



# IMF

## **Financial Sector Assessment Program – Australia**

Supporting Materials for Assessment Against the Insurance Core Principles

## Introduction

In 2005/2006, the IMF conducted an assessment of Australia under its Financial Sector Assessment Program (FSAP). A key part of the FSAP was an evaluation of APRA's policies and practices for the prudential supervision of insurance companies against the International Association of Insurance Supervisors (IAIS) *Insurance Core Principles*<sup>1</sup>. The IMF's detailed assessment of Australia's compliance with the Insurance Core Principles is being published separately.

In preparation for the IMF's assessment, APRA undertook a self-assessment of its compliance with the Insurance Core Principles. This paper sets out the material provided by APRA to the IMF to facilitate its assessment.

The 28 Insurance Core Principles represent an agreed set of high-level principles against which a country's prudential supervision framework can be benchmarked and assessed. Each of the principles is supported by a number of detailed 'essential' and 'additional' criteria to guide a compliance assessment.

The material provided to the IMF was prepared as at September 2005. Since then, APRA's supervisory procedures have evolved in some areas: in particular, APRA has finalised prudential standards dealing with Governance and with 'Fit and Proper'. In addition, the Government has released a draft Bill dealing with Anti-Money Laundering and Counter-Terrorism Financing which addresses issues raised by the IMF.

As an integrated prudential regulator, APRA seeks as far as possible to align its prudential requirements across all regulated institutions. However, industry-specific requirements and differences in the timing of changes in the regulatory framework mean that, the level of compliance with the Insurance Core Principles can differ between life and general insurers.

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<sup>1</sup> Insurance Core Principles and Methodology approved and issued by the International Association of Insurance Supervisors in October 2003.

## Assessment summary

Core Principles	Title	IMF Assessment
Principle 1	Conditions for effective insurance supervision	Observed
Principle 2	Supervisory objectives	Observed
Principle 3	Supervisory authority	Largely Observed
Principle 4	Supervisory process	Observed
Principle 5	Supervisory co-operation and information sharing	Observed
Principle 6	Licensing	Life - Largely Observed GI - Partly Observed
Principle 7	Suitability of persons	GI - Observed Life - Largely Observed
Principle 8	Changes in control and portfolio transfers	Observed
Principle 9	Corporate governance	Largely Observed
Principle 10	Internal control	Largely Observed
Principle 11	Market analysis	Observed
Principle 12	Reporting to supervisors and off-site monitoring	Observed
Principle 13	On-site inspection	Observed
Principle 14	Preventive and corrective measures	Life - Observed GI - Largely Observed
Principle 15	Enforcement or sanctions	Life - Observed GI - Partly Observed
Principle 16	Winding-up and exit from the market	Life - Observed GI - Partly Observed
Principle 17	Group-wide supervision	Largely Observed
Principle 18	Risk assessment and management	GI - Observed Life - Largely Observed
Principle 19	Insurance activity	Observed
Principle 20	Liabilities	Observed
Principle 21	Investments	GI - Observed Life - Largely Observed
Principle 22	Derivatives and similar commitments	Observed
Principle 23	Capital adequacy and solvency	Observed
Principle 24	Intermediaries	Observed
Principle 25	Consumer Protection	Observed
Principle 26	Information, disclosure and transparency towards the market	Observed
Principle 27	Fraud	Observed
Principle 28	Anti-money laundering, combating the financing of terrorism (AML/CFT)	Partly Observed

## ICP 1 Conditions for effective insurance supervision

### Insurance supervision relies upon:

- a policy, institutional and legal framework for financial sector supervision;
- a well developed and effective financial market infrastructure; and
- efficient financial markets.

### *Financial sector policy framework*

*EC (a): The government establishes and publicly discloses a policy statement aimed at ensuring financial stability, including the provision of effective financial sector supervision covering the insurance and other financial sectors.*

In response to the findings and recommendations of the Financial System Inquiry (known as the Wallis Inquiry) in 1997, the Australian Government adopted a functional approach to financial sector regulation with a framework incorporating prudential supervision under a prudential regulator, investment market integrity and transparency through the Australian Securities and Investments Commission (ASIC) and broader financial system stability through the Reserve Bank. The *Australian Prudential Regulation Authority Act 1998* (APRA Act) was enacted to establish the Australian Prudential Regulation Authority (APRA). Section 8 of the APRA Act states that:

‘APRA is established for the purpose of regulating bodies in the financial sector in accordance with other laws of the Commonwealth that provide for prudential regulation or for retirement income standards, and for developing the administrative practices and procedures to be applied in performing that regulatory role.

In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.’

APRA supervises the insurance sector pursuant to the provisions of the *Insurance Act 1973* (Insurance Act) and the *Life Insurance Act 1995* (Life Insurance Act). The main objective of insurance supervision, as stated under the Insurance Act and the Life Insurance Act, is to protect the interests of policyholders in a manner consistent with the continued development of a viable, competitive and innovative insurance industry.

*EC (b): An institutional and legal framework – comprising public institutions, laws and regulations – exists for financial sector issues, including those pertaining to insurance, to address system-wide issues. This framework is well-defined and publicly disclosed.*

Australia is a democracy supported by a well-established institutional and legal framework. Australia's legal framework and insurance related legislation are overviewed below.

## **Australian Law**

In Australia, the law consists of:

- Acts passed by the Federal Parliament acting within the scope of its powers under the Australian Constitution, together with delegated or subordinate legislation made under such Acts;
- Ordinances made in respect of the Territories, together with delegated or subordinate legislation made under such Ordinances;
- Acts passed by State Parliaments and the Legislative Assemblies of the Northern Territory, the Australian Capital Territory and Norfolk Island, together with delegated or subordinate legislation made under such Acts;
- so much of the common or statute law of England that was received, remains unrepealed and still applies to Australia; and
- the Australian common law, which developed from the English common law and is interpreted and modified by the Courts.

## **Australian Constitution**

Chapters I, II, and III of the Constitution confer the legislative, executive, and judicial powers of the Commonwealth on three different bodies which are established by the Constitution - the Parliament (Chapter I), the Commonwealth Executive (Chapter II), and the Federal Judicature (Chapter III). Legislative power is the power to make laws. Executive power is the power to administer laws and carry out the business of Government through such bodies as Government departments and statutory authorities. Judicial power is the power traditionally exercised by courts such as the conduct of criminal trials and determining disputes in contract, tort and equity.

## **Australian Parliament**

The Constitution established the Commonwealth Parliament comprising the Queen, the House of Representatives and the Senate (sections 1-60).

Before a proposed law (commonly referred to as a Bill) becomes an Act of Parliament, it must be passed by both the House of Representatives and the Senate. The Bill is then presented to the Governor-General who assents to it in the Queen's name (section 58). A Bill becomes an

Act of Parliament when it receives this assent. Constitutional convention requires that the Governor-General give effect to the resolutions of Parliament.

## **Australian Court System**

Chapter III of the Constitution (sections 71-80) provides for the establishment of the High Court of Australia. One of the High Court's principal functions is to decide disputes about the meaning of the Constitution. For example, it is the High Court which ultimately determines whether an Act passed by the Commonwealth Parliament is within the legislative powers of the Commonwealth. The Australian Constitution is a 'living document' and the power which the High Court has to interpret the Constitution means that it plays a critical role in the Australian legal system. The High Court is also the final court of appeal within Australia in all other types of cases, even those dealing with purely State matters such as the interpretation of State criminal laws.

Chapter III also gives the Commonwealth Parliament power to create other federal courts, and to vest federal judicial power in such courts and in courts of the States. 'Federal judicial power' is judicial power relating to one or more of the classes of dispute set out in sections 75 and 76.

In Australia, each of the Federal and State systems incorporates the three arms of government: legislative, executive and judicial. The High Court of Australia, however, is the final court of appeal in respect of all matters, whether decided in Federal or State jurisdictions, and the Federal Parliament is empowered under the Constitution to invest State courts with Federal jurisdiction.

Great importance is placed on the independence of the judiciary and its separation from the legislative and executive arms of government in Australia and there is a strong tradition that judges, in interpreting and applying the law, act independently of the Government. In the case of federal judges, their security of tenure is guaranteed by the Constitution. In the States and Territories legislation provides security of tenure for judges.

## **Financial System Regulation**

Federal, State and Territory legislation regulates the Australian insurance industry. There are three elements to the current federal regulatory regime:

- Treasury – advises the Government on regulatory policy, including issuing instructions for the drafting of legislation;
- Australian Prudential Regulation Authority (APRA) – is responsible for prudential regulation of banks (and other deposit-taking institutions), insurance companies and most of the superannuation industry; and
- Australian Securities and Investment Commission (ASIC) – regulates market conduct.

## Treasury

The Treasurer has overall responsibility for all of the policy matters falling within the Treasury portfolio including banking and insurance among others. The Minister for Revenue and Assistant Treasurer assists the Treasurer in the development, implementation and administration of policies in the areas of taxation, insurance and superannuation and the maintenance of regulatory best practice.

In relation to insurance, the Minister is responsible for:

- detailed design of laws relating to insurance;
- the making of regulations under insurance laws; and
- administration of insurance laws and administrative matters.

The Minister's responsibilities in the financial system extend to design of laws relating to the prudential regulation of financial entities; regulation of the payments system administered by the Reserve Bank of Australia (Reserve Bank); financial sector levies; and cheques and bills of exchange.

## Australian Prudential Regulation Authority

APRA is the prudential regulator/supervisor of banks, building societies, credit unions, insurance companies, most members of the superannuation industry and friendly societies. Its mission statement states:

'APRA's mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met within a stable, efficient and competitive financial system.'

APRA is responsible for administering the following legislation:

- *Australian Prudential Regulation Authority Act 1998;*
- *Banking Act 1959;*
- *Financial Sector (Collection of Data) Act 2001;*
- *Financial Sector (Shareholdings) Act 1998;*
- *Financial Sector (Transfer of Business) Act 1999;*
- *Insurance Act 1973;*
- *Insurance Acquisitions and Takeovers Act 1991;*

- *Life Insurance Act 1995*; and
- *Superannuation Industry (Supervision) Act 1993*.

### Australian Securities and Investment Commission

ASIC is responsible for monitoring and promoting market integrity and consumer protection in the Australian financial system. In relation to the insurance industry, it is concerned with regulating market conduct, disclosure standards, complaints handling and licensing of financial services providers, including insurance agents and brokers.

ASIC administers the following legislation:

- *Australian Securities and Investments Commission Act 2001*;
- *Corporations Act 2001* (including the Corporations Regulations) (previously the Corporations Law);
- *Insurance Contracts Act 1984*;
- Part 10 (other than sections 206 to 210) of the *Life Insurance Act 1995*; and
- *Superannuation Industry (Supervision) Act 1993*.

ASIC has carriage of the implementation of the Government's Corporate Law Economic Reform Program (CLERP). The *Financial Services Reform Act 2001* (FSRA) brought significant changes to the regulation of the financial services sector, introducing a uniform licensing, conduct and disclosure regime for all financial services providers.

### Financial Market Infrastructure

*EC (c): There is a reliable, effective, efficient and fair legal and court system (a body of ethical, professional and trained lawyers and judges) whose decisions are enforceable. Alternative dispute mechanisms operate within an appropriate legal framework.*

Australian courts have the power to enforce their own orders. Under the *Federal Court of Australia Act 1976*, the Federal Court may make rules of court in relation to the enforcement and execution of judgements of the Court. The Federal Court Rules provide that the Court may take steps to enforce its orders and judgements, including making further orders or by issuing writs. Similar enforcement arrangements operate for State and Territory courts. In some instances, a court may have the power to impose a financial or other penalty on a person who contravenes a court order.

High ethical and professional standards apply to the Australian judiciary. Judges are subject to established guidelines. The Australian Institute of Judicial Administration provides

Guidelines for Judicial Conduct. The Judicial Commission of New South Wales, an independent statutory corporation, also examines any complaints against judges. The goal of the complaints function is to promote judicial accountability through effective complaint handling.

To get a lawyer's licence to practice in Australia, a person must satisfy both the Supreme Court and the State or Territory authority that he has appropriate academic qualifications, adequate legal training, and is a fit and proper person. Australian lawyers are subject to a two tiered disciplinary scheme: unsatisfactory professional conduct and professional misconduct. The regulation of the legal profession is conducted at the State and Territory level, but the definitions of 'misconduct' are uniform across Australia and the range of disciplinary sanctions is nationally consistent.

Apart from the Courts, the major Commonwealth tribunal with authority to review decisions is the Administrative Appeals Tribunal (AAT). The AAT, established by the *Administrative Appeals Tribunal Act 1975*, is empowered, where jurisdiction is specifically vested in the tribunal by statute, to review on the merits of an administrative decision made in the exercise of a statutory power. An application for review may be made by or on behalf of any person whose interests are affected by an administrative decision made under an enactment for which the AAT has jurisdiction. Generally, the AAT, in reviewing a decision, has the same powers as the person or body which originally made the decision and may, if it considers it appropriate, vary or substitute its own decision for the original decision.

In addition to seeking review through the AAT, aggrieved persons, under both Federal and State law, are able to seek review of the lawfulness of administrative action taken by Government officials in the courts in accordance with established procedures and principles of the common law. The *Administrative Decisions (Judicial Review) Act 1977* (ADJR Act) provides for judicial review where, among other things, there is bad faith or improper purpose, or where irrelevant considerations have been taken into account, or relevant considerations have not been taken into account, or where there is evidence of unreasonableness, denial of natural justice or inflexible application of policy.

Furthermore, the Government has set up Ombudsman schemes to investigate complaints of government maladministration. There are also broad rights of access to government-held documents, and the right of an individual to update or correct government-held personal information under the *Freedom of Information Act 1982*.

*EC (d): Accounting, actuarial and auditing standards are comprehensive, documented, transparent and consistent with international standards. Accounting and actuarial standards are applied and disclosed in a manner that allows current and prospective policyholders, investors, intermediaries, creditors and supervisors to properly evaluate the financial condition of insurers.*

## Accounting Standards

The Australian Accounting Standards Board (AASB) is responsible for developing and issuing accounting standards and the 'care and maintenance' of the body of standards in Australia. The AASB's functions and powers are set out in the *Australian Securities and Investments Commission Act 2001* (ASIC Act). The work of the AASB is overseen by the Financial Reporting Council, appointed by the Treasurer.

Since 2002, the AASB has been implementing the strategic direction from the Financial Reporting Council to adopt International Accounting Standards Board (IASB) Standards for application to financial periods beginning on or after 1 January 2005.

Australia was a founding member of the International Accounting Standards Council, the predecessor organisation to the IASB. The AASB is one of eight national standard setters with which the IASB conducts formal liaison. A member of the IASB has been designated as Australia's liaison member and attends AASB meetings as an observer.

Entities regulated under the *Corporations Act 2001* (the Corps Act) are required to apply Australian Accounting Standards in preparing their financial reports. Members of the three main accounting professional bodies in Australia (see EC (f) below) have a professional obligation to take all reasonable steps within their power to ensure that entities with which they are involved comply with Australian Accounting Standards in preparing their general purpose financial reports.

## Actuarial Standards

The Life Insurance Act establishes the Life Insurance Actuarial Standards Board (LIASB) with the function of making actuarial standards for the life insurance industry relating to the actuarial techniques to apply in the valuation of liabilities and the determination of capital requirements for life insurance policies. The actuarial standards developed by the LIASB are legislative instruments and have been developed in accordance with the due process of the LIASB for exposure and consultation. Compliance with the LIASB actuarial standards are obligatory for life companies registered under the Life Insurance Act.

## Auditing Standards

The Auditing and Assurance Standards Board (AUASB) is the national auditing and assurance standards setter responsible for developing high quality standards and related guidance for auditors and providers of other assurance services.

The AUASB uses, as appropriate, International Standards on Auditing from the International Auditing and Assurance Standards Board as a base from which to develop Australian Auditing Standards.

*EC (e): Accountants, actuaries and auditors are competent and experienced and comply with technical and ethical standards to ensure the accuracy and reliability of financial data and its interpretation. Auditors are independent from the insurer.*

## Accounting

There are three main accounting professional bodies in Australia:

- Certified Practising Accountants (CPA) Australia;
- the Institute of Chartered Accountants in Australia (ICAA); and
- the National Institute of Accountants (NIA).

Each of the professional bodies has its own admission criteria but all require minimum academic qualifications and relevant practical experience.

## Actuarial

Actuaries in Australia have to be Fellows of the Institute of Actuaries of Australia (IAAust). To achieve the designation of 'Fellow' requires the completion of a rigorous education programme. One of the key education components is a Professionalism Course, a residential programme that deals with the Institute's Code of Conduct and the ethical requirements of being an actuary. A person must meet a practical experience requirement to be eligible to attend the Professionalism Course.

## Auditing

Auditors must be registered with ASIC. ASIC Policy Statement PS 180 *Auditor registration* details the minimum qualifications, including educational and practical experience requirements, as well as fit and proper criteria. Auditor independence requirements are provided under the Corps Act. In addition, from 1 July 2004, the Corps Act requires an auditor to give the auditor's independence declaration to directors at the same time as the auditor's report. ASIC may revoke a licence or deregister an auditor because of misconduct.

Both the Insurance Act and the Life Insurance Act prescribe minimum criteria for an insurer's appointed auditor and actuary (see also ICP 7 EC (h)). APRA has proposed additional auditor independence requirements in the recently released draft prudential standards on Governance (draft GPS 510 and LPS 510).

**EC (f): Professional bodies set and enforce technical and ethical standards. These standards are accessible to the public.**

The professional bodies of the key professions have all developed professional standards and codes of ethics that apply to their members. The standards are published on the websites of

the relevant bodies. Disciplinary processes are also in place to ensure compliance by members.

The IAAust has issued numerous technical standards and guidance notes on topics ranging from insurance liability valuation, workers' compensation, health insurance claims to benefits under defined benefits superannuation schemes. The standards and guidance notes are available under the IAAust's website.<sup>2</sup>

**EC (g): Basic economic, financial and social statistics are available to the supervisory authority, the industry and the public.**

Economic, financial and statistics data are widely available in Australia.

Treasury publishes a quarterly Economic Outlook with articles on the state of the economy, and includes the Government's forecasts in the annual Budget in May and the Mid-Year Economic and Fiscal Outlook in November.

The Reserve Bank issues a *Statement on Monetary Policy* four times a year. These *Statements* assess current economic conditions and the prospects for inflation and output growth. The *Reserve Bank Bulletin* is a monthly publication that contains economic commentary, feature articles, speeches and a set of statistical tables. In addition, the Reserve Bank issues a *Financial Stability Review* half-yearly. These *Reviews* assess the current condition of the financial system and potential risks to financial stability, and survey policy developments designed to improve financial stability. The Reserve Bank's publications are all available from its website.<sup>3</sup>

The Australian Bureau of Statistics publishes a wealth of social statistics.<sup>4</sup>

Publications by APRA and others on the insurance industry are detailed under ICP 11 EC (d).

***AC (h): Laws and regulations are updated, as necessary, to reflect current best practices and industry conditions.***

Substantial reforms have been undertaken in recent years to reflect market innovation and global best practice. The following major reforms are worth noting.

## Corporate Law Economic Reform Program (CLERP)

Started in 1997, CLERP is part of the Government's drive to promote business, economic development and employment in Australia. Progress to date includes:

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<sup>2</sup> [http://www.actuaries.asn.au/PublicSite/publications/publications2005/publications\\_frameset.htm](http://www.actuaries.asn.au/PublicSite/publications/publications2005/publications_frameset.htm)

<sup>3</sup> <http://www.rba.gov.au/publicationsandresearch/>

<sup>4</sup> <http://www.abs.gov.au/>

- CLERP 1-5: *Corporate Law Economic Reform Act 1999* implemented changes in the areas of fundraising, directors' duties and corporate governance, takeovers and accounting standards;
- CLERP 6: the *Financial Services Reform Act 2001* consolidated the regulation of the financial services sector by establishing a uniform licensing, conduct and disclosure regime for all financial services providers;
- CLERP 7: the *Corporations Legislation Amendment Act 2003* introduced changes from 1 July 2003 designed to simplify lodgement and compliance procedures for companies and schemes;
- CLERP 8: a Discussion Paper titled 'Cross-Border Insolvency' was released in October 2002;
- CLERP 9: the *Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004* became law on 30 June 2004 and introduces significant changes to the regulation of corporate governance in Australia (particularly in relation to auditor qualifications and independence, financial reporting, director and executive remuneration and disclosure).

## Financial Sector Reform

A major overhaul of the regulation of the financial sector in Australia took place in 1998 when the Government implemented the recommendations of the Wallis Inquiry. The *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998*, together with the APRA Act, led to the establishment of APRA and redefined the responsibilities for regulation and supervision of the financial sector in Australia.

### Reforms under APRA

Major supervisory initiatives introduced by APRA since its inception include:

- harmonisation of prudential standards for all deposit-taking institutions;
- the Probability And Impact Rating System (PAIRS);
- introduction of prudential standards for general insurers following passage of the general insurance reform legislation; and
- development of a comprehensive framework for the prudential supervision of conglomerates.

The last two in relation to the prudential supervision of general insurers and conglomerates are ongoing.

## Efficient Financial Markets

*EC (i): Well-functioning money and securities markets exist to support the availability of both long-term and short-term investment opportunities.*

Australia currently has four prescribed stock exchanges. The Australian Stock Exchange Limited (ASX) operates Australia's primary national stock exchange for equities, derivatives and fixed interest securities. The other exchanges are the Stock Exchange of Newcastle, the Bendigo Stock Exchange, and the Australia Pacific Exchange. The total stock market capitalisation is almost US\$500 billion, making Australia the eighth largest market in the world, and the second largest in the Asia-Pacific region behind Japan.<sup>5</sup>

Australia has an active money market, which is a conduit for short-term funds. The money market trades low risk, short-term instruments such as Treasury notes, commercial paper, promissory notes and bank-accepted bills, and therefore is an important source of liquidity for the Australian financial system.

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<sup>5</sup> FTSE International Ltd and Normura Group All-World Review Oct 2004.

## ICP 2 Supervisory objectives

The principal objectives of insurance supervision are clearly defined.

*EC (a): Legislation or regulation clearly defines the objectives of insurance supervision.*

The objectives of insurance supervision are clearly enunciated in both the Insurance Act and the Life Insurance Act.

Section 2A of the Insurance Act states that the main object is 'to protect the interests of policyholders and prospective policyholders under insurance policies in ways that are consistent with the continued development of a viable, competitive and innovative insurance industry'.

Section 3(1) of the Life Insurance Act states the principle object as 'to protect the interests of the owners and prospective owners of life insurance policies in a manner consistent with the continued development of a viable, competitive and innovative life insurance industry'. An additional object in section 3(1A) is 'to protect the interests of persons entitled to other kinds of benefits provided in the course of carrying on life insurance business'.

*EC (b): The key objectives of supervision promote the maintenance of efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders.*

The administration of the Insurance Act and the Life Insurance Act is shared between APRA and ASIC.

APRA is the prudential regulator of financial sector bodies, including insurers. The objectives and functions of APRA are stipulated in the APRA Act.<sup>6</sup> In performing and exercising its functions and powers, APRA is to 'balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality'. The legislated objective has been embodied in APRA's mission statement:

'We are committed to establishing and enforcing prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions we supervise are met, within a stable, efficient and competitive financial system.'

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<sup>6</sup> Sections 8 and 9 of the APRA Act.

ASIC is responsible for maintaining market integrity, consumer protection and the supervision of companies. One of ASIC's objectives<sup>7</sup> is to maintain and improve the performance of the financial system and promote the confident and informed participation of investors and consumers in the financial system.

*EC (c): In the event that the law mandates or specifies multiple objectives for insurance supervision, the supervisory authority discloses and explains how each objective will be applied.*

APRA takes a risk-based and consultative approach to supervision. In developing prudential policies and standards, APRA consults widely to ensure that the interests of all stakeholders are taken into consideration.

Section 2A(2) of the Insurance Act provides for the prudential supervision of general insurers by APRA, mainly by restricting those who can carry on insurance business, imposing responsibility on directors to protect policyholders, and imposing on general insurers requirements to promote prudent management.

Similarly, section 3(2) of the Life Insurance Act outlines the means to be adopted for the achievement of the object of the Life Insurance Act, principally by providing APRA with powers to impose requirements on life companies to ensure their prudent management, to monitor the life companies, and to take preventive and corrective measures when the interests of policyholders may be threatened.

*EC (d): The supervisory authority gives reasons for and explains any deviations from its objectives.*

APRA has to account for its supervisory actions and decisions to the Minister, the Parliament and the Australian public. See ICP 3 *Supervisory Authority* and ICP 4 *Supervisory Process* below.

*EC (e): Where objectives are contradictory, the supervisory authority initiates or proposes correction in law or regulation.*

APRA's objectives are detailed in ECs (a), (b) and (c) above. This criterion is 'Not Applicable' as APRA's objectives in insurance regulation are not contradictory. Should APRA encounter problems with achieving the objectives, it would propose changes to legislation.

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<sup>7</sup> Section 1 of the ASIC Act.

## ICP 3 Supervisory authority

The supervisory authority:

- has adequate powers, legal protection and financial resources to exercise its functions and powers;
- is operationally independent and accountable in the exercise of its functions and powers;
- hires, trains and maintains sufficient staff with high professional standards; and
- treats confidential information appropriately.

## *Legal Framework*

*EC (a), (b) and (c): Legislative Powers*

### Supervision of general insurers

Section 8 of the Insurance Act specifies that APRA is responsible for the general administration of the Insurance Act in Australia.

APRA has been given powers to license general insurers under section 12 of the Insurance Act, make prudential standards under section 32 of the Act and administer the Act's monitoring and enforcement powers under Parts IIIA and V of the Act. The power to revoke an insurance entity's authorisation is given to APRA under section 15 of the Insurance Act and APRA has the power under section 7 of the Act to determine that all or specified provisions of the Act do not apply to a person while that determination is in force. Where a person is carrying on an insurance business in Australia without authorisation or without an exemption under section 7 of the Insurance Act to hold such an authorisation, APRA is able (through the Director of Public Prosecutions) to pursue the prosecution of such persons under sections 9 or 10 of the Act.

The scope of APRA's powers to make standards is very wide and permits APRA to issue and enforce rules by administrative means across a broad range of prudential matters. At this time standards have been determined in relation to minimum capital requirements, the valuation of insurance liabilities, reinsurance requirements, business continuity management and the composition of insurers' boards. Standards have also been determined in relation to an insurer's assets in Australia and transfers and amalgamations of insurance business.

An insurance entity to whom a prudential standard applies must comply with the standard. This requirement is specified in section 35 of the Insurance Act. An insurance entity is

required under section 35A of the Act to notify APRA in writing if it becomes aware that it has breached a prudential standard or any other matter or occurrence that materially affects its financial position. Failure to do so or delay in doing so is an offence.

APRA is able to give a direction to an insurance entity under section 36 of the Insurance Act to comply with the whole or part of a standard where it is satisfied that the entity has breached a prudential standard or the entity is likely to breach a standard in a way that is likely to give rise to a prudential risk.

An entity commits an offence where it contravenes a direction given to it under section 36 of the Insurance Act. Such a contravention can also give rise to APRA commencing an investigation of the entity under section 52 of the Act.

The above powers enable APRA to issue and enforce rules by administrative means. The Insurance Act provides a solid foundation for the effective supervision of insurance entities in Australia.

### **Supervision of life companies**

Section 7 of the Life Insurance Act specifies that APRA has responsibility for the prudential supervision of life companies in Australia (other than certain matters pertaining to life policies which are specified as being the responsibility of ASIC).

APRA has the power to register life companies under section 21 of the Life Insurance Act. APRA is responsible for monitoring a life company's compliance with:

- its conditions of registration;
- the solvency, capital adequacy and management capital standards made under sections 65, 70 and 73B of the Life Insurance Act; and
- directions given to it under the Life Insurance Act (for example sections 134, 150 and 230B of the Act).

APRA has the power to investigate the affairs of a life company, to seek the appointment of a judicial manager to a life company or to seek the winding-up of a life company where the circumstances warrant such action. APRA has the power to seek an injunction to stop a person from issuing a life policy or undertaking liability under a life policy where the person is not a company registered under the Act (section 17 of the Life Insurance Act).

APRA has the power to determine prudential standards in relation to prudential matters to be complied with by all life companies, a specified class of life companies or one or more life companies under section 230A of the Life Insurance Act. A failure to comply with a prudential standard is not an offence but may lead to APRA giving a life company a direction under section 230B of the Act. A contravention of such a direction is an offence under section 230F of the Act.

APRA also has the power under section 252 of the Life Insurance Act to make rules in relation to any matter required or permitted by the Act to be prescribed by prudential rules. Currently rules have been prescribed in relation to a wide range of matters which go to the practical supervision of the operations of life companies (for example the restructure or termination of statutory funds, specifying a class of contract as reinsurance contracts). Where a life company failed to comply with a prudential rule, APRA is able to require compliance by issuing a direction to this effect under section 230A of the Life Insurance Act.

The above powers equip APRA to expeditiously issue and enforce rules in relation to life companies by administrative means. The Life Insurance Act provides APRA with sufficient powers to supervise life companies effectively.

The Life Insurance Act also establishes the LIASB which makes actuarial standards, and is comprised of members from the actuarial profession. The purpose of the LIASB is to develop standards for the life insurance industry relating to the actuarial techniques to apply in the valuation of liabilities and the determination of capital requirements for life insurance policies.

## Independence and Accountability

*EC (d) – (k), AC (l) and (m): Governance structure; independence, transparency and disclosure.*

### Independence

The APRA Act establishes APRA as an independent statutory authority charged with responsibility for prudential regulation of the financial sector. APRA is both substantially independent from, and accountable to, the Federal Government. APRA is headed by an executive Chairman and is governed by a three member executive group, including the Chairman, known as the APRA Members. The APRA Members are appointed by the Governor General, on advice of the Minister.

Under section 20 of the APRA Act, APRA Members are appointed for a term specified in the instrument of appointment, which cannot exceed five years. Section 25 of the Act governs the removal of APRA members during their term of office and specifies the reasons for termination. However, there is no legal requirement to publicly disclose the reasons for removing an APRA member from office.

The system of government in Australia draws heavily on the constitutional traditions of responsible government and separation of powers. In Australia, it is recognised that some functions of government – of which the prudential regulation of financial institutions is one example – are best conducted at arms length from the political process, while at the same time maintaining an appropriate degree of executive accountability. By placing responsibility for the function of prudential regulation of financial institutions with an independent statutory authority, the Government ensures both that this task receives specialised attention

and that it is conducted in a politically neutral manner. Accordingly, in practice, there is little evidence of Government interference in APRA's operations.

Nevertheless, APRA remains subject to a formal power of direction by the Minister under section 12 of the APRA Act. This power is limited to policies and operational priorities and cannot apply to individual cases. A direction must be in writing and can be given only after the Minister has notified APRA in writing that consideration is being given to making the direction and given the Chairman an opportunity to discuss the need for the proposed direction. The power is tempered by a requirement that the Minister must table any direction before Parliament within 15 sitting days. There have been no instances of APRA being formally directed by the Minister.

Internal oversight of APRA is monitored by the Risk Management and Audit Committee. The Committee comprises an external chair (with casting vote), one external member, one member of APRA's Executive Group and one Executive General Manager (on a one-year rotation). In addition, regular attendees at committee meetings are the General Manager – Risk Assessment and Internal Audit, the Chief Financial Officer and a representative of the Australian National Audit Office (ANAO). The Chairman of APRA may attend by invitation.

APRA is financed from levies imposed on all regulated entities. Separate levy scales apply to the different industry sectors supervised by APRA. The levy monies are collected by Government. Pursuant to section 50 of the APRA Act, APRA gets paid the amount of levies collected less a Retainable Amount (for costs incurred in providing market integrity and consumer protection in relation to prudentially regulated entities) as determined by the Minister. However, once levy funds are provided to APRA, these monies can be applied by APRA as it sees fit. APRA has discretion in setting its own organisational structure and autonomy in staffing.

## **Accountability**

To ensure that staff make balanced, accountable, consistent and professional decisions, APRA has developed *Supervisory and Technical Decision Making Procedures* to guide staff when they have to provide a regulated institution with a formal decision under legislation, or a legislative instrument or a ruling or advice which the institution is expected to comply with or rely upon. The decisions include supervisory decisions as well as decisions on technical issues.

The procedures clearly identify the APRA officer who is accountable for the decision and the officer(s) who are accountable for carrying out the actions associated with the decision. These must accord with APRA Delegations. Supervisory or technical decisions should demonstrate a consideration of the relevant issues, including similar issues previously examined by other parts of APRA. To this end, the procedures encourage consultation within APRA to ensure consistency and to draw on the broader professional expertise in the organisation.

Supervisory or technical decisions need to be adequately documented and recorded in APRA's record keeping systems, including recording the decision in APRA's Activity and Issue Management System (AIMS). At the minimum, the documentation should identify:

- what led to the need for a decision;
- what issues have been considered and advice received;
- what is the recommended decision and reasons for it;
- what is the final decision and who made it; and
- whether any follow-up action is required and, if it is, who is responsible for the action.

Section 33 of the Insurance Act requires APRA to consult extensively with insurance entities before making, modifying or varying a prudential standard. All prudential standards under the Insurance Act, and actuarial standards and prudential rules under the Life Insurance Act, are disallowable instruments for the purposes of section 46A of the *Acts Interpretation Act 1901* and subject to parliamentary scrutiny.

The LIASB, established under the Life Insurance Act to make actuarial standards, comprises members from the actuarial profession. Membership includes a Government representative which has by convention been a senior person from APRA. In developing actuarial standards, the LIASB follows a due process of exposure and consultation.

The *Legislative Instruments Act 2003* (LIA) establishes a comprehensive regime for the registration, tabling, scrutiny and sunseting of Commonwealth legislative instruments. The Act emphasises the importance of consultation by encouraging rule makers to consult experts and those likely to be affected by an instrument before it is made. The explanatory statement for the instrument, which will be tabled in the Parliament and accessible on the register, must also contain a description of any consultation undertaken, or if not undertaken, an explanation for its absence.

Subject to limited exceptions, the Government has decided that the preparation of a Regulation Impact Statement (RIS) by any Government agency is mandatory for all reviews of existing regulation; proposed, new or amended regulation and proposed treaties involving regulation which will directly affect business, have a significant indirect effect on business, or restrict competition. Accordingly APRA is obliged to prepare a RIS when proposing any new prudential standard or rule or in any review or amendment of existing prudential standards or rules.

A RIS is prepared after consultation with affected parties in the policy formulation process. It includes an assessment of the costs and benefits of options, and a recommendation supporting the most effective and efficient option. Preparation of a RIS ensures that all relevant information is documented and that the decision-making processes are made explicit and transparent. Every RIS has a consultation statement to record the details of the consultation; or in the absence of any consultation, a statement to explain the reasons why consultation was inappropriate.

APRA is subject to review before Parliamentary Standing Committees, such as the House of Representatives Committee on Economics, Finance and Public Administration. Its

performance is also subject to review in the Senate Estimates hearings and Senate Select committees. Transcripts of the proceedings of all of these committees are publicly available. In addition, APRA is subject to financial and performance audits by the ANAO, the latest of these being conducted in 2004. The reports of the ANAO are tabled in Federal Parliament and publicly available.

APRA releases press statements when introducing new policies or when APRA sees trends of concern that it wants to highlight. APRA senior staff regularly deliver speeches at industry forums and workshops to keep market participants updated with APRA's supervisory activities and policy developments.

The Insurance Act requires APRA to gazette any revocation of licences or when an insurer is no longer allowed to carry on insurance business because of the start of winding-up. When APRA has disqualified a person on fit and proper grounds the particulars of the disqualification must be gazetted (section 25A of the Insurance Act).

## Powers

*EC (n): When necessary, the supervisory authority has the power to take immediate action to achieve its objectives, especially to protect policyholders' interests (refer to ICP 4 EC (e)).*

Both the Insurance Act and the Life Insurance Act enable APRA to issue directions to insurers for the purpose of protecting policyholders. See Legal Framework above, as well as ICP 4 and ICP 15 below.

## Financial Resources

*EC (o) and (p): Budget, staffing and financial reporting.*

APRA has autonomy to apply levy funds allocated to it as it sees fit. Section 52 of the APRA Act allows APRA to apply its money to pay costs incurred in relation to performing its functions, including remuneration costs. So despite not having the ability to set levies or the amount of funds allocated to it, APRA considers that it has sufficient autonomy and independence in budgeting and expenditure to enable it to conduct effective supervision. Section 51 of the APRA Act also provides for APRA to charge for services and facilities provided.

APRA currently comes under the *Commonwealth Authorities and Companies Act 1997* (the CAC Act) in terms of financial arrangements. As a consequence of the Uhrig Review<sup>8</sup> the

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<sup>8</sup> In 2004 the Government published a report *A Review of The Corporate Governance of Statutory Authorities and Office Holders*, following a review of the corporate governance of statutory authorities (including APRA) and office holders to identify reforms that might assist in improving the performance of these bodies, without

Government is considering changing APRA's financial accountability arrangements by bringing it under the *Financial Management and Accountability Act 1997*.

While APRA must compete in highly competitive private sector markets for staff, APRA's salary scales are generally sufficient to allow it to attract and retain qualified staff, and to hire outside experts to deal with special situations, if required. APRA's training budget has enabled the development of a comprehensive in-house training programme and makes provision for regular external training opportunities for staff, including post-graduate studies. APRA is equipped with up-to-date computer equipment and other tools needed to perform its tasks.

APRA is required under section 9 of the CAC Act to prepare an annual report on its operational and financial performance. APRA's annual reports are tabled in Parliament and made public.

## Human resources and legal protection

### *EC (q), (r) and (s): Staff quality, protection and consultants.*

Division 4 of the CAC Act imposes obligations on APRA management to exercise their powers and discharge their duties in good faith and with care and diligence. APRA has issued a Code of Conduct setting the standards of conduct expected of staff and the consequences when the standards are not met. In accordance with the Code, APRA staff are required to sign a Declaration at the time of appointment undertaking that they would conduct themselves with honesty and due diligence and also fully observe and comply with the rules and instructions of APRA. One of the principles under the Code is that APRA staff should not be seen to have any conflict between their obligations to supervise regulated financial institutions in the public interest, and private financial interests in those institutions. Accordingly, APRA staff are not allowed to acquire equity holdings in APRA-regulated institutions (or close associates of regulated institutions), except as a direct consequence of demutualisation or the exercise of rights or pre-existing options. Staff are required to submit annually a summary statement of any direct security holdings, and those of their immediate family. Staff should notify a senior manager immediately if a conflict of interest arises, or could arise, in any way between their duties and their investments.

Section 58 of the APRA Act protects APRA staff from liability in the course of discharging their duties, provided they have acted with good faith. It effectively limits the possibility of a successful legal action being brought against APRA or its staff. Section 27M of the CAC Act allows APRA to indemnify staff from any liability. In the normal course, both the Commonwealth and APRA would assist staff in defending actions brought against them arising out of the proper discharge of their duties. APRA's Members have resolved to indemnify APRA staff for the costs incurred in defending such actions.

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compromising their statutory duties. The Government's response to Uhrig's review in relation to APRA is not yet finalised.

Under section 47 of the APRA Act, APRA may engage consultants or other people to provide advice to it or perform services for it.

## Confidentiality

### *EC (t) and (u): Protection of information.*

The APRA Act protects information and documents given to or obtained by APRA in the course of administering the regulatory framework. It is an offence for a person to disclose protected information or release any protected documents, except in situations as specified under section 56 of the APRA Act. Furthermore, where APRA releases information under specified circumstances, it is APRA's practice to notify the recipient of the information's protected status under the APRA Act, and to request that its confidentiality be maintained by the recipient. Information released under section 56 retains its protected status under the Act even if it is communicated to another financial sector supervisor and such information should only be used for prudential purposes.

The offence provision under section 56 of the APRA Act extends to all recipients of the protected information, whether they are an APRA staff member, an employee of another supervisory agency or an external consultant. APRA ensures that the secrecy provisions under the APRA Act are well known by anyone that it shares, under law, protected information with.

## ICP 4 Supervisory process

The supervisory authority conducts its functions in a transparent and accountable manner.

*EC (a): The supervisory authority adopts clear, transparent and consistent regulatory and supervisory processes. The rules and procedures of the supervisory authority are published and updated regularly.*

APRA has adopted a comprehensive supervisory process that integrates the functions of off-site analysis and on-site reviews.

APRA's off-site analysis is conducted by responsible supervisors in its 'frontline' divisions, Diversified Institutions Division and Specialised Institutions Division, with supervisors being assigned a portfolio of institutions. (In the case of larger institutions, this portfolio might consist of a single institution or part of an institution). Off-site analysis is undertaken on a continuous basis, with responsible supervisors producing annual and quarterly assessments on the prudential condition of their assigned institutions. The frequency of on-site reviews of insurers is determined by a combination of minimum review cycles and risk-based prioritisation.

At the heart of APRA's risk prioritisation is its PAIRS and its Supervisory Oversight and Response System (SOARS). These two key tools provide the infrastructure to ensure that risks are being assessed consistently across APRA and that proportionate prudential interventions are being taken.

PAIRS is a tool used by APRA supervisors to classify regulated financial institutions on two key dimensions:

- the probability that the institution may be unable to honour its financial promises to beneficiaries - depositors, policyholders and superannuation fund members. To prepare a PAIRS profile, the various elements of inherent risk in institutions – insurance risk; counterparty risk; market risk; operational risk; liquidity risk; legal/regulatory risk; strategic risk and related party risk – are assessed; and
- the potential impact should the institution fail (which is measured by the institution's balance sheet size).

PAIRS involves supervisors considering and assessing:

- for each of the elements of inherent risk, how risky each is and how significant it is for each institution;
- for seven elements of management and control in institutions, how important and effective are these at mitigating the institution's inherent risks;

- for three elements of capital support, how much of a buffer does this support provide to deal with unexpected issues and losses; and
- taking into account inherent risks, management and controls and capital support, what is the overall risk that the institution will fail to meet its obligations to its beneficiaries.

Each institution is assigned one of five PAIRS ratings: Low; Low Medium; High Medium; High; or Extreme.

SOARS is the system APRA uses to transform PAIRS risk assessments of a supervised entity into a supervision strategy for the entity. SOARS determines the qualitative nature of the supervisory relationship between APRA and the supervised entity and the planned supervisory activities for that entity in the near future.

APRA has four supervisory stances: Normal; Oversight; Mandated Improvement; and Restructure.

Normal supervision activities include assessment and analysis of regular data received from insurers, monitoring market intelligence on developments affecting an insurer, maintaining a good knowledge of changes occurring within an insurer, conducting on-site and off-site reviews on specific areas of an insurer's business and operations and conducting a formal PAIRS risk assessment of the insurer.

An insurer with an other than Normal stance may attract extra supervisory attention, including being subject to directions to rectify identified shortcomings in its strategy, structure, personnel, systems or business and, in the extreme, being issued with formal sanctions to adjust its business and risk profile to bring it within acceptable limits.

Papers detailing these processes are published on APRA's website. APRA members and staff regularly explain them in speeches and in their dealings with APRA-regulated institutions. Individual institutions are informed of their PAIRS ratings and of the factors considered in determining that rating. Insurers are also informed of any supervisory action consequent upon their PAIRS rating.

Another key function of APRA is the establishment and enforcement of prudential standards and practices designed to safeguard the soundness and solvency of authorised insurers. To ensure transparency and accountability, APRA is required, under the LIA, to register all prudential standards or rules made under either the Insurance Act or the Life Insurance Act. APRA must also take all reasonable steps, in accordance with section 34(3) of the Insurance Act and section 230A(10) of the Life Insurance Act, to ensure that copies of the current text of prudential standards are available for inspection and purchase. In practice, all prudential standards, rules, guidelines and determinations issued by APRA are published on APRA's website, which is kept up-to-date.

*EC (b): The supervisory authority applies all regulations and administrative procedures consistently and equitably, taking into account the different risk profiles of insurers.*

As noted in EC (a), APRA uses PAIRS and SOARS to determine its supervisory stance and allocation of resources for each supervised institution. Supervisory attention increases with increases in both relative risk and relative impact. SOARS sets the supervision cycles for insurers in Normal stance. APRA does not consider it appropriate to dictate supervision cycles for institutions in Oversight, Mandated Improvement and Restructure as these will need a more case-by-case approach depending upon the individual circumstances of the institution.

PAIRS and SOARS are supported by other internal frameworks.

The APRA Supervision Framework (ASF) includes an outline of APRA's supervision policy plus detailed instructions for undertaking core supervision activities such as prudential reviews and off-site analysis. By providing a structured approach to specific tasks, the ASF enhances the consistency and quality of APRA's supervision. Consistent with APRA's risk-based approach, however, the ASF incorporates a large degree of flexibility to allow supervisors to exercise their judgement to tailor their work to meet the risk profiles of individual entities.

The Activity and Issue Management System (AIMS) records and tracks all prudential reviews and other activities and interventions. This enables supervisory resources to be appropriately allocated and management to effectively follow up planned or outstanding supervisory activities.

To ensure staff make balanced, accountable, consistent and professional decisions, APRA has developed *Supervisory and Technical Decision Making Procedures* to guide staff when they have to provide a regulated institution with a formal decision under legislation or a legislative instrument or a ruling or advice which the institution is expected to comply with or rely upon (refer ICP 3 under Accountability).

*EC (c): The administrative decisions of the supervisory authority can be subject to substantive judicial review. However, such action must not unduly impede the ability of the supervisory authority to make timely interventions in order to protect policyholders' interests.*

APRA's administrative decisions can be subject to substantive judicial review under the ADJR Act. Various provisions of the Insurance Act<sup>9</sup> and Life Insurance Act<sup>10</sup> are subject to judicial review.

The availability of a judicial review process acts as a safeguard to ensure that APRA's decisions are lawfully made. Review is available where, among other things, there is bad faith or improper purpose, irrelevant considerations have been taken into account, or relevant

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<sup>9</sup> See sections 7, 12, 13, 17, 18, 21, 25A, 36, 42, 51, 52 and 62 of the Insurance Act.

<sup>10</sup> See sections 21, 230A and 230B of the Life Insurance Act.

considerations have not been taken in to account, or where there is evidence of unreasonableness, denial of natural justice or inflexible application of policy.

In practice, there have been few instances of judicial reviews of APRA decisions under either the Insurance Act or the Life Insurance Act and APRA has not experienced any impediments to its ability to take prompt corrective actions on insurers for the protection of policyholders.

*EC (d): The supervisory authority makes information on its role publicly available.*

As noted under EC (a), APRA maintains an up-to-date website. The public can access the APRA website for information on APRA policies, activities and APRA-supervised industries and institutions. All APRA's annual reports, which contain details of APRA's operations over the relevant periods, can be found on the website.

APRA releases press statements when introducing new policies or when APRA sees trends of concern that it wants to highlight. APRA senior staff regularly deliver speeches at industry forums and workshops to keep market participants updated with APRA's supervisory activities and policy developments.

*EC (e): The decision-making lines of the supervisory authority are so structured that action can be taken immediately in the case of an emergency situation (refer to ICP 3 EC (n) and ICP 15).*

Wherever possible, APRA seeks to make timely and preventative prudential interventions to bring the risks down to acceptable levels. APRA gives effect to this through its supervisory methodology, based around continuous off-site monitoring and a risk-based programme of on-site reviews, supported by the PAIRS risk-rating tool, the SOARS response system and the APRA Supervision Framework. These tools assist responsible supervisors to take timely and proportionate remedial actions. For more serious breaches or where policyholders' interests are threatened, APRA is able to respond quickly using its legal powers under the Insurance Act or the Life Insurance Act (ICP 3 under Legal Framework refers).

APRA's senior executive group receives monthly a report on the profile of the PAIRS ratings of insurers and a profile of the SOARS stances of insurers along with recent upgrades and downgrades. This provides a mechanism for querying and follow-up of individual cases which may not appear to be getting adequate and timely attention.

In addition, the APRA structure includes a specialised unit – Enforcement – to supervise entities identified to be of high risk, and to handle functions like issuing directions or enforceable undertakings, conducting investigations or freezing of assets. The unit is headed by a General Manager and staffed with specialists skilled in investigation and enforcement matters.

APRA has also established an Enforcement Committee to set priorities and allocate resources to all enforcement cases. The Committee, whose membership includes all the frontline

Executive General Managers and the Deputy Chair of APRA as chairman, has the power to meet quickly and decide on corrective or enforcement actions needed to be taken to remedy a problem situation or to limit losses (or further losses) to policy holders.

*EC (f): The process to appeal supervisory decisions is specified and balanced to preserve supervisory independence and effectiveness.*

Part VI of the Insurance Act specifies the procedure by which persons affected by reviewable decisions (in relation to general insurers, non-operating holding companies (NOHCs) or subsidiaries of general insurers), made by the Treasurer or APRA, can seek administrative review of those decisions. The Insurance Act explicitly states which decisions are reviewable.<sup>11</sup>

In summary, a person who is dissatisfied with a reviewable decision may request a review of that decision under section 63(2) of the Insurance Act. The Treasurer or APRA is required to reconsider the decision upon receipt of the request for review. The decision may be confirmed, revoked or varied as an outcome of such a review. Where a decision is confirmed, revoked or varied, notice of the decision must be given to the affected person setting out the result of the Treasurer or APRA's reconsideration of the decision. It must also set out the findings on material questions of fact, refer to the evidence or other material on which those findings were based and give the Treasurer's or APRA's reasons for confirming, revoking or varying the decision as the case may be.

A person not satisfied with the outcome of the review of the Treasurer or APRA may apply to the Administrative Appeals Tribunal (AAT) for a review of the decision under section 63(7) of the Insurance Act.

A similar review procedure exists under the Life Insurance Act in respect of decisions made (in relation to life companies) by APRA under that Act. Reviewable decisions are specified under section 236 of the Life Insurance Act. The section also sets out the process for persons seeking reconsideration by APRA of a reviewable decision (in subsections (3) to (7)). Where a decision is subsequently confirmed or varied by APRA, a person (if dissatisfied) may apply to the AAT for review of the APRA decision that has been confirmed or varied.

The AAT is required to review decisions based on their merit, which means that the AAT should 'stand in APRA or the Treasurer's shoes' and determine what is the correct or preferable decision based on the evidence put before it. The above processes ensure that care must be given by the Treasurer or APRA before a reviewable decision is made under either the Insurance Act or the Life Insurance Act.

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<sup>11</sup> See sections 12, 18, 26, 27, 40, 42, 44, 45, 62, and 93 of the Insurance Act.

*EC (g): The supervisory authority publishes a regular report – at least annually and in a timely manner – on the conduct of its policy, explaining its objectives and describing its performance in pursuing its objectives.*

Section 9 of the CAC Act requires APRA to prepare an annual report within four months after the end of the financial year. The report must include a report of APRA's operations for the year.

*AC (h): The supervisory authority provides and publishes information about the financial situation of the insurance industry and observations on major developments in the insurance or financial market.*

APRA publishes a quarterly publication, *Insight*, that provides editorial on the wide range of APRA's interests as prudential regulator. *Insight* combines prudential commentary and feature articles with a set of statistical tables and figures that focus principally on the financial and risk characteristics of supervised financial institutions.

APRA also publishes a *Quarterly General Insurance Performance Statistics* on general insurance and *Life Insurance Trends* (quarterly) and *Life Office Market Report* (six-monthly) for life insurance on its website.

APRA is in the process of designing a more comprehensive semi-annual publication that will include detailed information at both an individual insurer and aggregate industry level.

## ICP 5 Supervisory co-operation and information sharing

The supervisory authority cooperates and shares information with other relevant supervisors subject to confidentiality requirements.

*EC (a): The existence of a formal agreement with another supervisor is not a prerequisite for information sharing.*

Recognising the importance of supervisory co-operation, Parliament, when setting up APRA, explicitly provided that APRA should, in performing and exercising its functions and powers, have regard to the desirability of cooperating with other financial sector supervisory agencies (section 10A of the APRA Act).

Formal agreements are not a pre-requisite for information sharing. Section 56 of the APRA Act allows APRA to release protected information if the disclosure is for the purposes of prudential regulation framework law, or to assist a financial sector supervision agency (including foreign agencies) to perform its functions or exercise its powers.

APRA and the other agencies involved in Australia's financial sector regulation have defined mechanisms for interaction and coordination of actions. APRA participates in a number of councils, committees and working groups with ASIC, the Reserve Bank, the Treasury and the Australian Transaction Reports and Analysis Centre (AUSTRAC), through which regulatory interventions and supervision activities are coordinated. This network of co-operation and liaison promotes the sharing of information on financial sector developments and risks, and helps to influence the evolution of the domestic and international regulatory frameworks.

APRA's system of co-operation and information sharing extends to foreign agencies that have supervisory responsibility for insurance operations of material interest to APRA. Pursuant to section 56 of the APRA Act and consistent with its obligations to overseas regulators, APRA cooperates fully with its overseas counterparts and routinely makes available relevant prudential information to overseas supervisors irrespective of whether there is any formal agreement in place to provide for this. These exchanges are not limited to home/host supervision obligations, but also extend to host/host relationships and to issues of prudential policy development.

*EC (b): The supervisory authority, at its discretion, can enter into agreements or understandings with any other financial sector supervisor ('another supervisor') to share relevant supervisory information or to otherwise work together.*

Under section 11 of the APRA Act, APRA has powers to do anything that is necessary or convenient to be done for or in connection with the performance of its functions, including the power to enter into contracts. APRA has entered into a number of Memoranda of Understanding (MOUs) with domestic and overseas supervisors:

## Domestic

- Australian Securities and Investments Commission.
- Reserve Bank of Australia.
- Australian Government Treasury.
- Australian Taxation Office.
- Australian Competition and Consumer Commission.
- Private Health Insurance Administration Council.
- Motor Accident Authority of NSW.
- Financial Reporting Council.

## International

- Reserve Bank of New Zealand.
- Financial Services Authority (FSA), United Kingdom.
- Hong Kong Monetary Authority.
- China Banking Regulatory Commission.
- Bundesanstalt für Finanzdienstleistungsaufsicht of Germany (BaFin).

(By the time of the FSAP Mission, APRA also expects to have agreed an MOU with De Nederlandsche Bank.)

The MOUs establish a formal basis for co-operation, including the exchange of information and investigative assistance.

*EC (c): When reasonably requested and with appropriate safeguards, the supervisory authority is able to exchange with another supervisor (refer to ICP 7 EC (e)) the following:*

- *relevant supervisory information, including specific information requested and gathered from a supervised entity,*
- *relevant financial data, and*
- *objective information on individuals holding positions of responsibility in such entities.*

Section 56 of the APRA Act empowers APRA to release protected information to another financial sector supervisory agency (including foreign agencies) for the purposes of allowing that agency to carry out its functions. 'Protected Information' under the Act includes information, both financial and non-financial, relating to the affairs of a licensed insurer, which comes into APRA's possession in the course of discharging its supervisory functions.

Section 56(12) of the APRA Act specifically provides for the disclosure of personal information.

*EC (d): Information sharing, whether carried out under formal or informal arrangements, allows for a two-way flow of information without requiring strict reciprocity in terms of the level, format and detailed characteristics of the information exchanged.*

APRA disclosure powers under section 56 of the APRA Act are not subject to any reciprocity conditions.

*EC (e): The home supervisory authority provides relevant information to the host supervisor.*

Section 56 of the APRA Act allows disclosure of protected information to another financial sector supervisory agency only when the disclosure will assist the recipient agency to perform its functions or exercise its powers (APRA Act section 56(5) (a)). In practice, APRA has established good relationships with those host agencies which host significant operations of Australian based insurers.

*EC (f): The supervisory authority is required to take reasonable steps to ensure that any information released to another supervisor will be treated as confidential by the receiving supervisor and will be used only for supervisory purposes.*

Pursuant to the secrecy obligations under section 56, where APRA releases information to another supervisory agency, it is APRA's practice to notify the receiving agency of the

information's protected status under the APRA Act, and to request that its confidentiality be maintained by the receiving agency. Information released under section 56 retains its protected status under the APRA Act even if it is communicated to another financial sector supervisor and such information should only be used for prudential purposes. It is an offence under the APRA Act for an officer to disclose 'protected information'; the definition includes persons to whom protected information has been released.

*EC (g): The supervisory authority consults with another supervisor if it proposes to take action on the evidence of the information received from that supervisor.*

Before APRA acts on the evidence of any information received from another supervisor, it will notify and consult that supervisor.

*EC (h): The home supervisory authority informs relevant host supervisors of any material changes in supervision that may have a significant bearing on the operations of foreign establishments operating in their jurisdictions.*

APRA publishes any changes in its supervisory approach, including proposals under consultation, on its website. APRA cooperates fully with its overseas counterparts, with exchanges of information extending beyond home/host supervisory issues to broader issues of prudential policy development.

For example, APRA has established a very close working relationship with its counterpart in New Zealand, whose financial sector is dominated by Australian domiciled conglomerates. In addition to a MOU, APRA and the RBNZ have agreed a Terms of Engagement for the implementation of the new Basel Capital Framework. APRA is also in dialogue with the Ministry of Economic Development in New Zealand in relation to possible information sharing in relation to the insurance sector.

APRA also shares information with the Financial Services Authority (FSA) in the United Kingdom on a regular basis.

*EC (i): Where possible, the home supervisory authority informs the host supervisor in advance of taking any action that will affect the foreign establishment in the host supervisor's jurisdiction.*

Should APRA need to take action in regard to an insurer that would have a material effect on the insurer's overseas operations, APRA would promptly notify the relevant overseas supervisors. In recent years APRA has been in close contact with the FSA and the Hong Kong regulator over particular entities.

*EC (j): Where possible, the host supervisory authority informs the home supervisor in advance of taking any action that will affect the parent company or headquarters in the home supervisor's jurisdiction.*

Before APRA takes such action on the Australian branch or subsidiary of a foreign insurer, APRA would inform the home supervisor. There are a number of recent examples where this has occurred.

## ICP 6 Licensing

An insurer must be licensed before it can operate within a jurisdiction. The requirements for licensing are clear, objective and public.

*EC (a): The insurance legislation:*

- *includes a definition of insurers;*
- *requires licensing of insurers, and prohibits unauthorised insurance activities;*
- *defines the permissible legal forms of insurers;*
- *allocates the responsibility for issuing licences.*

A general insurer is defined as a body corporate that is authorised under section 12 of the Insurance Act to carry on insurance business in Australia. General insurer also includes a foreign general insurer, which can operate branches in Australia. Insurance business under the Insurance Act means 'the business of undertaking liability, by way of insurance (including reinsurance), in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event, and includes any business incidental to insurance business as so defined'. Certain businesses, including life insurance business, business in relation to benefits provided by a friendly society, or business as a registered health or medical benefits organisation, are specifically excluded.

Pursuant to sections 9 and 10 of the Insurance Act, it is an offence to carry on insurance business in Australia without being authorised.<sup>12</sup> APRA may authorise an applicant to carry on insurance business in Australia in accordance with section 12 of the Act.

The Life Insurance Act defines a life company as a company that is carrying on life insurance business in Australia. Life insurance business under the Life Insurance Act consists of the issuing of life policies and the undertaking of liability under life policies while what constitutes a life policy is listed under section 9 of the Act. In addition, APRA may declare certain insurance business, annuity business or other financial business as life insurance business under sections 12A or 12B of the Act.

Part 3 of the Life Insurance Act prohibits companies from issuing life policies or carrying on life business without registration under the Life Insurance Act. Under section 20(1) of the Life Insurance Act, 'any company may apply to APRA for registration under this Act', while 'company' under the Life Insurance Act is defined to mean a company incorporated under the Corps Act or any law of a State or Territory in Australia or, an 'eligible foreign life insurance company' under section 16ZD of the Life Insurance Act (see EC (e) below).

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<sup>12</sup> See EC (c) below for exceptions.

*EC (b): Clear, objective and public licensing criteria*

APRA issued a Guidance Note *Guidelines on Authorisation of General Insurers* to apply to prospective applicants seeking an authority to carry on insurance business in Australia when the new supervisory regime for general insurance was put in place in 2002. The Guidance Note sets down the minimum criteria to be addressed by applicants and the necessary information and documents to be submitted with an application, including:

- all substantial shareholders of an applicant to demonstrate to APRA that they are 'fit and proper' in the sense of being well-established and financially sound entities or individuals of standing and substance;
- the applicant must provide to APRA information on the proposed senior management team and management structure so that APRA can make an assessment of the fitness and propriety of those in key positions;
- ability to comply with all of APRA's prudential requirements, as set out in the Insurance Act and Prudential Standards, from the commencement of insurance business in Australia and continuously thereafter. The prudential requirements include minimum capital requirements that must be maintained, as stipulated in Prudential Standard GPS 110 *Capital Adequacy*; and
- risk management systems, including reinsurance arrangements, internal control systems, information technology systems, policies and procedures consistent with the nature and scale of the business in question.

Furthermore, Attachment A of the Guidance Note lists the supporting information required for an application to conduct insurance business. Amongst the information to be provided is a business plan incorporating the goals of the first three years of planned operation, and details on the products that the insurer plans to offer. Details of existing or proposed subsidiaries and associates are also required.

Sections 24 and 25 of the Guidance Note discuss APRA's requirements for foreign insurer applicants. Specifically, foreign insurer applicants must have received consent from their home supervisor for the establishment of an insurance operation in Australia.

Regulation 3 of the *Life Insurance Regulations* requires applications for registration as a life company to be in writing and sets out the particulars to be provided in the applications, including:

- managerial structure with details of the directors, senior executives, auditor and appointed actuary;
- plans for new business with sample premium rates and particulars of reinsurance;
- particulars of the financing of new life business;

- operational structure covering classes of business and types of policies;
- investment policy;
- outsourcing arrangements where applicable; and
- details of the administrative and accounting systems and the appointed actuary's statement with regard to their adequacy. The application must be accompanied by written advice from the appointed actuary (as required under section 116 of the Life Insurance Act) about the terms and conditions and reinsurance arrangements of proposed policies, plus service agreements for all outsourced functions.

The applicant must also satisfy the minimum capital requirement for the General Fund as stipulated under *Prudential Standard No 3*.

*EC (c): The supervisory authority requires that no domestic or foreign insurance establishment escape supervision.*

The Life Insurance Act applies to all life business carried on in Australia, whether by a domestic or foreign insurance establishment through agents, except for State insurance that does not extend beyond the limits of the State concerned.

While it is an offence to conduct general insurance business without authorisation from APRA, section 3 of the Insurance Act specifically excludes:

- State insurance;
- Australian Government insurance;
- a body corporate prescribed elsewhere by regulations; and
- insurance business prescribed elsewhere by the regulations.

Furthermore, some foreign general insurers, referred to as Direct Offshore Foreign Insurers (DOFIs), are not supervised by APRA because their business functions (such as underwriting, claims and policy issues) are not conducted in Australia. DOFIs market directly in Australia and are required to hold an Australian Financial Services Licence (AFSL). AFSL holders are subject to disclosure requirements (see ICP 25 *Consumer Protection*) but not prudential supervision by APRA.

DOFIs were the subject of a Government review, *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers* (the Potts Review) in 2004 which examined insurance-like products provided by institutions not regulated by APRA. The review's key recommendations for DOFIs are outlined below.

- 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 only 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.

DOFIs account for approximately 2.5 per cent of the Australian insurance market.

The Potts Review also considered products which provide discretionary cover. '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 (such as doctors or lawyers) may jointly agree to meet the costs of certain risks that members face.

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' under the Insurance Act. It should be noted, however, that products providing discretionary cover account for less than 0.5 per cent of the market.

The Government's formal response to the Potts Review is yet to be released.

*EC (d): All insurance establishments of international insurance groups and international insurers are subject to effective supervision. The creation of a cross border establishment should be subject to consultation between the host and home supervisor.*

The Life Insurance Act requires a life company to have a statutory fund or statutory funds exclusively in respect of life insurance business carried on outside Australia. The statutory fund would be subject to all statutory requirements pursuant to Part 4 of the Life Insurance Act. The Life Insurance Act, however, does not apply to life insurance business carried on outside Australia by an eligible foreign life insurance company (see EC (e) below).

The Insurance Act currently does not directly apply to insurance activities carried on outside Australia by insurers domiciled in Australia. However, Part III Division 4 of the Insurance Act requires NOHCs to be authorised, which provides APRA with the ability to regulate any Australian based companies 'holding' overseas operations. Draft proposals released in May 2005 relating to the supervision of corporate groups involving authorised general insurers would extend APRA's supervisory net to include overseas operations. The proposals include a requirement for APRA's prior approval for the establishment or acquisition of a regulated presence overseas.

The authorised branch or subsidiary of a foreign insurer must meet all statutory requirements under the Insurance Act. Sections 24 and 25 of the *Guidelines on Authorisation of General Insurers* stipulate supervision by the home supervisor for foreign insurers seeking authorisation under the Insurance Act. The foreign insurance applicant must have received consent from their home supervisor for the establishment of an insurance operation in Australia. APRA also requires an acknowledgement by the applicant that APRA may discuss the conduct of the Australian operation with the home supervisor.

*EC (e): The insurance legislation determines the method by which a foreign insurer can carry on business in the jurisdiction. This may be by way of a local branch or subsidiary that must be licensed, or on a services basis only.*

Foreign insurers may apply to establish locally-incorporated subsidiaries to carry on general insurance business in Australia or alternatively, a foreign insurer may seek an authority to operate in Australia as a branch.

Before amendments to the Life Insurance Act in 2004, foreign life insurers could only carry on life insurance businesses through locally incorporated subsidiaries and as such are subject to all the provisions of the Life Insurance Act as local insurers. Under the US-Australia Free Trade Agreement concluded in 2004, foreign life companies which are both incorporated in the US and authorised to conduct life insurance business in the US are eligible to seek authorisation to conduct life insurance business in Australia through branches. *Part 2B* was inserted into the Life Insurance Act to provide for the operation of these entities, termed 'eligible foreign life insurance companies'.

*EC (f): Information from a foreign insurer applicant*

The *Guidelines on Authorisation of General Insurers* stipulate supervision by the home supervisor for foreign insurers seeking authorisation under the Insurance Act (see EC (c) above). Only applicants who are authorised insurers in their home country will be authorised in Australia. Foreign insurer applicants must satisfy APRA that they are subject to adequate prudential supervision in their home country. In addition, Attachment B of the *Guidelines on Authorisation of General Insurers* details the supporting information required from a foreign insurer in its application to conduct insurance business in Australia, including information necessary to demonstrate the applicant's financial standing.

The requirements in Regulation 3 of the *Life Insurance Regulations* also apply to foreign insurers that apply for authorisation.

*EC (g): An insurer licensed to underwrite life insurance business must not also be licensed to underwrite non-life insurance business, and vice versa, unless the supervisory authority is satisfied that the insurer has satisfactory processes requiring that risks be handled separately on both a going-concern and a winding-up basis.*

Section 234 of the Life Insurance Act prohibits a life company from carrying on any insurance business other than life insurance business. The definition of general insurance business under section 3 of the Insurance Act specifically excludes life insurance business so a general insurer licensed under the Insurance Act is not eligible to conduct life business.

*EC (h): The supervisory authority imposes additional requirements, conditions or restrictions on an applicant where the supervisory authority considers this appropriate. This might include restrictions on non-insurance activities.*

Section 22 of the Life Insurance Act provides for APRA to impose conditions on the registration of a life company while section 13 of the Insurance Act enables APRA to impose conditions on an insurer's licence at any time.

*EC (i): The supervisory authority assesses the application and makes a decision within a reasonable time. No licence is issued without its approval. The applicant must be informed of the decision without delay and, if the licence is denied or conditional, be provided with an explanation.*

Section 34 of the *Guidelines on Authorisation of General Insurers* notes that 'all applications will be processed within a reasonable time, having regard to the particular circumstances of each application'. No licence is issued without APRA's approval.

For life company registration applicants, section 21 of the Life Insurance Act provides guidance on the decision process.

*EC (j): The supervisory authority refuses to issue a licence where it considers the applicant not to have sufficient resources to maintain the insurer's solvency on an ongoing basis, where the organisational (or group) structure hinders effective supervision, or where the application is not in accordance with the licensing criteria.*

In accordance with the *Guidelines on Authorisation of General Insurers*, APRA will only grant an authority under the Insurance Act if it is satisfied that the applicant has the capacity and commitment to conduct insurance business and may refuse an application on prudential grounds.

Section 21(3) of the Life Insurance Act outlines the grounds on which APRA may refuse to register a company, including when the applicant 'is not able, or is unlikely to be able, to meet its obligations ...'. Refusal needs the Treasurer's approval (section 21(2) (b)).

*EC (k): As necessary, after an insurer has been licensed, the supervisory authority evaluates and monitors the degree to which the insurer satisfies the relevant licensing principles and requirements of the jurisdiction.*

Insurers licensed under the Insurance Act or registered under the Life Insurance Act are subject to ongoing supervision by APRA (see ICPs 12 and 13).

## ICP 7 Suitability of persons

The significant owners, board members, senior management, auditors and actuaries of an insurer are fit and proper to fulfil their roles. This requires that they possess the appropriate integrity, competency, experience and qualifications.

*EC (a): Legislation identifies which key functionaries must meet fit and proper requirements. The key functionaries identified may differ depending on the legal form and governance structure of the insurer.*

As part of the general insurance reforms in 2001, the Insurance Act was amended to include provisions so that disqualified persons may not be or act as directors or senior managers of general insurers. Section 25 defines a 'disqualified person' to include bankrupts and persons convicted of offences under the Insurance Act, the FSCD Act, the Corps Act or of offences concerning dishonest conduct or conduct relating to a financial sector company within the meaning of the *Financial Sector (Shareholdings) Act 1998* (FSSA). In addition, section 25A of the Insurance Act enables APRA to disqualify a person if APRA is satisfied that the person is not a fit and proper person to be or act as a director or senior manager of a general insurer. Fitness and propriety criteria are set out in Prudential Standard GPS 220 *Governance*, which is also applicable to the Approved auditor and Approved actuary of a general insurer.

Section 245 of the Life Insurance Act disqualifies bankrupts and convicted persons from serving as director, principal executive officer or appointed actuary of a life company. Section 84 of the Life Insurance Act stipulates that only an individual who is an approved auditor may hold an appointment as the auditor of a life company. Approval of auditors of life companies by APRA is governed by section 85 of the Life Insurance Act based on qualifications and experience. Section 93 of the Life Insurance Act covers the appointment, and APRA's approval of the appointment, of the actuary of a life company. Similar to the approval of auditors, the eligibility criteria only relate to qualifications and experience.

APRA has released draft prudential standards (LPS 520 and GPS 520) on minimum requirements that insurers must apply in determining the fitness and propriety of individuals to serve in responsible person positions. Amongst other things, these requirements will further strengthen the fitness and propriety requirements required of responsible persons. The standards define 'responsible person' as a director, a senior manager, an auditor and an appointed actuary of an insurer. Public consultation on the draft prudential standard has closed and implementation of the final standard is imminent.

*EC (b): In cases where significant owners no longer meet fit and proper requirements, the supervisory authority must be able to take appropriate action, including requiring that the owners dispose of their interests.*

Significant shareholdings in, and control of, financial sector companies (which include authorised general insurers and registered life companies) are governed by the FSSA and the *Insurance Acquisitions and Takeovers Act 1991* (IATA).

The FSSA requires ownership stakes in excess of 15 per cent in a financial sector company to be approved by the Treasurer. Approval is subject to the ownership stake being in the national interest.

The IATA applies to any proposal to acquire a significant portion (15 per cent or more) of the assets in, or to enter into agreements relating to the directors of, an Australian-registered insurance company. All proposals are to be notified and approved by the Treasurer prior to any acquisition. As for FSSA applications, IATA proposals are approved only when doing so would be in the public interest.

The aim of the FSSA and IATA is to protect public interest by:

- ensuring that the affairs of APRA-regulated institutions are carried out in a prudential manner;
- preventing unsuitable persons from being in a position of influence over APRA-regulated institutions; and
- preventing the undue concentration of economic power in the Australian insurance and banking industries or in the Australian financial system.

Both the FSSA and IATA provide for the Treasurer to delegate the approval powers to APRA. The Treasurer has delegated the exercise of his powers under the FSSA and IATA to APRA staff members, subject to size limitations (for life companies, total assets of the life company involved must not exceed \$5 billion and for general insurers, total assets of the insurer must not exceed \$1 billion). In those cases where the Treasurer's approval is still required, the Treasurer would seek APRA's advice. In evaluating FSSA or IATA proposals, APRA would apply the fit and proper criteria to the applicants as if they were directors under EC (a) above.

Section 18(1) of the FSSA allows the Treasurer to revoke any approval previously granted if it is in the national interest to do so. Furthermore, the Treasurer may apply to the Court to order disposal of shares to remedy any unacceptable shareholding situation (section 12 of the FSSA).

*EC (c): The supervisory authority disqualifies the appointment of key functionaries including auditors and actuaries of insurers that do not comply with fit and proper requirements.*

See first paragraph under EC (a) for general insurers.

The Life Insurance Act provides APRA with the power to disqualify auditors and actuaries if they fail to adequately and properly perform their functions as required under the Life Insurance Act.<sup>13</sup> APRA's directional powers under section 230B of the Life Insurance Act include directions to remove a director, executive officer, employee, the approved auditor or approved actuary from office. APRA has indicated it would exercise these powers to ensure compliance with the fit and proper criteria (section 23 of Draft LPS 520).

*EC (d): The insurer should be required to demonstrate to the supervisory authority the fitness and propriety of key functionaries by submitting documentation illustrating their knowledge, experience, skills and integrity upon request, or where there are changes in key functionaries. The knowledge and experience required depends on the position and responsibility of the functionary within the insurer.*

Consistent with APRA's self-assessment approach to the fit and proper test, general insurers must have in place policies and procedures to address fitness and propriety. Accordingly, as stipulated in Guidance Note GGN 220.1, a general insurer must assess all new persons filling key positions, and those of existing staff, and should review these assessments at least annually. However, APRA should be notified 'immediately if a key person no longer complies with the tests of fitness and propriety established by the insurer'. APRA may conduct a review of the fitness and propriety of a person if it so wishes. APRA assesses the fitness and propriety of the Board of directors and the management team of insurers under Modules 1 and 2 of the on-site prudential review process.

The draft standards on fit and proper have detailed requirements of what information, in respect of responsible persons of an insurer, is to be provided to APRA. Changes, including new appointments, retirement or removal of a person, must be notified as soon as practicable, and in any event not later than 14 days after the change occurring.

The draft standard notes that in determining whether a person is 'fit and proper' to serve as a responsible person, the insurer must give regard to the responsible person position that the person holds or is being considered for.

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<sup>13</sup> Sections 86(1) and 94(3) of the Life Insurance Act.

*EC (e): The supervisory authority exchanges information with other authorities inside and outside its jurisdiction where necessary to check the suitability of persons. The supervisory authority uses this information as an additional tool to effectively assess the fitness and propriety of, or to obtain information on, a key functionary of an insurer (refer to ICP 5).*

The draft prudential standard provides for APRA to require 'information from law enforcement agencies, other regulators, current and former employers of the individual, professional associations and other parties who APRA believes may have relevant information about the responsible person' for the purpose of the fit and proper assessment. In addition, APRA 'may make other enquiries...to enable APRA to form an opinion as to the fitness and propriety of the individual concerned'.

*EC (f): The supervisory authority disallows actuaries, auditors, directors and senior managers, from simultaneously holding two positions in an insurer where this could result in a material conflict.*

Section 6(d) of Prudential Standard GPS 220 *Risk Management for General Insurers* stipulates that responsible persons must have 'no actual or potential conflicts of interest that are likely to influence their ability to carry out their role and functions with appropriate probity and competence'. Further on, section 10 specifically prohibits a person from holding the positions of both approved auditor and approved actuary simultaneously.

In a similar vein, the draft prudential standards on fit and proper disallow a person from being appointed as both the Approved auditor and Approved actuary of an insurer. The appointed auditor must not be a director or employee of the insurer or of a related body corporate within the meaning of section 50 of the Corps Act while the approved actuary must not be a director or chief executive of the insurer. Also one of the fit and proper considerations under the draft prudential standards is 'whether the person has a conflict of interest which may influence his or her ability to carry out the role and functions of the responsible person position they are being considered for, or already fill'.

APRA has released a discussion paper on Governance as well as draft prudential standards proposing minimum governance requirements that supervised institutions must adhere to as part of their overall governance arrangements. The Governance standards have specifications on the composition of boards and the independence of directors of insurers.

*EC (g): Where the insurer becomes aware of circumstances that may be relevant to the fitness and propriety of its key functionaries, it is required to notify the supervisory authority as soon as possible.*

Currently a general insurer has to notify APRA 'immediately if a key person no longer complies with the tests of fitness and propriety established by the insurer', pursuant to Section 4 of Guidance Note GGN 220.1 *Governance*.

When the draft prudential standards come into force, insurers will have to notify APRA 'as soon as possible, and in any event not later than 14 days' of changes in the insurer's ongoing assessment of the fitness and propriety of a responsible person.

*AC (h): Criteria to assess the fitness and propriety of auditors' and actuaries' include qualifications, professional proficiency, appropriate practical experience and updated knowledge on developments within their profession and membership of professional bodies.*

To gain approval from APRA for appointment as auditor or actuary of an insurer, a person must:

- have appropriate formal qualifications;
- be a member of a suitable professional body; and
- have a minimum of five years' experience in the relevant industry.

Pursuant to section 93(4) of the Life Insurance Act, life company actuaries must be a Fellow of the IAAust and have been a Fellow for at least five years.

*AC (i): In the case of auditors and actuaries, the supervisory authority may give regard to or rely on professional bodies that set and enforce standards of professional conduct.*

See AC (h) above. Should an auditor or actuary be disqualified by the professional bodies to which they belong, they would no longer be eligible to hold office as the approved auditor or appointed actuary of an insurer.

## ICP 8 Changes in control and portfolio transfers

The supervisory authority approves or rejects proposals to acquire significant ownership or any other interest in an insurer that results in that person, directly or indirectly, alone or with an associate, exercising control over the insurer. The supervisory authority approves the portfolio transfer or merger of insurance business.

### Changes in Control

*EC (a): The term 'control' over an insurer is defined in legislation and it addresses:*

- *holding of a defined number or percentage of issued shares or specified financial instruments (such as compulsory convertible debentures) above a designated threshold in an insurer or its intermediate or ultimate beneficial owner;*
- *voting rights attached to the aforementioned shares or financial instruments;*
- *power to appoint or remove directors to the board and other executive committees.*

Under the FSSA, a person's stake in a financial sector company, which for the purpose of the FSSA includes an authorised insurer under either the Insurance Act or the Life Insurance Act, must not exceed 15 per cent unless the person has received approval from the Treasurer that the stake holding is in the national interest. A person's stake in a financial sector company is the aggregate of the person's voting power and the voting power of the person's associates.

In addition, a person whose stake in a financial sector company does not exceed 15 per cent may be declared by the Treasurer to have practical control of the company (section 23 of the FSSA) in which case the person must take steps to relinquish practical control of the company (section 24 of the FSSA).

Schedule 1 of the FSSA contains a comprehensive glossary of ownership definitions including 'associates', 'direct control interest', 'interest in a share', 'power to appoint a director', 'voting power' and 'control of the voting power' relevant to the consideration of shareholdings restrictions under the FSSA.

Proposals relating to the acquisition or leasing of assets of Australian-registered insurers or the entering into of agreements relating to directors of Australian-registered insurers are subject to the Treasurer's approval under the IATA. Where the proposal involves the acquisition:

- of assets of more than 15 per cent of the total book value of the assets of the company; or
- of interests in life contracts exceeding 15 per cent of the total book net liabilities of the company's life insurance contracts; or

- of interests in general insurance contracts exceeding 15 per cent of the unearned premiums provision or outstanding claims provision of the insurers contracts; or
- leading to the control or appointment of one or more directors in either a life or general insurance company.

The proposal would require notification and approval under IATA (see ICP 7 EC (b)).

The ownership definitions under the IATA are consistent with those in Schedule 1 of the FSSA.

*EC (b): The supervisory authority requires that the potential controlling owners apply for approval for the acquisition, or change in control, of the insurers. The insurer must inform the supervisory authority of any acquisitions or changes in control.*

See EC (a) and also ICP 7 above. Proposals that meet the criteria of 'trigger proposals' as set out in section 36 or section 50 of IATA must not be carried out before notice in the prescribed form has been given to the Treasurer as per section 52 of IATA. Pursuant to Division 5 of the FSSA, regulations may require records to be kept, and information to be given, for purposes relating to the restrictions on shareholdings.

*EC (c): The supervisory authority approves any significant increase in shareholdings above the predetermined control levels in an insurer by legal or natural persons, whether obtained individually or in association with others. This also applies to any other interest in that insurer or its intermediate or ultimate beneficial owners.*

The FSSA and IATA apply to ownership by a 'person'. Under the *Acts Interpretation Act 1901* 'person' includes a body politic or corporate as well as a natural person. The definition of 'stake' under the FSSA and the criteria of 'trigger proposal' in the IATA extend to a person and its associates. The meaning of 'associate' is sufficiently broad to capture interests held through any interposed companies, partnerships or trusts. The voting power of shareholders also includes any indirect control that a shareholder may have.<sup>14</sup>

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<sup>14</sup> Schedule 1 of the FSSA.

*EC (d): The requirements in criteria b and c above also refer to the acquisition or change of control where the intermediate or ultimate beneficial owner(s) of an insurer is (are) outside the jurisdiction where the insurer is incorporated. Supervision of changes in control may require coordination with supervisors in other jurisdictions (refer to ICP 5).*

Neither the FSSA nor IATA exempts overseas persons. In assessing the acquisition or change of control where the intermediate or ultimate beneficial owner(s) of an insurer is (are) outside Australia, APRA would seek information from the overseas supervisors. In practice, APRA assesses any change in control applications as if they were licence applications, using the Guidelines on Authorisation of General Insurers where applicable.

Where relevant, the proposal may need separate approval from the Foreign Investment Review Board.

*EC (e): The supervisory authority must be satisfied that those seeking control meet the criteria applied during the licensing process. The requirements in ICP 7 – Suitability of persons – will apply to the prospective owners in control of insurers.*

See ICP 7 (b) above.

*EC (f): The supervisory authority requires that the structures of the financial groups containing potential controlling owners of insurers be sufficiently transparent so that supervision of the insurance group will not be hindered (refer to ICP 17).*

APRA assesses proposals relating to changes in control as if they were initial licence applications. Any structure that would hinder the effective supervision of the insurer would not be acceptable. With the current supervisory regime on a solo rather than consolidated basis, however, there is little emphasis on the insurance group. This will change when the current proposals to extend the supervisory framework to corporate groups involving insurers are implemented. The discussion paper on prudential supervision of corporate groups involving authorised general insurers, released in May 2005, places considerable importance on the corporate structure of insurance groups.

Given the requirement to segregate assets and liabilities in statutory funds, life insurance operations in Australia are less vulnerable to risks arising from complex ownership structures. Notwithstanding, group-wide supervision for life companies is on APRA's reform agenda (see ICP 17).

*EC (g): The supervisory authority rejects applications of proposed owners to control insurers if facts exist from which it can be deduced that their ownership will be unduly prejudicial to policyholders. The supervisory authority should know who is the intended beneficial owner.*

The Treasurer may only approve an application of proposed owners to control an insurer if the application can demonstrate that it is in the national interest. In determining what is in the national interest, the safety and protection of policyholders will be taken into account.

*EC (h): To assess applications for proposed acquisitions or changes in control of insurers the supervisory authority establishes requirements for financial and non-financial resources.*

Apart from the national interest test, the Treasurer has not set any specific assessment criteria for FSSA or IATA approvals. In practice, proposals will be assessed by APRA against the licensing criteria, which include fitness and propriety standards for the proposed owners and their financial capacity to provide capital support if needed.

*AC (i): Upon request insurers provide the supervisory authority with information on their shareholders and any other person directly or indirectly exercising control. The supervisory authority determines the content and format of this information.*

APRA may give notice to a general<sup>15</sup> or life<sup>16</sup> insurer requiring the company to provide information or produce records relating to the affairs of the company.

## Portfolio Transfer

*EC (j): The supervisory authority requires that insurers get approval from the authority before they transfer all or any part of their insurance business.*

Approval from APRA is effectively required prior to an insurer transferring insurance business.

Division 3A of the Insurance Act specifies that no part of the insurance business of a general insurer may be transferred to, or amalgamated with, another general insurer except by a scheme confirmed by the Federal Court. The insurer cannot make an application to the Court unless the insurer provides APRA with a copy of the scheme and any actuarial reports on which the scheme is based.

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<sup>15</sup> under section 51 of the Insurance Act.

<sup>16</sup> under sections 131 and 132 of the Life Insurance Act.

Prior to making an application to the Court, and with APRA's approval, the insurer must also publish a notice of intention to make the application in the Government Gazette and relevant newspapers.

Part 9 of the Life Insurance Act prohibits the transfer or amalgamation of any life insurance business of a life company to, or with the business of, another life company, except under a scheme confirmed by the Court, or where the transfer is a transfer of business made under the *Financial Sector (Transfer of Business) Act 1999* (FSTB Act), in accordance with that Act.

*EC (k): The supervisory authority establishes requirements to assess insurers' applications to transfer all or any part of their insurance business.*

A transfer of insurance business must follow the process set out in Division 3A of the Insurance Act or Part 9 of the Life Insurance Act.

Alternatively life companies seeking to transfer business between themselves have to comply with Part 3 of the FSTB Act.

Prudential Standard GPS 410 *Transfer and Amalgamation of Insurance Business for General Insurers* deals with the transfer or amalgamation of insurance business of a general insurer. These requirements are designed to ensure that affected policyholders and other interested members of the public are informed about any such transfer or amalgamation, are given accurate information about it, and are provided with the opportunity to obtain more detailed particulars if they wish to do so.

*EC (l): The supervisory authority requires that the interests of the policyholders of both the transferee and transferor be protected when insurance business is transferred (refer to ICP 15 EC (c)).*

Section 1(c) of the FSTB Act stipulates that, for a transfer of business to be approved, APRA must have regard to the interest of the policy owners of the transferring body and the receiving body. For the Court to confirm transfers under either the Insurance Act or the Life Insurance Act, an actuarial report on the scheme is required.<sup>17</sup>

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<sup>17</sup> See section 17D of the Insurance Act and section 191 of the Life Insurance Act.

## ICP 9 Corporate governance

The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.

*EC (a): The supervisory authority requires and verifies that the insurer complies with applicable corporate governance principles.*

As prudential regulator of the insurance industry, it is APRA's responsibility to ensure that the interests of policyholders would not be compromised by the actions of the Board and management of an insurer. APRA needs to be confident that insurers have robust governance arrangements and are managed prudently. Accordingly, assessment of the quality and effectiveness of an insurer's board and management is a routine component of APRA's on-site prudential review. One of the key topics under Module 1 *Board* of the APRA Supervision Framework involves assessing the role of an insurer's board. The assessment includes checking how the Board sets the risk management framework, approves strategies and policies, determines remuneration packages for directors and senior management, and the Board's knowledge of the regulatory regimes and its obligations.

To formalise APRA's requirements on corporate governance, APRA released draft Prudential Standard LPS 510 and GPS 510 *Governance* in May 2005, setting out the minimum governance requirements that insurance companies must adhere to as part of their overall governance arrangements.

Directors of insurers are obliged, under the Corps Act, to exercise due care and diligence in the discharge of their duties. Furthermore, insurers which are listed companies are subject to the Principles of Good Corporate Governance and Best Practice Recommendations of the Australian Stock Exchange (ASX). These best practice recommendations are not prescriptions, but aspirations of best practice for optimising corporate performance and accountability in the interests of shareholders and the broader economy. If a company considers that a recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt the particular recommendation but it has to explain why. Under ASX Listing Rule 4.10, companies are required to provide a statement in their annual report disclosing the extent to which they have followed these best practice recommendations in the reporting period. Where companies have not followed all the recommendations, they must identify the recommendations that have not been followed and give reasons for the departure.

### *EC (b): Role of the board of directors.*

Prior to the release of the draft prudential standard on governance, APRA had signalled to industry its intention to introduce governance requirements. In response, industry has expressed its concerns that highly prescriptive provisions may hinder the effective and efficient functioning of boards. Mindful of industry's concerns and wary that one size does not fit all, APRA has now proposed a principles-based, rather than prescriptions-based approach. The draft standard sets out eight key principles that companies should have regard to when developing and implementing governance arrangements. The principles are listed below.

- **Responsibility** – the Board has ultimate responsibility for the sound and prudent management of an insurance company. The Board should establish a formal charter setting out its roles and responsibilities. The Board must ensure that an appropriate, adequate, and effective system of risk management and internal control is established and maintained, and that senior management monitors the effectiveness of the risk management framework. The delegation of authority to management must be clearly set out and documented.
- **Independence** – the Board of an insurer must have a majority of independent non-executive directors at all times. No single individual or shareholder group should be able to exercise undue or disproportionate control or influence over the Board or the operations of the insurer. Directors must inform the Board and remove themselves from any discussions or decision-making with respect to matters that may give rise to conflicts of interests.
- **Renewal** – companies should have a policy of renewal that regularly provides for fresh insight and general reinvigoration of the Board.
- **Expertise** – directors must collectively have the necessary skills, knowledge and experience to discharge their functions. The Board should ensure that senior management of the company, collectively, have the full range of skills needed for the effective and prudent operation of the company.
- **Diligence** – the board and management of an insurer should, at all times, discharge their duties and responsibilities diligently.
- **Prudence** – the Board and management should always focus on the prudent management of the company. Both the Life Insurance Act and the Insurance Act oblige directors to ensure the insurer's compliance with APRA's prudential requirements.
- **Transparency** – the Board and management must be open and honest in all their dealings on behalf of the company. The Board should have in place procedures for assessing the Board's performance relative to its objectives. There must also be procedures for assessing the performance of individual directors and senior managers. Members of the Board and senior management must be available to meet with APRA on request.

- Oversight – the Board should ensure that the management and operation of the insurer is in accordance with the strategy, direction and policies set by it.

Every life and general insurer must have an approved actuary and an appointed auditor. For general insurers, Prudential Standard GPS 220 *Risk Management for General Insurers* and associated Guidance Notes detail the Board’s responsibility to establish audit functions, actuarial functions, strong internal controls and applicable checks and balances.

***EC (c): Role of senior management***

Sections 20 and 21 of Prudential Standard GPS 220 *Risk Management for General Insurers* define senior management responsibilities to include:

- high level decision making;
- implementing strategies and policies approved by the Board;
- developing processes that identify, manage and monitor risks incurred by the insurer; and
- monitoring the appropriateness, adequacy and effectiveness of the risk management system.

***AC (d): The board of directors may establish committees with specific responsibilities like a compensation committee, audit committee or risk management committee.***

Draft LPS/GPS 510 requires insurers to establish Board committees for the purpose of overseeing critical functions. In establishing committees, the Board should have regard to the risk profile of the insurer, the complexity of the insurer’s business, the Board’s composition, and the experience and expertise of the insurer’s directors. At the minimum, a life company must have a Board Audit Committee and a general insurer must have both a Board Audit Committee and a Board Risk Committee.

***AC (e): The remuneration policy for directors and senior management has regard to the performance of the person as well as that of the insurer. The remuneration policy should not include incentives that would encourage imprudent behaviour.***

In assessing the role of the Board in an on-site prudential review, APRA looks for a formal and transparent process for fixing the remuneration packages of directors and senior management.<sup>18</sup> The draft prudential standard on Governance requires an insurer to have in place a procedure for assessing the performance of individual directors and senior managers. One of the ASX Good Corporate Governance Recommendations relates to continuous

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<sup>18</sup> Section 3.2 of Module 1 *Board* of the APRA Supervision Framework.

disclosure of the remuneration of the chief executive officer of a company. In a note to companies, the ASX urges companies to consider communication of remuneration policies and the linkage of remuneration frameworks to performance.

*AC (f): The board of directors identifies an officer or officers with responsibility for ensuring compliance with relevant legislation and required standards of business conduct and who reports to the board of directors at regular intervals (refer to EC (b)).*

While there is no specific requirement for a compliance officer or officers, APRA expects insurers to have a compliance function with roles and responsibilities clearly established. Review of the compliance function is a routine item under Module 6 *Risk Management* of the APRA Supervision Framework.

*AC (g): When a 'responsible actuary' is part of the supervisory process, the actuary has direct access to the board of directors or a committee of the board. The actuary reports relevant matters to the board of directors on a timely basis.*

The draft prudential standard on governance provides the external auditor and the appointed actuary of an insurer with the opportunity to raise matters directly with the Board.

Specifically, section 97 of the Life Insurance Act provides the appointed actuary with powers to access any information or document of the company necessary for the proper discharge of the appointed actuary's functions and duties. It also entitles the actuary to attend Board meetings and annual general meetings of the company. The appointed actuary is obliged to report to the directors of a life company any matter that comes to his attention that may prejudice the interests of policyholders (section 98 of the Life Insurance Act).

For general insurers, section 9 of Guidance Note GGN 220.1 *Governance* requires that 'the Board must provide the Approved auditor and Approved actuary of the insurer with the opportunity to raise matters directly with the Board. This includes instances where the matters have already been raised with senior management or the Board Audit Committee, but have not been dealt with to the satisfaction of the Approved auditor or Approved actuary'. Further section 32 states that 'the Approved actuary must provide the [actuarial report on liabilities] to the insurer's Board within such time as to give the Board a reasonable opportunity to consider and use the report in preparing the insurer's yearly statutory accounts for that financial year'.

## ICP 10 Internal control

The supervisory authority requires insurers to have in place internal controls that are adequate for the nature and scale of the business. The oversight and reporting systems allow the board and management to monitor and control the operations.

*EC (a): The supervisory authority reviews the internal controls and checks their adequacy to the nature and the scale of the business and requires strengthening of these controls where necessary. The board of directors is ultimately responsible for establishing and maintaining an effective internal control system.*

APRA's regular supervisory activities include the undertaking of on-site prudential reviews to assess the soundness of the supervised institutions and their compliance with relevant legislation and standards. Prudential reviews are based around a suite of Modules that address the key functional and risk areas of the supervised institutions. The Modules relevant to internal controls include Module 2 *Management* covering the roles and responsibilities including delegations of senior management; Module 4 *Structure and Relationships* covering key relationships and reporting lines; Module 6 *Risk Management* covering compliance, management information systems, and the audit and actuary functions; and Module 7 *Operational Risk* that addresses outsourcing, fraud, and administration. Mindful that one size does not fit all, APRA's review procedures emphasise that the depth of assessment under each of the modules will be determined by the nature, size and complexity of the institution under review.

As part of the general insurance reforms in 2002, APRA introduced governance standards to strengthen the internal checks and balances of insurers. Section 15 of Prudential Standard GPS 220 *Risk Management for General Insurers* requires the Board of an insurer to 'ensure that an appropriate, adequate and effective system of risk management and internal control is established and maintained' and 'use its best endeavours to ensure that senior management monitors the effectiveness of the risk management and control system.' Section 13 of Guidance Note GGN 220.2 *Risk Management Systems* states that 'an insurer should have appropriate control mechanisms in place to ensure that the policies and procedures established for risk management are adhered to at all times'.

*EC (b): The framework for internal controls within the insurer includes arrangements for delegating authority and responsibility, and the segregation of duties. The internal controls address checks and balances; for example cross-checking, dual control of assets, double signatures (refer to ICP 9 EC (b)).*

While APRA acknowledges that the scope of control mechanisms will vary depending on the size, business and complexity of operations in an insurer, section 14 of GGN 220.2 defines the minimum scope to include:

- clearly defined management responsibilities;

- adequate segregation of duties;
- a risk committee or audit function to establish and maintain the control processes;
- a system of approvals, limits, authorisations and reporting lines;
- policies to document the insurer's procedural controls;
- activity controls for each division or department;
- verifications of activities such as underwriting, pricing and claims management, and reconciliations;
- reviews by Board, senior management and internal audit; and
- physical controls.

For life insurers, Part 4 of the Life Insurance Act provides for the establishment of statutory funds in life companies to safeguard the investments and assets of policyholders. It sets rules on eligible investments and expenditures that the life company may undertake in the statutory fund. Section 48 of the Life Insurance Act imposes an onus on directors to take reasonable care, and use due diligence, to ensure that the interests of policyholders are given priority.

Furthermore, the Life Insurance Act mandates the establishment of an audit committee to assist the directors to ensure that the life company at all times has a proper system of management and financial controls.

*EC (c): The internal and external audit, actuarial and compliance functions are part of the framework for internal control, and must test adherence to the internal controls as well as to applicable laws and regulations.*

Section 39(1) of the Insurance Act requires a general insurer to have both an approved actuary and an approved auditor. GGN 220.1 details the responsibilities of the approved auditor, requiring a certification that the insurer has adequate systems and procedures in place to ensure it observes all the prudential standard requirements, complies with statutory general insurance requirements, any conditions on the authority to carry on insurance business, and any other conditions imposed by APRA in relation to an insurer's operations.

The Life Insurance Act imposes obligations on the appointed auditor and approved actuary of a life company to bring to the attention of the directors of the life company any contravention of the Life Insurance Act or any matter that may prejudice the interests of policyholders. Should they fail to get the attention of the directors, the appointed auditor and approved actuary must take the matter to APRA in writing. While both the auditor and actuary focus on financial issues they have a responsibility to satisfy themselves that the underlying data systems are adequate and accurate enough to be relied upon.

*EC (d): The board of directors must provide suitable prudential oversight and establish a risk management system that includes setting and monitoring policies so that all major risks are identified, measured, monitored and controlled on an ongoing basis. The risk management systems, strategies and policies are approved and periodically reviewed by the board of directors (refer to ICP 18).*

One of the key requirements in GPS 220 is a written Risk Management Strategy (RMS). The RMS must be approved by the Board (or in the case of foreign insurers, approved by an appropriate senior officer from outside Australia with requisite Board delegation), and reviewed regularly (at least annually) to ensure it provides an adequate framework to monitor the operating circumstances that may impact on the insurer's risk profile. To ensure the Board undertakes a regular informed assessment of all key risks, APRA requires a Board Declaration from an insurer every year, certifying that the insurer has complied with the RMS and the Reinsurance Management Strategy and that both strategies are operating effectively in practice, having regard to the risks that they are designed to control.

*EC (e): The board of directors provides suitable oversight of market conduct activities.*

The Corps Act charges the directors of a corporation with several duties in the course of fulfilling its obligations. The relevant duties include that directors must:

- use the care and diligence of a reasonable director in the corporation's circumstances occupying the same office and with the same responsibilities (section 180); and
- act in good faith in the best interests of the corporation and for a proper purpose (section 181).

In order to fulfil their obligations, the directors must take steps to inform themselves and to familiarise themselves with the affairs and conduct of the company in relation to its activities within the market. The directors must further ensure that the company's conduct in relation to its activities within the market is compliant with the law. In this way the duties prescribed in sections 180 and 181 ensure that the directors provide adequate supervision of the company's market conduct activities. There is a range of actions under the Corps Act that enable ASIC to enforce a breach of directors duties: application of a civil penalty order (section 1317J), seek compensation for damages suffered as a result of the breach (section 588J), and seek orders to disqualify the directors who have not complied with the Corps Act requirements (section 206A).

Section 912A also imposes obligations on directors of entities that hold AFSLs<sup>19</sup> to have adequate monitoring systems in place to supervise market conduct activities. ASIC expects the AFSL holder to have appropriate systems in place to monitor its compliance with the Corps Act and the obligations and conditions attached to the licence and has powers under section 915C to revoke or suspend an AFSL for non-compliance with the obligations set out in

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<sup>19</sup> See ICP 24.

section 912A. This power to suspend or cancel an AFSL under section 915C of the Corps Act cannot be exercised without the AFSL holder being afforded an opportunity to appear at a hearing before ASIC and to make submissions in relation to the matter.

*EC (f): The board of directors should receive regular reporting on the effectiveness of the internal controls. Internal control deficiencies, either identified by management, staff, internal audit or other control personnel, are reported in a timely manner and addressed promptly.*

Pertinent information and effective communication are important ingredients in the risk monitoring process. To ensure that the board of directors has access to these elements, GPS 220 requires periodic internal audits with results being reported promptly to the board or the board audit committee or to senior management. An insurer is required to establish a board audit committee whose function is to monitor compliance with the board's policies, as well as prudential and statutory requirements.

The Life Insurance Act mandates an audit committee to assist the directors to ensure that the life company at all times has a proper system of management and financial controls. To ensure the proper functioning of the audit committee, directors must ensure that the auditor and approved actuary of a life company have access to the audit committee as necessary for them to perform their functions under the Life Insurance Act.

*EC (g): The supervisory authority requires that internal controls address accounting procedures, reconciliation of accounts, control lists and information for management.*

See EC (b) above.

*EC (h): The supervisory authority requires oversight and clear accountability for all outsourced functions as if these functions were performed internally and subject to the normal standards of internal controls.*

Currently, outsourcing is covered in sections 3 to 8 of Guidance Note GGN 220.5 *Operational Risks*, under which insurers are required to 'ensure that they retain ultimate control over the outsourced operations and that the division of risks and responsibility is clear and mutually understood'.

In May 2005, APRA released a draft Prudential Standard GPS 221 *Outsourcing* to strengthen the requirements in relation to outsourcing arrangements. The aim of the draft standard is to ensure that material outsourcing arrangements entered into by an insurer are subject to appropriate due diligence, approval and ongoing monitoring. The prime responsibility for managing outsourcing arrangements of the insurer remains with the Board of the insurer. The key proposals of the draft Prudential Standard include:

- notifying after entering into agreements to outsource material business activities within Australia, and seeking prior approval from APRA when entering into agreements to outsource material business activities to service providers who conduct the activities outside Australia;
- mandating the Board and senior management to ensure risk management policies are in place;
- establishing the minimum matters to be addressed by the risk management framework for outsourcing;
- allowing APRA access to documentation and premises of the service provider;
- ensuring sufficient monitoring and reporting processes to management and the Board are in place; and
- enabling APRA to require from the insurer an independent assessment of the risk management processes.

A similar standard for life companies is being developed.

*EC (i): The supervisory authority requires the insurer to have an ongoing internal audit function of a nature and scope appropriate to the business. This includes ensuring compliance with all applicable policies and procedures and reviewing whether the insurer's policies, practices and controls remain sufficient and appropriate for its business.*

APRA has released draft prudential standards on governance which, when finalised, will require an insurer to have an independent and adequately resourced internal audit function.

*EC (j): The supervisory authority requires that an internal audit function:*

- has unfettered access to all the insurer's business lines and support departments;*
- assesses outsourced functions;*
- has appropriate independence, including reporting lines to the board of directors;*
- has status within the insurer to ensure that senior management reacts to and acts upon its recommendations;*
- has sufficient resources and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; and*
- employs a methodology that identifies the key risks run by the institution and allocates its resources accordingly (refer to ICP 18).*

The draft standard proposes that the objectives of the internal audit function must include evaluation of the adequacy and effectiveness of the financial and risk management framework of the insurer. It also identifies that, 'to fulfil its functions, the internal auditor must have unfettered access to all the insurer's business lines and support functions'.

The draft Prudential Standard GPS 221 *Outsourcing* requires the Board to ensure that any outsourcing arrangements are regularly reviewed by the audit function.

*EC (k): The supervisory authority has access to reports of the internal audit function.*

Section 131 of the Life Insurance Act allows APRA access to a copy of any document relating to the business of a life company. For the purposes of the Insurance Act, APRA may require a general insurer to produce information or documents in respect of the general insurer. In practice, APRA would review at least a selection of the internal audit reports of an insurance company in the course of a prudential review.

*EC (I): Where the appointment of an actuary is called for by applicable legislation or by the nature of the insurer's operations, the supervisory authority requires that actuarial reports be made to the board and to management.*

A key function of the appointed actuary of a life company is the annual investigation of the financial condition of the life company and the preparation of a financial condition report (FCR) to be provided to the board of the life company and APRA.<sup>20</sup> In discharging his or her functions, an actuary is bound by the professional standards of the Institute of Actuaries of Australia. At a minimum, the actuary must verify the life company's compliance with the Actuarial standards under the Life Insurance Act, including the processes and assumptions used by the life company in deriving its liability valuations, and solvency and capital requirements. Verification of compliance will involve assessments of management information systems, reinsurance arrangements, veracity of assets and liabilities data, and procedures for identifying and mitigating various risks.

For general insurers, sections 23 and 33 of Guidance Note GGN 220.1 *Governance* require that:

- the Approved actuary must provide the [actuarial] report [on the insurer's liabilities] to the insurer's Board within such time as to give the Board a reasonable opportunity to consider and use the report in preparing the insurer's yearly statutory accounts for that financial year; and
- the insurer must submit the Approved actuary's report to APRA on or before the day that the insurer's yearly statutory accounts are required to be given to APRA under the *Financial Sector (Collection of Data) Act 2001* (FSCD Act).

In addition, APRA has released a draft prudential standard in relation to a requirement that the actuary provide the insurer's Board with an FCR, which must provide an assessment of the key risks and issues impacting on the financial condition of an insurer. This includes providing the insurer with implications of issues identified and, where these implications are adverse, proposing recommendations designed to address the issues.

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<sup>20</sup> Sections 113 and 119 of the Life Insurance Act.

## ICP 11 Market analysis

Making use of all available sources, the supervisory authority monitors and analyses all factors that may have an impact on insurers and insurance markets. It draws conclusions and takes action as appropriate.

*EC (a): The supervisory authority conducts regular analysis of market conditions.*

To monitor the soundness of individual insurers and ensure their compliance with prudential requirements, APRA requires extensive reporting from all licensed entities. APRA has established procedures to conduct off-site analysis of all the data collected. While the main focus is on the financial condition of individual entities, considerable attention is paid to aggregate data so as to identify trends and industry norms, as they are instrumental to APRA's risk-based approach to supervision.

APRA has established industry groups, one for general insurance and one for life insurance, as the key forum to address emerging industry issues. One of the roles of the industry groups is to prepare industry-wide reviews, both for internal APRA use and for external publication. The industry groups are to serve as the 'designated user' for APRA's statistical reports and publications on the regulated industries.

APRA also has a dedicated Research Unit that undertakes high quality applied research into topics of relevance to APRA, Australia's regulated industries, and the financial system more generally.

*EC (b): The market analysis not only includes past developments and the present situation, but also aims to identify trends and possible future scenarios and issues, so that the supervisory authority is well prepared to take action at an early stage, if required.*

As noted in EC (a) above, identification of trends is instrumental to APRA's risk-based approach to supervision. The APRA industry groups' key role is identification of emerging industry issues so they can be escalated for appropriate policy response. The Research Unit's work is also forward-looking.

*EC (c): The market analysis is both quantitative and qualitative and makes use of both public and confidential sources of information.*

In addition to data submitted by insurers, APRA also uses industry publications, market surveys, media releases, and government statistics as references in its analysis. The assessment covers both quantitative and qualitative aspects.

APRA also makes use of 'Moody's KMV', the world's leading provider of quantitative credit analysis tools, to follow changes in market trends.

*EC (d): The supervisory authority or others, such as the insurance industry, publish aggregated market data that is readily and publicly available to the insurance industry and other interested parties.*

APRA publishes a quarterly publication, *Insight*<sup>21</sup>, which provides editorial on the wide range of APRA's interests as prudential regulator. *Insight* combines prudential commentary and feature articles with a set of statistical tables and figures that focus principally on the financial and risk characteristics of supervised financial institutions.

APRA is in the process of designing a more comprehensive semi-annual publication that will include detailed information at both an individual insurer and aggregate industry level.

For general insurance, APRA's *Quarterly General Insurance Performance Statistics* provides industry aggregate summaries of financial performance, financial position and key ratios. It replaces APRA's previous publication, *General Insurance Trends*.

APRA publishes statistics collected from life companies in *Life Insurance Trends* (quarterly) and *Life Office Market Report* (six-monthly).

A number of industry bodies and statutory agencies regularly collate and publish market data on the industry, most of which are publicly available. Examples include:

- the Insurance Council of Australia (ICA)<sup>22</sup>, the peak body for general insurance companies in Australia, produces a quarterly briefing paper for their members on issues pertinent to the general insurance industry;
- the IAAust<sup>23</sup> produces a bimonthly magazine, *Actuary Australia*, and the quarterly *Australian Actuarial Journal*. The IAAust also compiles mortality and morbidity statistics;
- Insurance Statistics Australia<sup>24</sup> was established in 1988 by a group of Australian insurance companies wanting to produce management information of relevance to the pricing and profitability of selected classes of insurance business;

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<sup>21</sup> <http://www.apra.gov.au/Insight>

<sup>22</sup> <http://app01.ica.com.au/>

<sup>23</sup> <http://www.actuaries.asn.au/index.htm>

- Insurance Reference Services was established as a member owned, not-for-profit company controlled by a Board of Directors made up of representatives primarily from the insurance industry. Its database provides a comprehensive and accessible source of information to assist members to make informed risk decisions and develop competitive pricing strategies. The database contains more than 18 million insurance claims of Australian individuals and companies dating back ten years;
- the Motor Accidents Authority <sup>25</sup>, a statutory corporation that regulates the NSW Motor Accidents Scheme, the Compulsory Third Party (CTP) personal injury insurance scheme for motor vehicles registered in New South Wales, makes available bulletins, information sheets, newsletters and regular comprehensive industry claims analysis to insurers with CTP licenses;
- the Motor Accident Insurance Commission<sup>26</sup>, the regulator of the CTP scheme in Queensland, develops and maintains a claims register and statistical database for the purpose of providing management information to participating insurers; and
- the Australian Competition and Consumer Commission<sup>27</sup>, responsible for consumer protection under the *Trade Practices Act 1974*, has conducted a number of studies into the insurance industry and published the findings.

In addition to the agencies and their publications listed above, brokers and analysts such as KPMG, JP Morgan, ABN Amro and Deutsche Bank, regularly report on individual insurers and the industry.

*EC (e): The supervisory authority requires market-wide systematic reporting to analyse and monitor particular market-wide events of importance for the financial stability of insurance markets.*

The FSCD Act provides APRA with a lot of flexibility in data collection. APRA may determine reporting standards to require specific data, over different time periods, and from different entities (see ICP 12 EC (a)).

For example, APRA determined a reporting standard in July 2004 that requires all APRA-regulated general insurers, and participating State and Territory Governments, to contribute data to the National Claims and Policies Database (NCPD)<sup>28</sup> for public and products liability and professional indemnity insurance. At the request of Government, the NCPD was established in response to the liability 'crisis' observed in Australia in recent years, with a view to improving the affordability and availability of these indemnity classes of insurance in the Australian market. Reports are produced twice a year covering data from 2003 onwards.

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<sup>24</sup> <http://www.insurancstats.com.au/>

<sup>25</sup> <http://www.maa.nsw.gov.au/>

<sup>26</sup> <http://www.maic.qld.gov.au>

<sup>27</sup> <http://www.accc.gov.au>

<sup>28</sup> <http://www.ncpd.apra.gov.au>

*AC (f): Insofar as international relationships affect internal insurance and financial markets, the analysis is not limited to the home market, but also includes developments elsewhere.*

APRA keeps track of international developments through its involvement in the activities and committees of international organisations. APRA staff regularly attend meetings and conferences run by the International Association of Insurance Supervisors (IAIS), the International Actuarial Association (IAA), the Joint Forum and the Financial Stability Forum. Knowledge and information gathered from participating in these international activities are disseminated within APRA and fed into APRA's work. In fact, due to APRA's active representation on a number of committees of the IAIS and the IAA, APRA often conducts analysis and contribute papers on topics of interest to the international community.

*AC (g): The supervisory authority monitors trends that may have an impact on the financial stability of insurance markets. It assesses whether macro-economic risks and vulnerabilities are adversely impinging on prudential safeguards, financial stability or consumer interests.*

Australia has a functional approach to financial sector supervision under which APRA is responsible for the prudential regulation of licensed institutions in the financial sector. While APRA's supervisory focus is primarily on the soundness and health of individual institutions to ensure the protection of policyholder interests, APRA should do so in a manner consistent with the continued development of a viable, competitive and innovative industry (see ICP 2). In practice, APRA keeps track of developments and monitors trends in the insurance market through its analysis of data submitted by the insurers and close co-operation and coordination with other regulators and industry bodies.

Maintaining overall financial system stability is the responsibility of the Reserve Bank. The Reserve Bank is in a natural position to monitor macro-economic risks and vulnerabilities; given it also has responsibility for monetary policy in Australia.

The Reserve Bank chairs the Council of Financial Regulators (CFR) which is the coordinating body for Australia's main financial regulatory agencies. Other members of the CFR are APRA, ASIC and the Australian Government Treasury. As specified in the Council's charter, the Council's role is to contribute to the efficiency and effectiveness of financial regulation by providing a high-level forum for co-operation and collaboration among its members. It operates as an informal body in which members are able to share information and views, discuss regulatory reforms or issues where responsibilities overlap and, if the need arises, coordinate responses to potential threats to financial stability. The Council also has a role in advising the Government on the adequacy of Australia's financial system architecture in light of ongoing developments.

## ICP 12 Reporting to supervisors and off-site monitoring

The supervisory authority receives necessary information to conduct effective off-site monitoring and to evaluate the condition of each insurer as well as the insurance market.

*EC (a): The supervisory authority:*

- *sets the requirements for the submission of regular and systematic financial and statistical information, actuarial reports and other information from all insurers licensed in the jurisdiction.*
- *defines the scope and frequency of those reports and information, including any requirement that reports and information be audited.*
- *requires, as a minimum, an audit opinion should be provided annually (refer to ICP 1 EC (e)).*
- *requests more frequent and more detailed additional information whenever there is a need.*

Accurate and timely information is essential for effective off-site surveillance. To ensure that APRA has the requisite data to monitor the financial condition of insurers under supervision, APRA requires, at the licensing stage, a written undertaking that the licensed insurer will provide APRA with any information which may be required for the prudential supervision of the licensee, and in the case of a licensed general insurer, of the consolidated group.

In September 2001, the FSCD Act was enacted to enable the collection by APRA of information to assist it in the prudential regulation of bodies in the financial sector. The FSCD Act authorises APRA to determine reporting standards for, among others, entities regulated by APRA under the Insurance Act and the Life Insurance Act. Section 13 of the FSCD Act provides broad powers regarding the scope and timing of documents to be provided, including:

- types of documents;
- forms of documents;
- information to be contained;
- timing and frequency; and
- whether the reporting standard is to apply to a particular entity, class of entities or in different situations and in respect of different businesses or activities.

APRA has determined 28 general insurance reporting standards.<sup>29</sup> In addition to reports pursuant to the reporting standards, licensed general insurers must provide APRA regularly with:

- a Risk Management Strategy under GPS 220;
- a Reinsurance Management Strategy under GPS 230;
- an annual Board Declaration pursuant to section 21 of GGN 220.2; and
- actuarial reports in accordance with section 49L(1)(b).

In accordance with section 49J of the Insurance Act, the approved auditor of a general insurer must perform functions and prepare and provide reports as required under the prudential standards. The approved auditor must submit an annual certificate to APRA. The opinion required in the certificate is detailed in section 24 of GGN 220.1, and includes confirmation that the statistical and financial data provided by the insurer to APRA in its yearly statutory accounts are reliable.

APRA's Stage 2 Reforms of the prudential supervision of general insurance include a number of proposals relating to audit and actuarial arrangements, particularly in reporting and valuation. A new prudential standard GPS 310 *Audit and Actuarial Reporting and Valuation* is under consultation. GPS 310 clearly specifies that the certification from the approved auditor must include a reference to compliance with the FSCD Act. Furthermore, amendments proposed to prudential standard GPS 220 *Risk Management* require the submission of a Financial Information Declaration to APRA on an annual basis. The Financial Information Declaration, co-signed by the chief executive officer and the chief financial officer, must state that the financial information lodged with APRA is accurate and complete, and has been prepared in accordance with the Insurance Act, the FSCD Act, Regulations, prudential standards, accounting standards and other mandatory professional reporting requirements in Australia, to the extent that the accounting standards and professional reporting requirements do not contain any requirements contrary to the legislative and prudential requirements.

Section 115 of the Insurance Act provides APRA with power to require the production of information, books, accounts or documents in respect of a general insurer, the authorised non-operating holding company or subsidiary of a general insurer.

APRA has not issued any reporting standards for life companies. Currently, the broad obligations on life companies to make quarterly, half-yearly and annual reports to APRA are set out in Division 6 of Part 6 of the Life Insurance Act. A detailed list of reports that life companies have to submit is provided on APRA's website and at Attachment C of the published requirements for registering a new life company. The formats and methods of reporting are spelled out in Prudential Rules and Actuarial Standards.

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<sup>29</sup> <http://www.apra.gov.au/Statistics/General-Insurance-Reporting-Standards.cfm>

Section 83 of the Life Insurance Act requires the auditor to audit the records of a life company in respect of a financial year and stipulates the audit to be carried out before reporting documents as at the end of the financial year are given to APRA.

In accordance with section 116 of the Life Insurance Act, a life company must provide APRA with the FCR by the appointed actuary within three months after the end of the period as at which the report is made.

APRA has powers under Division 2 of Part 7 of the Life Insurance Act to request a life company to provide information, documents and records relating to the business of the life company and its subsidiaries.

*EC (b): If making a distinction between the financial reports and requirements of companies incorporated in the jurisdiction and branches, or between private entities and government-sponsored insurers that compete with private enterprises, the supervisory authority should not distort the market in favour of or against any particular form of enterprise.*

The reporting requirements under the Life Insurance Act apply to all registered life companies without distinction.

All licensed general insurers have to comply with reporting requirements under the FSCD Act. Although separate sets of reporting forms apply to foreign general insurers operating in Australia through branch operations and locally-incorporated general insurers, the difference in the forms reflects the structural difference in the balance sheets and does not create any distortion in favour of or against branch operations.

Reporting requirements do not apply to state or territory insurers who are exempt from the Life Insurance Act and/or Insurance Act (see ICP 6 EC (c)).

*EC (c): The supervisory authority requires insurers to submit information about their financial condition and performance on both a solo and a group-wide basis. It may request and obtain financial information on any subsidiary of the supervised entity.*

The 28 general insurance reporting standards call for a wide range of information including statements of financial position, statements of financial performance, capital positions, investments, asset concentrations and information on claims. Separate reports are required for the licensed entity and the consolidated group where applicable.<sup>30</sup>

It is to be noted that one of APRA's functions, as listed under section 38 of the Insurance Act, is to collect and analyse information on prudential matters concerning general insurers, authorised NOHCs and the subsidiaries of general insurers.

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<sup>30</sup> <http://www.apra.gov.au/statistics/Prudential-Forms.cfm>

Each of the general insurance reporting standards comprise a reporting form and an instruction guide setting out the basis on which data is to be reported. Generally, general insurers are requested to follow the Australian accounting standards regarding the definition, recognition and measurement of assets, liabilities and equity items, notably AASB 1023 *General Insurance Contracts*. Consolidation is based on Australian Accounting Standards as they apply in relation to reporting periods that began immediately before 1 January 2005. Where APRA methodology departs from accounting standards, the requirements are clearly spelled out (for example in respect of valuation of premium liabilities, deferred reinsurance expenses and deferred acquisition costs).

The General Insurance Reporting Form GRF 130 series collects information on off-balance sheet exposures.

- GRF 130.0 Off Balance Sheet Business – Credit Substitutes Provided and Risk Charge.
- GRF 130.1 Off Balance Sheet Business – Liquidity Support Facilities Obtained.
- GRF 130.2 Off Balance Sheet Business – Charges Granted and Risk Charge.
- GRF 130.3 Off Balance Sheet Business – Credit Support Received.

Off-balance sheet data is also collected under GRF 150.0 - Asset Exposure Concentrations and Risk Charge.

Currently, Guidance Note GGN 220.5 *Operational Risk* addresses risk management issues in relation to the outsourcing of material parts of a general insurers business. APRA's Stage 2 Reforms of the prudential supervision of general insurance includes proposals to strengthen the monitoring of outsourcing risk. The proposals are reflected in new Prudential Standard GPS 221 *Outsourcing* and Guidance Note GGN 221.1 *Managing Outsourcing Arrangements*, released for consultation in May 2005. The draft standard requires a general insurer to provide APRA with details of outsourcing agreements.

The principal executive officer of a general insurer is responsible for the timely submission of reporting documents under section 14 of the FSCD Act. Going forward, the chief executive officer and the chief financial officer will have joint responsibility for the accuracy of data (see discussion on Financial Information Declaration under EC (a)).

Section 17 of the FSCD Act enables APRA to direct an entity to amend information so that it ceases to be inadequate, incorrect, incomplete or misleading. It is an offence for the entity to fail to comply with this direction. Furthermore, sections 137.1 and 137.2 of the Criminal Code provide for offences when false or misleading information or documents are provided to APRA.

For life insurance, Prudential Rule 35 *Financial Statements* notes that where a life company is a parent in an economic entity, the financial statements to be provided to APRA must comprise consolidated financial reports of the economic entity constituted by the life

companies and its subsidiaries. Forms C1 and C2 (Prudential Rule 26) collect financial information on subsidiaries.

Prudential Rule 35 also requires that financial statements prepared by life companies comply with the requirements of Corporations Law, Accounting Standards (both Australian and International) and Actuarial Standards.

Off-balance sheet exposures are addressed in Form H (Prudential Rule 26). Although there are currently no explicit reporting requirements in respect of outsourcing, a prudential standard on Outsourcing is under development which will require life companies to provide APRA with detailed information on all their outsourcing arrangements.

Prudential Rule 26 also stipulates the signatories for the various statistical forms to be either the principal executive officer, the chief financial officer, the compliance manager or the appointed actuary.

Sections 137.1 and 137.2 of the *Criminal Code 1995* provide for offences when false or misleading information or documents are provided to APRA. APRA may use its directional powers under section 230B of the Life Insurance Act to require a life company to correct any incorrect information.

APRA regularly reviews the financial information and statistics provided by insurers in the off-site surveillance process. APRA staff check the returns regularly for compliance with minimum prudential requirements and conduct peer analysis of the data to identify trends and anomalies. The latter are instrumental to APRA's risk-based supervisory framework and contribute to APRA's understanding of industry developments. APRA has developed detailed guides for analysing quarterly returns. The guides require analysis under the headings of capital, assets, liabilities, performance, premiums, and reinsurance.

*AC (d): From time to time, the supervisory authority reviews its regular and systematic reporting requirements to ensure they still serve their intended aims and are carried out in an efficient and effective manner.*

Reporting methodologies and forms are regularly reviewed taking into account changes in prudential requirements and industry developments. For example, the Prudential Rules applicable to life companies were varied in 1999 upon the release of Accounting Standard 1038. New reporting requirements for general insurers came into effect in July 2002 to coincide with the implementation of reforms to the general insurance supervisory framework. Reporting forms for both general insurers and life companies are under review to give effect to the adoption of International Financial Reporting Standards in Australia.

*AC (e): The supervisory authority requires insurers to report promptly material changes that affect the evaluation of their condition.*

Section 25 of the Life Insurance Act requires a registered life company to give prompt notice to APRA of any change in circumstances from the time of registration.

A general insurer is obliged to notify APRA:

- of any changes to the determination of its Maximum Event Retention (section 19 of GGN 110.5);
- of any amendments to its Risk Management Strategy (section 43 of GPS 220);
- if the insurer's right to conduct insurance business outside Australia has been limited or otherwise materially affected under a law of the jurisdiction in which the business is being conducted (section 58 of GPS 220);
- of an amendment to its Reinsurance Management Strategy (section 7 of GPS 230); and
- within 24 hours of experiencing a major disruption that has the potential to materially impact policyholders (section 42 of GPS 222).

To ensure a general insurer will inform APRA of any material developments relating to its operations, APRA has strengthened notification requirements under the Stage 2 Reforms of the prudential supervision of general insurers. Draft GPS 220 requires an insurer to consult with APRA prior to implementing any changes in operations that may materially affect the risk profile of the insurer.

## ICP 13 On-site inspection

The supervisory authority carries out on-site inspections to examine the business of an insurer and its compliance with legislation and supervisory requirements.

*EC (a): By law, the supervisory authority has wide-ranging powers to conduct on-site inspections and gather information deemed necessary to perform its duties.*

Section 133 of the Life Insurance Act enables APRA staff members to enter any premises to inspect and take extracts from records relating to the affairs of a life company. Sections 131 and 132 of the Life Insurance Act require a life company to provide information and produce records relating to the business of the life company.

For the purpose of the Insurance Act, APRA may enter the premises of a general insurer to inspect or take extracts from and make copies of any books of the insurer (section 115). The Insurance Act also enables APRA to require information from the approved actuaries and auditors.<sup>31</sup> APRA collects regular data from general insurers using powers granted to it under paragraph 13 of the FSCD Act (see ICP 12). APRA also has on hand a range of information under the various prudential standards and guidance notes. These include:

- the Statutory accounts;
- the Board Declaration;
- the Risk Management Strategy;
- the Reinsurance Management Strategy;
- audit reports of the Business Continuity Management arrangements, as required; and
- actuarial reports on liability valuations.

In practice, APRA conducts routine on-site prudential reviews of insurers without having to invoke any legislative powers.

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<sup>31</sup> Sections 49, 49A, 49B of the Insurance Act.

*EC (b): The supervisory authority, external auditors or other suitably qualified parties verify information in regulatory returns periodically through on-site inspections. Where parties other than the supervisory authority verify information, then arrangements for communication with the supervisory authority should be established.*

APRA's prudential review programme is based around a suite of Modules that are designed to cover the key risk areas of supervised institutions and ensure compliance with relevant legislation. Module 6 *Risk Assessment*, one of the six prescribed modules for all supervised institutions, assesses the effectiveness of the institution's risk management framework in relation to its inherent risk profile. Four of the key topics in Module 6 are: Management Information Systems, Internal Audit, External Audit and Appointed actuary. The Management Information Systems review includes an assessment of the systems supporting regulatory reporting, data quality testing and the 'vouching' of APRA's financial returns to source data.

Section 119 of the Life Insurance Act requires the lodgement of an annual FCR based on the appointed actuary's investigation of the financial condition of the life company. The appointed actuary must confirm the life company's compliance with actuarial standards. Section 83 of the Life Insurance Act provides that the records of life companies be audited before reporting documents are given to APRA. The Life Insurance Act obliges the appointed actuary and approved auditor to report to APRA contraventions by the life company of the Life Insurance Act or the company's reporting obligations (sections 88 and 98 of the Life Insurance Act). The adequacy of the external audit and actuary functions of the life insurer is assessed as part of the prudential review process. APRA may ask to meet with the external auditor or the appointed actuary in the course of the on-site process or separately.

Section 49J of the Insurance Act requires the Approved auditor to audit the annual statutory accounts. In consultation with an insurer, APRA may request the Approved auditor to undertake a specific review of a particular aspect of the insurer's operations or risk management system (section 28 of GPS 220).

*EC (c): The supervisory authority may conduct on-site inspections on either a full scale, or a focussed basis investigating areas of specific concern.*

The supervisory cycle for an insurer depends on APRA's assessment of the insurer's risk profile and is determined by PAIRS and SOARS (refer ICP 4 EC (a) and EC (b)). Full prudential reviews mostly follow a standard supervisory cycle varying between one and four years depending on the PAIRS rating. However, APRA may choose to undertake one or more prudential reviews in the supervisory period to address specific risk issues or to enhance its understanding of certain aspects of the insurer's operations. APRA may also direct targeted investigations by an auditor or actuary chosen by APRA.

*EC (d): The supervisory authority promptly discusses findings and any need for corrective action with the insurer and obtains appropriate feedback from the insurer.*

APRA always holds a closing meeting after the completion of a prudential review at which the main findings of the review would be outlined to the insurer. The meeting gives the insurer an opportunity to correct factual errors.

*EC (e): The supervisory authority follows up with the insurer to ensure that any required action has been taken.*

A final review report, including the findings and any required or recommended actions to be taken by the company, is sent to the insurer after the closing meeting. The insurer must respond to the report in writing no later than four weeks from receiving the report. The response should include timetables to implement the proposed actions. The timelines provided are entered into APRA's Activity and Issue Management System (AIMS) to allow monitoring and tracking. APRA needs formal correspondence from the insurer confirming that the matter has been addressed before it can close the item in AIMS. If relevant, the subject matter will normally be re-tested in the next prudential review.

*EC (f): The supervisory authority can extend on-site inspections to obtain information from intermediaries and companies that have accepted functions outsourced by the supervised insurer.*

APRA's powers to access premises to inspect records and take extracts from records relating to the affairs of a life company under section 133 of the Life Insurance Act extend to third parties, such as an intermediary or other persons providing outsourced services to the life company.

In May 2005, APRA released draft Prudential Standard GPS 221 *Outsourcing* under the Insurance Act seeking to ensure that material outsourcing arrangements entered into by an insurer are subject to appropriate due diligence, approval and ongoing monitoring. One of the requirements under the proposed standard is that any outsourcing agreement entered into by a supervised institution should include a clause giving APRA access to documentation related to the outsourcing arrangement and the right to conduct on-site visits to the service provider if APRA considers it necessary in its role as prudential supervisor of the supervised institution. The standard is expected to be finalised to take effect from 2006.

A similar standard for life companies is being drafted.

In practice, APRA has conducted on-site visits to service providers, joint venture partners and underwriting agencies of general insurers, in conjunction with the supervised institutions.

## ICP 14 Preventive and corrective measures

The supervisory authority takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.

*EC (a): The supervisory authority has available and makes use of adequate instruments to enable timely preventive and corrective measures if an insurer fails to operate in a manner that is consistent with sound business practices or regulatory requirements.*

The Life Insurance Act provides APRA with a range of powers that it can exercise on life companies for the purpose of protecting policyholders.

Section 22 of the Life Insurance Act enables APRA to impose conditions on the authorisation of a life company at any time. APRA has used this power to address deficiencies in life companies as and when they arise. Conditions have included reporting obligations and maintaining specified levels of capital.

Under section 230A of the Life Insurance Act, APRA may determine standards for all life companies, a specified class of life companies or one or more specified life companies. Standards may relate to any aspect of the business of a life company and may be imposed where it is necessary in order to protect the interests of policy owners or prospective policy owners of the life companies concerned. A failure to comply with a standard is not an offence but may lead to a direction being given under section 230B of the Life Insurance Act.

Section 230B of the Life Insurance Act gives APRA powers to issue a wide range of directions to life companies, including any direction as to the way in which the affairs of a life company are to be conducted or not conducted. Non-compliance with the direction is an offence under section 230F of the Act. Directions may be given wherever there has been either a contravention of the Life Insurance Act or the FSCD Act or the direction is necessary in the interests of owners or prospective owners of policies issued by a life company.

Section 49 of the Life Insurance Act enables APRA to give a written notice to a life company requiring it to remedy a breach of a requirement of Part 4 of the Life Insurance Act (provisions relating to the operation of the statutory funds of a life company). Where the company fails to comply with such an order, directors of the life company may become liable for losses to the statutory fund arising from non-compliance with the Life Insurance Act's requirements.

Part 5 of the Life Insurance Act provides for the setting of solvency and capital adequacy standards for statutory funds as well as management capital requirements outside statutory funds. APRA may, with the Treasurer's approval, give directions to life companies in regard increasing their capital levels so as to comply with the Life Insurance Act's solvency, capital adequacy and management capital requirements (sections 68, 73 and 73F of the Life Insurance Act).

Subject to the Treasurer's approval, APRA may give directions to freeze the assets of a life company for a period up to 6 months (under section 134 of the Life Insurance Act). Finally, APRA may give directions during or after an investigation of a life company (under section 150 of the Life Insurance Act). Directions which require ministerial approval are exempt from merits review under section 236 of the Life Insurance Act. These directions (unlike those under section 230B of the Act) can only be given where a life company is, or is likely to become, unable to meet its policy or other liabilities as they become due.

While APRA also has powers to give directions to general insurers under the Insurance Act, the operation of the provisions is constrained by an assortment of requirements, high thresholds and narrow triggers.

APRA may, at any time, impose conditions, or additional conditions, on a general insurer's authorisation pursuant to section 13 of the Insurance Act. The conditions, however, must relate to prudential matters.

Section 32 of the Insurance Act enables APRA at any time to determine prudential standards for all insurance companies and NOHCs of registered insurance companies, all their subsidiaries, a specified class of insurance companies, NOHCs or their subsidiaries. A failure to comply with a prudential standard is not an offence in itself. However, it does allow APRA to give directions under section 36(1) of the Insurance Act to require compliance with the standard or relevant part of the standard. Non-compliance with a section 36 direction is an offence under section 37 of the Insurance Act. APRA has issued directions in the past to require:

- a financial provision in the insurer's accounts for its Outstanding Claims Provision; and
- the insurer to value a receivable at a specified amount.

Sections 49M and 49N of the Insurance Act enable APRA (with the Treasurer's agreement) to give an insurer a direction requiring the insurer to make provisions in its accounts in respect of its liabilities or specified assets, respectively.

Under section 51 of the Insurance Act, APRA may, if it appears specific trigger events are, or are likely, to happen, seek the Treasurer's agreement to freeze the insurer's assets for a period of up to six months.

When the affairs of an insurer are being investigated under section 52 of the Insurance Act, APRA can give an insurer directions under section 62 of the Insurance Act relating to the conduct of the insurer's business. The directions might include requiring the insurer:

- not to issue new, or renew existing policies, except under specified conditions;
- not to dispose of or deal in certain of the insurer's assets;
- to make provisions in its accounts in respect of its liabilities;

- to seek to enter into reinsurance arrangements of a specified kind;
- to increase its capital; and
- not to enter into arrangements or reconstructions without APRA's approval.

In practice, however, APRA has experienced difficulties in enforcing these powers in a timely manner. See ICP 15 assessment.

*EC (b): There should be a progressive escalation of action or remedial measures if the problems become worse or if management of the insurer ignores more informal requests from the supervisory authority to take corrective action.*

As noted in EC (a), legislation provides APRA with a host of directions powers. However, APRA would not normally invoke legislative powers to issue directions at the first signs of any problems. For a start, APRA would seek voluntary remedial actions from the institutions. In practice, if APRA was to become concerned with the risk profile of one of its regulated entities, it would increase the frequency and intensity of its supervisory oversight of that entity. Typically, more frequent prudential reporting from the area of the insurer causing concern would also be required.

Wherever possible, APRA seeks to make timely and preventative prudential interventions to bring the risks down to acceptable levels. APRA gives effect to this through its supervisory methodology, based around continuous off-site monitoring and a risk-based programme of on-site reviews, and supported by the PAIRS risk-rating tool, the SOARS response system and the APRA Supervision Framework. These tools assist responsible supervisors to take timely and proportionate remedial actions.

APRA has established a specialist enforcement team that is responsible for taking enforcement action. Front-line responsible supervisors escalate cases or issues to Enforcement in the following instances:

- entities in 'Restructure', where likely supervisory actions may involve:
  - forced sale of its insurance business to one or more other general insurers; and/or
  - placing the general insurer into a forced run-off.
- entities in 'Mandated Improvement' likely to require one or more of the following actions:
  - the imposition of licence conditions or the giving of statutory directions in response to serious/intentional/reckless breaches of prudential requirements;
  - the appointment of an Inspector to investigate the whole or part of the affairs of the insurer;

- the giving of an Enforceable Undertaking by the insurer or persons connected with the insurer (directors, shareholders etc);
- the closure of an entity to new business and/or freezing of its assets;
- the disqualification of key personnel;
- civil litigation to impose a penalty or claim damages; and/or
- preparation of a criminal prosecution brief for the Australian Government’s Director of Public Prosecutions (DPP).

If a life company engages in or proposes to engage in conduct in contravention of the Life Insurance Act or a direction given under the Life Insurance Act or a condition of its registration, APRA may apply for injunctions against the life company under section 235 of the Life Insurance Act. The injunction may restrain the life company from engaging in the conduct or require the company to do a particular act.

*EC (c): The supervisory authority has the capacity and standing to communicate with insurers, and insurers comply with such communications, to ensure that relatively minor preventive or corrective measures are taken.*

APRA has maintained good rapport with institutions under its supervision. APRA supervision staff members meet regularly with the management of insurers through prudential consultations and on-site reviews. Minor preventive or corrective actions are normally conveyed at these face-to-face meetings. In APRA’s experience, these communications have been very effective to get issues addressed before they become serious concerns.

*EC (d): If necessary the supervisory authority requires the insurer to develop an acceptable plan for correction of problems. Corrective plans include agreed and acceptable steps to be taken to resolve the issues raised and an acceptable timetable.*

For remedial measures that require a sequence of steps or that involve a considerable time span, APRA would seek action plans with timetables from the insurer so APRA can monitor progress.

*EC (e): The supervisory authority initiates measures designed to prevent a breach of the legislation from occurring, and promptly and effectively deals with non-compliance with regulations that could put policyholders at risk or impinge on any other of the authority’s objectives.*

In providing powers to give directions on solvency and capital adequacy to life companies, the Life Insurance Act specifically stipulates that APRA may give directions to a life company in relation to a statutory fund even if, when the direction is given, the company meets the

solvency and capital requirements. This would enable APRA to initiate preventive actions before breaches have occurred.

Wherever possible, APRA seeks to make timely and preventative prudential interventions to bring the risks down to acceptable levels. Section 126 of the Insurance Act enables APRA to accept an enforceable undertaking from a general insurer at any time in respect of any matter in relation to which APRA has a function or power under the Insurance Act. Where an enforceable undertaking is breached, APRA is able to seek enforcement orders from the Federal Court of Australia. An enforceable undertaking is a guarantee made to APRA by regulated entities in relation to their responsibilities under the Insurance Act or the prudential standards. Enforceable undertakings aid the maintenance of open and cooperative relationships between APRA and the entities it regulates and enable regulatory concerns to be resolved in a cost effective, timely and non-adversarial manner, for both parties.

Enforceable undertakings can be in relation to a variety of matters. For example, an entity may promise to take immediate action to rectify a breach of the prudential standards. Alternatively, the undertaking may be made by the entity in response to risks or concerns that APRA may have raised with the entity. These risks or concerns may not constitute a breach of the prudential standards but nonetheless are matters that can be the subject of an undertaking.

The undertakings are initiated by an entity or individual and may be made following discussions between the insurer and APRA. APRA cannot require an entity to give an enforceable undertaking and the entity cannot compel APRA to accept an enforceable undertaking: they are made and accepted purely on a voluntary basis.

The Insurance Act is interspersed with sanctions by way of fines against individuals and insurers where the provisions of the Insurance Act are breached.<sup>32</sup> These penalties serve to discourage any breaches of the legislation from occurring.

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<sup>32</sup> See sections 7A, 9, 10, 14, 17, 20, 24, 27, 28, 37, 47, 49, 49A, 49F, 49L, 49P, 49Q, 51, 56, 61, 62, 70, 74, 77, 78, 82, 87, 115, 128, and 128A of the Insurance Act

## ICP 15 Enforcement or sanctions

The supervisory authority enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.

*EC (a): The supervisory authority can issue formal directions to companies to take particular actions or to desist from taking particular actions. Failure to comply with a formal direction issued by the supervisory authority has serious consequences for those that take such a step.*

See EC (a) of ICP 14.

There are various sanctions, offences and penalties interspersed throughout the Life Insurance Act. For example, a breach of a written notice given to a life company under section 49 of the Life Insurance Act to remedy a contravention of Part 5 of the Act exposes directors of the company jointly and severally to make good losses that arise from the contravention. APRA can initiate legal proceeding to recover the loss. Failure to comply with directions under section 230B of the Life Insurance Act is an offence (under section 230F of the Life Insurance Act).

For general insurers, failure to comply with directions under sections 49M and 49N of the Insurance Act is an offence under section 49P. Breaches of directions under section 51 or section 62 are offences under the respective sections of the Insurance Act.

Furthermore, sections 137.1 and 137.2 of the *Criminal Code 1995* provide offences for giving false or misleading information or documents to APRA.

*EC (b): The supervisory authority has the power to prevent the insurer issuing new policies.*

Pursuant to section 230B(1) of the Life Insurance Act, APRA may direct a life company not to issue any policy, collect any premium or discharge any policy or other liability of the company where to do so may prejudice the interests of policy owners. APRA may also (with the Treasurer's agreement) direct a life company not to issue any further policies under section 150 of the Life Insurance Act if the life company is, or has been, under investigation and the company is, or is about to become, unable to meet its policy or other liabilities or it has contravened the Life Insurance Act or a direction of condition applicable to the company under the Life Insurance Act.

APRA can, with the Treasurer's approval, restrict an insurer from issuing new, or renewing existing, policies under section 62 of the Insurance Act when an investigation is underway.

*EC (c): The supervisory authority can arrange for compulsory transfer of the obligations under the policies from a failing insurer to another insurer that accepts this transfer (refer to ICP 8 EC (I)).*

If APRA believes that a life company is, or is likely to become, unable to meet its policy or other liabilities as they become due, APRA may apply to the Court for the life company to be placed under judicial management (Part 8 of the Life Insurance Act). The judicial manager may recommend that the business, or part of the business, of the life company be transferred to another company whereupon the judicial manager would seek an order from the Court to give effect to the recommendation. Once the Court grants the order, the recommendation becomes binding on all persons and the transfer of the relevant business will take place in accordance with Part 9 of the Life Insurance Act.

APRA may also apply to the court to wind-up a life company or make a compulsory transfer determination under the FSTB Act.

Section 17 of the Insurance Act enables APRA to direct an insurer to arrange to assign its liabilities to one or more other general insurers. APRA may only do so where it is satisfied that such an assignment is in the interests of policyholders (of the assignor and the assignee) and the national interest. After such an assignment takes place the insurer will be taken to have no liabilities and its authority can then be revoked.<sup>33</sup> This ensures that insurers can be forced to exit the market if there is little prospect of the insurer being able to manage its affairs in a prudent and financially sound manner. Section 17(4A) goes on to say that policies 'are to be treated for all purposes as if each policy had been transferred by novation'.

*EC (d): The supervisory authority can require capital levels to be increased, restrict or suspend dividend or other payments to shareholders, restrict asset transfers and restrict an insurer's purchase of its own shares. It can also initiate action to restrict the ownership or activities of a subsidiary where, in its opinion, such activities jeopardise the financial situation of the insurer.*

Sections 68, 73 and 73F of the Life Insurance Act enable APRA to give solvency and capital adequacy directions to a life company. Directions powers under section 230B of the Act cover directions not to repay any amount paid on shares, not to pay a dividend on any shares, and not to transfer any asset of a statutory fund. If APRA believes that a life company is, or is likely to become, unable to meet its policy or other liabilities as they become due, APRA can freeze the assets of the life company for a period up to six months under section 134 of the Life Insurance Act. Should the life company not comply with any direction given to it under the Life Insurance Act, APRA may seek an injunction under section 235 of the Life Insurance Act requiring the company to refrain from certain conduct or to do a particular act.

APRA has power to investigate all or part of the business of any company associated with the life company where it believes such an investigation is required for the purposes of

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<sup>33</sup> Under section 15 of the Insurance Act

investigating the business of the life company. APRA may issue directions to the life company regarding its ownership or dealings with an associated company (section 203B(1)).

The Life Insurance Act imposes both a solvency requirement and a capital adequacy requirement at a statutory fund level. Solvency is determined on the basis that each statutory fund has sufficient assets to fund existing liabilities in the event of the fund being wound up while the capital adequacy requirement for a fund is determined based on a going concern scenario. Capital adequacy requirements are generally higher than solvency requirements and act as an early warning trigger to protect against the breach of solvency levels.

Prudential Standard GPS 110 *Capital Adequacy for General Insurers* enables APRA to 'adjust an insurer's Minimum Capital Requirement where it believes that the amount determined under this Standard does not adequately reflect the risk profile of an individual insurer.' (section 10).

Guidance Note GGN 110.1 *Measurement of Capital Base* restricts an insurer's ability to purchase its own shares without APRA approval. Paragraph 19 determines that 'an insurer may not, without obtaining APRA's prior approval, enter into an arrangement where it may purchase, or provide financial assistance with a dominant purpose of facilitating the purchase by another party of, its own Tier 1 or Tier 2 capital instruments.'

When an insurer is under investigation by APRA, section 62 of the Insurance Act enables APRA to place restrictions on the insurer disposing of, or dealing with, assets other than with APRA's approval.

Part IIIA of the Insurance Act provides that subsidiaries of a general insurer are also bound by the prudential standards.

*EC (e): The supervisory authority has effective means to address management problems, including the power to have controlling owners, directors, and managers replaced or their powers restricted. More generally the supervisory authority in extreme cases, imposes conservatorship over an insurer that is failing to meet prudential or other requirements. The supervisory authority has the power to take control of the insurer, or to appoint other specified officials or receivers for the task, and to make such arrangements for the benefit of the policyholders as are necessary.*

Pursuant to section 230B(1) of the Life Insurance Act, APRA may direct a life company to:

- remove a director, secretary, executive officer or employee of the company from office;
- ensure a director, secretary, executive officer or employee of the company does not take part in the management or conduct of the business of the company except as permitted by APRA; or
- appoint a person or persons as a director, secretary, executive officer or employee of the company for such terms as APRA directs.

APRA can temporarily freeze the assets of a life company under section 134 of the Life Insurance Act or direct the company not to transfer any assets of a statutory fund under section 230B of the Life Insurance Act. Other options to halt the business of a life insurer in extreme cases are discussed under EC (a) of ICP 16. APRA can apply to court for a life company, or part of the business of a life company, to be placed under judicial management (Division 1 Part 8 of the Life Insurance Act).

Under section 51 of the Insurance Act, APRA may, if it appears that specific trigger events have, or are likely to happen, seek the Treasurer's agreement to freeze the insurer's assets for a period of up to six months.

Section 27 of the Insurance Act states that 'APRA may direct (in writing) that the general insurer [...] remove [a director or senior manager] from the position if APRA is satisfied that the person is a disqualified person or does not meet one or more of the criteria for fitness and propriety set out in the prudential standards.' Failure to act in accordance with such a direction is an offence. In recent years, APRA has successfully disqualified various senior persons from holding key positions in general insurance companies. Some examples include:

- Mr Stephenson, while Managing Director of the company formerly known as Rural & General Insurance Limited and currently known as ACN 000 007 492, was ultimately responsible and accountable for misconduct by that company;
- Mr Fodera held various senior positions at HIH from 1995 to March 2001 including, at various times-Group Chief Financial Officer, HIH Finance Director and Chief Operating Officer;
- Mr Gosling was Group Reinsurance Manager at HIH Insurance Ltd (HIH) from 1995;
- Mr Sturesteps, over a long period, held various senior positions in HIH Insurance Ltd (HIH) and its predecessor companies, including Managing Director International from the end of 1988, Executive Director from June 1992, Deputy Chief Executive Officer from 1995. He was also a member of HIH's reinsurance committee;
- Mr Lo was Company Secretary of HIH Insurance Limited (HIH) between November 1991 and March 2001 and HIH Underwriting and Agency Services Pty Limited (HUAS) between November 1998 and March 2001; and
- Mr Slee, a consulting actuary to HIH, was found not to meet the 'fitness and propriety' requirements set out in APRA's prudential standards under the Act, in particular that 'the person has adequate experience and demonstrated competence and integrity in the conduct of business duties.'

APRA has also accepted enforceable undertakings from individuals obliging them not to hold senior positions, such as that from Mr Richard Mayo, who was an executive of Zurich Australian Insurance Limited (ZAIL) and its actuary approved under section 40 of the Act for the period from June 2003 until August 2004.

*EC (f): Once action has been taken or remedial measures have been imposed, the supervisory authority periodically checks to determine that the insurer is complying with the measures.*

The enforcement team in APRA is responsible for dealing with problem entities. APRA has established an Enforcement Committee, chaired by APRA's Deputy Chairman, to set priorities and review strategies for cases handled by the Enforcement Division. Cases are notified by Enforcement case managers to the Enforcement Committee, which meets twice monthly, under three headings: Significant, Minor and No Further Action. Each notification is accompanied by an Initial Action Plan, a Case Management Plan or a No Further Action recommendation. The Committee may upgrade or downgrade or leave unchanged the status (priority) of the case. Significant cases are reviewed by the Enforcement Committee at each meeting; Minor cases are monitored by the relevant Manager; and a file-note is prepared for No Further Action cases, indicating why the Committee chose not to investigate or act.

APRA conducts routine on-site prudential reviews of insurers (see ICP 13). On completion of an on-site review, a final review report, including the findings and any required or recommended actions to be taken by the company, is sent to the insurer after the closing meeting. The insurer must respond to the report in writing no later than four weeks from receiving the report. The response should include timetables to implement the proposed actions. The timelines provided are entered into APRA's AIMS to allow monitoring and tracking. APRA needs formal correspondence from the insurer confirming that the matter has been addressed before it can close the item in AIMS. If relevant, the subject matter will normally be re-tested in the next prudential review.

*EC (g): The insurance legislation provides for sanctions by way of fines against individuals and insurers where the provisions of the legislation are breached.*

See EC (a) above.

In addition, the Life Insurance Act provides that the directors of a life company may be liable to compensate the company if they breach their duties under the Act (sections 48(6), 50(1) and 188(1)). Section 147 of the Act provides for offences related to investigations under Division 3 of Part 7 of the Act.

There are various provisions in the Insurance Act that provide for sanctions by way of fines against individuals and insurers where the provisions of the Insurance Act are breached.<sup>34</sup>

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<sup>34</sup> See sections 7A, 9, 10, 14, 17, 20, 24, 27, 28, 37, 47, 49, 49A, 49F, 49L, 49P, 49Q, 51, 56, 61, 62, 70, 74, 77, 78, 82, 87, 115, 128, and 128A of the Insurance Act.

*EC (h): The insurance legislation provides for sanctions against individuals who withhold information from the supervisory authority, provide information that is intended to mislead the supervisory authority or fail to provide information to the supervisory authority in a timely fashion.*

Under sections 137.1 and 137.2 of the *Criminal Code 1995*, a person is guilty of an offence punishable on conviction by imprisonment for 12 months if the person gives false or misleading information or documents to a Commonwealth entity, which includes APRA.

Section 13 of the FSCD Act enables APRA to determine reporting standards. Where an insurer is required to provide information to APRA under a standard within a specified period or by a particular time, it is an offence for the insurer not to do so (under section 9). Furthermore, section 14 requires that the principal executive officer must notify the governing body of the entity if the insurer has failed to provide the information. A penalty applies for breaching this requirement.

Section 56 of the Insurance Act provides that a person must comply with the requirements of APRA or an inspector who is carrying out an investigation of an insurer under section 52 of the Insurance Act. Inspectors have the power to request information or to require all reasonable assistance under section 55 of the Insurance Act.

It is an offence under section 61 of the Insurance Act for a person to conceal, destroy, mutilate or alter a book relating to the affairs of an insurer which is being investigated under Part V of the Insurance Act.

A person commits an offence under section 147 of the Life Insurance Act, punishable on conviction by imprisonment for not more than six months, if the person delays or obstructs an investigation of a life company by concealing, destroying, mutilating, changing or removing records relating to the business of a life company that is under investigation under Part 7 of the Life Insurance Act.

*EC (i): Individuals can be barred from acting in responsible capacities in the future.*

Section 25A of the Insurance Act allows APRA to disqualify a person if it is satisfied that the person is not a fit and proper person to act as a director or senior manager of a general insurer, a foreign general insurer or an authorised Non Operating Holding Company.

Section 44 of the Insurance Act enables APRA to disqualify a person from being an auditor or an actuary of an insurer. Furthermore, section 48 of the Insurance Act enables APRA to refer the matter of a disqualification of an auditor or actuary to the Companies Auditors and Liquidators Disciplinary Board, and to that person's professional disciplinary body.

APRA may revoke the approval of a person as auditor of a life company if the person has failed to perform adequately and properly the functions and duties of an auditor under the Life Insurance Act (section 86(1)(b)). Similarly, APRA may declare that a person is not eligible

for appointment as a life company's actuary if the person has failed to perform adequately and properly the functions and duties of an appointed actuary under the Life Insurance Act (section 94(3)).

APRA's draft prudential standard on fit and proper prohibits a person to act as a responsible person of an insurer if that person is a disqualified person under any APRA-administered legislation (section 24).

*EC (j): The process of applying sanctions should not delay necessary preventive and corrective measures and enforcement.*

Proceedings to initiate the judicial management or winding-up of a life company, or of part of the business of the life company, are not hindered by the bringing of proceedings against a life company for an offence under the Life Insurance Act (section 248(2)).

In general insurance, APRA experienced difficulties in the investigation of an insurer when APRA's proceedings to wind-up the insurer was thwarted by the insurer's actions to voluntarily appoint an administrator, followed by the execution of a Deed of Company Arrangement. APRA therefore considers the legal framework to be short of full observance under general insurance for this EC.

*EC (k): The supervisory authority takes action to withdraw the license of an insurer where appropriate.*

APRA can apply to court to wind-up a life company (under section 181 of the Life Insurance Act).

Division 3 of the Insurance Act (sections 15 to 17) details the procedures for dealing with insurers who are unlikely to continue to be solvent but for whom there is a reasonable prospect of arranging a compulsory transfer of business (should the circumstances warrant it). The Treasurer's approval is required prior to APRA taking appropriate action to revoke an insurer's authority under section 15 of the Insurance Act.

In the alternative where an insurer is, or is likely to become, unable to meet its debts as they fall due a winding-up of the insurer may occur under the Corps Act. Additionally, APRA has standing to bring an application at an earlier time (during or after the investigation of an insurer under section 52 of the Insurance Act) where it can demonstrate that the insurer has liabilities in excess of its assets within the meaning of the prudential standards. In this regard, section 462 of the Corps Act permits APRA to apply to a State Supreme Court for the appropriate winding-up order.

*EC (l): The supervisory authority has the powers to protect one or more insurers within its jurisdiction that belong to a group from the financial difficulties in other parts of the group.*

Given that all life companies in Australia are incorporated entities in their own right, and the further ring-fencing of assets referable to life policies in statutory funds pursuant to Part 4 of the Life Insurance Act, the interests of policyholders of Australian life companies belonging to a group are protected from contagion which might otherwise arise from failure in other parts of the group.

APRA has released a discussion paper on the prudential supervision of corporate groups including authorised general insurers, with the view to introducing prudential standards to the appropriate members of the corporate groups. The proposed framework will allow APRA to supervise Australian authorised general insurers and their corporate groups on a consolidated basis, addressing contagion risks posed to the insurer(s) in the group from group activities and inter-relationships.

*EC (m): The supervisory authority, or another responsible body in the jurisdiction, takes action to enforce all the sanctions noted above.*

Supervision of life companies under the Life Insurance Act is the joint responsibility of APRA and ASIC. APRA as the prudential regulator has responsibilities for monitoring the compliance with all the prudential standards and ensuring that policyholders' interests are safeguarded. APRA and ASIC will conduct joint investigations into life companies and take coordinated actions where appropriate.

With regard to general insurance, most of the sanctions in the legislation were put in place with the general insurance reform measures in 2002 so there have been relatively few opportunities for APRA to take actions. However, APRA has done so on the following occasions:

- APRA has used its disqualification powers under section 25A of the Insurance Act in respect of directors, auditors, actuaries and accountants following the collapse of a major insurance group in 2001;
- APRA has accepted an increasing number of enforceable undertakings under section 126 of the Insurance Act;
- APRA has used its powers to impose conditions on insurers' authorities wherever necessary due to weaknesses in an insurer's management or capital position; and
- APRA has widened the circumstances in which it is likely to investigate the affairs of insurance companies, for example in exploring financial reinsurance arrangements where there may be only limited risk transfer.

*EC (n): The supervisory authority ensures consistency in the way insurers are sanctioned, so that similar violations and weaknesses attract similar preventive and corrective measures.*

See EC (f) above. In overseeing all the enforcement cases, the Enforcement Committee in APRA ensures that any breaches of prudential requirements and violations of legislation are addressed in a consistent manner.

*EC (o): The supervisory authority or other authority takes action against those individuals or entities that are operating an insurance business without a licence.*

It is an offence for a person to carry on an insurance business in Australia without an authority (or exemption) under the Insurance Act. Where instances of such activity are found, APRA attempts to encourage such persons to cease and desist from their activities. If necessary, the matter is then referred to the Australian Government's Director of Public Prosecutions for the bringing of criminal proceedings under section 9 or 10 of the Insurance Act.

It is a contravention of the Life Insurance Act for a person to carry on life insurance business without registration under the Life Insurance Act (under section 17 of the Act). APRA has standing to seek an injunction to prevent persons from so acting should the case arise.

## ICP 16 Winding-up and exit from the market

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.

*EC (a): The legal and regulatory framework provides for the determination of the point at which it is no longer permissible for an insurer to continue its business.*

The Life Insurance Act provides for a range of options to halt the business of a life insurer. If it appears to APRA that a life company is, or is likely to become, unable to meet its policy or other liabilities as they become due APRA may freeze the life company's assets for a period up to six months (section 134 of the Life Insurance Act). If a life company has contravened the Life Insurance Act APRA may issue directions under section 230B of the Life Insurance Act prohibiting the life company from issuing any policy, collecting any premium or discharging any policy or other liability. The directions may be given where APRA considers the directions to be necessary in the interests of policy holders or prospective policy holders. If a life company engages in conduct in contravention of the Life Insurance Act or a direction given under the Life Insurance Act, APRA may apply for injunctions against the life company under section 235 of the Life Insurance Act. The injunction may restrain the life company from engaging in the conduct or require the company to do a particular act.

APRA or the life company itself can apply to the Federal Court for an order that a life company, or part of the business of a life company, be placed under judicial management (under section 157 of the Life Insurance Act). Provisions for the appointment and powers of the judicial manager are in Division 1 of Part 8 of the Life Insurance Act. An application may be brought by APRA after an investigation into the life insurance business of the company under Division 3 of Part 7 of the Life Insurance Act. Alternatively, APRA may bring an application where the life company is, or is likely to become, unable to meet its policy or other liabilities as they become due or in the event the company fails to comply with the Life Insurance Act's solvency standard or there are reasonable grounds for believing that the financial position or management of the company may be unsatisfactory. A life company may not issue policies without the leave of the Court at all times it is under judicial management.

For general insurers, section 15(1) of the Insurance Act permits APRA to revoke an insurer's authorisation in certain circumstances. Where APRA revokes an insurer's authority to carry on insurance business in Australia it is an offence for the company to write or renew policies or to discharge liabilities under existing contracts of insurance.

APRA, with the Treasurer's agreement, is able to revoke an insurer's authority where an insurer has no liabilities in respect of insurance business carried on by it in Australia and:

- the insurer is failing to comply with legislative requirements including requirements, directions or conditions which are applicable to it under the Insurance Act; or

- continuation of the insurer's authorisation would be contrary to the national interest; or
- the insurer has failed to pay levies; or
- the insurer is insolvent and is unlikely to return to solvency within a reasonable period of time; or
- the insurer has inadequate capital and is unlikely to have adequate capital within a reasonable period of time; or
- the insurer has failed to commence insurance business within 12 months after being granted an authority under the Insurance Act.

Where APRA wishes to revoke the authority of an insurer that has liabilities in respect of its insurance business in Australia, subject to the Treasurer's approval, APRA may direct the insurer, to assign its liabilities (in respect of its insurance business in Australia) to another authorised insurer. This can be done under section 17 of the Insurance Act. APRA may only do so where it is satisfied that such an assignment is in the interests of policyholders (of the assignor and the assignee) and the national interest. After such an assignment takes place the insurer will be taken to have no liabilities and its authority can then be revoked under section 15 of the Insurance Act. This ensures that insurers can be forced to exit the market if there is little prospect of the insurer being able to manage its affairs in a prudent and financially sound manner. However, it should be noted that APRA has yet to test these powers.

In addition, section 62 of the Insurance Act enables APRA to give directions to an insurer with respect to the conduct of its insurance business. The directions can be given during, or at the conclusion of, an investigation into the affairs of the insurer under section 52 of the Insurance Act. It is an offence to contravene such directions. Directions can be given to cover a wide range of matters including prohibiting the issue or renewal of policies, requiring the sale or reconstruction of the insurer's business, requiring the insurer (where practicable) to increase its capital or to make such reinsurance arrangements as APRA specifies.

Furthermore, section 126 of the Insurance Act enables APRA to accept an enforceable undertaking from an insurer at any time in respect of any matter in relation to which APRA has a function or power under the Insurance Act. Where an enforceable undertaking is breached, APRA is able to seek enforcement orders from the Federal Court of Australia. In the past, enforceable undertakings have been used to manage the exit of an insurer from the market-place. Past enforceable undertakings have included an undertaking to cease the underwriting of any new business if certain matters are not attended to by a certain date, and to cease underwriting any business if a reinsurer withdraws from a specified reinsurance treaty with the insurer.

Section 462 of the Corps Act also enables APRA to apply to a State Supreme Court for the winding-up of an Insurer. To do so the insurer must have been the subject of an investigation under section 52 of the Insurance Act and APRA must be able to demonstrate that its liabilities exceed its assets for the purposes of the prudential standards.

*EC (b): The procedures for dealing with insolvency and the winding-up of the insurer are clearly set forth in the law.*

Division 2 of Part 8 of the Life Insurance Act contains the winding-up provisions for life companies. A winding-up order may be made on an application by the judicial manager or APRA. APRA can apply to court for a life company to be wound up where it is satisfied, having regard to the results of an investigation of the life company under Division 3 of Part 7 of the Life Insurance Act, that it is necessary or proper to do so. An order will be granted where the Court is satisfied that it is in the interests of policy owners that such an order be made. In practice, this would require an actuarial report detailing recommendations as to how all policies should be dealt with.

For general insurers, Division 3 of the Insurance Act (sections 15 to 17) details the procedures for dealing with insurers who are unlikely to continue to be solvent but for whom there is a reasonable prospect of arranging a compulsory transfer of business (should the circumstances warrant it).

Where an insurer is, or is likely to become unable to meet its debts as they fall due, a winding-up of the insurer may occur under the Corps Act. There is a requirement for APRA to prove that the insurer is, or is likely to become, unable to meet its debts as they fall due, and a reliance on the Courts to wind-up the insurer. Additionally APRA has standing to bring an application at an earlier time (during or after the investigation of an insurer under section 52 of the Insurance Act) where it can demonstrate that the insurer has liabilities in excess of its assets within the meaning of the prudential standards.

The Treasurer's approval is required prior to APRA taking appropriate action to revoke an insurer's authority under section 15 of the Insurance Act.

*EC (c): A high legal priority is given to the protection of the rights and entitlements of policyholders and other policy beneficiaries in the event of an insurer becoming insolvent and winding-up. This priority ensures that, as far as is practical, there is limited disruption to the provision of benefits to policyholders.*

Generally the winding-up of a life company is to be conducted in accordance with the Corps Act (section 182 of the Life Insurance Act). In this regard, the assets of a statutory fund of a life company must first be applied to discharging debts and claims referred to in section 556(1) of the Corps Act including relevant expenses, administrator debts, wind-up costs, staff wages and injury compensations.

Thereafter, preference is to be given to discharging policy liabilities of the life company referable to the statutory fund. Other liabilities referable to the business of the statutory fund are not to be met out of the assets of the fund unless all policy owner liabilities have first been discharged (section 187 of the Life Insurance Act). The operation of this preference provision ensures a material level of protection for policy owners in the event of the winding-up of a life company. Discharge of policy owner liabilities is only deferred to first meeting winding-up expenses and employee wages, injury compensation and retrenchment payments where these expenses relate to the business of the statutory fund.

Section 17 of the Insurance Act requires that the interests of policyholders are considered in the event that the insurer's liabilities are assigned to one or more other general insurers.

However, policyholders and other policy beneficiaries do not have a higher legal priority than other creditors in the event of an insurer becoming insolvent and being subject to a winding-up order under section 461 of the Corps Act. In the winding-up of a general insurer, the insurer's assets in Australia must not be applied in the discharge of its liabilities other than its liabilities in Australia unless it has no liabilities in Australia (section 116 of the Insurance Act applies in these instances).

## ICP 17 Group-wide supervision

The supervisory authority supervises its insurers on a solo and a group-wide basis.

In Australia, the supervisory regime for life companies is based upon a statutory fund concept. Protection of policyholders' interests is achieved by ring-fencing the assets that are backing policy liabilities in a statutory fund. Section 29 of the Life Insurance Act requires a life company to establish statutory funds to relate solely to the life insurance business of the company or a particular part of that business. A statutory fund includes all the assets and investments related to the business of the fund and all liabilities (including policy liabilities) of the company arising out of the conduct of the business of the fund. To ensure the highest protection for owners of life policies, investment and management of the assets of the statutory funds is subject to stringent rules under Part 4 of the Life Insurance Act. Under the actuarial standards for solvency and capital adequacy, a life company's equity investment in regulated subsidiaries is treated as inadmissible assets. A life company must not invest assets of a statutory fund in a related company that is not a subsidiary of the life company without APRA approval. All investments in subsidiary and related companies must be reported to APRA at six monthly intervals but there is no formal supervision of the group under the Life Insurance Act.

The current prudential regime for general insurance focuses largely on regulating and supervising individual authorised insurers, without explicit regard to linkages to, or activities conducted by, the wider corporate group to which the authorised insurers belong. Nor does the current regime have explicit regard to general insurance activities conducted in separately incorporated entities in overseas jurisdictions.

The current regimes, however, have been earmarked for change. One of the goals when APRA was established as an integrated supervisor was to supervise financial conglomerates more effectively. In the years following APRA's formation, there was extensive policy development in respect of a framework of prudential supervision for conglomerates involving authorised deposit-taking institutions (ADIs). After a series of discussion papers and public consultation, this framework was finalised in October 2001 with prudential standards that give effect to the framework's recommendations finalised in late 2002. Work to extend the framework to insurers is well underway. A discussion paper on *Prudential supervision of corporate groups involving authorised general insurers* was released for public consultation in May 2005. Following the general insurance reforms in 2002, the Insurance Act has provisions for the regulation of corporate groups. Division 4 of Part III of the Insurance Act allows APRA to authorise, and impose reporting obligations on, non-operating holding companies. Development of a similar framework for life insurance is also on APRA's agenda. This would include APRA seeking legislative amendments to the Life Insurance Act to enable APRA to license NOHCs, consistent with powers APRA has under the Banking Act and Insurance Act.

As noted in the May 2005 discussion paper, the consolidated supervision framework proposed for insurers reflects the IAIS insurance core principle of group-wide supervision as well as the

principle in relation to the supervision of insurers' cross-border business operations. The proposed framework in the discussion paper covers policy proposals in the following areas:

- permissible corporate structures to facilitate prudential supervision of insurers and other members of their corporate group on a consolidated basis;
- approaches to the measurement of capital adequacy for groups and parent insurers;
- an insurer's dealings with related entities;
- risk concentrations at both the authorised entity and group levels;
- governance requirements at group level;
- group risk management;
- management of group-wide reinsurance arrangements (both intra-group and those with third party insurers/reinsurers);
- appointment of an approved actuary (or actuaries) for the group; and
- management of intra-group relationships.

In respect of the structure of corporate groups, the structure should be sufficiently transparent to enable APRA to effectively exercise prudential oversight of the group as a whole. The discussion paper proposes three preferred models, under which the group may be headed by:

- an Australian insurer;
- a NOHC authorised by APRA under either the Insurance Act or the Banking Act; or
- certain other APRA-regulated entities.

Exceptions to the preferred group structures would be considered by APRA on a case-by-case basis.

As a result of the adoption by the Australian Government of the recommendations of the 1997 Financial System Inquiry, financial system regulation in Australia is now organised on a functional basis. APRA is the prudential regulator for all ADIs including banks, insurers authorised under either the Insurance Act or the Life Insurance Act, and superannuation funds. ASIC administers and enforces company and financial services laws to protect consumers, investor and creditors. As the central bank, the main responsibility of the Reserve Bank is monetary policy. The Reserve Bank also has a role in maintaining financial system stability and promoting the safety and soundness of the payments system. The Treasury is the Federal department responsible for advising Government on policies relating to the financial system. Co-operation between APRA and ASIC, the Reserve Bank and Treasury is underpinned

by signed Memoranda of Understanding (MOU). In addition, the agencies are all members of the Council of Financial Regulators. The Council's role is to contribute to the efficiency and effectiveness of financial regulation by providing a high-level forum for co-operation and collaboration among its members. The Council provides a forum for information sharing, harmonising regulatory and reporting requirements, and resolving any issues where members' responsibilities overlap.

APRA has also entered into MOUs with the Motor Accident Authority of NSW and the Private Health Insurance Administration Council.

In terms of reporting, APRA receives information from life companies on a group basis (see ICP 12). The proposed consolidated supervisory framework includes provision for effective group systems and controls to ensure the availability and reliability of group statistical and financial data.

## ICP 18 Risk assessment and management

The supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively.

*EC (a): The supervisory authority requires and checks that insurers have in place comprehensive risk management policies and systems capable of promptly identifying, measuring, assessing, reporting and controlling their risks (refer to ICP 10 EC (d)).*

APRA follows a systems-based approach in supervising risk management of insurers. This approach recognises that the primary responsibility for risk management rests with the Board and senior management of an insurer. Pursuant to section 35 of GPS 220 *Risk Management for General Insurers*, the Board and senior management of an insurer must develop, implement and maintain a sound and prudent Risk Management Strategy (RMS) that identifies the insurer's policies and procedures, processes and controls that comprise the insurer's risk management and control systems. An insurer's RMS must be submitted to APRA within 14 days of being approved by the Board. Guidance on the RMS and the management of specific risks, such as credit, market and operational risks, is detailed in guidance notes GGN 220.2 to GGN 220.5.

With the experience gained through the re-authorisation of general insurers in 2002, and in response to a number of recommendations made by the HIH Royal Commission, APRA embarked on a 'Stage 2' Reform of the prudential supervision of general insurers. After a first round of consultation in late 2003, revised prudential standards were released for industry consultation in May 2005. To reflect industry practice, the revised standards adopt the all-encompassing term 'risk management framework' to replace 'risk management and control systems'. A risk management framework is defined as the totality of systems, structures, processes and people within the insurer that identify, assess, mitigate and monitor all internal and external sources of risk that could have a material impact on an insurer's operations. The Board and senior management of an insurer must ensure that an effective risk management framework is in place to mitigate the risks arising from the insurer's business activities. The existing requirement of a RMS is expanded with additional proposals to increase disclosure about the activities of general insurers to promote market discipline. In response to industry requests, APRA has included more detailed guidance to assist insurers to develop their risk and reinsurance management documentation.<sup>35</sup>

Although there are no prudential standards on risk management for life insurers, it is an implicit requirement that registered life companies must have comprehensive risk management systems capable of identifying and monitoring their risks. Part 5 of the Life Insurance Act provides for the setting of solvency and capital requirements in life companies via actuarial standards. Actuarial standards 2.03 and 3.03 stipulate that the requirements are to be determined by considering the various risks undertaken in the statutory fund which

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<sup>35</sup> Draft Guidance Notes GGN 220.2 to GGN 220.6.

could impact the security of the policyowners' entitlements, and requiring the provision of a prudent level of reserve against such risks. For a life company to be able to properly determine its solvency and capital requirements it must have in place risk identification and assessment capabilities.

Risk management frameworks are assessed in the course of APRA's on-site prudential reviews of insurers. Module 6 *Risk Management* of the prudential review framework covers the assessment of an insurer's risk profile, risk management framework development and implementation, and risk identification and assessment.

Outside the conduct of prudential reviews, APRA receives regular returns from life companies and also relies on the appointed actuary's oversight of a life company. The Life Insurance Act requires the appointed actuary of a life company to assess a life company's compliance with the solvency and capital adequacy standards and include the assessment in the FCR to APRA. Through the FCR, APRA is informed of the adequacy and effectiveness of a life company's risk management policies and procedures.

Life companies are also expected to be re-visiting their risk management plans as they prepare for the licensing of their subsidiary superannuation trustees and the associated superannuation funds under the SIS Act. Amendments to the SIS Act in 2004 require all trustees operating an APRA regulated superannuation entity to hold a Registrable Superannuation Entity (RSE) licence by 30 June 2006. A key requisite of the licence application is a risk management plan for the RSE. With superannuation assets making up nearly 90 per cent of total life company assets, most, if not all, life companies will be impacted by the licensing requirements.

*EC (b): The risk management policies and risk control systems are appropriate to the complexity, size and nature of the insurer's business. The insurer establishes an appropriate tolerance level or risk limit for material sources of risk.*

APRA recognises that the scope of risk management systems will vary among insurers depending on the size, business mix and complexity of their operations. This is reflected in section 40 of GPS 220 *Risk Management for General Insurers* which states that 'the RMS should be appropriate to the size, business mix and complexity of operations of the insurer and must define and document the insurer's objectives and strategy for risk management and internal control.' Furthermore, an insurer's minimum capital requirement (MCR) should be commensurate with the full range of risks to which the insurer is exposed. GPS 110 *Capital Adequacy for General Insurers* requires an insurer to hold eligible capital in excess of its MCR.

A life company's solvency and capital requirements depend on the level of risks undertaken in the statutory funds. Accordingly the life company's risk management policies and risk control systems will reflect the complexity, size and nature of the life company's business. APRA is promoting the concept of 'target surplus', being a margin above capital adequacy at which attention of the Board will be triggered. Life companies are encouraged to actively manage their capital to reduce the likelihood of the solvency/capital levels falling to an unacceptable level.

*EC (c): The risk management system monitors and controls all material risks.*

GPS 220 *Risk Management for General Insurers* requires the risk management systems of an insurer to address all material risks. APRA considers that at a minimum the following categories must be addressed in an insurer's risk management systems:

- balance sheet and market risk (including investment risk, insurance risk, product design and pricing risk, underwriting and liability risk, liquidity risk, risk arising from claims management and derivatives risk);
- credit risk; and
- operational risk (including legal and reputational risks).

In addition, an insurer's risk management systems should also take into account the potential risks arising out of the insurer's reinsurance arrangements.

In determining solvency and capital requirements, a life company has to take into account all risks that would impact the security of the policyholders' entitlements. The actuarial standards address a wide range of risks:

- liability risks include the risk of inaccurate estimation of the mean, the risk of deterioration of the assumed mean, the risk of adverse statistical fluctuations about the mean and the risk of unexpected changes in the underlying distribution of experience; while; and
- asset risks include adverse asset movements, asset realisation, holdings in associated entities which are prudentially regulated, asset concentration, counterparty default and liquidity.

*EC (d): Insurers regularly review the market environment in which they operate, draw appropriate conclusions as to the risks posed and take appropriate actions to manage adverse impacts of the environment on the insurer's business.*

Risk management is a dynamic process. Accordingly GPS 220 *Risk Management for General Insurers* requires insurers to review regularly 'the operating circumstances that may impact on the insurer's risk profile' and to amend the RMS if these circumstances bring about any material change to the insurer's operation.

To take account of market changes and their likely impact on asset and liability valuations of a statutory fund, the actuarial standards prescribe a resilience reserve in the computation of solvency and capital adequacy requirements. Resilience is the ability of the statutory fund to sustain shocks to the economic environment which are likely to result in an adverse movement in the value of the assets relative to the value of the liabilities. In determining the resilience reserve, consideration should be given to changes in investment markets such as changes in the shape of the yield curve, in credit and liquidity margins, and in market

spreads, volatility and correlation reflected in the market values of derivative assets and liabilities. For capital adequacy, the actuary must undertake projections of new business plans and in force businesses to determine the life company's solvency requirement over the next three years.

*AC (e): Larger insurers establish a risk management function and a risk management committee.*

Currently, the only mandated Board committee under the Life Insurance Act and general insurance prudential requirements is an Audit Committee.

The draft *prudential standard GPS 220 Risk Management for General Insurers*, however, proposes the establishment of a risk management function (or role) within an insurer, with responsibility for assisting the Board, the Board Risk Committee and senior management in developing and maintaining the risk management framework. The function should have direct access to the Board Risk Committee or executive management, independent of the business functions. In addition, the draft prudential standard on governance (GPS 510) requires an insurer to set up a Board Risk Committee, responsible for formulating the risk strategy of the insurer, for determining policies that ensure that the strategy is adhered to, and for monitoring adherence to those policies.

*EC (a): The supervisory authority requires insurers to have in place strategic underwriting and pricing policies approved and reviewed regularly by the board of directors.*

The correct identification of risks and appropriate setting of premiums is crucial to the viability of insurance business. Before a life company can issue a new type of policy, the appointed actuary is required to produce a written report under section 116 of the Life Insurance Act giving the life company advice on the proposed terms and conditions, the basis of payment of any surrender values, and the basis on which unit values are to be determined (if relevant). Furthermore, a life company must not enter into a reinsurance arrangement unless the appointed actuary has given the company written advice as to the likely consequences of the proposed arrangement. As the requirements stipulate advice rather than approval by the appointed actuary, responsibility for entering into new policies and reinsurance arrangements remains with the life company and its board. The board of the life company must take into account the appointed actuary's advice in its decision making process.

*GPS 220 Risk Management for General Insurers* requires the Board and management of an insurer to develop, implement and maintain a sound and prudent RMS that identifies the insurer's policies and procedures, processes and controls that comprise the insurer's risk management and control systems. These systems must address all material risks, financial and non-financial, likely to be faced by the insurer. One of the material risks is balance sheet and market risk which in turn includes investment risk, product design and pricing risk, underwriting and liability risk, liquidity risk, derivatives risk, and risk arising from claims

management. GGN 220.3, which provides guidance to insurers on how to address balance sheet and market risk, lists minimum requirements in respect of an insurer's risk management systems for underwriting<sup>36</sup>, and product design and pricing. In terms of pricing, components which an insurer must consider include:

- estimation of claims;
- investment returns;
- operating expenses such as administration, commissions and legal costs;
- reinsurance costs;
- capital allocation; and
- margin for profit (based on targeted return on equity).

Prudential requirements on reinsurance arrangements, including a separate Reinsurance Management Strategy (REMS), are detailed in GPS 230 *Reinsurance Arrangements for General Insurers* and GGN 230.1 *Reinsurance Management Strategy*. In addition, GPS 220 requires an annual Board Declaration for assurance that the insurer has complied with legislative and prudential requirements, and its own risk management and reinsurance arrangements.

*EC (b): The supervisory authority checks that insurers evaluate the risks that they underwrite and establish and maintain an adequate level of premiums. For this purpose, insurers should have systems in place to control their expenses related to premiums and claims, including claims handling and administration expenses. These expenses should be monitored by management on an ongoing basis.*

APRA's on-site prudential review programme is based around a suite of Modules that are designed to cover the key risk areas of supervised institutions and ensure compliance with relevant legislation. Module 10 *Insurance Risk* focuses on the assessment of product development, pricing, underwriting, claims, administration, reinsurance and distribution in an insurer. At a minimum, APRA seeks to check that the insurer has documented policies and procedures in relation to pricing, underwriting, claims and all administration processes. There must be a formal process in place for making pricing decisions that involve consideration of all the pricing risks and input from at least the underwriting and claims area. During the on-site prudential review, APRA would check that senior underwriters are monitoring portfolio performance through tracking average premium on policies, rate movement, underlying claims costs and frequency of claims versus severity of claims. The analysis of the senior underwriters should form part of the monthly Board reports on portfolio performance.

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<sup>36</sup> See section 6 of GGN 220.3.

Verifying data quality is another key aspect of the Module 10 process. Systems should be integrated with both the underwriting and claims systems being able to adequately capture any data on reinsurance arrangements. It is imperative that the insurer has formalised its process around data extraction. The data source must be examined and validated and the basis of the data calculation understood and followed.

For life insurers, APRA also looks to the FCR from the appointed actuary for assurance that the life company is monitoring its expenses appropriately. Assessing an insurer's expense experience is a top priority task on the appointed actuary's work agenda.

*EC (c): The supervisory authority is able to review the methodology used by the insurer to set premiums to determine that they are established on reasonable assumptions to enable the insurer to meet its commitments.*

Specialist skills are needed to ensure a meaningful review of an insurer's premium methodologies and assumptions. APRA's structure provides for a number of in-house specialist teams. The Insurance Risk team provides expertise on key areas of insurance risk including underwriting, claims management, product design and pricing of insurance products, and reinsurance. Participation by the Insurance Risk team is mandatory for the conduct of Module 10 in the prudential review process for high and extreme impact insurers.

In addition, the Actuarial Services team provides actuarial advice on the interpretation of FCRs from life companies. The team also assists in any assessment of the adequacy of a life company's operations which has actuarial involvement, such as product pricing, life underwriting and decrement analysis, expense apportionment, unit pricing, surrender value calculation and allocation and distribution of surplus or profit. On the general insurance side, the team has involvement in reviewing liability valuation reports and other actuarially related matters where the frontline supervisors require actuarial expertise and input.

Section 116 of the Life Insurance Act prohibits a life company from issuing policies unless the appointed actuary has given written advice about the proposed terms and conditions on which the policies were to be issued. The actuary's advice can assist APRA in its review of how the life company sets its premiums.

*EC (d): The supervisory authority requires that the insurer has a clear strategy to mitigate and diversify risks by defining limits on the amount of risk retained and taking out appropriate reinsurance cover or using other risk transfer arrangements consistent with its capital position. This strategy is an integral part of the insurer's underwriting policy and must be approved and regularly monitored and reviewed by the board of directors.*

See ICP 18 above. Two of the key topics under Module 6 *Risk Management* of the prudential review framework are Risk Profile and Risk Governance – Role of the Board. APRA sees the Board as having primary responsibility for the management of risks across the insurer. An insurer's risk management framework should include its strategy for limiting risk (such as

premium loadings, policy exclusions and reinsurance) consistent with the insurer's risk appetite.

For general insurers, the REMS should include a statement on risk tolerance describing the maximum amount the insurer is prepared to lose both from any one risk and any one event, plus the rationale and method used to determine the amount, the reinsurance programme to be adopted to achieve the limit, and the process for changing the risk tolerance level.

For life companies, the FCR should include the appointed actuary's comments on the appropriateness and suitability of reinsurance arrangements, including topics such as the level and amounts of retention levels, the spread of reinsurers, and reinsurance administration arrangements.

*EC (e): The supervisory authority reviews reinsurance arrangements to check that they are adequate and that the claims held by insurers on their reinsurers are recoverable. This includes that:*

- the reinsurance programme provides coverage appropriate to the level of capital of the insurer (taking into account the real transfer of risk) and the profile of the risks it underwrites.*
- the reinsurer's protection is secure. This might be addressed through different means, such as relying on a system of direct supervision of reinsurers or obtaining collateral (including trusts, letters of credit or funds withheld).*

APRA reviews reinsurance arrangements under Module 10 of its prudential review process. The assessment includes consideration of the structure and comprehensiveness of the reinsurance programme, the structure of the reinsurance function and how reinsurance is managed. While on-site, APRA reviews reinsurance documentation, results of reinsurance audits, financial reinsurance arrangements and the insurer's monitoring of reinsurance counterparties. With regard to the latter, APRA expects the insurer to have processes in place to review reinsurance counterparties both at the time of selection of reinsurers and also on an ongoing basis. Insurers should regularly monitor the performance and strategy of their reinsurers and should devise a contingency plan, well in advance, to replace reinsurers who are looking to exit the market.

For life companies, allowance for reinsurance is subject to the reinsurance arrangements meeting the criteria in section 3.3 of Actuarial Standards AS2.03 and AS3.03. Where the reinsurance arrangements are with 'ineligible' reinsurers, the arrangements are to be ignored when calculating the liabilities in respect of the policies. Section 125 of the Life Insurance Act

prohibits life companies from entering into reinsurance contracts as defined in Prudential Rule 24<sup>37</sup> without APRA approval.

For general insurers, the on-site review includes checking REMS compliance with the requirements of GPS 230. While on-site, APRA verifies the insurer's methodology for establishing net retention and checks the reinsurance structure to ensure that there is adequate cover for the insurer's estimated probable maximum loss (PML).

As part of APRA's Stage 2 Reforms of the prudential supervision of general insurers, oversight of an insurer's reinsurance management will be strengthened. Amendments are proposed for GPS 230 and GGN 230.1. In addition to the REMS, APRA is proposing an annual Reinsurance Arrangements Statement from every insurer with detailed information on the actual reinsurance arrangements they have put in place. To confirm that reinsurance arrangements are actually in place via legally enforceable documentation, APRA is proposing a two-stage process under which the insurer would be required to prepare two signed declarations: the first relating to the degree of documentation in place two months after the reinsurance arrangements take effect, and the second relating to the degree of documentation six months after the reinsurance arrangements take effect. Both declarations need to be signed by the CEO and the Chief Reinsurance Officer (or equivalents). Reinsurance not satisfying the two- and six-month documentation tests will not be able to be taken into account for the purposes of capital adequacy calculations (that is reinsurance recoveries to which they relate will not be eligible assets of the insurer, nor will the arrangements be eligible to be included in Maximum Event Retention calculations). Concerned with insurers possibly entering into non-risk transfer arrangements which they do not account for in a legitimate fashion, APRA proposes to introduce a new guidance note GGN 230.3 *Limited Risk Transfer Arrangements*. Insurers will have to seek APRA's approval before entering into limited risk transfer arrangements. Where APRA determines that such an arrangement is for financing purposes only, it must be accounted for accordingly for prudential purposes. Only those arrangements that involve a material transfer of risk can be treated as reinsurance and be taken into account in the calculation of an insurer's capital requirements, including Maximum Event Retention computations.

Reinsurers which have established operations in Australia are supervised directly by APRA.

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<sup>37</sup> A reinsurance contract between a life company and a reinsurer which provides for the provision of a financial benefit by the reinsurer to the insurer or to any other entity and the provision of a financial benefit by the insurer to the reinsurer or to any other entity.

*EC (f): The supervisory authority checks that risk transfer instruments are properly accounted for in order to give a true and fair view of the insurer's risk exposure.*

Section 123 of the Life Insurance Act requires every life company to give APRA an annual reinsurance report as prescribed by Prudential Rule 23. As noted under EC (e) above, section 125 of the Life Insurance Act prohibits life companies from entering into reinsurance contracts as defined in Prudential Rule 24 without APRA approval. If a life company enters into such a contract in accordance with APRA approval, the company must give APRA a copy of the document containing the terms of the contract within 14 days after entering into the contract. The appointed actuary must confirm the life company's compliance with sections 123 and 125 of the Life Insurance Act in the FCR. In checking financial reinsurance arrangements on-site, APRA specifically enquires as to whether any contract has any side letter or any other arrangement that impact on the contract.

Proposed amendments under APRA's Stage 2 Reforms of the prudential supervision of general insurance include strict rules for recognising reinsurance and limited risk transfer products in an insurer's capital calculations (see EC (e) above). APRA also proposes expanding the role of the Approved actuary. Draft GPS 310 *Audit and Actuarial Reporting and Valuation* requires the Approved actuary to assess the overall financial condition of the insurer annually and to prepare an FCR to the Board of the insurer. The FCR must list any limited risk transfer products, with comments on the extent of risk transfer and whether any risk transfer is negated or qualified by a separate agreement. The approved actuary must comment on any issues relating to the insurer's use of these products and any risks they may pose for the reporting of the financial position of the insurer (Draft GGN 310.1 *Financial Condition Report*).

## ICP 20 Liabilities

The supervisory authority requires insurers to comply with standards for establishing adequate technical provisions and other liabilities, and making allowance for reinsurance recoverables. The supervisory authority has both the authority and the ability to assess the adequacy of the technical provisions and to require that these provisions be increased, if necessary.

*EC (a): Legal provisions are in place for establishing adequate technical provisions and other liabilities based on sound accounting and actuarial principles.*

Section 114 of the Life Insurance Act provides that the valuation of policy liabilities referable to a statutory fund must be made in accordance with actuarial standards. Division 4 of Part 6 of the Life Insurance Act establishes the LIASB with the function of making actuarial standards for the purpose of the Life Insurance Act.

The Insurance Act requires insurers to account for their liabilities, whilst Australian Accounting Standard AASB 1023 *General Insurance Contracts* defines the accounting rules relevant to general insurers.

*EC (b): The supervisory authority prescribes or agrees to standards for establishing technical provisions and other liabilities.*

The LIASB has promulgated Actuarial Standard 1.03 *Valuation of Policy Liabilities* for application to all life insurance business of a registered life company under the Life Insurance Act.

For general insurance, APRA may determine standards relating to prudential matters that must be complied with by all general insurers (section 32 of the Insurance Act). APRA has determined a prudential standard GPS 210 *Liability Valuation for General Insurers* that establishes a set of principles for the consistent measurement and reporting of the insurance liabilities of all general insurers. In developing the standard, APRA has paid regard to the requirements of accounting standards promulgated by AASB 1023. GPS 210 requires the approved actuary of a general insurer to provide written advice to the Board of the insurer of the value of insurance liabilities in accordance with the prudential standard at least annually, except where the insurer is exempt from the requirement to appoint an approved actuary.

GPS 210 applies to all licensed general insurers. Furthermore, actuaries must follow the IAAust Professional Standard 300 *Actuarial Reports and Advice on General Insurance Technical Liabilities* and Guidance Note 353 *Evaluation Of General Insurance Technical Liabilities* in preparing estimates of the technical liabilities for any entities involved in general insurance activities, such as general insurance companies, reinsurers, self insurers, insurance pools and statutory authorities involved in general insurance activities.

*EC (c): The supervisory authority in developing the standards considers:*

- *what is to be included as a liability;*
- *the procedure and the internal control system that are in place to ensure reliable data (refer to ICP 10; and*
- *the methods and assumptions for assessing, on a reliable, objective, transparent and prudent basis, technical provisions to cover all expected and some unexpected claims and expenses.*

Actuarial Standard 1.03 *Valuation of Policy Liabilities* defines 'Policy Liability' as the sum of the Best Estimate Liability and the value of expected future profits. The Policy Liability must provide for both a best estimate value of the liability of the company in respect of obligations under life insurance policies and a uniform emergence of profit from those policies relative to one or more appropriate Profit Carriers.

Allocation of expenses is integral for the determination of the emergence of profit. The methodologies under the Actuarial Standard therefore require all relevant expenses, whether direct or indirect and in aggregate, to be allocated both into the categories of acquisition, maintenance and investment management and into related product groups. As noted by the LIASB in the introduction to the actuarial standards, the standards were developed with the objective of ensuring transparency in disclosure and comparability in reporting. In order to meet the requirements of the actuarial standards, life companies must have management information systems that can generate reliable data.

GPS 210 defines insurance liabilities to include both an insurer's Outstanding Claims Liabilities and its Premiums Liabilities for each class of business. Outstanding Claims Liabilities relate to all claims incurred prior to the calculation date, whether or not they have been reported to the insurer. Premiums Liabilities are future claim payments arising from future events insured under existing policies, assessed on a prospective basis. The value of insurance liabilities is the sum of:

- the central estimate value of the Outstanding Claims Liabilities;
- the central estimate value of the Premiums Liabilities; and
- risk margins that relate to the inherent uncertainty in each of these central estimate values.

While the valuation of insurance liabilities should reflect the individual circumstances of each insurer, to ensure that valuation processes are consistent and sufficiently rigorous across the industry, APRA requires a risk margin to be established on a basis that is intended to secure the insurance liabilities of the insurer at a given level of sufficiency – that level is 75 per cent. Having regard to the highly skewed nature of some insurance distributions, GPS 210 further provides that the risk margin should not be less than one half of the coefficient of

variation for the insurance liabilities of the insurer. The principles and assumptions on which central estimates and risk margins are to be determined are provided in GPS 210.

Requirements to ensure sound risk management and robust internal control in an insurer are detailed in prudential standard GPS 220 *Risk Management for General Insurers*. For pertinent information to be identified, captured and communicated in a form and timeframe that will enable the responsibilities of the insurer to be met, APRA requires an insurer to put in place a capable, secure information system supported by adequate contingency arrangements.

***EC (d): The supervisory authority reviews the sufficiency of the technical provisions through off-site monitoring and on-site inspection (refer to ICPs 12 and 13).***

APRA conducts regular on-site prudential reviews to check an insurer's risk management systems and internal controls (see ICP 10 and ICP 13). Specifically for general insurers, Topic 5 of Module 10 *Insurance Risk* provides guidance on what to look for in assessing the adequacy of an insurer's liability valuation process.

Outside the on-site process, APRA monitors a life company's solvency and capital levels via returns submitted by the company. APRA also relies on the oversight by the appointed actuary. Section 13 of AS1.03 requires the appointed actuary to report the details of the process and assumptions used in arriving at the value of liabilities for a statutory fund in the FCR. APRA devotes a lot of effort to reviewing FCRs.

As for life companies, APRA takes comfort in the approved actuary's role in the valuation of liabilities of general insurers (see EC (a) above). Section 30 of GPS 220 requires the approved actuary to prepare a report in accordance with GPS 210 and provide this report to the Board of the insurer as well as APRA.

APRA's Actuarial Services team provides interpretation or clarification of actuarial reports on aspects of a regulated entity's business, including, FCRs for life insurers, actuarial reports on business transfers and capital changes, and liability valuation reports for general insurers. The team also reviews the process and adequacy of any aspect of an insurer's operations which has encompassed an actuary's involvement or advice.

***EC (e): The supervisory authority requires the technical provisions to be increased if they are not sufficient.***

APRA may invoke powers under section 230B of the Life Insurance Act to direct a life company to increase technical provisions.

Section 49M of the Insurance Act provides APRA with the ability to direct an insurer to increase the amount provided for in its accounts in respect of its liabilities. The capital adequacy standard also allows APRA to set a higher minimum capital adequacy requirement in respect of individual insurers and APRA has exercised this power on a number of occasions.

*EC (f): The supervisory authority ensures that standards stipulate:*

- general limits for the valuation of the amounts recoverable under reinsurance arrangements with a given reinsurer for solvency purposes, taking into account the ultimate collectability and the real transfer of risk;*
- sound accounting principles for the booking of the amounts recoverable under reinsurance arrangements; and*
- the credit for technical provisions for amounts recoverable under reinsurance arrangements. In that case, the amount recoverable is disclosed in the financial statement of the insurer by reporting the respective gross and net figures in the accounts.*

For life companies, treatment of reinsurance is specified in the actuarial standard. Section 2.3 of AS1.03 requires net policy liability that contributes to profit to be calculated in accordance with the principles of the standard. The policy liability gross of reinsurance, required to be disclosed in the financial statements of the company, should be determined as the sum of the net policy liability and the reinsured policy liability.

Rules for the recognition of reinsurance for the purpose of determining solvency and capital adequacy requirements are stipulated in the actuarial standards (section 3.3 in AS2.03 and AS3.03).

For general insurers, estimation of reinsurance recoveries should follow the same principles as for the valuation of insurance liabilities (that is in accordance with GPS 210). Although the focus of GPS 210 is for estimates of insurance liabilities that are net of reinsurance and other recoveries, analysis and valuation of outstanding claims will normally be on a gross basis, with separate estimates for reinsurance and other recoveries. Even when the process is undertaken on a net basis, insurers are required to value separately estimate of the gross liability and the recovery amounts. The approved actuary's Liability Valuation Report (see EC (d) above) must consider the estimation of reinsurance recoveries.

Currently, the risk that recoveries will not be received from the reinsurer is part of the investment risk for the insurer. An additional capital charge for concentration may apply where the aggregate exposures to a particular reinsurer exceed the set thresholds<sup>38</sup> under the capital adequacy framework. APRA has proposed stricter rules to monitor reinsurance arrangements in insurers under its Stage 2 Reforms of the prudential supervision of general insurers (see ICP 19 EC (e) and EC (f)).

Additional capital is also required for both life and general insurers if the reinsurer from which there are expected reinsurance recoveries experiences a credit rating downgrade below investment grade.

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<sup>38</sup> Sections 16 and 17 of GGN 110.4.

*AC (g): The supervisory authority requires that insurers undertake regular stress testing for a range of adverse scenarios in order to assess the adequacy of capital resources in case technical provisions have to be increased (refer to ICP 21 AC(k) and ICP 23 AC (j)).*

For life companies, both the solvency and capital adequacy requirements include a resilience reserve. Resilience is assessed as the ability of the statutory fund to sustain shocks to the economic environment in which it operates and which are likely to result in an adverse movement in the value of the assets relative to the value of the liabilities. To accurately assess a life company's resilience requirements, the appointed actuary must undertake capital projections that consider how the value of a life company's assets and liabilities would be affected by adverse scenarios.

General insurers using the Internal Model Based Method for determining their minimum capital requirements must have in place a comprehensive stress testing programme to supplement their capital measurement calculations.

General insurers using the APRA prescribed methodology to determine minimum capital requirements are required to calculate a Maximum Event Retention (MER), which is an estimation of the largest loss that the insurer would be exposed after taking into account reinsurance arrangements. Determining MER requires a consideration of:

- all relevant areas of risk concentration (for example geographic region);
- those perils which produce the greatest MER;
- the return period of the relevant catastrophes and the sensitivity of the MER to changes in those return periods;
- the results produced by modelling the insurer's own past experience; and
- any externally, commercially available data and modelling facilities, bearing in mind the appropriateness of these data to the insurer's portfolio of risks.

Furthermore, insurers are expected to undertake stress testing analysis as part of their business planning process in estimating projections.

APRA has also proposed to introduce, under draft GGN 230.1 *Reinsurance Management Strategy*, additional minimum requirements to be covered by an insurer's RMS. If accepted, insurers must allow for analysis of trends within its business and stress scenario testing in relation to the adequacy of the reinsurance arrangements over the previous 12 months.

It should be noted that in practice, a number of the large general insurers in Australia undertake regular scenario analysis for their own purposes.

## ICP 21 Investments

The supervisory authority requires insurers to comply with standards on investment activities. These standards include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management.

Investments are the key assets backing insurance liabilities so it is imperative that an insurer has prudent policies and procedures for managing its investment portfolio.

APRA requires a general insurer to address investment risk in its RMS as part of the management of balance sheet and market risk (see ICP 18 EC (a) and EC (c)). As explained in GGN 220.3, investment risk refers to the possibility of an adverse movement in the value of an insurer's assets and derives from a number of sources including market risk, credit risk, investment concentration risk and asset and liability mismatch risk. Pursuant to section 4 of GGN 220.3, an insurer's risk management system should document clearly the investment decision making framework, and include information on the process for monitoring, controlling and reporting investment exposures (for example asset allocation, liability portfolio matching criteria, limit structures and dealing authorities and performance analysis). Requirements also extend to credit risk, concentration risk, liquidity risk and derivatives. Limits on credit exposures are discussed in GGN 220.4 *Credit Quality*.

Consistent with APRA's systems-based approach in supervising risk management of insurers, the primary responsibility for the oversight of an insurer's investment policies and procedures rests with the board of the insurer. Under GPS 220, APRA requires an annual declaration from the board of an insurer to certify compliance with the RMS.

As explained in ICP 18 EC (a), APRA has embarked on a second stage of reform of the prudential supervision of general insurance. The reform proposals include a number of enhancements in regard to the management of investment risk, which have been incorporated in Draft GGNs 220.2, 220.3, 220.4 and 220.5:

- A new section on risk mitigation and control is introduced under draft GGN 220.2. An insurer must have in place various control mechanisms, documented in the RMS, to mitigate identified risks and ensure compliance with the risk management framework. Among the mechanisms are activity and procedural controls for each division or department (for example segregation of duties); regular verification and reconciliation of transactions and accounts; and safeguards for access to, and use of, an insurer's assets and records (physical and electronic controls).
- Draft GGN 220.3 features a discussion of investment risk and asset-liability mismatch risk. In addition, section 8 of draft GGN 220.3 lists the essential elements that must be included in the RMS to ensure adequate implementation and monitoring of the investment strategy. A statement of the investment objective and strategies on allowable asset classes, assets allocation ranges, benchmarks, risk limits and target currency exposures and ranges are among the key elements.

- In addition to limits on credit exposures, draft GGN 220.4 requires a mandate setting out the acceptable ranges, quality and diversification of credit exposures (section 5(a)).
- Draft GGN 220.5 includes a section on human resources. An insurer's RMS must document how the insurer ensures that adequate human resources are in place including sufficient levels of personnel with the necessary knowledge, skills and expertise to enable the insurer to effectively carry out its business obligations.

Assets backing general insurance liabilities are to be valued at fair value, consistent with the present value measurement approach for general insurance liabilities under Australian accounting standards.<sup>39</sup>

In life insurance, safeguarding of assets and investments backing policy liabilities is achieved through statutory funds. Section 29 of the Life Insurance Act requires a life company to establish statutory funds to relate solely to the life insurance business of the company or a particular part of that business. A statutory fund includes all the assets and investments related to the business of the fund and all liabilities (including policy liabilities) of the company arising out of the conduct of the business of the fund. The Life Insurance Act requires a life company to comply with Part 4 of the Life Insurance Act in the investment, administration and management of the assets of a statutory fund and to give priority to the interests of policyholders. Part 4 includes provisions which prohibit the mortgage or charging of any assets of a statutory fund, control the movement of assets in and out of a statutory fund, provide a definition of restricted investments and a requirement to report restricted investments.

The Life Insurance Act makes it very clear that it is the duty of a director of a life company to ensure the company's compliance in this regard. Section 48 of the Life Insurance Act declares that, in the event of conflict between the interests of owners and prospective owners of policies referable to a statutory fund and the interests of shareholders of a life company, a director's duty is to take reasonable care, and use due diligence, to see that the company gives priority to the interests of owners and prospective owners of those policies over the interests of shareholders. Should a director breach his duty which results in a loss to a statutory fund, the director is liable to make good the loss pursuant to sections 48 and 50 of the Life Insurance Act. In addition Prudential Rule 35 requires a Directors' declaration to be attached to a life company's annual financial statements. The declaration must state, amongst other matters, whether any assets of the statutory funds of the life company have been applied or invested in contravention of the Life Insurance Act.

Statutory funds are subject to solvency and capital adequacy requirements to ensure that the assets will be sufficient to meet the liabilities under different adverse scenarios. The actuarial standards on solvency and capital adequacy deal with the following asset risks:

- adverse market movements;

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<sup>39</sup> Australian Accounting Standards Board Accounting Standard AASB 1023.

- assets realisation;
- holdings in associated entities;
- asset concentration;
- credit risks; and
- liquidity risks.

The actuarial standards stipulate reserves to be held against asset concentration and holdings in associated and subsidiary entities which are prudentially regulated. For solvency calculations, an additional reserve is required to take account of any changes in the value of assets in a run-off situation. Although not specified, the appointed actuary must consider how credit and liquidity risks and the overall asset risks affect his assessment of the statutory fund's solvency and capital adequacy positions. Furthermore, the appointed actuary must assess the resilience of the statutory fund and provide for a resilience reserve. Computation of the resilience reserve must include considerations of asset and liability mismatches.

It is the responsibility of the appointed actuary to assess, in relation to each statutory fund of a life company, the extent to which the company has complied with the solvency and capital adequacy standards and to report his views in the FCR at the end of every financial year to the company and to APRA. Professional Standard 200 *Actuarial Reports and Advice to a Life Insurance Company* by the IAAust guides actuaries in making a financial condition investigation with a checklist of matters to be considered. In respect of assets the actuary should check the veracity of data, summary by type, derivatives, suitability to liabilities, valuation methods, mismatching and default risks in portfolio, and admissible assets and provide comments required by APRA. For investment policy, the actuary is to check current policy and trend, impact on future returns, suitability to current and future liabilities, and provide comments required by APRA. APRA reviews the FCR together with other statutory returns submitted by the life company.

Asset and investment risks are covered in the course of APRA's regular prudential reviews of insurers. Risk management systems and internal controls (EC (d) and EC (e)) in particular are addressed under Modules 4 and 10 and board and management oversight and capabilities (EC (f) and EC (g)) in Modules 1 and 2.

The Life Insurance Act requires the appointment of an independent auditor (EC (h)) to conduct an annual audit of the life company's records. Prudential Rule 35 provides for an auditor's report to be attached to the annual financial statements. The auditor's report must include a statement by the auditor as to whether any part of the assets of the statutory fund has been applied directly or indirectly in contravention of the provisions of Division 1 of Part 4 of the Life Insurance Act. Financial statements must comply with Australian accounting standards (AASB 1038) and Corps Law. Consistent with International Financial Reporting Standards, AASB 1038 requires assets backing life insurance liabilities or life investment contract liabilities to be measured at fair value (EC (b)).

A general insurer must appoint an independent auditor, in accordance with the Insurance Act, and have this appointment approved by APRA. The approved auditor's annual statement to the insurer must certify that the insurer has adequate systems and procedures in place to ensure it observes all the prudential standard requirements set by APRA and whether there are any matters which will, or are likely to, adversely affect the interests of the insurer's policyholders. Under the proposed Stage 2 reforms, the approved actuary of a general insurer will be required to prepare an annual FCR to the Board of the insurer on the overall financial condition of the insurer. The proposed FCR would contain an assessment of the insurer's approach to asset and liability management and must comment on any issues arising from the use of that approach, having regard to the insurer's liability profile and liquidity needs.<sup>40</sup>

APRA has issued Prudential Standard GPS 222 *Business Continuity Management*. A general insurer must develop, implement and maintain a Business Continuity Plan that documents procedures and information which enable the insurer to respond to disruptions and recover critical business functions.

## Advanced Criteria

Proposed amendments to the RMS<sup>41</sup> require modelling and stress-testing of the impact of current and alternative investment strategies on the financial outcomes and asset-liability mismatch assessments of a general insurer.

For life companies, the requirement for a resilience reserve ensures that the statutory fund would be able to sustain shocks to the economic environment in which the life company operates.

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<sup>40</sup> Sections 18 and 19 of Draft GGN 310.1 *Financial Condition Report*.

<sup>41</sup> Section 8(g) of Draft Guidance Note GGN 220.3 *Balance Sheet and Market Risk*.

## ICP 22 Derivatives and similar commitments

The supervisory authority requires insurers to comply with standards on the use of derivatives and similar commitments. These standards address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.

The use, management and control of derivatives by life companies is governed by Circular No C.I.1, first issued by the Insurance and Superannuation Commission (one of APRA's predecessor regulatory agencies) in 1995. Notwithstanding the lack of formal legal standing, the circular has worked well with the industry generally accepting the provisions as being 'required'. APRA has not experienced any problems with compliance by supervised insurers.

The circular defines a derivative as 'a financial asset or liability whose value depends on (or is derived from) other assets, liabilities or indexes (the 'underlying')'. While most derivatives would fit comfortably within the definition, life companies should not be constrained by the definition, with individual boards of directors free to determine which other instruments should be classified as derivatives. However, use of the following types should be generally restricted:

- highly leveraged derivatives;
- uncovered derivatives;
- derivatives where the potential for losses is considerably higher than the initial investment or is unlimited;
- derivatives where the potential exposure cannot be reliably measured;
- derivatives where closing out is difficult considering the illiquidity of the market; and
- derivatives where the underlying asset is not admissible for solvency purposes.

The key feature of the circular is that life companies using derivatives must have satisfactory risk management practices for derivatives as evidenced by a RMS. While directors of life companies are free to determine the contents of their respective company's RMS, in accordance with the extent of derivative usage and in the context of their overall internal control framework, the circular lists some minimum elements that a RMS should include. For the purpose of the essential criteria under this core principle, the following elements are of relevance:

- identify the Board's objectives of using derivatives;
- identify the risk tolerances set by the Board of Directors;

- clearly delineate the lines of authority and responsibility, including trading limits;
- require Board approval of all significant policies and procedures relating to the management of risks;
- require that the Board is regularly informed of significant individual exposures and the aggregate exposure (both derivatives in isolation and combined with physical exposure);
- make the Board Audit Committee responsible for ensuring:
  - authority limits are not exceeded;
  - systems are adequate (for example measuring risk, monitoring limits, separation of duties);
  - reporting is regular and comprehensive; and
  - senior management is notified of breaches in internal control;
- ensure that expertise and resource levels, both personnel and systems, are sufficient;
- provide for reporting to the regulator;
- analyse all relevant types of risks including credit, market, liquidity, basis, operations and legal risk, and provide adequately for them; and
- contain guidelines to ensure that staff responsible for control and monitoring procedures are adequately segregated or independent from individuals conducting derivative activities and have sufficient expertise to perform their tasks.

To ensure effective implementation and monitoring, the circular requires:

- a specific statement from directors confirming their responsibilities regarding the RMS;
- the appointed auditor to report on compliance with the RMS; and
- the approved actuary to consider the RMS as well as assess the impact of derivatives exposures in the insurer's annual FCR.

A similar circular was put in place for general insurers in 1995. Derivatives also feature in the prudential standards issued in 2002 under the general insurance reform measures. Pursuant to GGN 110.4 *Investment Risk Capital Charge* insurers must set aside capital to cover the Investment Risk arising from derivative contracts. For insurers with limited usage of derivatives, the method for computing a capital charge is prescribed.<sup>42</sup> Where an insurer

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<sup>42</sup> Sections 23-27 of GGN 110.4.

enters into significant derivative transactions, APRA may prescribe a method to calculate an additional capital charge against the resulting positions.

In addition to upgrading capital adequacy charges, the 2002 reforms also strengthened governance and risk management measures. GPS 220 *Risk Management for General Insurers* requires the Board and management of an insurer to institute effective internal governance within the insurer and ensure that appropriate systems and controls are in place to address the risks arising from the insurer's business activities. Specifically, the risk management systems and controls must address balance sheet and market risks, which include risk arising from the use of derivatives. Section 15 of GGN 220.3 stipulates the minimum requirements for derivatives control:

- a statement of the insurer's objectives in using derivatives;
- the risk tolerances of the insurer and a limit framework consistent with those risk tolerances;
- appropriate lines of authority and responsibility for transacting derivatives, including trading limits; and
- consideration of worst case scenarios and sensitivity analysis and reporting of that analysis.'

For general insurers, the reforms in 2002 coincided with the introduction of a new suite of reporting forms. Information on derivatives activities and commitments are collected through a number of forms such as GRF 140.1 *Investments-Direct Equity Holding and Risk Charge*, GRF 140.4 *Assets Indirectly Held by Insurer and Risk Charge* and GRF 310.3 *Investment and Operating Income and Expense*. In particular, GRF 160.0 *Derivative Activity and Risk Charge* requires all information on an insurer's derivative activities and exposures for the purpose of calculating an appropriate capital charge. Going forward, disclosure requirements for insurers will be reviewed in the context of international developments as part of APRA's Stage 2 Reforms of the prudential supervision of general insurance.

## ICP 23 Capital adequacy and solvency

The supervisory authority requires insurers to comply with the prescribed solvency regime. This regime includes capital adequacy requirements and requires suitable forms of capital that enable the insurer to absorb significant unforeseen losses.

*EC (a): The solvency regime addresses in a consistent manner:*

- *valuation of liabilities, including technical provisions and the margins contained therein;*
- *quality, liquidity and valuation of assets;*
- *matching of assets and liabilities;*
- *suitable forms of capital; and*
- *capital adequacy requirements.*

APRA recognises the important role of capital as a buffer to absorb losses thus enabling an insurer to continue to operate in the event of unforeseen problems. Accordingly, APRA requires that each insurer maintains sufficient capital to enable its insurance obligations to be met under a wide range of circumstances.

In general insurance, the detailed capital requirements are set out in Prudential Standard GPS 110 *Capital Adequacy for General Insurers* and associated guidance notes. The required level of capital for regulatory purposes is referred to as the Minimum Capital Requirement (MCR). Under GPS 110, a general insurer may choose one of two methods for determining MCR – the Internal Models Based Method or a Prescribed Method. Regardless of the method chosen to determine the MCR, the calculation must address all key risks that may threaten the ability of the insurer to meet policyholder obligations. At a minimum, there must be capital charges against:

- insurance risk - APRA has determined Prudential Standard GPS 210 for the valuation of liabilities for general insurers. The insurance risk capital charge is in response to the risk that the true value of net insurance liabilities may exceed the valuation under GPS 210;
- investment risk - the investment risk capital charge is in response to risks arising from credit quality, market/mismatch, and liquidity;<sup>43</sup> and

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<sup>43</sup> Section 2 of GGN 110.4 *Investment Risk Capital Charge*.

- concentration risk - this risk reflects the largest loss to which an insurer will be exposed (taking into account the probability of that loss) due to a concentration of policies, after netting out any reinsurance recoveries.

A general insurer must, at all times, have capital in excess of its MCR. APRA imposes restrictions on the composition of capital eligible to meet the MCR. The eligibility criteria and conditions are prescribed in GGN 110.1 *Measurement of Capital*.

For life companies, actuarial standards 1.03, 2.03 and 3.03 establish the principles and methodologies for the valuation of policy liabilities, and solvency and capital adequacy requirements for the purposes of the Life Insurance Act.

The policy liability is the sum of the best estimate liability and the value of the expected future profits. AS1.03 provides for the incorporation of profit margins, either explicitly or implicitly, in the release of expected future profits.

The solvency requirement broadly comprises the solvency liability, other liabilities, an expense reserve, a resilience reserve and an inadmissible assets reserve while the capital adequacy requirement is made up of a capital adequacy liability, other liabilities, a resilience reserve, an inadmissible assets reserve and a new business reserve. Asset risks, in respect of valuation, liquidity and credit quality, are addressed through the inadmissible asset reserve or other additional reserves while the resilience reserve deals with the matching of assets and liabilities.

With the solvency and capital requirements met by the excess of assets over liabilities, rather than issued capital, in a statutory fund, the definition of eligible capital is not relevant. Instead, the attributes associated with capital, that is permanency and loss absorption capabilities, become important features for the assets. To this end, assets short of the requisite attributes are treated as inadmissible assets under AS2.03 and AS3.03.

To ensure that life companies are adequately capitalised outside the statutory funds, APRA has determined a Management Capital standard (section 73A of the Life Insurance Act). A life company must hold sufficient assets in the General Fund in accordance with Actuarial Standard 6.02 *Management Capital Standard*. APRA has also issued Prudential Standard No 3, *Prudential Capital Requirement* under section 230A of the Life Insurance Act requiring each life company to maintain a minimum prescribed amount of capital outside the statutory fund, irrespective of the requirements imposed by actuarial standards.

*EC (b): Any allowance for risk mitigation or transfer considers both its effectiveness and the security of any counterparty.*

A general insurer, as part of its Reinsurance Management Strategy (REMS), must put in place sound systems for the selection of insurance programmes. The system must consist of policies and procedures that set out principles for the selection of reinsurance counterparties including formal evaluation procedures to assess the diversification and creditworthiness of reinsurance counterparties, as well as set concentration limits for credit risk exposure to reinsurance counterparties and appropriate systems for monitoring these exposures.<sup>44</sup> The investment risk capital charge is designed to cover the risk of counterparty default. In addition, a capital charge for concentration may apply where the aggregate exposures to a particular reinsurer exceed the set thresholds<sup>45</sup> under the capital adequacy framework. APRA has proposed stricter rules to monitor reinsurance arrangements in general insurers under its Stage 2 reforms of the prudential supervision of general insurers. Proposed GGN 230.2 will require confirmation of reinsurance documentation for reinsurance recoveries to be recognised for capital adequacy purposes. Proposed GGN 230.3 will seek to ensure the robustness of risk transfer by requiring APRA approval for limited risk transfer arrangements as well as their treatment for capital adequacy purposes (see ICP 19 EC (e) and EC (f)).

In the determination of solvency and capital adequacy requirements of life companies, allowance for reinsurance is subject to the reinsurance arrangements meeting the criteria in section 3.3 of AS2.03 and AS3.03. Where the reinsurance arrangements are with 'ineligible' reinsurers, the arrangements are to be ignored when calculating the liabilities in respect of the policies.

*EC (c): Suitable forms of capital are defined.*

In general insurance, eligibility of capital is prescribed in GGN 110.1 *Measurement of Capital*, which distinguishes between two tiers of capital. Tier 1 or core capital comprises proceeds from instruments that are permanent and non-cumulative in nature. Tier 2 instruments include hybrid capital instruments that have the characteristics of both equity and debt. At least 50 per cent of an insurer's capital base must be in Tier 1 instruments.

In life insurance, capital is defined under Prudential Standard No 3. For companies limited by shares only, capital for the purpose of the prudential standard must take the form of ordinary shares, irredeemable preference shares or APRA approved redeemable preference shares. For a life company that is limited both by shares and guarantee or that does not have any share capital, capital must be held in the form of eligible assets as defined in the prudential standard.

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<sup>44</sup> GGN 110.4 Reinsurance Management Strategy.

<sup>45</sup> Sections 16 and 17 of GGN 110.4.

*EC (d): Capital adequacy requirements are sensitive to the size, complexity and risks of an insurer's operations, as well as the accounting requirements that apply to the insurer.*

An insurer's capital requirements should reflect the size, business mix and complexity of its business. To this end, APRA adopts a risk-based approach to the measurement of capital adequacy for all general insurers. A general insurer's MCR is intended to be broadly commensurate with the full range of risks to which an insurer is exposed (including risks relating to insurance claims, investments, counterparty default, asset-liability mismatches, catastrophes, and operational errors and problems). The MCR computation allows for different risk capital factors depending on business class, asset type, counterparty grading and concentration.

Solvency and capital adequacy requirements for life companies are not set as fixed absolute amounts or as fixed percentages of total assets or liabilities. Actuarial standards prescribe the principles but the relevant requirements for a life company are calculated by applying acceptable methodologies to the individual company's assets and liabilities. The level of requirements will therefore depend on the size and nature of the life company's operations.

*EC (e): The minimum capital adequacy requirements should be set at a sufficiently prudent level to give reasonable assurance that policyholder interests will be protected.*

The aim of imposing capital adequacy requirements on a general insurer is to ensure that each insurer maintains sufficient capital to enable its insurance obligations to be met under a wide range of circumstances. (See EC (d) above.)

Section 66 of the Life Insurance Act notes that the purpose of the solvency standard is to ensure, as far as practicable that, at any time, the financial position of each statutory fund of a life company is such that the company will be able, out of the assets of the fund, to meet all policy and other liabilities referable to the fund at that time as they become due.

*EC (f): Capital adequacy requirements are established at a level such that an insurer having assets equal to the total of liabilities and required capital will be able to absorb significant unforeseen losses.*

In recognition of the inherent uncertainty in the estimate of an insurer's liabilities, GPS 210 requires the incorporation of a risk margin as a component of the value of the insurance liabilities. The risk margin ensures that the value of insurance liabilities is established at an appropriate and sufficient level. In addition, the MCR must include a Maximum Event Retention to take account of losses from catastrophic events. Also GPS 110 limits the form of capital to a few eligible capital instruments, which must be unconditionally committed and meet minimum 'permanency' criteria. With all these embedded features, a general insurer's MCR is well placed for absorption of unforeseen losses.

Section 71 of the Life Insurance Act states that the purpose of the capital adequacy standard is to ensure, as far practicable, that there are sufficient assets in each statutory fund of a life company to provide adequate capital for the conduct of the business of the fund in accordance with the Life Insurance Act and in the interests of the owners of policies referable to the fund. To ensure that the life company can be a viable going concern, the capital adequacy requirement must be sufficient to absorb losses arising from a range of adverse circumstances.

*EC (g): Solvency control levels are established. Where the solvency position reaches or falls below one or more control levels, the supervisory authority intervenes and requires corrective action by the insurer or imposes restrictions on the insurer. The control level is set so that corrective action can be taken in a timely manner (refer to ICP 14).*

APRA has publicly stated that a minimum coverage of 1.2 times the MCR is necessary for a general insurer to be considered 'soundly capitalised'. APRA sees the MCR as a 'hard floor' and therefore remedial action to increase capital should be taken at higher than MCR levels of capital. APRA has proposed measures to strengthen capital management by insurers under the Stage 2 reforms of the prudential supervision of general insurers. The proposals require insurers to set out, in their RMS, strategies for holding capital reserves above the MCR. More specifically, insurers must put in place processes and controls to monitor and ensure continual compliance with the MCR, including setting trigger ratios appropriate for each insurer.<sup>46</sup>

As noted under EC (a), the Life Insurance Act imposes both a solvency requirement and a capital adequacy requirement at a statutory fund level. Solvency is determined on the basis that each statutory fund has sufficient assets to fund existing liabilities in the event of the fund being wound up while the capital adequacy requirement for a fund is determined based on a going concern scenario. Capital adequacy requirements are generally higher than solvency requirements and act as an early warning trigger to protect against the breach of solvency levels.

Furthermore, APRA encourages life companies to hold assets in excess of the regulatory requirements to minimise the risk of any intervention by APRA. A life company should have a target surplus policy commensurate with the life company's overall risk profile. The policy should articulate how the life company would respond when the level of surplus falls below the target. APRA expects to see a discussion of the target surplus by the appointed actuary in the FCR.

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<sup>46</sup> Sections 8 and 9 of Draft GGN 220.2 Risk Management Framework – General Requirements

*EC (h): Inflation of capital – through double or multiple gearing, intra-group transactions, or other financing techniques available as a result of the insurer’s membership in a corporate group – is addressed in the capital adequacy and solvency calculation (refer to ICP 17).*

Being an integrated supervisor, APRA supervises many of the conglomerate groups to which insurers that are not standalone entities belong. In many cases, these conglomerate groups are subject to banking prudential requirements. Bank capital adequacy rules require that capital investments in insurers must be deducted from the capital base of the standalone bank as well as the consolidated banking group. In May 2005 APRA released a discussion paper on the prudential supervision of corporate groups involving authorised general insurers. The proposed consolidated approach builds on APRA’s existing framework for the supervision of conglomerate groups involving banks, requiring capital deductions of investments in subsidiaries to avoid double leveraging of capital.<sup>47</sup> APRA plans to extend the consolidated approach to life companies in due course.

For life companies currently, both the solvency and capital adequacy requirements address the risk of double gearing of capital of associated entities. Holdings in an associated entity which is an institution itself subject to legislated minimum capital requirements are treated as inadmissible assets under the solvency and capital adequacy standards.

*EC (i): The solvency regime addresses the requirements placed upon an insurer operating through a branch.*

Sections 25-26 of GPS 110 require foreign-incorporated insurers operating branches in Australia to meet a variant of the minimum capital requirement. Specifically, the foreign insurer must maintain assets in Australia<sup>48</sup> in excess of their liabilities in Australia, of an amount at least equal to the minimum capital requirement as determined under GPS 110.

Currently all registered life companies are incorporated subsidiaries. The Life Insurance Act has been amended to allow eligible foreign life insurance companies to operate as branches but any such branches will be required to operate their Australian business in a separate statutory fund which will be subject to the Life Insurance Act solvency and capital adequacy regimes.

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<sup>47</sup> Chapter 5 of Discussion Paper on the Prudential supervision of corporate groups involving authorised general insurers dated 16 May 2005.

<sup>48</sup> In this context, ‘assets in Australia’ are those within the meaning of sections 28 and 116A of the Insurance Act and Prudential Standard GPS 120 Assets in Australia for General Insurers.

**AC (j):** The solvency regime provides for periodic, forward-looking analysis (for example, dynamic solvency/ stress testing) of an insurer's ability to meet its obligations under various conditions (refer to ICP 20 AC (g) and ICP 21 AC (k)).

General insurers which use the Internal Model Based Method for determining their minimum capital requirements must have in place a comprehensive stress testing programme to supplement their capital measurement calculations. For other insurers, APRA has not stipulated stress testing as a requisite but a number of the large general insurers in Australia undertake regular scenario analysis for their own purposes.

General insurers using the APRA prescribed methodology to determine minimum capital requirements are required to calculate a Maximum Event Retention (MER), which is an estimation of the largest loss to which the insurer would be exposed after taking into account reinsurance arrangements. Determining MER requires a consideration of:

- all relevant areas of risk concentration (for example geographic region);
- those perils which produce the greatest MER;
- the return period of the relevant catastrophes and the sensitivity of the MER to changes in those return periods;
- the results produced by modelling the insurer's own past experience; and
- any externally, commercially available data and modelling facilities, bearing in mind the appropriateness of these data to the insurer's portfolio of risks.

For life companies, both the solvency and capital adequacy requirements include a resilience reserve. Resilience is assessed as the ability of the statutory fund to sustain shocks to the economic environment in which it operates and which are likely to result in an adverse movement in the value of the assets relative to the value of the liabilities. To accurately assess a life company's resilience requirements, the appointed actuary must undertake capital projections that consider how the value of a life company's assets and liabilities would be affected by adverse scenarios.

**AC (k):** *The supervisory authority assesses the structure of its solvency regime against structures of a peer group of jurisdictions and works towards achieving consistency.*

Via strong representation on various committees of the International Association of Insurance Supervisors and the International Actuarial Association, APRA keeps up-to-date with international policy developments. APRA also maintains close relationships with peer regulators, such as the Financial Services Authority, United Kingdom (FSA) and the Office of the Superintendent of Financial Institutions, Canada (OSFI), to ensure consistency with their solvency regimes.

## ICP 24 Intermediaries

The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.

*EC (a): The supervisory authority requires intermediaries to be licensed or registered.*

Insurance intermediaries are required to hold an Australian Financial Services Licence (AFSL) under section 911A of the Corps Act, except when the intermediary is acting as an authorised representative of an AFSL holder or an exemption applies under the special circumstances as specified under section 911A(2).

Section 911A of the Corps Act requires all persons who carry on a financial services business in Australia to hold an AFSL. The definition of 'financial services business' (section 761A) includes providing 'financial product advice' and dealing in 'a financial product'. The general definition of 'financial product' (section 763A) includes the management of financial risk which in turn includes the management of the financial consequences to them of particular circumstances happening. Contracts of insurance would fit into this category.

In addition, insurance is specifically referred to in section 764A of the Corps Act in relation to 'things that are financial products'. Most types of life and general insurance fall within the specific definition of financial product (except for health insurance, insurance provided by the Commonwealth or State Governments and reinsurance, which are specifically excluded under section 765A(1) of the Corps Act). Generally a person in the business of advising or dealing in a general or life insurance would be carrying on a financial services business and be required to hold a AFSL.

As a principal, an insurance broker or a financial services business giving advice on an insurance product is required to hold its own AFSL.

As an authorised representative of an AFSL holder, an insurance agent of the AFSL holder is exempted from the requirement to hold an AFSL (section 911A(1)(a) of the Corps Act).

An AFSL holder can authorise a representative by giving written notice to the representative to provide specified financial services on behalf of the AFSL holder. There is also provision for an authorised representative to be an authorised representative for more than one AFSL holder. However, each of the AFSL holders has to give their consent (section 916C) and ASIC must be advised within 15 business days of the appointment of an authorised representative (section 916F).

There is no requirement for an AFSL holder to appoint as authorised representative its own employees. The staff of an AFSL holder are considered to be representatives of the AFSL holder.

Section 916D of the Corps Act prohibits an AFSL holder from acting as an authorised representative of another AFSL holder. However, this statutory prohibition does not apply where an AFSL holder is acting as an authorised representative of another AFSL holder under a binder given by an insurer (section 916E). The effect of this binder is that the authorised representative acts for the insurer who holds an AFSL in relation to contracts of insurance or claims under such contracts. This exception means that an insurance broker (who generally holds an AFSL) can act as an authorised representative of an insurance company (who also holds an AFSL) for the purposes of entering into insurance policies on behalf of the insurance company with clients or settling claims made under those policies on behalf of the insurance company.

*EC (b): The supervisory authority requires intermediaries to have adequate general, commercial and professional knowledge and ability as well as having a good reputation.*

AFSL applicants must meet obligations imposed by section 912A of the Corps Act including that they:

- ensure that the financial services covered by the AFSL are provided efficiently, honestly and fairly;
- maintain the competence to provide the financial service; and
- ensure that the AFSL holder's representatives are adequately trained and competent to provide the financial service.

ASIC Policy Statement PS 164 *Licensing: Organisational Capacities* provides guidance on how to address competence of senior management. Training requirements are specified in Policy Statement PS 146 *Licensing: Training of Financial Product Advisers*, including minimum training standards where the staff or the authorised representatives of an AFSL holder are providing advice about financial products to retail clients. The onus is on the AFSL holder to ensure that the representative meets the training requirements. Appendices A and B of PS 146 detail the knowledge and skills requisites for advisers who provide personal advice to retail clients.

Section 913B of the Corps Act requires the AFSL holder, or the AFSL holder's responsible officers (if the AFSL holder is a corporation), partners (if the AFSL holder is a partnership), or trustees (if the AFSL holder is a trust arrangement), to be of good fame and character. There is no requirement for an authorised representative to be of good fame and character; the onus is on the AFSL holder in relation to the conduct of an authorised representative or a representative that it appoints (section 917A of the Corps Act).

When considering whether or not a person is of good fame or character, ASIC has regard to:

- any conviction within the previous 10 years the person has for serious fraud;
- whether the person has held an AFSL that was suspended or cancelled;
- whether a banning order has been previously issued against the person; and
- any other matter ASIC considers relevant.

*EC (c): If necessary, the supervisory authority takes corrective action, including applying sanctions, directly or through insurers, and cancelling the intermediary's licence or registration, when appropriate.*

In the event that an intermediary, being itself an AFSL holder, is unable to meet its ongoing licence requirements, ASIC has the power, after providing the AFSL holder with an opportunity to make written submissions and to appear at a hearing before an ASIC delegate, to suspend or cancel the AFSL pursuant to section 915C of the Corps Act.

Section 915B of the Corps Act allows ASIC to suspend or cancel an AFSL, without affording a person a hearing, if the AFSL holder:

- ceases to carry on the financial services business;
- becomes insolvent;
- is convicted of serious fraud;
- becomes incapable of managing their affairs because of mental or physical incapacities; or
- lodges an application with ASIC.

Section 920A of the Corps Act allows ASIC to make a banning order against a natural person after giving the person an opportunity for a hearing and to make a submission on the matter.

ASIC can also impose or vary conditions on an AFSL under section 914A of the Corps Act. This serves as a means of ensuring that specific matters affecting compliance by the AFSL holder with the financial services law are addressed by the AFSL holder.

In the event of misconduct by an authorised representative ASIC can seek to suspend or cancel an insurer's AFSL for non-compliance with section 912A of the Corps Act (section 915B). Section 912A imposes various ongoing requirements in relation to the insurer's authorised representatives, including that the AFSL holder must:

- take reasonable steps to ensure that the AFSL holder's representatives comply with the financial services law; and

- ensure that the AFSL holder's representatives are adequately trained and competent to provide the financial service.

If an AFSL holder is an insurer regulated by APRA, additional requirements apply before ASIC can suspend or cancel the AFSL, or impose or vary any condition applying to it. ASIC cannot make such any change to the AFSL held by an insurer without ASIC first consulting APRA<sup>49</sup> if doing so, in ASIC's opinion, would prevent the AFSL holder carrying out the activities regulated by APRA. Even when ASIC is not required by law to consult with APRA before making a decision to suspend or cancel an AFSL, ASIC is still required to advise APRA of its action within a week.

*EC (d): The supervisory authority requires an intermediary who handles client's money to have sufficient safeguards in place to protect these funds.*

Section 981(1)(a) of the Corps Act requires an intermediary who is an AFSL holder to pay money from a client into an account with an APRA authorised deposit-taking institution, or an account with an approved foreign bank or a cash management account. This account can only be used for client money. There is however, no requirement to maintain separate accounts for each client; an AFSL holder can have a single account for all client money.

Section 981E of the Corps Act provides that money in an AFSL holder's client account (or an authorised investment made with that money) is not capable of being taken in satisfaction of a Court judgment or being used to set off against other debts. Section 981H of the Corps Act provides that money paid to the AFSL holder by the client, on the client's behalf or for the benefit of the client, is taken to be held on trust for the client. In the event that the AFSL holder becomes insolvent, all client money being held on trust for clients by the AFSL holder remains the property of the clients and cannot be used for the purposes of paying the AFSL holder's creditors.

Further guidance on the operation of client accounts can be found in Regulations 7.8.01 and 7.8.02. The regulations provide that money paid to an AFSL holder by the insured in respect of a contract of insurance to be issued is to be paid into the account. Similarly, money paid to the AFSL holder by an insurer in respect of the insured is also to be paid into the account. The effect of this regulation is that where a client pays a premium to an insurance broker (that is the AFSL holder) in relation to an insurance policy to be issued by an insurance company, then the insurance broker is to pay this premium into the broker's client funds account. In the event that the insurance company is paying a claim via the insurance broker, then these funds are to also be placed in the broker's client funds account.

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<sup>49</sup> Sections 915I(1)(a) and 914A(4) of the Corps Act.

**EC (e): The supervisory authority requires intermediaries to give customers information on their status, specifically whether they are independent or associated with particular insurance companies and whether they are authorised to conclude insurance contracts on behalf of an insurer or not.**

Section 941 of the Corps Act requires the provision of a Financial Services Guide (FSG) to assist a retail client in deciding whether to acquire a financial service (as opposed to a financial product). The obligation applies to an AFSL holder as well as the authorised representatives of an AFSL holder. The information to be included in a FSG is specified in section 942B of the Corps Act and comprises:

- name and contact details of the AFSL holder;
- information about the kinds of financial services that the AFSL holder is authorised by its AFSL to provide;
- who the AFSL holder acts for when providing service to the client;
- association or relationship between the AFSL holder and the issuer of any financial product; and
- details of the binding agreement in the event that the AFSL holder is acting under a binder.

In the case of an authorised representative, section 942C of the Corps Act requires additional information including:

- name and contact details of the authorised representative;
- a statement that the authorised representative is authorised by the AFSL holder to provide the financial service;
- the kinds of financial services that the authorised representative is authorised to provide by the AFSL;
- who the authorised representative acts for when providing the service to the client; and
- any association or relationship between the authorised representative (or any employer of the authorised representative) and the issuer of any financial product.

*EC (f): The supervisory authority or other authority must have powers to take action against those individuals or entities that are carrying on insurance intermediation activity without license or registration.*

An insurance intermediary, who carries on a financial services business without an AFSL and is not acting as an authorised representative of an AFSL holder, is in breach of section 911A of the Corps Act. Section 1324 of the Corps Act enables ASIC to take enforcement action against a person who has contravened the Corps Act. ASIC can apply for an injunction to restrain the person from continuing to engage in the conduct.

In the event that the unlicensed insurance intermediary is a corporation and ASIC is proposing to wind-up that corporation, ASIC may apply to the Court for the appointment of a provisional liquidator. The liquidator would be appointed to preserve the current position until the Court has had time to consider ASIC's application to wind-up the company. ASIC would generally seek to wind-up an unlicensed insurance intermediary on the basis that it was insolvent (naturally this ground would depend on the financial position of the company) or that it is just and equitable to do so (section 461 of the Corps Act).

In addition to possible civil remedies, ASIC can seek to impose penalties under a criminal jurisdiction. Failure to comply with the requirement to hold an AFSL when carrying on a financial services business is an offence subject to a penalty of \$220,000 or 2 years imprisonment or both. Section 911C of the Corps Act also makes it an offence for a person to hold out that they have an AFSL when they do not. The penalty for this offence is \$5,500 or imprisonment for 1 year or both.

## ICP 25 Consumer protection

The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied.

*EC (a): The supervisory authority requires insurers and intermediaries to act with due skill, care and diligence in their dealing with consumers.*

Before granting an AFSL, ASIC must have no reason to believe that the applicant will not comply with the obligations imposed by section 912A of the Corps Act. The obligations imposed by section 912A include requirements that the AFSL holder 'do all things necessary to ensure that the financial services covered by the AFSL are provided efficiently, honestly and fairly' and 'maintain the competence to provide those financial services'.

ASIC has the power to suspend or cancel an AFSL in the event that the Licence holder is unable to meet its ongoing licence requirements imposed by section 912A of the Corps Act (section 915C of the Corps Act). Therefore, ASIC may suspend or cancel the AFSL if the AFSL holder has not complied with the obligations under section 912A noted above or ASIC has reason to believe that the AFSL holder will not comply with those obligations. However, ASIC cannot suspend or cancel an AFSL using this power without first providing the AFSL holder with an opportunity to attend or be represented at a hearing before ASIC and to make submissions to ASIC about the matter (section 915C(4) of the Corps Act).

ASIC has approved the ICA's General Insurance Code of Practice and the Code's independent complaints resolution scheme, Insurance Enquiries and Complaints Ltd. The Code implements various recommendations for:

- making policy wording and information more user friendly, and
- improving training and accountability for the conduct of employees, agents, loss adjustors, assessors and debt collectors who handle insurance claims.

*EC (b): The supervisory authority requires insurers and intermediaries to have policies on how to treat consumers fairly and to have systems and provide training to ensure compliance with those policies by their employees and other sales collaborators.*

Section 912A of the Corps Act imposes a number of ongoing obligations on an AFSL holder to support the fair treatment of consumers and training of staff. These include obligations to:

- do all things necessary to ensure that the financial services covered by the AFSL are provided efficiently, honestly and fairly;
- comply with the financial services laws;
- take reasonable steps to ensure that its representatives comply with the financial services laws;
- maintain the competence to provide those financial services; and
- ensure that its representatives are adequately trained, and are competent, to provide those financial services.

In Policy Statement PS 164 *Licensing: Organisational Capacities*, ASIC states that the focus of the obligations is on protecting consumers' interests and making sure that services are provided efficiently, honestly and fairly. Further, this necessitates, at a minimum, that AFSL holders establish and maintain compliance measures, processes and procedures that ensure, as far as is reasonably practicable, that the AFSL holder complies with the financial services laws. An AFSL applicant must set out the arrangements (including a description of systems) by which the person will comply with its general obligations set out in section 912A of the Corps Act. ASIC will not grant an AFSL if it has reason to believe that the applicant will not comply with the section 912A obligations if the licence is granted.

In addition to the Corps Act requirements, the *Insurance Contracts Act 1984* imposes a duty on insurers to act with the utmost good faith (section 13 of the Insurance Contracts Act) which is implied in all contracts of insurance. Founded in common law, it imposes on all parties to a contract of insurance an obligation to act honestly and fairly in their dealings with one another.

Certain other provisions<sup>50</sup> of the Insurance Contracts Act have the effect of preventing an insurer from denying claims where it would have been entitled to do so at common law but to do so would be unfair on the consumer.

In terms of training, skills and experience, there is a statutory obligation on the AFSL holder to maintain the competence to provide the financial services and ensure that its representatives are adequately trained, and are competent to provide those financial services. Training requirements are specified in Policy Statement PS 146 *Licensing: Training*

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<sup>50</sup> Sections 28, 46, 47 and 54 of the Insurance Contracts Act.

*of Financial Product Advisers, including minimum training standards when the staff or the authorised representatives of an AFSL holder are providing advice about financial products to retail clients.*

*EC (c): The supervisory authority requires insurers and intermediaries to seek the information from their consumers that is appropriate in order to assess their insurance needs, before giving advice or concluding a contract.*

Section 945A of the Corps Act imposes a requirement on an AFSL holder and an authorised representative that there be a reasonable basis for 'personal advice' provided to a 'retail client'. When providing personal advice to a retail client, the AFSL holder or an authorised representative must determine the relevant personal circumstances of the client and make reasonable inquiries in relation to those personal circumstances to establish a reasonable basis on which to give advice. Given the information obtained from the client, the AFSL holder or the authorised representative must give consideration to, and where appropriate, conduct further investigation of, the subject matter of the advice to ensure the advice provided is appropriate.

If the AFSL holder or the authorised representative believes, when providing personal advice to a retail client, that the client's personal information is incomplete or inaccurate, they must warn the client that the advice is based on incomplete or inaccurate information and that the client should consider the appropriateness of the advice (section 945B(1) of the Corps Act).

If the AFSL holder or the authorised representative provides general advice to a client, they must notify the client that the advice has been prepared without taking account of the client's specific objectives, financial situation or needs.

If the advice relates to the acquisition, or possible acquisition, of a particular financial product, the client should obtain a Product Disclosure Statement relating to the product and consider it before making any decision about whether to acquire the product (section 949A(2)(c) of the Corps Act).

Both 'personal advice' and 'general advice' are defined in the Corps Act (section 766B).

*EC (d): The supervisory authority sets requirements for insurers and intermediaries with regard to the content and timing of provision of information:*

- *on the product, including the associated risks, benefits, obligations, and charges*
- *on other matters related to the sale, including possible conflict of interest to existing or potential policyholders.*

Part 7.7 of the Corps Act contains the financial services disclosure requirements that apply to AFSL holders and their authorised representatives.

- **Financial Services Guide (FSG):** An AFSL holder or an authorised representative who provides a financial service to a person, as a retail client, must give that person a FSG. The information that is to be included in the FSG includes contact details of the AFSL holder, information on the services provided, who the AFSL holder or authorised representative is acting for, details on services provided for under a binder with an insurer, remuneration rates, and complaints procedures.
- **Statement of Advice (SOA):** A SOA is obligatory on an AFSL holder and its authorised representative in providing personal advice to a retail client, except in limited circumstances.<sup>51</sup> A SOA must contain information about the basis on which the advice is or was given, the name and contact details of the AFSL holder, information about any remuneration and benefits received by the AFSL holder, and details on relevant interests and associations that the AFSL holder has.
- **Product Disclosure Statement (PDS):** AFSL holders and their authorised representative are required to provide a PDS in certain circumstances in relation to the issue or sale of financial products.<sup>52</sup> The PDS must include all the information that a policyholder would reasonably require to make a decision whether to acquire the product. It should include information such as any significant benefits and risks associated with a product, significant characteristics or features of the product, dispute resolution information, and any other information that may have a material influence on the decision to acquire the product.

There are also disclosure obligations in the Insurance Contracts Act relating to the provision of information.<sup>53</sup>

Section 912A(1)(aa) of the Corps Act imposes a general obligation to manage conflicts of interest. ASIC has issued Policy Statement PS 181 *Licensing: Managing conflicts of interest* setting out ASIC's approach to compliance with the obligation and to provide guidance to AFSL holders on controlling, avoiding and disclosing conflicts of interest.

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<sup>51</sup> Section 946B of the Corps Act.

<sup>52</sup> Sections 1012B and 1012C of the Corps Act.

<sup>53</sup> Sections 35, 37 and 58 of the Insurance Contracts Act.

*EC (e): The supervisory authority requires insurers and intermediaries to deal with claims and complaints effectively and fairly through a simple, easily accessible and equitable process.*

Section 912A(1)(g) of the Corps Act requires an AFSL holder who provides financial services to a person as a retail client to have a dispute resolution system and membership of one or more external dispute resolution schemes.

ASIC's requirements for licensing dispute resolution schemes are contained in Policy Statement PS165, which stipulates that internal dispute resolution procedures must satisfy the Essential Elements of Effective Complaints Handling in *Australian Standard AS 4269 1995: Complaints Handling*. Essential elements that must be covered include: commitment, fairness, resources, visibility, access, assistance, responsiveness, charges, remedies, data collection, systemic and recurring problems, accountability and reviews.

To satisfy the Corps Act's membership requirement of an external dispute resolution scheme, membership must be of a scheme approved by ASIC in accordance with the *Corporations Regulations 2001*. In addition to the requirements in PS 165, external dispute resolution schemes also come under Policy Statement PS 139. The key principles that external schemes must address are: accessibility, independence, fairness, accountability, efficiency and effectiveness.

The Insurance Ombudsman Service is a national service which also assists in resolving disputes between consumers and insurers or other financial service providers that are members of the Service.

Furthermore, the industry has adopted a Code of Practice which is a self-regulatory code that aims to raise the standards of practice and service in the insurance industry. The Code is administered by the Ombudsman.

*AC (f): The supervisory authority requires insurers and intermediaries to set rules on the handling of customer information paying due regard to the protection of private information of customers.*

The Corps Act requires an AFSL holder to keep detailed financial records that correctly explain the transactions of the financial services business carried out, including charges and credit arising from those transactions, and the names and details of the persons acquiring or selling any of the financial products. Insurers and intermediaries therefore acquire a lot of private information in the course of their business activities. In Australia, the collection and handling of personal information is governed by the Privacy Act and its ten National Privacy Principles (NPPs). The NPPs must be followed by private sector organisations.<sup>54</sup> The NPPs address data security, restricted use and disclosure, including transborder information flows, and prohibit the collection of sensitive information, except in certain circumstances.

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<sup>54</sup> With some exceptions, for example for certain organisations with annual turnover of AUD 3,000,000 or less.

*AC (g): The supervisory authority gives information to the public about whether and how local legislation applies to the cross-border offering of insurance, such as e-commerce. The supervisor issues warning notices to consumers when necessary in order to avoid transactions with unsupervised entities.*

The public can access ASIC's website to conduct free searches to check whether a business is licensed or whether a person holds an AFSL or is an authorised representative of an AFSL holder. This is a simple process for checking to see if an insurance broker or agent is licensed. The ASIC website also lists names of people who have been banned or disqualified under a provision of the Corps Act. The website also provides information about the financial services licensing regime and the obligations of licensees.

The ASIC publication, *Consumers and Money*, is a quick guide for consumers about consumer protection laws, insurance, fees and charges, credit cards, superannuation and scams.

ASIC maintains a consumer website called FIDO<sup>55</sup> for consumers with updates of:

- warnings on scams and swindles, including information on misleading advertisements and websites; and
- financial tips, including a guide to insurance.

Segments of the website have been designed specially for the more vulnerable sectors of the population, such as retirees, young adults and indigenous people.

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<sup>55</sup> [www.fido.gov.au](http://www.fido.gov.au).

*AC (h): The supervisory authority promotes the consumers' understanding of the insurance contracts.*

See EC (g) above.

One of ASIC's statutory aims is 'to promote the confident and informed participation of investors and consumers in the financial system'. To this end, ASIC seeks to create a financially literate community. A Consumer Education Strategy was developed for 2001 to 2004, one aspect of which focused on providing financial services education in schools.

ASIC publications, such as *Your Money, Don't kiss your money goodbye*, and *You can complain*, have proved to be popular and very effective in promoting financial awareness among the public.

## ICP 26 Information, disclosure and transparency towards the market

The supervisory authority requires insurers to disclose relevant information on a timely basis in order to give stakeholders a clear view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed.

ASIC has promulgated reporting requirements under the Corps Act for companies in general and for AFSL holders in particular. These would apply to insurers. In addition, insurers which are listed are subject to the listing rules of the exchanges requiring continuous disclosure requirements.

### Obligations on companies in general under the Corps Act

A financial report and directors' report must be prepared for each financial year by disclosing entities, public companies, large proprietary companies and registered schemes (section 292). The annual financial report must be audited (section 301).

Annual financial reports, annual directors' reports and half-yearly reports are required to be lodged with ASIC (sections 319 and 320). Annual reports must be lodged within 3-4 months of the end of the financial year, depending on the type of entity. Half-yearly reports must be lodged within 75 days after the end of the half-year. Reports that have been amended after they have been lodged must be lodged with 14 days following the amendment (section 322).

Companies, registered schemes and other disclosing entities are under an obligation to send members a copy of their yearly financial report, directors' report and auditor's report, or alternatively, a concise report (section 314). The timeframe for reporting and means of reporting are stipulated (sections 314, 315 and 316). If a public company is required to hold an Annual General Meeting, the directors are obliged to lay before the meeting the financial report, directors' report and auditor's report for the last financial year (section 317). If a report has been amended and the amendment is considered to be a material one, the entity must notify members as soon as practicable (section 322).

The Corps Act contains general and specific content requirements for the annual financial report and the annual directors' report along with special rules for public and listed companies (sections 295, 295A, 298, 299, 299A, 300 and 300A). There is an obligation that annual financial reports comply with Australian accounting standards and present a true and fair view of the financial position and performance of the entity (section 305). Australian accounting standards follow the International Financial Reporting Standards from 1 January 2005. The financial statements are to be prepared in accordance with Australian accounting standard AASB 101 *Presentation of Financial Statements*, the overall objective of which is to ensure comparability both with an entity's financial reports of previous periods and with the financial reports of other entities. Along with the quantitative information on financial position and performance, AASB 101 requires the notes to the financial statements to include certain non-financial disclosures such as:

- information about the basis of preparation of the financial report and the specific accounting policies;
- the entity's financial risk management objectives and policies (section 105);
- the measurement basis used in preparing the financial statement (section 108);
- the judgments made by management in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statement (section 113); and
- key assumptions regarding the future or other source of estimation uncertainty that has a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities in the next annual reporting period (section 116).

## Obligations on AFSL holders under the Corps Act

AFSL holders are under an obligation to keep financial records that correctly record and explain the transactions and financial position of the financial services business carried on (section 988A). Each year, the AFSL holder must prepare a true and fair profit and loss statement and balance sheet (section 989B(1)). These financial statements must be lodged with ASIC within the timeframe specified in the Corps Act:

- for an AFSL holder that is not a body corporate, before 2 months after the end of the financial year;
- for an AFSL holder that is a body corporate and a disclosing entity or registered scheme, before 3 months after the end of the financial year (section 989D); and
- for an AFSL holder that is a body corporate but not a disclosing entity or registered scheme, before 4 months after the end of the financial year.

The financial statements required to be lodged by AFSL holders with ASIC must be in accordance with Form FS70. FS70 requires certification that, in the case that the AFSL holder is a reporting entity, the financial statements comply with Australian accounting standards. In the case that the AFSL holder is not a reporting entity, FS70 requires certification that the financial statements are prepared in accordance with recognition and measurement requirements of the accounting pronouncements, and in accordance with the disclosure requirements of those pronouncements.

The financial statements must be audited by an auditor in accordance with the auditing standards (section 989). The financial statements lodged with ASIC must be accompanied by the auditor's report (sections 989B(2) and (3)) in accordance with Form F71. The auditor's report must contain a statement of the auditor's opinion in respect of:

- the effectiveness of internal controls used by an AFSL holder to comply with certain provisions of Pt 7.8 of the Corps Act (for example, regarding payments for insurance to AFSL holders that are not the insurer, financial records, statements and audit);
- whether accounts required by the Corps Act (sections 981B and 982B) regarding dealing with client's money are maintained by the AFSL holder and operated and controlled in accordance with those sections; and
- whether all necessary records, information and explanations were received from the AFSL holder (reg 7.8.13(2) CR).

## Listed companies

Australia's main financial markets are the ASX, NSX, BSX and APX. Each of these markets has listing rules<sup>56</sup> that have continuous disclosure requirements. These requirements oblige listing entities to disclose information or events that are material to the price or value of listed securities that a reasonable person would expect (ASX LR 3.1, NSX LR 6.4, BSX LR 3.1, APX LS 8.1.1). Section 674 of the Corps Act imposes an obligation on a listed disclosing entity to comply with these listing rules. Non-compliance with section 674 of the Corps Act (adherence to the continuous disclosure obligations contained in the listing rules) may result in a fine of up to \$220,000 or imprisonment for 5 years or both.

If the listing rules do not contain a provision such as those outlined above, the Corps Act obliges a listed disclosing entity to disclose certain information to ASIC (section 675 of the Corps Act). Information that is not generally available and that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of enhanced disclosure securities of the entity must be disclosed to ASIC.

In complying with obligations to inform the market operator of information or events that are material to the price or value of listed securities, the company must inform the operator 'immediately' (in the case of the ASX (LR 3.1) and the BSX (LR 3.1)) or 'without delay' (in the case of the NSX (LR 6.4) and the APX (LS 8.1.1)). Where the information is to be disclosed to ASIC, the entity is to disclose the information as soon as practicable (section 675 of the Corps Act).

Listed public companies must also include information that members of the company would reasonably require to make an informed assessment of the following matters: the operations of the entity; the financial position of the entity; and the entity's business strategies and its prospects for future financial years (section 299A of the Corps Act).

Along with ASX LR 3.1, which imposes continuous disclosure obligations on participants, ASX LR 4.10 requires companies to provide a statement in their annual report disclosing the extent to which they have followed the ASX's Best Practice Recommendations as contained in

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<sup>56</sup> Ch 1 ASX Listing Rules, Sec IIA NSX Listing Rules, Ch 1 BSX Listing Rules, Ch 4 APX Listing Standards.

its Principles of Good Corporate Governance and Best Practice Recommendations (ASX LR 4.10.3). The Best Practice Recommendations are:

- lay solid foundations for management and oversight (Principle 1);
- structure the Board to add value (Principle 2);
- promote ethical and responsible decision-making (Principle 3);
- safeguard integrity in financial reporting (Principle 4);
- make timely and balanced disclosure (Principle 5);
- respect the rights of shareholders (Principle 6);
- recognise and manage risk (Principle 7);
- encourage enhanced performance (Principle 8);
- remunerate fairly and responsibly (Principle 9); and
- recognise the legitimate interests of stakeholders (Principle 10).

### **Life company obligations under the Life Insurance Act**

The reporting by life companies to APRA is discussed under ICP 12. Section 124 of the Life Insurance Act provides policy owners in the life company with the right to receive the financial statements and annual returns given by the life company to APRA. APRA maintains a register of returns for individual life companies for inspection by the public. The register includes:

- Prudential Rule 26 – Schedule 1 Forms A and B, which detail assets by type and country;
- Prudential Rule 26 – Schedule 2 Form A, which contains information on adviser and broking agreements, complaints, new policies and replacement policies; and
- Prudential Rule 32 – Parts 1-3, which detail half yearly market statistics including premiums and assets under management.

### **Obligations under the Insurance Act**

APRA requires extensive reporting from general insurers (see ICP 12) but currently only publishes a limited amount of this data and only at an aggregate level. APRA recognises that the public disclosure of pertinent information is an important way of improving market

responsiveness and of encouraging accountable corporate behaviour. To this end, APRA is reviewing its disclosure regime with a view to expanding the range of published information to facilitate the assessment of the financial strength of individual insurers by stakeholders. In evaluating such proposals, APRA has to consider confidentiality constraints and the concerns of insurers to the disclosure of information that is commercially sensitive, as well as taking account of international developments.

Work is advanced in the design of a new annual publication containing company specific general insurance statistics using data contained in audited annual returns submitted by insurers. The proposed publication will disclose key profit and loss, balance sheet and solvency data at an individual insurer level. Consultation with industry is pending.

## **Accessibility**

A person is entitled to inspect and obtain a copy or extract of certain public documents lodged with ASIC, including financial reports and directors' reports. Periodic reports lodged pursuant to AFSL holder obligations or other Corps Act obligations are accessible by the public. ASIC has also appointed a number of information brokers that can provide a copy of these documents on behalf of ASIC.

Announcements made to the market by a listed company, such as those provided to the ASX in accordance with LR 3.1, are available on the respective exchange's website.

## Surveillance

ASIC has various programmes in place to carry out inspections of AFSL holders on a routine basis, for example:

- a Financial Reporting Team within ASIC undertakes a variety of tasks to promote compliance with accounting standards and to ensure consistency and comparability of financial information presented to shareholders. ASIC has a Financial Accounts Surveillance Programme, which is an annual examination of the financial reports of selected listed entities; and
- ASIC monitors news items on a daily basis for specific company information with the goal of detecting continuous disclosure breaches, market manipulation cases and other market anomalies.

ASIC undertakes a risk-based approach to testing industry compliance with financial services laws within ASIC's jurisdiction. ASIC undertakes surveillance visits of entities and individuals, as well as engaging in pro-active or campaign-based surveillance work in areas in which ASIC perceives industry risk.

## ICP 27 Fraud

The supervisory authority requires that insurers and intermediaries take the necessary measures to prevent, detect and remedy insurance fraud.

*EC (a): The supervisory authority has the powers and resources to establish and enforce regulations and to communicate as appropriate with enforcement authorities, as well as with other supervisors, to deter, detect, record, report and remedy fraud in insurance.*

ASIC has the necessary investigative powers to enforce compliance with the laws and regulations under the ASIC Act, the Corps Act and the Insurance Contracts Act, to enable ASIC to deter, detect, record, report and remedy fraud in insurance. ASIC has a general power under the ASIC Act to commence investigations where there is a suspected contravention of:

- the corporations legislation; or
- a contravention of a law of the Commonwealth or a State or Territory that involves fraud or dishonesty and relates to a body corporate or managed investment scheme or to financial products (section 13 of the ASIC Act).

The ASIC Act confers various powers upon ASIC that enable it to administer and enforce laws relating to, among other things, fraud, including powers to:

- conduct examinations (section 19 of the ASIC Act);
- inspect books without charge (section 28 of the ASIC Act);
- issue notices to produce books (sections 30, 31, 32A, 33 of the ASIC Act);
- apply for a search warrant in relation to books not produced (section 36 of the ASIC Act);
- require AFSL holders to provide information to ASIC (section 912C of Corps Act); and
- require AFSL holders to give ASIC reasonable assistance on request (section 912E of the Corps Act).

Insurers and intermediaries, as AFSL holders, are subject to the conduct and disclosure obligations and licensing requirements for financial services providers. Market misconduct and other prohibited conduct relating to financial products and financial services are set out in Pt 7.10 of the Corps Act. For example, section 1041E proscribes false or misleading statements or information that is likely to induce people in Australia to apply for, dispose of, or acquire financial products. The ASIC Act also proscribes unconscionable conduct and consumer protection in relation to financial services (Pt 2, Div 2). For example, provisions relating to the prohibition of misleading representations (section 12BB of the ASIC Act), unconscionable

conduct in business (section 12CC of the ASIC Act) and misleading or deceptive conduct (section 12DA of the ASIC Act) are all effective tools against fraud.

Section 11 of the Insurance Contracts Act provides ASIC with the power to do all things that are necessary and/or convenient to be done in connection with the relevant legislation. Under the Insurance Contracts Act, ASIC may issue notices to insurers to provide documents detailing insurance cover and review any documents, statistics and particulars issued by the issuer and given to ASIC.

With regard to enforcement, ASIC has the power to cause a prosecution to be commenced (section 49 of the ASIC Act). In practice, ASIC only undertakes minor summary prosecutions and refers other matters to the Commonwealth Director of Public Prosecution (DPP) for prosecution. ASIC also has the power to commence criminal proceedings in relation to offences under the Corps Act. ASIC has the power to commence civil proceedings if ASIC considers it to be in the public interest to do so.

ASIC has certain administrative powers such as the ability to issue infringement notices for contraventions of a disclosing entity's continuous disclosure obligations under the Corps Act (section 1317D). ASIC also has the power to ban persons from being a director providing financial services (section 920A). ASIC has banned insurance agents on the grounds of misleading and deceptive conduct in relation to insurance transactions. These actions, with corresponding media coverage, should deter fraud in insurance.

A range of civil and criminal remedies is available to ASIC in its administration of the Corps Act. These include injunctive powers, ability to freeze assets and ability to wind-up companies or managed investment schemes. Furthermore, where fraud is established, ASIC may apply to Court for a declaration that there has been a breach of the civil penalty provisions (section 1317E). ASIC may then apply for a civil penalty order (section 1317J), seek compensation for damages suffered as a result of the breach (section 588J), and seek orders to ban the persons who have committed the fraud (section 206C).

ASIC has sufficient resources to achieve its target outcome of 'a fair and efficient market characterised by integrity and transparency and supporting confident and informed participation of investors and consumers'. In 2003-04, ASIC jailed 28 criminals, obtained 118 civil orders against people or companies, banned 22 people from directing companies and 42 people from offering financial services, and disciplined or deregistered 13 company auditors and liquidators for misconduct, in addition to discharging its other functions.

ASIC does not have a regulation-making power. This power resides with the Governor General (acting on the advice of the relevant Minister, which in this case is the Treasurer or one of the other portfolio Ministers). However, ASIC can (and does) impose licence conditions on AFSL holders that require them to do specific things over and above legislative requirements. For example ASIC could impose enhanced procedures around the handling of client funds if it thought that procedures in a licensee were lax or had been taken advantage of by a fraudulent employee. Enforceable undertakings are sometimes used in specific cases to achieve similar results.

As noted, ASIC liaises closely with the DPP in respect of prosecutions. ASIC has MOUs with APRA and AUSTRAC, enabling timely exchange of information and facilitating co-operation in the detection and investigation of fraud in the financial system.

*EC (b): Legislation addresses insurer fraud.*

The ASIC Act, the Corps Act, and the Insurance Contracts Act are the principal pieces of legislation that address insurer fraud, which may be administered and enforced by ASIC.

## **ASIC Act provisions**

Part 2, Div 2 proscribes unconscionable conduct and consumer protection in relation to financial services. More particularly, the following conduct is addressed:

- misleading representations regarding future matters;
- misleading or deceptive conduct;
- false or misleading representations;
- misleading conduct in relation to financial matters; and
- unconscionable conduct.

## **Corps Act provisions**

The Corps Act addresses such matters as:

- misstatements in, or omissions from takeover and compulsory acquisition and buy-out documents;
- misstatements in, or omission from, disclosure documents;
- the right to recover for loss or damage resulting from contravention;
- representations about future matters taken to be misleading if made without reasonable grounds;
- misleading or deceptive statements in, or omissions from, market disclosure statements;
- market manipulation;
- false trading and market rigging; creating a false or misleading appearance of active trading etc;

- false trading and market rigging, artificially maintaining etc trading price;
- false or misleading statements; and
- misleading or deceptive conduct (civil liability only).

## Insurance Contracts Act provisions

The Insurance Contracts Act contains provisions that address issues such as:

- the insured's duty of disclosure;
- ambiguous questions;
- warranties of existing facts to be representations;
- misrepresentation by life insured;
- certain statements not misrepresentations; and
- failure to answer questions.

### *EC (c): Claims fraud is a punishable offence.*

Fraud is a punishable offence under the ASIC Act, the Corps Act, the Insurance Contracts Act and under relevant State criminal codes.

Under the ASIC Act, misleading representations, misleading or deceptive conduct, false or misleading representations, and unconscionable conduct are a manifestation of fraud. They are punishable through the imposition of penalties, fines, injunctions, punitive and non-punitive orders, imprisonment, and such orders as the court thinks fit. The relevant provisions are contained in subdivision G of the ASIC Act.

Similarly, misstatements in, or omissions from takeover and compulsory acquisition and buy-out documents; misstatement in, or omission from, disclosure documents and product disclosure statements; misleading representations about future matters if the statement is made without reasonable grounds, and false or misleading statements are a manifestation of fraud. These offences are also punishable through the imposition of penalties, fines, injunctions, punitive and non-punitive orders, imprisonment, and such orders as the court thinks fit, under various provisions under the Corps Act.

Breaches of the Insurance Contracts Act involving general or life insurance may be punished through the avoidance of insurance contracts; restitution if it only relates to general insurance, or varying the contract if the fraud relates to life insurance. If the fraud relates to a misstatement of age, the insurer may apply to vary the contract by either substituting or

decreasing the amount payable according to the relevant formula provided for under the Insurance Contracts Act.

*EC (d): The supervisory authority requires insurers and intermediaries to ensure high standards of integrity of their business.*

ASIC has responsibility for monitoring and promoting the integrity of the market and the protection of consumers in relation to the financial system (section 12A of the ASIC Act). To this end, ASIC has put in place record keeping, disclosure, corporate conduct and licensing requirements to ensure insurers and intermediaries maintain a high standard of integrity within their businesses. The ASIC Act also contains consumer protection provisions that proscribe misleading and deceptive, and unconscionable conduct in relation to financial services.

Licensing requirements<sup>57</sup> are particularly effective in ensuring that insurers and intermediaries, and indeed the broader financial services industry, maintain high standards of integrity. ASIC is able to refuse to grant a licence, or where a licence is held, to revoke it, if ASIC has reason to believe that the applicant or licensee is not of good fame or character.

The Insurance Contracts Act also contains disclosure-like provisions that seek to discourage fraud.

Section 13 of the Insurance Contracts Act makes the duty to act with the utmost good faith an implied term of a contract of insurance, which ensures insurers and intermediaries maintain a high standard of integrity in their business. This principle, founded in common law, (also referred to as *uberrimae fide*) imposes a duty on all parties to an insurance contract to act honestly and fairly in dealing with each other.

Trust account obligations are another safeguard against fraud. Any money paid by, or on behalf of, a client to an AFSL holder must be held in trust by the AFSL holder, for the client where that money was paid in connection to a financial service or for a financial product (see ICP 24 EC (d)).

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<sup>57</sup> Refer ICP 24.

*EC (e): The supervisory authority requires that insurers and intermediaries allocate appropriate resources and implement effective procedures and controls to deter, detect, record and, as required, promptly report fraud to appropriate authorities. This function is under the responsibility of senior staff of the insurer and intermediary.*

Section 912A of the Corps Act imposes general requirements on an AFSL holder to have adequate financial, technological and human resources to provide the financial service and to carry out supervisory arrangements. It also requires the AFSL holder to have adequate risk management procedures in place. At a minimum, ASIC expects that AFSL holders will establish and maintain compliance measures, processes and procedures to ensure that, as far as reasonably practicable, the AFSL holder complies with the financial services laws, including those that proscribe fraud. ASIC also expects all AFSL holders to have in place monitoring and reporting processes and procedures, so that these compliance measures can be monitored and any compliance breaches can be reported and acted upon.

The onus is on an AFSL holder's management to ensure appropriate standards of conduct and adherence to proper procedures by the firm (PS 164 *Licensing: Organisational Capacities*). In this regard, ASIC will take into account the competency of the AFSL holder's responsible officers who are directly responsible for the significant day to day business decisions about the provision of the financial services. In the AFSL application, the applicant is required to nominate responsible officers and demonstrate how they meet the above requirements. In particular ASIC expects the applicant to provide evidence that each responsible officer has the knowledge and skills necessary to carry out their role.

AFSL holders are required to report to ASIC significant breaches or likely breaches of their obligations (including the majority of financial services laws) within 5 days after becoming aware of the breach (section 912D of the Corps Act). ASIC expects licensees to report to it fraud engaged in by their employees under this obligation.

Section 912A of the Corps Act does not apply to AFSL holders who are supervised by APRA as these entities would be subject to APRA prudential requirements. APRA requires licensed insurers to have in place robust risk management frameworks, encompassing comprehensive systems, structures, processes and people within the insurer to identify, assess, mitigate and monitor all internal and external sources of risk that could have a material impact on an insurer's operations (see ICP 18). APRA checks on insurers' risk management frameworks through regular on-site prudential reviews. Topic 3 under Module 6 *Risk Management* addresses fraud. APRA expects fraud risks and controls to be included in the reporting and monitoring process in an insurer's risk management framework.

APRA holds the Board and senior management responsible for meeting prudential requirements. Specifically in respect of risk management, an insurer's RMS must be approved by the Board. In addition, the Board must provide APRA with an annual Board Declaration that the Board is satisfied with the adequacy of, and compliance with, the insurer's risk management practices (see ICP 10)

To safeguard the investments and assets of life policyholders, the Life Insurance Act provides for the establishment of statutory funds in life companies. Part 4 of the Life Insurance Act stipulates strict rules to govern the operation of statutory funds and imposes a duty on directors to take reasonable care, and use due diligence, to protect the interests of policyholders. Directors guilty of breaching their duty are liable to make good any losses incurred by the life company.

*EC (f): As required, the supervisory authority ascertains that insurers take effective measures to prevent fraud, including providing counter-fraud training to management and staff. The supervisory authority promotes the exchange of information between insurers with respect to fraud and those committing fraud including, as appropriate, through the use of databases.*

Responsibility for ensuring compliance with the statutory obligations relating to licensing that are imposed by the Corps Act, and any AFSL conditions, is on the AFSL holder. ASIC expects the AFSL holder to have appropriate systems in place to monitor its compliance with the Corps Act and the obligations and conditions attached to the licence. ASIC sees the prevention of fraud as an implied requirement.

The requirement to provide counter fraud training to management and staff is implied in the statutory requirement that an AFSL holder maintain the competence to provide financial services. *Policy Statement 146 Licensing: Training of Financial Product Advisors* sets out minimum training standards for people who provide financial product advice to retail clients (training standards). Part A2.6 Insurance: sets out the specific knowledge that an advisor providing advice on insurance products should be able to apply. For example, it is expected an advisor providing insurance advice should have knowledge of the legal environment, particularly relating to disclosure and compliance. This includes:

- the role of the representative advisor, relevant legal principles contained in the Corps Act, the ASIC Act, Insurance Contracts Act, Life Insurance Act and the *Privacy Amendment (Private Sector) Act 2000*;
- the relationship between ethics and regulatory requirements (for example good faith, faith, utmost good faith, full disclosure of remuneration/fees and any other conflicts of interest which may influence the advisor's recommendation);
- relevant industry standards and codes of conduct;
- regulators' guidelines, including ASIC's, requirements for this policy; and
- complaints resolution procedures (both external and internal).

ASIC checks the effectiveness of internal processes and training including fraud prevention measures when conducting surveillances of licensees. APRA also checks on the adequacy of staff training and awareness in fraud in the course of its prudential review of insurers. Given staff are not likely to be experts in fraud management, APRA urges insurers to provide special

training to their staff on the potential sources of fraud and controls used in fraud risk management to guard against the occurrence of insurance fraud.

*EC (g): The supervisory authority cooperates with other supervisory authorities including, as appropriate, in other jurisdictions in countering fraud.*

ASIC cooperates with other supervisory authorities through sharing publicly available and confidential information, as well as exercising compulsory powers on behalf of other supervisory authorities, including foreign supervisory authorities.

ASIC is empowered to cooperate with a government or an agency of a foreign government by sharing confidential information under section 127(4)(c) of the ASIC Act.

ASIC can also cooperate through the provision of publicly available information on an unsolicited basis. Publicly available information may be shared as a matter of practice, or provided under either a bilateral MOU into which ASIC has entered, and/or the IOSCO Multilateral Memorandum of Understanding (MMOU), to which ASIC is a signatory. The MOUs that ASIC has entered into with various domestic and foreign authorities reflect a willingness to cooperate in respect of information exchange, investigative assistance and regulatory matters generally. The IOSCO MMOU provides an effective information sharing mechanism. The IOSCO MMOU facilitates the detection and deterrence of cross-border misconduct and assists ASIC to administer, monitor and enforce licensing and surveillance activities across borders.

ASIC can also cooperate with foreign supervisory authorities through compulsorily obtaining and transmitting information, documents or evidence to a foreign regulator for the administration and enforcement of a foreign business law under the *Mutual Assistance in Business Regulation Act 1992*. For proceedings in relation to a criminal matter or in respect of a foreign serious offence, ASIC can cooperate with foreign supervisory authorities under the *Mutual Assistance in a Criminal Matter Act 1987*.

Recent cases that required ASIC to liaise with overseas counterparts, such as the Cayman Islands Monetary Authority in the Triton and Trans Pacific case, and Bosnian authorities in relation to Australian companies writing insurance on behalf of Bosnian based insurer Grand Osiguranje, are indicative of ASIC's co-operation with other supervisory authorities.

## ICP 28 Anti-money laundering, combating the financing of terrorism (AML/CFT)

The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter, detect and report money laundering and the financing of terrorism consistent with the Recommendations of the Financial Action Task Force on Money Laundering (FATF).

*EC (a): The measures required under the AML/CFT legislation and the activities of the supervisors should meet the criteria under those FATF Recommendations applicable to the insurance sector.*

Currently the main AML/CFT legislation that affects financial institutions is the *Financial Transaction Reports Act 1988* (FTR Act) and the *Financial Transaction Reports Regulations 1990*, which are largely compliant with the FATF's Forty Recommendations (1996 version). The FTR Act imposes reporting, customer due diligence and document retention provisions on the broader cash dealer community. The term cash dealer is defined in section 3 of the FTR Act and includes insurers or insurance intermediaries.

The Australian Transaction Reports and Analysis Centre (AUSTRAC) supervises insurers and intermediaries only in relation to their obligations under the FTR Act. More generally, supervision of insurers is the responsibility of APRA, for prudential matters and ASIC for market conduct (see ICP 1).

Australia is in the process of undertaking a review of AML/CFT measures involving extensive consultation with industry. A draft exposure Bill is currently being prepared that will bring Australia's AML/CFT regime in line with the latest FATF recommendations. It will address areas of FATF interest including customer verification and ongoing due diligence requirements, suspicious and other threshold transaction reporting obligations, recordkeeping and other requirements relevant to the financial sector.

*EC (b): The supervisory authority has adequate powers of supervision, enforcement and sanction in order to monitor and ensure compliance with AML/CFT requirements. Furthermore, the supervisory authority has the authority to take the necessary supervisory measures to prevent criminals or their associates from holding or being the beneficial owner of a significant or controlling interest or holding a management function in an insurer or an intermediary.*

The framework for Australian financial sector regulation is organised on functional lines incorporating prudential regulation through APRA, market integrity and consumer protection through ASIC and broader financial system stability through the RBA. AUSTRAC complements this broader framework through its role as Australia's anti-money laundering/counter-terrorist financing (AML/CFT) regulator. AUSTRAC has a dual role as the financial intelligence unit (FIU). AUSTRAC is responsible for administering the FTR Act and is an agency within the

Attorney-General's portfolio, where policy responsibility for Australia's AML/CFT regime resides.

AUSTRAC's supervision of insurers and intermediaries relates only to compliance with the FTR Act. Part V and other provisions of the FTR Act provide for criminal sanctions or civil injunction powers. Part IVA of the FTR Act provides AUSTRAC with powers of inspection.

AUSTRAC has no role in supervising ownership or control of insurers or insurance intermediaries. Ownership of insurers is governed by the FSSA, which is administered by Treasury, with powers delegated to APRA below specified financial limits. Any changes in ownership control have to meet a national interest test and be approved by the Treasurer (see ICP 8).

APRA has powers, under both the Insurance Act and the Life Insurance Act, to disqualify persons from acting as directors or senior managers in insurance companies. APRA is also proposing minimum fit and proper requirements for individuals taking up responsible person positions in insurance companies (see ICP 7). Insurance intermediaries are required to hold an Australian Financial Services Licence (AFSL) or a relevant authority from an AFSL holder and are subject to Corps Act provisions (see ICP 24).

*EC (c): The supervisory authority has appropriate authority to cooperate effectively with the domestic Financial Intelligence Unit (FIU) and domestic enforcement authorities, as well as with other supervisors both domestic and foreign, for AML/CFT purposes.*

Pursuant to Regulation 5 of the Australian Prudential Regulation Authority Regulations, APRA may disclose protected information to AUSTRAC, the Australian Federal Police, the Police Force of a State or Territory, the Australian Crime Commission and the Australian Treasury, among others. Section 56 of the APRA Act allows APRA to disclose protected information to a financial sector supervisory agency (both domestic and foreign) where the disclosure will assist the recipient agency to perform its functions. APRA has entered into MOUs or exchange agreements with a number of domestic and overseas supervisors.

AUSTRAC currently has 43 exchange agreements allowing it to share financial intelligence with other FIUs. It also maintains partner agency agreements with a broad range of law enforcement, national security, revenue collection and social justice agencies (as listed in section 27 of the FTR Act) which enable the exchange of financial intelligence.

*EC (d): The supervisory authority devotes adequate resources - financial, human and technical – to AML/CFT supervisory activities.*

The resources are adequate for the regulatory responsibilities provided for in the FTR Act.

*Essential Criteria (e): The supervisory authority requires insurers and intermediaries, at a minimum those insurers and intermediaries offering life insurance products or other investment related insurance, to comply with AML/CFT requirements, which are consistent with the FATF Recommendations applicable to the insurance sector.*

Cash dealers, including insurers or insurance intermediaries, offering products considered to be accounts for the purposes of the FTR Act are obliged to ensure they obtain and retain the prescribed account opening and identification verification requirements.

Currently the customer due diligence requirements are limited to identification verification of signatories of products considered to be accounts for the purposes of the FTR Act. Identification verification generally occurs when an account is opened and where a cash transaction involving \$10,000 or more occurs. However, the insurance industry does not normally deal in cash transactions.

Insurers and insurance intermediaries also have reporting obligations under the FTR Act. They are required to report significant cash transactions (\$10,000 or more), all international funds transfer instructions and suspicious transactions.



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