

Key findings of the

# Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers

May 2004

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## INTRODUCTION

1. On 12 September 2003, in response to the recommendations of the HHH Royal Commission, the Government commissioned Mr Gary Potts (former Executive Director of the Treasury) to undertake an independent study of discretionary mutual funds (DMFs) and direct offshore foreign insurers (DOFIs). The terms of reference for the Review are at Attachment A. The Review received numerous submissions and undertook extensive industry consultation.

2. Consistent with the terms of reference, Gary Potts reported to the Treasurer on 28 January 2004 making a number of recommendations. The Government has accepted these recommendations and these will be implemented in full. The Government will undertake further consultation during the implementation of these reforms. This paper outlines the key findings of the DMF and DOFI Review (the Review).<sup>1</sup>

## KEY FINDINGS

3. The Review made a number of recommendations for change concerning the regulation of DMFs and DOFIs. The Government will implement these recommendations.

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1 The nature of the terms of reference for the Review meant that the majority of the detailed Review is commercial-in-confidence, based on information provided confidentially to the Review. This document provides the key findings of the Review.

## Discretionary mutual funds

4. The key findings relating to DMFs are as follows.
  - Require discretionary mutual cover to be offered only as a contract of insurance under the *Insurance Act 1973* (the Insurance Act) unless the Australian Prudential Regulation Authority (APRA) considers in the case of an individual entity that no contingent risk that would need to be met by additional undefined member contributions is retained in the entity (in these cases such risks would fall on the general insurer providing top up cover).
  - Require APRA to collect and collate data on business written by DMFs under the exemption.
5. The Government does not intend to regulate discretionary cover that is 'carried on' by State or local governments.

## Direct offshore foreign insurers

6. The key findings in relation to DOFIs are as follows:
  - Allow DOFIs marketing insurance in Australia to be exempt from prudential regulation in Australia if they are domiciled in a country APRA considers to have comparable prudential regulation, subject to a market significance threshold to prevent established authorised insurers moving offshore. DOFIs not meeting this test would be able to market insurance in Australia as an authorised insurer, through a branch or subsidiary.
  - Give APRA enhanced enforcement and investigative powers to establish whether the nature of a DOFI's operations is such as to require authorisation under the Insurance Act, subject to satisfactory safeguards.
  - APRA to assume a data collection role in relation to offshore insurers.

## BACKGROUND

### The HIH Royal Commission

7. The Royal Commission established to examine the failure of HIH Insurance made a number of recommendations concerning the regulation of general insurance. In his report, the Royal Commissioner Justice Owen notes 'I saw my role as essentially to identify any weaknesses in the existing regulatory landscape in light of the stresses and experience that arose from HIH and its failure'.<sup>2</sup>

8. The Royal Commission recommended that the Commonwealth Government amend the Insurance Act to extend prudential regulation to all discretionary insurance-like products – to the extent that it is possible to do so within constitutional limits. Justice Owen also commented on unauthorised foreign insurers although he did not make a recommendation in this regard.

### Discretionary insurance-like products

9. 'Discretionary cover' is a term used to describe an insurance-like product that involves no legal obligation by the provider to meet the costs of an 'insured' event. The provider of such cover merely accepts that it will, at its discretion, consider meeting such costs. Most discretionary schemes have grown out of mutual-type arrangements based around particular professions. In these schemes, a group of professionals may jointly agree to meet the costs of certain risks that members face.

10. The discretionary-nature of the products provided by these mutual funds means that the funds are not subject to the provisions of the Insurance Act as they do not meet the definition of 'insurance business'.<sup>3</sup>

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<sup>2</sup> HIH Royal Commission (April 2003) p. 197.

<sup>3</sup> *Insurance Act 1973*, section 3.

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11. The HHH Royal Commission made a specific recommendation concerning discretionary insurance cover. Recommendation 42 of the report states:

‘I recommend that the Commonwealth Government amend the *Insurance Act 1973* to extend prudential regulation to all discretionary insurance-like products – to the extent that it is possible to do so within constitutional limits.’

12. This recommendation arose largely as the result of difficulties experienced by medical defence organisations (MDOs), in particular United Medical Protection. The report notes that ‘there are reasons to believe that consumers would be unwilling to accept the failure of a provider of discretionary cover even though they may recognise that the provider was not subject to prudential regulation’.<sup>4</sup>

13. His Honour observes:

‘The discretionary structure of such arrangements, however avoids the application of the Insurance Act. A consequence of this is that the provider can avoid the costs of complying with the requirements of the Act. This may result in a cheaper product but leaves consumers without Insurance Act protections.’<sup>5</sup>

14. His Honour notes that one approach to deal with the issue is disclosure but, of course, disclosure to the insured does not ultimately protect a third party where the cover being provided is a cover relating to liability.

## Direct offshore foreign insurers

15. Foreign insurers wishing to conduct authorised insurance business in Australia must establish a subsidiary or branch in Australia and apply to APRA for licensing under the provisions of the Insurance Act. However, foreign insurers can still sell insurance to Australians via an insurance agent or broker licensed in Australia, without establishing a subsidiary or branch in Australia. These foreign insurers, known as DOFIs, are not subject to the provisions of the Insurance Act, because they are not considered to be ‘carrying on’ insurance business in Australia.

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<sup>4</sup> HHH Royal Commission (April 2003) p. 243.

<sup>5</sup> *Ibid.*



16. Following on from recommendation 42, Justice Owen made some observations about insurance written offshore, although no recommendation was made in this regard. These observations can be summarised as:

- In many instances it is unnecessary to regulate insurance written offshore because it involves large commercial insurance contracts where a purchaser is well able to judge the risks involved in the transaction.
- A number of disclosure requirements in relation to offshore insurance are imposed on insurance agents and brokers under the *Insurance (Agents and Brokers) Act 1984* (the *Insurance (Agents and Brokers) Act*).<sup>6</sup> Depending on the particular circumstances it may be that an offshore insurer operating through an Australian agent or broker would be carrying on insurance business in Australia within the meaning of sections 9 or 10 of the *Insurance Act*.

17. The Royal Commission also drew an important link between direct offshore foreign insurance and a financial system guarantee. Specifically, it was noted that a policyholder support scheme would relate to authorised insurance products and may make offshore insurance less attractive.

## DISCUSSION AND OPTIONS FOR CHANGE

### A: Discretionary mutual funds

#### Overview

18. The key factors taken into account by the Review in considering whether the current regulation of DMFs is adequate are set out below.

- i. DMFs account for a very small part of the general insurance market (less than half of one percent). With the recent hardening of the market their business has been expanding relatively quickly, especially in long tail (public liability) cover, but is destined to remain

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<sup>6</sup> The *Insurance (Agents and Brokers) Act 1984* ceased to apply from 11 March 2004. It has been replaced by amendments made to the *Corporations Act 2001* by the *Financial Services Reform Act 2001*.

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a niche part of the overall market. While the failure of DMFs is unlikely to pose any systemic threat to the industry, the withdrawal of their services could affect consumers who have found it difficult to obtain specialised insurance cover.

- ii. DMFs benefit from significant cost advantages over authorised insurers because of their exemption from State taxes (stamp duty and special levies) and, to a lesser degree, prudential supervision. Some observers believe this is an important factor behind the growth of DMFs; others believe that the difficulty in obtaining cover tailored to the specialised needs of client groups from the authorised market is more crucial.
- iii. DMFs utilise two primary legal structures:
  - incorporated as companies limited by guarantee; and
  - unincorporated associations whose financial pool is held in a discretionary trust.

The former is used by a small number of larger DMFs and the latter by one major broker in running more than 50 DMFs typically for business franchises, community groups and sporting associations. The structure chosen appears to be influenced by tax and commercial considerations.

- iv. The financial structures of DMFs have common features but also distinguishing elements that are important in considering the need for prudential regulation.
  - A common feature is that the DMFs retain a limited level of risk for individual losses within the entity (for example, the first \$1 million of a defined loss) with the cost met directly from members' contributions. Insurance cover for losses above this amount up to a prescribed maximum is obtained separately; about one third of member contributions is used (on average) to purchase this cover. Member contributions are generally held on deposit in bank accounts and therefore effectively carry no capital investment risk.

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- A distinguishing feature of some DMFs is the extent to which risk is retained in the entity that may necessitate an additional call on members in the event of unforeseen developments. In such cases members remain exposed even though the DMFs are described as fully funded.
  - All DMFs examined are structured differently from most of the MDOs. While DMFs retain insurance for claims in excess of the fund, typically MDOs were insuring the first layer of cover and providing unlimited discretionary cover beyond this layer for the insured events.
- v. The application of prudential regulation to DMFs under the Insurance Act is unlikely to be feasible while they retain their discretionary character.
- vi. DMFs, while currently not subject to prudential regulation, are subject to market conduct and disclosure rules under the *Corporations Act 2001* (the Corporations Act) which have been tightened in recent years. Specific exemptions are available depending on the nature of the product being provided, as for other financial products.
- vii. Overseas regulatory practice towards DMF-type structures varies considerably. In the US such structures are not permitted, while in the UK current practice is not dissimilar from that in Australia.

## Review Option 1

19. Require discretionary mutual cover to be regulated by APRA as a contract of insurance under the Insurance Act unless APRA considers in the case of an individual entity that no contingent risk that would need to be met by additional undefined member contributions is retained in the entity (in these cases such risks would fall on the general insurer providing top up cover).

20. Require APRA, or the Australian Securities and Investments Commission (ASIC), to collect and collate data on business written by DMFs under the exemption.

### Comments of the Review

- To achieve this outcome the same legal approach could be adopted as in the case of the MDOs. Legislation would need to prescribe that insurance-type cover could be provided only by way of contract.
- Possible exemption from regulation would be an unusual feature of the regulatory framework but would recognise the fact that a large number of current DMFs are structured in a way that does not warrant prudential regulation.
- A possible additional exemption for funds offering cover only to large companies could be considered on the grounds that wholesale consumers are in a position to be fully informed about the risks of insuring through an unregulated entity.
- Suitable transition arrangements would be necessary to give effect to this option.

## Review Option 2

21. Instead of bringing DMFs under prudential regulation based on Option 1, strengthen the ASIC consumer protection framework applying to DMFs by:

- i. Improving disclosure requirements to consumers, including legislative prohibition of the terms 'insurance' and 'insurer' and legislative compulsion of disclosure of the fact that the cover is

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‘discretionary’ and provided by an entity not prudentially regulated;  
and

- ii. Requiring, by regulation under the Corporations Act, certain consumer protection provisions applying to insurance products under the *Insurance Contracts Act 1984* (for example, duty of information disclosure, compulsory renewal notices for members/policyholders) to apply also to DMFs.
22. Require ASIC, under Australian Financial Service (AFS) licence conditions, to collect and collate data on business written by DMFs.

### Comments of the Review

- The introduction of AFS licensing is an important step forward in the regulatory oversight of financial bodies, including DMFs. The ASIC financial requirements placed on licensees are comprehensive and not in need of any obvious tightening as far as DMFs are concerned. Of importance will be the issue of how effectively the requirements are monitored from year-to-year. The current AFS licence condition that auditors sign off each year on DMFs’ prescribed financial requirements is appropriate and should be supported by ASIC monitoring.
- This Option would fall short of prudential supervision. ASIC has neither the mandate nor competence to conduct proper prudential supervision. While it could seek APRA’s advice on specific issues from time to time, APRA advice on a regular basis would not be satisfactory.
- Compulsory disclosure to DMF members of the status of their DMF would be helpful. However its value may not be significant. In many cases, members are already well informed or are seeking cover not elsewhere available in the market or, if so, at a significantly higher price; nor would it provide any additional protection to third parties involved in public liability and professional indemnity claims.
- As an alternative to Option 1, Option 2 is a stand-alone option. However, if Option 1 were implemented, Option 2 should apply to DMFs exempt from APRA regulation.

### Preferred approach

- Option 1 was the preferred approach of the Review. It targets prudential supervision to where it is justified and does not unnecessarily penalise

DMFs filling market gaps. In essence DMFs would be subject to prudential supervision unless members have no unquantified risks against current contributions. This would include professional indemnity schemes like the previous MDOs where members of the public can be at risk. Option 2 should apply to DMFs exempt from APRA regulation.

## B: Direct offshore foreign insurers

### Overview

23. In considering options for change in the current regulatory arrangements for DOFIs the key issues the Review noted are set out below.

- i. DOFIs represent only a small part of the general insurance market in Australia (about 2½ per cent) but provide important additional capacity in specialised insurance lines. They operate largely out of comparable regulatory jurisdictions, and much of the business written is for large corporate entities less likely to require prudential regulatory protection – for example, in wholesale markets such as maritime, aviation and other large commercial risks. At the retail and smaller corporate level, DOFIs have been filling gaps in the long tail market in response to the withdrawal of domestic capacity. DOFIs also enjoy significant tax advantages (largely not being subject to State stamp duties), especially in some insurance classes, over Australian authorised insurers, which are reflected in lower business costs for Australian companies.<sup>7</sup> This profile underlines the importance of not implementing regulatory changes of a magnitude or a time frame that could prove disruptive, especially in parts of the general insurance market already under strain. It also suggests that the current arrangements, despite their conceptual weaknesses (see below), are not in need of urgent repair as far as policyholder protection is concerned.
- ii. The current regulatory treatment of foreign insurers operating in Australia lacks consistency. Foreign insurers treated in different ways are: foreign insurance companies operating as authorised subsidiaries or branches in Australia; Lloyd's underwriters authorised under

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<sup>7</sup> For a property risk policy written out of Singapore taxes levied represent 2 per cent of the pre-tax cost of the premium; the comparable figure for an Australian policy is 20-70 per cent depending on the State of origin of the policy.

special provisions of the Insurance Act; and foreign insurers conducting business in Australia through agents or brokers and either authorised or not, depending on how business is conducted. In addition, foreign insurers not authorised in Australia are domiciled in jurisdictions of different regulatory discipline. This difference in regulatory treatment means that the degree of protection afforded to policyholders for exactly the same insurable risk will vary depending on the country of origin of the insurer selected.

- iii. Establishing a fully consistent prudential regime could require a review of the Insurance Act addressing both the 'carrying on insurance business in Australia' test and the special provisions for Lloyd's underwriters. The 'carrying on insurance business in Australia' test lacks clarity, is unnecessarily restrictive and does not reflect the implications of the internationalisation of insurance services. A test based more on 'location of risk' being insured may be more suitable in providing more uniform protection to policyholders.
- iv. Scope exists to improve current prudential regulatory arrangements for DOFIs with less significant change to the Insurance Act. Desirably this should seek to avoid prohibiting commercial arrangements that have worked satisfactorily to date and target areas of highest risk such as foreign insurance companies operating out of low status regulatory jurisdictions with minimal prudential requirements and where indeed most of the problems have been originating. Measures to improve APRA enforcement powers could be considered.
- v. Even in the absence of changes to prudential supervision, consumer protection is likely to be enhanced by requirements introduced by the *Financial Services Reform Act 2001* (the FSR Act) requiring DOFIs (with some exemptions) to hold AFS licences. Licensees will be required to meet ASIC financial conditions and information disclosure/market conduct rules. Scope exists to improve the information disclosure rules in particular, as a means of ensuring consumers are as well informed as possible about the status of DOFIs and their products.

## Review Option 1

24. Allow foreign insurers, operating either directly or through intermediaries, to market insurance products in Australia only as authorised branches or subsidiaries.

### Comments of the Review

- This Option would prevent the current practice of foreign insurers selling through brokers and agents. It would be achieved by modifying the current 'carrying on insurance business in Australia' test to make it clear that it covered insurance products marketed in Australia through intermediaries.
- Foreign insurers conducting business in Australia would be placed on an equivalent regulatory footing (although Lloyd's underwriters would continue to receive special treatment). All would need to be authorised, and as such would be supervised by APRA. Consumers would enjoy maximum protection available from prudential regulation. For reasons set out in the summary above this option could be seen as excessive in dealing with an issue of limited practical significance. The insurance business written is largely wholesale; it has been growing in the public liability area where onshore capacity has been diminishing; and most of the foreign insurers are already supervised by regulators of comparable standing. Importantly there would be a risk of some insurers, unwilling to meet additional capital standards and liability valuation rules, withdrawing from the market.
- Under this Option (and Option 2) DOFIs operating as captive insurers, for example those insurers established by large corporations in offshore jurisdictions, would not be considered to be marketing insurance in Australia and accordingly would not be required to be authorised. These insurers pose little threat to retail policyholders and accordingly exemption from the authorisation requirement would be appropriate.

## Review Option 2

25. Introduce arrangements for DOFIs along the lines of the trust fund-type arrangements applying to Lloyd's underwriters requiring DOFIs marketing insurance in Australia, either directly or through intermediaries, to maintain both funds and a presence in Australia through an agent.



### Comments of the Review

- This Option would allow the existing approach for authorised insurers and intermediaries to continue and place DOFIs on a similar footing to Lloyd's underwriters. It would provide protection for Australian policyholders where the insurer is located in another jurisdiction. Both APRA and ASIC would be able to take enforcement action.
- The method of providing financial security could be flexible if the current trust fund arrangements were considered too cumbersome to extend to a range of insurers. A letter of credit or other suitable bank security related in size to the level of Australian liabilities could be considered.
- Even with modifications, the arrangements would be administratively burdensome. They would place additional financial standards on insurers from high status jurisdictions and may not be significantly less demanding than full authorisation. It would also seem burdensome to alter regulatory arrangements for Lloyd's given that the arrangements were amended from 2000.
- Exemptions could be considered for DOFIs only undertaking large scale wholesale business.

### Review Option 3

26. Allow DOFIs marketing insurance in Australia to be exempt from prudential regulation in Australia if they are domiciled in a country APRA considers to have comparable prudential regulation, subject to a market significance threshold to prevent established authorised insurers moving offshore. DOFIs not meeting this test would be able to market insurance in Australia as an authorised insurer, through a branch or subsidiary.

### Comments of the Review

- The advantage of this approach is that it represents a practical and well-targeted response to the issues arising in relation to DOFIs. It would leave untouched the great bulk of DOFI activities which, even though not regulated in a consistent manner, are not giving rise to significant problems. On the other hand, it would bring into the regulatory net in Australia those DOFIs that choose to be domiciled in countries with low status regulation or no prudential system.

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- Differentiating between overseas regulatory systems will require the co-operation of countries considered. The approach would be similar to ASIC's current practice of allowing recognition of comparable market regulation in other jurisdictions.
- A 'market significance' test would be necessary to prevent domestic insurers moving offshore to jurisdictions of perceived lighter regulation. The test could be set in terms of annual premium income and/or range of insurance classes in which business is written.
- For foreign insurers qualifying for an exemption, Australian creditors could be placed at a disadvantage compared to creditors in the insurer's home jurisdiction in the event of a wind up. This is a (small) risk that Australian policyholders would need to accept. The foreign insurer could be required to inform retail consumers of this risk along with details of its home jurisdiction, under the Corporations Act provisions.
- Foreign insurers qualifying for an exemption could be subject to the disclosure obligations under Option 4.

## Review Option 4

27. An alternative approach to prudential regulation would be to strengthen rules on information disclosure to consumers under the FSR Act by requiring brokers, agents and other intermediaries offering DOFI business in Australia to disclose certain information such as country of origin of the insurer, prudential regulator in country of origin (and whether the insurer is authorised to conduct insurance business in that country), reinsurance arrangements and solvency rating (if any).

## Comments of the Review

- ASIC could make the information publicly available to give the process credibility.
- This should better inform consumers interested in making informed choices between products offered by authorised and non-authorised insurers. It may not assist, however, where no choice is available (that is, only a DOFI offers the required product) or where, a consumer is motivated by price only (including taking out public liability cover mandated by statute).
- The disclosure requirements could apply to policies being sold to both wholesale and retail policyholders, even though FSR disclosure rules apply

only to retail policyholders. This could be warranted on the grounds that all policyholders regardless of size need to be aware of the status of unauthorised insurers. This approach would follow the disclosure requirements relating to unauthorised insurers in the (soon to be repealed) Insurance (Agents and Brokers) Act.

- This would be a relatively straightforward option to implement.

## Other issues identified by the Review

### Issue 1

28. Give APRA enhanced enforcement and investigative powers to establish whether the nature of a DOFI's operations is such as to require authorisation under the Insurance Act, subject to satisfactory safeguards.

#### Comments of the review

- Current enforcement provisions have some perceived weaknesses.
- This Issue could be addressed in implementing any of Options 1 to 4.

### Issue 2

29. As the Insurance (Agents and Brokers) Act ceased to apply from March 2004 there are no longer legislative requirements relating to DOFI data collection. If options implementing prudential regulation of DOFIs are pursued it would be appropriate for APRA to assume a data collection role in relation to offshore insurers. If market regulation is pursued then ASIC could compile statistics on DOFIs and provide this information publicly; comprehensive data collection would require legislative authority.

### Preferred approach

30. Option 3 is the preferred approach. It would deal effectively with the foreign insurer issue without relying on a rigorous across-the-board approach which could be disruptive to a market already under strain. Enhanced information disclosure requirements would reduce the risks associated with foreign insurers from low status jurisdictions (the source of recent problems) but would stop short of the level of protection afforded by full prudential regulation. Issues 1 and 2 identified above also warrant support.

## ATTACHMENT A: SCOPE OF THE REVIEW

On 12 September 2003, in response to the Recommendations of the HIIH Royal Commission, the Treasurer announced a review of unregulated insurance-like products.

The scope of this Review is set out by the following terms of reference:

1. The Review shall examine the extent and nature of discretionary mutual funds (DMFs) and direct offshore foreign insurers (DOFIs) operations in Australia and their contribution to overall insurance capacity.
2. In undertaking this examination the Review should have regard to:
  - a. the reasons why DMFs and DOFIs choose to do business in the manner they do; and
  - b. the level of financial and organisational resources available to DMFs and DOFIs operating in Australia.
3. The Review shall have regard to the systemic risk associated with the failure of a DMF or DOFI to meet its obligations.
4. The Review shall examine the adequacy of existing protection arrangements for consumers of products supplied by DMFs and DOFIs and provide options for improving protection arrangements.
5. In providing options, the Review will have regard to the different characteristics of DMFs and DOFIs.
6. The Review shall report to the Government on its findings by 30 January 2004.

The Review conducted by Mr Gary Potts, former Executive Director of Markets Group of the Treasury, with the assistance of Treasury, received numerous submissions from interested parties and undertook widespread industry consultation.