

The Senate

Standing Committee on Economics

Financial Sector Legislation Amendment
(Discretionary Mutual Funds and Direct
Offshore Foreign Insurers) Bill 2007 [Provisions]

Corporations (National Guarantee Fund
Levies) Amendment Bill 2007 [Provisions]

August 2007

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ISBN 978-0-642-71843-3

Printed by the Senate Printing Unit, Parliament House, Canberra.

Senate Standing Committee on Economics

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Chapter 1

Introduction

Background

1.1 The Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 and the Corporations (National Guarantee Fund Levies) Amendment Bill 2007 were introduced into the House of Representatives on 21 June 2007 by the Parliamentary Secretary to the Treasurer the Hon. Chris Pearce, MP.

1.2 On 21 June 2007, on the recommendation of the Selection of Bills Committee, the Senate referred the provisions of the bills to the Standing Committee on Economics for inquiry and report by 31 July 2007.¹

Conduct of the inquiry

1.3 The committee advertised the inquiry in the *Australian* newspaper on 27 June 2007 and invited written submissions by 9 July 2007. Details of the inquiry were placed on the committee's website. The committee also wrote to a number of organisations and stakeholder groups inviting written submissions.

1.4 The committee received eight submissions. These are listed in Appendix 1. A public hearing was held in Melbourne on Friday 27 July 2007. Treasury gave evidence via teleconference and addressed the concerns raised in the submissions.

Acknowledgments

1.5 The committee thanks all those who contributed to its inquiry by preparing written submissions. Their work has been of considerable value to the committee.

Background to the bill

1.6 The Bill implements the approach to the regulation of Discretionary Mutual Funds (DMFs) and Direct Offshore Foreign Insurers (DOFIs) announced by the Minister for Revenue and Assistant Treasurer on 3 May 2007. DOFIs will be prudentially regulated under the Insurance Act. DMFs will not be prudentially regulated but information will be collected to determine the nature and scope of their operations.²

1 Selection of Bills Committee, *Report No. 11 of 2007*, dated 21 June 2007.

2 Explanatory Memorandum (EM), p. 1.

1.7 It addresses an outstanding HIH Royal Commissioner's recommendation and a regulatory gap identified in the International Monetary Fund's 2006 Financial Sector Assessment Programme for Australia, and makes a minor amendment to support changes made by the Corporations (National Guarantee Fund Levies) Amendment Bill 2007. This complementary Bill will impose a cap on levies payable.³

Outline of the bill

1.8 The Bill is structured into three Schedules.

- (a) Schedule 1 – 'Amendments commencing on Royal Assent' – introduces amendment relating to the proposed monitoring of Discretionary Mutual Funds;
- (b) Schedule 2– 'Amendments commencing on 1 July 2008' – introduces provisions relating to the proposed regulation of DOFIs and their supervision by the Australian Prudential Regulation Authority (APRA); and
- (c) Schedule 3 – 'Amendments commencing on the 28th day after the day on which this Act receives the Royal Assent' – introduces the amendment to the Corporations Act 2001 which caps the levy payable under the Corporations (National Guarantee Fund Levies) Amendment Bill 2001.

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.¹ 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

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

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.² 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.³ 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.

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

3 EM, pp 13-14.

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.⁴ 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 consultation⁵ 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.⁶ Additionally, the Government will amend the Corporations Regulations so as to collect information from Australian Financial Service Licence holders who promote or develop DMFs.⁷ 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 Regulations⁸ 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

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.⁹

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).

9 EM, p. 31.

Chapter 3

Corporations (National Guarantee Fund Levies) Amendment Bill 2007

Overview

3.1 The Corporations (National Guarantee Fund Levies) Amendment Bill 2007 imposes a cap on levies payable to the National Guarantee Fund (NGF) in any financial year, equal to the minimum amount of the NGF.

Background

3.2 The National Guarantee Fund (NGF) is the compensation scheme, generally for the protection of retail clients, of the Australian Securities Exchange (the ASX). It is administered by the Securities Exchanges Guarantee Corporation (SEGC), a subsidiary of the ASX, which holds the assets of the NGF on trust.

3.3 The NGF was formed when the six State stock exchanges merged in 1987 to form the national ASX and the assets of the fidelity funds of those State exchanges were also merged to form the NGF. Up until March 2005, the SEGC provided investor compensation and clearing and settlement support in the circumstances set out in Part 7.5 of the Corporations Act. However, on 31 March 2005, the NGF was split by a payment from it to Australian Clearing House Limited (ACH) which then assumed sole responsibility for clearing counterparty risk. As a result, the NGF now only covers investor compensation.

3.4 As at 30 June 2006, the NGF holds \$96.8 million and its major source of funding is investment income. It is not government funded. The Corporations Act sets a minimum amount (currently \$76 million) that must be held in the fund.¹ If the fund falls below this amount the SEGC currently has the discretion to levy participants and the market operator (the ASX) without any cap on annual payments.

3.5 The Bill amends the *Corporations (National Guarantee Fund Levies) Act 2001*. It imposes a cap on the levies payable in a financial year. All levies imposed in a financial year must not in total exceed the minimum amount that is in force at the date a levy determination is made by the SEGC. The existing SEGC discretion to decide who is levied (the ASX and/or market participants), and how the amount of a levy is calculated, is not changed by the Bill.

1 Section 889I of the Corporations Act sets \$80 million as the minimum amount, but this was altered to \$76 million by SEGC determination under subsection 889I(2) on 31 March 2005.

Chapter 4

Issues

Introduction

4.1 The Committee received eight submissions, most of which focussed on the exemption provision on Direct Offshore Foreign Insurers (DOFIs). Before reviewing the debates on that issue, there will be a short overview of the submissions which focussed on other aspects of the Bill and on the complementary Corporations (National Guarantee Fund Levies) Amendment Bill 2007.

Corporations (National Guarantee Fund Levies) Amendment Bill 2007

4.2 The Committee received two submissions on the Corporations (National Guarantee Fund Levies) Amendment Bill 2007. Both the Australian Financial Markets Association (AFMA) (submission 4) and the Australian Securities Exchange (submission 8) supported the Bill's introduction.

4.3 The AFMA commented that the amendments:

...would leave the regulatory protection afforded to securities investors materially unaffected but it would increase the potential for competition and efficiency, improved delivery of services and enhanced financial stability.¹

4.4 The Australian Securities Exchange strongly supported the Bill.

ASX believes that the imposition of a cap on the levies payable by exchanges and their participants in any one year offers the potential to allow the National Guarantee Fund (NGF) to attract a wider range of, well-capitalised, institutions to consider direct participation in ASX markets and associated clearing facilities.²

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

4.5 The remaining six submissions essentially focussed on the legislation pertaining to Direct Offshore Foreign Insurers (DOFIs) and its exemption provisions.

4.6 While most of the six submissions provided in principle support for the Bill,³ the Law Council of Australia, and the Association of Consulting Engineers Australia (ACEA) were more judicious. ACEA expressed concern about the impact of the Bill

1 Australian Financial Markets Association (AFMA), *Submission 4*, p. 1.

2 Australian Securities Exchange, *Submission 8*, p. 1.

3 Underwriting Agencies Council (UAC), *Submission 1*, p. 3; and Insurance Council of Australia (ICA), *Submission 2*, p. 1.

on the consulting engineering industry's ability to obtain adequate levels of professional indemnity insurance.⁴

4.7 The Law Council expressed their 'considerable concern' over the regulation of both Discretionary Mutual Funds (DMFs) and DOFIs.⁵ Although DMFs were included in the Law Council's concerns, their correspondence essentially focussed on the same concerns as the remaining submissions; the access of Australian companies to DOFIs and the lack of information regarding the exemption provisions provided in the Bill.

Concerns over the DOFI provisions

4.8 The concern expressed by all six submissions is essentially that should DOFIs effectively be precluded from the Australian market through stringent provisions and limited exemptions, then Australian companies will lose access to essential insurance products which can only be supplied at a competitive price by DOFIs due to their much larger economies of scale, and spread of risk that such international insurers can access.

4.9 ACEA commented:

...that the proposal in the DOFI Bill will be detrimental for consumers because decreased competition from DOFIs coupled with the requirement to buy locally means that insurers are less likely to provide cover at commercially competitive rates or to insure an adequate range of risks, because they have a captive market. Even if local insurers do attempt to manage larger and more complex risks, previously insured overseas, they will look to spread that risk by increasing the cost of premiums.⁶

4.10 The National Insurance Brokers Association (NIBA) gives in principle support to the Bill, agreeing that stronger regulation of insurers is needed.⁷ However, they share the same concerns as ACEA:

Access to global markets is important for Australian larger businesses. They provide these businesses with consistency of cover particularly for more complex risks and in a hard market cycle are often the only markets offering meaningful cover.

The proposed approach in the Bill is unlikely to result in many... global market participants seeking local authorisation. Such global players are simply not interested in placing risks in particular country silos or adding another layer of compliance costs and red tape to their businesses.⁸

4 Association of Consulting Engineers Australia (ACEA), *Submission 5*, p. 3.

5 Law Council of Australia, *Submission 7*, p. 2

6 ACEA, *Submission 5*, p. 3.

7 National Insurance Brokers Association (NIBA), *Submission 6*, p. 3.

8 NIBA, *Submission 6*, p. 4.

4.11 The Law Council of Australia supports these arguments, and also argues that the DOFIs are more resilient in the face of global financial upheavals due to their larger size compared with Australian insurers.⁹

4.12 The Bill provides for DOFI exemptions – such as Lloyd's of London – but does not clarify under what criteria these exemptions are given, and it is a clarification of these criteria that a number of submissions seek.¹⁰

4.13 A number of submissions also noted the Bill's deviation from the recommendations of the 'Potts Review'¹¹ and suggested that the recommendations made by the Review should be adopted within the Bill, rather than the current proposed provisions.¹²

Treasury response

4.14 Treasury officials provided evidence at the Melbourne hearing on 27 July 2007 via teleconference. The officials advised the Committee that Treasury had consulted widely with stakeholders, including those organisations which had lodged submissions to the inquiry.

4.15 Treasury is planning the release of a discussion paper on the planned exemptions in August 2007 for further comment and input by stakeholders, with the intention of publishing an exposure draft setting out the insurance regulations for the exemptions in late 2007, or early 2008 for finalisation in early 2008. Treasury advised the Committee that it is aiming to achieve a balance through a set of exemptions that are practical, flexible in terms of the insurance market cycle, minimise cost to government of administration, as well as minimise costs to customers while still maintaining prudential standards.¹³

4.16 Officials said that Treasury aims to create arrangements so that Australian companies can still access suitable insurance cover from DOFIs should Australian insurers be unable to deliver the required cover at competitive rates. Their aim is to structure exemptions so as not to discourage large and reputable DOFIs from entering the Australian market, while at the same time not discouraging Australian insurers from producing domestic insurance products that can compete with those of the DOFIs.¹⁴

9 Law Council of Australia, *Submission 7*, p. 5.

10 UAC, *Submission 1*, p. 3; ICA, *Submission 2*, pp 1-2.; NIBA, *Submission 6*, p. 3.

11 On 12 September 2003, the Government commissioned the *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers* known as the 'Potts Review'.
<http://www.treasurer.gov.au/pcd/content/pressreleases/2007/042.asp> accessed 16 July 2007.

12 NIBA, *Submission 6*, p. 6; ACEA, *Submission 5*, p. 9.

13 Treasury, *Proof Committee Hansard*, 27 July 2007, p. 53.

14 Treasury, *Proof Committee Hansard*, 27 July 2007, pp 53-54.

Committee conclusions

4.17 The Committee, having heard the concerns expressed in the submissions, is satisfied that the consultative mechanism to be implemented by Treasury with regard to DOFI exemptions will produce a set of regulatory provisions that will satisfy the requirements of Australian businesses for access to suitable insurance products, while still maintaining the required prudential standards for the insurance industry. The Committee supports the closure of regulatory gaps identified by the HIH Royal Commission, and the International Monetary Fund. The Committee does not share the fears expressed by some witnesses as to possible significant negative market effects from changes to regulation. Nonetheless, Treasury and APRA should actively monitor market effects to be certain of this.

Recommendation 1

4.18 The committee recommends that the bill be passed.

A handwritten signature in blue ink, consisting of a large, sweeping initial 'M' followed by a series of connected, fluid strokes that end in a small dot.

**Senator the Hon. Michael Ronaldson
Chair**

APPENDIX 1

Submissions Received

**Submission
Number**

Submitter

- | | |
|---|--|
| 1 | Underwriting Agencies Council (UAC) |
| 2 | Insurance Council of Australia |
| 3 | Confidential |
| 4 | Australian Financial Markets Association (AFMA) |
| 5 | Association of Consulting Engineers Australia (ACEA) |
| 6 | National Insurance Brokers Association (NIBA) |
| 7 | Law Council of Australia |

APPENDIX 2

Public Hearing and Witnesses

Friday, 27 July 2007 – Melbourne

KLJAKOVIC, Ms Marion, Manager, Marketing Integrity Unit
Department of the Treasury

LEGG, Mr Chris, General Manager
Department of the Treasury

LYON, Mr Christopher, Senior Advisor
Department of the Treasury

RUECKERT, Ms Michelle, Policy Analyst
Department of the Treasury

