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Dear Mr Trowbridge and Ms Wilkinson,

REGULATION OF DIRECT OFFSHORE FOREIGN INSURERS (DOFIS)

Following the release of the Government's decision on prudential regulation of DOFIs and DMFs by the Assistant Treasurer and Minister for Revenue on 3 May 2007 and the subsequent industry briefing on 14 May by Treasury, APRA and ASIC, the Insurance Council of Australia¹ (the Insurance Council) was asked to comment on aspects of the new regime. In particular, the mechanism by which the exemption would be exercised and the categories of insurer to which prudential regulation applied. We understand that this input will be used to develop a consultation paper which will be issued towards the end of June 2007.

The Insurance Council appreciates the consultative approach taken by both APRA and Treasury and looks forward to close co-operation as the means are developed and then put in place to implement the Government's decision on prudential regulation of DOFIs.

The Basis for Regulation of Insurance

We note from Minister Dutton's media release that the Government intends to amend the Insurance Act "so that anyone carrying on business in Australia, either directly or through the

¹ The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. 2007 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross premium revenue of \$28.2 billion per annum and has assets of \$82.2 billion. The industry employs approx 60,000 people and on average pays out about \$70 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, commercial property, and directors and officers insurance).

actions of another, must become an authorised insurer". The Government will have carefully considered the implications of choosing this approach as the basis for prudential regulation of insurance. However, it does have potential for serious adverse consequences such as allowing an Australian corporation or captive to travel to another jurisdiction and conclude its insurance placements in that jurisdiction with a non authorised carrier or through an intermediary offshore. It would also have extra territorial implications for cover taken out in Australia for offshore risks.

In its submissions to the HIH Royal Commission and its response of March 2006 to the Treasury discussion paper on regulation of DOFIs and DMFs, the Insurance Council recommended that, rather than attempting to define what is 'marketing' and further complicating the definition of 'carrying on business', the Insurance Act should be amended to remove the ambiguities and ensure that as a starting point all insurance of risks situated in Australia are regulated. Once this base position is established, it would be easier to define particular exemptions.

Defining the scope of regulation in terms of risk within a jurisdiction is the approach taken in most other Australian legislation regarding insurance including the Terrorism Insurance Act 2003, the federal Life Insurance Act 1995 and the legislation governing medical indemnity. It is also the approach taken in many international jurisdictions, including the United States and Canada.

The Insurance Council would be pleased to discuss the feasibility of a regime regulating the insurance of risks situated in Australia.

Preliminary Nature of Comments

The Insurance Council position is based on the fact that the Australian insurance industry is highly capitalised and backed by a strong reinsurance sector. It has the capacity to cover most risks offered to it. The role of Lloyds in the Australian market must also be considered. Consequently, there will be only limited exemptions needed to ensure the requirements of Australian insureds are met.

Should the Government proceed with its initial proposal to prudentially regulate insurance on the basis of "carrying on insurance business", there are significant details of the proposed regulatory regime that are undecided, or remain unclear. Important definitional issues exist, for example around:

- Australian residents insuring risks situated in Australia;
- Australian residents insuring property situated outside Australia; and
- non residents insuring risks situated in Australia.

Therefore the following comments should be regarded as considered input to the consultative process, rather than as final Insurance Council positions. There are many complex issues of policy and practical administration, such as the need for transitional arrangements, which must be thoroughly examined. The Insurance Council looks forward to having time to respond comprehensively to the consultation paper when it is released.

Furthermore, there are wider issues which need to be considered in relation to foreign insurers. For example, the need for insureds and brokers to disclose an offshore placement of insurance so that liability for Australian Commonwealth and State taxes, levies and duties can be properly policed and appropriate taxes collected. Also, whether in order to facilitate the international operation of the Australian insurance industry, an exemption mechanism

should also preclude the placing of insurance in Australia by an insurer domiciled in a jurisdiction which prohibits the insurance of risks by Australian domiciled insurers, for example many major European and South East Asian countries.

The Exemption Mechanism

It is understood that Treasury is considering several options for allowing exemptions, including:

- Certain kinds of insureds. For example, large corporates that have the means and the expertise to go directly to offshore markets, with the exemption applying to insureds above a particular turnover or a premium above a certain amount.
- Insureds that arrange complex programs, consisting of several layers and placed with several insurers.
- Lines of business that cannot be placed in Australia. The example of insuring the storage and transportation of nuclear waste has been given.

It appears that thinking thus far has been focussed on exempting certain kinds of risk and insured, rather than exempting particular insurers. The Insurance Council generally endorses this approach. Another option along these lines is exemption of a particular class of risk on a case by case basis.

The Australian insurance industry is highly capitalised, is backed by a strong reinsurance sector (both within Australia and overseas) and, we submit, has the capacity to cover most risks offered to it. This is particularly the case when the role of Lloyds in the Australian market is considered. It is acknowledged that a number of larger risks do go offshore but in many instances this is a historical practice and these risks are offered first directly to the overseas insurers. Therefore the Insurance Council believes that exemptions should be minimal and only where there is a demonstrated inability of Australian insurers to provide cover.

In order to clarify thinking around the viability of the options for exemption mechanisms, the following paragraphs explore the advantages and disadvantages which the Insurance Council sees in each.

Exemption for the "big end of town"

The basis for the Government's decision to prudentially regulate DOFIs is the protection of Australian policyholders and competitive neutrality between Australian and foreign insurers. Therefore there is no policy basis to provide a standing exemption for businesses by reason of their size only, whether judged on turnover or amount of premium to be paid. The size of a business does not correlate with having complex or hard to place insurance needs. Smaller niche companies often have complex and diverse insurance needs.

In practical terms, a "big end of town" exemption would be complex to administer as it would need to make allowances for those organisations that over time newly meet, or no longer meet, the exemption criteria and how this would affect their insurance purchase arrangements

Exemption for complex programs

The Insurance Council recognises that large businesses may require complex, layered programs of insurance. However, as argued above, size of the insurance needed to be

placed does not offer sufficient reason for in-principle exemption. It may be that there are components of a program on occasion which cannot be placed in Australia either because of unavailability of cover for that particular class of risk or because capacity has been exhausted. In this case, an exemption could be sought or advantage taken of a limited number of existing class of risk exemptions (see below).

Case by case exemption

With the focus being on the availability of cover, there is logic in a case by case exemption mechanism, with each application for an exemption having to demonstrate that a particular type of insurance cover is unavailable in Australia. However, administration of this process would be resource intensive for the regulator (whether APRA or ASIC), involving the examination of the evidence of unavailability in terms of capacity or price. This would be on top of already onerous responsibilities and likely to involve decisions outside their field of expertise.

Large insurance risks are often cyclical in nature and across the Australian industry the 30 June and 31 December renewals are particular busy. It is doubtful that any regulator would be able to manage the workflow at these peak dates when they could be required to respond to a high number of proposals within a short timeframe. In a worse case scenario, any delay could expose the insured to being left without insurance cover.

The exemption process would also require a review mechanism which would add time, cost and complexity to the process.

Given the difficulties of the case by case approach, the Insurance Council considers that it should not be the principal exemption mechanism. While ad hoc exemptions should remain possible, to cater for temporary situations, a number of limited exemptions for classes of risk is the most practical option.

Limited exemptions for classes of risk

As explained above, the Insurance Council considers that a number of exemptions are probably necessary in relation to particular classes of insurance that are demonstrated to be difficult to place in Australia. While allowing for an ongoing mechanism, these could be determined before commencement of the regulatory changes on 1 July 2008 and would result from applications by those wanting to benefit from the exemption.

The Insurance Council does not believe that it is appropriate to propose particular classes which should, on the face of it, be exempt. Insurance Council members want the chance to compete for this business before it is taken offshore. Given the strong insurance industry which exists in Australia, the Insurance Council considers that an extensive list of exemptions will not be necessary. Even the often used example of storage and transportation of radioactive material could now be covered by a number of Insurance Council members.

A narrow exemption is likely to be required for global policies where the Australian risk is merely incidental to the global cover being provided such as group travel and marine. Also, an exemption would be needed for the situation where an Australian registered entity places a global policy, for example world wide property coverage, and use of a local insurer for risks located in that country is required.

It is essential that the Insurance Council be involved with the detailed design of the exemption process, for example how unavailability of cover is to be proven and whether price should be considered. There are strong arguments that applying a comparative costing mechanism may be impracticable and only exacerbate underpricing and undercutting which occurs on a cyclical basis, introducing harmful volatility to the Australian market. Price does not take into account the coverage being provided nor the prudential risk of placing cover with an unauthorised insurer.

All exemptions should have a “sunset clause” so that they expire after a set period unless unavailability of cover can be again proven. The duration of an exemption should strike a balance between certainty for those benefiting from it and recognition that the insurance market is very dynamic. This is a question which needs to be determined after close consultation between affected stakeholders.

Regulator

Given its central role in prudential regulation, the Insurance Council strongly considers that APRA is the proper body to administer the exemption mechanism. ASIC’s role in supervising Australian Financial Service Licensees that only deal in products from authorised insurers unless an exemption applies is not as directly relevant.

However, while it may be advisable that APRA check that the foreign insurer is prudentially regulated, the Insurance Council does not envisage that APRA would evaluate the strength of prudential regulation in the foreign insurer’s home jurisdiction. This would be difficult and onerous to do properly and the insureds likely to want to access foreign insurance would be able to make their own judgements about the risks they are taking.

Differentiation of Prudential Standards

The Insurance Council has also been asked for input on the classification of insurers for the purposes of differentiating prudential requirements in line with risk. APRA has indicated that an approach based on a matrix built up of categories of insurer and aspects of regulation would be favoured. DOFIs, apart from those benefiting from an exemption, would be required to become authorised and having done so, would fit in to one of the agreed categories. It may be that an exemption is subject to conditions to be supervised by APRA which would raise the question of whether the foreign insurer benefiting from the exemption should be added to the regulatory matrix.

The Insurance Council understands that APRA has identified seven different categories:

- locally incorporated insurer
- wholly owned subsidiary of a local or foreign insurer
- branch of a foreign insurer
- lenders mortgage insurer
- captive with a sole corporate parent
- captive – owned by a partnership
- captive – owned by an association.

The Insurance Council considers that these groupings are satisfactory to be used as the basis for discussion in the APRA consultation paper. However, further consideration of the practical consequences of differentiation may indicate that more or fewer groupings may be a better option. While there are likely to be benefits from being able to apply prudential standards with a different emphasis depending on the category of insurer, there may be disadvantages in making prudential standards more complex as, for example, certain paragraphs do not apply to particular categories of insurer.

Please do not hesitate to contact John Anning, General Manager Policy, Regulation Directorate, on (02) 9253 5121 or janning@insurancecouncil.com.au, if you have any questions or comments in regard to this submission.

Yours sincerely



Kerrie Kelly
Executive Director & CEO