

CLAYTON UTZ

Insurance Law Reforms and Requirements for Direct Offshore Foreign Insurers ("**DOFIs**")

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1. Reforms to DOFIs and Discretionary Mutual Funds ("DMFs")

Reforms to DOFIs and DMFs were announced by the Minister for Revenue and Assistant Treasurer, the Hon Peter Dutton MP, on 3 May 2007. The Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 ("**Bill**") was introduced in Parliament on 21 June 2007, and proposes to amend the *Insurance Act 1973* (Cth) ("**Act**") and the *Corporations Act 2001* (Cth) ("**CA**") by reforming activities of Direct Offshore Foreign Insurers ("**DOFIs**") in Australia.

1.1 Background

The HIH Royal Commissioner's report raised concern about the regulation of DOFIs and DMFs.

In September 2003, the Commonwealth Government commissioned the *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers* (the "**Potts Review**").

In January 2004, the Potts Review reported to the Treasurer, recommending that all DMFs with 'contingent risk' and all DOFIs not under a prudential regulation regime considered comparable to the Australian framework should be regulated by the Australian Prudential Regulation Authority ("**APRA**").

In December 2005, the Treasury released a discussion paper seeking public submissions on proposals to implement the Potts Review recommendations.

These reforms are proposed to commence on 1 July 2008, with further industry consultation planned ahead of implementation of the reforms.

1.2 Direct Offshore Foreign Insurers - *Corporations Act* Amendments

The Bill proposes to introduce into the CA a prohibition on financial services licensees and their authorised representatives dealing in a general insurance product involving an insurer that is not either:

- (a) a general insurer within the meaning of the Act; or
- (b) a Lloyd's underwriter within the meaning of the Act; or
- (c) a person allowed to carry on insurance business without being authorised under the Act by determination of APRA.

Breach of the prohibition is deemed to be a strict liability offence carrying a financial penalty.

This reform is likely to be the real barrier to DOFIs selling products in Australia, given the broader scope of "dealing" compared with "carrying on insurance business" - although this will depend on the specifics of the amending legislation.

AFSL holders will be required to provide data to the Australian Securities and Investments Commission ("**ASIC**") on their dealings in products from exempt DOFIs.

1.3 Direct Offshore Foreign Insurers - *Insurance Act* Amendments

The Bill proposes to amend the definition of insurance business under s 3(1) of the Act so as not to include reinsurance business carried on by:

- (a) a body corporate incorporated in a foreign country; or
- (b) an unincorporated body established under the law of a foreign country capable of either suing or being sued, or holding property in the name of an appropriate office holder;

that is not a general insurer. Accordingly, the authorisation requirements will not extend to foreign reinsurers of Australian risks. There will, however, be a higher investment risk capital charge applied to recoverables from reinsurers who are not Australian general insurers, see below.

The Bill proposes to provide that certain advertising and marketing activities will constitute business incidental to insurance business for the purposes of defining insurance business under s 3(1) of the Act. These activities are taken to occur in Australia to the extent that they have or are likely to have effect in Australia.

The Bill proposes to amend the Act to provide that a person is taken to carry on insurance business in Australia if:

- (a) the person carries on a business offshore that would constitute insurance business under the Act if conducted onshore; and
- (b) another person onshore acts:
 - (i) directly or indirectly as their agent; or
 - (ii) as a broker of their products, or directly or indirectly as an agent of a broker.

Entities may be exempted from the application of this provision for up to 2 years under regulations. During any such period, the entity will be deemed to be a general insurer within the meaning of the Act for the purposes of the prohibition on dealing by financial services licensees and their authorised representatives.

The Bill proposes to amend the Act to provide that certain insurance contracts may be excluded from the definition of insurance business by specification in either regulations or determinations made under regulations. Specification may include by product type or by insured.

The rationale for exemptions provided was to ensure the continued underwriting of risks that could not otherwise be underwritten in Australia due to limited size and/or lack of specialisation of the Australian general insurance market.

The Bill proposes to give the Federal Court broad powers to grant injunctions against persons involved with past, present and/or future breaches of sections 9 and 10 of the Act relating to carrying on insurance business in Australia. The Court is also given the power to award damages either in substitution of or addition to the granting of injunctions.

The Bill proposes to provide the Australian Prudential Regulation Authority ("**APRA**") with the power to investigate conduct contravening sections 9 and 10 of the Act or constituting aiding, abetting, counselling or procuring of such a contravention. APRA may conduct the investigation itself or appoint an inspector.

Powers granted to APRA and its appointed inspectors to conduct such an investigation include powers to:

- (a) gain access to premises (subject to the granting of a warrant by Magistrate where required);
- (b) require production of documents;
- (c) take copies of documents produced;
- (d) require reasonable assistance be given to the investigation; and
- (e) require appearance for examination.

Refusal or failure to comply (to the full extent possible) with requests for production of documents, reasonable assistance and appearance for examination constitutes an offence punishable by financial penalty and/or imprisonment.

A person is not excused from complying with a request on the ground of self-incrimination, although reference to potential self-incrimination prior to answering any required questions deems such questions and answers inadmissible in any criminal proceedings against the answerer except for refusal or failure to comply.

A person being examined by APRA or an appointed inspector may be represented by a legal practitioner, although such representation may be restricted where APRA or the appointed inspector believe the representation is being used to obstruct the examination.

In conducting an examination, APRA or an appointed inspector may record the examination in writing and require the examined person to sign the record. Any signed record may subsequently be used in evidence in proceedings against the examined person. A copy of the record must be provided to the examined person, and where conducted by an appointed inspector, to APRA.

Both APRA and appointed inspectors may delegate their powers of investigation under the Act.

Investigations must be completed within a reasonable time, and investigated parties advised of both the completion of the investigation and whether APRA proposes any further conduct. Where the investigation was conducted by an appointed inspector, the inspector must provide a written report to APRA on the outcome.

The Bill proposes to expand the powers of APRA under Part X of the Act by introducing a power to require the provision of information in writing or the production of documents. Similarly with the investigation powers described above, refusal or failure to comply is punishable albeit by financial penalty only (not imprisonment) and self-incrimination provisions apply.

1.4 APRA Discussion Paper on Refinements to General Insurance Prudential Framework

The Discussion Paper outlines proposed "modifications and clarifications" to the prudential framework following from the introduction of the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 (Cth).

The refinements will impact both current and future authorised insurers.

Insurers will be grouped into one of five categories (based on risk profile): (A) locally incorporated insurers; (B) wholly owned subsidiaries of a local or foreign insurer; (C) foreign insurers authorised to operate in Australia as a branch; (D) association captives; and (E) sole parent captives.

For all insurers, the reporting framework will shift in focus from capital adequacy to performance analysis, with the claims development table to be reduced in scope, investment income required to be allocated between assets supporting insurance liabilities and other net assets, and premiums for bound but not incepted business to be identified separately.

Reinsurance recoverables from foreign reinsurers will attract higher investment risk charges than those from authorised insurers; and be recognised as part of an insurer's capital base where outstanding less than 12 months, from an authorised insurer, or supported by assets in Australia guaranteed to be available when required. Assets held by a foreign sub-custodian will be specifically excluded from being "assets in Australia".

For Category A, B and C insurers, the total amount of premium ceded to reinsurers will be expected not to exceed 60% of gross written premium.

For Category B and C insurers, use of a group actuary not resident in Australia will be allowed, and strategic plans prepared on a group basis will be accepted provided there is adequate detail about each authorised insurer in the group.

For Category C insurers, 'assets in Australia' requirements will be amended to provide greater flexibility in holding assets, and corporate agents will be allowed in Australia.

For Category D insurers, outsourcing of material business activities to related parties will need to be documented in written contracts.

For Category D and E insurers, the minimum capital requirement floor will be lowered from \$5m to \$2m, with the expected buffer to increase from 20% to 50% above minimum where the minimum capital requirement is less than \$5m.

The total amount of premium ceded to reinsurers will be expected not to exceed 90% of gross written premium.

For Category E insurers, up to 100% of the capital base may be lent back to the parent group on commercial terms, and new pre-conditions will apply for granting alternative arrangements where there is not a majority non-executive Board.

The Discussion Paper notes that Treasury is currently developing options for limited exemptions to prudential regulation for DOFIs, and will release a separate discussion paper.

1.5 Discretionary Mutual Funds

The *Financial Sector (Collection of Data) Act 2001* (Cth) will be amended to require DMFs to provide data to APRA on their operations.

AFSL holders will be required to provide data to ASIC on their dealings in products from DMFs.

Within three years of the start of this data collection regime, the Government will review the data to determine whether prudential regulation is required for DMFs.

DMFs will be subject to enhanced product disclosure requirements.

These reforms are proposed to commence as soon as practicable.

2. Insurance Contracts Amendment Bill reforms

2.1 Proposed Reform of the Insurance Contracts Act 1984 (Cth)

The Exposure Draft of the *Insurance Contracts Amendment Bill 2007* (Cth) (the "**Bill**") implements most of the recommendations proposed in the 2003 review of the *Insurance Contracts Act 1984* (Cth) (the "**ICA**").

The change of most concern to foreign insurers is the proposed amendment to section 8 of the ICA. Pursuant to the changes proposed to section 8, the ICA will apply to a contract of insurance if the insured is domiciled in Australia or if the risk of loss or damage is in Australia, irrespective of the insurer's location or where the contract of insurance was entered into. Accordingly, the ICA will, for purposes of Australian law, govern contracts of insurance entered into by direct offshore foreign insurers, whether authorised or not, if either the insured or the risk is located in Australia. This will override, as a matter of Australian law, any choice of law or choice of forum clauses to the contrary, in the policies themselves.

The other main changes proposed in the Bill include the following:

- (a) in relation to "bundled contracts" of insurance (i.e. contracts which provide different types of insurance in the one contract), the ICA will apply to the parts of the contract which are subject to the ICA but not to those parts of the contract which are exempt;
- (b) the insured's duty of disclosure in section 21 will be amended to clarify that factors relevant to the scope of the duty include the nature and extent of the insurance cover, the class of persons to whom insurance is provided, the insurer's business and the circumstances in which the contract of insurance was entered into;
- (c) a breach of the implied term to act with utmost good faith, in section 13, will also be a breach of the ICA, thereby allowing ASIC to bring an action against the insurer on behalf of the insured or to impose penalties for a breach of the ICA;
- (d) the duty of utmost good faith will also apply to and be owed by third party beneficiaries, although this will be only after the insurance contract is entered into;
- (e) at present, a party cannot rely on a provision in a contract of insurance if to do so would constitute a breach of utmost good faith. The ICA will be amended so that a party also cannot rely on a provision of the ICA itself if to do so would be a breach of utmost good faith;
- (f) third party beneficiaries will obtain new rights similar to the rights of named insureds, including enhanced access to information from insurers about the scope of coverage;
- (g) the Bill clarifies that a third party beneficiary claiming under a policy is in no better position than the insured and the insurer can raise any defences relating to the insured's conduct (including non-disclosure) against the third party beneficiary as well; and
- (h) an insured can notify the insurer of facts that may give rise to a claim up to 28 days after the expiry of the policy period. Accordingly, under "claims made and notified" policies, an insurer can refuse a subsequent claim if the insured knew of facts that could give rise to a claim and did not notify the insurer either during the policy period, or within 28 days of its expiry. This amendment is intended to address the concerns of insurers that section 54 of the ICA has the effect of frustrating the

operation of claims made policies, by permitting insureds to notify circumstances after expiry. The amendment is incorporated in a new section 54A, which will apply to claims made policies. Section 54 will no longer apply to failures to notify circumstances under such policies.

Notably, the Bill has not dealt with the recommendations relating to the rights of innocent co-insureds.

3. Requirements for DOFIs to operate in Australia

3.1 Introduction

A foreign insurer wanting to carry on general insurance business in Australia currently may do so by establishing either a locally-incorporated foreign-owned subsidiary ("**subsidiary**") or a local branch ("**branch**").

In each instance, application in writing must be made to the APRA for authorisation under the *Insurance Act 1973* (Cth).

3.2 Requirements for Establishing a Subsidiary

An application for authorisation of a subsidiary must include:

- (a) details of the ownership, board and management of the subsidiary including:
 - (i) state of incorporation;
 - (ii) address of both the registered and operational offices; and
 - (iii) information about directors and senior managers;
- (b) a business plan including:
 - (i) goals for the first three years of operations;
 - (ii) an outline of the proposed activities and operations such as the proposed classes of insurance business to be written and any relevant expertise;
- (c) a written risk management strategy detailing procedures to control and monitor risks in relation to both domestic and offshore operations of the subsidiary;
- (d) a written undertaking by substantial shareholders, such as the foreign parent, to provide additional capital (if required) and confirm that their investment in the insurer represents a long term commitment;
- (e) details of the foreign parent including:
 - (i) a brief history and an outline of operations;
 - (ii) details of substantial shareholders (both direct and ultimate), and directors (including principal business associations);
 - (iii) balance sheet, profit and loss, and off-balance sheet data for the last three years (plus any available current year data);
 - (iv) an outline of the proposed reporting lines from the subsidiary to the foreign parent; and

- (v) an outline of the supervisory arrangements to which the foreign parent is subject in its home country;
- (f) a written undertaking from the foreign parent that it will:
 - (i) co-operate in the supervision of the subsidiary, including providing information required by APRA for effective supervision;
 - (ii) keep APRA informed of any significant developments adversely affecting its financial soundness and/or reputation globally; and
 - (iii) provide APRA with copies of its published financial accounts and any significant media releases;
- (g) a written statement from the home supervisor of the foreign parent that:
 - (i) the foreign insurer is of good financial standing;
 - (ii) the supervisor consents to the application for an authority to operate through a subsidiary in Australia; and
 - (iii) the supervisor is willing to co-operate with APRA in the supervision of the subsidiary; and
- (h) an acknowledgement from the subsidiary that APRA may discuss its conduct and status with its foreign parent and with its parent home supervisors.

The subsidiary must also ensure that adequate systems and controls are in place, including a strategy and systems for reinsurance management that incorporate policies and procedures for selecting and monitoring reinsurance programs and management responsibilities and controls.

3.3 Requirements for Establishing a Branch

An application for authorisation of a branch must include:

- (a) a brief history of the foreign insurer and an outline of its operations;
- (b) the names of substantial shareholders (both direct and ultimate) and their respective shareholdings, together with details of any related entities in Australia;
- (c) information necessary to demonstrate financial standing including the balance sheet, profit and loss and off-balance sheet data for the insurer and any holding company for the last three years (plus any available current year data), and information on capital ratios;
- (d) details on whether the head office carrying on business outside Australia has complied with the applicable insurance law during the preceding five years;
- (e) a business plan including:
 - (i) goals for the first three years of operations;
 - (ii) an outline of the proposed activities and operations such as the proposed classes of insurance business to be written and any relevant expertise;
- (f) details of the location of the head office in Australia and an outline of the branch network envisaged and a timeframe for establishment;

- (g) evidence that, from the commencement of operations, information and other systems will be capable of producing all required statutory accounts and reporting forms in an accurate and timely manner;
- (h) an undertaking to keep APRA informed of developments in its subsidiaries in Australia;
- (i) information regarding the proposed agent or employee representative in Australia, including details of arrangements to cover periods where the agent is absent from Australia or for any reason unable to perform his or her duties;
- (j) details of contractual and power-of-attorney arrangements proposed to be entered into between the foreign insurer and the agent in Australia;
- (k) a statement from the home supervisor of the foreign insurer that:
 - (i) it consents to the application to establish a branch in Australia;
 - (ii) confirms that the foreign insurer is of good financial standing; and
 - (iii) agrees to co-operate with APRA in the supervision of the branch; and
- (l) an acknowledgement by the foreign insurer that APRA may discuss the conduct of the Australian operations with its head office and the home supervisors of the head office.

Although it will remain necessary for DOFIs who wish to pursue authorisation in Australia to do so by way of the establishment of either a local subsidiary or a branch, APRA has indicated that it is prepared to discuss the requirements and procedures on an individual basis, and encourages contact for this purpose. In relation to the establishment and maintenance of onshore branches, in particular, APRA is contemplating a reasonable degree of flexibility in the application of the prudential standards and reporting requirements, depending upon the risk profile of the applicant and its home jurisdiction regulatory requirements.

In considering an application for authorisation, including the terms and conditions of any authorisation granted, APRA would be likely to give significant regard to the content and strength of the regulatory regime of the DOFI's home jurisdiction. For DOFIs that are regulated by the UK's Financial Services Authority or comparable European or US regulators, this may mean a relatively minimal additional regulatory burden.