

## Chapter 2

### **Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007**

2.1 The Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 strengthens the requirement that anyone conducting a general insurance business in Australia must be authorised and regulated by Australian Prudential Regulation Authority (APRA). APRA will have the power to investigate insurance businesses where it has a reasonable belief they are not properly authorised, and to apply for a Federal Court injunction to stop an entity from acting illegally.

2.2 Discretionary Mutual Funds (DMFs), which provide risk management tools as an alternative to insurance, will not be subject to prudential regulatory oversight. However, the bill provides APRA with powers to monitor them and gather information about the nature and scope of their operations.

#### **Background**

2.3 DMFs and Direct Offshore Foreign Insurers (DOFIs) currently provide some level of insurance cover or insurance-like risk management in the Australian market.<sup>1</sup> However, they are not subject to the same level of prudential regulation by APRA as Australian authorised insurers.

2.4 DMFs offer 'discretionary cover' that is an insurance-like product often involving a contractual obligation on the DMF to consider a claim when a risk eventuates, but provides the DMF with discretion whether to pay the claim. DMFs provide a means of risk management that is an alternative to insurance. They sometimes meet risks for which insurance may be neither available nor affordable.

2.5 DMFs may be established as a corporation limited by guarantee or as a trust fund. They are subject to the broader regulatory requirements contained in legislation and under the common law. The Explanatory Memorandum (EM) outlines common features of DMF structures at pages 10-11.

2.6 DOFIs are foreign insurers that sell insurance to Australians either directly or via another person who is in Australia, such as an Australian financial services licence (AFSL) holder that is a general insurance agent or broker. DOFIs do not currently

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1 This section is taken from the Treasury discussion paper, *Regulation of Discretionary Mutual Funds and Direct Offshore Foreign Insurers*, December 2005, p. 1, viewed on 29 June 2007, at: [http://www.treasury.gov.au/documents/1041/PDF/RDMFDOFI\\_discussion\\_paper.pdf](http://www.treasury.gov.au/documents/1041/PDF/RDMFDOFI_discussion_paper.pdf)

need to be authorised in accordance with the Insurance Act because they are not considered to be carrying on insurance business in Australia.

### *Current regulation of DOFIs*

2.7 DOFIs may be subject to prudential and consumer regulation in their home jurisdiction. To the extent that they are carrying on a financial services business in Australia as defined under the Corporations Act, they are subject to consumer protection regulations in this country. They are required to hold an Australian Financial Services Licence (AFSL) and comply with the conditions of that licence, set out in Chapter 7 of the Corporations Act.

2.8 Under the Corporations Regulations, DOFIs must inform purchasers of particular insurance products (generally those aimed at retail clients) through their Product Disclosure Statement (PDS) that they are a foreign insurer and not prudentially regulated in Australia.

2.9 Currently only insurers carrying on insurance business in Australia are subject to the *Financial Sector (Collection of Data) Act 2001*. DOFIs that do not operate through such a structure are not subject to any information collection requirements on their activities in Australia.

### *The Potts Review*

2.10 On 12 September 2003, the Government commissioned the *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers* (the 'Potts Review') in response to a recommendation by the Hon. Justice Owen, HIH Royal Commissioner, that the Insurance Act be amended to extend prudential regulation to all discretionary insurance-like products, to the extent possible within constitutional limits.

2.11 The purpose of the review was to consider the appropriate level of prudential and consumer regulation for DMFs and DOFIs.<sup>2</sup> It found that there was no comprehensive industry or government information available on DMFs. However, from the limited information that was available, it estimated that DMFs only account for approximately 0.5 per cent of the general insurance market.

2.12 Further, in relation to DOFIs, the review found that the current regulatory treatment of foreign insurers operating in Australia lacked consistency.<sup>3</sup> Foreign insurers were treated in different ways depending on whether they were foreign insurers authorised by APRA operating in Australia, Lloyd's underwriters authorised under Section 93 of the Insurance Act, or DOFIs. This meant that the degree of protection afforded to Australian policyholders with similar insurance risks would vary depending on the country of origin of the insurer they selected.

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2 The Potts review reported to the Treasurer on 28 January 2004.

3 EM, pp 13-14.

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*Changes in the Bill that affect DMFs*

2.13 The EM comments that since the Potts Review, structural and cyclical changes to the Australian general insurance market have altered the impetus for regulation.<sup>4</sup> These changes include: tort law reforms, a softening of the insurance market and a greater understanding of the impact of the *Financial Services Reform Act 2001*.

2.14 As a result, and after ongoing industry consultation<sup>5</sup> since the Pott's Review, the Government decided that DMFs will not be subject to prudential regulation at this time. However, Schedule 1 of the Bill provides APRA with powers to monitor them and gather information on their role in the Australian general risk market. Twice a year, APRA will collect information on the risks DMFs are covering, the volume of business and any other information (for example, information on their structure) that the Government will require.<sup>6</sup> Additionally, the Government will amend the Corporations Regulations so as to collect information from Australian Financial Service Licence holders who promote or develop DMFs.<sup>7</sup> Once there is sufficient information, and within three years of the commencement of Schedule 1 of the Bill, the Government will conduct a review to determine whether it is appropriate to prudentially regulate DMFs.

*Are the changes to the regulations in the bill or is that a separate undertaking?*

2.15 In the meantime, the Government will strengthen the consumer protection provisions that apply to DMFs in dealing with both their wholesale and retail clients. It will amend the Corporations Regulations<sup>8</sup> to specify the information that a DMF must provide to its members before they join the fund, namely the mutual rights and obligations that flow from becoming a member of a DMF (including whether and to what extent they will be subject to a call), the discretionary nature of the product they are purchasing and how the rules governing their membership can be altered. ASIC and the Treasury, in consultation with the industry, will develop the exact form that this regulation will take.

*Changes in the Bill that affect DOFIs*

2.16 Schedule 2 of the Bill amends the Insurance Act to expand and clarify the existing definition of 'insurance business' to capture DOFIs that carry on insurance business in Australia, either directly or through the actions of another (for example, an insurance agent or broker). As a result, all DOFIs that fit within this expanded

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4 EM, p. 8.

5 EM, p. 59.

6 EM, p. 62.

7 EM, p. 62.

8 EM, p. 8.

definition will have to become authorised under the Insurance Act if they wish to carry on insurance business in Australia. As authorised general insurers, they will be required to comply with Australia's general insurance prudential standards. They will also be required to provide information to APRA under the *Financial Sector (Collection of Data) Act 2001*. All DOFIs that operate in Australia will thus be prudentially regulated by APRA, unless an exemption applies.

2.17 The Bill includes a mechanism to exempt risks that cannot be adequately insured by authorised insurers and allow them to be placed with insurers not authorised in Australia. It also includes powers to enable APRA to effectively enforce the expanded definition of 'insurance business' by allowing it to investigate the activities of persons it believes are carrying on insurance business in Australia without being authorised or persons aiding, abetting, counselling or procuring these activities. APRA will be able to seek an injunction from the Federal Court restricting unauthorised activity.

2.18 Schedule 2 of the Bill also amends the Corporations Act to prohibit Australian Financial Services Licence holders and authorised representatives from dealing in a general insurance product that is not from an authorised insurer, Lloyd's underwriter or where an exemption applies. An offence in breach of this new section 985D will be a strict liability offence. The EM states that this is considered necessary to maximise the defensive value of the new offence, thus maximising its role in complementing and reinforcing the regulation of general insurance.<sup>9</sup>

### **Amendment to support the Corporations (National Guarantee Fund Levies) Amendment Bill 2007**

2.19 Schedule 3 of the Bill makes a minor change to the note at subsection 889J(2) of the *Corporations Act 2001*. It supports the changes in the NGF Bill (see next chapter).

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9 EM, p. 31.