Australian Government

The Treasury

29 April, 2009

John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Hawkins

INQUIRY INTO THE FINANCIAL SECTOR LEGISLATION AMENDMENT (ENHANCING SUPERVISION AND ENFORCEMENT) BILL 2009

Thank you for your correspondence of 9 April 2009 inviting Treasury to provide a submission to the Senate Standing Committee on Economics Inquiry into the above Bill.

Please find Treasury's submission attached, providing information in relation to the proposed regulation of the non-operating holding companies of life insurers.

I trust the submission will be of assistance to the Inquiry. Please do not hesitate to contact me on 02 6263 3993, or Rhonda Luo on 02 6263 3933, if you have any questions regarding the information provided.

Yours sincerely

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The Treasury

Senate Standing Committee on Economics

Inquiry into the Financial Sector Legislation Amendment (Enhancing Supervision and Enforcement) Bill 2009

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Contents

INTRODUCTION

The Treasury welcomes the opportunity to make a submission to the Senate Economics Committee in its inquiry into the Financial Sector Legislation Amendment (Enhancing Supervision and Enforcement) Bill 2009.

The submission begins with a statement of the key prudential principles and policy objectives for the prudential regulation of non-operating holding companies (NOHC) of life insurance groups. The second section reviews the consultation and the Regulatory Impact Statement (RIS) that was completed in relation to the proposed Bill. The next section provides further detail of the proposed regulatory framework including the permitted activities for NOHCs, the expected registration process, how the proposed regulatory framework would apply to subsidiaries of life insurers and registered NOHCs, and selected supervisory powers that would apply to NOHCs (directions, investigation and enforceable undertakings).

Policy statement

One of the principles of prudential regulation is that institutions making financial promises warrant prudential regulation where their promises have a high intensity, having regard to the inherent difficulty of honouring promises, the difficulty in assessing the creditworthiness of promisors and the adversity caused by breaching promises. Prudential regulation is considered necessary where there is a significant asymmetry of information between the consumer and the financial institutions which makes it difficult to assess the financial institution’s creditworthiness, and where the externalities, or the adverse consequences for consumers and the financial system from institutions’ failure, are particularly high.

Pursuant to these principles, life insurers are subject to prudential regulation by the Australian Prudential Regulation Authority (APRA).

With developments in the international financial system, the regulation of insurance groups is an increasingly important issue in prudential regulation, and a central aspect of group supervision is the appropriate regulation of holding companies that control the corporate groups. In Australia, the holding company of APRA regulated entities (apart from life insurers) is required to be an NOHC that is authorised by APRA.

International experience suggests that the life insurance industry worldwide continues to be affected by the global financial turmoil, and life insurers in overseas jurisdictions are expected to report declining capital and profitability. In this context, it is important that APRA has the ability to monitor the financial and other prudential soundness of Australian life insurers and their local or international groups, so as to have early information about developments that may affect the insurers and their policyholders.

Financial System Inquiry

The proposal to allow a non-operating holding company to be the head of a financial conglomerate was one of the recommendations from the Financial System Inquiry of 1997 (recommendation 49) (the Wallis Review). The Wallis Review recommended allowing NOHCs to head financial groups so as to foster diversity in financial services and allow flexibility in the corporate structure for financial entities and their related entities.

The Inquiry considered that, subject to a financial conglomerate meeting prudential requirements, there should be flexibility in the types of corporate structures allowed, but that those structures must satisfy the requirements of the regulator in the areas of:

- capital management;

- adequacy of firewalls

- reporting of intra-group activities, and
- independent board representation on subsidiary entities.

The Wallis Review particularly considered that economic, reputational and contagion risks were to be managed by giving the regulator power to supervise the activities of the group that may affect the regulated financial entities: 'The regulator must also have the power and capacity to monitor the group as a whole, including intra-group activity.' (page 346 of the Wallis Review final report)

The Wallis Review considered that these measures would assist in managing failure in one or more parts of the conglomerate. This remains an important consideration in the current environment.

It should be noted that the Wallis Review recommended enhancing prudential oversight of the corporate group despite the existence of the depositor preference provisions in the *Banking Act 1959*. The Report explicitly compared policyholder protection in the *Life Insurance Act 1995* and depositor preference in the Banking Act, and said that the two were 'comparable'.

In response to the Inquiry, amendments were made to the Banking Act (through the *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998* and the *Financial Sector Legislation Amendment (Restructures) Act 2007*) to enable an authorised deposit-taking institution (ADI) group to be headed by an NOHC.

Similar amendments were made to the *Insurance Act 1973* (through the *General Insurance Reform Act 2001*) in response to Recommendations 38 and 39 of the HIH Royal commission, which dealt with the need for better NOHC supervision of general insurers (APRA's inability to supervise the HIH entities' group-level activities contributed to the severity of the failure). The group supervision arrangements for general insurance were finalised in March 2009, with the determination of group-level prudential standards following extensive industry consultation.

Recent international fora support a group-level and system-focused approach

The International Association of Insurance Supervisors (IAIS) has established principles on Group-wide supervision, one of which is 'the supervisory authority supervises its insurers on a solo and a group-wide basis' (Insurance Core Principle ICP17). This principles requires that 'the operations of other group companies, including any holding companies if applicable, are taken into account in assessing the totality of the risk exposures of the insurers, insurance groups and conglomerates.' The IAIS represents insurance regulators and supervisors of some 190 jurisdictions in nearly 140 countries, constituting 97 per cent of the world's insurance premiums.

In October 2008, the IAIS published further guidance to the role and responsibilities of a group-wide supervisor in support of its Insurance Core Principles.

The guidance paper noted that the 'financial position and the risk profile of an insurer may be affected by its belonging to a group, with the possibility of both positive and negative effects on its prudential situation'. It was therefore 'important for supervisors of insurers within a group to be able to form a comprehensive view of the business strategy, financial position, legal and regulatory position, and risk exposure of the insurance group as a whole, which will enable them to assess (and react to, as necessary) the prudential situation and solvency of the respective insurers within the group.' (page 5, IAIS Guidance Paper No. 3.7 on the role and responsibilities of a group-wide supervisor)

The guidance identified key roles and responsibilities of a group-wide supervisor as:

- Fitness and propriety of significant owners at the group level;
- The overall standard and compliance of corporate governance of the group;

- The group's internal control mechanisms, including sound reporting and accounting procedures, to monitor and to manage the intra-group transactions and the risk concentration;

- Group-wide risk analysis to monitor the risk assessment, risk reporting as well as risk management on a group-wide basis;

- Capital adequacy of the group, by monitoring the sufficiency and adequacy of allocation of capital on a group-wide basis in order to gain a balanced view of the risk-based and financial situation of the group as a whole.

The OECD's current work on insurance governance supports these principles. Although in draft form, the OECD's work recognises the importance of ensuring that the Board and the regulator are well informed through reporting and risk management at the entity level, the holding company level and at the level of other companies and subsidiaries.

The G20 *Declaration on Strengthening the Financial System*, published on 2 April 2009, also supports these principles, as it states 'large and complex financial institutions require particularly careful oversight given their systemic importance.' The Declaration also encourages national regulators to 'review and adapt the boundaries of the regulatory framework regularly to keep pace with developments in the financial system and promote good practices and consistent approaches at the international level.'

These principles have been applied in some overseas jurisdictions. As an example, the European Parliament and Council issued *Directive 2002/87/EC* on 16 December 2002 on the supervision of financial conglomerates. Implicit in this directive is the requirement for regulators to regulate parent holding companies.

Key principles of proposed NOHCs supervision

Consistent with international developments and the Wallis Review, the NOHC supervisory framework focuses on capital adequacy, risk management and timely and accurate information flow.

Capital adequacy enables entities to meet their depositor or policyholder obligations as well as other creditor obligations. The NOHCs framework would expand capital requirements to the group level, to ensure that emerging developments within the corporate group do not undermine the life insurer's solvency and capital adequacy.

Risk management and adequate audit and actuarial arrangements aim to reduce the incidence of failure. Responsibility for risk management resides primarily with the management and owners of financial institutions, subject to the minimum standards that the regulator imposes. The NOHCs framework also places ultimate responsibility for group-level risk management with the management of the holding company and reinforces best practice in corporate governance generally.

Prudential supervision requires that problems within particular institutions or groups be resolved before the problems develop to threaten systemic stability. Therefore, timely and accurate information from the regulated entities, NOHCs and their subsidiaries are central to providing early warning of distress to the management and the regulator.

Consistency across prudentially regulated industries

The need for a consistent approach to regulation across industries and to maintain efficiency is another key policy consideration for prudential regulation.

One of the priorities in the past few years in Australia has been removing inconsistencies in capital, risk management and other operational and prudential requirements unless those inconsistencies are justified by specific industry features, in line with international developments.

While some corporate groups only operate in one or two financial sectors, other conglomerates operate across all four prudentially supervised sectors. Conglomerates develop asset, liability and management control issues that tend to be common across their respective sectors. For these participants, imposing differing minimum regulatory requirements without sound policy rationale for doing so creates the risk of regulatory arbitrage, which in turn increases the risk of instability in the financial sectors. Inconsistency also results in an uneven playing field for financial groups depending on their sector and structure.

Principles-based regulation

Prudential regulation legislation in Australia is principles-based. Principles-based supervision enshrines principles and expected regulatory outcomes in law, and relies on the regulator to apply the principles to the regulated entities. This style of regulation looks for outcomes rather than process and aims to embed sound risk management practices within the regulated entities. This approach to legislation retains greater flexibility in the system and seeks to avoid unintended regulatory barriers hampering the entities' ability to innovate, grow or change their company or conglomerate structure. The approach also avoids the need for frequent legislative amendments which tend to create uncertainty and additional costs for industry. Principles-based legislation allows scope for application by the regulator, APRA, in a way that is appropriate in the circumstances and for the entity, rather than setting out a single, inflexible way in which entities are required to operate or comply with prudential requirements.

Regulatory Impact Statement

Treasury completed a Regulatory Impact Statement (RIS) in relation to the Bill, which was approved by the Office of Best Practice Regulation. Extracts from the approved RIS were published in the explanatory memorandum. Further relevant extracts follow.

> There are currently 32 life companies (not including friendly societies) registered under the Life Insurance Act. All of these are owned by other companies and are each part of a group. APRA regulates the head company of 11 of these groups. Therefore, up to 21 life companies (that are not friendly societies) could be affected by the proposed amendments.
>
> There are currently 24 friendly societies registered under the Life Insurance Act. Of these, seven are part of a group headed by a company not regulated by APRA, and could be affected by the proposed amendments.
>
> One of the costs of regulating an NOHC is the application fee which must be paid by all NOHCs of life companies and friendly societies.
>
> There are various other implicit costs for NOHCs that are currently not authorised. These include meeting three prudential standards in relation to consolidated capital requirements, governance, and fit and proper criteria. This is consistent with the approach taken with NOHCs of ADIs and general insurers which currently only need to meet prudential standards on these matters.
>
> > The prudential standards for fit and proper and governance would be as similar as possible to those that apply to life companies and NOHCs of ADIs and general insurers. The prudential standard on capital would be different to that applying to NOHCs of ADIs and general insurers reflecting the different risks facing the life industry.
>
> While the exact costs cannot be quantified it is expected that the costs will not be significant as well run NOHCs of life insurance groups are already likely to meet most of the requirements.
>
> *Capital*
>
> Currently, the capital requirements for individual life companies, are specified in APRA's prudential standards. These standards only apply to individual life companies (not NOHCs). In reality, capital

is usually managed at a group level. Registration of NOHCs will enable APRA to develop capital requirements for the group on a consolidated basis. For well-run groups, the total capital requirement is expected to be similar to that currently held. Capital requirements will be higher if the risks are higher. This may be the case, for example, if there is a concentration of risks through the NOHC or if there is contagion risk. This will not usually be the case as conglomerates will generally organise themselves to make most efficient use of capital.

Governance

It is expected that APRA will extend its current standard on governance for life companies to apply to NOHCs of life companies. The standard will be similar to that applying to NOHCs of ADIs and general insurers. This standard will require the NOHC of the life company to have minimum foundations for good governance. It aims to ensure that the parent is managed in a sound and prudent manner by a competent board of directors, which is capable of making reasonable and impartial business judgements in the best interest of the consolidated life insurance group and give due consideration to the impact of its decision on policyholders.

The key requirements of the prudential standard will be modelled on comparable standards for ADI and general insurance NOHCs. NOHCs of life companies which are also NOHCs of ADIs and NOHCs of general insurers already meet the requirements for good governance.

Fitness and propriety

It is expected that APRA will extend its current standard on fitness and propriety for life companies to apply to NOHCs of life companies. Directors and senior managers of NOHCs of life companies will be required to meet, as is the case for directors and senior managers of NOHCs of ADIs and of NOHCs of general insurers, minimum fitness and propriety standards prior to being appointed and on a continuing basis. The standards ensure that the director or senior manager has both the appropriate technical expertise – including skills, experience and qualifications – and is also of good fame and character – such as exhibiting honesty, integrity and judgement. This is important as directors and senior managers play a critical role in ensuring the continuing financial health of the entity.

Many directors on the Board of the Life Company are also likely to be appointed to Board of the NOHC and therefore already meet fit and proper criteria. Thus, the extra costs involved in meeting the criteria are likely to be low.

Benefits to the community

[Regulating life insurance NOHCs] is likely to reduce contagion effect within a corporate group where the NOHC owns and controls the life company and to give consumers greater confidence that financial promises of life insurance companies will be met. This in turn would assist the Government in promoting safety and stability of the life insurance sector.

Benefits to regulated NOHCs

All NOHCs of life companies would be regulated thereby providing a level playing field. That is, NOHCs regulated by APRA under the Banking and Insurance Acts would no longer be at a competitive disadvantage compared to unregulated NOHCs.

Consultation and future reforms

The Treasurer's press release of 2 June 2008 (no. 061) and the Minister for Superannuation and Corporate Law's press release of 2 March 2009 (no. 018) announced the intention to introduce prudential regulation of life insurance NOHCs.

Prior to the Bill being developed and introduced into Parliament, APRA indicated to life insurance industry groups that regulation of life insurance non-operating holding companies was being considered by the Government. While these statements were necessarily at a high level, the life insurance industry was aware of the possibility of this legislative reform to remove an inconsistency in the prudential regulation framework.

In light of the Bill, APRA has indicated that it intends to undertake industry consultation on proposed amendments to its prudential standards for life companies. APRA proposes to extend its 'Governance' and 'Fit and Proper' standards to also apply to registered NOHCs of life companies. APRA expects to issue the consultation package (a discussion paper and draft amendments to its standards) in May or June. At this stage the Bill may not have been passed, but APRA considers that early consultation is appropriate in order to indicate to the life insurance industry how APRA proposes to regulate NOHCs of life companies. Early consultation will also allow APRA to amend its standards in a timely fashion, if the Bill is passed.

The proposed amendments seek to harmonise the regulation of life insurance NOHCs with the regulation of general insurance and banking NOHCs where it is appropriate to do so. This is intended to ensure that where a conglomerate operates across different financial sectors, the regulation that applies to the holding company and the group as a whole remains consistent, thus reducing the scope for regulatory arbitrage and maintaining a level playing field amongst financial groups irrespective of their structure and business focus.

Regulatory proposals affect sectors and participants differently depending on their group structure, existing corporate practices and systems. For this reason, any future reviews or proposed changes to the prudential group-level supervisory arrangements are expected to be undertaken through consultation that would provide sufficient opportunity for all players in all prudentially regulated industries to put forward their views. This would ensure that any proposed change creates the desired outcome and is the most efficient regulatory solution for all affected sectors and participants.

Definition of an NOHC and permitted activities

As part of its recommendations relating to non-operating holding companies, the Wallis Review considered that some restrictions and regulation of the activities of a holding company were necessary to manage the contagion risks and conflict of interest risks within a corporate group.

As discussed above, the Wallis Review supported the concept of a non-operating holding company as well as supervisory oversight of the holding company, and considered that tight supervision was necessary in addition to the entity-level protections for consumers (depositor preference in the Banking Act and policyholder protection in the Life Insurance Act).

On this basis the definition of non-operating holding company from ADI and general insurance amendments were adopted. The current regulation of the NOHCs of ADIs and general insurers allow NOHCs to undertake activities that are consistent with their function as holding companies to support the functioning of the group and as holding companies for investments in group companies.

An indication of APRA’s attitude regarding appropriate activities for regulated life NOHCs can be found in its authorisation guideline for general insurance NOHCs:

> “The operations of the authorised NOHC heading a consolidated insurance group are expected to be limited to:
>
> - providing executive leadership across the consolidated insurance group;
> - holding investments in subsidiaries;
> - holding properties used by consolidated insurance group members;
> - raising funds to invest in, or to provide support to, subsidiaries;

- raising funds to conduct its own limited activities;
- investing funds (i.e. surplus capital) on behalf of the consolidated insurance group;
- conducting the financial activities required for its own limited functions; and
- providing administrative, risk management and financial services to support the operation of the consolidated insurance group (subject to statutory or prudential restrictions).

"In addition, an authorised NOHC would not be permitted to:

- trade in financial instruments (other than for hedging purposes for itself and the consolidated insurance group, and managing its costs of capital and funding);
- engage in general insurance or reinsurance activities;
- guarantee the obligations of corporate group entities outside the consolidated insurance group without the approval of APRA;
- utilise its investments in subsidiaries as security without the approval of APRA; or
- conduct any other business not ancillary to its core role as holding company for investments in consolidated insurance group companies."

There is some flexibility in the proposed prudential framework that enables APRA to apply the NOHC supervision at a level that is appropriate to the corporate structure. The registration process would allow APRA to apply these criteria on a case-by-case basis to ensure appropriate outcomes. APRA's general insurance NOHC registration guideline states "APRA's authorisation process, as with its approach to supervision, is consultative and each applicant is assigned a responsible supervisor who is the main contact for the entity on all APRA-related matters."

Coverage of the proposed regulatory framework

Application to subsidiaries and requirement to notify APRA

The prudential supervision that APRA will conduct is intended to apply at the group level, which includes the legal entities within the corporate group held by the holding company. As part of the proposed framework, notification requirements would apply to the NOHCs, subsidiaries of the life insurers and NOHCs and auditors of these entities.

This is consistent with the recommendations of the Wallis Review, that allowing non-operating holding companies to become the head of corporate groups should come with a corresponding ability for the regulator to supervise intra-group activities, exposures and risks. The prudential requirements seek to enhance corporate governance best practice and are consistent with the international principles outlined above. A history of recent amendments relating to notification requirements under prudential and general corporate regulation is at page 8.

The operational changes required in the event of the regulation of NOHCs for life insurance groups would depend on the group structure and existing regulation. For groups whose NOHC is already prudentially supervised (where a life company is held within a general insurance or ADI group), the existing arrangements would likely meet the requirements under the proposed life insurance framework and consequently, minimal or no changes would be required. For other groups, the NOHC and subsidiaries of the life insurer and NOHC may be expected to implement a risk management program.

The proposed amendments would be particularly relevant for subsidiaries that provide business functions, hold assets or undertake other activities relevant to the life insurer. However, from time to time, other subsidiaries may become significant for the group's financial position or other prudential compliance (such as through a financial, technological or product development, corporate restructure or another event), and it may be necessary for a subsidiary to provide a report to APRA in relation to the development or event even though it has not previously reported to APRA.

Recent reforms to notice requirements

The reporting obligations under prudential legislation were amended by the *Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007*. The key policy outcome was harmonising the criteria and deadlines for notifying breaches of prudential matters to APRA across the *Banking Act 1959*, *Insurance Act 1973*, *Life Insurance Act 1995* and the *Superannuation Industry (Supervision) Act 1993*. This amending Act ensured that only significant breaches and breaches that affect an entity's financial soundness, rather than all breaches, are required to be reported. More specifically:

- A general insurer or life insurer is required to immediately notify APRA if a breach relates to financial obligations the insurer has to its policy holders or to the insurer's minimum capital requirements.
  - By comparison, an ADI is required to immediately notify APRA of a breach if the ADI may not be in a sound financial position; a superannuation trustee is required to immediately notify APRA if it becomes aware of the occurrence of an event having a significant adverse effect on the financial position of the superannuation fund.
- All APRA-regulated institutions and subsidiaries are required to provide a written report to APRA if they become aware of a matter that *materially and adversely* affects the body corporate's financial position.
  - The requirement for NOHCs and subsidiaries to report material adverse financial issues and, where applicable, 'significant' breaches, ensures timely information flow to the prudential regulator. Some 'material' adverse events affecting a subsidiary's financial position can have clear impact on the life insurer and in turn the policyholders; they may also highlight the need for closer monitoring of the group or lead to earlier remedial measures.
  - For example, related entities in a corporate group may move capital within the group to support a subsidiary, and this may have an impact on the life insurer's capital adequacy or liquidity. Deterioration in a subsidiary's financial position may prompt an examination of intra-group financial or risk management.
- All APRA-regulated institutions are required to provide a written report to APRA if they commit a 'significant' breach of a provision of a prudential Act or Regulation, prudential standard, a direction given by APRA or a condition of the institution's licence or authority. The criteria for determining whether a breach is 'significant' are:
  - the number or frequency of similar breaches;
  - the impact the breach will have on the institution's ability to conduct its business;
  - the extent to which the breach indicates that the institution's arrangements to ensure compliance with the prudential Act, Regulations or other requirements, might be inadequate;
  - the actual or potential financial loss arising or that will arise from the breach to the institution and its customers; and
  - any other matters prescribed by the regulations (none have been prescribed to date).

As part of the reform, APRA introduced a voluntary electronic reporting system for all breaches. The same amending Act ensured that APRA can receive breach reports on behalf of ASIC, where a breach is a breach for prudential and Corporations Act purposes, so the entities do not need to 'double report'. These amendments introduced significant cost savings for industry.

The amended notification requirements foster a whole-of-group risk management culture. It applies to all subsidiaries but limits the breaches that must be notified. Doing so ensures that the legislative framework remains flexible and adapts to corporate group restructures, takeovers as well as financial, human resources or technical innovations within the group.

The breach reporting framework introduced under the Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act will be applied to the breach reporting obligations of life insurance NOHCs and the subsidiaries of life insurers and their NOHCs.

Prudential standards

A key element of the prudential supervision framework is APRA's ability to determine prudential standards. These standards set out, in greater detail, how specific prudential requirements are to be applied, and provide APRA with the flexibility (subject to parliamentary oversight) to adapt prudential standards to changing industry practices or regulatory environment.

The prudential standards that would apply to the NOHCs of life insurers and subsidiaries are, in general, expected to be similar to the existing prudential standards that apply to the NOHCs and subsidiaries of general insurers or ADIs. As noted above, prudential standard on capital requirements would be expected to differ, to take into account the different risks in the life insurance industry.

For comparison, the prudential standards that are relevant for general insurance NOHCs and subsidiaries go to the group-level minimum capital, risk management and audit and actuarial arrangements. At the NOHC level, the responsible persons are expected to meet 'fitness and propriety' requirements. Broadly speaking, 'fitness and propriety' standards apply to persons who are responsible for the regulated entity's management and operations, as well as auditors and actuaries, and go to the person's relevant experience, competence, honesty and integrity.

These standards, where they apply to more than one entity, are legislative instruments. As such, they are subject to disallowance by the Parliament and are published on the Federal Register of Legislative Instruments.

The existing group-level prudential standards that apply to general insurers and ADI groups were finalised following extensive consultation with industry. Changes to existing prudential standards are also undertaken following due consultation with industry on the proposed changes. As discussed above, APRA has indicated that it would prepare a consultation package in relation to the proposed changes for life insurers, their NOHCs and subsidiaries, in anticipation of the new regime being enacted.

Proposed extension of supervisory powers

If the Bill is enacted, some existing supervisory powers in the Life Insurance Act would apply to NOHCs without specific amendment. Other supervisory powers would be amended by the provisions of the Bill so as to apply in an appropriate manner to NOHCs.

The first group of supervisory powers include the power to accept **Enforceable Undertakings**. The drafting of the current provision (section 133A of the Life Insurance Act) enables APRA to accept an enforceable undertaking from 'a person', and 'in connection with a matter in relation to which APRA has a power or function under [the Life Insurance] Act'. If an NOHC becomes registered under the Act, this provision would already enable APRA to accept an enforceable undertaking from the NOHC.

The second group of supervisory powers include the power to investigate the affairs of an NOHC and the power to issue directions to an NOHC. Proposed amendments to both are discussed in detail here.

Triggers for investigation

The proposed amendments provide for APRA to commence an investigation of an NOHC where it believes that it is in the public interest to do so.

The concept of 'public interest' already exists in the Life Insurance Act, in relation to when APRA may refuse an application for registration as a life insurer. The same concept is used in the Insurance Act, in the context of APRA's power to commence an investigation of a general insurer or NOHC following the issue of a show-cause notice.

In the Banking Act, APRA has broad powers to commence an investigation of an ADI, NOHC or subsidiary if APRA is 'satisfied that such a report is necessary' (section 61 of the Banking Act). Sections 9A and 11AB of the Banking Act contains a similar concept of 'national interest' in relation to APRA's decisions to revoke an ADI or NOHC's authority.

Treasury notes that broad terms like 'public interest', along with all words and phrases used in an Act, are read in their context. That context includes the Act's expressed objects. Treasury notes the objects clause of the Life Insurance Act (section 3), which relevantly states:

> (1) The principal object of this Act is to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry.
>
> (1A) An additional object of this Act is to protect the interests of persons entitled to other kinds of benefits provided in the course of carrying on life insurance business (including business that is declared to be life insurance business).
>
> (2) The principal means adopted for the achievement of these objects are the following:
>
> > (a) restricting the conduct of life insurance business to companies that are able to meet certain requirements as to suitability;
> >
> > (b) imposing on life companies requirements designed to promote prudent management of the life insurance business of such companies, including requirements designed to ensure the solvency and capital adequacy of statutory funds;
> >
> > (c) providing for the supervision of life companies by APRA and ASIC;
> >
> > (d) providing for judicial management of life companies whose continuance may be threatened by unsatisfactory management or an unsatisfactory financial position, so as to protect the interests of policyholders and financial system stability in Australia;
> >
> > (e) making provision to ensure that, in the winding-up of a life company, the interests of policy owners are adequately protected;
> >
> > (f) providing for the supervision of transfers and amalgamations of life insurance business by the Court.

In addition, Treasury notes that, all of APRA's powers and functions are to be exercised against the background of such general provisions as subsection 8(2) of the *APRA Act 1998*:

> In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.

The 'public interest' trigger for commencing an investigation is intended to create a broad but appropriate trigger where the other, more specific triggers under section 230B of the Life Insurance Act may not cover all situations where the interest of the Australian public requires APRA to investigate. The key policy considerations are balancing the rights and interests of the regulated entities with avoiding inappropriately proscribing the circumstances in which an investigation may be undertaken.

Directions and merits review of APRA decisions

APRA's decisions in relation to life insurance NOHCs will be subject to merits review to the same extent as other regulated NOHCs under the existing prudential legislation. APRA's decisions to refuse to register a life NOHC, refuse to vary a condition on the NOHC's registration, as well as decisions in the current life insurance regulatory framework that would also apply to NOHCs will be subject to internal review and merits review by the Administrative Appeals Tribunal (section 236 of Life Insurance Act).

Where APRA issues a direction to a life insurance NOHC, the availability of merits review for each direction would remain consistent with the availability of merits review for life insurers, general insurers and their NOHCs, ADIs and their NOHCs.

The existing approach has been maintained because the provision for APRA's directions, and the availability of merits review for each direction, was the result of recent reform introduced under the *Financial Sector Legislation Amendment (Review of Prudential Decisions) Act 2008*. It should also be noted that while some directions are exempt from merits review, neither this Bill nor the existing NOHC regulation provisions exclude judicial review under the *Administrative Decisions (Judicial Review) Act 1977*.

A short history of the amendments relating to the directions that can be issued by APRA and the availability of merits review for certain directions follow.

- In December 2006, the Government outlined measures to improve the processes concerning the review of prudential decisions, including consolidating the directions that APRA may issue under the prudential legislation and making these directions consistent across the sectors where it is appropriate to do so. The same package of measures also included proposals for expanding the availability of merits review, improving flexibility in the disqualification regime and removing the requirement for ministerial consent. These proposals were developed in response to Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business.

- In light of industry comments, the Government announced on 16 April 2007 that it would make further changes to the proposals relating to the directions that APRA may issue under the prudential legislation, as well as the disqualification process, availability of merits review and removal of ministerial consent, to provide a greater degree of certainty and clarity with respect to these matters. The Government undertook further consultations on these measures through its consultation paper, Review of Prudential Decisions, released in May 2007.

- The proposals relating to APRA's ability to issue directions and merits review aim to balance the requirement to provide a review mechanism and ensure fairness of administrative decision making with that of ensuring that APRA can act promptly and decisively where policyholder or depositor interests or financial system stability are at risk. In submissions to the first consultation paper, Rethinking Regulation, concerns were raised about how the proposal giving APRA discretion in certain circumstances to determine that a specific decision is not subject to merits review would work in practice. The revised proposals contained in the second consultation paper, Review of Prudential Decisions, address these concerns by providing greater clarity to the arrangements.

- The revised proposal provides greater clarity to the arrangements relating to APRA's directions by specifying a limited set of triggers for issuing a direction under the proposed new general directions power, which, if invoked, would exempt the resultant direction from merits review.

- In developing policy options for streamlining APRA's directions powers, it was considered important that ensuring the availability of merits review for APRA decisions is balanced with ensuring that APRA can act decisively where it is necessary in the public interest. To address the remaining industry concerns, threshold materiality tests were incorporated into the limited set of proposed triggers which, if invoked, would exempt the resultant APRA direction from merits review. This approach would ensure that an APRA direction is only exempt from merits review where failure by APRA to act decisively would materially prejudice the interests of depositors, policyholders or beneficiaries, or the stability of the financial system more broadly.

- While some industry participants expressed concern about the proposed model for the consolidated directions power, other industry participants and the Administrative Review Council supported the revised proposals for incorporating a threshold materiality test into some of APRA's directions and clarifying the availability of merits review for these directions as providing more certainty, accountability and transparency.

Penalties

The penalties provisions in this proposed Bill extend the existing penalty that already applies to life insurers under the Life Insurance Act. For example, a life insurer that does not report a 'significant' breach of the life insurance regulatory framework within 10 business days commits a strict liability offence under subsection 132A(4). Under the proposed Bill, it would also be a strict liability offence for a registered NOHC not to report a significant breach of the life insurance framework within 10 business days (items 82 to 88 of Schedule 1 of the Bill).

This approach maintains consistency for the life industry, as it applies the same offence to equivalent breaches that may be committed by an NOHC under the proposed Bill, and makes the same defences available for the equivalent breaches.

Some holding companies of life insurers are also the authorised NOHC for a general insurer and/or an ADI, and the proposed Bill seeks to maintain consistency in the offences and defences for offences across the prudentially regulated industries where it is appropriate to do so.

For example, under the Banking Act, Insurance Act and (if the Bill is passed by Parliament) Life Insurance Act, it is an offence for a person who is disqualified from being a director, executive officer or senior manager, or auditor of the NOHC to hold that position. It is not considered appropriate for different penalties to apply, or different defences to be available, to the disqualified person simply because the breach was committed under a different prudential Act. A similar example is the obligation for NOHCs to notify APRA of significant prudential breaches under the Banking Act, Insurance Act and (if the Bill is passed by Parliament) Life Insurance Act.