

AIDA Working Group State supervision - Australian response

Introductory questions

Can you give a short overview over the insurance supervisory framework (eg bodies, structures and law) in your country immediately before the GFC?

In short, the insurance supervisory framework in Australia is split between two regulators:

- the Australian Prudential Regulation Authority (**APRA**) - the prudential regulator responsible for solvency of authorised general and life insurers <http://www.apra.gov.au/>; and
- the Australian Securities and Investments Commission (**ASIC**) - the regulator responsible for the main consumer protection legislation applying to insurers. Other regulators are responsible for other legislation indirectly impacting on insurers but ASIC is the principal regulator insurers would deal with in this regard <http://www.asic.gov.au/asic/asic.nsf>.

Prudential supervision

APRA acts as prudential regulator of the financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry. APRA is funded largely by the industries that it supervises. APRA currently supervises institutions holding approximately \$3.6 trillion in assets for 22 million Australian depositors, policyholders and superannuation fund members.

Australia's prudential framework pre GFC was already relatively sophisticated.

APRA was established on 1 July 1998 taking over insurer supervision from the ISC, however APRA inherited a weak solvency regime which had:

- no robust standards or actuarial standards for assessing claims liabilities
- a very basic capital requirement of the higher of 20% of premiums and 15% of outstanding claims, and
- a significant weakness in the eligible capital (ie the capital counted by APRA for solvency purposes) formula. This measured net assets measured as gross assets less *the company's own measure of liabilities*. The liabilities could be measured as a central estimate, discounted, with no risk margin which meant that the lower the liabilities in the accounts, the higher the capital would appear.

From the mid 90s to 2001 the Australian insurance industry was very competitive. The second largest insurer in Australia HIH, essentially led prices down to unprofitable levels, in particular for liability and other commercial insurance classes.

HIH's profitability was illusory and its low pricing conduct combined with increasing liability claims costs also resulted in the poor profitability of other insurers in the late 1990s.

HIH failed in 2001 in which much of the insurer's AUD\$5.3 billion in losses were borne by former policy holders.

For more detail see: <http://www.hihroyalcom.gov.au/finalreport/index.htm>.

HIH also followed the failure in 2000 of UMP, an unregulated discretionary mutual medical indemnity organisation, for similar reasons to HIH. UMP was not insurance and thus was not regulated at the time.

In addition, in 2001, after 9/11, reinsurers withdrew terrorism cover which brought commercial property lending in Australia to a stand still.

After the above:

- with the exit of HIH and its unrealistic pricing, insurers increased prices, in particular for liability classes and some simply withdrew from the market;
- this combined with UMP's failure resulted in an "insurance liability crisis". Insureds, especially smaller businesses and not-for-profit groups, were unable to afford the insurance and in relation to medical indemnity, many doctors retired or withdrew their services;
- the Government reacted by:
 - introducing Tort reform in every Australian State;
 - rescuing medical indemnity organisations but requiring them to become licensed insurers regulated by APRA;
 - restructuring APRA (which was unsurprisingly subject to much criticism by the Royal Commission in relation to the failure of HIH). APRA disqualified certain persons associated the HIH failure, introduced risk management requirements (e.g compulsory preparation of business plans and financial projections) and built up its supervisory capabilities and activities which are summarised further below.

However, according to APRA itself, "the single most important change was in the assessment of claims liabilities, which were required to be measured as the central estimate plus a risk margin at 75% probability of sufficiency, irrespective of the numbers that companies might insert in their published accounts. Also the measurement had to be made by a suitably qualified actuary working to professional standards issued by the Institute of Actuaries of Australia."¹

1 See APRA Regulatory Update 2010 John Trowbridge Executive Member Australian Prudential Regulation Authority Insurance Council of Australia 17 February 2010.

- establishing the national claims and policies database (**NCPD**) in 2003 under which APRA in consultation with the insurance industry and other stakeholders collects information from insurers to provide insurers, the community and State and Federal Governments with a better understanding of public and products liability insurance and professional indemnity insurance and the ability to monitor trends in premiums and claim costs.

As a result of:

- the ability of insurers to increase prices
- the effectiveness of the tort reform which reduced claims costs in some classes
- a strong economy, and
- low claims incidents due to benign weather conditions,

the insurance industry fared very well up until around 2007, from which time:

- price competition returned
- adverse weather events occurred (Cyclone Larry in 2006, Hunter Valley Storms in 2007, storms in Sydney, Brisbane and Mackay in 2007 and 2008 and Victorian bushfires in 2009)
- insurers, becoming more confident, undertook more underwriting risk and business expansion
- the stock market peaked in or around October 2007 and declined through 2008 until it reached a low in or around March 2009, and
- interest rates declined and there were increasing credit spreads and difficulties in the equity and property markets, all of which reduced economic growth. In 2008 the Government took the unprecedented step of stabilising the economy and banking system by introducing a wholesale funding and large deposit guarantee. A policy holder financial claims scheme was also introduced which is discussed further below.

Australia has not been as adversely impacted as some countries and the general insurance industry less affected than many other industries.

Ironically, the HIH failure and liability crisis has meant that post GFC, most changes to the existing APRA regime have in effect been "fine tuning" as a result of additional lessons learnt from the GFC issues that arose internationally. The changes are addressed further below in answer to the following questions.

The regime pre GFC was primarily risk based, consultative and consistent with international best practice. The regime recognised that an insurer's management and Board are primarily responsible for its financial soundness.

APRA's powers pre GFC (and now) are broken into:

■ **Preventative powers**

- Authorisation - APRA has authorisation and minimum standard frameworks that apply to insurers wishing to carry on insurance business in Australia. General insurers must be authorised by APRA under the *Insurance Act 1973* (Cth) (exceptions do apply although the reach of the Act is broad - see below). Life insurers must be registered under the *Life Insurance Act 1995* (Cth) (exceptions do apply although the reach of the Act is broad).
- Prudential standards - APRA is able to determine minimum standards that apply to general insurers as well as their subsidiaries and non-operating holding companies (**NOHC**). APRA is also able to determine prudential standards for life insurers. For example insurers must meet standards relating to Capital Adequacy, Assets in Australia, Risk Management, Business Continuity Management, Reinsurance Management, Outsourcing, Audit and Actuarial Reporting and Valuation and Governance amongst other things. These are aimed to improve the clarity and certainty of the prudential regulation and maintain flexibility.

The standards are complimented by monitoring of insurers and a compliance regime that encourages adherence to the relevant standards. Remedial action can be taken where an insurer or individual fails to meet the minimum requirements.

APRA has powers to require information regarding an insurer's operations which forms the basis of assessments by APRA as to the insurer's prudential status and assist in the detection of developing risks.

APRA also has responsibility for policing foreign ownership of authorised insurers and various additional legislation applies in relation to sale of insurance business between competitors and shareholdings of foreign entities in authorised and registered insurers.

- **Correction powers** - APRA has enforcement powers to compel compliance and rectify breaches of the minimum standards e.g. court enforceable undertakings, injunctions, the ability to issue enforceable directions regarding compliance etc.
- **Failure management** - APRA has the power to intervene where an insurer is at risk regarding its ongoing viability which are designed to ensure the orderly exit of the insurer from the financial sector without undermining the financial stability if the difficulties cannot be resolved. E.g. power to apply for a transfer of business from a failing insurer to a healthy one, the initiation of external administration and initiation of winding up proceedings.

- **Data Collection Powers** - The Financial Sector (Collection of Data) Act (**FSCODA**) aims to ensure APRA can collect the data it requires for the purpose of its prudential functions.
- **Levy Arrangements** - APRA's activities are funded through industry levies determined annually by Government. They also cover consumer protection and market integrity functions of ASIC and the Australian Taxation Office in relation to APRA regulated entities.

Consumer protection (non prudential)

ASIC is Australia's corporate regulatory body. It is responsible for promoting market integrity and consumer protection as well as for licensing and overseeing the conduct of corporations generally, in particular the conduct of insurers and other persons involved in the distribution of insurance.

The main legislation ASIC is responsible for which affects the non prudential conduct of general and life insurers and others involved in the distribution of insurance are:

- the *Corporations Act 2001* (Cth), in particular Chapter 7 which was introduced in 2001 http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/; and
- the *Insurance Contracts Act 1984* (Cth) introduced in 1986. http://www.austlii.edu.au/au/legis/cth/consol_act/ica1984220/.

Corporations Act

The Corporations Act requires general and life insurers (subject to certain exceptions that apply eg where an insurer is APRA regulated and not dealing directly with what are called "retail clients" - essentially individuals and small businesses. Reinsurance is not caught) to obtain an Australian Financial Services Licence to be able to advise and deal in relation to insurance products.

This licensing regime also applies to other persons involved in the provision of advice and dealing services concerning insurance eg insurance brokers and agents.

The licensing requirements impose obligations on licensees that are designed to ensure that they operate in an efficient, honest and fair way e.g. Licensees must have:

- compliance and risk management plans in place,
- meet certain minimum financial requirements,
- undertake training to specified set levels,
- belong to a free independent and external dispute resolution scheme (not run by the Government) that is binding on them up to certain limits (for general insurers it is AUD\$280,000) For more detail see: http://www.fos.org.au/centric/home_page.jsp; and

- have approved professional indemnity insurance in place.

The Professional Indemnity, financial and risk management requirements do not apply to authorised insurers as APRA covers these in the prudential legislation referred to above.

In addition to the above licensing requirements, Chapter 7 of the Corporations Act imposes certain disclosure, money handling and other obligations on licensees and their representatives designed to better inform and protect consumers about the services and products being provided to them. Different obligations apply depending on whether the client is retail (see above) or wholesale (anyone who isn't retail). Significant penalties apply for non compliance.

The regime also applies to other financial services eg banking and investment products and superannuation.

Insurance Contracts Act

ASIC also regulates the *Insurance Contracts Act 1984* (Cth), specific insurance legislation (not applicable to certain insurance such as Government underwritten insurance, reinsurance, Marine Insurance or private health insurance) which imposes rights and obligations on insurers and insureds and others covered under policies so as to achieve a fair balance between them all.

This legislation which was introduced in 1986 has been recently comprehensively reviewed and found to be working well and only minor changes are proposed. ASIC has various powers to intervene in proceedings and take representative action on behalf of affected insureds.

The UK is apparently moving towards something similar to the Australian model and a detailed analysis of the Australian Insurance Contracts Act was carried out in this process See the Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre Contract Disclosure and Misrepresentation*.

Other consumer protection legislation

Numerous other non insurance specific legislation also affects the non prudential conduct of insurers and others involved in the insurance industry such as the *ASIC Act 2001* (Cth), *Trade Practices Act 1974* (Cth) and *Privacy Act 1988* (Cth).

Industry supervision

There is a degree of industry supervision as well which whilst not imposed by law (the obligations arise by way of contract when a person joins) plays an important role in managing the conduct of insurance industry participants.

- There is a General Insurance Code of Practice which sets minimum standards in relation to the conduct of insurer members of the Insurance Council of Australia (the representative body of most insurers in Australia).

This body manages complaints relating to breaches of the Code and conducts audits of member compliance.

- For more detail see: <http://www.insurancecouncil.com.au/> or <http://www.codeofpractice.com.au/Portals/0/ICA%20Code%20of%20Practice.pdf>
- There is also an Insurance Brokers Code of Practice run by the National Insurance Broker's Association of Australia (the representative body of most insurance brokers in Australia) which operates in a similar way for insurance brokers.
- For more detail see: <http://www.niba.com.au/html/> or <http://www.niba.com.au/resource/NIBA%20Code%20of%20Practice%202006.pdf>

In particular, was the supervision of insurance combined in any way with the supervision of any other financial service (eg banking)?

APRA is responsible for the supervision of general and life insurance as well as banking, superannuation and friendly societies.

However, each is managed under separate legislation and APRA issues separate prudential standards and practice guides for general insurers, life insurers, banks, superannuation trustees and friendly societies.

APRA's policy is to keep regulation as consistent as possible across the different business types so the standards and practice guides are, for the most part, industry-specific applications of the same principles. The standards and practice guides also take into account the multi disciplinary and group risk associated with insurers which are part of a group which carries on other businesses, whether financial services or otherwise. Refinements are currently proposed to better achieve this objective - see further below.

Chapter 7 of the *Corporations Act* and the associated regulations apply to all financial services providers, which includes insurers, banks, financial planners and advisers and credit rating agencies. ASIC issues regulatory guides indicating its position on the Corporations Law which have a significant influence on financial services providers including banks and insurers. Some are specific to a particular industry and others generic where appropriate.

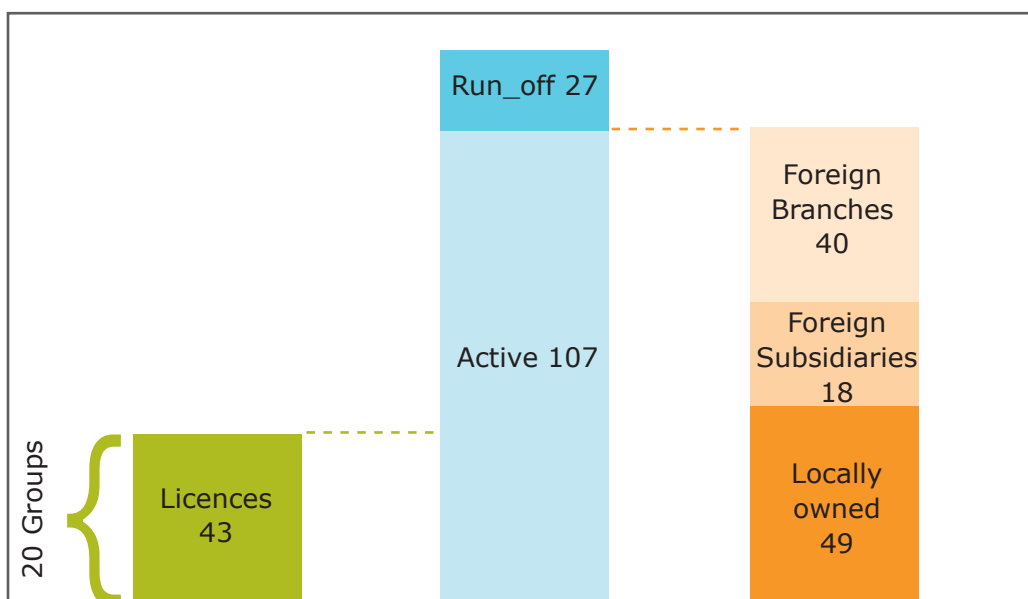
Effect of the GFC on the insurance / reinsurance market

Please summarise how the GFC has affected – or been perceived as having affected – the insurance / reinsurance market in your country?

The impact has not been as great as feared given the pre GFC failure of HIH as referred to above and Australia's relatively strong economy. It is encouraging, however, to see that in April 2010 the IMF published data

indicating that Australia currently has the highest post-GFC GDP growth rates in the western world.

The following diagram, taken from the APRA Regulatory Update 2010 given by John Trowbridge, Executive Member Australian Prudential Regulation Authority to the Insurance Council of Australia on 17 February 2010, gives a snap shot of the licensed general insurers in Australia and how they are broken up.



It is generally acknowledged that the general insurance market has fared well for reasons such as the following:

- while the assets of Australian insurance companies fell as a result of falls in stock markets and property prices and investment returns, Australian companies had more than sufficient capital to satisfy solvency requirements by reason of the minimum standards imposed pre GFC and more recently there has been considerable recovery in asset values
- while interest rates are down, the impact is not as great as expected and reasonable investment returns continue for insurers
- business insolvencies have not been as high as expected
- increased loss as a result of fraud or increased unemployment have not had the impact thought, and
- Australia's new proportional liability regime which effectively only allows plaintiffs to recover from a person, their proportion of responsibility, has helped to reduce the level of litigation generally in Australia.

The general view appears to be that:

- there remains ample capacity generally and plenty of competition and any strong upward pressure on rates is likely to be affected because of this
- underwriting has become more and more targeted and more accountable
- in property, more focus has been placed on loss impacted accounts, hazardous risks and catastrophe exposed risks, particularly where reinsurance costs will have an influence
- All trade credit insurers have suffered in Australia with claims attached mostly to second half 2008 and first half 2009 transactions. Loss ratios quickly deteriorated and measures had to be taken by all markets, i.e. reduction of capacity, price increases and tighter policy terms. Reinsurance rates for trade credit are significantly increased for 2010 and it's a back to basics approach and away from sophisticated structured trade transactions
- Workers compensation insurance has seen rate increases
- In the states of NSW and Victoria builders warranty insurance was privately underwritten per a Government approved form of wording. To obtain authorisation builders were required to buy this insurance from approved insurers which covered the owner of the building from defects in building work and failure of the builder to perform. Private insurers, due to failures of builders, have withdrawn from the market forcing the Government to take over the area and underwrite it directly
- GFC related claims against financial planners and mortgage brokers has seen a withdrawal from the market of many professional indemnity insurers and cost increases. This has also arisen from the fact that in difficult financial times people are more likely to bring claims against providers than they are where the times are less difficult where the financial incentive is less i.e. time is better spent making money than seeking to recover losses in complex litigation
- Financial institution rates are also expected to increase, and
- Reinsurance rates have edged up and appetite for unusual non traditional risk is more limited but overall the impact has not been significant. This may lead to a hardening of the market.

In particular, what effect has the GFC had on the availability, pricing and in terms of certain lines/classes (eg life insurance or credit insurance), or ancillary or associated products (eg disaster/catastrophe bonds) or services (eg debt or capital)?

[See above]

Have there been any notable developments in the run-off or discontinuation of risk carrier or intermediary business, in particular, what particular classes of business have been affected?

As noted above, by reason of the relatively robust solvency requirements in place before the GFC, principally because of the failure of HIH in 2001 and reforms that followed and the relative strength of the Australian economy, there have been no insurer failures in Australia since the GFC.

The main examples of concern arose in 2008 when:

- the fear arose that the AIG group could collapse if US Government support were not given and in Australia these concerns affected the Australian operation, however no regulatory issues arose in this regard.
- bancassurance groups such as ING and Fortis in Europe, discovered that issues in their banking arms risked the failure of their insurance arms, leading in these cases to dismemberment of the groups.

Commercially, insureds focussed more on diversifying their risk with insurers rather than relying on just one.

The GFC has also focussed many insurers on reviewing portfolios and running off/selling unprofitable ones and acquisitions are continuing in Australia where appropriate.

Which other developments do you observe within the insurance and reinsurance market?

[Covered above]

What examples are there during or since the GFC of the insurance supervisory authority of your country taking specific steps to influence, control or intervene in the conduct or operations of insurance / reinsurance risk carriers, or their directors and officers?

From a regulatory perspective (as discussed in detail below) the impact has not been significant, mainly because of the failure of HIH and the regime put in place as a result of this and Australia's relatively robust economy.

No formal intervention occurred to my knowledge however APRA was likely to have engaged in non public discussions with relevant insurers pursuant to its various preventative powers referred to above. It is likely that as a result of this interaction certain current reform proposals for refinement have been put forward which are discussed below.

Were the powers of intervention – existing before and during the GFC – of your country's insurance supervisory authority sufficient?

Australia's regulation of financial services providers is among the most interventionist in the western world.

APRA's view as to the level of regulation (including its intervention powers) before and during the GFC is that it was sufficient but that the regulatory framework was and still is in need of refinement.

From the outset of the GFC, APRA has maintained that its regulatory response to the GFC would be "modest" and it has indeed proven to be so.

While Australia (like most if not all countries in the world) was affected by the GFC, the regulators did not consider this to be a regulation-related fault.

While APRA has not claimed that the Australian regulatory environment is to be credited for this positive result, it is likely to have been a contributing factor.

Since GFC various changes are proposed relevant to intervention that enhance the rights that already exist but which will have a significant impact on industry.

Have there been any examples during or since the GFC of the payment of insureds'/policyholders' claims being at risk from the potential insolvency of an insurance / reinsurance risk carrier or intermediary?

No major Australian insurers or reinsurers have been affected by the GFC to the extent of their solvency being threatened. The main area of commercial/industry focus in Australia at the time appeared to be the position of AIG's Australian operation, but no regulatory issues arose.

Payment of insureds' claims has not been significantly affected by the GFC, although the number of claims have increased and will continue to be at a heightened level until the effects of the GFC are fully absorbed. The level has not been as high as anticipated in a GFC type environment.

Amendments of the insurance supervisory law

In general terms, what (if any) changes have there been in the regulatory framework for the insurance or reinsurance industry since the onset of the GFC? In particular: Has there been an increase in funding or manpower for any supervisory authority? Has – in consequence of the GFC – the insurance supervisory/regulatory law and the powers of intervention been tightened in your country?

For Australia, the GFC did not cause the introduction of a mass of new regulation or significantly tightened controls. APRA indicated at the outset of the GFC that its proposed regulatory refinements would be "modest", which they have proven to be.

That said, Australian regulators have been acutely aware of other countries' GFC-related experiences and some changes have been made to take such matters into account.

The key changes in date order relating to the GFC can be summarised as follows.

2008 Refinements

In 2008 a number of refinements were made to the APRA regulated regime. The following covers some of the key changes.

Changes to what insurers needed to be authorised in Australia

The *Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007* was introduced requiring Direct Offshore Foreign Insurers (**DOFIs**), many of which were not required to be authorised under the *Insurance Act*, to obtain authorisation.

The effect of the DOFI legislation is that now, only APRA-authorized general insurers, Lloyd's underwriters and unauthorised foreign insurers (**UFIs**) acting within one of a number of limited exceptions to the Act are permitted to carry on insurance business in Australia.

The aim was to ensure there was an even playing field between Australian regulated insurers and others carrying on insurance business in Australia, especially given the high regulated nature of the Australian insurance industry. It also helped rid the market of certain foreign insurers that may not have been able to meet the APRA solvency and other prudential standards, and thus reduced the risk of unsuspecting insureds using such insurers. Specific consumer notice obligations apply where non authorised insurers are used.

Fine tuning of certain prudential requirements

Changes were also made in relation to:

- the harmonisation of the definition of capital base for general insurers and ADIs;
- the calculation of the Minimum Capital Requirement (**MCR**) for equity and real property investments;
- a better recognition of the risks of reinsurance due from non-APRA-authorized reinsurers through changes to the calculation of the MCR and requirements covering reinsurance contracts.
- Risk management, reinsurance management and outsourcing requirements and fit and proper requirements in relation to the need for directors and senior managers to meet fit and proper standards. APRA has powers to seek their removal or disqualification.

Financial Claims Scheme (FCS)

The FCS, was introduced in late 2008 at around the same time and the banking guarantee arrangement referred to above and provided a mechanism for resolving insurance failure.

Although no insurance failure occurred in Australia during the GFC, insurance failures abroad during the crisis sheeted home the need for Australia to be able to deal with such failures systematically. Australia's experience with insurance failure had been (and still is) limited and was dealt with on a case-by-case basis.

The FCS gives powers to the appropriate Minister to declare that APRA will administer the scheme in relation to a failed insurer that is authorised under the Insurance Act (it does not apply to non authorised insurers nor Lloyd's which is subject to a special arrangement in Australia), in which case:

- for claims under AUD\$5,000 under a "protected policy" (see below), APRA initiates a "fast-track" process for assessing and paying out the claims (no need for policy holders to meet eligibility criteria)
- for claims over AUD\$5,000 under a "protected policy", APRA assesses and pays out the claims, provided the policy holders meet certain eligibility criteria (see below), and
- APRA stands in the place of the policy holder in the liquidation of the insurer.

Persons eligible for claim payments under the FCS are primarily Australian citizens, permanent residents, non-residents insured against risk in Australia, small business, family trusts and not-for-profit organisations.

The Minister may exclude a person as ineligible if of the belief that the person knew of or was involved in the events leading to the failure. This is intended to target persons such as directors of failed insurers and their associates.

The "protected policies" under the scheme are mainly retail-type insurance and State and Territory insurance not protected under arrangements administered by the relevant State or Territory. Reinsurance, retrocession, indemnification of another policy and pre-authorisation liability is excluded. Discretionary mutual funds are also excluded.

The FCS provides for levies to be imposed on general insurers with the levy funds deposited into a Policy Holder Compensation Facility (**PHCF**). The facility provides funds for claim payments APRA pays out during FCS administration (limit of AUD\$20 billion per failure applies) and for covering APRA's expenses in the administration (limit of AUD\$100 million limit per failure applies). If claim payments or administrative expenses exceed the respective limits, a special levy of an amount up to 5% of insurers' gross premiums may be imposed on general insurers to recoup the difference.

Certain refinements to this legislation are currently proposed, as discussed below.

2009 refinements

Refinements continued in 2009 which included the following key changes.

Group supervision

In December 2008, in response to recommendations by the Royal Commission into the collapse of insurer HIH, APRA released prudential standards applicable to general insurance groups having an APRA-authorized general insurer or APRA-authorized non-operating holding company as the parent company of the group (Level 2 supervision).

The changes were introduced from 31 March 2009 and extended the scope beyond risk management and Governance. The effect was to enable APRA to treat the insurance group as one economic entity and to regulate the group as an individual general insurer would be regulated, ie in areas such as:

- levels of capital
- risk management
- audit, actuarial reporting and valuation standards
- governance, and
- fitness and propriety of responsible persons.

One outcome has apparently been the simplification of structures increasing transparency and reducing complexity and risk.

Proposals have now been released in relation to conglomerates - see below.

New reporting arrangements for intermediaries

In the wake of the GFC, APRA became interested in gaining a better understanding of the effects of market turmoil and insurance failure. As a result, general insurance intermediaries (brokers, agents and insurers acting as intermediaries for other insurers) were required to provide certain data from 1 May 2010 onward, on a periodic basis.

Two types of data are required:

- The first is aggregate data, expressed as an amount of premium invoiced in the reporting period in question, of total business placed with APRA-authorized general insurers, Lloyd's underwriters and unauthorized foreign insurers.
- The second type of data is at the transaction level and only covers intermediated business placed directly, or indirectly through a foreign intermediary, with UFIs. It includes data as to the exemption arrangements used in such dealings (ie high value insured, atypical risks, risks that cannot reasonably be placed in Australia and insurance required by foreign law: see above). A variety of data must be given including the APRA class of business, the amount of premium and effective date of policy.

For more detail see: <http://www.comlaw.gov.au/comlaw/Legislation/LegislativeInstrument1.nsf/0/C8A6954B8BD7DC26CA257682001A6A02?OpenDocument>.

Executive remuneration changes

In November 2009, APRA finalised its position on the prudential requirements for remuneration given the concerns that arose in relation to the impact of remuneration arrangements on the GFC. Extensions to the governance standard (GPS 510) and a prudential practice guide (PPG 511) were published which come into effect on 1 April 2010.

APRA requires that a Board Remuneration Committee, with appropriate composition and charter, be established and a suitable Remuneration Policy be in place.

The industry broadly supported APRA's approach, accepting that poorly structured remuneration practices may result in excessive risk-taking by individuals and undermine the risk management systems of prudentially regulated institutions.

Credit rating agencies

Although the Australian activities of credit rating agencies (**CRAs**) were not considered as contributing in any way to the global financial crisis or adversely affecting the Australian economy, regulators were aware of the role CRAs played in the US subprime mortgage crisis.

In response, new requirements were introduced requiring CRAs to hold Australian financial services licences (AFSLs) under Chapter 7 of the Corporations Act covering the issuing of credit ratings. This is regulated by ASIC and not APRA.

Previously CRAs benefited from a licensing exemption which was removed in order to align Australia's regulation of CRAs with international standards.

CRAs have obtained AFSLs authorising them to provide general advice to wholesale clients by issuing a credit rating but not retail clients. Standard & Poor's (Australia) Pty Limited, Moody's Investors Service Pty Limited and Fitch Australia Pty Limited each only have a wholesale client authorisation.

This has created some compliance challenges as a CRA will effectively need to take steps to avoid its credit ratings from being provided in circumstances where it could be seen as the provision of advice to a retail client in relation to financial products covered by the Corporations Act (eg certain types of general and life insurance).

ASIC has issued guidance to assist CRAs and others involved in passing on ratings to manage various compliance issues. ASIC has indicated that CRAs without a retail client AFSL must not:

- directly give credit ratings to retail clients, or
- cause or authorise their credit ratings to be given or directed to retail clients by others (eg insurers and insurance brokers) because this will constitute the provision of advice by the CRA to the retail client in breach of the Corporations Act.

The effect of this is that CRAs must ensure that their credit ratings applicable to insurers are not provided to or accessible by retail clients and in many cases insurers are seeking to pass on similar restrictions to insurance brokers and other intermediaries to whom they supply their credit ratings.

If the CRA is not authorised under its AFSL to provide credit ratings to retail clients, any member that passes the credit rating to a retail client in a manner that could reasonably be regarded as being intended to influence a retail client in making a decision in relation to the insurance, may breach the Corporations Act.

ASIC has indicated its view that disclosure of ratings in advertising and marketing materials, other communications and websites that may be provided to or accessed by retail clients (perhaps via a hyperlink to a wholesale client webpage from a webpage intended for retail clients) run the risk of constituting Retail Client Advice.

The provision of an insurance Product Disclosure Statement (**PDS**) with a credit rating in it to a retail client deciding whether to acquire the insurance is another example of conduct which may breach the Corporations Act.

What (if any) changes are currently being discussed or proposed with respect to any part of the regulatory framework governing the insurance / reinsurance industry (eg further legislative proposals / draft bills / self regulation directives issued by the supervisory authority / increase in staff / more financial resources / modification of the authorities' structures, eg merging of banking and insurance supervision)?

The following key changes are proposed in relation to 2010 and beyond.

Changes to prudential reporting Framework

APRA has recently consulted on proposals to change the prudential reporting framework aimed to align APRA reporting closely with statutory reporting under AASB1 023 so as to allow improved performance analysis and a clearer view of profitability for APRA at a level of detail previously not available through the APRA returns.

It is expected that the final prudential standards and reporting standards will be effective on 1 July 2010.

See http://www.apra.gov.au/Policy/upload/GI_DP-prudential-reporting-3-December-2009.pdf.

Capital review

APRA is presently conducting a review of the general insurance and life insurance capital standards with the objectives being to:

- improve the risk-sensitivity and appropriateness of the standards

- improve the alignment of the standards between industries, and
- consider the standards in light of international developments.

APRA intends to adjust the current standards in the light of experience to date with the existing standards but this is a significant project. Modest changes are proposed to general insurers but more significant ones will apply to life insurers with the new standards intended to be implemented in 2012.

Changes to the national claims and policies database

APRA has undertaken various consultations on the NCPD which is designed to:

- provide insurers, the community and governments with a better understanding of public and product liability and professional indemnity insurance, and
- help make these products more affordable and available by providing insurers with detailed information to help them assess risks and premiums for these insurance products.

APRA proposes to publish all premium data in Level 1 and Level 2 reports with no masking, with the data being published without masking, except for those data items that need to be protected for privacy reasons.

Event reporting

The insurer representative body in Australia is The Insurance Council of Australia. It collects and publicises industry data on major weather events. APRA has an interest in accessing this information and agreement on how to do this has recently been reached between the Board of the Insurance Council and APRA. APRA will receive data from insurers more or less simultaneously with the Insurance Council receiving the same data from insurers.

Supervision of conglomerate Groups

APRA released a discussion paper in March 2010 outlining APRA's proposals to extend its current prudential supervision framework to conglomerate groups (containing APRA-regulated entities) that have material operations in more than one APRA-regulated industry and/or have one or more material unregulated entities.

As noted above APRA is already supervising banking and general insurance groups on a group basis. However, APRA is aware that:

- the failure of one entity (regulated or not) within a conglomerate group may damage or even cause the failure of related entities and a narrow, stand-alone view of regulated entities is insufficient to obtain a full picture of the financial risks to which depositors and policyholders may be exposed
- the more material a group's activities outside its primary industry, the greater the risk that an industry-focused supervisory regime will not appropriately detect or respond to risks associated with these activities, and

- APRA's proposes a Level 3 supervision framework to ensure that prudential supervision adequately captures the risks to which APRA-regulated entities within a conglomerate group are exposed and which, because of the operations or structures of the group, are not adequately captured by the existing prudential frameworks at Level 1 and (where it applies) Level 2.

Internationally, this need for a broader group-wide view has been well recognised. The proposed framework is a flexible one intended to ensure that group structures are not unduly restricted by supervisory intervention whilst giving both APRA and the group itself a better understanding of the risks that arise from the group and its activities.

See <http://www.apra.gov.au/Policy/upload/Discussion-paper-Supervision-of-conglomerate-groups-March-2010.pdf>.

Proposed changes to crisis management and other powers of APRA

An exposure draft of the Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Bill 2010 was released on 1 January 2010.

The purpose of the Bill is to improve the ability of APRA to manage future financial sector crises by strengthening its ability to effectively supervise and, where necessary, manage distress of regulated institutions, in particular insurers.

The Bill proposes to make amendments to legislation affecting APRA's "crisis management and prudential framework" - including the *Insurance Act 1973*, the *Life Insurance Act 1995*, the *Banking Act 1959*, the *Australian Prudential Regulation Authority Act 1998*.

New Preventative powers relevant to insurance are proposed which include the power to:

- exclude assets or amounts from being included as "assets in Australia" for the purposes of compliance with prudential standards applying to general insurers and clarify that the term Australian assets applies to the requirement that, in the liquidation of an authorised insurer, the Australian assets would firstly be applied to meeting its liabilities in Australia
- set binding minimum criteria for the granting of an authorisation to carry on a regulated business or to operate a non-operating holding company of a regulated business. This is aimed to enhance the authorisation framework
- maintain an authorisation of an insurer where APRA exercises a right to revoke the insurer's authority has been included
- make prudential standards in respect of consolidated general insurance groups as a whole, and in respect of certain parts of a group. APRA would be empowered to impose requirements in areas such as capital adequacy, risk management and governance upon the entire group. Currently APRA can only do so in relation to the head entity of a general insurance group

and require it to monitor subsidiaries. This change would result in a significant broadening of APRA's powers. A discussion paper has already been released on the relevant standards. For more detail see: <http://www.apra.gov.au/Policy/Supervision-of-conglomerate-groups.cfm>

New Correction powers are proposed which include the power to:

- issue directions where there is a "material deterioration" in a regulated entity's financial position (currently it is only a "sudden" material deterioration). The concept behind this is that it is the extent not the speed of the deterioration which is relevant, and
- issue directions as a result of the conduct of a subsidiary of a regulated entity

New failure management powers are proposed which include the power to:

- obtain timely information on the appointment of external administrators
- compel the compulsory transfer of business between general insurers (the powers already exists for life insurers) and also the compulsory transfer of parts of a general or life insurance business to an unregulated entity, and
- directing a general or life insurer to recapitalise should the circumstances in which APRA may appoint a statutory or judicial manager arise.

New Investigative changes are proposed that include:

- the power to commence or continue an investigation where an entity enters external administration - currently APRA's power is unclear in this regard
- amendment preventing persons from refusing to comply with information requests on the basis that it may make the person liable to a penalty or disqualification etc
- record keeping requirements eg must be kept in Australia, notice of location and changes of location and in English or in a form readily convertible to English etc, and
- new protection and sharing of information requirements are broadened to ensure any documents collected from financial sector entities regulated by APRA are subject to the existing protections in a consistent way.

New Data collection powers are proposed which include the power:

- on receiving a direction from the Minister, to collect data under the *Financial Sector (Collection of Data) Act 2001 (FSCD Act)* and to determine reporting standards for entities which provide financial services or participate in payments systems which are not currently covered by the FSCD Act
- to impose a reporting standard relating to information collected on a one-off basis which won't be made available to the public, and
- to make urgent reporting standards under the FSCD Act without consultation - existing powers will be expanded to include circumstances

where APRA is satisfied that the delay involved in consultation would have a detrimental effect on financial system stability.

Other powers

The Bill also:

- makes fine tuning amendments to the Financial Claims Scheme
- makes fine tuning amendments to the rules regarding the appointment and conduct of auditors and actuaries, and
- amends the operation and method of calculation of levies payable to APRA.

For more detail see: www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1708.

Lenders Mortgage insurers

Lenders mortgage insurers in Australia are subject to certain standards that only apply to these insurers. Amended standards are proposed in relation to the Maximum Event Retention (MER) from 1 May 2010.

See www.apra.gov.au/General/upload/ADI_RS_MERLMI_032010_v5-2.pdf.

New Proposal for Compensation fund

On 3 May 2010 the Federal Government's announced that a statutory compensation scheme will be examined. Their concern is that the current requirement that Australian Financial Services licensees hold professional indemnity insurance does not provide consumers with an assurance that they will be duly compensated. At present it is only proposed to apply to investors rather than insureds under insurance policies but FOS is lobbying for it to be extended to insurance.

For more detail see: <http://www.moneymanagement.com.au/article/FOS-welcomes-statutory-compensation-scheme-examination/516186.aspx>

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