

□ GENERAL INSURANCE REGULATION

What to expect in 2006: regulation of general insurance

After the frenzy of implementation of the financial services reform regime, 2005 has been a year of fine tuning, consultation and breath-holding.

Fine tuning has revolved around the financial services regime, dealing with disclosure, client money, conflicts of interest, breach notifications and audits, through the ASIC policy statements and proposed amendments to regulations. Responsibilities and liabilities pertaining to authorised representatives and what is expected of responsible officers have also occupied the industry's attention.

A new General Insurance Code of Practice developed by the Insurance Council of Australia was launched on 18 July. The Code sets out minimum service standards extending to most types of general insurance products for individuals and businesses.

There has been a range of industry consultation particularly in the area of the prudential supervision of Australian regulated general insurers, spearheaded by a discussion paper entitled "Prudential Supervision of General Insurance Stage 2 Reforms" released by APRA on 20 November 2003. This year, several discussion papers were released on the topics: risk and financial management, governance, fit and proper, the prudential supervision of corporate groups involving authorised general insurers and, most recently, capital, assets in Australia and custodian requirements.

The industry has held its breath in relation to several proposals:

- The review of the *Insurance Contracts Act 1984* – there have been no new developments on this since the Government released the June 2004 panel report in January 2005.
- The Davis Report on the study of financial system guarantees considering the merits of introducing guarantee schemes in various sectors of the financial services system is now, at the time of writing, the subject of industry consultation.
- The Potts Report providing recommendations on the proposed regulation of direct offshore foreign insurers and discretionary mutual funds has been progressed by way of the release of a consultation paper.

So what regulatory developments should be expected in 2006?

The General Insurance Stage 2 Reforms will be implemented. This will require APRA regulated general insurers to comply with new governance procedures and "fit and proper" standards for directors, senior managers, auditors and actuaries. Outsourcing and reinsurance requirements will also have to be met along with several other requirements.

The Government has announced its intention to regulate direct offshore foreign insurers. This will involve a clarification of which foreign insurers are caught by the Australian regulatory regime, an assessment of comparable prudential regulation and the establishment of a market significance threshold test to prevent established authorised insurers moving offshore.

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introduction



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In our final **Financial Services Law Bulletin for 2005** we discuss the developments that the general insurance industry can expect next year – don't expect a break from regulatory reform for some time.

We also outline some of the issues covered in APRA's discussion paper, "Prudential Supervision of General Insurance – Stage 2 Reforms, Capital, Assets in Australia and Custodial Requirements". The paper builds on general insurance industry consultation relating to the APRA Stage 2 reforms and continues APRA's response to the recommendations made by the HIH Royal Commission.

Seasons Greetings

Ebsworth & Ebsworth's partners and staff wish all our clients and friends health and happiness for the festive season and new year. This year, instead of mailing cards, we have made a donation to the Inspire Foundation and WWF Australia, two of the charities we support as part of our Workplace Giving program.

□ APRA STAGE 2 REFORMS

APRA Stage 2 discussion paper: the issues

APRA released a discussion paper on 27 October 2005 which builds on general insurance industry consultation relating to the APRA Stage 2 reforms¹. The paper focuses on capital, assets in Australia and custodian requirements and continues APRA's response to the recommendations made by the HIH Royal Commission. This article outlines some of the issues covered in the paper.

¹ The paper is titled "Prudential Supervision of General Insurance – Stage 2 Reforms, Capital, Assets in Australia and Custodial Requirements" and a copy is available from the APRA website at: www.apra.gov.au/media-releases/05_54.cfm

Reinsurance recoveries

APRA proposes not to take reinsurance recoveries into account in calculating an insurer's minimum capital requirement (MCR) unless the relevant reinsurance contracts have been properly documented. In recognition that it may take insurers some time to fully document all current reinsurance arrangements, APRA proposes a transition period – an insurer will be fully compliant with the reinsurance documentation requirements where at the end of the first financial year, 60% of reinsurance recoveries by value are supported by legally binding arrangements and at the end of the second financial year, 80% are supported. At the end of the transitional period, reinsurance recoveries that do not satisfy the requirements will be required to be deducted from an insurer's Tier 1 capital.

Run off

For general insurers in run off, APRA is committed to prohibiting reductions in capital unless assets are sufficient to cover insurance liabilities valued at a 99.5% level of sufficiency. There is no proposed relief for insurers in run off that are part of a group. This is to ensure that there is greater certainty of the ability of the individual run off insurer to meet its liabilities if there is capital strain in the rest of the group.

Custodian requirements

Custody arrangements external to a general insurer should be considered

within the overall risk management policies of an insurer. APRA's comment is generally that external custody arrangements are a form of outsourcing arrangement. Risks should be mitigated by enquiring about the custodian's internal controls, organisational structure, staffing capabilities, administrative resources and the custodian's process of selecting, monitoring and reviewing its sub-custodians. Additionally, the insurer will need to deal with the custodian's financial strength in its risk management statement. The custodian will be required to agree that it accepts responsibility for liability arising from its failure to exercise reasonable care based on standards applicable in the relevant market.

Where to from now?

Comments were due by 28 November 2005, following which the standards are expected to be finalised. The final standards resulting from the paper are anticipated to apply to general insurers from 1 October 2006.

Given the short time frame leading up to implementation it appears that there will not be many variations made to the proposed standards which reflect the changes in the discussion paper. We urge the general insurance industry to familiarise itself with the content of the changes and the potential implications on their business.

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Discretionary mutual funds are also to be regulated by APRA as providing contracts of insurance, bringing them within the capital, solvency and supervisory regime applicable to general insurers. APRA may be given the power to exempt certain DMFs from this regulation.

Expect further discussion on the establishment of a policyholder protection guarantee fund.

Anti-money laundering regulation will remain an evolving topic with some draft legislation having been released this month. This will require general insurers to assess their systems and processes for compliance with the new regime and may provide opportunities for providing new insurance products. In addition, the proposed changes to the Insurance Contracts Act may be promulgated, the financial services

reform regulation will continue to be fine tuned and the General Insurance Code of Practice must be implemented by July 2006. All these developments, combined with the introduction of International Financial Reporting Standards, will mean that the general insurance industry should not expect a break from regulatory reform for some time.

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□ NEWS IN BRIEF

Superannuation

- The ATO has released Superannuation Guarantee Ruling SGR 2005/2, which outlines the superannuation guarantee obligations for tripartite employment arrangements, commonly involving labour hire firms, service firms and employment agencies.
- Treasury released in late November revised draft superannuation contributions splitting regulations to address some of the issues arising from the public consultation period.
- The ATO has announced that Part IVA will not apply where taxpayers are simply commencing a transition to retirement pension, and making salary sacrifice contributions to superannuation.
- Superannuation Guarantee Determination SGD 2005/1 was released in mid November and provides that a failure by a clearing house to forward contributions to a superannuation fund by the required date for the quarter under superannuation legislation, will result in a failure by the employer to make that contribution by the required date. Moreover, it makes no difference if the clearing house is operated by the superannuation fund. The contribution is taken to be made to the superannuation fund when the trustee of the fund receives the contribution.
- Superannuation Industry (Supervision) Amendment Regulations 2005 (No. 5) have been issued and specify matters that are to be taken into account in determining whether two people have a "interdependency" relationship for the purposes of the taxation of superannuation death benefits in circumstances where, if they are paid to a "dependant" of the deceased, they are tax free.
- In November 2005 Treasury released draft amendments to the SIS Regulations proposing to update the allocated pension drawdown factors and provide further flexibility for market linked income streams. The draft Regulations seek to give effect to the measures announced on 27 September 2005 as part of the Government's response to its review of pensions provided by small superannuation funds.

FSR

General advice warning

ASIC has recently provided relief under Class Order CO 05/1195 for providers of general financial product advice, to allow advisers to give a shorter, simpler general advice warning when they provide oral general advice. Examples of warnings that may be given under the relief are:

- "This advice is general; it may not be right for you."
- "This advice is not tailored, so you can't assume it will be suitable for you."

- "This advice may not be suitable for you because it is general advice."
- "You will need to decide whether this advice meets your needs because I haven't."

Under the relief, the simpler warning needs to be given only once in any telephone conversation or face-to-face meeting where general advice is provided to a retail client.

New Professional Standard: Statement of Financial Advisory Service APS 12

Jointly issued by the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia, the new standard came into effect on 1 November 2005. The new standard "will set fair, ethical and professional conduct standards for Australians seeking financial planning advice" and "will govern all aspects of financial advice provided by members of CPA Australia and ICAA, including clear definitions in relation to fees and commission, whether fees should be the preferred method of remuneration, and the banning of heavy initial-fee discounting".

"Unit Pricing – Guide to good practice"

APRA and ASIC have jointly published a document entitled "Unit Pricing – Guide to good practice" (November 2005) to address serious problems for investors when errors in the calculation of unit prices occur. The five good practice principles set down in the document are:

- unit pricing policies and practice must be consistent with the relevant PDS and offer documents;
- sound unit pricing policies should seek to treat unit-holders consistently and be kept up-to-date;
- adjustments to unit prices, if based on sound policy, are not errors: compensation need not always be paid in such a situation;
- while estimation should be avoided, where it is unavoidable it should be done with reference to estimation policies which seek to provide equity to unit-holders and potential unit-holders; and
- disclosed information should be made readily available in an appropriate form.

APRA and ASIC note that justifiable alternative practices may be appropriate at times. For further information see: www.apra.gov.au/media-releases/05_55.cfm

AFS licence application changes

ASIC has introduced changes which will reduce the amount of paperwork required to be submitted as part of an application for an Australian financial services (AFS) licence. Changes to ASIC's AFS Licensing Kit see the introduction of a new three-part structure:

- Part 1 explains how to apply for a licence, and how to later apply for a variation to it.

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- Part 2 covers technical issues applicants will encounter when completing their licence or variation application. It also identifies the core proofs that must be provided by all applicants when they lodge their application with ASIC.
- Part 3 explains any additional proofs that ASIC may ask for later on.

Further information about the changes to ASIC's AFS Licensing Kit is available on the ASIC website at: www.asic.gov.au/afsl

International Financial Reporting Standards: APRA's first consultation package released

On 29 November 2005 APRA issued the first of two consultation packages outlining its proposed prudential response to the adoption of International Financial Reporting Standards in Australia by authorised deposit-taking institutions (ADIs) and general insurers. The consultation package outlines APRA's approach on a range of issues including fair value measurement, excess of market value over net assets (EMVONA), employer sponsored defined benefit superannuation fund surpluses and deficits, and loan loss provisioning. Comments on the proposed ADI prudential standards are invited by 16 January 2006. The standards will come into force from 1 July 2006. The response can be viewed at APRA's website at: www.apra.gov.au/ADI/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=9595

Auditors

ASIC has released the findings of its on-site auditor inspection program, since the enactment of new regulatory requirements. Under the *Corporations Act 2001*, ASIC has responsibility for the surveillance, investigation and enforcement of auditor independence requirements. ASIC's inspections focused on the "Big Four" professional service firms and identified that:

- all firms had documented policies in place and these were generally adequate;
- while ASIC conducted a limited review of engagement files to see whether these policies were being implemented in practice, it did not seek to comprehensively test for breaches of the audit independence requirements; and
- no breaches of the *Corporations Act 2001* were identified in the course of the inspections.

General

- APRA introduced a new prudential standard and authorisation guidelines for providers of purchased payment facilities (PPFs), a new class of authorised deposit-taking institution (ADI) on 17 November 2005. PPFs are new forms of payment instruments such as stored-value cards and internet-based payment systems or "electronic purses". The new standard applies a simplified framework for capital adequacy, liquidity and operational risk to PPF providers that have stored value at risk. PPF providers must also meet ADI prudential standards on governance, fitness and propriety, outsourcing, business continuity management and auditing requirements.
- ASIC has published a new policy, Non-cash Payment Facilities PS 185 (15 November 2005). The policy marks a necessary shift to a more flexible approach to full regulation of NCPs. For more information see ASIC's media release IR 05-60 at: www.asic.gov.au > Media & information releases.

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