Inquiry into the Provisions of the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007

Submission to Senate Economics Committee

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Executive Summary

1. The regulation of discretionary mutual funds ("DMFs") and Direct Offshore Foreign Insurers ("DOFIs") remains a matter of considerable concern for the Law Council of Australia's constituent bodies. Our constituent bodies comprise the Large Law Firm Group (through LLFG Limited), state and territory law societies and bar associations, all of which are more fully identified at **Attachment A** to this submission.

2. In his second reading speech, the Parliamentary Secretary to the Treasurer declared the objects of the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007("Bill"), include the protection of Australian consumers and businesses; the promotion of new entrants into the Australian General Insurance market to stimulate competition and innovation and the desire not to unduly restrict market capacity.

3. It is the Law Council's view that care must be exercised in balancing the interests of Australian insurance providers, the Australian economy and consumers generally with the need for particular consumers to be able to access the wider world insurance markets.

4. The Law Council supports the development of regulations that appropriately recognise the need for 'exemptions' to allow larger and sophisticated Australian insurance consumers, with risks that cannot appropriately or conveniently be placed with an authorised insurer in Australia, to secure insurance offshore.

5. Large professional service firms are by the nature of their activities required to carry significant insurance to cover their legitimate business and commercial exposures. Under existing arrangements, a number of large law firms purchase insurance from specialist DOFIs. Further, captive insurers are used in the legal profession to provide compulsory professional indemnity insurance to lawyers practising within Australian jurisdictions.

6. Our constituent members choose to purchase insurance from DOFIs for a range of efficiency directed and commercially valid reasons. Uppermost amongst them is that equivalent local cover is either not available in Australia or not available on comparable terms or at a competitive price.

7. Left un-exempted, such DOFI arrangements would, pursuant to the proposed legislation, adversely impact on the business of some members of our constituency and ultimately their clients. Indeed were the proposed legislation implemented, DOFIs may cease or limit the cover they offer. The consequences of this are that in terms of equivalent coverage and price, a comparable Australian product may not be available. The value of the long-standing existing relationships with DOFIs would also be lost. It is of course imperative that the bodies concerned continue to obtain high levels of cover in order to:

    - meet the expectations of clients;
    - be able to compete locally and globally; and
    - adequately protect the interests of partners of firms.

8. Accordingly the Law Council's submissions are that its members' DOFI arrangements should be exempted under the framework proposed by the Bill.

Background

9. Within the context of the HIH Insurance Limited collapse, the HIH Royal Commission considered some of the issues relating to DMFs and DOFIs.

10. Noting that DOFIs are not subject to the provisions of the *Insurance Act* 1973, Justice Owen made observations the essence of which is as follows:

    - It is in many instances unnecessary to regulate insurance written offshore because it involves large commercial insurance contracts where a purchaser is well able to judge the transactional risks involved.

    - The *Insurance (Agents and Brokers) Act* 1984[1] provided for a number of disclosure requirements. In any event an offshore insurer operating through an Australian agent or broker may, depending on individual circumstances, be 'carrying on insurance business in Australia' within the meaning of that test /phrase at sections 9 or 10 of the Insurance Act. In short those Australian entities may insure risks in Australia with offshore foreign insurers that are not authorised under the Insurance Act.

11. The Royal Commissioner made no recommendation regarding the regulation of DOFIs.

12. In response to the HIH Royal Commission Report, the Government commissioned the Potts review to examine the extent and nature of DMFs and DOFIs operating in Australia and their contribution to overall risk capacity. In May 2004, the Government accepted the Potts review recommendations.

Beyond the Potts Review

13. Treasury's 2005 paper entitled 'Key Findings of the Review of Discretionary Mutual Funds *and Direct Offshore Foreign Insurers'* made the following pertinent observations:

    'DOFIs represent only a small part of the general insurance market in Australia (about 2-1/2 per cent) but provide important additional capacity in specialised insurance lines. They operate largely out of comparable regulatory jurisdictions, and much of the business written is for large corporate entities less likely to require prudential regulatory protection—for example in wholesale markets…At the retail and smaller corporate level, DOFIs have been filling the gaps in the long tail market in response to the withdrawal of domestic capacity. DOFIs also enjoy significant tax advantages (largely not being subject to stamp duties), especially in some insurance classes, over Australian authorised insurers, which are reflected in lower business costs for Australian companies.'

14. Treasury referred to the desire to avoid prohibiting commercial arrangements that have worked satisfactorily to date. In respect of Review Options 1 and 2, that 'DOFIs operating as captive insurers…pose little threat to retail policyholders…'

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[1] The *Insurance (Agents and Brokers) Act* 1984 in this sense has been replaced by amendments made by the *Financial Services Reform Act* 2001 to the *Corporations Act* 2001.

15. The HIH Royal Commission, Potts Review and indeed Treasury's 2005 Discussion Paper maintain no necessity exists to regulate the captive insurer of an Australian parent regardless of whether the insurance is situated on or offshore.

16. The Australian general insurance industry has undergone organisational and cyclical change since the Potts review. Some of the drivers of these changes include a more profound understanding of the impact of the *Financial Services Reform Act* 2001, tort law reform and a softening of the insurance market environment, all of which have dampened the need for response.

17. The Explanatory Memorandum to the Bill mentions the Government's desire to depart the Potts review recommendations.[2] This is given to be a result of submissions to Treasury's 2005 Discussion Paper and the release of the Banking Industry Taskforce report *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*.

18. In March 2006 the Law Council made a submission to Treasury's Financial Services Division on the *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers*. The substance of the Law Council's 2006 submission remains relevant to these submissions.

Issues

General observations

19. The Bill will amend the *Insurance Act* 1973 to expand and clarify the definition of 'insurance business'. The expanded definition captures DOFIs that carry on business in Australia, either directly or through the actions of another and requires that they become authorised and prudentially regulated by APRA.

20. The Bill includes a mechanism to exempt from the new regime risks that cannot be adequately insured by 'authorised' insurers (through the creation of limited exemptions in the regulations).

21. The Law Council supports a regime aimed at the protection of unsophisticated consumers of insurance. However, the proposed legislation will predominantly affect the insurance interests of sophisticated purchasers who are 'well able to judge the transactional risks involved'"[3]. Given that Treasury's 2005 paper highlighted that '[DOFIs] operate largely out of comparable regulatory jurisdictions', unsophisticated consumers will primarily only be at risk where there exists a gap between APRA's regulatory requirements and those of overseas jurisdictions not subject to comparable regulatory regimes. It is difficult to predict the extent to which DOFIs will be willing to become compliant with more than one regulatory regime by taking up the option to become 'authorised'. If they choose to not become APRA authorised, then the effect of the Bill will be to benefit local insurers (who are set to pick up the business written through DOFIs prior to the Bill's enactment) while disadvantaging Australian sophisticated consumers.

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[2] Explanatory Memorandum to the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 page 47.

[3] HIH Royal Commission following on from recommendation 42 per Justice Owen remarking about insurance written offshore. This statement is reproduced at page 2 of the Treasury's 2005 Paper entitled *Key Findings of the Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers*

22. The Law Council is concerned that the Bill will have an unnecessarily disruptive effect on the insurance markets and its members. It is an effect likely to become even more pronounced upon a return to a hard market cycle. DOFIs are able to offer cover of greater scope and specialisation particularly around more complex risks and are by their global nature less susceptible to cyclic vicissitudes than are local insurers.

23. The specific exemption arrangements proposed by the Bill will add to the industry's bureaucratic compliance burden and will unjustifiably lead to an increase in administration costs. In this regard, the regime proposed by the Bill is at odds with Government's approach to financial services industry reform and its oft stated desire to streamline business by reducing red tape and minimising costs.

24. DOFIs who do not seek local authorisation may cease to make their products available. This will have an anti-competitive effect caused by the loss of diversity in the market place and is inconsistent with the ambition that '…Australian businesses remain internationally competitive…'[4]

25. To bring the captives of Australian businesses under prudential regulation as proposed by the Bill can only raise costs for the insuring public without any meaningful increase to its protection.

Existing arrangements

26. It is a legislative requirement in all States and Territories pursuant to legal profession legislation that Australian legal practitioners carry professional indemnity insurance. One Law Council constituent body member law society is the sole shareholder of a special purpose subsidiary which is a captive insurer based offshore. The captive is, pursuant to the foreign jurisdiction's regulatory arrangements, subject to a regime of oversight comparable to that exercised by APRA over local insurers. The captive insurer provides compulsory professional indemnity insurance to lawyers practising within that law society's state.

27. Presently, the minimum level of cover must be for least $1.5 million for each and every claim. The adequacy and appropriateness of the minimum terms of professional indemnity insurance is carefully monitored and prescribed by Professional Standards Councils pursuant to professional standards legislation enacted in every Australian jurisdiction. Also, the Attorney-General in each jurisdiction annually reviews, assesses and approves the policies for professional indemnity insurance by reference to claims data and standards.

28. Beyond this compulsory layer, however, many firms also purchase "top up" insurance cover. Such cover is often purchased from DOFIs, based on each firm's particular insurance needs.

29. Larger Australian law firms tend to source cover from specialist markets not replicated or competitively available in Australia, using the skills of specialist local and overseas insurance brokers and agents. For example DOFIs provide insurance in specialised areas such as public liability insurance, directors and officers insurance and property insurance. In some instances large law firms are required by their clients or interests in overseas jurisdictions to obtain insurance for

[4] Treasury's Press Release entitled *Enhancing the Integrity of Insurance in Australia* contains this quote by Mr Dutton, Minister for Revenue and Assistant Treasurer

certain risks relating to that jurisdiction with a local DOFI. These arrangements have worked well as most foreign insurers are already supervised by regulators of comparable standing to APRA.

30. Sophisticated insurance purchasers such as large law firms are well placed to assess the security of their insurance underwriters, including any rating of the underwriter allocated by AM Best, Moody's, Fitch Worldwide or Standard and Poor's or equivalent rating agencies. The major brokers generally have security committees which provide a sophisticated and extensive review of insurers.

Impact of the Bill

31. The Law Council repeats the concern of its large law firm members that the Bill as proposed (absent an appropriate exemption) will unnecessarily impact on those members' ability as sophisticated purchasers to deploy the specialist skills of qualified Australian insurance brokers in circumstances where it is appropriate to do so.

32. Our members' principal concern arises from Government's intention to treat those foreign insurers (not reinsurers) operating from foreign jurisdictions as carrying on insurance business in Australia and require them to be subject to APRA regulation (with attendant costs) if they *underwrite the business overseas* and:

    - the insurance business, including any incidental business, is obtained through a person acting as an insurance broker in Australia as agent of the insured. The Bill appears to provide that the involvement of the broker in the transaction deems the insurer to be carrying on business in Australia. It is not clear what level of broker involvement will be sufficient to trigger the provision. The proposed Corporations Act prohibition on Australian Financial Services Licensees "dealing" in DOFI products may be inconsistent with the Insurance Act provision which appears to have broader operation.

    - the insurer has a web site or other publications made available to Australian insureds (without making direct contact using lists etc). The Bill and Explanatory Memorandum suggest that such insurers carry on insurance business in Australia because they carry on this "incidental business" in Australia.

33. The above is likely to catch most of the DOFIs currently providing insurance skills and capacity to the large law firms.

34. It is unclear under the proposed definition of "insurance business":

    - whether an insurer is caught by undertaking the liability in Australia (i.e. enter into the contract here directly or through an agent or broker); or

    - who can be caught if they underwrite it overseas but carry on incidental business in Australia (e.g. inducing a person here to apply).

35. The Explanatory Memorandum suggests the intent is the latter but it would be helpful for the intent to be clarified.

36. The Explanatory Memorandum indicates only pre- and not post-contractual activities, such as claim handling, will be caught within the concept of incidental business and the law firms support this approach.

37. It is also noted that the deeming provision in the proposed section 3(7) of the *Insurance Act* 1973 is unclear and may well go further than Section 2.30 of the Explanatory Memorandum suggests is intended.

38. It has been assumed that the definition of insurance business is only intended to apply to the entity underwriting the insurance business which carries on the business incidental to this (whether it is done directly by them or through an agent). This would mean that a person who does not act for the insurer in providing incidental services (e.g. bringing someone's attention to the existence of a foreign insurer without payment for this service) will not be caught. A clarification of whether or not this is the intention would be helpful as this can create additional complications.

39. The Bill will increase costs for DOFIs. DOFIs not presently subject to the requirements of the *Insurance Act* 1973 will incur significant costs ensuring that their arrangements are not caught to come within the proposed regime. Where their practices do bring them within the scope of the Bill's regime, DOFIs will face costs in ensuring their compliance with the new requirements.

40. For example DOFIs underwriting business risks overseas would need to ensure their web site content does not offer inducement to Australian insureds. If they did, they would come within the proposed regime.

41. It is difficult to estimate what may be the cost to DOFIs of complying with the proposed Australian requirements as this is likely to vary. However, where the DOFI has already organised its capital and investment strategy and its systems and procedures in compliance with its own regulatory requirements, any changes required to comply with Australia law would be likely to be significant. This is likely to deter many DOFIs from writing insurance cover with the law firms unless an appropriate exemption is provided.

Likely detriment

42. The Law Council believes than the loss of access to DOFIs would have the following effects:

- Reduce access to global markets that offer diversity, specialisation of products and consistency of cover across market cycles. Such markets also allow sophisticated consumers to develop risk analysis and management skills required to transact globally;

- Historically, during full hard insurance market cycles the range, breadth, depth and complexity of cover is withdrawn from the local market. Access to DOFIs allows firms to secure meaningful cover from global insurers less adversely affected by the market cycle than local insurers;

- Local cover would in an environment of reduced competition become more expensive. The presence of overseas insurers in the market place increases the competitiveness and efficiency of local insurers;

- Comparable insurance cover is often unavailable in the local market because of the absence of specialist underwriting skills, breadth of policy wording/innovation and levels of cover locally. This may result in firms retaining more risk in their own businesses;

- The value of existing long term relationships, continuity of cover and sense of security from insuring with DOFIs would be lost. This loss could adversely affect a firm's ability to make a future claim where the relationship no longer exists;

- The insurance requirements of other countries in respect of risks located in those jurisdictions may conflict with Australian law and create unnecessary complications;

- Clients at times require their legal advisors to carry high levels of insurance cover. If such cover were not available locally on appropriate terms, it could affect the ability of Australian law firms to act for such clients; and

- The Bill's transition provisions do not take into account policies that have been entered into for a greater than two year period. An exemption would avoid such an issue. If no exemption is provided any policy entered into prior to the implementation date of the legislation should be exempt until its termination.

Proposed exemption

43. The Second Reading Speech to the Bill states that the Government will continue to welcome well capitalised and well managed foreign insurers and does not want the proposed changes to unduly restrict market capacity.

44. That Speech foreshadowed "limited exemptions from the new regime. These exemptions will allow Australia's largest businesses, with risks that cannot appropriately be placed with an authorised insurer in Australia, to obtain insurance offshore". Concern exists as to the manner in which the exemption will be determined.

45. The Law Council supports the submission that a determination and exemption would be appropriate to enable a law practice and its associated entities to obtain insurance cover from either APRA authorised underwriters or from DOFIs (whether or not APRA authorised).

46. Some options for the terms of such an exemption are as follows:

    - Where there is legislative requirement for members of the legal profession to hold professional indemnity insurance cover of a type and on terms approved by the Attorney General of a State or Territory, a general exemption should be made for the captive insurers of an Australian parent and "top up" insurance. As mentioned above, this is the situation in Australia and the compulsory $1.5 million cover affords adequate protection to those consumers whose interests require legislative protection.

    - An exemption for corporations and large professional firms based on aggregate revenue of the relevant entity (and its associated entities).

    - An exemption where cover is purchased through a registered insurance broker acting as agent of the intending insured in respect of classes of insurance other than those classes within the ambit of section 761G(5)(b) of the Corporations Act.

    - An exemption for overseas risks.

47. Generally it would seem appropriate for a distinction to be drawn between domestic or general consumers and sophisticated buyers of insurance, and perhaps by reference also to the type of insurance product – eg home and contents insurance, motor vehicle insurance etc.

48. Law practices, such as the large law firms, typically purchase various types of insurance cover in respect of their practices (whether constituted as a partnership or a corporation) employees, partners, directors and those associated entities engaged or involved with the practice. If an exemption were granted it would need to take this into account.

49. We also wish to address the exemption of captives from the operation of the Bill.

50. Captive insurers generally:

    - operate as an efficient risk management tool that allows partners some sense of ownership of the risk. This drives the improvement of the risk management culture within a firm. It is the direct correlation between the partners' management of risk and the premium which the captive needs to charge the firm in order to pay for the risk that engenders a sense of ownership and which helps drive the quality services provided by the firm.

    - facilitate use of alternative dispute resolution processes. A firm can use the captive to control the claims process in a way that saves money and time and protects the reputation of the firm whilst looking after the proper interests of its clients.

    - can gain access to European and other reinsurance markets which are not available to firms as a direct buyers.

51. In light of Australia's prudential framework, captives are generally established overseas because it is economically more efficient to do so.

52. An Australian professional service entity setting up a captive must deal with the issue of how the capital base needed to assume the risk can be established. Professional partnerships are of course unable to raise funds in order to invest capital in such ventures. Developing a captive is for this reason generally a slow process.

53. There is a significant inconvenience in having a captive based in a foreign country particularly given the regulatory obligations here which require all management decisions to be taken off-shore.

54. The Law Council supports the call for further discussions with local regulators to provide an alternative domicile in Australia without the rigours and constraints that are imposed (quite properly) on commercial insurers which exist for a purpose other than what is in substance a single business (whether comprised of one or more organisations).

55. Single purpose captives should be exempted. Experience suggests that subjecting corporate captives to APRA regulation will not lead corporations to relocate their overseas captive on shore. Instead businesses will be disadvantaged without any meaningful benefit by the increase in cost in obtaining insurance.

Attachment A

Profile – Law Council of Australia

The Law Council of Australia is the peak national representative body of the Australian legal profession. The Law Council was established in 1933. It is the federal organisation representing approximately 50,000 Australian lawyers, through their representative bar associations and law societies (the "constituent bodies" of the Law Council).

The constituent bodies of the Law Council are, in alphabetical order:

- Australian Capital Territory Bar Association
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society of the Australian Capital Territory
- Law Society of the Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar Association
- The Victorian Bar Inc
- Western Australian Bar Association
- LLFG Limited (a corporation with large law firm members)

The Law Council speaks for the Australian legal profession on the legal aspects of national and international issues, on federal law and on the operation of federal courts and tribunals. It works for the improvement of the law and of the administration of justice.

The Law Council is the most inclusive, on both geographical and professional bases, of all Australian legal professional organisations.

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