseas prudential regulation regime; and
- the mechanism for obtaining an exemption.

### Conditions to be met for exemption

49. To obtain and maintain an exemption from prudential requirements in Australia, a DOFI would need to:

- be authorised and writing business in a comparable prudential regime;
- comply with relevant requirements under the *Financial Sector (Collection of Data) Act 2001* (the Financial Sector (Collection of Data) Act); and
- report to APRA any change in its circumstance relevant to its exemption.

50. The second condition is intended to facilitate the collection of information about DOFIs operating in Australia. An amendment to the Financial Sector (Collection of Data) Act would enable APRA to collect relevant data from DOFIs as a condition for any exemption.

51. The third condition for eligibility establishes that it is the DOFI's responsibility to inform APRA of any change in its circumstances that may affect its eligibility for the exemption, both in terms of its home regime and its own circumstances. APRA would be given the power to vary or revoke an exemption to reflect conditions placed on the insurer in their home jurisdiction, such as it being suspended or placed in run-off.

52. The obligation for the DOFI to report to APRA any relevant changes in circumstance will be supported by ensuring APRA has sufficient monitoring, investigation and enforcement powers in relation to the exemption from the Insurance Act.

## Regulation of discretionary mutual funds and direct offshore foreign insurers

53. In the event that a DOFI breaches a condition of the exemption, section 14 of the Insurance Act would apply to impose a penalty for a strict liability offence.

### Question 10

Are these conditions appropriate for DOFIs seeking to obtain an exemption from the Insurance Act?

### Question 11

Are any further conditions necessary to effectively implement the review's recommendations?

## *Assessment of comparable regulatory regimes*

54. In order to conduct an assessment of an insurer's home regime, APRA would be required to compare broad objectives and outcomes rather than conduct a line-by-line comparison of the requirements in each regime. Outlined below are broad principles that could be used to assess a regime. They are in line with principles used by APRA to consider lenders' mortgage insurance in its guidance note on risk-weighted on-balance sheet credit exposure (AGN112.1).

### Characteristics of the overseas regulator

55. In making its assessment, APRA would consider the appropriateness and sufficiency of the:

- 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 at minimum on-site reviews, information analysis and risk assessments; and
- sanctions and powers available to the regulator to enforce corrective action.

### Characteristics of the overseas general insurance prudential regulatory regime

56. APRA would assess the extent and nature of mandatory requirements and the standards that the overseas regime places on the general insurers including that the insurer is:

- licensed and writing business in the relevant jurisdiction (where licensing is based on clear, objective and public requirements);
- subject to group-wide supervision where the insurer is part of a corporate group;
- operating under appropriate governance standards;
- maintaining risk-based minimum capital adequacy and solvency standards;
- able to meet claims when and if they arise; and
- making appropriate use of reinsurance.

### Additional criteria

57. APRA would also be able to take into account any other significant factors in its assessment of the comparability of a foreign regime, such as ensuring active supervision of a general insurer in its home jurisdiction. For example, an insurer may be domiciled in a regime where the prudential regulation is comparable with that of Australia, but the insurer itself may have had its licence suspended in that regime, or have been placed in run-off.

58. As such, an additional criterion would require the DOFI to satisfy APRA that it is actively operating and writing business in its home jurisdiction, and being regulated for that business. APRA could be satisfied by a variety of means, including a letter from the home regulator or evidence that the DOFI was undertaking a material amount of business in the home jurisdiction, or some alternative measure.

**Question 12**

Do the proposed criteria to determine the eligibility of an overseas regime provide sufficient certainty that the DOFI is appropriately regulated without requiring APRA to conduct an exhaustive examination of the DOFI, its home regime and its prudential stability?

**Question 13**

Are there other criteria that ought to be considered when determining a 'comparable regime'?

***Mechanism for obtaining an exemption***

59. One approach for the granting of exemption would be to amend section 7 of the Insurance Act to allow APRA to make a determination to exempt a DOFI from some or all parts of the Insurance Act where APRA considers the overseas regime to be comparable, based on the broad principles outlined above.

60. A DOFI would apply to APRA in writing for an exemption from the requirement to be authorised under the Insurance Act to market insurance business in Australia.

61. APRA would consider the application for exemption on a case-by-case basis and assess whether the offshore regime was comparable based on broad principles outlined in law. It would be the insurer's responsibility to provide APRA with the necessary information although APRA could ask the DOFI to provide any information necessary to determine whether to grant an exemption.

62. If APRA considers that the DOFI operates out of a regime that is not comparable, the entity would be required to meet all requirements of the Insurance Act should it wish to market insurance in Australia.

63. A fee for assessing the application would be charged. Section 51 of the *Australian Prudential Regulation Authority Act 1998* would give APRA the ability to charge a DOFI for the work involved in considering a DOFI's application for exemption.

**Question 14**

Are there any concerns with this possible mechanism or process for obtaining an exemption?

**Question 15**

Are there any preferred options?

**Data collection**

64. As noted above, one condition of the exemption would be the provision of data to APRA, under the Financial Sector (Collection of Data) Act. APRA would establish standards for DOFIs so that they are not subject to all of the data requirements of authorised insurers.

65. Such data would not be collected to assist with prudential regulation (as APRA will not be regulating exempt DOFIs). Instead, the purpose of this data collection will be to develop and maintain a clear understanding of the size and type of business DOFIs write in Australia. For example, details on the lines of insurance and volumes of business written in Australia could be collected.

66. Such data could also be used to determine whether exempt DOFIs continue to satisfy the exemption criteria. However, as noted earlier, the obligation rests with the DOFI to inform APRA should its situation change.

**Question 16**

What type of data should be collected from exempt DOFIs to inform understanding on their role in the insurance market?

## Other exemptions

### *Captive insurers*

67. Domestic captives<sup>2</sup> are currently regulated under the Insurance Act. (The Insurance Act does not recognise captives as a separate type of insurer.) Wholesale consumers use captives as an alternative to self-insurance.

68. APRA has been exploring proposals to exempt from prudential regulation domestic captive general insurers whose business is limited to wholly-owned corporate groups. APRA released its discussion paper on exempting captives from prudential regulation on 23 February 2005.

69. In general, the services provided by captives often resemble self-insurance within a corporate group that is itself not subject to regulation. The decision to retain insurance risk within a corporate group, either through a captive insurer or through self-insurance by member companies in that group, is a commercial one.

70. To ensure consistency with APRA's proposal to exempt domestic captives from prudential regulation, it may be appropriate to extend the proposal to offshore captives.

71. In implementing the review recommendations on DOFIs, the Insurance Act could also be amended to allow for an exemption of captives. Captives meeting appropriate criteria (both domestic and DOFIs) would be exempt from prudential regulation in Australia.

72. However, determining the appropriate criteria for captives to be exempt from regulation exposes a tension between securing appropriate protection for policyholders but defining captives and their service sufficiently broadly to have some practical benefit.

73. Possible criterion already explored by APRA include the captive:

- being a wholly-owned company within a corporate group;
- providing insurance only to other companies that are wholly-owned within the group;

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2 Captive insurance involves an arrangement where a separately formed company (the 'captive' insurance entity), within a group of related companies or persons, performs the functions of insurer to that group.

## Regulation of discretionary mutual funds and direct offshore foreign insurers

- not insuring any third parties (including assigned beneficiaries) under the insurance provided, such as contractors, sub-contractors, joint venture partners or customers;
- not writing statutory classes of insurance; and
- providing insurance to an APRA-regulated institution only if the exemption does not prejudice the interests of the policyholders, depositors or members of that APRA-regulated institution.

74. Some of these criteria may be appropriate for all captives and others may not.

75. For example, it may be appropriate for jurisdictions that mandate statutory classes of insurance, such as workers' compensation and some professional indemnity insurance, to consider specifying what type of insurer can provide the statutory insurance.

76. These jurisdictions need to be aware that captives, DMFs and DOFIs that write statutory classes of insurance business, or write insurance business to enable a corporate group to meet statutory obligations, may face a lower level of supervision.

77. However, rather than the Australian Government restricting an exemption from prudential regulation available for those classes of insurance, it is the responsibility of those jurisdictions mandating certain types of insurance to specify what classifies as appropriate insurance in these situations.

78. Some jurisdictions already stipulate the appropriate source of statutory insurance. Other jurisdictions may wish to consider whether they wish to limit who can provide mandated insurance.



**Question 17**

Should offshore captive insurers be exempt from the requirements of the Insurance Act, in line with current proposals to exempt domestic captives?

**Question 18**

What would be the appropriate criteria for a captive insurer to qualify for an exemption from prudential regulation?

**Question 19**

Should criteria for eligibility vary between domestic and offshore captives?

**Reinsurers**

79. The scope of the Insurance Act captures both insurance and reinsurance arrangements. To that extent, if the scope of the Insurance Act is broadened to capture DOFIs marketing insurance in Australia, unless a specific exemption is made, the business of foreign reinsurers marketing insurance in Australia will also be captured.

**Question 20**

Is there any reason why foreign reinsurers should be caught by the proposed DOFI regulation regime?

**Question 21**

What would be the implications for the domestic insurance market if offshore reinsurers (and their brokers and agents) are forbidden to market insurance in Australia unless they are domiciled in a comparable regime?

**Question 22**

Is this approach consistent with the international treatment of reinsurers?

## Market significance test

### *Rationale for market significance test*

80. Concerns were raised during the review that changes to the regulation of DOFIs could provide an incentive:

- for Australian-based insurers to move offshore and write insurance back into Australia; or
- for a DOFI currently operating in Australia under the Insurance Act in a branch or subsidiary structure to instead operate out of its home jurisdiction.

81. However, given the comparable regime recommendations, options for regulatory arbitrage appear to be limited. It is not obvious that the proposed changes would introduce significant incentives for Australian insurers or foreign insurers currently authorised under the Insurance Act and operating through subsidiaries or branches to move offshore.

- Under the current regime, a foreign insurer could write business for Australians without being authorised under the Insurance Act, as long as it wrote the policies overseas. Yet insurers have been choosing to be based and authorised in Australia.
- There are a number of commercial imperatives to be an authorised insurer and to operate through a branch or subsidiary structure. For example, it is easier to build a consumer base with a physical presence in a country. Insurers without a physical presence have to rely on broker-sourced business.
- Consumers who wish to buy quality insurance tend to look to an Australian-authorised insurer.

#### Question 23

What are the incentives for insurers to move offshore once established in Australia should the DOFI recommendations be implemented?

## Regulation of discretionary mutual funds and direct offshore foreign insurers

82. To limit situations in which insurers marketing insurance in Australia do so as a DOFI, and to deliver increased policyholder protection, the review recommended a 'market significance' test. The market significance test would limit any exemption for DOFIs to those DOFIs that are not considered to be significant players in the market.

### Question 24

Is it appropriate to introduce barriers to a DOFI writing insurance business in Australia if APRA is satisfied it is comparably regulated in its home regime?

### *Mechanisms for market significance test*

83. If a market significance test is introduced, market significance could be measured in a number of ways, including:

- an absolute value of premiums written in Australia;
- a proportion of the insurer's premium income that is written in Australia;
- the insurer's share of the Australian market; or
- a combination of these.

84. Any test adopted may need to vary depending on the line or lines of insurance being written. For example, premium income for one contract insuring a submarine may be greater than income from thousands of home and contents insurance contracts. Practical difficulties would flow from such an arrangement. Market segmentation in developing the market significance test would reduce simplicity and make assessment against the test far more complex for insurers that write across a number of lines of insurance.

85. One restriction in developing an appropriate market significance test is the current lack of data on DOFIs operating in Australia and their share of the Australian market.

Question 25

What would be an appropriate market significance test?

Question 26

Should a market significance test vary by class of business (to reflect different market shares being 'significant' depending on market concentration and average premium size)?

86. Whatever test is adopted, once 'market significance' is reached, the DOFI would be required to establish as a branch or subsidiary in Australia.
87. There are significant practical difficulties in implementing and enforcing the market significance test, including how to manage DOFIs that become 'significant' and therefore require authorisation, or foreign insurers that, while currently authorised, reduce in significance and seek to become exempt DOFIs.
88. APRA may require discretion to consider other factors to determine whether the DOFI may continue to operate as an exempt DOFI or should set up as a branch or subsidiary in Australia. Such flexibility would be important to cover such situations as where a DOFI unexpectedly exceeds the dollar limits. As an example, if the premium limit is set at \$10 million and the DOFI's business reaches \$10,000,001 it would apply to APRA to determine whether it could continue to operate as a DOFI, despite exceeding the limit.

Question 27

How should the business written in Australia by a DOFI that had been exempt but is then required to become authorised be treated? Should such business be APRA-regulated?

Question 28

Alternatively, how should the business of an authorised insurer that reduces its market significance and becomes a DOFI operating from its home regime be treated?

Question 29

Does the complexity of designing and managing the market significance test, both for APRA and the insurer, outweigh any benefits it may have for Australian policyholders?

### Transitional issues and revocation of authorisation

89. Once the review recommendations are implemented, new entrants into the Australian market would be required to comply immediately. They would need to be authorised insurers under the Insurance Act or receive an exemption from APRA as a DOFI operating from a comparable prudential jurisdiction.

90. Those DOFIs that have been marketing insurance in Australia without being authorised general insurers or establishing subsidiaries or branches will require a transition period to seek authorisation or receive an exemption from APRA. A transition period of approximately two years would seem appropriate to minimise transition costs both for insurers and Australian policyholders, particularly for short-tail business.

91. Foreign insurers currently authorised by APRA may seek to conduct their business from comparable offshore jurisdictions. Such an insurer would need to seek revocation of its authorisation under the Insurance Act.

92. Arrangements for the revocation of a licence are already in place under the Insurance Act. APRA can only revoke the authorisation if the insurer has no liabilities in Australia. There are two options under existing provisions of the Act.

#### *Option 1: Transfer of business*

93. Under this option, the insurer would transfer all of its business to another insurer by way of a court-approved scheme under Part 3 of the Insurance Act. A transfer or amalgamation of the insurance business may also require approval under the *Insurance Acquisitions and Takeovers Act 1991*. Following a go-ahead under that Act and court approval, APRA could revoke authorisation because the insurer would no longer have liabilities in Australia.

94. Should an authorised insurer be seeking to transfer its business to allow the revocation of its license and to move offshore to become an exempt DOFI, there are three options in terms of the recipients of the insurance business:

- another general insurer;
- the newly established exempt DOFI; and
- another exempt DOFI.

95. Currently, the application of Part 3 of the Insurance Act only allows transfer of business to another authorised general insurer. This would require the modification of the meaning of 'general insurer', to ensure that it includes overseas insurers that are eligible to carry on insurance business in Australia.

*Option 2: Voluntary run-off*

96. Another option would be for the insurer to go into voluntary run-off. The insurer would be required to meet all prudential requirements associated with conducting run-off insurance business but would be able to write all renewals from the overseas-incorporated insurer.

97. The benefits of this option for the insurer moving offshore appear questionable, as the insurer would still be required to devote capital and other resources to manage the run-off. Particularly for long-tail liabilities, the run-off could take many years.

**Question 30**

Are these options sufficient for managing the Australian business of an insurer seeking to move offshore?

**Question 31**

Is there any reason to restrict to general insurers those insurers to which business is transferred under the first option?

**Question 32**

Are there particular risks for Australian policyholders that need to be addressed?

**Question 33**

If so, what alternative mechanisms would best address these concerns?

**Enforcement powers**

98. To the extent that DOFIs are marketing insurance in Australia, APRA requires sufficient powers to enforce the recommended regulatory requirements.

**Question 34**

With the extension of the Insurance Act, will APRA have jurisdiction to monitor and enforce, as required, compliance with the proposed DOFI regulatory requirement?

**Question 35**

Are further changes to APRA's powers under the Insurance Act required?

## Consumer protection

### *Application of the Corporations Act*

99. The review suggested that it would be desirable to strengthen information disclosure to consumers under the Corporations Act by requiring brokers, agents and other intermediaries marketing DOFI business in Australia to disclose certain information to consumers. This information would include such details as the country of origin of the insurer, the prudential regulator in the country of origin and whether the insurer is authorised to conduct insurance business in that country, its reinsurance arrangements and its solvency rating.

### **Current licensing regime**

100. Generally, a DOFI that sells its products in Australia will require an Australian Financial Services Licence (AFSL).

101. A person requires an AFSL to deal in financial products or provide financial product advice in Australia. A financial product includes a facility through which a person manages a financial risk, such as general insurance products.

102. As a financial services licensee, a DOFI must comply with certain obligations, including maintaining competency, ensuring their financial services are 'provided efficiently, honestly and fairly' and taking responsibility for the actions of authorised representatives. Where a licensee provides services to retail clients (consumers), they must also belong to an external dispute resolution scheme.

## Regulation of discretionary mutual funds and direct offshore foreign insurers

103. There are exemptions from the need to obtain an AFSL. Some DOFIs may make use of such exemptions and hence will not hold an AFSL. For example, licensing exemptions apply where:

- a person is regulated by an overseas regulatory authority, the provision of the service by the person is covered by an exemption specified by the Australian Securities and Investments Commission (ASIC) and they only provide services to wholesale clients (sophisticated clients).

104. Other exemptions include where:

- a person deals in financial products in Australia, and they provide such products through a financial services licensee:
  - whose licence covers the provision of the service; and
  - who arranges for the person to provide the service.

(Note: if dealing with retail clients, this exemption does not excuse a product issuer from the disclosure requirements of the Corporations Act.)

- a person provides financial product advice, makes a market or provides custodial or depository services to wholesale clients in Australia, and such services are provided through a related body corporate or a party to a joint business venture:
  - whose licence covers the provision of the services;
  - who arranges for the person to provide the services; and
  - who has assumed responsibility for the conduct of the person providing the financial services (through a licence condition).

### Current disclosure regime

105. When providing financial services to retail clients, a regulated entity must disclose certain information orally and/or through written documents.

- The Financial Services Guide (FSG) provides general information about a service provider.
- The Statement of Advice (SoA) provides a written record of personal financial advice.



## Regulation of discretionary mutual funds and direct offshore foreign insurers

- The Product Disclosure Statement (PDS) discloses important information about a financial product.

106. The FSG and SoA requirements only apply to licensees and authorised representatives. However, the PDS requirements apply to product issuers (including DOFIs) whether they are licensed or not.

107. Under Corporations Regulation 7.9.15, a DOFI must also include the following information in a PDS:

- a statement that the product issuer is an unauthorised foreign insurer and is not authorised under the Insurance Act to conduct insurance business in Australia;
- a statement that an insurer of that kind is not subject to the provisions of the Insurance Act, which establishes a system of financial supervision of general insurers in Australia; and
- a statement that the person (that is, the consumer) should consider whether to obtain further information, including:
  - the country in which the product issuer is incorporated, and whether the country has a system of financial supervision of insurers;
  - the paid-up capital of the product issuer; and
  - which country's laws will determine disputes in relation to the financial product.

## Current treatment of intermediaries

108. Insurance brokers would usually hold their own AFSL. They would be subject to the same licensing, conduct and disclosure requirements as other licensees.

109. There are no additional specific disclosure requirements that apply to intermediaries that recommend or arrange for the sale of DOFI products. However, brokers represent consumers and they may disclose information about DOFIs when providing advice to their clients.

110. The National Insurance Brokers Association of Australia is currently updating its Code of Conduct. A requirement of the Code will be that brokers inform their clients when they are recommending insurance offered by a DOFI.

**Question 36**

Do the current requirements under the Corporations Act already make relevant information with regard to DOFIs available to retail consumers?

**Question 37**

Why should the wholesale business of DOFIs be treated differently to the wholesale business of foreign securities, in relation to any additional disclosure requirements?

***Application of the Insurance Contracts Act***

111. The *Insurance Contracts Act 1984* (the Insurance Contracts Act), which regulates the terms included in insurance contracts and insurer conduct in relation to such contracts, applies to actual or proposed contracts of insurance whose proper law is, or would be, the law of a State or the law of a Territory to which the Act applies or to which it extends.

112. Insurance contracts issued by DOFIs may fall within the scope of the Insurance Contracts Act. However determining what the 'proper law' of the particular contract is could involve the application of private international law rules.

113. To overcome the ambiguity surrounding the Insurance Contracts Act's application to DOFIs, a recent review of its terms recommended the Act be amended to clarify that it applies to all contracts of insurance issued by DOFIs to Australian insureds or in respect of Australian risks.

114. That proposal, together with other proposed changes to the Act will be the subject of consultations in the future. There is some concern about whether such a provision would be enforceable in overseas jurisdictions.

**Other issues?**

**Question 38**

Are there other matters or issues that should be addressed in the implementation of the review's recommendations for the regulation of DOFIs?

## DISCRETIONARY MUTUAL FUNDS

### Background on DMFs

115. 'Discretionary cover' is a term used to describe an insurance-like product that involves no contractual obligation by the provider to meet the costs if a risk eventuates. At its discretion, the provider will consider meeting such costs.

116. The HIIH Royal Commissioner recommended that the Government extend prudential regulation to all discretionary insurance-like products.

117. DMFs provide alternative means of risk management. DMFs are sometimes applied to risks for which commercial insurance may not be available or affordable. While DMFs benefit from cost advantages compared to authorised insurers due to their exemption from State taxes and, to a lesser degree, prudential regulation, it is not clear whether their recent growth (although still a small proportion of the market) is due to these lower costs or the market demand for tailored products that commercial insurers do not provide.

118. The review noted that the withdrawal of DMF services could affect consumers who have found it difficult to obtain specialised insurance cover.

119. The review found that DMFs comprise less than one-half of one per cent of the insurance market. As such, the failure of a DMF is unlikely to pose any systemic threat to the industry, or given their current scope, the economy as a whole.

120. However, the expansion of the DMF sector without adequate supervision or regulation could weaken the security of the insurance industry.

### Review recommendations

121. The key findings of the review in relation to DMFs are as follows:

- Require cover to be offered only as a contract of insurance under the Insurance Act unless APRA considers in the case of an individual entity that no contingent risk that would need to be met by additional undefined member contributions is retained in the

entity (in these cases such risks would fall on a general insurer providing 'top-up cover'<sup>3</sup>).

- Require APRA to collect and collate data on business written by DMFs under the exemption.

122. The Government does not intend to regulate discretionary cover that is 'carried on' by State or local governments.

## Objectives of the recommendations

123. The review recommendations seek to target prudential supervision where it is justified without unnecessarily penalising DMFs filling market gaps.

124. The exemption for no contingent risk, while unusual for prudential regulation in general, recognises that some DMFs might be structured in a way that does not warrant prudential regulation.

### Question 39

Treasury invites comments on whether the objectives of the review recommendations are appropriate.

### Question 40

If the objectives are appropriate, is implementation of the recommendations the best means of achieving the objectives?

### Question 41

What will be the implications of the recommendations on the supply of insurance and insurance-like products in Australia?

## Issues for clarification

125. Implementing the review recommendations for DMFs poses a number of issues in terms of defining and implementing the criteria involved. Matters to address include:

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3 In this paper, reference to 'top-up cover' or 'external insurance' means insurance purchased by the DMF to meet claims that exceed a certain agreed level (the retention) per claim and in the aggregate. See paragraph 154 for an example.

## Regulation of discretionary mutual funds and direct offshore foreign insurers

- a mechanism for prudentially regulating DMFs;
- defining ‘contingent risk’;
- the structure of an exemption for no contingent risk;
- determining eligibility for a no contingent risk exemption;
- data to be collected from DMFs;
- transitional arrangements and APRA enforcement powers; and
- any need for additional consumer protection measures to be placed on exempt DMFs.

### Regulating DMFs

126. One option for implementing the review recommendations is to introduce legislation that would regulate the provision of discretionary cover – ensuring that it could only be offered in situations where the DMF carries no contingent risk. Alternatives for DMFs that could not offer products without retaining some contingent risk would be to cease operation or to restructure to become an authorised insurer. Paragraph 170 explores these options.

127. As a base structure, the legislation could state that entities are prohibited from doing activity X unless (a) it is done under a contract of insurance, or (b) it is undertaken with no contingent risk retained by the entity. In this case, X would be a definition of writing insurance or insurance-like business that captures discretionary arrangements.

### Defining the business of DMFs

128. In defining activity X, a definition of insurance and insurance-like business is required.

129. The *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003*, which requires previously discretionary medical indemnity cover to be provided by contracts of insurance, defines the provision of medical indemnity cover with reference to the person receiving the cover and the nature of claims covered. Such a definition may not prove feasible in this situation as there are a variety of products, risks covered and potential clients.

130. A definition that relies on the basic principle of a provision of an indemnity, whether or not by binding contract, is likely to be too broad. Not all risk management tools provided in forms other than insurance contracts are DMF cover.

131. Another possibility would be to refer to the discretionary provision of indemnification that, were it not for its lack of a clear right to indemnification, would be considered insurance.

**Question 42**

Would any of these definitions capture the full range of discretionary insurance-like products provided by DMFs?

**Question 43**

What alternative definitions could be used?

**Question 44**

Are there any unintended consequences from any of these definitions?

### Contingent risk

132. In order to shape an exemption from prudential regulation for DMFs carrying no contingent risk, it is first necessary to determine what is meant by 'contingent risk'. No clear definition is provided in the review and subsequent discussions with stakeholders have not yielded a uniform view of what constitutes contingent risk.

133. A DMF will meet the cost of a claim from either or both of:

- the DMF's retained funds; and
- any external or 'top-up' insurance purchased.

134. Thus, the review noted that a DMF will commonly retain a limited initial level of risk for individual claims (that is, to fund small claims and the lower end of larger claims). It may then obtain external insurance to cover the rest of its risks. A prudently managed DMF relies on adequate external insurance to control its risk exposure.

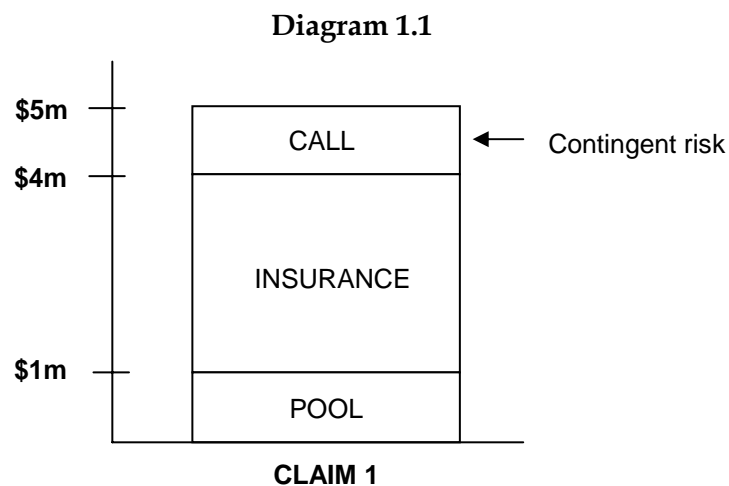
## Regulation of discretionary mutual funds and direct offshore foreign insurers

135. A possible definition of contingent risk may be based on the extent to which a legitimate claim on a DMF might not be able to be paid from these two sources of funds and the extent to which a call for additional funds may be made on members.

136. This could occur with one large claim that exceeds the capacity of the DMF's retained funds and external insurance (Example 1). A more likely scenario is where a number of claims have exhausted the DMF's own funds but its external insurance does not meet the lower end of the claim (Example 2).

### Example 1

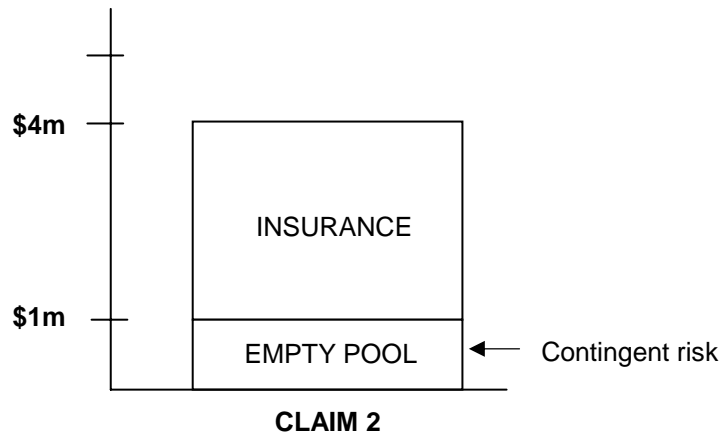
137. In diagram 1.1, a contingent risk remains should a \$5 million claim be made, exceeding the \$1 million pool of funds and the \$3 million insurance. Such a risk could occur due to one large claim or many smaller ones.



### Example 2

138. A more common form of contingent risk can emerge if a DMF's arrangement with its external insurer requires it to meet an initial level of \$1 million per claim but the DMF has already exhausted its retained funds paying out other claims. Once a new claim comes in, the DMF no longer has sufficient funds to pay the claim or, should it be a large claim, to pay the first \$1 million. Members face an additional contingent risk in that a call will be required for any future claims since the DMF's funds are now exhausted.

**Diagram 1.2**



139. Contingent risk could also apply to the risk the DMF as a whole faces that members may refuse to meet the call and therefore leave the DMF under-funded.

**Question 45**

Is this an appropriate interpretation of contingent risk facing DMFs and their members?

**Question 46**

Is another interpretation more appropriate?

**No contingent risk exemption**

140. If the above interpretation of contingent risk is accepted, then the contingent risk test could consider the extent to which it might be expected that a legitimate claim will be met.

141. DMFs that minimise or eliminate standard insurance-type risk to members to the degree possible – by transferring their contingent risk to external insurers – can be seen as being fully funded to an appropriate degree. DMFs that internalise risks, leaving members potentially liable for additional financial obligations or unmet claims, cannot.



### *Options for determining no contingent risk*

142. There are a range of possible approaches to setting the point at which a DMF would qualify for exemption by divesting itself of contingent risks that would otherwise need to be met by additional undefined member contributions. Four alternative approaches include exempting a DMF that:

- has eliminated all risks to its members;
- does not allow a call on members;
- maintains assets greater than expected liabilities; or
- structures its own funds and external insurance to reduce to an acceptable level the risk that the DMF cannot meet its obligations.

### **Elimination of all risk**

143. It is unrealistic to expect that members of a DMF should not face any risks associated with that membership. Such a requirement would impose a more stringent regime than that applying to any other prudentially-regulated institution. It is not possible to eliminate risk. For example, APRA regulation of authorised insurers does not eliminate the risk that the insurer may have inadequate funds to pay out on all claims. Rather, it ensures that those risks are appropriately managed.

144. For example, even if a DMF were to purchase external insurance to cover all known risks, the presence or absence of risk to members of the DMF or the public would still depend on the strength of the insurance arrangements.

145. DMFs should ensure that members are aware that the discretionary nature of the cover means that there are additional risks, beyond those of traditional insurance. To the extent that members of DMFs are willing to accept those risks (and associated benefits, such as lower cost), it would be inappropriate to legislate that members of DMFs bear no risk (even if such an arrangement were feasible). The existing Corporations Act regime seeks to ensure appropriate disclosure of these types of risk.

### **No call on members**

146. The review recommendation states that the exemption should apply when the entity retains no contingent risk that would 'need to be met by additional undefined member contributions' (that is, a call on members).

147. Exempting DMFs that do not allow calls on members would be a straightforward way of ensuring that there would be no request for additional

undefined member contributions. However, this second option would not address the risks retained by the DMF, only limit its options should those risks materialise. To an extent, such an exemption would in fact increase the risk that the DMF, once exempt, would fail to meet claims made against it.

148. That a DMF may need additional undefined member contributions can in effect be seen as an outcome of the DMF not prudently managing its risks.

#### **Assets greater than liabilities**

149. Exempting DMFs with assets (including insurance receivables) greater than expected liabilities would be a simple test, but would be significantly weaker than prudential regulation.

150. It also would not remove or address the risks associated with fluctuations in the value of both assets and liabilities. Members of the DMF would remain exposed to those risks without appropriate regulation.

151. Further, to the extent that the DMF is incorporated under the Corporations Act, its directors will already have a duty to avoid insolvent trading. Similarly, a trustee of a DMF trust will already have a fiduciary duty to exercise the care, diligence and skill that a prudent person engaged in that profession, business or employment would exercise in managing the trust's affairs.

#### **Use of own funds and external insurance**

152. The fourth option is to exempt DMFs to the extent that risks associated with providing insurance-like arrangements are reduced to an acceptable level. This would be by way of purchasing appropriate external insurance and holding adequate assets to fund any retained risk.

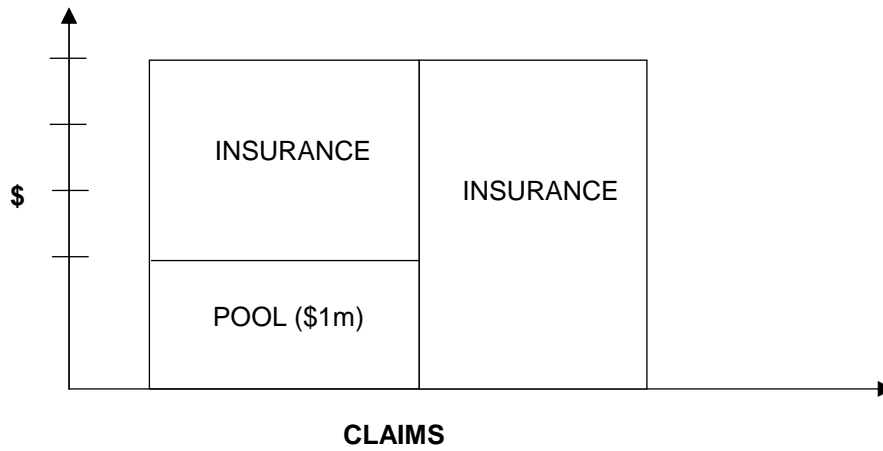
153. In practice, this may mean that insurance arrangements would be made to back up the DMF such that should claims exceed the DMF's pool of funds or the proportion of the pool allocated to any one claim, the insurer would step in. Such arrangements would need to apply both on a per claim basis and in aggregate. An appropriate aggregate retention with its external insurance cover will address the contingent risk highlighted in Example 2 in paragraph 138.

#### ***Example of insurance arrangement with no contingent risk***

154. For example, Diagram 2.1 below demonstrates a basic structure in which the DMF's pool would meet the first portion of a claim. Insurance would meet

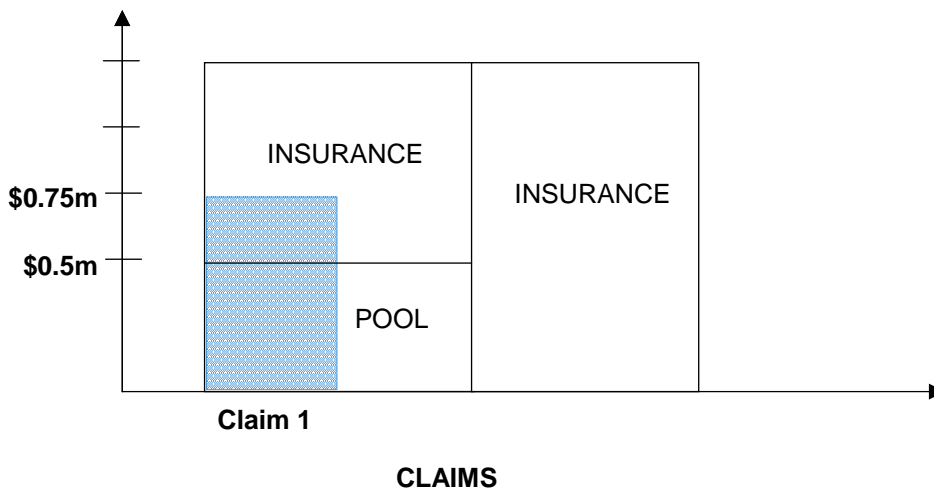
that portion of any one claim in excess of the DMF's individual claim retention and also the full value of any claims made once the pool's funds are exhausted. In this case, the DMF could have an arrangement with its top-up insurer that the DMF would meet the first \$500,000 of any one claim (its per claim retention), with the insurer meeting amounts above that level. The DMF would have a total pool of \$1 million from which to meet its share of claims payouts (its aggregate retention). Once the pool is exhausted, the external insurance would pay the value of any claims.

**Diagram 2.1**

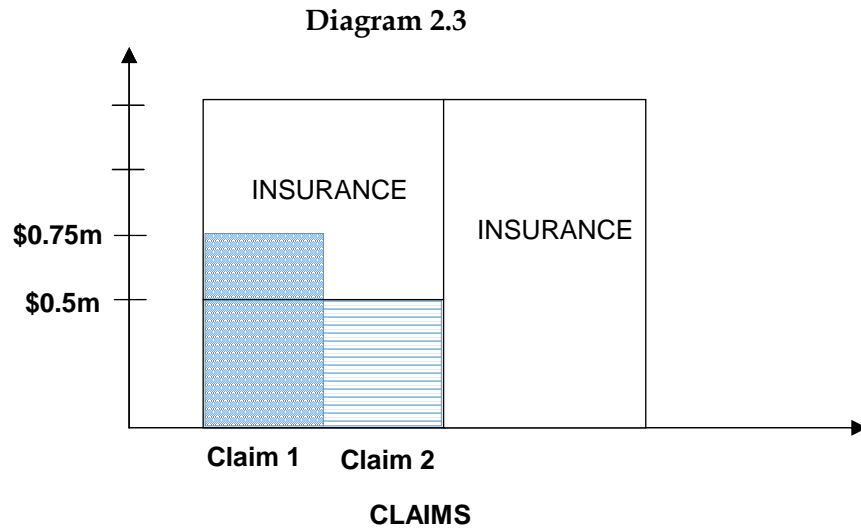


155. When the first claim is paid out, totalling \$750,000, the DMF's pool pays \$500,000 and the insurer pays \$250,000 (Diagram 2.2).

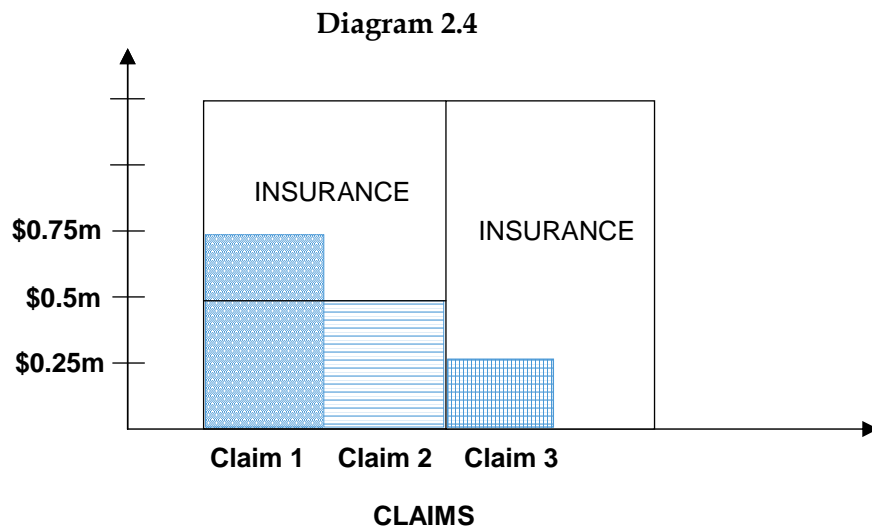
**Diagram 2.2**



156. When a second claim of \$500,000 is paid, the full amount is paid from the remaining funds in the DMF pool. The original pool of \$1 million is now exhausted (Diagram 2.3).



157. When the DMF exercises its discretion and a third claim is paid out, totalling \$250,000, for the DMF to be considered to have no contingent risk, the insurance cover would need to step in and pay out the full value of the claim, since the DMF has no further assets in the pool (Diagram 2.4).



158. However, a number of restrictions may be required to ensure that the risk transfer mechanism is fully effective in protecting members from contingent risk. Such rules may need to cover:

- the amount of funds that the DMF has retained compared to its retained risk levels, particularly its aggregate retention (for example, retained funds should exceed the DMF's aggregate retention);
- the management and investment of funds retained by the DMF (for example, in an account with an AAA-rated authorised deposit-taking institution);
- the quality of the DMF's external insurance providers (that is, from authorised insurers or exempt DOFIs only);
- the amount of external insurance cover for any one claim (that is, the DMF's retention for any one claim plus its external insurance will fund the maximum cover the DMF offers to a member);
- the amount of external insurance cover in the aggregate (that is, external insurance will meet the full claim once the DMF has exhausted its own funds);
- the responsiveness of the external insurance arrangements to the DMF's discretion (that is, the insurer must consider the exercise of discretion as counting against the retention per claim and in the aggregate);
- any requirement for the DMF to hold additional funds to provide protection against the risk of default by its external insurer;
- arrangements for any annual wind-up and distribution of remaining DMF assets (for example, assets may not be distributed to members or reallocated if there are outstanding liabilities); and
- any requirements in terms of legal structure and governance.

**Question 47**

Are such criteria necessary to ensure effective risk management by the DMF? Are there alternatives?

**Question 48**

If they are necessary, how can they be defined so as to be both practical and effective?

**Question 49**

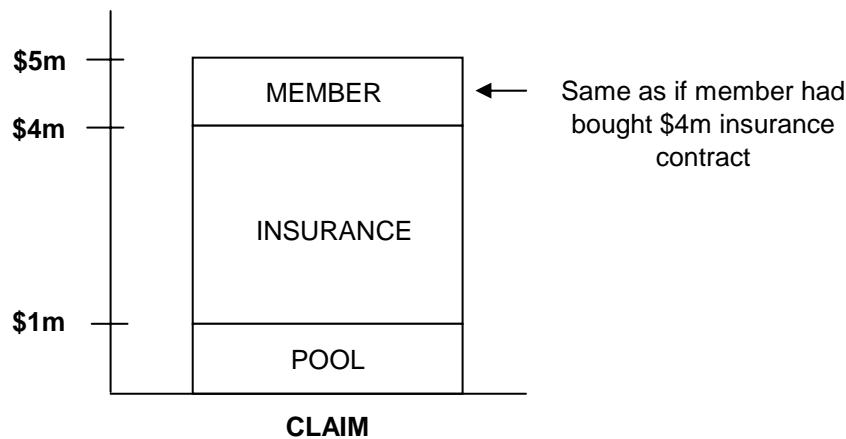
Given the complexity of such criteria, will any DMF qualify for exemption?

**Question 50**

Would the costs of determining, enforcing and complying with the exemption criteria outweigh any benefits to the community overall from regulating DMFs?

159. In practice, if external insurance is adopted as the risk management mechanism, a member of a DMF may still face some individual risk (see Diagram 3 below). With a particularly large claim, the fund would meet a set portion of the claim, the insurer meet another set portion in excess of the fund's contribution and, if the required payment exceeds the insurer's upper limit, the individual fund member would be required to meet the balance.

**Diagram 3**



160. Such a risk is comparable with the exposure faced by policyholders of authorised insurers, in that should a claim exceed the contract limit of the

## Regulation of discretionary mutual funds and direct offshore foreign insurers

policy, the individual policyholder remains liable for amounts in excess of the limit.

161. With the individual fund member meeting any residual balance (as opposed to a call being made), there is no contingent risk to the members of the DMF as a group.

### Determination of eligibility for exemption

162. A DMF will not be required to issue contracts of insurance and be APRA-regulated if it does not retain contingent risk. There are three possible approaches to assessing whether a DMF is eligible for exemption and therefore able to continue to operate as a DMF:

- self-assessment;
- self-assessment and lodgment with APRA; and
- assessment by APRA.

#### *Self-assessment*

163. A DMF could assess itself against the legislation establishing criteria for a DMF wishing to continue to operate. The assessment would need to be conducted by appropriately qualified and independent individuals (for example, an auditor or actuary, depending on the details of the 'no contingent risk' test). A DMF that considered that it met the test would continue to provide discretionary cover. A DMF that found it did not meet the requirements of the exemption would either stop providing insurance-like cover or apply to APRA for authorisation as a general insurer.

#### *Self-assessment and lodgement with APRA*

164. A DMF seeking an exemption could formally certify that it satisfies the contingent risk test, as under the self-assessment option. The certification would be submitted to APRA, but no formal assessment by APRA required. Clearly, if this option were adopted APRA would be provided with powers to assess the certification should it be considered necessary.

#### *Assessment by APRA*

165. Alternatively, the DMF could apply to APRA to be granted an exemption, providing all necessary information required by APRA to determine whether the DMF meets the no contingent risk test.

## Regulation of discretionary mutual funds and direct offshore foreign insurers

166. As APRA will, in all three cases, require powers to investigate ongoing exemptions and will be collecting data from exempt DMFs, it may be more appropriate for all applications for exemptions to be formally assessed by APRA to ensure effective removal of contingent risk before being granted.

### Question 51

Would self-assessment provide sufficient integrity for the successful implementation of the DMF regulatory regime?

## Data collection

167. In order for the Government to monitor the DMF industry and its role in meeting the needs of Australian consumers, any DMF exempt from prudential regulation will be required to provide data to APRA under the Financial Sector (Collection of Data) Act.

168. APRA would collect statistics on the number and size of DMFs operating in Australia, the lines of business they write, and, over time, changes in the DMF market. APRA would establish standards for DMFs so that they are not subject to all of the data requirements of authorised insurers.

169. Unlike most other data collected under Financial Sector (Collection of Data) Act, the information would be used to inform future policy on DMFs, rather than as part of APRA's prudential regulation responsibilities.

### Question 52

Is there any particular data that would be useful in the consideration of DMFs and their role in the Australian market?

## Transitional arrangements and APRA enforcement powers

170. Some DMFs' current structure will already meet the standards set by the no contingent risk exemption. Others will need to restructure their affairs to continue to operate as DMFs. A third set will be unable to meet the exemption criteria and will need to cease writing business as DMFs.

171. In order to allow an orderly move to the new regime, a transition period is likely to be required for the second and third sets of DMFs.



## Regulation of discretionary mutual funds and direct offshore foreign insurers

172. A transition period of two years, for example, would allow the expiration of current cover arrangements made by the DMF. The DMF would then be able to restructure to be eligible for the exemption and continue writing business as a DMF, exit the market or seek authorisation as a general insurer.

173. Some arrangement for the management in run-off of long-tail DMF cover may be required, extending beyond the transition period.

### Question 53

What transitional arrangements will be required to allow DMFs to adjust to the new prudential regime?

### Question 54

How is the wind-down of a DMF's business best managed, given that it is currently not regulated by APRA?

174. APRA will be required to enforce the regulation of DMFs and the application of exemptions.

### Question 55

Does APRA require enhanced enforcement and investigative powers to establish whether the nature of a DMF's operations is such as to require authorisation under the Insurance Act?

## Consumer protection

### *Application of the Corporations Act*

175. The review noted that the ASIC financial requirements placed on licensees, including DMFs, are appropriate and not in need of any obvious tightening as far as DMFs are concerned.

176. The review proposed a legislative prohibition on the use of the terms 'insurance' and 'insurer' in relation to DMF products and a legislative compulsion to disclose that the cover is 'discretionary' and provided by an entity not prudentially regulated.

### Current licensing requirements

177. Generally, a DMF that sells its products in Australia will require an Australian Financial Services Licence (AFSL).

178. A person requires an AFSL to deal in financial products or provide financial product advice in Australia. A financial product includes a facility through which a person manages a financial risk, such as:

- general insurance products; and
- like products, for example, from a DMF.

179. Financial services licensees must comply with certain obligations, including maintaining competency, ensuring their financial services are 'provided efficiently, honestly and fairly' and taking responsibility for the actions of authorised representatives. Where a licensee provides services to retail clients (consumers), they must also belong to an external dispute resolution scheme.

180. As noted in paragraphs 103 and 104, there are exemptions from the need to obtain a financial services licence. Some DMFs may make use of such exemptions and hence will not hold an AFSL.

### Current disclosure requirements

181. When providing financial services to retail clients, a regulated entity must disclose certain information orally and/or through written documents.

- The Financial Services Guide (FSG) provides general information about a service provider.
- The Statement of Advice (SoA) provides a written record of personal financial advice.
- The Product Disclosure Statement (PDS) discloses important information about a financial product.

182. The FSG and SoA requirements only apply to licensees and authorised representatives.

183. However, the PDS requirements apply to product issuers whether they are licensed or not.

## Regulation of discretionary mutual funds and direct offshore foreign insurers

184. A PDS includes information about significant characteristics or features of the product. Regarding products offered by DMFs, a significant feature is the discretionary nature of such products and this should be disclosed in the PDS under current requirements.

### Current treatment of intermediaries

185. Insurance brokers would usually hold their own AFSL. They are subject to the same licensing, conduct and disclosure requirements as other licensees.

186. There are no additional specific disclosure requirements that apply to intermediaries that recommend or arrange for the sale of DMF products. However, brokers represent consumers and they may disclose information about DMFs when providing advice to their clients.

#### Question 56

Are additional disclosure requirements required for DMFs or are current requirements adequate?

### *Application of the Insurance Contracts Act*

187. The review recommended that some consumer protection provisions of the Insurance Contracts Act apply to DMF cover, including the duty of information disclosure and compulsory renewal notices for members and policyholders.

188. DMFs do not provide cover by way of a contract of insurance for the purposes of the Act because there is no legal entitlement to indemnity. As such, the Insurance Contracts Act does not apply to DMF arrangements.

#### Question 57

Treasury invites comments on which consumer protection provisions applicable to insurance products under the Insurance Contracts Act should also apply to DMFs exempt from prudential regulation.

#### Question 58

Given that the application of the Insurance Contracts Act hinges on the existence of a contract of insurance, how should such provisions be applied to DMFs?

## Other issues?

### Question 59

Are there other matters or issues that should be addressed in the implementation of the review's recommendations for the regulation of DMFs?

