

# **Regulation of Direct Offshore Foreign Insurers — Exemption Discussion Paper**

20 September 2007

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## INVITATION FOR PUBLIC COMMENT

The paper *Regulation of Direct Offshore Foreign Insurers – Exemption Discussion Paper* outlines a proposed approach to a limited exemption for insurance business from having to be provided by a general insurer authorised under the *Insurance Act 1973*, and the mechanism for implementing the exemption. The approach seeks to ensure that while general insurers carrying on insurance business in Australia are authorised, access to the global insurance market for insurance business that cannot be appropriately placed with an authorised general insurer is not restricted.

Interested parties are invited to provide comments on the proposals discussed in the paper, including the design of the proposals and their potential effects on stakeholders. Submissions should be sent to:

Regulation of Direct Offshore Foreign Insurers – Exemptions Discussion Paper

Financial System Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600  
DOFexemptions@treasury.gov.au

The closing date for submissions is 31 October 2007.

It is assumed that submissions are not confidential and will be made publicly available on the Treasury website. If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly on the submission. A request made under the *Freedom of Information Act (1982) (Cth)* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Requests to meet to discuss the issues addressed in the paper are welcome.

Inquiries about this paper or the consultation process may be directed to:

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## ACRONYMS

AFSL	Australian Financial Services Licence, issued under Chapter 7 of the Corporations Act
APRA	Australian Prudential Regulation Authority
APRA Act	<i>Australian Prudential Regulation Authority Act 1998</i>
ASIC	Australian Securities and Investments Commission
Authorised insurer	Insurer authorised under section 12 of the <i>Insurance Act 1973</i> to carry on insurance business in Australia
Corporations Act	<i>Corporations Act 2001</i>
Corporations Regulations	<i>Corporations Regulations 2001</i>
DMFs	Discretionary Mutual Funds. DMFs offer 'discretionary cover', that is, an insurance-like product that often involves a contractual obligation on the DMF to consider a claim when a risk eventuates, but provides the DMF with a discretion whether it will pay the claim.
DOFIs	Direct Offshore Foreign Insurers. DOFIs are foreign insurers that carry on insurance business in Australia, either directly or via an insurance agent or broker, without being authorised under the Insurance Act.
Insurance Act	<i>Insurance Act 1973</i>
Insurance Regulations	<i>Insurance Regulations 2002</i>
Lloyd's underwriters	Lloyd's underwriters as defined in the <i>Insurance Act 1973</i> and authorised under section 93 of that Act
Potts review	2004 Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers



# 1. INTRODUCTION

## THE ANNOUNCED APPROACH TO REGULATING DOFIS

On 3 May 2007, the Australian Government announced its approach to regulating DMFs and DOFIs. This followed a recommendation and comments made in the 2003 HIH Royal Commissioner's report, the 2004 Government review (*Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers*<sup>1</sup>), the 2005 Treasury discussion paper (*Regulation of Discretionary Mutual Funds and Direct Offshore Foreign Insurers*<sup>2</sup>), and additional extensive consultation with interested stakeholders.

The Minister for Revenue and Assistant Treasurer announced that from 1 July 2008 all DOFIs seeking to carry on general insurance business in Australia, whether directly or through another (for example, a financial intermediary), would be required to become authorised under the Insurance Act. The Financial Sector Legislation (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 giving effect to the Minister's announcement passed the House of Representatives on 12 September 2007 and the Senate on 13 September 2007.

In response to comments from stakeholders, the Minister also indicated that there would be limited exemptions for those insurance risks that could not be appropriately placed with an authorised general insurer. These limited exemptions would be developed in consultation with stakeholders and implemented through changes to the Insurance Regulations.

Currently, DOFIs are not considered to be carrying on insurance business under the Insurance Act. They are not authorised by APRA or required to comply with Australia's general insurance prudential requirements.

Under the announced approach, the Insurance Act definition of 'insurance business' would be expanded to include the activities of DOFIs. As a result, all DOFIs (subject to limited exemptions) seeking to carry on general insurance business in Australia would be required to be authorised by APRA and comply with Australia's general insurance prudential requirements.

The announced changes do not apply to foreign reinsurers or Lloyd's underwriters. These entities will continue to be regulated under the existing arrangements.<sup>3</sup>

To complement the changes to the Insurance Act and ensure the DOFI regime operates as intended, Chapter 7 of the Corporations Act would be amended to prohibit AFSL holders from dealing in general insurance products that are not issued by an authorised insurer or a Lloyd's underwriter, unless an exemption applies. The prohibition would not prevent AFSL holders from providing advice to their general insurance clients on the range of options available to them to manage their risks.

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1 [http://www.dmfreview.treasury.gov.au/content/\\_report/key\\_report.asp](http://www.dmfreview.treasury.gov.au/content/_report/key_report.asp).

2 <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1041>.

3 Currently, APRA does not directly regulate foreign reinsurers unless they choose to establish a branch or subsidiary in Australia, in which case, they are regulated as a general insurer under the Insurance Act. Lloyd's underwriters are regulated under Part VII of the Insurance Act.

Data would also be collected under the Corporations Regulations from AFSL holders on the general insurance business they are placing through the exemption with DOFIs not authorised under the Insurance Act.

## **RECENT MARKET DEVELOPMENTS**

Following the Minister's announcement on 3 May 2007 there have been further developments in the insurance market. APRA has been approached by a number of general insurers who currently operate as DOFIs and who are interested in applying for authorisation under the Insurance Act. Several of these have already applied for authorisation while others have advised that they will await the release of this exemption paper prior to making a final decision on whether to apply to become authorised.

A number of other DOFIs who have related APRA-authorised insurers have confirmed that, while they will not seek APRA authorisation, they will continue to underwrite Australian risks by amending their group administrative processes such that the business is 'fronted' through the APRA-authorised insurer and then reinsured to the related offshore entity.

These early market developments in response to the Government's announcement demonstrate that there will be an expansion in the capacity of the APRA-authorised market. This will clearly allay some of the concerns that have been expressed about a possible reduction in access to the insurance capacity of DOFIs.

In addition, it does not appear to have always been generally recognised that business written by Lloyd's underwriters is not affected by the changes in the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007. Part VII of the *Insurance Act 1973* relating to Lloyds remains unchanged and Lloyd's underwriters continue to be APRA-authorised providers of insurance.

## **APRA'S REFINEMENTS TO THE GENERAL INSURANCE PRUDENTIAL FRAMEWORK DISCUSSION PAPER**

Since the Government's announcement in May 2007, APRA has also proposed refinements to the current general insurance prudential framework in Australia. These refinements recognise the different prudential risk profiles of different categories of insurers. They provide both existing APRA-authorised insurers and potential new applicants with greater clarity around how the prudential framework will apply to their business as well as identifying how APRA requirements should apply to different categories of insurer.

APRA has released a discussion paper, *Refinements to the General Insurance Prudential Framework*, proposing refinements to APRA's prudential standards and guidance material.

The discussion paper identifies five potential general insurance categories as the basis for the refinements. These are:

- Category A: locally incorporated insurers;
- Category B: wholly owned subsidiary of a local or foreign insurer;
- Category C: foreign insurer operating as a foreign branch;
- Category D: association captive; and
- Category E: sole parent captive.

The aspects of the general insurance prudential framework subject to the proposed refinement for different categories of general insurers are: capital adequacy, assets in Australia, governance, risk management, outsourcing, and actuarial reporting and valuation.

APRA's paper is available from the following link: <http://www.apra.gov.au/policy/>. It is open for submissions until 28 September 2007.

This discussion paper should be read in conjunction with APRA's discussion paper.

## 2. CONSIDERATIONS

Australia has a robust, competitive general insurance market which will be enhanced by well capitalised and managed DOFIs choosing to become authorised and offer insurance products to Australian businesses and consumers.

It is expected that authorised insurers will continue to develop insurance products to meet the current and future insurance needs of Australian businesses and consumers.

There may be some Australian businesses and consumers that can clearly demonstrate that they cannot obtain insurance through an authorised insurer for a particular risk.

For these Australian businesses and consumers there will be an option to obtain insurance through a DOFI not authorised under the Insurance Act. This option will be implemented through a limited exemption.

The proposed exemption will be framed around the characteristics of the particular insured or the particular risk that cannot be insured through an authorised insurer to ensure that the majority of Australian policyholders are protected by Australia's general insurance prudential framework and the exemption does not undermine the DOFI regime.

The proposed exemption outlined in this discussion paper reflects some of the particular risks that have been identified to date. Robust evidence supplementing these claims is necessary.

The purpose of this paper is to outline the proposed scope and approach to implementing that limited exemption and seek stakeholder comments on the proposed approach.

Where an exemption applies it will be up to the individual insured and advisers to ascertain the soundness or quality of the DOFI the business is placed with as the DOFI will be operating outside Australia's prudential regime.

Rather than using a DOFI, Australian businesses or consumers or their AFSL holding intermediaries may instead decide to restructure their insurance requirements so that those requirements can be met by an authorised insurer and they get the benefit and protection of the Australian prudential regime.

The exemption is designed to ensure that during the transition period to the new regime, Australian business and consumers can continue to insure their risks.

Data will be collected by ASIC from AFSL holders on the general insurance business they are placing with DOFIs not authorised under the Insurance Act. Based on that data, it is expected that the scope of the exemptions will be narrowed over time. However, the extent to which the exemption is narrowed will partly be determined by the responsiveness of insurers authorised in Australia (both existing and those coming in as a result of the DOFI changes). Where there is an innovative domestic market that is responsive to unmet demand in relation to quality, price and capacity, there will be scope for the exemption to be further limited.

Other factors that need to be balanced in developing and implementing the exemption include:

- minimising the cost to business of seeking an exemption;
- ensuring the exemption can be sought by business in a timely manner and is practically workable;
- making the exemption simple to administer; and
- ensuring that the exemption does not unduly restrict the way that insurance is currently placed in the general insurance market.

The mechanism should also be sufficiently flexible that it can be applied successfully and adapt to changing market conditions.

### 3. SUMMARY OF THE PROPOSED EXEMPTION

It is proposed that the limited exemption have three limbs, with each limb aimed at meeting different needs where insurance cover is not available through authorised insurers. The three limbs are:

- high value insureds exemption;
- atypical risks exemption; and
- customised exemption.

Where an Australian business or consumer has an insurance risk that cannot be placed with an authorised insurer and one of the limbs of the exemption is met, then a DOFI that provides cover for that risk will not be required to be authorised for the purposes of covering that risk. The AFSL holding intermediary who deals with that specific general insurance business will also gain the benefit of the exemption and will not be in breach of the prohibition in the Corporations Act.

The exemption from having to be authorised only extends to business covered by that high value insured, atypical risk or customised exemption. To the extent that an individual DOFI writes other insurance business in Australia that is not exempt, the DOFI will need to be authorised under the Insurance Act.

The first two limbs will be defined in the Insurance Regulations and Australian businesses and consumers will be able to self-assess against the definition. The criteria for the third limb will be set out in the Insurance Regulations and will be administered through either a market-based or regulator-based mechanism.

It is expected that the three limbs of the exemption would operate together, such that an Australian business or consumer with an insurance risk that could not be placed with an authorised insurer would first self-assess whether they met the first limb of the exemption (that is, they meet one of the criteria of the high value insured test). If they could not satisfy that limb, they would self-assess whether they met the second limb of the exemption (that is, did the insurance risk they were seeking to place fit within the list of atypical insurance lines in the Insurance Regulations). It is only if they did not satisfy the first two limbs that they would seek to use the third limb of the exemption and apply for a customised exemption.

It is unlikely that there will be a significant number of Australian businesses and consumers who will need to use the third limb of the exemption; that is, who have an insurance risk that they cannot place with an authorised insurer and who do not meet one of the first two limbs of the exemption.

## **4. FIRST LIMB OF THE PROPOSED EXEMPTION — HIGH VALUE INSUREDS**

### **PROPOSED APPROACH**

It is proposed that there would be a limited exemption from the requirement to be authorised under the Insurance Act for DOFIs who provide insurance products to Australia's largest publicly listed and private businesses (that is, high value insureds).

It is expected that this limb of the exemption would also be used by global companies headquartered in Australia who take out insurance to cover their global insurance risks. It is not proposed that there be a separate exemption for these policies. As a result, the business can restructure how it obtains insurance cover for its global risks, assess whether it satisfies the high value insured exemption, or seek to satisfy the customised exemption.

### **RATIONALE**

The proposed first limb of the exemption recognises that high value insureds are sophisticated purchasers of general insurance products with complex risks that may not be able to be covered solely through authorised insurers.

Australia's high value insureds have sophisticated risk management frameworks in place to assist them in assessing the risk profile of the general insurers they use. For example, their risk management framework may require them to insure most of their risk with insurers who hold a minimum credit rating from an international rating agency or set out the maximum concentration levels for regions and individual insurers.

In many instances these large businesses have an insurance program that consists of multiple layers of insurance and in some cases, where an insurance captive has been set up by the large business, reinsurance. At each layer there may be multiple insurers who insure a small part of that overall layer. In some cases, these programs can involve a significant number of insurers including Australian authorised insurers, global insurers and Lloyd's underwriters.

Without access to the global insurance market, large businesses have argued that they would not be able to obtain appropriate insurance coverage for their risks and would have to underinsure some of their risks, concentrate their risk exposure in one geographic location, or use insurers with a lower international credit rating. In all these cases the risk to the Australian business is increased. This is not a desirable outcome. As a result, it is proposed that high value insureds will have the benefit of an exemption and DOFIs not authorised under the Insurance Act will be able to supply insurance to these insureds.

## **MECHANISM FOR IMPLEMENTATION**

It is proposed that a definition of high value insureds be inserted into the Insurance Regulations. The high value insureds and their AFSL holding intermediary would then self-assess against this definition at the time of purchasing insurance, renewing a policy, or materially altering the terms and conditions of an existing insurance contract.

The business could then choose to place its business with a DOFI not authorised under the Insurance Act. As a result of the exemption, the DOFI with whom the business was placed would not be required to become authorised under the Insurance Act, and the AFSL holding intermediary would not be in breach of the Corporations Act in dealing with that business.

The exemption from having to be authorised would only extend to business in respect of that high value insured exemption. To the extent that an individual DOFI wrote other insurance business in Australia that was not exempt, the DOFI would need to be authorised under the Insurance Act.

The proposed test in the Insurance Regulations would be based on a modified large proprietary company Corporations Act test covering a combination of the following: turnover, assets, and number of employees of the business.

### **Details of the existing Corporations Act test**

The existing Corporations Act test for a large proprietary company is defined in section 45A(3) of the Corporations Act as a large proprietary company for a financial year if it satisfies at least two of the following criteria:

- (a) the consolidated gross operating revenue for the financial year of the company and the entities it controls (if any) is \$10 million or more;
- (b) the value of the consolidated gross assets at the end of the financial year of the company and the entities it controls (if any) is \$5 million or more;
- (c) the company and the entities it controls (if any) have 50 or more employees at the end of the financial year.

However, it has been suggested that the levels specified in the existing Corporations Act test are too low for the high value insureds exemption. Setting the exemption at the levels of the large proprietary company test would allow a significant number of medium sized businesses, who may not have appropriate risk management frameworks or sufficient expertise to fully understand the prudential risk of using an unauthorised insurer, to place business with these DOFIs not authorised under the Insurance Act.

### **Proposed high value insured exemption test**

Instead, for the purposes of the first limb of the exemption, it is proposed that the consolidated gross operating revenue test should be set at \$200 million, the consolidated gross assets test at \$200 million and the number of employees set at 300 for the company or entities controlled by the company obtaining the insurance cover and included in the insurance cover being taken out.

However, unlike the Corporations Act test, a business that could satisfy at least one of these tests would be able to place their insurance risk with DOFIs that were not authorised under the Insurance Act. Given the range of different business structures of high value insureds that this exemption is designed to assist, it is essential that the test is flexible enough to accommodate businesses that may not meet two of the tests. For example there may be particular industries that are capital intensive and thus a high value insured in those industries may hold \$200 million in assets, but would fail the 300 employee test. Similarly, a policy may be sought to cover more than 300 employees, but because of the structure of the business there may be only minimal assets held by the business (for example, in a legal or accounting partnership).

The high value exemption test has the advantage that its structure is modelled on the existing test in the Corporations Act, which has worked satisfactorily to date and is well understood by industry.

Regulatory compliance would be straightforward and would require little additional costs to high value insureds or their AFSL holding intermediary. They could rely on the previous year's annual financial reports, which they are already providing to ASIC.

The proposed high value exemption would not require the setting of a separate test for each line of insurance as it is based on the characteristics of the insured rather than the insurance product.

### **Question 1**

Does the proposed approach adequately define a high value insured?

What percentage of business would be exempted using the proposed approach?

## **ALTERNATIVE TESTS**

During discussions Treasury has had with interested parties since the Minister's announcement, two alternative tests for high value insureds have been suggested: a premium-based test and an insurance coverage test.

### **Alternative 1 — Premium-based test**

#### **Test**

One alternative test for high value insureds that has been suggested is a test based on premium. It has been suggested that an aggregate premium of \$30,000 per annum (including taxes and charges) is an appropriate level. This would buy approximately \$30 million of insured value for normal commercial property.

Others have suggested an alternative level of aggregate premium of \$1 million per annum.

## **Mechanism**

Under this test the exemption would be set at a particular premium level in the Insurance Regulations and businesses and their AFSL holding intermediary would self-assess whether or not the business' premiums were above the minimum threshold.

A business could then choose to place its business with a DOFI not authorised under the Insurance Act. As a result of the exemption, the DOFI with whom the business was placed would not be required to become authorised under the Insurance Act, and the AFSL holding intermediary would not be in breach of the Corporations Act in dealing with that business.

The exemption from having to be authorised would only extend to business in respect of that high value insured exemption. To the extent than an individual DOFI wrote other insurance business in Australia that was not exempt, the DOFI would need to be authorised under the Insurance Act.

## **Issues to consider**

This test would be responsive to changes in the insurance market cycle. In a hard market the premiums paid to insure the same risk would increase and more Australian businesses would be able to choose to access insurance from DOFIs not authorised under the Insurance Act.

However, this test would require the Australian insured to work out the cost of cover and then add the taxes and charges that would apply before they could establish whether they met the test. As a result, it is likely to be quite complex for high value insureds to administer.

In addition, insurance premiums depend on the scope of the insurance contract's terms and conditions and on what risk is being covered. Insurance contracts could be structured in such a way as to circumvent the restrictions, particularly where there is a significant difference in the premiums charged or terms and conditions of insurance policies offered by authorised insurers compared to policies offered by DOFIs not authorised under the Insurance Act (for example, a business may take a lower deductible or seek to have broader cover in its terms and conditions as a way of being able to obtain insurance offshore).

In these cases, smaller businesses who do not usually have sophisticated risk management frameworks in place and who may not fully understand the increased risks of using a DOFI not authorised under the Insurance Act (that is, the DOFI is not subject to Australia's strong prudential framework and that the business may need to litigate claims in a foreign court) may be encouraged to cross these thresholds without understanding the additional risk they may then bear.

Finally, there is also an issue of timing. This approach may mean that an insurance broker could go to all the efforts of negotiating terms for a premium over \$30,000 and on the point of writing the business when the client's asset schedule or requirements change (for example, the terms and conditions of the insurance policy they need change), putting the business below the threshold and the insured or their insurance broker must start all over again in seeking appropriate insurance cover. This may have a significant impact on the timeliness of obtaining cover.

## **Question 2**

Are there additional advantages or disadvantages to this alternative test compared to the proposed high value insured test?

Is the suggested threshold of the premium test appropriate?

## **Alternative 2 — Insurance cover-based test**

### **Test**

Another test that has been suggested is one based on the amount of insurance cover purchased, being in aggregate at least \$30 million. For example, if a business purchases a total of \$30 million in insurance cover for their risks, any DOFI that insures that risk would be exempt from having to be authorised under the Insurance Act in relation to that business.

### **Mechanism**

Under this test the exemption would be set at a particular insurance coverage level in the Insurance Regulations and a business or its AFSL holding intermediary would self-assess whether or not the business' insurance needs were above the minimum threshold.

The business could then choose to place its business with a DOFI not authorised under the Insurance Act. As a result of the exemption, the DOFI with whom the business was placed would not be required to become authorised under the Insurance Act, and the AFSL holding intermediary would not be in breach of the Corporations Act in dealing with that business.

The exemption from having to be authorised would only extend to business in respect of that high value insured exemption. To the extent than an individual DOFI wrote other insurance business in Australia that was not exempt, the DOFI would need to be authorised under the Insurance Act.

### **Issues to consider**

This alternative has the advantage that it would remain stable through a changing insurance market cycle. That is, during either a hard or soft market cycle the amount of insurance an insured requires is unlikely to change significantly, however the cost of that insurance would change. Under this option, regardless of the changing costs of the premium, the business would be able to choose to access the global insurance market because the required insurance cover was above the threshold.

This test would be simple to administer for the insured and its AFSL holding intermediary as the insured and its intermediary are in the best position to assess how much insurance is required. In discussions with their AFSL holding intermediaries businesses would assess what level of cover was required and if it was above the threshold a business would be able to place it with a DOFI not authorised under the Insurance Act.

This approach would not be as directly affected by the terms and conditions or the size of a policy's deductible when compared to alternative 1. It may however, still encourage a business to hold more insurance than it strictly requires so as to meet the threshold with the

associated costs of this increased insurance possibly being passed on to the consumers of that business' products.

### **Question 3**

Are there additional advantages or disadvantages to this alternative test compared to the proposed high value test?

Is the suggested threshold of the insurance cover test appropriate?

## 5. SECOND LIMB OF THE PROPOSED EXEMPTION — ATYPICAL RISKS EXEMPTION

### PROPOSED APPROACH

In discussions with stakeholders, it was suggested that there are number of limited specific atypical insurance risks that currently cannot be placed as stand-alone insurance lines with authorised insurers.

These atypical insurance risks may be covered as part of a bundled insurance product that includes a range of risks, including these atypical risks. However, to avoid complexity, the paper proposes that a risk will be included under this second limb where it is not available as a stand alone insurance line, regardless of whether it is available as part of a bundled product or not.

As a result, it is proposed that there be a limited exemption for atypical risks. Discussions with stakeholders indicate that the exemption should cover the following list of atypical insurance lines:

- Kidnap and ransom;
- Malicious product tampering;
- Commercial shipping hull;
- Ship owners protection and indemnity in excess of \$50 million;
- Asbestos;
- Nuclear;
- Political;
- Environmental impairment;
- War; and
- Satellite or space cover.

It is also suggested that for the atypical risks and customised exemption limbs of the exemption, AFSL holding intermediaries that deal with particular general insurance products that are subject to an exemption and can be placed with a DOFI not authorised under the Insurance Act will be required to disclose to the Australian insured the same sort of information that they are currently disclosing to general insurance retail clients under Corporation Regulation 7.9.12 (that is, the risks of using an insurer not authorised in Australia, including, that the client may need to defend their claim in a foreign court and that they may not be able to recover the premiums paid or have a claim paid out if the insurers becomes insolvent).

Again, in most instances AFSL holding intermediaries are likely to discuss these risks with their Australian clients as part of the general obligations that attach to their AFSL. However, including this requirement in the Corporations Act will increase the protection to Australian small to medium businesses and consumers by ensuring that these risks are disclosed and these entities have this additional information when making decisions about how to best manage their risks.

It is not proposed that this requirement be extended to the high value insured exemption as the businesses using that exemption are sophisticated purchasers of general insurance and, unlike at least some of the businesses and consumers using the second and third limbs of the exemption, are likely to understand the additional risks associated with using a DOFI not authorised under the Insurance Act.

## **RATIONALE**

The second limb of the exemption recognises that there are some very specific sets of risks where insurance cover through authorised insurers may not be available. This could be for a range of reasons including: that authorised insurers lack capacity, lack of appropriate terms and conditions in the insurance policies of authorised insurers, and the cost of the premium.

In many cases, there are only a very limited number of global insurers that offer insurance to cover these risks and given the low levels of business being written in Australia these insurers may not choose to become authorised following the commencement of the DOFI regime.

Even if limited insurance cover is available through authorised insurers there may not be sufficient capacity available to satisfy local demand for the cover or the cover may only be available if bundled with other insurance risks.

As a result, if Australian businesses with these specific insurance risks are to effectively manage their business they need access to the global insurers and the cover they offer.

For example, there are a limited number of global insurers that offer insurance cover for asbestos risks yet there are a number of Australian business seeking to purchase asbestos cover. Some of these businesses may be able to obtain cover through an authorised insurer. However, once the capacity of authorised insurers is exhausted other Australian businesses will either have to bear the risk themselves or obtain an exemption to access global insurers.

## **MECHANISM FOR IMPLEMENTATION**

The limited list of atypical lines will be set out in the Insurance Regulations. An Australian business or its AFSL holding intermediary will self-assess whether any of its risks fit within the list.

The business could then choose to place its insurance with a DOFI not authorised under the Insurance Act. As a result of the exemption the DOFI with whom the business was placed would not be required to become authorised under the Insurance Act, and the AFSL holding intermediary would not be in breach of the Corporations Act in dealing with that business.

The exemption from having to be authorised would only extend to business in respect of that atypical risk exemption. To the extent that an individual DOFI wrote other insurance

business in Australia that was not exempt, the DOFI would need to be authorised under the Insurance Act.

These atypical insurance lines would be defined in Insurance Regulations that would commence on 1 July 2008. The list would be reviewed after three years. If, as a result of the data collected from AFSL holders under the Corporations Regulations or through the third limb of the exemption, in the intervening period it became apparent that there are additional atypical risks that could not be placed with authorised insurers then insurance lines covering those atypical risks could be added to the list.

It is proposed that atypical insurance lines will not be removed from the list prior to the three year review period as this could cause significant disruptions for Australian businesses and consumers in accessing insurance to meet their needs.

#### **Question 4**

Are the listed insurance lines available domestically at an appropriate price and with appropriate terms and conditions as either a stand-alone insurance line and/or when bundled?

Are there any other atypical insurance lines that need to be added to the list? If so, is there any data to indicate the size of that insurance line?

Are there any atypical insurance lines that should be removed from the list?

How should the listed atypical insurance lines be described/defined in the Insurance Regulations?

## 6. THIRD LIMB OF PROPOSED EXEMPTION — CUSTOMISED EXEMPTION

### PROPOSED APPROACH

Based on discussions Treasury has undertaken with a range of stakeholders, it is clear that there may be individual insureds with specific risks that the increased pool of authorised insurers may not be willing to insure and which would not fit under the first two limbs of the exemption.

It is proposed that limited exemptions be granted to these individual insureds for these specific risks on a case by case basis.

To ensure that individual insureds are aware of the risks they may bear in placing their business with unauthorised DOFIs, AFSL holding intermediaries would be required to disclose to these insureds the risks associated with insuring these specific risks through a DOFI not authorised under the Insurance Act (that is, the same sort of information that they are currently disclosing to general insurance retail clients under Corporation Regulation 7.9.12, including: that the client may need to defend their claim in a foreign court and that they may not be able to recover the premiums paid or have a claim paid out if the insurer becomes insolvent).

In most instances AFSL holding intermediaries are already discussing these risks with their clients as part of the general obligations that attach to their AFSL. However, the proposed requirement in the Corporations Act will increase the protection to small to medium businesses and consumers by ensuring that these risks are disclosed and these entities have this additional information when making decisions about how to best manage their risks.

### RATIONALE

The proposed third limb of the exemption recognises that there may be a limited range of circumstances where a business or consumer has a unique risk that cannot be placed with an authorised insurer. These circumstances could include:

- where a past high profile or expensive claims experience has resulted in the Australian general insurance industry being reluctant to renew insurance for that risk (even where subsequent risk management strategies have been implemented by the insured);
- where authorised insurers do not offer the necessary terms and conditions to cover a particular risk (for example, authorised insurers may cease to cover civil engineering advice for multi-storey buildings under their professional indemnity insurance policies); and
- where there is a significant rise in premium prices (or increase in the deductible) from one year to the next (for example, as a result of the hardening of the insurance cycle – after the collapse of HIH and the hardening of the insurance market, it has been argued that in

some cases Australian businesses saw their professional indemnity premiums rise from one year to the next by as much as 500 per cent).

These situations highlight the difficulty of establishing criteria for assessing availability as the particular cover may be available for some insureds but not for others or cover may be available but at an unaffordable rate due to a lack of domestic competition or capacity.

## **MECHANISM FOR IMPLEMENTATION**

Under this limb of the proposed exemption, either AFSL holders that represent Australian insureds or a regulator, APRA or ASIC, would determine at the time of negotiation, inception, renewal or material change in the terms and conditions of the relevant policy that the Australian business or consumer could not place a specific risk with an authorised insurer. In making this determination, either the AFSL holders that represents insureds or the regulator would rely on information provided by the Australian business or consumer seeking insurance and obtained from the market and would assess this information against a set of criteria specified in the Insurance Regulations.

### **Criteria**

The criteria to be used, by either the AFSL holders that represent Australian insureds or the regulator, in determining whether or not a specific risk could appropriately be placed with an authorised insurer would extend beyond the strict question of whether there was any authorised insurer who offered that specific insurance product. It would include a range of factors such as:

- capacity;
- price;
- quality (that is, non-price terms and conditions); and
- continuity of existing relationship.

The criteria will be outlined in the Insurance Regulations and will be developed in consultation with stakeholders and APRA and ASIC. It is also proposed that the criteria be reviewed and amended as necessary on a regular basis, perhaps once a year, to ensure that it is appropriate for the exemption.

It is expected that guidance will be published on how to interpret the criteria set out in the Insurance Regulation to help Australian businesses and consumers and their AFSL holding intermediaries in assessing whether they should apply for an exemption.

The criteria for assessing whether an exemption should be given under this limb will seek to balance the needs of Australian businesses and consumers to access affordable insurance cover against the need to ensure that the exemption does not become a mechanism to undermine the DOFI regime.

For example, significant differences in price will be considered in assessing whether or not a specific risk can be placed with authorised insurers, but so too will the need to encourage the development of insurance products to fill gaps in the Australian general insurance market.

Similarly with quality, the inability to obtain insurance cover with particular terms and conditions from an authorised insurer will be considered, but the Australian business or consumer may need to demonstrate that the excluded term or condition is important to the operation of their business or prospective business. For example, a customised exemption may be warranted where a civil engineer cannot obtain professional indemnity for construction work done on buildings of more than three-storeys.

### **Question 5**

Are the listed criteria appropriate for deciding whether or not an Australian insured can obtain appropriate insurance?

Are there any other criteria that should also be included?

### **Assessor**

There are two alternative ways to implement the third limb of the exemption: a market-based mechanism or a regulator-based mechanism.

Option 1 outlines the market-based mechanism where insurance brokers assess against criteria set out in the Insurance Regulations whether their client's risk can appropriately be placed with an authorised insurer before seeking to place the risk with a DOFI not authorised under the Insurance Act.

Option 2 outlines the regulator-based mechanism where a regulator, on evidence provided by the Australian business or consumer, assesses whether the risks of that business or consumer can be placed with an authorised insurer before allowing the risk to be placed with a DOFI not authorised under the Insurance Act.

Initially, it may be appropriate to allow the market-based mechanism to operate. If it becomes evident however that a market-based mechanism is not working effectively then an alternative regulator-based mechanism for the exemption could be considered.

#### **Option 1 — Insurance brokers assess**

Under this option, Australian businesses and consumers would approach an AFSL holder that represents Australian insureds (insurance broker) requesting that they find appropriate insurance to cover their insurance risk. Insurance brokers, in finding that insurance cover, would need to assess whether or not that insurance cover was available through an authorised insurer, taking into account the clients' insurance needs.

If the insurance broker assessed that the client's needs could not be appropriately met through an authorised insurer, the client could then choose to place their business with a DOFI not authorised under the Insurance Act. As a result of the exemption the DOFI with whom the business was placed would not be required to become authorised under the Insurance Act, and the AFSL holding intermediary would not be in breach of the Corporations Act in dealing with that business.

The exemption from having to be authorised would only extend to business in respect of that customised exemption. To the extent than an individual DOFI wrote other insurance business in Australia that was not exempt, the DOFI would need to be authorised under the Insurance Act.

The Insurance Regulations would include a regulation that stated that where an insurance broker was satisfied that the risk could not be placed with an authorised insurer, that risk could lawfully be covered by a DOFI not authorised under the Insurance Act. Criteria to be used in assessing whether the client's risks could be placed with an authorised insurer would be placed in the Insurance Regulations and guidance would be published on how to interpret the criteria.

It is proposed that this mechanism only apply to insurance brokers, that is, those AFSL holding intermediaries that represent the insured in insurance business transactions. It is not proposed that insurance agents, who represent insurers, would operate this mechanism. However, the Corporations Act does not use the term insurance broker and so the concept of an AFSL holder representing the insured will need to be defined.

Insurance brokers, as AFSL holding intermediaries, would continue to be subject to the existing Chapter 7 disclosure requirements (including Corporations Regulation 7.9.12) in the Corporations Act, and in addition these disclosure requirements would be extended to include any Australian business or consumer that applied for an exemption under this limb.

As part of the DOFI regime, AFSL holding intermediaries who deal in general insurance products (including insurance brokers) will be required to provide data to ASIC on the insurance risks they are placing through the exemption with a DOFI not authorised under the Insurance Act. This data will assist ASIC in monitoring the operation of the exemption to ensure that it is not being used to circumvent the DOFI regime.

This option is based on the assumption that insurance brokers, as sophisticated players in the general insurance market, would be able to assess the solvency and other standards of a DOFI not authorised under the Insurance Act and advise their clients on the consequences of using one of these entities.

The advantage of this approach is that it is likely to be the least costly, most timely and practically workable approach as it closely aligns to the current way the industry operates. Anecdotal evidence suggests Australian businesses and consumers, who have difficulty obtaining insurance through authorised insurers, already approach insurance brokers to seek assistance in obtaining insurance and a large number of insurance brokers first approach authorised insurers, before seeking to have their client's insurance placed in the global insurance market.

In addition, as a market-based approach, it minimises the administration costs to industry in implementing the exemption and is likely to be flexible and responsive to both future developments in the insurance market and changes in the insurance market cycle.

However, this approach also has the potential to be applied too broadly undermining the DOFI changes as insurance brokers will have significant flexibility in assessing whether or not a risk can be placed with authorised insurers. As a result, there is the possibility more insurance risks may go offshore than is strictly necessary.

In addition, the approach may create too much uncertainty for insurance brokers as there would be no set number of authorised insurers that needed to be consulted before the insurance broker could conclude the insurance risk could not be placed with an authorised insurer and could be placed with an exempt DOFI. Instead, the assessment of whether insurance was available through an authorised insurer would need to be made on a case by case basis looking at all the circumstances.

If it became evident that the market-based mechanism was not working effectively, alternative mechanisms for the exemption could be considered.

### **Question 6**

Is this approach practically workable given how the insurance industry operates?

Should the criteria set out in the Insurance Regulations be varied to suit the market-based mechanism? If so, in what way should the criteria change?

Do insurance brokers have sufficient capacity and expertise to implement this option?

Does this option provide sufficient disclosure and protection for Australian businesses and consumers who will need to access this limb of the exemption?

How do we define insurance brokers for the purposes of this mechanism?

### **Option 2 — Regulator assess**

Under this option, Australian businesses and consumer would apply to a regulator (either APRA or ASIC) for an exemption allowing them to insure their specific risk with a DOFI not authorised under the Insurance Act. The regulator would consider the evidence presented to them by an individual business or consumer and assess whether or not that business or consumer had satisfied the criteria in the Insurance Regulations and established that they could not access appropriate insurance cover from an authorised insurer. If the regulator was satisfied that the business or consumer had met the criteria, they would exercise their discretion enabling the business or consumer or their AFSL holding intermediary to place the insurance risk with a DOFI not authorised under the Insurance Act.

To the extent that the Australian business or consumer used an AFSL holding intermediary to seek the exemption, the AFSL holding intermediary would continue to be subject to the existing Chapter 7 disclosure requirements (including Corporations Regulation 7.9.12) in the Corporations Act and, in addition, these disclosure requirements would be extended to include any Australian business or consumer that the AFSL holding intermediary sought an exemption under this limb on behalf of.

As a result, the business or individual could then choose to place their business with a DOFI not authorised under the Insurance Act. As a result of the exemption the DOFI with whom the business was placed would not be required to become authorised under the Insurance Act, and the AFSL holding intermediary would not be in breach of the Corporations Act in dealing with that business.

The exemption from having to be authorised would only extend to business in respect of that customised exemption. To the extent that an individual DOFI wrote other insurance business in Australia that was not exempt, the DOFI would need to be authorised under the Insurance Act.

It has been suggested that APRA, as the regulator of general insurers in Australia, should be the regulator exercising the discretion as they are more likely to have the necessary expertise to assess whether or not a particular risk can be covered through authorised insurers.

However, concerns have been raised that this would be blurring APRA's role and taking it away from APRA's core function of prudentially regulating the industry.

ASIC has been suggested as an alternative. ASIC already regulates AFSL holding intermediary, including insurance brokers. In a large number of cases brokers are likely to be the entity seeking the exemption under this limb on behalf of a client.

This option would ensure that the exemption was used as intended for the limited number of cases that did not fit under the first two limbs of the exemption, but where it could be established that a particular insurance risk could not be placed with an authorised insurer.

It would also be flexible to changes in the insurance market and the fluctuations in the insurance cycle, as the regulator would take these factors into account in exercising its discretion.

However, this approach raises issues as to whether this option could be sufficiently timely and practically workable given the reality of the insurance market (that is, that most insurance cover is negotiated within very tight timeframes during the peak insurance renewal periods of June and December) and the potential need for the regulator's decision to be reviewable.

In addition, having to apply to a regulator for an exemption may significantly increase the administration costs to Australian businesses and consumers in obtaining appropriate insurance cover and would impose an additional administration cost on the regulators.

#### **Question 7**

Should the criteria set out in the Insurance Regulations be varied to suit the regulator-based mechanism? If so, in what way should the criteria change?

What information would the regulator need to determine that a particular risk could not be appropriately placed with authorised insurers?

Is this approach practically workable, given how the insurance industry operates?

Do APRA or ASIC have sufficient capacity and expertise to implement this option?

Does this option provide sufficient disclosure and protection for Australian businesses and consumers who will need to access this limb of the exemption?

#### **Question 8**

Are there other matters or issues that should be addressed?

## ANNEX 1 — BACKGROUND

The question of whether to prudentially regulate DMFs and DOFIs arose within the context of the collapse of HIH Insurance Limited. The HIH Royal Commissioner recommended that the Australian Government amend the Insurance Act to extend prudential regulation to all discretionary insurance-like products – to the extent possible within constitutional limits. He also identified a potential regulatory gap that might allow offshore insurers, for example, an insurer who has been refused authorisation by APRA on prudential grounds and moved offshore, to issue insurance policies through an agent or broker in Australia in an attempt to avoid the operation of the Insurance Act.

In response to the HIH Royal Commissioner's report, the Government commissioned the 2004 Potts review to examine the extent and nature of DMFs and DOFIs operating in Australia and their contribution to overall market capacity. In May 2004, the Government accepted the Potts review recommendations.

Since then there has been a number of structural and cyclical changes to the Australian general insurance market, including sufficient time for the impact of the *Financial Services Reform Act 2001* to be observed, the reforms to tort law and a softening of the insurance market, to alter the impetus for regulation.

In December 2005, Treasury released a discussion paper seeking public input on proposals to implement the Potts review recommendations. Treasury received submissions from Australian general insurers, DOFIs, DMFs, captives, reinsurers, brokers and agents, state governments and regulators.

As a result of these submissions and the release of the Banks Taskforce report *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* on 7 April 2006, the Government announced the revised approach to regulating DMFs and DOFIs on 3 May 2007.