

**Australia: Insurance Core Principles—Detailed Assessment of Observance**

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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE  
**AUSTRALIA**

INSURANCE CORE PRINCIPLES  
**DETAILED ASSESSMENT OF  
OBSERVANCE**

NOVEMBER 2012

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## GLOSSARY

A	Australian dollar
AASB	Australian Accounting Standards Board
ACCC	Australian Competition and Consumer Commission
ADIs	Authorized deposit-taking institutions
AFSL	Australian Financial Services License
ADJR Act	Administrative Decisions (Judicial Review) Act 1977
APRA	Australian Prudential Regulatory Authority
APS	Australian Public Service
ASIC	Australian Securities and Investment Commission
ASIC Act	Australian Securities and Investments Commission Act 2001
ASX	Australian Securities Exchange
ATO	Australian Tax Office
AUASB	Auditing and Assurance Standards Board
AUSTRAC	Australian Transaction Reports and Analysis Centre
CA	Corporations Act 2001
CAC Act	Commonwealth Authorities and Companies Act 1997
CARI Team	Consumer and Retail Investors Team
CFR	Council of Financial Regulators
DCI Team	Deposit Takers Credit and Insurers Team
DMFs	Discretionary mutual funds
DOFIs	Direct Offshore Foreign Insurers
DPP	Commonwealth Director of Public Prosecutions
D2A	Direct to APRA
EFLIC	Eligible Foreign Life Insurance Company
FAs	Financial advisers
FATA	Foreign Acquisitions and Takeovers Act 1975
FATF	Financial Action Task Force
FCMP	Financial Crisis Management Plan
FCR	Financial Condition Report
FCS	Financial Claims Scheme
FCODA	Financial Sector (Collections of Data) Act 2001
FMA Act	Financial Management and Accountability Act 1997
FIU	Financial Intelligence Unit
FOFA	The Future of Financial Advice
FOS	Financial Ombudsman Service
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSG	Financial Services Guide
FSGRTB	Financial Sector (Group Restructure and Transfer of Business) Act 1999
FSSA	Financial Sector (Shareholdings) Act 1998
FTR Act	Financial Transaction Reports Act 1988
GPS	General Insurance Prudential Standards
IAAust	The Institute of Actuaries of Australia
IAIS	International Association of Insurance Supervisors
IATA	Insurance Acquisitions and Takeovers Act 1991
ICA	Insurance Contracts Act 1984

ICAAP	Internal Capital Adequacy Assessment Process
ICPs	Insurance Core Principles
IFRS	International Financial Reporting Standards
IMB	Internal Model-Based
ILVR	Insurance Liability Valuation Report
LAGIC	Life and General Insurance Capital Review
LMIs	Lenders' mortgage insurers
LPS	Life Insurance Prudential Standards
LSD	Legal Services Directions 2005
MCR	Minimum capital requirement
MoC	Memorandum of Cooperation
MoU	Memorandum of Understanding
MMoU	Multilateral MoU
MPR	Money Protection Ratio
NOHC	Non-operating holding company
NPPs	National Privacy Principles
NZ	New Zealand
OBPR	Office of Best Practice Regulation
ORSA	Own risk and solvency assessment
PAIRs	Probability and Impact Rating System
PCA	Proceeds of Crime Act 2002
PCR	Prescribed Capital Requirement
PDS	Product Disclosure Statement
PER	Performing Entity Ratio
PHIA	Private Health Insurance Act 2007
PHIAC	Private Health Insurance Administration Council
RBA	Reserve Bank of Australia
RBNZ	Reserve Bank of NZ
RIS	Regulation Impact Statement
SAI	Supervisory Attention Index
SAP	Supervisory Action Plan
SMR	Suspicious Matter Reports
SOARs	Supervisory Oversight and Response System
SPV	Special Purpose Vehicle
SUSTR	Suspect Transaction Report
Treasurer	Australian Treasurer
UFI	Unauthorized Foreign Insurers
ULPs	Unit-linked policies

## EXECUTIVE SUMMARY

**The insurance industry in Australia has weathered the global financial crisis well and was resilient to the catastrophic events in 2010/11.** The insurance industry is mature but relatively small compared to the banking sector. Assets held by insurers represented only about 8 percent of the financial system total assets as at end-2011. Since 2007, the insurance market has been consolidating steadily as the total number of players fell from 190 to 172 although branches of foreign-owned general insurers rose from 36 to 43. The industry was comprised of 24 life insurers, 108 general insurers, 19 reinsurers, 7 captive general insurers and 14 friendly societies as at end-June 2011.

**The life insurance industry is concentrated and is focused on wealth management products, mostly related to superannuation products.** The top three life insurers accounted for 66 percent of total life industry assets as at end-June 2011. Wealth management products made up almost 70 percent of life insurance business. However, life insurers' share of superannuation assets had fallen from a peak of 44 percent 20 years ago to 15 percent of total superannuation assets. This reduction is partly due to conglomerate groups writing superannuation investment business outside their insurance entities. The four banking groups continue to dominate the Australian wealth management markets partly through wholly-owned life insurance subsidiaries. Risk insurance business has been growing at more than 10 percent annually in recent years, largely boosted by the default insurance cover offered by superannuation schemes. The key risks for the life insurance industry include depressed financial markets with adverse impact on investment performance, inadequate pricing (e.g., for group risk schemes) and the refocussing of their strategies in response to domestic and global regulatory developments.

**The general insurance industry offers a diversified range of products and is dominated by the larger insurance groups.** Property and motor insurance accounted for more than half of general insurance business for the past three years. The top three insurers accounted for about 75 percent of earned premiums from personal lines in 2010/11 although there is less concentration in commercial lines. Of the 19 insurance groups, only QBE Insurance Group had a significant share of its operations overseas. The key risks for the general insurers are catastrophic exposures and reinsurance concentration and placement risks. Despite the spate of natural disasters in 2010/11 (e.g., flood in Queensland and earthquake in Christchurch), general insurers reported profits, albeit at a lower level. While insurers' gross exposures were dampened by their reinsurance programs, reinsurers have raised renewal rates and some reinsurers were reluctant to write lower layers of catastrophe cover or offer aggregate reinsurance programs.

**The Australian authorities have made significant progress in updating the insurance regulatory regime since the initial FSAP in 2006.** Australia adopts a functional regulatory structure. The Australian Prudential Regulation Authority (APRA) is responsible for the prudential regulation and supervision of regulated institutions while the Australian Securities and Investment Commission (ASIC) is responsible for market conduct regulation and supervision. Significant progress has been made in addressing the 2006 recommendations: the implementation of Stage II reforms and Level 2 supervision of general insurance groups; broadening the enforcement powers of APRA; restrictions on unauthorized foreign insurers; and greater clarity in the Treasurer's role in supervisory matters. Currently, APRA is

consulting on enhancing and harmonizing the capital regimes for life and general insurers and the introduction of Level 3 supervision of financial conglomerates.

**The updated regulatory framework has a high level of observance with the ICPs, supported by robust prudential supervision by APRA.** The risk-based supervision framework is comprehensive and well-documented, which facilitates supervisory risk assessments. APRA has established internal policies and processes to promote prompt and consistent supervisory actions. More importantly, APRA has adequate supervisory resources and technical capacity to conduct effective supervision. Industry participants have high regard for APRA supervisors. While there are some minor gaps in the regulatory regime, APRA seeks to address these through its supervisory process, wherever practicable.

**There is scope to review the effectiveness of the current regulatory regime and supervisory approach relating to the conduct of business by insurers and insurance intermediaries.** In supervising the large numbers of licensees with limited resources, ASIC has adopted a predominantly desktop approach to supervision. Supervisory activities are typically triggered by industry intelligence, complaints and breach reports submitted by licensees. The authorities are advised to consider broadening ASIC's legal power in ensuring fair treatment of customers, e.g., group-wide market conduct requirements, claims handling practices; servicing of life policies; and requiring insurers to take accounts of interests of different types of customers during product development. It is critical that ASIC be equipped with adequate supervisory resources, including the technical capacity for effective and proactive supervision of insurers' conduct of business.

## I. ASSESSMENT OF INSURANCE CORE PRINCIPLES

### A. Introduction and Scope

1. **This assessment provides an update on the significant regulatory and supervisory developments in the insurance sector of Australia since 2006.** The current assessment was conducted by Michael Hafeman (external expert engaged by the IMF) and Su Hoong Chang (Senior Financial Sector Expert, International Monetary Fund (IMF)) from April 30 – May 15, 2012. Australia undertook an initial Financial Sector Assessment Program (FSAP) in 2006, which included a formal assessment of its observance with the Insurance Core Principles (ICPs) issued by the International Association of Insurance Supervisors (IAIS) in 2003. The Financial Stability Board has conducted a peer review of the authorities' implementation the recommendations arising from the 2006 assessment and issued its report in September 2011.

2. **The current assessment is benchmarked against the ICPs issued by the IAIS in October 2011.** The ICPs apply to all insurers, whether private or government-controlled. Specific principles apply to the supervision of intermediaries. The ICPs are presented according to a hierarchy of supervisory material:

- a) ICP statements prescribe the essential elements that must be met in order to achieve observance;
- b) Standards are linked to specific ICP statements and set out the key high level requirements that are fundamental to the implementation of the ICP statement; and
- c) Guidance material provides detail on how to implement an ICP statement or standard.

### B. Information and Methodology Used for Assessment

3. **The level of observance for each ICP reflects the assessments of its standards.**

Each ICP is rated in terms of the level of observance as follows:

1. Observed: where all the standards are observed except for those that are considered not applicable. For a standard to be considered observed, the supervisor must have the legal authority to perform its tasks and exercise this authority to a satisfactory level.
2. Largely observed: where only minor shortcomings exist, which do not raise any concerns about the authorities' ability to achieve full observance.
3. Partly observed: where, despite progress, the shortcomings are sufficient to raise doubts about the authorities' ability to achieve observance.
4. Not observed: where no substantive progress toward observance has been achieved.

4. **The assessment is based solely on the laws, regulations and other supervisory requirements and practices that are in place at the time of the assessment.** Ongoing regulatory initiatives are noted by way of additional comments, e.g., proposed Level 3 supervision of financial conglomerates and the Life and General Insurance Capital Review (LAGIC). A comprehensive self-assessment and other pertinent information (reports, studies, consultation papers, public statements, directives, etc.) provided by the authorities facilitated a meaningful assessment. The assessors also benefitted from the valuable inputs and

insightful views from meetings with insurers, industry and professional organizations, as well as representatives of the Private Health Insurance Administration Council and the Motor Accidents Authority of New South Wales, which are responsible for overseeing specific segments of the insurance market.

5. **The assessors are grateful to the authorities for the full cooperation, thoughtful logistical arrangements, including the helpful co-ordination of various meetings with industry participants.** Technical discussions with and briefings by officials from APRA and ASIC have enriched the analysis in this report.

### C. Overview—Institutional and Macro Prudential Setting

#### Market Structure and Industry Performance

6. **The insurance industry in Australia is relatively small in asset size compared to the banking sector.** Life and general insurance accounted for a small share of total financial system assets (Table 1). In contrast, authorized deposit-taking institutions (ADIs)<sup>1</sup> represented nearly 60 percent of total financial system assets, with the four dominant banks<sup>2</sup> representing about 75 percent of total ADI assets.

**Table 1. Insurance Industry's Share of Total Financial Sector Assets**  
(in A\$ billions)

	Assets as at 30/06/2011	Percentage of total
General insurers	115	2.6%
Life insurers	235	5.2%
APRA-regulated institutions	3,972	88.3%
<b>Total financial sector assets<sup>3</sup></b>	<b>4,497</b>	

Source: APRA.

7. **The penetration and density of the Australian insurance market are generally lower compared to other industrialized economies** (Table 2). The insurance penetration ratios for both life and general insurance were less than 3 percent compared to the averages (as at end-2010) recorded by industrialized countries of 5.1 percent and 3.8 percent, respectively. Similarly, the premiums density of Australia is lower than the average for industrialized countries of US\$ 2,069. However, the insurance density achieved by Australian general insurers was higher than the average for industrialized countries (US\$ 1,458).<sup>4</sup> Feedback from industry suggested under-insurance of Australians in both life and general

<sup>1</sup>Authorized Deposit-taking Institutions (ADIs) are corporations which are authorized under the Banking Act 1959. ADIs include; banks; building societies; and credit unions. All ADIs are subject to the same Prudential Standards but the use of the names 'bank', 'building society' and 'credit union' is subject to corporations meeting certain criteria.

<sup>2</sup> Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank, and Westpac Banking Corporation.

<sup>3</sup>APRA-regulated institutions and non-APRA regulated superannuation.

<sup>4</sup> Source: World Insurance in 2010, Swiss Re.

insurance, due at least partly to the implications of high premium taxes in some states and the fact that Australian life insurers write very little savings and investment business, apart from superannuation business.

8. **After two decades of consolidation, the number of insurers has remained relatively stable over the period since 2006** (Table 3). The number of captive insurers remained small. With the introduction of the insurance-group supervision framework (termed as Level 2 supervision) in 2009, there were 19 authorized general insurance groups as at end-June 2011. Level 2 supervision does not apply to life insurers. Notably, more foreign general insurers are tapping into the Australian market, as indicated by the increase in the foreign branches from 36 to 43, and a few new entrants obtained authorization in response to the change in the previous Direct Offshore Foreign Insurers (DOFI) regime.<sup>5</sup> There are no foreign life insurance branches in Australia.

**Table 2. Insurance Penetration and Density as at 30 June 2011**

	Insurance Penetration (As % of GDP)	Insurance density (US\$ per capita)
General		
Direct (include captives)	2.5	1,463
Reinsurance	0.1	88
Life		
Direct	2.7	1,817
Reinsurance	0.2	121

Source: APRA

**Table 3. Trend in Insurance Market Structure**

<i>As at end-June</i>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Life	28	26	26	26	24
General	104	106	108	110	108
Reinsurance	27	24	22	18	19
<i>Life</i>	6	6	6	6	7
<i>General</i>	21	18	16	12	12
Captive	6	6	8	8	7
Friendly societies	25	24	19	16	14
<b>Total Insurers</b>	<b>190</b>	<b>186</b>	<b>183</b>	<b>178</b>	<b>172</b>
<i>Supplementary information</i>					
Foreign branches (General)	36	40	45	47	43
Insurance groups-General	NA	NA	12	18	19

Source: APRA

9. **The majority of insurers are Australian owned** (Table 4). Of the 108 direct general insurers, 97 were owned by non-financial entities, with banks owning only 9 general insurers. In contrast, 9 out of the 24 life insurers were owned by Australian banks and they focus mainly on wealth management products. On the other hand, insurance and fund management typically account for only 3 to 8 percent of the group income for the four large domestic banks.

<sup>5</sup>IA was amended in 2008 to require DOFIs be authorized by APRA, unless specific exemption provisions are met. This was one of the recommendations arising from the 2006 FSAP. Please refer to details in ICP 4 on Licensing.

10. **Insurances delivered by the social security system are not regulated by APRA.** These include: a) health, disability and sickness insurance provided by the Department of Human Services through Medicare and Centrelink; b) workers' compensation insurance, builder's warranty insurance and accident insurance for motor accident injuries provided by state statutory authorities in some states; c) medical indemnity reinsurance provided by the Department of Health and Ageing; and d) terrorism reinsurance provided by the Australian Reinsurance Pool Corporation (commercial lines only).

**Table 4. Ownership Structure as at 30 June 2011**

	Life	Non-life	Reinsurance	Captives
<u>Domestic</u>				
Banks	9	8	1	1
Securities firms	0	0	0	0
Non-financial entities <sup>6</sup>	10	51	0	6
Public sector	0	0	0	0
	19	59	1	7
<u>Foreign</u>				
Banks	0	1	0	0
Securities firms	1	2	0	0
Non-financial entities	4	46	17	0
Public sector	0	0	1	0
	5	49	18	0

Source: APRA

### Life insurance industry

11. **The life insurance industry in Australia is dominated by three groups when measured by assets, with a low level of overseas operations.** However, there is much greater diversification when measured by life insurance cover because a number of life insurers focus on term life and disability income insurance. The top three life insurers<sup>7</sup> accounted for 66 percent of the total assets of life insurers as at end-June 2011. This trend continued in 2010/11 and further rationalization of the multiple licenses held by a number of financial groups is expected in the near term. Of the top 10 life insurance groups, only three had overseas operations.<sup>8</sup> However, more than 99 percent (weighted average) of their premiums were sourced domestically. In terms of ownership, 92 percent of the life industry's assets were held by Australian owners, with French owners having a 6 percent interest.<sup>9</sup>

12. **The broader financial services industry has moved away from the traditional business model that utilized life insurers for wealth creation business. Notwithstanding this, much of the life insurance market is focused on wealth management business** (Table 5). Driven by tax and government policies, wealth management products (mainly in the form

<sup>6</sup>Non-financial entities include all entities which are not banks, securities firms or public sector agencies. Examples include other insurance companies, retail shareholders, offshore listed companies and NOHCs.

<sup>7</sup>AMP Life Limited, MCL Limited and OnePath Life Limited.

<sup>8</sup>AMP, Colonial and Swiss Re.

<sup>9</sup> The remaining 2 percent ownership stake was distributed between the US, Switzerland, Germany and Hong Kong.

of unit-linked policies) comprised almost 70 percent of business in 2010/11. Life insurers offer superannuation products through statutory funds,<sup>10</sup> totaling A\$ 38.7 billion as at end-2010 or 3 percent of total superannuation assets. However, life insurers' share of total Australian superannuation assets had fallen from its peak of 44 percent 20 years ago to 15 percent in early 2012. Despite this trend, life insurers' superannuation assets continued to grow at 6 percent per annum, due largely to investment earnings.

13. **The four banking groups continue to dominate the Australian wealth management and life insurance markets.** Notably, life insurers must hold capital resources for their wealth management products compared to competitors in the other financial industries. The merger of AMP and AXA Asia Pacific Holdings' Australian and New Zealand business was completed in March 2011, with increased size and resources to rival the big four banks in the wealth management segment.<sup>11</sup>

**Table 5. Major Lines of Life Insurance Business**  
(in A\$ million)

	Net Premiums Written			Percent
	2009	2010	2011	
<b>Domestic risks</b>				
Participating <sup>12</sup>	2,888	2,658	1,668	4.7%
Non-participating	-	-	-	
Term <sup>13</sup>	5,540	6,443	6,842	19.2%
Annuities	913	1,069	1,912	5.4%
Unit-linked <sup>14</sup>	31,969	27,835	24,911	69.8%
<b>Foreign risks</b>				
Participating	112	93	86	0.2%
Term	228	224	233	0.7%
Unit-linked	33	26	23	0.1%
<b>Total</b>	<b>41,684</b>	<b>38,347</b>	<b>35,674</b>	<b>100.0%</b>

Source: APRA

14. **In recent years, life risk insurance business has been growing at a fairly constant rate,** and expanded by 10 percent in 2010. A key contributor to this growth is the default level of insurance cover provided by many superannuation schemes. The key products are mainly age-rated guaranteed renewability policies for death, disability covers, etc. Products catering for retirement, e.g., allocated pension (unitized market-linked) have been popular for many

<sup>10</sup>A life insurer must maintain one or more statutory funds in respect of its life insurance business. A life insurer is required to credit a statutory fund with all amounts attributable to that fund, and assets of the fund are only available for expenditure properly related to the fund. Life insurers are also subject to various statutory and prudential obligations in respect of statutory funds. However, a statutory fund is not a distinct legal entity and does not operate as a trust concept. The statutory funds exclude superannuation funds operated through other investment vehicles offered by life insurers, which are recorded as assets held in the superannuation sector.

<sup>11</sup>The merged entity has A\$ 130 billion in funds under management.

<sup>12</sup>Participating (or with-profits) includes conventional and participating investment account. Conventional includes whole life policies and endowment policies.

<sup>13</sup>Term includes individual and group lump sum risk and disability income insurance products.

<sup>14</sup>Unit-linked includes non-participating investment policy and other products. Non-participating investment policies include non-participating investment account and investment linked policies.

years. However, there is little interest in annuities. Life policies are mainly distributed by independent or aligned advisers but direct sales (television, internet, etc.) have been growing rapidly in recent years, albeit from a small base. An increasing number of life insurers are offering simple products (low-value funeral plans, etc.) through direct channels, often targeted at the lower social economic demographics; APRA is closely monitoring the potential operational and reputational risks.

**15. The bulk of life insurers' assets were held in equities (A\$ 117 billion or 51 percent) and debt securities (A\$ 71 billion or 31 percent) as at end-June 2011.** Total assets rose by 1.5 percent from A\$ 227 billion to A\$ 230 billion, the growth coming almost entirely from investment earnings. The high proportion of equity investments was largely attributable to life insurers' unit-linked policies (ULP) portfolio. Cash and bank balances totaled A\$ 17.4 billion.

**16. Profitability of life insurers has stabilized although remained uneven, reflecting the diversified range of business models.** In general, profitability has stabilized at a level achieved prior to the 2008/09 global financial crisis, driven largely by investment earnings on reserves and retained profits for non-investment-linked business. While aggregate claims experience had deteriorated recently, it would appear to be insurer-specific and not widespread. Profits from pricing margins for group and wholesale business have been eroding due to intensifying competition and the stronger bargaining power of the increasingly-large industry superannuation funds.

**17. The overall capital adequacy coverage ratio<sup>15</sup> for the life insurance industry was 142 percent as at end-June 2011,** a slight decrease from the 149 percent as at end-2009/10. The aggregate technical provisions (TP) maintained by life insurers was A\$ 201.8 billion, which accounted for 88 percent of total liabilities. Total shareholders' funds amounted to A\$ 16.2 billion.

**18. The key risks for the life insurance industry include depressed financial markets, inadequate pricing and strategic risks.** In response to the heightened market uncertainty from the middle of 2011, APRA has been monitoring emerging developments closely. There were concerns over the sustainability of pricing for large group risk schemes given a trend towards reductions in premiums and generous profit sharing arrangements. Life insurers are reviewing their strategies, business models and practices to prepare for various policy and legislative changes, e.g., government policies on financial advice (and remuneration), superannuation reforms and proposed changes in the prudential standards, e.g., enhanced/harmonised capital regime. In response, life insurers may have to refocus their strategies, capital management, governance, compliance, distribution channels and required competence to deal with the changes. The move by some life insurers to the greater use of direct marketing channels may pose underwriting and pricing risks.

### **General Insurance Industry**

**19. There is high concentration in the personal lines of business.** The top three insurers for this segment accounted for about 75 percent of earned premiums in 2010/11. The commercial lines are more diversified across the general insurers. Most commercial lines of business were placed through brokers, while personal lines were mainly sold by direct marketing channels. Of the insurance groups, only QBE Insurance had a significant share of

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<sup>15</sup>The total available capital adequacy reserve divided by the required capital adequacy reserve.

its operations overseas, which represented more than two-thirds of its premiums for 2010/2011 and assets as at end-June 2011.

20. **Property and motor insurance accounted for more than one-half of general insurance business for the past three years** (Table 6). The growth in property (including householders) premium in 2010/2011 could be attributed to increased premiums rates in response to a series of natural catastrophes. Growth in domestic motor vehicle premium has started to plateau due to pricing competition amongst incumbents and the entry of new players in this profitable class of business. The overall net retention ratio for the past three years has been relatively high at around 75 percent. Compulsory lines of business include workers' compensation, compulsory third party insurance for motor vehicle drivers and builders/home warranty insurance in some states.

**Table 6. Major Lines of General Insurance Business**  
(in A\$ million)

	Gross Premiums written			
	2009	2010	2011 <sup>16</sup>	
<b>Domestic risks</b>				
Motor	7,780	8,339	8,433	26.1%
Property <sup>17</sup>	7,758	8,472	8,883	27.5%
Liabilities <sup>18</sup>	6,828	7,262	7,374	22.8%
Accident and health	947	968	1,013	3.1%
Others <sup>19</sup>	5,490	5,106	5,463	16.9%
	28,804	30,148	31,167	96.3%
<b>Foreign risks</b>				
Motor	28	56	53	0.2%
Property	124	127	156	0.5%
Liabilities	191	188	187	0.6%
Accident and health	33	41	30	0.1%
Others	780	745	755	2.3%
	1,156	1,156	1,182	3.7%
<b>Total</b>	29,960	31,304	32,348	

Source: APRA

21. **Total assets of general insurers rose 14 percent to reach A\$ 100 billion as at end-June 2011**, A\$ 12.7 billion was invested in government securities and A\$ 17.6 billion in corporate securities (mainly in banks). Reinsurance recoverables totaled A\$ 15.2 billion, with more than 90 percent due from reinsurers rated A or above. Cash and bank balances amounted to only A\$ 1.7 billion. General insurers' intra-group receivables totaled A\$ 4 billion.

<sup>16</sup>APRA changed the reporting framework from a written concept to an earned concept as of 1 July 2010. Figures from September 2010 are reported on an AASB 1023 basis. Prior figures are based on a prospective reporting framework.

<sup>17</sup>House-owners/householders, fire and industrialized special risks.

<sup>18</sup>Professional indemnity, Employers' Liability, Public and product liability, compulsory third party motor vehicle.

<sup>19</sup>Travel, Marine, Aviation, Consumer credit, Mortgage, Other as well as reinsurance business written by direct insurers.

22. **Despite the spate of natural disasters in 2010/11, general insurers reported profits, albeit at a lower level.** Gross losses from the Christchurch earthquake were estimated at A\$ 11.2 billion, although the impact was dampened by insurers' reinsurance programs and stronger investment income.<sup>20</sup> However, higher claims arising from the catastrophes resulted in reinsurers raising their renewal rates and some reinsurers have subsequently been reluctant to write lower layers of catastrophe cover or offer aggregate reinsurance programs. Consequently, many insurers retained higher catastrophe risks and APRA has been monitoring the situation closely to ensure prudent risk retention is maintained. Some insurers have passed the higher costs to policyholders through higher premiums, particularly for home building and contents policies.<sup>21</sup> In 2011, insurers also had to increase their TP for long-tail claims due to the decline in risk-free interest rates used to discount liabilities. The resulting small underwriting loss was mitigated by higher valuation gains from their duration-matched assets.

23. **Mortgage debt levels and elevated housing prices are key vulnerabilities for the lenders mortgage insurance (LMI) sector.** While the overall LMI sector was supported by a strong Australian economy and a sustainable immigration rate that held up housing prices, this positive outlook could be undermined by extended weakness in the global market.

24. **The general insurance industry remains well-capitalized, holding capital resources equivalent to 175 percent of the minimum capital requirement as at end-June 2011.** This was a slight decrease from 191 percent as at end-June 2010, largely attributable to increases in required capital for the higher reinsurance recoveries and insurance concentration risk. TP increased significantly from A\$ 51.9 billion to A\$ 64.8 billion (65 percent of total liabilities). Aggregate shareholders' funds amounted to A\$ 25.1 billion (A\$ 25.9 billion as at end-June 2010). Intra-group liabilities totaled A\$ 4.3 billion or 17 percent of shareholders' funds.

25. **The key risks for the general insurers are their exposures to catastrophic events and the counterparty risks arising from the reinsurance programs.** The spate of natural disasters in Australia and New Zealand during 2010/11 has heightened insurers' vigilance with regards to these risks. APRA also expects insurers to enhance their stress testing, including taking into consideration potential increases in reinsurance rates and severe reduction in reinsurance capacity.<sup>22</sup> The Natural Disaster Insurance Review commissioned by the Australian Government released its final report in November 2011, and the recommendations included requiring insurers to provide flood cover as a standard in home building and contents policies. The Review also recommended a government agency to coordinate national flood risk management, including flood mapping, to enhance the industry's understanding of and ability to price flood risks. The proposed review and harmonization of the capital standards for life and general insurers may also have significant implications for some general insurers.

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<sup>20</sup>The gross losses arising from the March 2010 Melbourne and Perth storms and December 2010 Queensland floods were estimated at A\$ 42.6 billion by the Insurance Council of Australia.

<sup>21</sup>For example, affordability of insurance coverage became an issue in some segments such as strata title insurance for apartment buildings in North Queensland.

<sup>22</sup>APRA has established a small unit of specialist staff to conduct a targeted review of insurers with material property exposures to assess their reinsurance strategies and changes to their reinsurance arrangements in response to these events.

## Reinsurance

26. **The scale of APRA-authorized reinsurance operations in Australia is small.** The top three **general** reinsurers by gross earned premiums were Munich Re, Swiss Re and Hannover Re, all of which operate in Australia through branches. General Re is the only APRA-authorized general reinsurer that is locally incorporated. The top three APRA-authorized life reinsurers are Swiss Re, Munich Re and RGA Reinsurance Company, all of which operate through locally-incorporated companies. Some reinsurers underwrite both direct and reinsurance business. Net premiums of life reinsurers amounted to A\$ 1.6 billion in 2010/11, an increase of 12 percent from 2009/10. APRA-authorized general reinsurers wrote about A\$ 1.5 billion, a marginal increase from 2009/10.

27. **Despite the relatively lower life insurance penetration and the typically lower cessions by life insurers, there were more life reinsurers (12) than general reinsurers (7).** Reinsurance premiums in respect of life business hovered around A\$ 1.5 billion for the past three years. Reinsurance premiums for general business were also about A\$ 1.4 billion for the same period. A new life reinsurer (SCOR Re) was admitted into the saturated life insurance market in Australia.

## Institutional Framework and Arrangements

28. **Australia adopts a functional regulatory structure.** APRA is responsible for the prudential regulation of ADIs, life and general insurers (including reinsurers) and most of the superannuation industry. ASIC is responsible for market conduct regulation and supervision, promoting market integrity and consumer protection across the financial services sector. The Reserve Bank of Australia (RBA) is responsible for monetary policy as well as overseeing financial system stability and the payments system.

29. **All the three financial sector authorities are statutory authorities and share responsibility with the Treasury for the stability, efficiency and integrity of the financial system.** The Treasury advises the Australian Government on: a) the framework for financial sector regulation, as well as on policy and possible reforms to promote the stability and efficiency of the financial system; b) matters relating to the exercise of the Treasurer's powers; and c) the broader economic and fiscal implications of developments that pose a threat to the stability of the financial system.

30. **The Council of Financial Regulators (CFR) serves as a coordination forum for the three regulatory agencies and the Treasury, with the objectives of contributing to the efficiency and effectiveness of regulation and the stability of the Australian financial system.** The CFR is a non-statutory body chaired by the Governor of the RBA and plays an active role in reviewing global market conditions, coordinating advice to the Government and enhancing Australia's crisis management arrangements. It regularly forms working groups with agreed terms of reference to undertake more detailed policy development. During the global financial crisis in 2008/09, the CFR was the focal point for agency cooperation.

31. **The CFR agencies have a long history of effective inter-agency cooperation and coordination on financial sector policy issues** through: a) overlapping representation on the agencies' boards: one APRA member sits on the RBA Payments System Board and the Secretary to the Treasury sits on the RBA Board; b) bilateral Memoranda of Understanding (MoU) between CFR members and an MoU on Financial Distress Management among the four CFR member agencies; c) regular bilateral coordination arrangements, e.g., the RBA-APRA Coordination Committee comprising senior executive staff from both agencies, which

meets approximately every six weeks; and d) legislation that allows APRA and the RBA to share institution-level data to carry out their respective duties. Underlying all these formal structures is a culture of cooperation and collegiality.

32. **The four CFR agencies work together to closely coordinate crisis management polices and responses.** APRA, as the prudential supervisor, is the lead resolution authority. A number of enhancements have been made to the crisis management framework in the last five years. These include strengthening APRA's statutory powers, formalizing the CFR's coordination arrangements, implementing the Financial Claims Scheme, developing crisis resolution strategies in respect of ADIs, and conducting ADI crisis simulation exercises. The CFR agencies have also worked with their New Zealand counterparts to operationalize cross-border crisis resolution coordination arrangements.

33. **APRA has embarked on two major regulatory initiatives in 2011/12: to enhance the solvency regimes for insurers and formalize conglomerate supervision.** One is an updating and harmonization (where appropriate) of capital requirements for general and life insurers, including enhancing the risk-sensitivity of the capital framework. APRA expects to release the final revised capital standards in May 2012, with an effective date of 1 January 2013. APRA has also issued a consultation paper on the development of a prudential framework for conglomerate groups, referred to as Level 3 Supervision.

34. **The regulation of private health insurance in Australia is primarily conducted under the Private Health Insurance Act 2007 (PHIA) and by the Private Health Insurance Administration Council (PHIAC) in relation to prudential supervision.** PHIAC has close links with APRA. Private Health Insurance is an intrinsic element of Australia's overall health system and is community rated, and not underwritten by health status. A risk-equalization trust fund is maintained in the sector to make up for the lack of underwriting. The Private Health Insurance Ombudsman deals with consumers' complaints, health service provider and insurer contracting arrangements, and the conduct of agents and brokers. The Department of Health and Ageing also has regulatory powers, and focuses on pricing and product features. Other regulators with a role in the regulation of private health insurance include the Australian Competition and Consumer Commission (ACCC), which considers any competition issues (in consultation with PHIAC) and ASIC, in relation to the operation of the corporate entities.

#### **D. Preconditions for Effective Insurance Supervision**

##### **Sound and Sustainable Macroeconomic and Financial Sector Policies**

35. **The macroeconomic and fiscal policy framework in Australia is well established.** The *Charter of Budget Honesty Act 1998* requires the Government to clearly and regularly outline its fiscal strategy and report on its fiscal objectives and expected outcomes. After taking fiscal measures to support the Australian economy during the global financial crisis, the Government's current fiscal strategy is aimed at achieving a budget surplus in 2012/13. The RBA has established procedures to ensure transparency and accountability of its monetary policies and has committed to keeping the average inflation rate at between two and three percent.

36. **Regulatory proposals of APRA and ASIC must comply with the Government's policy on best practice regulation.** The Office of Best Practice Regulation (OBPR)<sup>23</sup> is part of the Deregulation Policy Division (DPD) of the Department of Finance and Deregulation. The OBPR promotes the Government's objective of improving the effectiveness and efficiency of regulation. The DPD assists the Ministers responsible for deregulation through providing policy advice and support to reform poorly-performing government operations and regulations. The OBPR reports to the government annually on the compliance of various agencies, including APRA and ASIC, with the best regulation policies. The OBPR has consistently found both APRA and ASIC to be compliant with the policy on best practice regulation.

### **A Well-developed Public Infrastructure**

37. **The legal system in Australia is highly developed and the independence of the judiciary is respected.** There is a comprehensive body of business laws, including those governing insolvency as well as contractual and property rights. All legislation must be passed by the two houses of the Federal Parliament, i.e., the Senate and the House of Representatives. There is a strict separation between the judiciary, the Parliament and Executive Government. The Australian courts uphold the principle of judicial independence, which ensures that judges are free from legislative and/or executive interference in performing their judicial functions. The High Court is the final court of appeal.

38. **Accounting and auditing standards adopted in Australia are in line with international best practices.** Accounting standards in Australia are made by the Australian Accounting Standards Board (AASB). The AASB is involved in the International Accounting Standards Board's standard-setting process. The AASB issues the Australian-equivalent of the International Financial Reporting Standards (IFRS), which apply to Australian companies with the force of law. The Auditing and Assurance Standards Board (AUASB) establishes Australian auditing standards based on the International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The Financial Reporting Council is responsible for overseeing the effectiveness of the financial reporting and auditing frameworks in Australia and oversees the activities of AASB and AUASB. Auditors must meet the registration requirements of ASIC and there are currently about 5,200 registered company auditors in Australia.

39. **The Institute of Actuaries of Australia (IAAust) enforces professional and ethical standards of its members.** It has 1,842 Fellow, 831 Associate and 1,060 student members as at May 2012. One-quarter of its members are based outside of Australia, including in New Zealand and Asian countries. Fellow members are fully qualified to sign actuarial reports required by APRA. The IAAust has established a Code of Professional Conduct to maintain the quality, integrity, and professional standards of practicing actuaries and has established an internal disciplinary process to enforce the Code and its professional standards. Since 2006, the IAAust publishes disciplinary action taken on its website. On average, there are about two new legitimate complaints annually, mostly relating to technical issues. Some of the complaints were referred by APRA.

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<sup>23</sup>In 2005/06, an independent Taskforce on Reducing Regulatory Burdens on Business reported on the systemic causes of over-regulation and ways to further improve the quality of regulation. Its recommendations were largely accepted by the Australian Government. One of the measures taken was the establishment of OBPR, extending the role of the former Office of Regulation Review.

40. **APRA is the central repository of statistical information on the Australian financial sector.** APRA supervisors have timely access to financial statistics from a wide range of financial institutions, both regulated and unregulated, as part of their supervisory assessments at entity, industry and cross-sectoral levels. Around 80 percent of APRA's data collections are shared with or collected on behalf of other agencies, in particular the RBA and the Australian Bureau of Statistics. APRA produces 13 statistical publications, which provide regular updates on the financial performance of APRA-regulated industries.

### **Effective Market Discipline in Financial Markets**

41. **Australia's corporate governance system complies with the Organization for Economic Cooperation and Development's Principles of Corporate Governance.** ASIC is responsible for monitoring and enforcing compliance with the corporate governance requirements in the Corporations Act 2001 (CA). Companies that are prudentially regulated by APRA are subject to additional corporate governance requirements set out in APRA's prudential standards.

### **Mechanisms for Consumer Protection**

42. **The consumer protection regime in Australia is supported by three pillars: licensing of financial product advisers; continuous disclosure requirements; and access to dispute resolution mechanisms.** Anyone who conducts financial services business in Australia or sells financial products must possess an Australian Financial Services License (AFSL) issued by ASIC. The CA and the Australian Securities and Investments Commission Act 2001 (ASIC Act) regulate consumer protection in relation to financial products.<sup>24</sup>

43. **Consumers of financial services have a number of options for resolving disputes without going to a court or tribunal.** These include mediation, conciliation, conferencing, neutral evaluation, and arbitration. ASIC also requires licensed entities to have internal and external dispute resolution mechanisms. The policy is to encourage alternative dispute resolution before commencing court proceedings. The Civil Dispute Resolution Act 2011 and the Financial Ombudsman Service (FOS) provides a framework for resolving disputes with financial service providers at no cost to the consumers. Both domestic and international arbitral awards can be enforced in Australia. Australia is a signatory to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

### **Efficient Financial Markets**

44. **The financial markets in Australia offer a broad range of instruments that facilitate insurers' asset-liability management.** The 2,222 companies listed on the Australian Securities Exchange (ASX) had a combined market capitalization of A\$ 1.17 trillion as at end-2011. The ASX has an average daily turnover of around A\$ 5 billion. Australia's over-the-counter market is active but small by international standards, with a turnover of around A\$80 trillion in financial year (FY) 2010/11. However, Australia's debt market is relatively underdeveloped, with a low turnover in corporate bonds (A\$ 900 billion in FY 2010/11). The RBA regulates the payments system, as well as providing oversight of the stability of clearing and settlement facilities.

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<sup>24</sup>The *Competition and Consumer Act 2010* covers consumer protection non-financial products and exclude consumer credit.

**Table 7. Summary of Compliance with the ICPs**

Insurance Core Principle	Level	Overall Comments
1- Objectives, Powers and Responsibilities of the Supervisor	LO	<p>The responsibilities for insurance supervision in Australia are shared among a number of authorities, each of which has a clearly-defined mandate and objectives. However, elsewhere in this assessment, instances are described where a weakness of powers could compromise the achievement of the overall objectives of insurance supervision. For example, as noted under ICP 20, ASIC does not have the power to impose disclosure requirements beyond those set out in the CA or the accounting standards, while APRA has not issued disclosure standards other than on capital adequacy, on the basis that disclosure is not a prudential matter.</p>
2- Supervisor	PO	<p>Several elements of the Australian regulatory framework need to be carefully considered in order to assess the extent of operational independence, accountability, transparency and adequacy of resources of APRA and ASIC. In light of the standards under ICP 2, they relate in particular to the following:</p> <p>The relevant Minister has been provided with powers ranging from the possibility to give policy directions to APRA and ASIC, to being in charge of certain supervisory decisions, such as in regarding the suitability of controlling shareholders of an insurer. Their use is generally subject to a clear and transparent process set out in legislation, which includes a requirement that decisions are made on the basis of the advice of the supervisory agency. Some of these powers have been rarely, if ever, used, and they do not generally include decision-making on day-to-day technical matters affecting particular regulated entities. However, the existence of these powers remains a concern, because they could potentially be exercised in a manner that would adversely affect supervisory policy.</p> <p>APRA and ASIC are dependent on the approval of the Government for their funding. A significant amount of ASIC's funding is non-core funding earmarked for specific projects. The relative share of this non-core funding has been increasing in the last few years, with the budget for 2012-13 continuing this trend. This raises concerns about the ability of ASIC to decide on the operational allocation of a significant part of its resources. Also, as highlighted under ICP 9, resources allocated by ASIC to proactive surveillance are very limited and leave a significant part of the regulated population, including insurance intermediaries, subject to largely reactive surveillance. While</p>

Insurance Core Principle	Level	Overall Comments
		currently there are no indications of political interference in the supervision of insurers, approval of the budgets of APRA and ASIC by elected government officials leaves them exposed to cutbacks for financial or political reasons, there are no indications of political interference in the supervision of insurers or insurance intermediaries. If an APRA Member or an ASIC Commissioner is removed from office, the reasons are not required to be publicly disclosed and the Government considers mandated disclosure to be inappropriate.
3- Information Exchange and Confidentiality Requirements	O	APRA is empowered to obtain and exchange information with other relevant supervisors and authorities subject to confidentiality, purpose and use requirements. It is signatory to a network of bilateral MoUs and the IAIS Multilateral MoU. APRA has also established close collaboration with relevant supervisors, domestically and internationally, which facilitates proactive information exchange. The existence of an agreement or understanding on information exchange is not a prerequisite for information exchange. The effectiveness of APRA's information exchange could be enhanced by clear internal policies and procedures on notifying other relevant supervisors in advance of taking action against an insurer.
4- Licensing	O	Insurance activities within Australia can only be conducted by authorized insurers. APRA is the licensing authority under the IA and LIA and has established appropriate licensing requirements in line with international best practices. Licensing procedures are clear and APRA establishes internal guidelines and ensures the consistency of licensing decisions. The licensing process involves significant interaction with the applicants and APRA exercises appropriate due diligence. APRA publishes the licensing requirements and maintains a register of licensed insurers on its website. The authorities are monitoring the level of activities of the UFI and DMFs to determine the need to subject such entities to prudential supervision.
5- Suitability of Persons	LO	APRA requires responsible persons of insurers and their NOHCs to meet fitness and propriety criteria commensurate with their respective roles. Significant owners must have the financial soundness and integrity necessary to ensure sound and prudent operations of insurers. Compliance with fit and proper standards is monitored by APRA through its prudential supervision and reporting framework. Where necessary, APRA may direct insurers to remove responsible persons who are not fit and proper for their appointments. In addition, APRA may also remove or apply to the Federal Court to disqualify a responsible person.

Insurance Core Principle	Level	Overall Comments
		<p>However, there is no explicit requirement for insurers to notify APRA of any circumstances that may materially adversely affect the suitability of significant owners. While key persons in 'Control Functions' are covered under the scope of Responsible Persons through the definition of Senior Managers, there are merits to clarifying the scope of "responsible persons" to include an explicit category of "Key Persons in Control Functions", to enhance transparency and to highlight the need for independence of control functions from senior management.</p>
6- Changes in Control and Portfolio Transfers	LO	<p>The FSSA sets clear ownership and control thresholds above which approval is required. The Treasurer, or APRA as the delegate, is empowered to approve proposals to acquire or increase significant ownership or interest in an insurer. In practice, APRA assesses all proposals as if they were initial license applications. While insurers are not explicitly required to notify APRA in the case of a significant decrease in the ownership by a person(s) below the pre-determined control level, such cases may be identified through APRA's supervisory process.</p> <p>Insurers need to obtain approvals from APRA and/or the Federal Court to transfer all or part of their business to another insurer. Prior approval of the Minister is required for transferring 15 percent or more of the insurance business of an insurer.</p>
7 - Corporate Governance	O	<p>Corporate governance requirements for insurers are extensive and the assessment of corporate governance is a key element of APRA's supervisory assessments. Nonetheless, there is scope to enhance corporate governance requirements for insurers to reflect evolving international best practices.</p> <p>Only listed insurers are required to disclose comprehensive information on their governance.</p>
8- Risk Management and Internal Controls	O	<p>In recent years, APRA has strongly emphasized the importance of risk management and internal controls, and some insurers have sophisticated systems in place. In some jurisdictions, each insurer is required to designate a compliance officer.</p>
9 - Supervisory Review and Reporting	LO	<p>APRA's risk-based supervision framework is anchored on PAIRS and SOARS, designed to facilitate better supervisory risk assessment as well as prompt and consistent supervisory actions. There is a baseline supervisory program for all insurers. APRA collects extensive regulatory and statistical information from insurers and the reporting obligations of general insurers extend to their NOHC and related companies within an insurance group. It may also request supervisory information on an <i>ad hoc</i> basis. There are clear</p>

Insurance Core Principle	Level	Overall Comments
		<p>scoping statements and processes for onsite reviews. APRA issues formal review reports on its findings and remedial measures in a timely manner and monitors the implementation of required measures. APRA is empowered to inspect service providers of outsourced functions and has conducted such inspections.</p> <p>Given its broad mandate in supervising a large number of licensees, ASIC typically monitors insurers' compliance with conduct of business requirements through desktop reviews. Onsite reviews of insurers are mainly conducted in response to suspected or identified misconduct or other concerns. While ASIC does not issue any report to individual insurers arising from its thematic reviews, it would discuss its findings with the insurers concerned. ASIC may exercise compulsory information gathering powers against service providers of outsourced functions by insurers, where appropriate.</p> <p>Feedback from industry participants suggested that there is scope for ASIC to have more proactive engagement on conduct of business issues and a more consultative approach. There are merits in promoting more effective on-going dialogue and monitoring to prevent breaches rather than having to manage the consequences of systemic misconduct.</p>
10-Preventive and Corrective Measures	O	<p>The SOARS framework supports the progressive escalation of actions or remedial measures. APRA has wide powers to initiate timely and proportionate preventive and corrective measures where insurers are unable or unwilling to adequately address supervisory concerns. While the conduct of unauthorized life insurance business is not explicitly an offence under the LIA, APRA would address such cases through indirect means including cooperating with ASIC. APRA may commence civil proceedings in its own name and at its own initiative. Where APRA considers criminal prosecution is appropriate, APRA may refer the matter to the DPP to decide whether to prosecute. There have been no instances of civil or criminal proceedings being commenced in respect of unauthorized insurance activities taken since 2006.</p>
11 - Enforcement	O	<p>In 2008, the enforcement powers of APRA were broadened to include power to issue directions and appoint judicial managers. APRA enforces corrective action and imposes sanctions, where necessary. Enforcement action is taken in accordance with applicable legislative criteria and guided by an Enforcement Manual, which is publicly available. There is a dedicated Enforcement Unit to deal with matters escalated by frontline supervisors. APRA's Enforcement</p>

Insurance Core Principle	Level	Overall Comments
		Committee promotes consistency in its approach to enforcement. APRA has taken enforcement actions in respect of a number of general insurers but it has not had cause to exercise enforcement powers in respect of life insurers since 2006.
12 - Winding-up and Exit from the Market	LO	<p>Insolvency is defined in the CA and APRA has extensive powers to take timely intervention by requiring the discontinuance of insurance business, and the orderly exit of an insurer. The winding-up of insurers is based on the procedure set out in the CA, subject to certain insurance specific modifications set out in IA and LIA.</p> <p>There is no formal requirement under the IA that policy liabilities of a general insurer must be met ahead of liabilities to other unsecured creditors. However, the requirement that an insurer must hold assets in Australia of a value which equals or exceeds its liabilities in Australia, gives a large measure of protection to policyholders. This protection is supplemented by the establishment of the Policyholder Compensation Facility.</p> <p>Life policyholders have priority of claims over unsecured creditors in the same statutory fund. Capital requirements must be met for each statutory fund. However, where their policy liabilities cannot be met from that fund, policyholders may rank behind the unsecured creditors of another statutory fund that has surplus assets. The Court may take into account the interests of policyholders in deciding on the distribution of the surplus assets of any fund that has first met its obligations to the unsecured creditors of that fund. The authorities may also consider invoking appropriate resolution measures, including the use of public funds available under the LIA to fund a transfer of a life insurance portfolio to protect policyholders.</p>
13 - Reinsurance and Other Forms of Risk Transfer	O	Australia's exposure to natural catastrophes makes strong reinsurance coverage essential to the insurance market and overall economy. APRA reviews the reinsurance strategies and programs of insurers, and assesses the exposure of both individual insurers and the industry to the various reinsurers that are providing coverage.
14 - Valuation	O	The risk margins in general insurance liabilities are calculated to meet a specified level of uncertainty. However, the risk margins in life insurance solvency liabilities are calculated using specified assumptions, which means that the risk margins can vary depending on the current best estimate assumptions. The risk margins in life insurance capital adequacy liabilities are explicit, but can be selected from prescribed ranges, which means that the level of uncertainty provided for by the margins can vary.

Insurance Core Principle	Level	Overall Comments
15 - Investment	O	Insurers have a very broad choice of investment assets and many of the requirements are qualitative and principles-based in nature. Responsibility for the proper management of investment risks lies with the insurer, supported by adverse treatment under the capital adequacy standards in respect of risky or concentrated investments, along with rigorous supervisory assessments. Such a regime is appropriate for a developed market and supervisory system like Australia, but some additional quantitative restrictions might nevertheless be useful.
16 - Enterprise Risk Management for Solvency Purposes	LO	Enterprise risk management is an evolving field, both in Australia and internationally. Some Australian insurers have sophisticated enterprise risk management systems, while others are at earlier stages of development. The LAGIC project is intended to strengthen the regulatory framework in areas relevant to enterprise risk management and its implementation should be helpful in that regard.
17 - Capital Adequacy	LO	APRA's requires insurers to establish their own solvency control levels, which must be agreed with APRA, rather than defining solvency control levels as part of the requirements. This approach helps to ensure that insurers are actively involved in assessing their capital needs and developing appropriate capital plans. However, the resulting solvency control levels are not transparent to the market and might not provide a consistent level of sufficiency at which intervention would be triggered.
18 - Intermediaries	O	The regulatory regime for insurance intermediaries is mature, well-understood and has a broad coverage. ASIC has established clear licensing guides and regulatory guides on the supervision of representatives by AFSL holders, including minimum training standards. The CA gives ASIC adequate powers to take action in relation to breaches. However, to supervise the large numbers of licensees with limited resources, ASIC has adopted a more reactive approach to supervising intermediaries (see ICP 19). There is also scope to have explicit and more comprehensive corporate governance requirements for intermediaries.
19 - Conduct of Business	PO	The current regulatory regime, which sets high-level principles for conduct of business in the area of fair treatment of customers, should be supported by clearer regulatory guidance in line with international best practices. In particular, the current minimum training and competencies standards for intermediaries should be strengthened. Gaps in ASIC's legal authorities and regulatory requirements, e.g., to supervise insurers' claim practices and policy servicing; dilute the

Insurance Core Principle	Level	Overall Comments
		effectiveness of the conduct of business supervision. Partly due to limited supervisory resources, ASIC's supervisory approach is predominantly based on desk-top review and relies heavily on self-reporting of breaches of regulatory requirements or third-party notifications (ICP 9). To enhance protection of policyholders, there is scope to broaden ASIC's authority in ensuring fair treatment of customers, e.g., supervising insurers' claims handling practices; requirements for servicing of policies until their expiries; and product development. It is also critical for ASIC to be adequately resourced to supervise the conduct of business of about 1,560 AFSL holders.
20- Public Disclosure	PO	Public disclosure is receiving increasing emphasis internationally as key element of the framework for supervising financial institutions. It is one of the main elements of the IAIS Framework for insurance supervision and the requirements under this ICP were considerably strengthened in the 2011 revisions. The disclosure requirements applicable to insurers in Australia have not kept pace with these developments. Some of the types of disclosures called for by ICP 20 are required only of listed insurers in Australia, while some of the specific items are not required to be disclosed at all. This situation, at least in part, arises from a gap in supervisory responsibilities and powers. ASIC does not have the power to impose disclosure requirements beyond those set out in the CA or the accounting standards, while APRA has not issued disclosure standards other than on capital adequacy.
21-Countering Fraud in Insurance	O	Fraud in insurance is an illegal act punishable by law. APRA assesses insurers' fraud risk management frameworks, determining their appropriateness and effectiveness for managing the fraud risk exposures. ASIC may undertake surveillance visits where it becomes aware of any deficiencies in an insurer's compliance obligations in relation to identifying and managing fraud risk. ASIC and APRA cooperate, coordinate and exchange information with other competent authorities, including foreign supervisory authorities.
22 - Anti-Money Laundering and Combating the Financing of Terrorism	O	APRA and ASIC are aware of the money laundering and terrorism financing risks of the insurance industry and have effective mechanisms to cooperate, coordinate and exchange information with both domestic and foreign supervisors/FIUs. Financial Action Task Force (FATF) standards apply at a minimum to the underwriting and placement of life insurance and other investment-related insurance. However, in some jurisdictions, money laundering activities have extended to the

Insurance Core Principle	Level	Overall Comments
		<p>general insurance sector. Accordingly, where the non-life sector, or part of that sector, is assessed by a jurisdiction as posing a ML/FT risk the FATF standards require that the jurisdiction considers applying the FATF standards to that sector. In Australia, general insurance is subject to the FTR Act, but is not subject to the more comprehensive AML/CFT requirements prescribed by the AML/CTF Act.</p>
23 - Group-wide Supervision	LO	<p>APRA has established an effective and efficient framework for supervision of general insurance groups. The Level 2 supervision framework has been designed to enable better understanding of group risks and address potential contagion from both regulated and non-regulated entities. APRA has adequate powers and flexibility to determine the scope of Level 2 groups and to effectively supervise insurance groups and has exercised sound supervisory discretion in applying the framework. Although APRA has powers to set requirements for life insurance groups including on an individual group basis, an equivalent Level 2 supervision framework has not been developed for life insurers. This will be largely addressed by the impending Level 3 supervision of financial conglomerates.</p> <p>ASIC's supervision of market conduct is at the legal entity level and there are no group-wide market conduct requirements.</p>
24 - Macroprudential Surveillance and Insurance Supervision	O	<p>APRA has a comprehensive set of processes and tools that support its ability to perform macroprudential surveillance and insurance supervision. Its plans to make increasing use of stress testing in the future should further strengthen its quantitative analyses of industry-wide risks.</p>
25-Supervisory Cooperation and Coordination	O	<p>APRA has in place coordination arrangements with other involved domestic and foreign supervisors that facilitate effective prudential supervision on a legal-entity and a group-wide basis. Where appropriate, APRA coordinates with relevant agencies from other sectors, including central banks and government ministries. Domestically, APRA liaises closely with all relevant agencies involved in Australia's financial sector supervision, bilaterally and at the CFR level, and has formalised some of the arrangements through bilateral and joint MoUs.</p> <p>At the international level, APRA has established coordination arrangements and regularly shares information with relevant foreign regulators, particularly with RBNZ in view of the significant operations of a few Australian insurers in New Zealand. Where APRA is the designated group-wide supervisor, it establishes the key functions of supervisory colleges and other coordination</p>

Insurance Core Principle	Level	Overall Comments
		mechanisms as the key coordinator or chairman of the supervisory college.
26-Cross-border Cooperation and Coordination on Crisis Management	LO	APRA maintains effective working relationships with relevant foreign home and host supervisors, particularly in jurisdictions where the cross-border insurance activities are systemically important. These relationships assist in facilitating effective, coordinated cross-border crisis resolution in the event of need. The MoU on financial distress management executed by the CFR agencies also applies to cross-border financial stress. APRA is well equipped with the necessary statutory powers and tools to respond to cross-border crisis involving insurers effectively. There is currently no requirement for insurers to maintain recovery or resolution plans.
<i>Aggregate Level:</i> Observed (O), largely observed (LO), partly observed (PO), not observed (NO), not applicable (N/A).		

### Summary of Observance Level

Observed (O)	14
Largely observed (LO)	9
Partly observed (PO)	3
Not Observed (NO)	0
<b>Total</b>	<b>26</b>

**Table 8. Recommendations to Improve Observance of ICPs**

Insurance Core Principle	Recommendations
1- Objectives, Powers and Responsibilities of the Supervisor	Legislation should be amended to give ASIC the power to make rules, which will help to close gaps in the current regulatory framework for conduct of business.
2- Supervisor	It is recommended that the authorities take the following steps to strengthen the ability of APRA and ASIC to exercise their functions and powers in a more effective and operationally-independent manner: <ul style="list-style-type: none"> <li>a) Eliminate or further restrict the ability of the Minister to give directions to APRA and ASIC on matters of supervisory policy;</li> <li>b) Eliminate or further restrict the involvement of the Minister in decisions related to individual regulated entities or individuals; and</li> <li>c) Consider the various possibilities to arrange the funding of APRA and ASIC in such a manner that will ensure they will have the resources needed to respond to the current and emerging supervisory challenges.</li> </ul>
5- Suitability of Persons	The current suitability requirements could be

Insurance Core Principle	Recommendations
	<p>enhanced by:</p> <ul style="list-style-type: none"> <li>a) requiring insurers to notify APRA of any circumstances that may materially adversely affect the suitability of significant owners; and</li> <li>b) separating “Key Persons in Control Functions” from the definition of “senior manager” under “responsible persons”.</li> </ul>
6- Changes in Control and Portfolio Transfers	Insurers should be required to notify APRA on any significant decrease in the ownership by a person(s) below the pre-determined control level approved by the Minister.
7 - Corporate Governance	Corporate governance might be further enhanced by amending the requirements to more explicitly indicate the responsibility of Boards to maintain and enforce policies to deal with conflicts of interest. All insurers should be required to disclose their governance practices in their annual reports, which would make important information on governance available to all relevant stakeholders.
8- Risk Management and Internal Controls	APRA should consider requiring each insurer to designate an officer with overall responsibility for compliance, which could both reinforce accountability and facilitate communication between the insurers and their supervisors.
9 - Supervisory Review and Reporting	<p>The authorities are advised to:</p> <ul style="list-style-type: none"> <li>a) review the effectiveness of ASIC’s current predominantly desktop approach to supervising insurers’ conduct of business;</li> <li>b) empower ASIC to inspect service providers of outsourced functions by insurers; and</li> <li>c) ensure that ASIC is equipped with adequate supervisory resources including the technical capacity for effective and proactive supervision of insurers’ conduct of business.</li> </ul>
11 - Enforcement	Significant progress has been made in strengthening and harmonising the enforcement powers of APRA in dealing with life and general insurers. Differences remain, e.g., lack of power to revoke the license of a life insurer directly and it is recommended that the momentum is maintained for the on-going review on harmonising the powers of APRA across financial sectors.
12 - Winding-up and Exit from the Market	The authorities should consider providing for the legal priority of claims by policyholders of general insurers over unsecured creditors, as well as greater legal priority of life policyholders’ claims to the assets of other statutory funds, ahead of unsecured creditors.
14 - Valuation	APRA should consider specifying the level of uncertainty to be provided for by the risk margins in life insurance liabilities.
15 - Investment	APRA should consider the establishment of additional quantitative restrictions, for example, on large exposures, investments with related parties,

Insurance Core Principle	Recommendations
	<p>more-complex and less-transparent classes of assets, and investments in markets or instruments that are subject to less governance or regulation. Such restrictions might be useful in the supervision of both insurers and insurance groups. As noted under ICP 23, APRA should also formally extend its supervision to life insurance groups, which would include relevant investment requirements.</p>
16 - Enterprise Risk Management for Solvency Purposes	<p>Whether through LAGIC or otherwise, APRA should enhance the requirements on enterprise risk management. In particular, insurers should be required to explicitly describe the relationship between their risk tolerance limits, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk. They should be required to document their approach to measuring risks, to establish quantitative and qualitative risk tolerance levels and defines risk tolerance limits which take into account all relevant and material categories of risk and the relationships between them, and to make use of such limits in their business strategy and day-to-day operations. APRA should also provide more explicit guidance regarding the performance of own risk and solvency assessments.</p>
17 - Capital Adequacy	<p>APRA should take steps to increase the transparency and ensure the consistency of the solvency control levels.</p>
19 - Conduct of Business	<p>The authorities should strengthen the current regime for conduct of business by:</p> <ul style="list-style-type: none"> <li>a) implementing the enhanced training and competencies standards proposed by ASIC;</li> <li>b) requiring insurance intermediaries to ensure the privacy protection of customers;</li> <li>c) empowering ASIC to establish or enforce regulatory requirements to ensure fair treatment of customers and product development; and</li> <li>d) ensuring that ASIC is adequately resourced to conduct proactive supervision to prevent misconduct instead of the current more reactive approach to deal with identified breaches and shortcomings.</li> </ul>
20-Public Disclosure	<p>APRA and ASIC should cooperate to identify and deal with the shortcomings in the disclosure requirements. As noted in the description, the shortcomings include:</p> <ul style="list-style-type: none"> <li>a) the exemption of small and unlisted insurers from many disclosure requirements;</li> <li>b) the limited detail disclosed on the capital adequacy of life insurers;</li> <li>c) the need for disclosure of an analysis of sources of earnings; and</li> <li>d) the need for comprehensive disclosures on</li> </ul>

Insurance Core Principle	Recommendations
	<p>corporate governance, risks and risk management.</p> <p>The authorities should consider requiring all insurers to make their audited financial statements and required disclosures available to the public at no cost.</p>
21-Countering Fraud in Insurance	<p>Consistent with the recommendations under ICP 9, ASIC might further strengthen its oversight of the fraud controls of AFSL holders by adopting a more proactive inspection program.</p>
22 - Anti-Money Laundering and Combating the Financing of Terrorism	<p>The authorities should periodically reconsider whether or not general insurance should be subject to the more comprehensive requirements prescribed by the AML/CTF Act.</p>
23 - Group-wide Supervision	<p>The impending introduction of Level 3 supervision of financial conglomerates will formalise group regulatory requirements for life insurers. The authorities should incorporate group-wide market conduct requirements in both Level 2 and Level 3 supervision frameworks.</p>
26-Cross-border Cooperation and Coordination on Crisis Management	<p>The authorities should implement the requirement for insurers to establish and maintain contingency plans and procedures for use in a going- and gone-concern situation.</p>

### Authorities' responses to the assessment

45. **The Australian authorities wish to express their appreciation to the IMF and its assessment teams for their assessment.** Australia is strongly committed to the FSAP process and the insights that the FSAP provides into a country's financial sector. Australia acknowledges that it is important to continually review and seek to improve the regulatory framework and supervision practices.

46. **The Australian authorities share the view expressed in the report that Australia has a high level of observance with the Insurance Core Principles, supported by robust supervision by APRA.** There are, however, some areas where the Australian authorities disagree with the assessment or do not consider that the recommendations will necessarily support better regulatory outcomes.

47. **The Australian authorities consider that there are some principles for which the rating does not reflect the strengths and performance of Australia's supervisory approach or where the issues raised do not reflect actual deficiencies in practice or outcomes.** These include the following Core Principles:

- **CP 17 Capital adequacy.** The Australian authorities strongly disagree with the assessment. Australia is rated 'Largely Observed' on the basis that the solvency control levels are not transparent or consistent. However, the Australian authorities consider that APRA sets very robust capital requirements under a consistent and transparent framework. APRA sets a relatively high level for the Minimum Capital Requirement (MCR), supplemented by a Prescribed Capital Requirement (PCR)

determined separately for each insurer based on its risk profile. Introducing a simple relationship between these control levels would, apparently, address the issue identified in the assessment. The Australian authorities' view, however, is that a simple relationship is not appropriate, given the complex nature of insurance and the variety of insurance businesses. The Australian authorities remain of the view that APRA's capital framework better addresses the inherent risks of each insurer and the manner in which they are addressed by the insurer. At the same time, APRA's capital framework is transparent to the market. APRA intends to retain this approach under the new regulatory capital framework for general and life insurers effective from January 1, 2013.

- **CP 2 The supervisor.** The Australian authorities have concerns about the rationale for the rating for operational independence, accountability, transparency and adequacy of resources. While the authorities understand the reasons for the assessment, the authorities consider the impact of these matters on independence of the regulators has been overstated and Australia has been assessed with an undue focus on process rather than outcomes. APRA and ASIC are both established as statutory authorities at arm's length from Government and with substantial statutory and operational independence.
- **CP 20 Public disclosure.** The Australian authorities accept the assessment. However, the authorities wish to re-emphasize that all insurers are already subject to significant public disclosure obligations under the Corporations Act and Australian accounting standards, while listed insurers are subject to additional continuous disclosure and governance disclosure obligations. For example, accounting standards include specific standards for listed and unlisted life insurers and general insurers that contain accounting and disclosure requirements for public financial reporting that go well beyond the requirements under the International Financial Reporting Standards that apply in many jurisdictions. These standards include disclosure requirements for financial results, capital and liability valuation. A listed insurer is also required to make comprehensive and timely disclosures, covering governance and risk management. Nonetheless, the Australian authorities acknowledge that disclosure obligations of unlisted insurers could be brought into line with international standards and will consider how this could best be achieved.
- **CP 19 Conduct of Business.** The Australian authorities accept some of the findings but consider that insufficient weight has been given to the existing Corporations Act and Insurance Contracts Act provisions that seek to achieve fair treatment of customers. In relation to supervision of insurers and insurance intermediaries, the Australian authorities note that implementation of the recommendations will require further funding and resources. The authorities will review the approach to supervision in light of future funding decisions.
- **CP 5 Suitability of persons and CP 6 Changes in Control and Portfolio Transfers.** The assessment recommends requirements for notification of any circumstances that may materially adversely affect the suitability of significant owners, and any significant decrease in the ownership below the pre-determined control levels. The Australian authorities accept these recommendations, but note that there is no evidence that the absence of such notification requirements has led to any adverse prudential outcomes in Australia.
- **CP 26 Cross-border cooperation and coordination on crisis management.** The assessment recommends a requirement for insurers to implement contingency plans

and procedures for use in a going- and gone-concern situation. In response, the Australian authorities note that APRA is considering the possible scope and nature of recovery planning requirements for insurers. Insurers will also be required to maintain Internal Capital Adequacy Assessment Processes (ICAAPs), under changes to come into effect on 1 January 2013, that involve a degree of contingency planning for events that could pose a threat to their capital position.

- **CP 22 Anti-Money Laundering and Combating the Financing of Terrorism.** The assessment comments that the Australian authorities should periodically reconsider whether general insurance should be subject to the more comprehensive requirements prescribed by the AML/CTF Act. Australia already adopts this approach. In 2011, Australia undertook a national threat assessment on money laundering that did not reveal money laundering through general insurance to be a threat. Australia has also undertaken a number of organized crime threat assessments over recent years and, again, money laundering through general insurance services has not appeared to present a threat. Australia will continue to monitor the environment for money laundering and terrorism financing threats in the general insurance sector and, if necessary, develop suitable legislative responses to those threats.

## II. DETAILED PRINCIPLE-BY-PRINCIPLE ASSESSMENT

**Table 9. Detailed Assessment of Observance of the ICPs**

ICP 1	<b>Objectives, Powers and Responsibilities of the Supervisor</b> The authority (or authorities) responsible for insurance supervision and the objectives of insurance supervision are clearly defined.
Description	<p>In Australia, the national authorities with responsibility for insurance supervision are as follows:</p> <ul style="list-style-type: none"> <li>• The Australian Prudential Regulation Authority (APRA) is responsible for prudential regulation and supervision of general and life insurance companies, as well as banking and parts of the superannuation sector.</li> <li>• The Australian Securities and Investment Commission (ASIC) is responsible for monitoring, regulating, and enforcing corporations and financial services laws, and for promoting market integrity and consumer protection across the financial services sector, including insurers.</li> <li>• The Private Health Insurance Administration Council (PHIAC) is responsible for the regulation of the private health insurance industry. PHIAC regulates private health insurers that conduct private health insurance business; however, APRA regulates non-health benefit fund business of companies that conduct both health insurance business and other insurance business.</li> </ul> <p>These authorities are identified in primary legislation, which also defines their respective objectives, mandates, responsibilities, and powers. In some cases, state-level authorities are responsible for the supervision of certain insurance activities, such as motor third-party liability insurance, in their states. This assessment is focused on the insurance activities that are supervised by APRA and ASIC, and observation of the ICPs has been assessed in that context.</p> <p>The primary legislation that defines APRA's authority and responsibility in respect of prudential supervision of general insurers and life insurers is as follows:</p> <ul style="list-style-type: none"> <li>• Australian Prudential Regulation Authority Act 1998 (APRA Act);</li> <li>• Insurance Act 1973 (IA);</li> </ul>

- Life Insurance Act 1995 (LIA);
- Insurance Acquisitions and Takeovers Act 1991 (IATA);
- Medical Indemnity (Prudential Supervision and Product Standards) Act 2003;
- Financial Sector (Shareholdings) Act 1998 (FSSA);
- Financial Sector (Business Transfer and Group Restructure) Act 1999;
- Financial Sector (Collection of Data) Act 2001 (FSCODA);
- Financial Sector (Collection of Data-Consequential and Transitional Provisions) Act 2001;
- General Insurance Supervisory Levy Imposition Act 1998;
- Life Insurance Supervisory Levy Imposition Act 1998; and
- Financial Institutions Supervision Levies Collection Act 1998.

The primary legislation that defines ASIC's authority and responsibility in respect of conduct of business supervision (including in respect of insurers and insurance intermediaries) is as follows:

- Australian Securities and Investments Commission Act 2001 (ASIC Act);
- Corporations Act 2001 (CA);
- Insurance Contracts Act 1984 (ICA);
- LIA<sup>25</sup>; and
- Medical Indemnity (Prudential Supervision and Product Standards) Act 2003.<sup>26</sup>

The primary legislation that defines PHIAC's authority and responsibility in respect of supervision of health insurers is the Private Health Insurance Act 2007 (PHIA).

The principal objectives of supervision promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders.

- The APRA Act requires APRA to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia. The IA and the LIA reinforce these objectives by indicating as their primary objectives the protection of policyholders and prospective policyholders in a manner consistent with the continued development of a viable, competitive and innovative general and life insurance industry.
- The ASIC Act indicates that ASIC's responsibilities include monitoring and promoting market integrity and consumer protection in relation to the Australian financial system.
- The PHIA requires PHIAC to achieve an appropriate balance between fostering an efficient and competitive health insurance industry, protecting the interests of consumers and ensuring the prudential safety of individual private health insurers.

Legislation provides the authorities with a range of powers that can be exercised in pursuit of their objectives. For example, each of the authorities is able to enforce rules by administrative means and to take immediate action. However, the extent of powers differs among the authorities.

- APRA has the power to issue prudential standards and to conduct supervision with respect to both insurers and insurance groups. Prudential standards have the force of law, with the same legal standing as regulations. APRA has the power to enforce rules by administrative means, although its

<sup>25</sup>ASIC has responsibility for certain provisions of Part 10 of the Life Insurance Act.

<sup>26</sup>ASIC has responsibility for Part 3 of the *Medical Indemnity (Prudential Supervision and Product Standards) Act 2003*.

	<p>ability to impose fines autonomously is limited to breaches of FSCODA. However, APRA does have the capacity to seek the imposition of fines through the Commonwealth Director of Public Prosecutions (DPP) and the Courts where there are breaches of legislation or prudential standards.</p> <ul style="list-style-type: none"> <li>• ASIC does not have the power to issue rules, but it has the ability to impose fines.</li> <li>• PHIAC has the power to issue rules, but its powers to conduct supervision on a group-wide basis are limited.</li> </ul> <p>Treasury is responsible for providing advice to the Australian Government regarding the legislative framework for financial sector regulation, including insurance regulation. APRA has a history of collaborating effectively with Treasury to identify areas in which relevant legislation conflicts with, or does not best support, supervisory objectives, and to recommend corrective amendments. Major reforms were made in 2001, in response to the failure of HIH, with more recent amendments in 2008 and 2010. A number of issues are currently under review by APRA and Treasury. ASIC has an internal law reform process, which is managed by its Strategic Policy team. Where ASIC has concerns that there is a regulatory deficiency related to any act it administers, ASIC may consult with Treasury and has proposed law reform, where appropriate.</p> <p>Where proposed legislative reforms concern the objectives of more than one of the Reserve Bank of Australia (RBA), APRA and ASIC, or otherwise are of particular significance to Australia's financial system, such reforms will often be considered by the members of the Council of Financial Regulators (CFR). The CFR is the primary coordinating body for Australia's main financial sector agencies: the RBA (Chair), APRA, ASIC, and Treasury. The CFR's objectives are to promote the stability of the Australian financial system and to contribute to the efficiency and effectiveness of financial regulation.</p> <p>PHIAC works with the Commonwealth Department of Health and Ageing on a regular basis to improve the operation of the PHIA.</p>
Assessment	Largely observed.
Comments	<p>The responsibilities for insurance supervision in Australia are shared among a number of authorities, each of which has a clearly-defined mandate and objectives. However, elsewhere in this assessment, instances are described where a weakness of powers could compromise the achievement of the overall objectives of insurance supervision. For example, as noted under ICP 20, ASIC does not have the power to impose disclosure requirements beyond those set out in the CA or the accounting standards, while APRA has not issued disclosure standards other than on capital adequacy, on the basis that disclosure is not a prudential matter.</p> <p>Legislation should be amended to give ASIC the power to make rules, which will help to close gaps in the current regulatory framework for conduct of business.</p>
<b>ICP 2</b>	<p><b>Supervisor</b></p> <p>The supervisor, in the exercise of its functions and powers:</p> <ul style="list-style-type: none"> <li>• is operationally independent, accountable and transparent;</li> <li>• protects confidential information;</li> <li>• has appropriate legal protection;</li> <li>• has adequate resources; and</li> <li>• meets high professional standards.</li> </ul>

Description	<p><b>Internal Governance</b></p> <p>APRA is governed by a commission-style structure of a three-member Executive Group, headed by an executive Chairman. The APRA Act requires the appointment of between three and five APRA Members, and currently there are three Members. APRA Members tend to reflect a balance of industry expertise and experience, with each Member usually having particular expertise in one or more of the insurance, banking or superannuation industries.</p> <p>The Executive Group is responsible and accountable for the operation and performance of APRA. The Executive Group meets formally on a monthly basis, and more frequently as required, to discuss and resolve the major policy, supervisory and strategic issues. It also holds Management Group meetings with APRA's senior management at least weekly for high-level information sharing and to make decisions on more routine supervisory and organizational matters.</p> <p>APRA has various procedures in place to help ensure the integrity of supervisory decisions. In particular, APRA staff follow documented procedures when making a formal decision under legislation, when issuing a legislative instrument or a ruling, or providing advice that an insurer is expected to comply with or rely upon. The procedures require that APRA provides the rationale for supervisory decisions made and actions taken. Further, they clearly identify the APRA officer who is accountable for a decision and the officers who are accountable for carrying out the actions associated with a decision.</p> <p>Clearly defined delegations (including both internal delegations to APRA staff, and delegations from the Treasurer in respect of certain powers under the FSSA and the IATA ensure that there is appropriate senior sign-off on defined matters, effective communication and prompt escalation of significant issues. This helps to ensure that action can be taken quickly where required.</p> <p>APRA's Risk Management and Audit Committee, which includes one Member and two persons appointed by the Treasurer, provides assurance and assistance to the Executive Group on APRA's risk management framework and compliance framework and its external accountability responsibilities. An annual audit plan is approved by the Executive Group and endorsed by the Risk Management and Audit Committee. The plan covers specific aspects of APRA's supervisory and operational processes and its financial systems, which includes compliance with both internal and external requirements. APRA's Risk Management and Internal Audit unit is responsible for audit reviews and follow-up reviews, with the results reported to the Executive Group and the Risk Management and Audit Committee.</p> <p>ASIC has a Corporate Governance Charter that outlines its internal governance structure and delegation of responsibilities. It also has policies and workflows for particular areas (e.g., enforcement and licensing). Specific ASIC business units have documentation in place to guide staff in conducting day-to-day work.</p> <p>ASIC is required to give reasons in writing for its decisions if the affected person is entitled to seek review of the decision. In addition, as a matter of sound regulatory practice, ASIC normally provides reasons in its decisions even if there is no statutory obligation to do so.</p> <p>Internal audits conducted by ASIC's Audit Committee are intended to identify, monitor and review the effectiveness and integrity of ASIC's risk management and internal control frameworks, the truth and fairness of ASIC's financial reporting and ASIC's compliance with relevant legislation. ASIC also has an Audit, Assurance and</p>
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Compliance Unit, which provides independent reviews, objective assurance and advisory services to the Commission.

#### **Appointment and Dismissal**

The procedures governing the appointment and dismissal of APRA's Members are outlined in the APRA Act. APRA Members are appointed by the Governor-General (representative of Australia's Head of State), on the advice of the Minister. They are appointed for a term specified in the instrument of appointment, which cannot exceed five years.

The limited circumstances under which the appointment of an APRA Member may be terminated are set out in the APRA Act. The power to terminate the appointment of an APRA Member is vested in the Governor-General. As a matter of constitutional convention, the Governor-General would exercise such power only upon the advice of Government Ministers.

The APRA Act does not provide for the public disclosure of the specific reasons for terminating the appointment of an APRA Member in a particular case and the Australian Government considers that such disclosure may not be appropriate. No APRA Member has ever been terminated.

ASIC's Commissioners are appointed by the Governor-General upon a nomination from the Minister. Their term can be up to five years and they are eligible for reappointment. The grounds on which the Governor-General can terminate a Commissioner's appointment include misbehavior, physical or mental incapacity and bankruptcy (*s9, s108 and s111 of ASIC Act*).

#### **Institutional Relationships**

APRA is an independent statutory authority established under the APRA Act, which is both independent from, and accountable to, the Australian Government.

APRA is subject to a formal power of direction by the Minister under the APRA Act. The Minister is only permitted to give APRA a written direction about the policies it should pursue, or priorities it should follow, in performing or exercising any of its functions or powers. The APRA Act does not empower the Minister to give APRA a direction regarding a particular regulated entity.

A direction must be in writing and can be given only after the Minister has notified the Chair of APRA in writing that consideration is being given to making the direction and after the Chair has had an adequate opportunity to discuss with the Minister the need for the proposed direction. Where a direction is given, the Minister must table any direction before the Australian Parliament within 15 sitting days and disclose the direction by publication in the Gazette. There have been no instances of APRA being formally directed by the Minister under the APRA Act.

APRA's Statement of Intent 2007 outlines APRA's mechanisms for sharing information, consulting and liaising with the Australian Government. APRA provides advice on significant matters in its core area of business and on problems APRA has identified in the course of performing its supervisory functions. In particular, APRA is required to advise the Minister if it considers an APRA-regulated institution is in financial difficulty.

APRA's working relationship with the Treasury is underpinned by a Memorandum of Understanding (MoU) and supported by regular coordination meetings between senior executives, including the CFR (see ICP 25). APRA and the Treasury also

liaise closely on the development of the prudential framework and on issues associated with legislation that APRA administers.

The relationship between judicial authorities and APRA is clearly defined and is transparent. Subject to limited exceptions, most decisions made by APRA are subject to judicial review. In addition, certain decisions of APRA are also subject to administrative review (i.e., review on the merits) before the Administrative Appeals Tribunal (AAT). However, crisis resolution-type decisions are generally not subject to administrative review, but only judicial review.

Additionally, the judiciary has responsibility for disqualifying persons, on an application by APRA, from being or acting in certain key positions (see ICP 5). The Federal Court is also responsible for confirming schemes for the transfer of business (see ICP 6). In practice, the Australian Federal Court attaches weight to APRA's views on whether or not a scheme should be confirmed. APRA has the power to require an independent actuarial investigation of a proposed scheme before an application is made to the Court for confirmation of the scheme. APRA (or the Treasurer, if above APRA's delegation) also has a right to refuse under IATA any material transfer of insurance business.

Various arrangements exist to ensure that APRA is accountable to the Australian Government, its supervised institutions and the public at large. 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 Australian National Audit Office (ANAO). A financial audit is conducted annually and performance audits on a targeted basis, the last of which involving APRA was a cross-agency Protective Security – Management of Personnel Security audit in 2008. The reports of the ANAO are tabled in Federal Parliament and are publicly available. APRA's Annual Report includes financial statements, audited by the ANAO, and statutory reports in accordance with legislation.

The Minister responsible for ASIC is the Treasurer, assisted by the Minister for Financial Services and Superannuation and the Parliamentary Secretary to the Treasurer. Ministerial responsibility for superannuation, financial services, credit and financial markets has been allocated to the Minister for Financial Services and Superannuation, whereas the Parliamentary Secretary of the Treasurer is in charge of corporate governance, audit, insolvency, financial literacy and the administration of ASIC.

The Minister may give a written direction to ASIC on policies it should pursue and priorities it should follow in performing or exercising any of its functions or powers under the corporations legislation. Before issuing a direction, the Minister must provide notice of the proposed direction to the ASIC Chairman, who has to be given adequate opportunity to discuss the need for the proposed direction with the Minister. Where the Minister does issue a direction, he is required to publish a copy of the direction in the Government Gazette within 21 days and table the direction in both Houses of Parliament within 15 sitting days of the publication of the direction (*s12 ASIC Act*).

The Minister is prevented from giving a direction with reference to a particular case. However, the Minister can direct ASIC to investigate a particular matter when he/she considers it to be in the public interest. The conduct of that investigation and any

decisions to be made (for example, whether to commence proceedings or whether to conclude the investigation) are matters for ASIC (*s12(3) and s14 ASIC Act*).

The Minister noted in his 2007 Statement of Expectations to ASIC that the use of the directions power would only be considered in rare and exceptional circumstances. There is only one instance the assessors are aware of, where the Minister has used the power to give a direction to ASIC. The direction was issued in 1992 as a consequence of the Minister's concerns that cooperation and collaboration between ASIC and the DPP did not meet Government expectations. The direction focused on ASIC and the DPP developing and implementing policy on collaboration and cooperation and the development of dispute resolution mechanisms.

A Statement of Expectations to ASIC was issued in February 2007. It highlighted, among others, the importance of administering the regulatory regime in a manner that minimizes procedural requirements and business costs. It also expressed the Government's preference for regulation to identify the outcomes that are desired rather than prescribe how to achieve those outcomes. It required ASIC to copy all information, briefings, press releases and correspondence it provides to Ministers to the Secretary to the Treasury.

In its Statement of Intent given in response to the Minister, ASIC expressed its agreement with the substance of the Statement of Expectations. However, it emphasized its position as an independent agency and noted that its undertaking to provide information to the Treasury is subject to that position and other legislative requirements which may limit ASIC's ability to provide such information to the Treasury.

Like APRA, ASIC is subject to a number of formalized processes to ensure its accountability. For example, it reports to the Federal Parliament, the Treasurer and the Parliamentary Secretary to the Treasurer. It needs to appear before some parliamentary committees on a regular basis, the most relevant of which is the Joint Parliamentary Committee on Corporations and Financial Services that inquires into and reports to both Houses of Parliament on the activities of ASIC and the Takeovers Panel. Twice a year ASIC appears before the Senate Estimates Committee, which inquires into the expenditure of public money by Government departments and agencies. In addition, ASIC's activities may be subject to review by ad hoc committees. ASIC is required to publish an annual report, including audited accounts, which is tabled in Parliament and provided to various parliamentary committees. ASIC also publishes information on its regulatory actions on its website.

#### **Independence and Funding**

The APRA Act promotes APRA's freedom from undue interference in the performance of its supervisory responsibilities by permitting APRA to do anything that is necessary or convenient to be done for or in connection with the performance of its functions. This is subject to APRA's accountability to the Minister and the Parliament. As noted above, APRA can be directed by the Minister regarding the policies it should pursue, or priorities it should follow. Prudential standards must be tabled with Parliament, which could reject them by a majority vote within 15 days, but has never done so. Also, the Treasurer is involved in assessing the suitability of potential owners of large insurers (see ICP 5).

APRA's budget is proposed by the APRA Members and is subject to endorsement by the Government. Since APRA's formation, successive Governments have strongly supported APRA, but endorsement of the budget proposed by APRA is not guaranteed.

APRA is funded primarily from annual levies collected from supervised entities, with a contribution from interest earnings, fees for services and miscellaneous cost offsets. The levy rates are not set by APRA but are determined by the Government after consultation with industry and APRA. The levy rate is calculated by reference to assets, subject to a minimum and maximum amount per institution (except for authorized non-operating holding companies (NOHCs), which are levied at a flat rate). From time to time, APRA has also received Special Appropriations from the Government to deal with particular matters; for example, significant additional funding was provided to enhance APRA's ability to deal with the global financial crisis.

From 1 July 2007, APRA's financial arrangements moved from the coverage of the Commonwealth Authorities and Companies Act 1997 (CAC Act) (applicable mainly to government business enterprises) to the Financial Management and Accountability Act 1997 (FMA Act) (applicable to Government departments and most statutory authorities). Under Australian financial management policy, the FMA Act is the preferred government framework where a body "...will...perform regulatory functions under a law of the Commonwealth."

Like other government agencies, APRA is subject to a range of measures designed to improve financial accountability and promote appropriate and economical use of resources; for example:

- a) APRA's budget is subject to scrutiny by the Department of Finance and Deregulation;
- b) APRA is subject to "whole of government" procurement and cost reduction initiatives, particularly in areas such as travel and information technology;
- c) APRA's staff enterprise agreement (covering remuneration and conditions) is vetted by the Australian Public Service Commission and approved by the relevant Minister; and
- d) APRA is subject to general "efficiency dividend" requirements, under which agency funding is reduced to drive efficiency savings.

APRA has discretion to allocate its financial and human resources in accordance with its mandate and objectives and the risks it perceives. In particular, APRA has discretion in setting its own organizational structure and autonomy in staffing.

As noted above, ASIC is subject to directions by the Minister on policies it should pursue and priorities it should follow. Certain supervisory decisions are conferred on the Minister, although not with respect to matters relevant to ASIC's supervision of insurers and insurance intermediaries.

Like APRA, ASIC is covered by the FMA Act. The funding of ASIC is appropriated to it each financial year by the Parliament and provided from the Commonwealth's Consolidated Revenue Fund under Appropriations Bill. Almost all fees and charges collected by ASIC are returned to the Commonwealth Consolidated Revenue Fund.

A portion of ASIC's funding is non-core funding, which is earmarked for new policy proposals, other special projects and new initiatives proposed by ASIC (such as Credit Reform and Market Supervision). ASIC is largely able to specify the operational allocation of core funding of resources. Even though it has been indicated that the delineation between core and non-core funding has no legal or accounting basis in the appropriation framework used to fund ASIC, in practice ASIC does not use the funds earmarked for specific purposes to fund any other activities. The trend has been for non-core funding to account for an increasing share of

ASIC's total funding; for the year 2011-12, it accounted for 18.7 percent of ASIC's funding.

#### **Transparency of Requirements and Procedures**

APRA's regulatory requirements for insurers are outlined in prudential standards and supplemented by guidance in the form of prudential practice guides, all of which are published on APRA's website. Procedures for activities such as licensing and reporting are also published on APRA's website.

APRA's risk prioritization is built around its Probability And Impact Rating System (PAIRS) and Supervisory Oversight And Response System (SOARS) frameworks, which determine APRA's supervisory stance and allocation of resources for insurers (see ICP 9). Papers describing these frameworks are published on APRA's website and APRA Members and staff regularly explain them in speeches and in their dealings with insurers. Insurers are informed of their PAIRS ratings and of the factors considered in determining that rating through their ongoing interaction with APRA. Insurers are also informed of proposed supervisory action that is a consequence of their PAIRS rating.

APRA's supervisory approach is documented in its Supervision Framework. The framework includes an outline of APRA's supervision policy plus detailed instructions for undertaking core supervision activities, such as prudential reviews and offsite analysis. By providing a structured approach to specific tasks, the framework enhances the consistency and equity of APRA's supervision. APRA also has various internal processes that also help to ensure consistency and equity (see ICPs 9 and 10). A description of the framework is published on APRA's website.

The majority of regulatory decision-making in ASIC is carried out in accordance with published policies. These policies set out how ASIC interprets the law and how it approaches performing its functions and exercising its powers under the law. This includes, where appropriate, setting out what matters ASIC will take into account in making particular decisions.

ASIC has a number of processes and systems to ensure that it can discharge its functions and powers consistently across its regulated population. These include internal manuals and guides as well as organizational arrangements and allocation of responsibilities to ensure sufficient coordination and consistency.

#### **Review of Requirements and Procedures**

APRA continuously assesses the need for changes to regulatory requirements and supervisory procedures. It monitors and analyses developments in domestic and international financial systems, and keeps abreast of changes in supervisory techniques, for example, through participation in international groups such as the IAIS.

APRA typically responds to the need for regulatory changes by issuing or amending prudential standards and prudential practice guides. In doing so, APRA consults widely and extensively with affected parties through a combination of targeted and public consultation. Where a consultation package has generated attention or is deemed controversial, a response paper is generated that summarizes the issues, the key points raised in the submissions and APRA's response to these points. Consultation packages, feedback from industry and response papers are all made publicly available on APRA's website.

The Government requires a Regulation Impact Statement (RIS) to be prepared for

significant regulatory proposals. Thus, APRA prepares a RIS when proposing any new prudential standard or a substantive amendment to an existing prudential standard. A RIS is prepared after external consultation as part of the policy formulation process. It includes an assessment of the costs and benefits of options, a recommendation supporting the most effective and efficient option, and 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 not appropriate.

With regard to supervisory procedures, in 2010 APRA engaged a consulting firm to undertake a review of the systems and software supporting APRA's supervision processes and systems, which led to various recommendations for enhancements that have either been implemented, are in progress, or are planned for the future. APRA consults publicly on changes to supervisory procedures that could have a material effect on industry. APRA also publishes a full listing of open and closed consultations on its website.

ASIC consults with the public and other government bodies in relation to new policy proposals through formal and informal consultation procedures. Early in the process of developing new policy, ASIC will often seek to hold informal "roundtable" discussions with representatives from industry and consumer advocacy groups.

ASIC also funds a Consumer Advisory Panel that comments on policy affecting investors and consumers and an External Advisory Panel that it consults on key issues. It also maintains regional liaison committees in each State and Territory to consult the local business community. ASIC generally circulates a consultation paper before finalizing new or revised policy, and deviates from this approach only for reasons of urgency. ASIC's policy development process is subject to the Government's Regulatory Impact Analysis process that entails examining the likely impacts of proposed regulation. Following consultation, it prepares a RIS that is reviewed by the Office of Best Practice Regulation (OBPR). ASIC publishes the RIS and a report on its response to feedback received together with the final RG.

ASIC also makes use of media releases to disclose and explain regulatory actions and the adoption of new or revised standards. It has published its policy on the areas where it issues media releases. ASIC provides a significant amount of information on its website on its regulatory policies, including on the way it prepares new policy.

ASIC typically also consults regarding major changes in supervisory procedures. For example, although not related to insurance, ASIC consulted publicly on its approach to breaches of Market Integrity Rules. For issues affecting the insurance sector, ASIC communicates with industry bodies and insurers to help shape both what ASIC looks at and ASIC's consideration of what standards it is appropriate to expect and impose through ASIC's surveillance work.

#### **Information on the Insurance Sector and the Supervisor**

As the lead national statistical agency for the Australian financial sector, APRA publishes information and analysis about the financial condition of the insurance sector. Specifically, APRA publishes several industry-based publications that detail the financial strength and performance of the general and life insurance industries. A full list of statistical publications is available on APRA's website, along with previous editions of these publications.

APRA maintains a website that the public can access for information on APRA's role and responsibilities, policies, activities and supervised industries and institutions.

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

APRA also accounts for its performance through its Annual Report, which is tabled in Parliament. APRA also has a number of other publications explaining its objectives, procedures and operations.

As part of the Annual Report, APRA publishes information in relation to problem or failed insurers, including the number of times a specific enforcement action (such as judicial review, directions and contravention notices, and investigation action) has been employed by APRA. It also includes transition matrices, which track the migration of insurers between the four supervision stances in SOARS. The Annual Report does not, however, publicly identify a troubled insurer, because of confidentiality and systemic risk considerations. However, APRA does prepare statistical publications, which include information on the solvency positions of individual insurers and are publicly available on its website.

ASIC is required to publish an annual report, including audited accounts, which is tabled in Parliament and provided to various parliamentary committees. ASIC also publishes information on its regulatory actions on its website.

#### **Appeal Against Supervisory Decisions**

Most administrative decisions made by APRA under the IA and LIA are subject to judicial review under the Administrative Decisions (Judicial Review) Act 1977 (ADJR Act); the exception is certain decisions in relation to the Financial Claims Scheme (FCS) established under the IA. The circumstances in which judicial review is available include where there is bad faith or improper purpose, 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. The judicial review process does not unduly impede APRA's ability to exercise its functions and powers effectively and swiftly in order to protect policyholders' interests.

Certain of APRA's decisions are also subject to merits review. 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 and notice of the decision must be given to the affected person. It must also set out the findings on material questions of fact, refer to the evidence or other material and give APRA's reasons for the decision. A person not satisfied with the outcome of the review may apply to the AAT for a review of the decision. The AAT is required to review decisions based on their merit, which means that the AAT should "stand in APRA's shoes" and determine what is the correct or preferable decision based on the evidence put before it.

ASIC's decisions are generally subject to judicial review as to their legality under the ADJR Act. Most decisions of a regulatory nature are also subject to merits review by the AAT. A small number of regulatory decisions are not subject to merits review. In addition, there are a few other decisions that are not reviewable for merits, such as decisions relating to a process where the rights of the affected party are otherwise protected. The AAT may affirm ASIC's decision or substitute it with a different decision. A person may appeal to the Federal Court against decisions of the AAT on questions of law. The Supreme Courts and the High Court also have jurisdiction to

review ASIC's decisions. The decisions of the Minister are also subject to both a merits and judicial review. ASIC's actions are also generally subject to review by the Commonwealth Ombudsman. The Ombudsman may make recommendations to ASIC about what action should be taken, but unlike the AAT, it does not have the power to change ASIC's decisions (*s1317C CA and s33 of AAT Act*).

### **Confidentiality**

Legislation protects information and documents given to or obtained by APRA and prescribes penalties for the wrongful disclosure of confidential information. Under the APRA Act it is an offence for a person to disclose protected information or release any protected documents, except in specified situations. APRA takes actions necessary to preserve, protect and maintain the confidentiality of information received from a regulated entity or another supervisor, including information given by APRA to another supervisor (see ICP 3).

Except where a request falls within the scope of one of the permitted exceptions in the APRA Act, APRA is barred from releasing entity-specific information or documents. In this regard, APRA's statistics area regularly upholds the confidentiality of requested information, in publications and ad-hoc data requests. For example, in 2011 APRA denied a request for entity-specific information on the liability insurance market.

The APRA Act specifies the penalties for wrongful disclosure of protected information. The offence provision extends to all persons (presently or in the past) gaining access to protected information, whether they are an APRA staff member, an employee of another supervisory agency or an external consultant. A person is liable on conviction for imprisonment of up to two years.

APRA has a Security Framework, which includes policies, procedures and infrastructure, designed to minimize APRA's security risk. APRA takes steps to ensure that the secrecy provisions under the APRA Act (and policies and procedures, where relevant) are well known by APRA staff and anyone with whom it shares, under law, protected information.

ASIC's use, collection, access, accuracy, security, storage and disposal of official information is governed by a number of Commonwealth Acts and Regulations. All staff must acknowledge their awareness of the existence and implications of this legislation upon commencement of their employment with ASIC. ASIC must take reasonable measures to protect confidential information from unauthorized disclosure. ASIC and its staff are also subject to the Privacy Act that requires them to observe standards governing the handling of personal information. If an ASIC staff member releases information in breach of these provisions, it might constitute a breach of the Australian Public Service (APS) Values and the APS Code of Conduct. Any breach might lead to disciplinary action by ASIC and could be punishable by imprisonment for up to two years (*s127(1) ASIC Act and s70 Crimes Act*).

### **Legal Protection**

Section 58 of the APRA Act protects APRA and its staff from any liability for any act or omission where they act in good faith.

APRA staff are protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith by the Legal Services Directions 2005 (LSD) issued by the Attorney General under section 55ZF of the Judiciary Act 1903. Appendix E to the LSD provides an extensive framework for determining assistance in relation to legal costs. The criteria cover employees of

FMA agencies, including APRA. Essentially, expenditure to cover legal costs of an employee should normally be approved to assist an employee who is a defendant in civil or criminal proceedings if: a) the proceedings arose out of an incident that relates to their employment with the employing agency; and b) the employee acted reasonably and responsibly. An employee will only be considered to have not acted in a manner that was not reasonable and responsible where the employee has engaged in serious or willful misconduct or culpable negligence.

Furthermore, APRA has purchased directors' and officers' liability cover that applies to all APRA staff. Insurance cover is reviewed annually and is routinely subject to internal audit.

ASIC, its Commissioners and its staff are protected from legal liability in relation to an act done or omitted in good faith in performance or purported performance of any function, or in exercise or purported exercise of any power, under the corporations legislation or a prescribed law. According to ASIC, from a practical perspective it is unlikely that ASIC staff would be sued in connection with the discharge of their obligations. In the event that a staff member was sued in relation to his or her employment, the Australian Government would cover the legal costs (unless it was in relation to an administrative law issue, in which case ASIC would cover the legal costs) (s246 ASIC Act).

#### **Supervisory Resources**

The funding structure of APRA has been described above. APRA considers that its funding has been sufficient to enable effective discharge of its supervisory role.

The APRA Act enables APRA to hire risk specialists, industry experts or other professional staff, where necessary. APRA's pay scales are benchmarked externally on an annual basis to ensure they generally align with movements in the broader market. APRA has had a strong emphasis over a number of years within its recruitment program on bringing financial sector skills and experience into the organization. The pay scales have generally been sufficient to allow APRA to attract and retain qualified staff, including those with specialist skills. However, APRA has faced high staff turnover when markets for financial and risk management skills are strong.

APRA invests heavily in training and development. In benchmark surveys on training and development expenditure by private and government organizations, APRA consistently ranks in the 90th percentile of organizations in terms of training expenditure. Although over 80 percent of APRA's staff training is targeted at the development of core supervisory skills, current priorities also include further developing prudential supervision and leadership capabilities. To complement its training programs, APRA also has a program of seconding staff to other prudential regulators and agencies abroad.

APRA is equipped with an adequate information technology infrastructure and staff members have access to computer equipment and other tools needed to monitor and review the insurance industry. APRA's travel budget allows it to undertake necessary onsite visits to insurers, including some reviews of foreign operations.

The funding structure of ASIC has been described above. ASIC is of the view that, measured in terms of the level and outcomes of interaction with the regulated population and the outcomes of enforcement activity, current funding levels are adequate. However, ASIC would need more resources if it were to adopt a more proactive approach to supervising the conduct of business by insurers and insurance

intermediaries (see ICPs 9 and 19).

ASIC's remuneration arrangements were benchmarked against all Australian Public Service (APS) agencies in August 2011. Senior Executives are paid 10-20 percent above the APS median, while more junior roles sit at the median of the APS pay scales. In addition to base salary, ASIC staff is also eligible to receive performance based bonuses ranging from 3 to 15 percent.

As of November 2011, ASIC's ongoing employee turnover rate was 12.5 percent (a rolling 12 month average), an increase of 3.6 percent from the previous year. In ASIC's recent internal survey, the level of self-reported staff retention over the next two years is 59 percent (higher than the 44 percent for large APS agencies) and 20 percent of staff indicated they intend to leave within the next two years. ASIC's management was of the view that the staff turnover is currently at a healthy level.

In 2010-2011, ASIC spent around A\$1.4 million on formal learning programs. It can also support staff's studies both financially (up to A\$5,000/year) and through study and leave entitlements. ASIC has developed a set of learning pathways, representing the main skill areas that the staff requires in order to effectively perform their roles, aligned with ASIC's business needs. In addition to these learning programs, seminars and other learning opportunities are offered as part of the Continuing Professional Development Program.

The ASIC Act allows ASIC to hire outside experts where necessary.

#### **Integrity and Professionalism**

APRA's code of conduct reinforces APRA's commitment to maintaining the highest professional standards. It outlines the standards of conduct set for APRA and its staff, and the consequences of failing to uphold these standards. This includes guidance on managing potential and existing conflicts of interest. Underpinning this commitment, APRA staff sign a declaration at the time of appointment, undertaking that they will conduct themselves with honesty and due diligence, and also fully observe and comply with the rules and instructions of APRA. APRA has conducted biennial surveys of stakeholders since 2009; in both such surveys the integrity and professionalism of its staff have received high ratings.

Legislation determines conflict of interest rules for APRA Members. The APRA Act requires that APRA Members disclose any interest, whether direct or indirect, and whether or not pecuniary, that the Member has if that interest could conflict with the proper performance of the functions of his or her office. Disclosure is required whether or not there is any particular matter under consideration that gives rise to an actual conflict of interest. Disclosure must be in writing given to the Minister and to each of the other Members of APRA. Where an APRA Member has an interest in a particular matter that could conflict with the proper performance of the functions of their office, the APRA Act requires that Member to disclose the potential conflict of interest and seek the consent of the other APRA Members before a matter is decided.

Legislation also requires conflict of interest rules for APRA staff. The APRA Act requires that the APRA Chair takes reasonable steps to ensure that there are, where appropriate, adequate disclosure-of-interests requirements applying to both APRA staff and APRA delegates. In practice, APRA staff members are required to submit an annual summary statement of any direct security holdings in financial sector companies regulated by APRA, and those of their immediate family. Staff members are also required to notify a senior manager immediately if a conflict of interest

arises, or could arise, in any way between their duties and their investments.

ASIC and members of its staff must avoid situations where external or personal interests may conflict, or appear to conflict with ASIC's administration or enforcement of the ASIC Act, the CA or other legislation. This is administered through the Declarations of Interest Program.

The ASIC Act requires ASIC Commissioners to disclose a direct or indirect pecuniary or other interest that could conflict with the proper performance of their decision-making functions in relation to a particular matter. The Commissioners are required to disclose to the Minister every six months any relevant pecuniary interest, including in financial products regulated by ASIC (*s124(2) ASIC Act*).

More generally, all ASIC staff members are required under the Public Service Act and internal ASIC policy to disclose and take reasonable steps to avoid any conflict of interest (real or apparent) in connection with their employment and not make improper use of inside information. They are also subject to an ongoing conflict disclosure obligation. Staff members are required to complete a disclosure of interest form on financial interests and on any outside employment upon commencement of employment and biannually thereafter. Since September 2011, ASIC internal policy has also prohibited trading by ASIC staff members most likely to handle market sensitive information, unless pre-trading approval has been obtained from ASIC's Risk and Security Unit, which compares the trading request to a restricted list of entities and products.

Compliance with the APS Code of Conduct is monitored by ASIC's Risk and Security Unit. ASIC has issued procedures for investigating and resolving breaches of the APS Code of Conduct. It has also published an Information Sheet that sets out how complaints are handled, with an internal guide covering investigation of allegations of misconduct. ASIC has a Professional Standards Unit, which reviews complaints about staff conduct in connection with ASIC's regulatory activities. In the event that an employee breaches the APS Code of Conduct, the Chairman of ASIC can impose a range of sanctions (including termination of employment) (*s15 Public Service Act*).

#### **Outside Experts**

APRA uses contractors, consultants and other outside experts in various ways, including: to support certain enforcement activities; to provide for the short-term replacement of existing staff or temporarily fill a role that it is difficult to find an employee to do; to support project work; and to provide specialist professional knowledge and expertise that may not be available internally and which is needed for the development of an intellectual output (for example, research, evaluation, advice or recommendations to assist with decision-making).

Contractors are required to sign a declaration at the time of appointment, undertaking that they will conduct themselves with honesty and due diligence, and also fully observe and comply with the rules and instructions of APRA. They are also required to sign the IT Security and Privacy Policy and Declaration and the Information Security Policy Manual and Declaration.

Outside experts are informed that they are governed by the same secrecy provisions as those that apply to APRA staff.

ASIC has a well-established procurement process. It uses a standard form contract, which covers monitoring, quality and conflicts. ASIC performs a due diligence process, which considers issues such as conflicts of interest and the ability and

	<p>suitability of a provider to perform the required task. For each expert appointed ASIC has one or more ASIC contacts responsible for monitoring work, meeting with the expert regularly, checking drafts, providing active quality assurance and signing-off on final content. Outside experts are governed by the same secrecy provisions as those that apply to ASIC staff.</p>
Assessment	Partly observed.
Comments	<p>Several elements of the Australian regulatory framework need to be carefully considered in order to assess the extent of operational independence, accountability, transparency and adequacy of resources of APRA and ASIC. In light of the standards under ICP 2, they relate in particular to the following:</p> <p>The relevant Minister has been provided with powers ranging from the possibility to give directions to APRA and ASIC, to being in charge of certain supervisory decisions, such as in regarding the suitability of controlling shareholders of an insurer. Their use is generally subject to a clear and transparent process set out in legislation, which includes a requirement that decisions are made on the basis of the advice of the supervisory agency. Some of these powers have been rarely, if ever, used, and they do not generally include decision-making on day-to-day technical matters affecting particular regulated entities. However, the existence of these powers remains a concern, because they could potentially be exercised in a manner that would adversely affect supervisory policy.</p> <p>APRA and ASIC are dependent on the approval of the Government for their funding. A significant amount of ASIC's funding is non-core funding earmarked for specific projects. The relative share of this non-core funding has been increasing in the last few years, with the budget for 2012-13 continuing this trend. This raises concerns about the ability of ASIC to decide on the operational allocation of a significant part of its resources.</p> <p>Also, as highlighted under ICP 9, resources allocated by ASIC to proactive surveillance are very limited and leave a significant part of the regulated population, including insurance intermediaries, subject to largely reactive surveillance. While approval of the budgets of APRA and ASIC by elected government officials leaves them exposed to cutbacks for financial or political reasons, there are no indications of political interference in the supervision of insurers or insurance intermediaries.</p> <p>If an APRA Member or an ASIC Commissioner is removed from office, the reasons are not required to be publicly disclosed and the Government considers mandated disclosure to be inappropriate.</p> <p>It is recommended that the authorities take the following steps to strengthen the ability of APRA and ASIC to exercise their functions and powers in a more effective and operationally-independent manner:</p> <ol style="list-style-type: none"> <li>a) Eliminate or further restrict the ability of the Minister to give directions to APRA and ASIC on matters of supervisory policy;</li> <li>b) Eliminate or further restrict the involvement of the Minister in decisions related to individual regulated entities or individuals; and</li> <li>c) Consider the various possibilities to arrange the funding of APRA and ASIC in such a manner that will ensure they will have the resources needed to respond to the current and emerging supervisory challenges.</li> </ol>

<b>ICP 3</b>	<p><b>Information Exchange and Confidentiality Requirements</b> The supervisor exchanges information with other relevant supervisors and authorities subject to confidentiality, purpose and use requirements.</p>
Description	<p>Insurers and insurance groups submit a broad range of regulatory information to APRA under various prudential standards. APRA also obtains extensive information through its ongoing supervisory activities. Where necessary, APRA may require an insurer, a NOHC or their subsidiaries to produce information, books, accounts or documents (<i>s13 of FCODA, s115 of IA and s131 and 132 of LIA</i>).</p> <p>The APRA Act imposes a strict obligation on current and former APRA members, APRA staff, contractors, consultants, etc. to maintain the confidentiality of protected information and documents.<sup>27</sup> It also establishes gateways for the disclosure of such information. In particular, APRA may share information with a domestic or foreign financial sector supervisory agency<sup>28</sup>, and also any agency specified in the regulations.<sup>29</sup> Information that may be shared covers both qualitative and quantitative information in relation to insurers or insurance groups, including subsidiaries of insurers and NOHCs (<i>s56 of APRA Act</i>).</p> <p>APRA has executed MoUs and letters of arrangement with many domestic and foreign agencies and publishes those which it has authority to make public on its website.<sup>30</sup> APRA became a signatory to the IAIS Multilateral MoU (MMoU) in October 2009 and had undergone a validation by the IAIS on its compliance with the strict confidentiality regime under the MMoU.</p> <p>APRA has established close collaboration with other relevant supervisors to strengthen proactive information exchange. Domestically, close and effective coordination between the agencies represented in the CFR has been the hallmark of Australia's financial regulatory arrangements. APRA has signed MoUs with many members of supervisory colleges that it participates in, and prepared confidentiality declarations or equivalent, which are signed by delegates on a meeting-by-meeting basis. Direct links with foreign supervisors provide important inputs into APRA's risk assessment of Australian insurers that operate in other jurisdictions and of foreign insurers for which APRA is the host supervisor. More details on domestic and cross-border coordination arrangements are outlined in ICP 25.</p> <p>The sharing of protected information and documents via the gateways established under the APRA Act is at the sole discretion of APRA, subject to appropriate confidentiality safeguards. The existence of an MoU or a similar agreement is not a prerequisite for information exchange. This is in line with the Parliament's intention that APRA should, in performing and exercising its functions and powers, have regard to the desirability of cooperating with other financial sector supervisory agencies (<i>s10A of APRA Act</i>).</p>

<sup>27</sup>—"Protected document" and "protected information" broadly refer to information or documents disclosed or obtained under or for the purposes of a prudential regulation framework law.

<sup>28</sup>This includes any domestic or foreign body whose functions include supervising or regulating financial institutions.

<sup>29</sup>The agencies specified in the regulations include the CRR, PHIAC, RBA, the Treasury, AUSTRAC, the Federal Police, the Crime Commission, the Financial Reporting Council, and the NZ Treasury.

<sup>30</sup><http://www.apra.gov.au/AboutAPRA/Pages/ArrangementsandMoUs.aspx>

APRA applies judgement in deciding whether it is necessary to give prior notification to another relevant supervisor before taking action against an insurer, e.g., the effect of the action on other group entities. While APRA believes that this approach has worked well, it intends to consider the need to develop internal guidelines for a formal framework to disclose material information to relevant supervisors before taking action.

APRA would not request information from another supervisor without a legitimate interest and a valid purpose. APRA generally requests information for a broad purpose, such as for the purposes of supervision or in relation to prudential matters. The process APRA adopts when seeking information is tailored according to the expectation and comfort level of the originating supervisor. These might range from informal telephone conversations to requests pursuant to MoUs. APRA has established internal procedures to ensure the confidentiality of documents received under MoUs and that the valid purpose tests for the IAIS MMoU are met.

APRA must assess the release of any protected information to an external party on a case-by-case basis. Nevertheless, as a starting principle APRA expects to provide the information requested by another supervisor except in unusual circumstances. A formal request for information under an MoU would be assessed based on the terms of the arrangement and internal protocols. A request to comment on the fitness and propriety of individuals is assessed according to internal protocols. Information exchanged between APRA and other supervisors does not need to be in writing. In fact, during the Global Financial Crisis informal discussions by phone or face-to-face (as well as by emails) proved highly effective.

APRA seeks to respond in a timely and comprehensive manner when exchanging information. This is facilitated by a wide range of formal (e.g., MoUs) and informal links to various domestic and international agencies. Locally, APRA has designated liaison officers for communication with specific agencies on a bilateral basis, such as RBA, ASIC and Australian Transaction Reports and Analysis Centre (AUSTRAC). APRA's Statistics unit has a policy of responding to requests by external agencies for data within two days of receiving the request. For international liaison, APRA has a central coordination point and seeks to ensure timely and comprehensive responses, which are individually tracked.

APRA's disclosure powers are not subject to any reciprocity conditions. In practice, APRA does not require, expect or ask for strict reciprocity when information is exchanged.

As part of the due diligence undertaken before signing an MoU, APRA examines the powers and ability of the counterpart to safeguard the confidentiality of shared information. A common provision in MoUs is that approval in writing must be sought before confidential information is shared with a third party. While MoUs are not enforceable legal agreements, APRA is not aware of any case where the confidentiality undertaking has been breached. In addition, APRA informs recipients of their obligations to safeguard confidentiality under the APRA Act, before disclosing protected information. Generally, APRA requires the recipients to seek permission in writing if they intend to pass protected information to another supervisor.

APRA will obtain agreement from the originating supervisor if it intends to use information received under an MoU for another purpose. In particular, the IAIS MMoU necessitates informing the originating supervisor prior to passing on any confidential information exchanged. APRA has internal procedures for maintaining the confidentiality of information received under the MMoU, e.g., APRA would restrict

	<p>the circulation of information received and the information would be kept in separate confidential files on APRA's systems.</p> <p>A person who is or has been an APRA officer cannot be required to disclose to a court any protected information, or to produce in a court a protected document, except when it is necessary to do so for the purposes of a prudential framework law. Any APRA employee who receives a subpoena or similar instrument must refer it immediately to APRA's legal unit. In addition, protected information cannot be released under the <i>Freedom of Information Act 1982 (s56 of APRA Act)</i>.</p> <p>To date, APRA has not been required to disclose information received from another supervisor to a third party. In the event that such a request is made, APRA would not disclose the information unless with the consent of the originating supervisor or if compelled by law. In both cases, APRA would promptly advise the originating supervisor that a request for the information had been made to APRA.</p>
Assessment	Observed.
Comments	APRA is empowered to obtain and exchange information with other relevant supervisors and authorities subject to confidentiality, purpose and use requirements. It is signatory to a network of bilateral MoUs and the IAIS Multilateral MoU. APRA has also established close collaboration with relevant supervisors, domestically and internationally, which facilitates proactive information exchange. The existence of an agreement or understanding on information exchange is not a prerequisite for information exchange. The effectiveness of APRA's information exchange could be enhanced by clear internal policies and procedures on notifying other relevant supervisors in advance of taking action against an insurer.
<b>ICP 4</b>	<p><b>Licensing</b></p> <p>A legal entity which intends to engage in insurance activities must be licensed before it can operate within a jurisdiction. The requirements and procedures for licensing must be clear, objective and public, and be consistently applied.</p>
Description	<p>APRA is empowered under the IA and LIA to authorize<sup>31</sup> general and life insurers as well as NOHCs of general or life insurers. APRA may license insurers to operate as a corporate entity<sup>32</sup> in Australia (this includes subsidiaries of foreign-incorporated entities) or as a branch of a foreign-incorporated entity. Only Eligible Foreign Life Insurance Company (EFLIC), are allowed to conduct life insurance as branches. Currently, EFLICs are restricted to corporations in the USA and no branches have been established. APRA maintains a register of licensed insurers, including details of any licensing conditions for general insurers, on its website.<sup>33</sup> (<i>Part III of IA, Part 3 of LIA and Life Insurance Regulations 1995</i>)</p> <p>APRA publishes separate guidelines that outline the licensing process for general and life insurance and their NOHCs on its website. Composite insurers conducting both life and general insurance activities are prohibited. APRA's power to deal with</p>

<sup>31</sup>IA and LIA use the terminology 'authorisation' and 'registration' respectively, but these have the same legal effect as licensing.

<sup>32</sup>This may include companies that are friendly societies governed under Part 2A of the LIA. As at 31 Dec 2011, friendly societies held \$6.1 billion of assets or 2.6 percent total assets of life insurers of \$236.3 billion.

<sup>33</sup>See: <http://www.apra.gov.au/GI/Pages/general-insurers.aspx>

unauthorized insurance activities is outlined under ICP 10 (s.9 and s.10 of IA and s234 of LIA).

An overriding consideration in assessing license applications is that the applicant must demonstrate to APRA's satisfaction the capacity and commitment of the proposed new insurer to conduct insurance business on a continuing basis, with integrity, prudence and professional skill. Applicants must satisfy APRA that the proposed new insurer will meet all applicable legislation, prudential and reporting standards. These include fit and proper standards for responsible persons (ICP 5), risk-based capital requirements (ICP 17) as well as governance and risk management standards (ICPs 7 and 8). Applicants must submit a three-year business plan covering the operations at both entity and group level (where applicable), including the structure of the business, proposed activities and detailed financial projections. Applicants who are part of a group or joint venture must provide additional information, including reporting lines within the group and policies addressing intra-group transactions.

APRA requires all substantial shareholders to be well-established and financially-sound entities of standing and substance. Substantial shareholders must demonstrate their long-term commitment and ability to contribute additional capital if necessary. In addition, ownership in insurers is subject to the following legislation:

- a) FSSA – limits shareholdings of an individual shareholder, or group of associated shareholders, to 15 percent of an insurer's voting shares. The Treasurer may approve shareholdings in excess of 15 percent if it is not contrary to the national interest.
- b) Foreign Acquisitions and Takeovers Act 1975 (FATA) – empowers the Treasurer to block proposed acquisitions of shares or assets by foreign persons and prohibit arrangements relating to the directorate of corporations. Proposals that would result in a substantial controlling interest by a foreign person must be submitted to the Foreign Investment Review Board. The FATA applies to all industries and is not restricted to the financial sector.
- c) IATA – protects the public interest by preventing unsuitable persons from being in a position of influence over general and life insurers, and prevents undue concentration in the insurance industry. There are certain triggers that require compulsory notification to the Minister and a "go-ahead" decision prior to a company entering into an arrangement for acquisition or takeover.

The power to make a decision under the FSSA and IATA has in some instances been delegated to APRA, subject to certain asset limits.<sup>34</sup>

In assessing an application to establish a foreign-owned subsidiary or a branch, APRA considers the level and scope of prudential supervision in the foreign applicant's home country. As part of the license application, applicants must provide:

- a) an outline of any prudential supervision arrangements by the home supervisor; and
- b) a statement from the home supervisor: consenting to the application; confirming that the foreign applicant is of good financial standing; and agreeing to cooperate with APRA in the supervision of the proposed new insurer.

The licensing process involves a preliminary consultation with APRA, submission of a draft application, onsite reviews by APRA and a final review of the application. While there is no statutory requirement for APRA to decide on a license within a particular timeframe, the process typically takes between 3 and 12 months,

<sup>34</sup>The Treasurer has delegated his power to APRA under the FSSA for those insurers with assets below a specified amount, currently A\$ 1,000 million for general insurers and A\$ 5,000 million for life Insurers.

depending on the complexity of the issues involved and the quality of the initial application. Successful applicants are informed of the outcomes in writing.

APRA has the authority to impose additional requirements, conditions or restrictions on an insurer, where appropriate. However, the conditions must relate to prudential matters. APRA may also make an authorization/registration conditional on the parent of an insurer being an authorized NOHC. Restrictions imposed on the scope of a general insurance license, e.g., lenders mortgage insurers are required to be mono-line operations, are clearly published on APRA's register of licensed general insurers on its website (*s13 of IA and s22 of LIA*).

It is rare for APRA to make a formal rejection of an application. It is more common that, where APRA has expressed significant concern about the likelihood of a license being granted, the application is withdrawn. The refusal by APRA to grant a license and the imposition of conditions or restrictions are reviewable decisions (see ICP 2).

The Licensing Group ensures consistency of licensing decisions, issues internal guidance on licensing issues, provides recommendations on application decisions, and responds to policy issues on licensing across all APRA-supervised industries.

All licensed insurers are required to have a physical presence within Australia. APRA has licensed some insurers with minimal physical presence in Australia. For these insurers, APRA has consulted with the relevant home supervisors and has undertaken onsite prudential reviews in the home jurisdictions.

Since 2006, APRA has licensed 24 general insurers, 1 life insurer, and 9 general insurance NOHCs. These included 8 foreign-owned general insurers and 1 foreign-owned life insurer.

#### General Insurance

General insurance business is defined as – subject to limited specified exclusions – 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 (*s3 of IA*).

Part VII of IA relates to Lloyd's underwriters authorized to carry on insurance business in Australia (*s93 of IA*).

Unauthorized Foreign Insurers (UFIs) are given limited exemption to conduct certain insurance business that cannot be appropriately placed in Australia without authorization.<sup>35</sup> The exemption is restricted to: insurance contracts for atypical risks (e.g., liability relating to radioactive material), high-value insureds,<sup>36</sup> or for other risks that cannot reasonably be placed in Australia; and insurance contracts required by foreign laws, typically for offshore properties or liabilities (*s3A of IA and Part 2 of Insurance Regulations 2002*).

Business placed with UFIs is typically placed through brokers who must hold an Australian Financial Services License (AFSL) issued by ASIC. The broker must

<sup>35</sup>UFI is a term that was introduced in 2008 to make it clear that these insurers are not authorized as general insurers and replaces the previous term —DOFI—. IA was amended to address the 2006 recommendation to require that DOFIs be authorized by APRA, unless specific exemption provisions are met.

<sup>36</sup>Operating revenues or total assets above \$200 million, or over 500 employees.

advise its clients that an UFI is not authorized under the IA and not subject to APRA supervision. A broker must also make reasonable enquiries before certifying that a contract cannot be placed with an Australian insurer. The enquiries and the reasons for believing a contract cannot be reasonably placed in Australia must be documented. APRA collects data on brokers, which includes the details on insurance placed with UFIs. APRA provides information to the Government and ASIC relating to UFIs and publishes such data to allow external analysis. Where the data suggests suspicious activities, APRA would refer the cases to ASIC for investigation. ASIC is currently looking at three referrals from APRA. For the six-month period ending 31 December 2011, total premiums placed with UFIs by brokers was A\$ 685 million relative to the A\$18 billion received by authorized general insurers.

Discretionary mutual funds (DMFs)<sup>37</sup> are entities that offer “discretionary covers”-that is, an insurance-like product that may involve an obligation on the DMF to consider meeting a claim made on it, but which gives the DMF discretion as to whether or not it will pay the claim. The majority of DMFs operate discretely over a one-year time horizon.<sup>38</sup> They operate on a claims-incurred basis and typically at the end of the year any surplus funds (where contribution revenue is greater than claims payments and expenses) are used to fund risk management activity to the mutual benefit of the contributing members or returned to the contributing members, either directly or indirectly as a reduced future contribution. Consequently, in most cases the funds do not retain earnings and do not build capital strength to withstand underwriting losses. In those instances where claims on the funds are greater than contributions received for the year, the trustees or directors in some cases have recourse to members for further contributions. Alternatively, claims can simply be declined or not paid in full.

The different types of DMFs can be broadly segmented into three categories: Category 1-financing and administration of the self-insured retention; Category 2- risk pooling arrangements between organizations with a common connection; and Category 3-provision of insurance-like coverage to members of professional, sporting and other associations.

DMFs are prohibited from writing medical indemnity covers due to the implications to third-party claimants who have legitimate claims under such covers. However, a DMF is not prohibited from writing product liability, public liability or other liability covers – provided they do not do so by way of a contract of insurance.

Due to the discretionary nature of the cover, a DMF is not captured under the definition of an “insurance contract” and hence does not require authorization to conduct “insurance business” under the IA. APRA has collected data on DMFs since 2008 and prepares analyses to enable the Treasury to monitor the use of DMFs, for the purpose of determining whether DMFs should be subject to prudential regulation (*Amended IA and Discretionary Mutual Funds Act 2007*).

#### Life Insurance

Life insurance business consists of the issuing of life or sinking fund policies and the undertaking of liability under life or sinking fund policies. Continuous disability policies are also considered to be life insurance business. APRA may declare certain

<sup>37</sup><http://www.apra.gov.au/NonReg/Pages/discretionary-mutual-funds.aspx>

<sup>38</sup>The majority of DMFs operates for 12 months but will leave the fund open for a period of time to allow claims to be reported.

	<p>insurance business, annuity business or other financial business as life insurance business (s9, s9A, s12A and s12B of LIA).</p> <p>Life insurers are required to maintain at least one statutory fund (see ICP 12) at all times and separate statutory funds for investment-linked and overseas business (s31 of LIA).</p> <p><u>Private Health Insurance</u> Private health insurance may only be offered by insurers registered by the PHIAC under the PHIA. Private health insurers are subject to product and pricing controls and have little scope for risk or underwriting selection; their principal function is in claims administration.</p>
Assessment	Observed.
Comments	Insurance activities within Australia can only be conducted by authorized insurers. APRA is the licensing authority under the IA and LIA and has established appropriate licensing requirements in line with international best practices. Licensing procedures are clear and APRA establishes internal guidelines and ensures the consistency of licensing decisions. The licensing process involves significant interaction with the applicants and APRA exercises appropriate due diligence. APRA publishes the licensing requirements and maintains a register of licensed insurers on its website. The authorities are monitoring the level of activities of the UFIs and DMFs to determine the need to subject such entities to prudential supervision.
<b>ICP 5</b>	<p><b>Suitability of Persons</b> The supervisor requires Board Members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer to be and remain suitable to fulfil their respective roles.</p>
Description	<p>APRA's Prudential Standards on Fit and Proper<sup>39</sup> identify the minimum requirements in determining the fitness and propriety of a "responsible person", defined as a director, senior manager, auditor or an appointed actuary of an insurer. A "senior manager" is defined broadly to cover persons who make significant decisions, persons who enforce and implement board strategy, and persons who impact financial standing or review and monitor risks. The IAIS defines control functions to include risk management, compliance, actuarial matters and internal audit.<sup>40</sup> APRA considers that the definition of senior managers is broad enough to include key persons in control functions. APRA may determine a person is a responsible person if APRA considers they play a significant role in the management or control of an insurer (CPS 520 ).</p> <p>An insurer's board of directors (Board) is primarily responsible for ensuring that responsible persons are fit and proper at the stage of licensing and on an on-going basis. Responsible persons must have the appropriate skills, experience and knowledge as well as act with honesty and integrity. The exceptions are: a) for a Category C insurer (i.e., a foreign branch), the responsibility lies with the senior</p>

<sup>39</sup>A new consolidated prudential standard *CPS 520 Fit and Proper* will come into effect on 1 July 2012.

<sup>40</sup>ICP Guidance 8.2.1.

officer outside Australia with delegated authority from the Board; and b) for an EFLIC, the responsibility lies with the Compliance Committee.<sup>41</sup>

Insurers and their NOHCs are required to: implement a written Fit and Proper Policy; assess the fitness and propriety of a responsible person prior to initial appointment and annually; ensure that a person is not appointed to, or does not continue to hold, a responsible person position for which they are not fit and proper; meet additional requirements for certain auditors and actuaries; and provide information to APRA regarding responsible persons and the assessment of their fitness and propriety.

An insurer's Fit and Proper Policy must be approved by its Board or, in the case of an EFLIC by its Compliance Committee. Insurers also must take all reasonable steps to ensure that all responsible persons are aware of, and understand, the Fit and Proper Policy.

APRA has established prudential practice guides, which set out minimum considerations when conducting fit and proper assessments of responsible persons. Such considerations include: the person's character, competence and experience relative to the duties involved; the person's track record in complying with legal obligations, regulatory requirements or professional standards; any deficiencies in the person's management resulted in failure of a company/business (*GPG 520 and LPG 520*).

Fit and proper requirements relating to significant owners are outlined in ICP 4.

APRA reviews the content of an insurer's Fit and Proper Policy against prudential standards. Supervisors also consider their own insights into the individuals based on previous their dealings with APRA, as well as media and other reports.

As part of their Fit and Proper Policy, insurers are required to conduct regular self-assessments to ensure that all responsible persons meet APRA's standards on an on-going basis. An insurer must notify APRA within 10 business days if it assesses that a responsible person is not fit and proper. If the person remains in the responsible person position, the notification must state the reason for this and the action taken. While there is no explicit requirement for significant owners, it is standard supervisory practice for APRA to be kept informed of any significant owners and to maintain dialogue with supervised entities on changes in this area (*Paragraph 51 of GPS 520 and Paragraph 44 of LPS 520*).

APRA is empowered to direct a general insurer to remove a director or senior manager where APRA is satisfied the person is not fit and proper to hold the appointment. The general powers to give directions to life insurers include the removal of persons based on specified statutory triggers. The power to remove such persons also applies to NOHCs. APRA may also apply to the Federal Court to disqualify a responsible person, actuary or auditor. The Federal Court will order disqualification where it is satisfied that the person is not fit and proper, and the disqualification is justified (*s24, s25, s25A, s27, s44 and s49R of IA and s230B(2)(d) and 245A of LIA*).

APRA has used the disqualification powers and publishes a disqualification register, which indicates, for example, the disqualification of several Zurich Australia

<sup>41</sup>There are no EFLICs currently operating in Australia.

	<p>Insurance Limited executive directors and other senior executives in response to certain financial reinsurance arrangements.<sup>42</sup></p> <p>An approval under the FSSA to have ownership stakes in excess of 15 percent in an insurer can be revoked where the Treasurer (or APRA as the Treasurer's delegate) considers that the significant owner is no longer suitable to be in a position of influence over an insurer and it would be in the national interest to do so.</p> <p>Auditors and audit firms must be registered with ASIC before they can conduct an audit under the CA. The registration criteria include qualifications and meeting auditing competency standards. ASIC is also responsible for auditor oversight. In addition, auditors must meet eligibility criteria under APRA's prudential standards. Disciplinary matters relating to registered auditors are dealt with by the independent Companies Auditors and Liquidators Disciplinary Board (<i>s39 of IA and s84 of LIA</i>).</p> <p>The CA provides criteria and requirements relating to the independence of auditors. These include: a) a general requirement for auditor independence; b) restrictions on auditors' employment and their financial relationships with clients; c) a two-year "cooling-off" period before an audit partner can become an officer of a client of the audit firm; d) a requirement for lead and review auditors of listed companies to be rotated after five years; and e) extensive disclosure requirements for listed companies in relation to non-audit services provided by their auditors. ASIC's surveillance and inspection programs include ensuring that audit firms are complying with their auditor independence and audit quality obligations.</p> <p>Similarly, actuaries must meet eligibility criteria under APRA's prudential standards (<i>s39 of IA and s93 of LIA</i>).</p> <p>If an auditor or actuary has failed to perform adequately and properly his/her duties or is not fit and proper, APRA may refer the matter to the relevant professional associations. APRA may also report to the Companies Auditors and Liquidators Disciplinary Board on the conduct of an auditor. APRA is empowered to give directions to insurers requiring the removal of an auditor or actuary where APRA is satisfied the person is not fit and proper (<i>s49R of IA and S125 and s125A of LIA</i>).</p> <p>APRA has mechanisms in place for exchanging information and coordination with domestic and overseas authorities, including on suitability of persons (ICP 3 and ICP 25).</p>
Assessment	Largely observed.
Comments	<p>APRA requires responsible persons of insurers and their NOHCs to meet fitness and propriety criteria commensurate with their respective roles. Significant owners must have the financial soundness and integrity necessary to ensure sound and prudent operations of insurers. Compliance with fit and proper standards is monitored by APRA through its prudential supervision and reporting framework. Where necessary, APRA may direct insurers to remove responsible persons who are not fit and proper for their appointments. In addition, APRA may also remove or apply to the Federal Court to disqualify a responsible person.</p>

<sup>42</sup> [www.apra.gov.au/CrossIndustry/Pages/Disqualification-Register.aspx](http://www.apra.gov.au/CrossIndustry/Pages/Disqualification-Register.aspx) Prior to 1 July 2008, disqualification determinations were made by APRA, rather than the Federal Court. The Zurich disqualifications occurred under the former regime.

	<p>However, there is no explicit requirement for insurers to notify APRA of any circumstances that may materially adversely affect the suitability of significant owners. While key persons in 'Control Functions' are covered under the scope of Responsible Persons through the definition of Senior Managers, there are merits to clarifying the scope of "responsible persons" to include an explicit category of "Key Persons in Control Functions", to enhance transparency and to highlight the need for independence of control functions from senior management.</p> <p>The current suitability requirements could be enhanced by:</p> <ul style="list-style-type: none"> <li>a) requiring insurers to notify APRA of any circumstances that may materially adversely affect the suitability of significant owners; and</li> <li>b) separating "Key Persons in Control Functions" from the definition of "senior manager" under "responsible persons".</li> </ul>
<b>ICP 6</b>	<p><b>Changes in Control and Portfolio Transfers</b></p> <p>Supervisory approval is required for proposals to acquire significant ownership or an interest in an insurer that results in that person (legal or natural), directly or indirectly, alone or with an associate, exercising control over the insurer. The same applies to portfolio transfers or mergers of insurers.</p>
Description	<p>Under the FSSA, the holding of ownership and other interests in financial sector companies (including general and life insurers) is subject to a 15 percent limit unless a higher limit is approved by the Treasurer on national interest grounds. In determining what is in the national interest, the safety and protection of policyholders is a material consideration.</p> <p>A person whose stake in an insurer does not exceed 15 percent may be declared by the Treasurer to have practical control<sup>43</sup> of the insurer. The Treasurer may declare a person as having practical control if: the directors of an insurer are accustomed or under an obligation to act in accordance with the directions of a person; or a person is in a position to exercise control over an insurer; and the Treasurer is satisfied that it is in the national interest to declare that the person has practical control of the insurer. A person's stake is the aggregate of the person's voting power and the voting power of the person's associates.</p> <p>Where a person's stake in an insurer exceeds 15 percent and the holding has not been approved by the Treasurer, this results in an unacceptable shareholding situation. The Treasurer may apply to the Federal Court for orders to remedy the unacceptable shareholding situation, which could include a divestment order (<i>s12 of FSSA</i>).</p> <p>A proposal that results a person being able, alone or with their associates, to control or appoint one or more directors in an insurer requires notification to and approval from the Treasurer under the IATA. The Treasurer may make a divestment order directing a person who has acted without such an approval (<i>s58 of IATA</i>).</p> <p>A person who is successful in applying for approval under the FSSA to hold more than a 15 percent stake in an insurer is granted approval to hold a specific percentage stake. Prior approval is required to raise the ownership stake above the approved percentage (<i>s17 of FSSA</i>).</p>

<sup>43</sup>Control includes control as a result of, or by means of, trusts, agreements, arrangements, understandings and practices, whether or not having legal or equitable force and whether or not based on legal or equitable rights.

Where a person reduces an ownership stake in an insurer, APRA is likely to become aware of this through its regular supervisory processes. In such cases, the Treasurer has power to vary or revoke the relevant FSSA approval if it is satisfied it would be in the national interest to do so. However, there is no requirement on insurers to notify APRA in the case of a significant decrease below the approved level (*s17(6) of the FSSA*).

A person who ceases to have a substantial holding in a listed insurer, or has a substantial holding in the insurer and there is a movement of at least one percent in the holding, must lodge a substantial shareholding notice with ASIC and the relevant stock exchange within two business days (*s671B of the CA*).

The FSSA applies the same way to persons outside Australia. Where relevant, the proposal may need separate approval from the Treasurer under the FATA. The Treasurer obtains advice from the Foreign Investment Review Board on whether the acquisition is consistent with the government's foreign investment policy. APRA will seek information from overseas supervisors where it is material in deciding on an application involving entities domiciled or regulated in a foreign jurisdiction.

In practice, APRA assesses any changes in control applications as if they were license applications, using the documented guidelines on authorization of general and life insurers, where applicable.

Persons seeking approval under the FSSA are required to provide appropriate information regarding shareholding interests as part of the application process. APRA also has the power to require insurers to give information on their shareholders. In addition, ASIC has powers to issue a disclosure notice to persons for their ownership and/or interests in a publicly listed corporation or a company with more than 50 members (*s115 of IA and s131 of LIA*).

Unless applicants can assure APRA that all beneficial owners who exercise control over an insurer have been identified in an application, the application will not be approved. The Treasurer requires an applicant to provide further information and may refuse to consider the application until it receives the information (*s20 of the FSSA*).

While the FSSA does not prescribe criteria for assessing the national interest test, financial and non-financial resources of the proposed acquiring entity, and the potential implications for policyholders of the insurer, are key factors. APRA's internal guidelines on assessing FSSA applications include consideration of factors such as capital position, capital management, financial viability, risk management, governance, fitness and propriety of responsible persons, and integration issues.

A change of a mutual company to a stock company, or vice versa, is subject to APRA's approval and involves extensive consultation with both APRA and ASIC. Where necessary to address any supervisory concerns, APRA may impose a condition on the insurer's authorization to prevent the change.

	<p>Prior approval of the Minister is required for transferring 15 percent or more of the insurance business<sup>44</sup> of an insurer. The Minister takes into account the financial position of the transferee and the transferor and must be satisfied that the interests of the policyholders of both the transferee and transferor will be protected (<i>s41 of IATA</i>).</p> <p><u>General insurance</u> No part of the insurance business of a general insurer may be transferred to, or amalgamated with, another insurer except by a scheme confirmed by the Federal Court. The insurer cannot make an application to the Federal Court unless the insurer provides APRA with a copy of the scheme and any actuarial reports on which the scheme is based. In assessing the application, APRA takes into account the financial position of the transferee and the transferor and satisfies itself that the interests of the policyholders of both the transferee and transferor will be appropriately protected. Although the Federal Court confirms the scheme, APRA has a right of appearance and the Court relies heavily on APRA's judgment as to whether a scheme should be confirmed (<i>Division 3A of , Part III of IA</i>).</p> <p><u>Life insurance</u> As in the case of transfers of general insurance business, any scheme to transfer life policies from one insurer to another must be confirmed by the Federal Court. Similarly, a life insurer cannot make an application to the Federal Court unless the insurer provides APRA with a copy of the scheme and any actuarial reports on which the scheme is based. In assessing the application, APRA takes into account the financial position of the transferee and the transferor and satisfies itself that the interests of the policyholders of both the transferee and transferor will be appropriately protected. Again, although the Federal Court confirms the scheme, APRA has a right of appearance and the Court relies heavily on APRA's judgment as to whether a scheme should be confirmed (<i>Part 9 of LIA</i>).</p> <p>Life insurance business may also be transferred under the Financial Sector (Group Restructure and Transfer of Business) Act 1999 (FSGRTB). A voluntary transfer will not be approved by APRA unless it is satisfied that the interests of policyholders in the transferring and receiving insurers are protected. This requires APRA to be satisfied that the transferor and transferee are in a satisfactory financial position both before and after the transfer of business (<i>s11 of FSGRTB</i>).</p>
Assessment	Largely observed.
Comments	The FSSA sets clear ownership and control thresholds above which approval is required. The Treasurer, or APRA as the delegate, is empowered to approve proposals to acquire or increase significant ownership or interest in an insurer. In practice, APRA assesses all proposals as if they were initial license applications. While insurers are not explicitly required to notify APRA in the case of a significant decrease in the ownership by a person(s) below the pre-determined control level, such cases may be identified through APRA's supervisory process.

<sup>44</sup>The threshold 15 percent is calculated on the basis of liabilities in respect of transferring policies, unearned premiums provision or outstanding claims provision. Where the transfer involves an acquisition by a related party of more than 15 percent of the assets of the insurer, separate approval is required. (*s36 of IATA*)

	<p>Insurers need to obtain approvals from APRA and/or the Federal Court to transfer all or part of their business to another insurer. Prior approval of the Minister is required for transferring 15 percent or more of the insurance business of an insurer.</p> <p>Insurers should be required to notify APRA on any significant decrease in the ownership by a person(s) below the pre-determined control level approved by the Minister.</p>
<b>ICP 7</b>	<p><b>Corporate Governance</b></p> <p>The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer's business and adequately recognizes and protects the interests of policyholders.</p>
Description	<p>Corporate governance requirements are set out in the CA, IA, LIA and the following APRA prudential standards: Governance (GPS 510 and LPS 510, for general and life insurers, respectively) and Risk Management (GPS 220 and LPS 220).</p> <p>The requirements establish that the Board has the ultimate responsibility for the sound and prudent management of an insurer. For branches of foreign insurers, although the Board retains ultimate responsibility, legislation provides for additional mechanisms to promote effective governance. In the case of general insurance branches, the insurer must nominate a senior officer outside Australia (whether a director or senior executive) with delegated authority from the Board who will be responsible for overseeing the branch operation. In the case of life insurance branches, the insurer must establish a Compliance Committee to oversee the branch operation. The senior officer or Compliance Committee, respectively, represents the Board for the purpose of the requirements set out in the prudential standards.</p> <p>The prudential standards require Boards to maintain and approve business plans and a risk management framework, and to oversee their implementation. APRA will allow a general insurance group to apply a single over-arching group business plan, as long as it adequately deals with the matters that would be covered by the business plans of each insurer within the group. Prudential practice guides on risk management (GPG 200 and LPG 200) provide guidance on the expected scope and content of business plans.</p> <p>APRA assesses the quality and effectiveness of an insurer's Board in setting and overseeing the implementation of its business objectives and strategies through onsite reviews. Internal guidance assists supervisors with such assessments.</p> <p>Prudential standards require the Board of an insurer to:</p> <ol style="list-style-type: none"> <li>a) have a formal charter that sets out its role and responsibilities;</li> <li>b) clearly set out and document any delegations to management;</li> <li>c) have mechanisms in place to monitor the exercise of delegated authority; and</li> <li>d) ensure the directors and senior management collectively have the full range of skills needed for the effective and prudent operation of the regulated entity.</li> </ol> <p>The prudential standards promote a separation of oversight and management by requiring the Board of an insurer to have a majority of independent directors and an independent chair. For branch insurers, separation is also achieved through the role of the senior officer outside Australia (for general insurers) or Compliance Committee (for life insurers, which must have at least five members, including one director of the insurer, two independent members and a non-executive chair).</p>

APRA assesses the effectiveness of the Board and senior management in overseeing the insurer. This includes assessment of the Board oversight of strategies and their implementation, risk management framework, statutory reporting and information flows.

The prudential standards require the Board to:

- a) ensure the directors, collectively, have the necessary skills, knowledge and experience to understand the risks of the insurer, including its legal and prudential obligations;
- b) ensure that the insurer is managed in an appropriate way taking account of these risks;
- c) have procedures for assessing, at least annually, the Board's performance relative to its objectives and a procedure for assessing the performance of individual directors;
- d) have a formal policy on Board renewal; and
- e) have mechanisms in place to monitor the exercise of the functions delegated to management.

APRA assesses the role of the chair and Board committees, Board charters, company constitutions and other documentation, the Board's ability to discharge its duties, and its use of delegations and resources. For branch insurers, such assessments focus on the effectiveness of the senior officer outside Australia and the Compliance Committee.

The CA requires directors to:

- a) act in good faith and in the best interests of the company;
- b) discharge their duties with the degree of care and diligence a reasonable person in the position of the director would exercise;
- c) exercise their powers for proper purposes;
- d) avoid undisclosed conflicts of interest; and
- e) not improperly gain or cause detriment due to their position.

In addition, the LIA requires directors to give priority to the interests of owners and prospective owners of policies in managing the respective statutory fund. The CA prescribes requirements for Boards in dealing with conflicts of interest, while prudential standards require the Compliance Committee of a branch insurer to adopt a policy on conflicts of interest. These requirements are reinforced by prudential practice guides.

Prudential standards require insurers to establish a Board Remuneration Committee, which is subject to certain composition requirements. Its responsibilities must include making regular reviews of remuneration policy and annual recommendations to the Board on the remuneration of a range of key positions. Such positions must include the chief executive officer, executive directors, direct reports to the chief executive officer, senior managers, persons whose primary role is risk management, compliance, internal audit, financial control or actuarial control, other persons who may affect the financial soundness of the insurer, and any other person specified by APRA. For branch insurers, the senior officer outside Australia or the Compliance Committee is required to perform the role of the Board Remuneration Committee.

Prudential standards specify that the remuneration policy must contain remuneration objectives that support the insurer's long-term financial soundness and risk management framework. The prudential standards provide specific criteria that must be met by the remuneration policy in support of such objectives.

APRA assesses compliance with the remuneration requirements through offsite and onsite reviews. It has undertaken a review of major entities' remuneration arrangements, which included meeting the Remuneration Committees of their Boards to assess compliance and provide feedback on their remuneration arrangements. APRA has also communicated its observations on the results of the review to all regulated institutions.

Prudential standards require insurers to establish a Board Audit Committee, which is subject to certain composition requirements. Its responsibilities must include oversight of compliance with APRA statutory reporting, financial reporting and accounting requirements, as well as oversight of internal and external audit and appointment of the auditor.

The external auditor is required to audit the annual financial statements and APRA statutory reporting, and to prepare an annual report on matters including whether the statistical and financial data provided to APRA is reliable and whether the systems, procedures and controls relating to actuarial data integrity and financial reporting risks are adequate.

APRA assesses the effectiveness of insurers' financial reporting frameworks through onsite and offsite reviews. Such reviews include examination of internal processes and investigation of the interaction between internal and external audit.

Insurers are required to report to APRA on various aspects of their governance, through regular statutory reporting, in response to supervisory requests and in connection with breaches of the requirements. APRA assesses the effectiveness of an insurer's governance-related communication systems through its supervision activities, for example, in conjunction with the assessment of functions such as risk management, Board performance, remuneration and outsourcing arrangements.

Listed insurers are subject to the Principles of Good Corporate Governance and Best Practice recommendations of the Australian Securities Exchange (ASX), and are required to disclose in their annual reports the extent to which they have followed these best practice recommendations.

As noted above, prudential standards require Boards to maintain and approve business plans and a risk management framework, and to oversee their implementation. As part of its risk management framework, insurers are required to document a Risk Management Strategy, which must include a description of the relationships between the Board, Board committees and senior management. Insurers must also identify the policies and procedures for ensuring relevant staff have an awareness of risk issues and instilling an appropriate risk culture, monitoring and reporting risk issues, and monitoring and ensuring continual compliance with all prudential requirements.

APRA assesses the effectiveness of the Board's oversight of senior management through the review of areas such as risk management, fitness and propriety, and specific risk areas covered by an onsite review. Such assessments typically include the review of Board documents, the structure and reporting lines within a risk management framework, the use of delegated authorities in underwriting and claims, the establishment of unfettered access to the Board by control functions, and the basis for the Board's assessment of the performance of senior management.

Prudential standards require insurers to make an annual Risk Management Declaration to APRA, stating that they have complied with the relevant prudential

	<p>and reporting standards, including risk management and governance standards.</p> <p>As noted above, APRA assesses various aspects of the governance of insurers through its supervisory processes. APRA also meets with the chair and the chief executive officer of most insurers at least once annually. Supervisors sometimes attend Board meetings or meet with the senior officer outside Australia or the Compliance Committee for branch insurers. The results of such meetings also inform the assessments. APRA can intervene if it identifies weaknesses in the corporate governance framework (see ICP 10).</p>
Assessment	Observed.
Comments	<p>Corporate governance requirements for insurers are extensive and the assessment of corporate governance is a key element of APRA's supervisory assessments. Nonetheless, there is scope to enhance corporate governance requirements for insurers to reflect evolving international best practices.</p> <p>Only listed insurers are required to disclose comprehensive information on their governance.</p> <p>Corporate governance might be further enhanced by amending the requirements to more explicitly indicate the responsibility of Boards to maintain and enforce policies to deal with conflicts of interest.</p> <p>All insurers should be required to disclose their governance practices in their annual reports, which would make important information on governance available to all relevant stakeholders.</p>
<b>ICP 8</b>	<p><b>Risk Management and Internal Controls</b></p> <p>The supervisor requires an insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters, and internal audit.</p>
Description	<p>Risk management and internal control requirements are set out in the APRA prudential standards on Risk Management (GPS 220 for general insurers, LPS 220 for life insurers, and GPS 221 for Level 2 general insurance groups), supplemented by a number of other prudential standards and practice guides that deal with various risks and controls. They cover such areas as capital adequacy, business continuity, outsourcing, reinsurance, information technology security, insurance, credit, and balance sheet and market risk.</p> <p>An insurer is required to establish a risk management framework and strategy that are appropriate to the nature and scale of its operations. The risk management framework is required to address all material risks likely to be faced by the insurer, which must include specified risks such as strategic risk, insurance risk and operational risk. Insurers are required to periodically review the risk management framework, including a review of the risk management strategy, internal control systems and the people and functions involved in risk management. Compliance with these requirements is assessed as part of the licensing process and the ongoing soundness of risk management and internal controls is assessed through various supervisory activities.</p>

APRA assesses the adequacy of risk management frameworks and the effectiveness of their implementation as a key element of its supervisory framework. This is done through both offsite analyses, for example, of risk management strategies, and onsite reviews. Specialist resources are sometimes involved in these reviews.

The same risk management and control requirements apply at the general insurance group level. In making its assessments in the context of group-wide supervision, APRA takes into account the role of the Board and senior management of the head of the insurance group, as well as the risks and risk management processes relevant at the group level.

As noted under ICP 7, prudential standards require an insurer to have a Board Audit Committee, with certain composition requirements. It is expected to provide an objective, non-executive review of the effectiveness of the insurer's financial reporting and risk management framework. Some insurers have also established a separate Board Risk Management Committee to deal with the risk management oversight responsibilities that otherwise fall to the Board Audit Committee.

Prudential standards specify the need for a direct relationship between the Board Audit Committee and control functions, including appointment, provision of reports and the requirement for unfettered access.

APRA assesses the effectiveness of an insurer's control functions through its onsite and offsite supervision, supported by assessment guidance. For example, supervisors will assess whether the control functions have sufficient qualified staff with the necessary experience, technical capabilities and access to resources, and whether staff responsible for monitoring and enforcing compliance with the insurer's risk policies have authority independent from the units they oversee. Other aspects of the assessment involve reviewing the control functions' documented policies, authorities and reporting lines.

The Board Audit Committee is also required to establish and maintain policies and procedures for employees of the insurer to submit, confidentially, information to the committee about accounting, internal control, compliance, audit and other matters about which the employee has concerns.

Prudential standards set out the requirements for a risk management function, while prudential practice guides on risk management (GPG 200 and LPG 200) provide additional guidance. Larger insurers are expected to have a specialist risk management function. The risk management function is expected to have direct access to the relevant board risk committee or executive management, independently of the business functions. An insurer that is part of an insurance group is allowed to rely on the group's risk management function instead of having its own risk management function, provided that the Board is satisfied that the arrangement is appropriate, and that it complies with APRA requirements.

APRA assesses the effectiveness of the risk management function in assisting the Board, the Board committee and senior management in developing, maintaining and implementing the insurer's risk management framework. Supervisory assessments in this area are made through onsite and offsite supervision activities, typically as part of the review of the overall risk management framework and its implementation.

Prudential standards require an insurer's risk management strategy to include an overview of the mechanisms in place for monitoring and ensuring continual

compliance with all prudential requirements. Furthermore, the Board must provide APRA with an annual Risk Management Declaration confirming, among other things, that the insurer has systems in place for the purpose of ensuring compliance with insurance legislation, prudential and reporting standards, licensing conditions, directions and any other requirements imposed by APRA. No specific requirements are imposed with respect to the structure or design of the compliance function and an insurer is not required to designate a compliance officer.

APRA assesses the compliance function as part of the licensing process, where the applicant must satisfy APRA that its processes and systems will ensure compliance with APRA's prudential standards, other Australian regulatory and legal requirements and foreign regulatory requirements, where applicable. Ongoing assessment of the compliance function is done through onsite and offsite review activities, such as reviewing policies and procedures, testing an insurer's compliance with legislative and regulatory requirements, and reviewing the adequacy of compliance reports.

The IA and LIA require each insurer and general insurance group to designate an Appointed Actuary. Prudential standards (GPS 310, LPS 320 and GPS 311) describe the roles and responsibilities of the Appointed Actuary. An Appointed Actuary's primary roles are to give advice on the valuation of an insurer's technical provisions and provide an impartial assessment of the overall financial condition of the insurer. The Appointed Actuary is subject to fit and proper assessment (see ICP 5), and cannot be a director of the insurer or related body corporate, its Chief Executive Officer or the Appointed Auditor. The Appointed Actuary is also subject to Professional Standards promulgated by the IAAust, including a Code of Professional Conduct.

The Financial Condition Report (FCR) prepared by the Appointed Actuary must cover areas such as the insurer's solvency position, risk management framework, compliance with prudential standards and, for general insurers, pricing and reinsurance. For life insurers, prudential standards require the Appointed Actuary to provide advice on pricing matters prior to the issuance or modification of a policy, and on reinsurance prior to a change in reinsurance arrangements. An insurer is required to ensure that its Appointed Actuary has access to all relevant data, information, reports and staff necessary to fulfill these responsibilities. The Appointed Actuary has access to the insurer's Board and Board Audit Committee, and is also required to immediately notify APRA of matters that may significantly affect the interests of policyholders, such as insolvency or contraventions of law.

APRA assesses the effectiveness of the actuarial function through both offsite analysis and onsite reviews. Actuarial reports required by the prudential standards are reviewed by APRA at least annually, and actuarial inputs in areas such as pricing and reinsurance are also reviewed. APRA's actuarial specialist unit often participates in such reviews.

Prudential standards (GPS 510 and LPS 510) require each insurer to have an independent and adequately resourced internal audit function. 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. To fulfill its functions, the internal auditor must have unfettered access to all of the insurer's business lines and support functions. The internal audit function must also have appropriate authority and access to the Board, as well as a direct reporting line and unfettered access to the Board Audit Committee.

APRA assesses the effectiveness of the internal audit function through both onsite

	<p>and offsite reviews. The assessment includes consideration of the quality and independence of the function, its willingness to challenge management, and how the Board utilizes the internal audit function and responds to audit findings. Other factors considered include any outsourcing of the internal audit function, structure and resources, the audit approach, the quality of internal audit planning and reporting, and audit coverage.</p> <p>Prudential standards (GPS 231 and LPS 231) describe the requirements for outsourcing arrangements and specify that the insurer is responsible for complying with all prudential requirements that relate to the outsourced business activity. Requirements relate to materiality, outsourcing policies, assessment of outsourcing options, outsourcing agreements, APRA's access to service providers, notification requirements, monitoring of the outsourcing relationship and audit arrangements. For example, an insurer must ensure it has sufficient and appropriate resources to manage and monitor the outsourcing relationship at all times, and the internal audit function must review any proposed outsourcing of a material business activity and regularly review and report to the Board or Board Audit Committee on compliance with the insurer's outsourcing policy.</p> <p>APRA assesses such aspects of outsourcing through both onsite and offsite reviews.</p>
Assessment	Observed.
Comments	<p>In recent years, APRA has strongly emphasized the importance of risk management and internal controls, and some insurers have sophisticated systems in place. In some jurisdictions, each insurer is required to designate a compliance officer.</p> <p>APRA should consider requiring each insurer to designate an officer with overall responsibility for compliance, which could both reinforce accountability and facilitate communication between the insurers and their supervisors.</p>
<b>ICP 9</b>	<p><b>Supervisory Review and Reporting</b></p> <p>The supervisor has an integrated, risk-based system of supervision that uses both off-site monitoring and onsite inspections to examine the business of each insurer, evaluate its condition, the quality and effectiveness of its Board and Senior Management and compliance with legislation and requirements. The supervisor obtains the necessary supervisory information to conduct effective supervision of insurers and evaluate the insurance market.</p>
Description	<p>This ICP outlines the supervisory approaches and practices of APRA (prudential) and ASIC (conduct of business). The regulatory regime for conduct of business relating to insurers and intermediaries is described in ICP 19.</p> <p><b>A. Prudential Supervision by APRA</b>  <u>Risk-based Supervision Approach</u></p> <p>APRA's risk-based supervision approach recognizes that management and boards of insurers are primarily responsible for financial soundness and prudent risk management. APRA's expectation is that prudential regulations cannot and should not seek to guarantee a zero failure rate of insurers or provide absolute protection to market participants (including consumers). APRA's risk appetite statement states that it "will not tolerate impaired understanding of a material risk when it should have been discoverable by high quality analysis and supervision".</p>

The risk-based supervision framework is anchored on the PAIRS and SOARS methodologies. The PAIRS rating of an insurer correlates to a SOARS stance that determines the level of supervisory intensity. Supervisory activities are detailed in an entity's Supervisory Action Plan (SAP). PAIRS and SOARS are briefly described at the end of this ICP.

At the time of assessment, the number of regulated entities subject to PAIRS ratings totaled 934; the majority of the entities were from the superannuation sector (391 superannuation funds and 203 trustees). APRA has advised the assessors that it has adequate resources to conduct offsite monitoring and onsite reviews for all prudentially regulated entities. The Executive Group reviews and monitors the allocation of supervisory resources based on quarterly reports.

Quality assurance of the supervisory process is achieved through sign-off protocols, benchmarking sessions, Executive Group Presentations of SAPs, and Executive Group Reporting. Benchmarking sessions are conducted to: promote consistent PAIRS assessment and rating practices across supervisors, identify key risk areas, and discuss the appropriate SAPs. The monthly reports to the Executive Group highlight trends and movements of insurers' SOARS stances and those insurers in mandated improvement or restructure stance. Detailed industry analysis are also provided every 12 months.

Supervisory activities include onsite reviews, prudential consultations and continuous offsite analysis. To ensure a minimum level of coverage, APRA's supervisory framework prescribes a baseline level of supervisory activities, based on the PAIRS impact ratings, to ensure that entity profiles are up-to-date. While supervisory assessments and plans are determined at an entity level, a group-wide perspective is taken, where appropriate (ICP 23).

In addition, supervisors may hold *ad hoc* meetings with insurers, engage external experts to report on certain matters, request additional information to be furnished, and/or take any other appropriate action. APRA also conducts prudential consultations to engage with the Board, Chief Executive Officer and/or senior executives of insurers. These consultations are often used to communicate APRA's assessment of an insurer's risk profile, the primary drivers of this assessment, and the resulting key supervisory activities.

Besides regulatory and statistical returns submitted by insurers, APRA takes into account other sources of industry information in planning its supervisory activities. This includes industry risk registers and other analysis conducted by APRA's Industry Analysis unit and Industry Groups (see ICP 24).

An essential element of the supervisory process is relationship management to encourage open dialogue in the supervisor-insurer relationship. Frontline supervisors are supported in this role by in-house expertise, including statistics, legal, and risk specialist units. Effective internal communication is facilitated through training, formal policies and procedures, work request management systems, and a "one APRA" culture promulgated by senior management.

APRA recognizes that supervisory effectiveness hinges on the right supervisory mindset. This means going beyond the more observable measures of adequacy of staff resourcing/skills, headcount, training budgets and quantitative indicators. In this regard, "APRA has worked hard to inculcate in each of its staff an inquiring mind, a certain level of feistiness and doggedness, a willingness to challenge and intervene,

the ability to see the broader industry or policy context and, of course, a strong professional ethos.”<sup>45</sup>

#### Offsite Surveillance and Analysis

Pursuant to the FSCODA, APRA has determined reporting standards for insurers, NOHCs and their subsidiaries. These standards prescribed the scope, content and frequency of regulatory reporting.

- General insurers-30 reporting standards at entity level and 12 standards at group level. These standards cover financial position, financial performance, capital adequacy, investments, asset concentrations, premiums, and claims data.
- Life insurers-14 reporting standards covering solvency, capital adequacy, financial position, financial performance, assets, and policy liabilities.

The reports are generally submitted quarterly and annually for insurers and half-yearly for insurance groups.

Insurers are required to report their off-balance sheet exposures including: credit substitutes provided, liquidity support facilities obtained, charges granted, and credit support received. Insurers must notify APRA of any outsourced material business activity and consult with APRA prior to entering into outsourcing arrangements with providers outside of Australia (*GRF 130 and LRF 210 and GPS 231 and LPS 231*).

APRA also requires insurers to report promptly any material changes that could affect their condition although some of the reporting requirements are different for life and general insurers :

- a) breaches of financial obligations to policyholders or minimum capital requirements (*s38AA of IA and s231A of LIA*);
- b) developments that materially affect the risk profile of a general insurer (*GPS 220*);
- c) a general insurer’s right to conduct insurance business has been limited or otherwise materially affected outside of Australia (*GPS 220*);
- d) material deviations from a life insurer’s risk management framework (*LPS 220*);
- e) major disruptions that have a potential material impact on risk profile or financial soundness (*CPS 232*); and
- f) changes to responsible persons (*CPS 520*).

Appointed Auditors and Appointed Actuaries must immediately notify APRA of matters that may significantly affect the interests of policyholders, such as insolvency or contraventions of law (*s49A of IA and s88 and s98 of LIA*).

The Board and senior management of insurers are responsible for the timely submission and accuracy of financial and other reporting to APRA. Insurers submit their regulatory reports to APRA electronically via a data collection system, Direct to APRA (D2A). APRA issues digital security certificates for an authorized officer of an insurer to digitally sign, authorize and encrypt data to be transmitted to APRA. Validation rules within D2A prevent insurers from submitting the data until errors are corrected. APRA also conducts post-submission data quality checks and expects insurers to promptly correct or explain data identified by these checks.

For general insurers, their annual Financial Information Declaration must be signed by the Chief Executive Officer and the Chief Financial Officer, confirming the accuracy and completeness of information. The Appointed Auditor must prepare a

<sup>45</sup>APRA Annual Report 2010/11, Chairman’s Statement.

certificate providing an opinion on whether the annual statutory accounts of a general insurer presents a true and fair view of its operations. For life insurers, the auditor must submit a report to APRA specifying whether the annual returns are reliable and in accordance with the relevant prudential requirements (*GPS 220, s49J of IA and GPS 310 and LPS 310*).

The external auditor of an insurer is required to prepare an annual report to address a range of matters including whether the statistical and financial data provided by insurers are reliable and whether their systems, procedures and controls relating to actuarial data integrity and financial reporting risks are adequate (*GPS 310 and LPS 310*).

The Appointed Actuary is required to advise on the valuation of insurance liabilities and provide an impartial assessment of an insurer's financial condition. Additionally for general insurers, a peer review actuary is required to comment on the reasonableness of the assumptions and methodologies used (*s49K of IA and GPS 310 and s97 of LIA and LPS 320*).

Tools to facilitate financial analysis including exception reporting, summary reports, and MicroStrategy dashboard. During the Quarterly Risk Reviews, supervisors form an outlook for a general insurer taking into consideration all information received during the quarter together with other information about the insurer, the industry, and the broader economy.

APRA periodically reviews its reporting requirements to ensure the reports still serve their intended objectives. For example, in 2007 APRA streamlined the specifications of the data collected from life insurers and upgraded the information technology use. Changes may also be made in conjunction with a specific policy initiative, e.g., changes to general insurance prudential reporting in December 2009 primarily to align reporting requirements with those of Australian Accounting Standards.

#### Onsite Inspections

The objectives and scope of an inspection (onsite review) is determined by an insurer's SAP. The planning for an onsite review is formalised in a scoping document which specifies the review objectives, scope, responsibilities of all internal parties, draft agenda, and information required from the insurer. The scoping document is also subject to formal sign-off protocols. APRA's baseline supervisory activities for an insurer provide for a minimum frequency for onsite reviews

Typically, APRA holds a closing meeting with the insurer within a week of the conclusion of an inspection. This is followed by the issuance of a formal review report on the findings and remedial actions to be taken. Depending on the nature of the findings, the actions will be classed as: a) requirements with which an insurer must comply. Requirements relate to failures to comply with legislation or prudential standards, or fundamental deficiencies in risk management or governance practices; b) recommendations that need to be formally considered by the insurer; c) requests for additional information that must be complied with; and d) suggestions for improvement.

Depending on the findings, APRA sends a formal review report to either the Chief Executive Officer or directly to the Board.<sup>46</sup> The insurer is expected to provide a

<sup>46</sup>Review reports relating to branches must be sent to the local Chief Executive Officer, with a copy to the immediate reporting supervisor in the Head Office.

formal response to APRA within 20 working days to address the findings. Frontline supervisors are responsible for following up on the remedial measures. The remedial measures and responses are taken into account in the future SAP of the insurer.

APRA has set prudential requirements relating to the outsourcing of material business activities by insurers. The outsourcing agreements must include a clause that allows APRA to conduct onsite reviews of the service provider where necessary. APRA has undertaken reviews of underwriting agencies and outsourced claims operations under these contract provisions (*GPS 231 and LPS 231*).

APRA has access to the premises of insurers, with or without their consent or with a search warrant, to ascertain whether they contravened provisions of the relevant legislation. APRA's power with respect to general insurers extends to their NOHCs and other related companies (*s115, s115A and s54 of IA and s132 and s133 of LIA*).

#### Assessment of Supervisory Performance

APRA publishes two broad quantitative indicators of its supervisory performance:

- a) "transition matrices" to track the migration of institutions between the four supervision stances in SOARS; and
- b) indicators linked to financial failures and losses to beneficiaries comprising:
  - the Performing Entity Ratio (PER)-the number of regulated institutions that met their commitments in a given year, divided by the total number of regulated institutions; and
  - the Money Protection Ratio (MPR)-the value of liabilities to beneficiaries in Australia that remained safe in a given year, divided by the total value of liabilities to beneficiaries in Australia in regulated institutions.

Based on the "transition matrices", as at end-June 2011, around 56 percent of institutions were in the Normal stance, 41 percent in Oversight, 1 percent in Mandated Improvement and 2 percent in Restructure. Over the past four years, the proportion of institutions in Oversight has risen significantly and the proportion in Normal has fallen as the global financial crisis exposed various weaknesses in a number of institutions. APRA's Enforcement unit continues to proactively manage these entities to minimise the risk of losses to policyholders or, if failure is unavoidable, to minimise the size of such losses.

Since APRA's inception in 1998, the annual PER has averaged 99.90 percent and the annual MPR, which is dominated by the losses associated with HIH Insurance, has averaged 99.96 percent.

#### **B. Conduct of Business Supervision by ASIC**

ASIC's supervisory responsibilities with respect to insurance activities include: a) enforcing the consumer protection provisions of the ASIC Act; b) enforcing the licensing, conduct and disclosure provisions of the CA; and c) administering the Insurance Contracts Act 1984 (ICA).

Under ASIC's supervisory approach, supervisory activities are typically triggered by industry intelligence, complaints, and breach reports. ASIC has also conducted proactive supervision involving mystery shopping, thematic reviews, and review of new licensees. ASIC can obtain information as well as meet and interview relevant persons to determine compliance. Where necessary, ASIC has a number of formal statutory powers to compel insurers and/or individuals to produce documents or respond to questions.

Where appropriate, ASIC will conduct "surveillances". Surveillances can be either:

- a) reactive (e.g., in response to a complaint or industry intelligence); or
- b) proactive-to examine the industry environment or test a concern, issue or practice.

Surveillances often involve direct interaction with an individual or entity and may also involve exercising ASIC's information-gathering powers to inspect books and records, or to compel the production of documents or the disclosure of information. ASIC usually conducts surveillances through desktop reviews, however, if considered appropriate it will conduct an onsite review of a licensee or other relevant person based on suspected or identified misconduct.

ASIC would not generally issue a formal report after surveillance. However, ASIC issues public reports on regulatory issues identified and the steps taken to address them. ASIC in its dealings with insurers promptly discusses findings and the need for corrective action, obtains appropriate feedback and follows up to ensure that required actions have been taken.

In 2011, ASIC conducted insurance-related thematic reviews which resulted in the release of three public reports on: a) Product Disclosure Statement (PDS) for telephone sales of general insurance products; b) sales practices of ADIs relating to consumer credit insurance; and c) general insurance claims handling and internal dispute resolution procedures. There were also thematic reviews that have not resulted in a public report on the conduct and disclosure relating to: insurance comparison websites; home building and contents insurance; travel insurance; and portable valuables insurance (usually an optional cover available with home contents insurance).

Where ASIC identifies serious or systemic misconduct or other compliance failures, it may require that an insurer rectifies them through additional statutory measures, e.g., extra reporting through Directions to Give Statements and Enforceable Undertakings. Failure to comply with these statutory measures would lead to further adverse regulatory outcomes for the insurer (*s912C of CA and s93AA of ASIC Act*).

ASIC recognizes that many licensees outsource functions that relate to their AFSLs, including administrative or operational functions. Outsourcing might be to external parties or other entities within a corporate group.<sup>47</sup> ASIC has a range of statutory based compulsory information-gathering powers to require a person or entity (including service providers of functions outsourced by insurers) to provide documents and information; and attend an examination to answer questions and/or provide reasonable assistance. ASIC must use these compulsory information-gathering powers responsibly and typically exercises such powers in its regulatory activity surveillances and investigations of suspected breaches of the law.

#### **PAIRS**

PAIRS assesses the probability and impact of the failure of an insurer. For the

<sup>47</sup>Functions that are commonly outsourced include: IT systems for storing records in relation to the provision of financial services; recruitment and training of representatives; research on financial products in relation to which financial services are provided; the operation of call centers; periodic compliance reviews of representatives; and unit pricing.

	<p>purpose of PAIRS assessment, insurers are split into peer groups to facilitate comparability of results.<sup>48</sup> APRA does not publish the PAIRS ratings but will inform an insurer of its PAIRS rating, which should be kept confidential.</p> <p>PAIRS risk assessment covers the following categories: board; management; risk governance; strategy and planning; liquidity risk; operational risk; credit risk; market and investment risk; insurance risk; capital coverage/surplus; earnings; and access to additional capital. The last three are the capital categories. APRA has established comprehensive internal guidance on PAIRS ratings.</p> <p>For each of the categories, assessment is made on the: a) inherent risks; b) management of and control over the inherent risks; c) net risk or the residual risk remaining after taking into account the mitigating effect of management and controls; and d) capital support.</p> <p>Assessment scores are applied to each category on a continuous scale of 0 to 4; 0 being the best and 4 the worst. The board, management and risk governance categories are scored at the net risk level. For the other categories (except the capital categories), supervisors give separate scores for the inherent risk and related management and controls and the simple average of these two scores is the net risk. A significance weight, based on the importance of the category to the overall business profile, is assigned to the net risk of each category.<sup>49</sup> This assessment leads to a determination of an insurer's <b>overall risk of failure</b>.</p> <p>The <b>probability of failure</b> incorporates two elements: a) probability rating – low, lower medium, upper medium, high and extreme; and b) the probability index. It is a continuous curve whose function is the fourth power of the overall risk of failure.<sup>50</sup></p> <p>The <b>impact of failure</b> incorporates: a) the impact rating – low, medium, high and extreme; and b) the impact index derived with reference to each entity's total resident Australian assets (except for general insurers, whose total assets are multiplied by three before applying relevant formulae). APRA may also adjust an impact rating, where appropriate.</p> <p><b>SOARS</b> SOARS stance determines the nature and intensity of APRA's supervisory activities. It also helps to ensure consistent application of supervisory intervention. There are four supervision stances, derived from the PAIRS ratings:</p> <ul style="list-style-type: none"> <li>• Normal-prudential reviews and periodic analysis of data;</li> <li>• Oversight-more frequent and/or more targeted prudential review and analysis, communication with auditors, actuaries or responsible persons; special investigations; requests for revised business plans, etc.;</li> <li>• Mandated Improvement-requiring rectification plans and monitoring milestones; requiring revised business plans; increasing capital requirements; issuing</li> </ul>
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<sup>48</sup>For example, general insurers are categorized into: diversified business lines, lenders mortgage insurers, medical indemnity insurers, reinsurers, other direct and inactive.

<sup>49</sup>The significance weights of all the categories (excluding the capital categories) add to 100 percent. For the capital categories, supervisors derive a score at the net risk level and significance weight for each of the three categories. The significance weights for the three capital categories add to 100 percent.

<sup>50</sup>For example, a very low overall risk of failure (0.25), with a probability index of 1 is calibrated to approximate an indicative external rating of AAA while a high medium overall risk of failure (1.83), with a probability index of 11 approximates a BBB rating.

	<p>directions; accepting enforceable undertakings, consideration of fitness and propriety issues; prohibitions on acquisitions, etc.; and</p> <ul style="list-style-type: none"> <li>• Restructure-withdraw licenses; replace persons and/or service providers; merge entities; run-off existing business; restrict business activities; quarantine assets; appoint an inspector, judicial manager or provisional liquidator; issue directions or sanctions; or place the company into receivership/liquidation.</li> </ul> <div data-bbox="376 443 1369 837" style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p style="text-align: center;"><b>Probability rating</b></p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 15%;"></th> <th style="width: 15%;">Low</th> <th style="width: 15%;">Lower Medium</th> <th style="width: 15%;">Upper Medium</th> <th style="width: 15%;">High</th> <th style="width: 15%;">Extreme</th> </tr> </thead> <tbody> <tr> <td style="text-align: center; vertical-align: middle;"><b>Impact rating</b></td> <td style="background-color: #00a0e3;"></td> <td style="background-color: #808000;"></td> <td style="background-color: #ffc000;"></td> <td style="background-color: #cc0000;"></td> <td style="background-color: #cc0000;"></td> </tr> <tr> <td style="text-align: center;">Extreme</td> <td style="background-color: #00a0e3;"></td> <td style="background-color: #808000;"></td> <td style="background-color: #ffc000;"></td> <td style="background-color: #cc0000;"></td> <td style="background-color: #cc0000;"></td> </tr> <tr> <td style="text-align: center;">High</td> <td style="background-color: #00a0e3;"></td> <td style="background-color: #808000;"></td> <td style="background-color: #ffc000;"></td> <td style="background-color: #cc0000;"></td> <td style="background-color: #cc0000;"></td> </tr> <tr> <td style="text-align: center;">Medium</td> <td style="background-color: #00a0e3;"></td> <td style="background-color: #808000;"></td> <td style="background-color: #ffc000;"></td> <td style="background-color: #cc0000;"></td> <td style="background-color: #cc0000;"></td> </tr> <tr> <td style="text-align: center;">Low</td> <td style="background-color: #00a0e3;"></td> <td style="background-color: #808000;"></td> <td style="background-color: #ffc000;"></td> <td style="background-color: #cc0000;"></td> <td style="background-color: #cc0000;"></td> </tr> </tbody> </table>   <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 20px; background-color: #00a0e3;"></td> <td>Normal</td> </tr> <tr> <td style="width: 20px; background-color: #808000;"></td> <td>Oversight</td> </tr> <tr> <td style="width: 20px; background-color: #ffc000;"></td> <td>Mandated Improvement</td> </tr> <tr> <td style="width: 20px; background-color: #cc0000;"></td> <td>Restructure</td> </tr> </table> </div> <p style="text-align: right; margin-top: 10px;"><i>Source: APRA: Supervisory Oversight and Response System, November 2010</i></p>		Low	Lower Medium	Upper Medium	High	Extreme	<b>Impact rating</b>						Extreme						High						Medium						Low							Normal		Oversight		Mandated Improvement		Restructure
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Assessment	Largely observed.																																												
Comments	<p>APRA's risk-based supervision framework is anchored on PAIRS and SOARS, designed to facilitate better supervisory risk assessment as well as prompt and consistent supervisory actions. There is a baseline supervisory program for all insurers. APRA collects extensive regulatory and statistical information from insurers and the reporting obligations of general insurers extend to their NOHC and related companies within an insurance group. It may also request supervisory information on an <i>ad hoc</i> basis. There are clear scoping statements and processes for onsite reviews. APRA issues formal review reports on its findings and remedial measures in a timely manner and monitors the implementation of required measures. APRA is empowered to inspect service providers of outsourced functions and has conducted such inspections.</p> <p>Given its broad mandate in supervising a large number of licensees, ASIC typically monitors insurers' compliance with conduct of business requirements through desktop reviews. Onsite reviews of insurers are mainly conducted in response to suspected or identified misconduct or other concerns. While ASIC does not issue any report to individual insurers arising from its thematic reviews, it would discuss its findings with the insurers concerned. ASIC may exercise compulsory information gathering powers against service providers of outsourced functions by insurers, where appropriate.</p> <p>Feedback from industry participants suggested that there is scope for ASIC to have more proactive engagement on conduct of business issues and a more consultative approach. There are merits in promoting more effective on-going dialogue and monitoring to prevent breaches rather than having to manage the consequences of systemic misconduct.</p> <p>The authorities are advised to:</p> <ol style="list-style-type: none"> <li>a) review the effectiveness of ASIC's current predominantly desktop approach to supervising insurers' conduct of business;</li> </ol>																																												

	<ul style="list-style-type: none"> <li>b) empower ASIC to inspect service providers of outsourced functions by insurers; and</li> <li>c) ensure that ASIC is equipped with adequate supervisory resources including the technical capacity for effective and proactive surveillance of insurers' conduct of business.</li> </ul>
<b>ICP 10</b>	<p><b>Preventive and Corrective Measures</b>  The supervisor takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.</p>
Description	<p>In general, APRA encourages voluntary remedial actions by insurers through its on-going supervisory activities. Where APRA's concerns are not addressed satisfactorily, it would increase the frequency and intensity of its supervisory oversight, in accordance with the SOARS stance, to facilitate timely intervention (ICP 9).</p> <p>Where necessary, APRA has a range of powers to take proportionate preventive and corrective measures:</p> <ul style="list-style-type: none"> <li>a) dealing with unauthorized insurance business. There are differences in the legal powers of APRA under the IA and LIA, as outlined below. In particular, unauthorized life insurance activities do not constitute an offence under the LIA. The decision to prosecute unauthorized persons carrying on general insurance activities lies with the DPP. There has not been any prosecution on unauthorized insurance business.</li> <li>b) higher prudential standards for a specific insurer or NOHC (general insurance). This may include increasing the minimum capital requirements or strengthening outsourcing arrangements; and</li> <li>c) enforcement measures (ICP 11)</li> </ul> <p>In deciding whether to prosecute, the DPP is guided by the DPP's Prosecution Policy. This will involve the DPP assessing whether there is a prima facie case and whether there are reasonable prospects of securing a criminal conviction.</p> <p>APRA has the operational capacity to take immediate action in an emergency situation. Detailed internal guidance addresses decision-making responsibility, coordination and communication protocols, and remedial options. APRA's internal delegations clearly define the authority levels of APRA in exercising its legal powers. Crisis management powers are generally delegated to Executive General Managers and APRA Members.</p> <p>The SOARS framework supports the progressive escalation of actions or remedial measures. This allows APRA to adjust its responses progressively, ranging from requirements made following an onsite review (ICP 9) through to the appointment of a judicial manager (ICP 12).</p> <p>Where an insurer is classified under "Mandated Improvement", it must submit and comply with agreed remedial plans. Frontline supervisors monitor and follow up on the implementation of these plans using APRA's Activity and Issues Management System. APRA may commence enforcement action, if the deliverables are not met satisfactorily or where warranted.</p> <p><u>General Insurance</u>  It is a criminal offence to carry on insurance business in Australia without an</p>

	<p>authorization from APRA. The offence is one of strict liability subject to clear penalties.<sup>51</sup> APRA is empowered to investigate suspected unauthorized insurance business. APRA may apply to the Federal Court for an injunction against any person engaging in unauthorized insurance business. Where APRA considers the offence has been committed, APRA may refer the matter to the DPP (s9, s10, s11A, s128A and Part VA of IA).</p> <p><u>Life Insurance</u></p> <p>A person must not issue or undertake liability under a life policy unless the person is registered under the LIA. However, there is no explicit provision stating that the conduct of unauthorized life insurance activities is an offence and hence there is no provision on penalties. APRA's interpretation is that it is possible to use its information gathering powers where a company is carrying on life insurance business, regardless of whether the company is registered. APRA may apply to the Federal Court for an injunction, e.g., to order such a company to unwind existing business. APRA may also cooperate with ASIC, which has power to take action against such an entity for breaching the requirement to hold an AFSL (s17 and s235 of LIA).</p>
Assessment	Observed.
Comments	<p>The SOARS framework supports the progressive escalation of actions or remedial measures. APRA has wide powers to initiate timely and proportionate preventive and corrective measures where insurers are unable or unwilling to adequately address supervisory concerns. While the conduct of unauthorized life insurance business is not explicitly an offence under the LIA, APRA would address such cases through indirect means including cooperating with ASIC. APRA may commence civil proceedings in its own name and at its own initiative. Where APRA considers criminal prosecution is appropriate, APRA may refer the matter to the DPP to decide whether to prosecute. There have been no instances of civil or criminal proceedings being commenced in respect of unauthorized insurance activities taken since 2006.</p>
<b>ICP 11</b>	<p><b>Enforcement</b></p> <p>The supervisor enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.</p>
Description	<p>APRA's approach is to work with insurers on a cooperative and open working relationship in the first instance. However, APRA may take enforcement action and escalate cases with serious concerns to the specialized Enforcement Unit. APRA runs a one-day training program every six months on the enforcement options available to APRA that is available to all frontline supervisors.</p> <p>When enforcement action is undertaken, front-line supervisors often form part of the enforcement team, to provide additional resources and continuity for background and follow-up. The SAPs for insurers would take into consideration any remedial measures, directions or sanctions imposed, which would be monitored closely by APRA.</p>

<sup>51</sup>The maximum penalty for the offence is 60 penalty units for individuals (A\$6,600) and 300 penalty units for corporations (A\$33,000). Where APRA gives a notice under s128A of IA, the person is deemed to have committed an offence on each and every successive day after the giving of the notice for so long as the relevant circumstances continue.

The Enforcement Committee ensures that a whole-of-APRA perspective is brought to investigation and enforcement actions. It comprises an APRA Member as the Chair, an Executive General Manager and representatives of supervision, enforcement and legal areas. The Committee monitors ongoing enforcement actions and provides a forum to ensure that a consistent and fair approach is taken to any significant use of coercive powers by APRA. Formal enforcement decisions are guided by APRA's Enforcement Manual.<sup>52</sup>

APRA is empowered to take the following enforcement measures:

- a) Requiring targeted audits or special purpose review in respect of general insurers (*s40 of IA and GPS 310*);
- b) Commencing formal investigations<sup>53</sup> into the affairs of general insurers, NOHCs and their subsidiaries and/or initiate criminal proceedings (*s50 of IA and s137 of LIA*);
- c) Imposing conditions on the authorization of a general insurer/NOHC and registration of a life insurer (*s13 and s 19 of IA and s22 and s28B of LIA*);
- d) Issuing directions, including recapitalization directions to general insurers and notices to life insurers relating to the statutory funds. This is a new power given to APRA since 2008 and is described below;
- e) Entering into an enforceable undertaking, a written undertaking to do or refrain from doing something for an agreed period of time<sup>54</sup> (*s126 of IA and s133A of LIA*);
- f) Applying for restraining or performance injunctions from the Federal Court. The Court may, either in addition to or in substitution for the grant of the injunction, order that person to pay damages to any other person (*s129A of IA and s235 of LIA*);
- g) Removal or disqualification of persons (ICP 5);
- h) Applying for judicial management (see below);
- i) Compulsory portfolio transfers when certain criteria are met. APRA may require the transfer of some or all of life (as from 2008) or general (with effect from June 2010) insurance business to another insurer. An insurer's assets and liabilities may also be transferred to a non-insurer (e.g., an asset management company). In addition, APRA must consult with the Australian Competition and Consumer Commission (ACCC) and ASIC unless they have requested otherwise. There is a technical issue that raises some question as to the possible enforceability of business transfers in respect of general insurers, life insurers, and ADIs. This issue is currently under review by APRA and Treasury; and
- j) Revocation of authorization of general insurers under specified grounds. APRA must be satisfied that the general insurer has no liabilities in respect of insurance business in Australia and this could be achieved through assignment of insurance liabilities. However, the cancellation of registration of life insurers is either voluntary or in respect of defunct insurers and is not enforcement-related. As an alternative, APRA imposes conditions on a life

<sup>52</sup><http://www.apra.gov.au/adi/Documents/APRA-Public-Enforcement-Manual.pdf>.

<sup>53</sup>Once an investigation has commenced, APRA has additional powers to require the production of books, to require persons to give reasonable assistance or attend an examination and to enter premises and copy documents.

<sup>54</sup>If the general insurer or person does not meet the undertaking, APRA may apply to the Federal Court to have it enforced. The enforceable undertakings that APRA has accepted since 1 January 2005 are available on the APRA website: <http://www.apra.gov.au/CrossIndustry/Pages/EnforceableUndertakings.aspx>

insurer's registration, e.g., prohibiting new business. The LIA position on cancellation of registration is under review by Treasury and APRA, and proposed to be harmonized with the IA position.  
(s15 to s17 of IA and s26 and s27 of LIA)

APRA's enforcement decisions are subject to merits review by the AAT, which can overrule such decisions. However, some of its crisis resolution powers are specifically exempted from the merits review, e.g., compulsory transfer of portfolios, or are available by application to a court e.g., disqualification of persons, and appointment of judicial managers.

The IA and LIA clearly set out the applicable sanctions for breaches of the different statutory requirements, which vary according to the nature and gravity of the offences. Distinctions are also made between strict liability offences and those that are not.

It is a criminal offence, punishable by imprisonment for 12 months, if a person gives false or misleading information or documents to a Commonwealth entity, including APRA. An insurer who fails to provide information to APRA within the specified period commits an offence under the FSCODA (s137 of the Criminal Code 1995 and s9 and s14 of FSCODA).

There are no statutory impediments hindering APRA in simultaneously seeking preventive and corrective measures while also pursuing sanctions. The LIA explicitly provides that the institution of proceedings for an offence does not prevent the proceedings to initiate the judicial management or winding-up of a life insurer. APRA recognizes that its primary regulatory objective of protecting beneficiaries can sometimes create a tension between "containment" type of measures<sup>55</sup> and general deterrence regulatory action such as disqualification of persons (s 26 and s27 of LIA).

Where criminal charges are considered appropriate, APRA refers matters to the DPP. The DPP determines whether criminal charges should be pursued and conducts any subsequent prosecution. Under arrangements put into effect in October 2011, where criminal sanctions such as fines are imposed, APRA is responsible for the monitoring of the receipt of such fines.

#### Issuance of Directions

Since 2008, APRA has been empowered to give directions to insurers/NOHCs based on statutory triggers, including: (likely) contraventions of provisions in the IA and LIA, prudential standards or regulations; protecting the interests of policyholders; solvency concerns, breach of directions or authorization condition(s); material risk to the security of assets or a material deterioration in financial condition; improper or unsound conduct; and potential impact on stability of the Australian financial system (s104 of IA and s230B of LIA).

The directions may require insurers to: comply with the IA and LIA, prudential standards, directions or condition(s) imposed on the insurer; conduct an audit or actuarial investigation; remove or replace a director, senior manager, auditor or actuary; refrain from certain actions (e.g., giving financial accommodation to any person, pay dividends or borrow/transfer monies); and cease issuing or renewing

<sup>55</sup>These measures include asset freezing, replacement of management, appointment of a judicial manager, injunctions, and transfers of business.

policies. Non-compliance with a direction is an offence on each and every day of successive non-compliance. In addition, APRA may apply to the Federal Court to obtain an injunction ordering compliance with a direction. The issuance of a direction is a reviewable decision.

APRA may also give a recapitalization direction to increase the insurer's level of capital, subject to consultation with the ACCC. In deciding whether to give a recapitalization direction, APRA must consult with the ACCC unless the ACCC notifies APRA that it does not wish to be consulted. A recapitalization direction is not a legislative instrument (*s103B of IA and s230AB of LIA*).

#### Judicial Management

APRA is empowered to apply to the Federal Court for the appointment of a judicial manager to assume control of an insurer. The objective is to facilitate the rehabilitation or resolution of an insurer in a manner that best promotes the interests of policyholders while promoting financial system stability in Australia. Judicial managers are also given statutory powers to facilitate recapitalization of insurers. A judicial manager is subject to the directions of the Court, rather than APRA.

During 2009/10, a judicial manager was appointed to each of two small general insurers that had been in run-off since 2002. Judicial managers are empowered to recapitalise an insurer and to cancel existing shares (*Part VB, Division 1 of IA and Part 8 Division 1 of LIA*).<sup>56</sup>

#### General Insurance

A person must comply with the requirements of APRA or an inspector who is carrying out an investigation. Inspectors have the power to request information or to require all reasonable assistance. It is an offence to conceal, destroy, mutilate or alter a book relating to the affairs of an insurer that is being investigated (*s55 and s61 of IA*).

While APRA has not recently had cause to issue directions to a general insurer, APRA has in the past issued directions to require insurers to: cease issuing or renewing policies; appoint a custodian to hold its assets; ensure adequate technical provisions; and to value a receivable at a specified amount.

In 2009/10, APRA completed the enforcement actions arising from the collapse of the HIH Insurance Group in 2001 and the improper reporting of financial reinsurance arrangements between General Reinsurance Australia Limited and Zurich Australia Insurance Limited. These included the disqualifications of 24 and 9 individuals, respectively, who were either formally disqualified or entered into enforceable undertakings not to occupy senior positions in the industry.

#### Life Insurance

APRA may direct life insurers by giving a notice of contravention of Part IV of LIA relating to statutory funds. Where an insurer fails to comply with such a notice, its directors are liable for losses to the statutory fund arising from non-compliance, except where they demonstrate they exercised due diligence in seeking to effect compliance. APRA has not issued any such notice so far (*s49 and s50 of LIA*).

It is a criminal offence, punishable by imprisonment for not more than six months, if a

<sup>56</sup>Pursuant to The Financial System Legislation Amendments (Financial Claims Schemes and Other Measures) 2008)

	<p>person delays or obstructs an investigation by concealing, destroying, mutilating, changing or removing records relating to the business of a life insurer that is under investigation (<i>s147 of LIA</i>).</p> <p>APRA has not had cause to exercise enforcement powers in relation to any life insurer since 2006.</p>
Assessment	Observed.
Comments	<p>In 2008, the enforcement powers of APRA were broadened to include power to issue directions and appoint judicial managers. APRA enforces corrective action and imposes sanctions, where necessary. Enforcement action is taken in accordance with applicable legislative criteria and guided by an Enforcement Manual, which is publicly available. There is a dedicated Enforcement Unit to deal with matters escalated by frontline supervisors. APRA's Enforcement Committee promotes consistency in its approach to enforcement. APRA has taken enforcement actions in respect of a number of general insurers but it has not had cause to exercise enforcement powers in respect of life insurers since 2006.</p> <p>Significant progress has been made in strengthening and harmonising the enforcement powers of APRA in dealing with life and general insurers. Differences remain, e.g., lack of power to revoke the license of a life insurer directly and it is recommended the momentum is maintained for the on-going review on harmonising the powers of APRA across financial sectors.</p>
<b>ICP 12</b>	<p><b>Winding-up and Exit from the Market</b></p> <p>The legislation defines a range of options for the exit of insurance legal entities from the market. It defines insolvency and establishes the criteria and procedure for dealing with insolvency of insurance legal entities. In the event of winding-up proceedings of insurance legal entities, the legal framework gives priority to the protection of policyholders and aims at minimizing disruption to provision of benefits to policyholders.</p>
Description	<p>The CA governs corporate insolvency in Australia. There are three types of external administration used for companies that are insolvent or are experiencing financial difficulty: liquidation, receivership, and voluntary administration. A company enters external administration when its directors relinquish control over the company's affairs to an insolvency practitioner. This usually occurs when a company becomes, or is about to become, insolvent. Directors of insolvent companies have a legal obligation to prevent the company from incurring debts, and they can be held personally liable for such debts incurred.</p> <p>APRA may apply to the Federal Court to wind up an insurer on grounds of insolvency. Insolvency is defined as "...if the person is unable to pay all the person's debts, as and when they become due and payable."<sup>57</sup> The CA prohibits insolvent companies from continuing to trade (<i>s459P and s95A of the CA</i>).</p> <p>The CA governs the appointment of insolvency practitioners. Insolvency practitioners are entitled to assume control over: company assets; the reconstruction of a company; arrangements and compromises with company creditors; and the</p>

<sup>57</sup>This is a "cashflow" test of insolvency.

voluntary winding up of a solvent company. The Government is currently reviewing the law relating to insolvency practitioners with the aim to enhance supervision. Australia has enacted as domestic law the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency, subject to a prudential carve-out in Australia for insurance companies.

The principal resolution options available to APRA to deal with a failing insurer are: application to the court for the appointment of a judicial manager; winding-up of an insurer; facilitating a transfer of business; revoking the authorization of a general insurer, or imposing conditions on its authorization; issuance of directions (including to facilitate recapitalization); and the transfer of business from a distressed insurer to another existing insurer or a bridge insurer. In each case, the trigger points for action are set out in the IA or LIA, as applicable (ICP 11).

#### General Insurance

APRA may apply to the Federal Court to wind up a general insurer after an investigation. The Court may make the order if satisfied that it is in the interests of policyholders. In addition, a judicial manager may recommend to the Court that a general insurer be wound up by filing a report recommending a course of action that is most advantageous to the interest of policyholders while promoting financial system stability in Australia (*s62ZU and s62ZI of IA*).

Policyholders rank *pari passu* with other unsecured creditors in the event of winding up, although Australian policyholders and other creditors in Australia have priority over the insurer's assets in Australia. General insurers are required to hold assets in Australia having value not less than their liabilities in Australia. In a winding-up of an insurer, the assets of the insurer in Australia must be applied first to discharge its Australian liabilities (*s116A of IA*).

Eligible policyholders are covered under the Policyholder Compensation Facility under the FCS<sup>58</sup> established in October 2008. For claims less than A\$ 5,000, there are no eligibility criteria. For claims of A\$ 5,000 or greater, the eligibility criteria mainly limit the FCS to claimants who are Australian citizens or permanent residents, small business entities in Australia, and non-profit bodies in Australia. The FCS can be invoked by the Treasurer where a general insurer is under judicial management or where an external administrator has been appointed and APRA has assessed the general insurer to be insolvent. The FCS also provides a limited period of time within which policyholders remain covered pending their purchase of replacement policies with another insurer.

Certain classes of insurance policies are not covered by the FCS. These include reinsurance and retrocession policies, insurance policies being an indemnification of other policies, and certain historical pre-authorization liabilities of a foreign general insurer.

The FCS is post-funded. Payouts are met by a standing appropriation, currently capped at A\$ 20 billion per general insurers. APRA administers the FCS and steps into the claim of the policyholder in the liquidation of the insurer. The government can recover any shortfall after winding-up by imposing a levy on the general insurance industry.

During 2010/11, APRA developed its internal arrangements for putting the FCS into

<sup>58</sup>The funding for the FCS is capped at A\$ 20 billion.

operation. These arrangements include guidance on matters such as eligibility assessment, claims determination, and payout arrangements. In 2010/11, the FCS paid out around A\$ 73,000 in relation to one general insurer. The Scheme has been extended for a further 12 months to enable the submission of claims. APRA has also been working closely with the liquidator of another general insurer to assess its solvency position.

Where appropriate, APRA may facilitate a transfer of insurance business to prevent a failure from otherwise occurring where it is in the interests of policyholders or protecting financial system stability in Australia. A standing legislative appropriation provides funding of A\$10 billion for such a purpose (*s. 131A IA*).

#### Life Insurance

A life insurer is not to be wound up except by order of the Court on an application made under the LIA. APRA may apply for an order that a life insurer be wound up if, as a result of an investigation, APRA is satisfied that it is necessary or proper that the application be made. In addition, a judicial manager may recommend to the Court that a life insurer be wound up by filing a report recommending a course of action that is most advantageous to the interest of policyholders while promoting financial system stability in Australia (*S180, s175 and s181 of LIA*).

A life insurer must maintain one or more statutory funds in respect of its life insurance business. A life insurer is required to credit a statutory fund with all amounts attributable to that fund, and assets of the fund are only available for expenditure properly related to the fund. Life insurers are also subject to various statutory and prudential obligations in respect of statutory funds, which are not distinct legal entities. In particular directors are required to give priority to the interests of policy owners ahead of shareholders in the event of conflict. Where they breach their duties and loss results to a statutory fund, they may be liable for the loss (*Part 4 of LIA*).

In the event of liquidation, assets of a statutory fund are first to be used to discharge the preferential claims specified in the CA, i.e., the relevant costs of any external administrator, certain other winding-up costs, priority employee entitlements and injury compensation claims (*s556 of CA*).

Assets remaining in a statutory fund (primary fund) after meeting preferential claims are applied in the following ranking: a) policy liabilities referable to the primary fund; b) other liabilities referable to the business of the primary fund; and c) any assets of remaining to be applied in such manner as the Court considers equitable. In this regard, the Court has to consider the interests of policyholders referable to the primary fund, policyholders referable to other statutory funds, creditors, and shareholders.

This means that the policyholders whose liabilities cannot be discharged from the assets of a statutory fund do not automatically have priority over the unsecured creditors of another fund that has surplus assets. A court may, but is not required to, apply surplus assets of a statutory fund to first discharging policy liabilities of another fund.

A liquidator may apportion certain liabilities to one or more funds.<sup>59</sup> APRA is required

<sup>59</sup>s187(5) states: If a liability of the company: (a) is referable to 2 or more statutory funds; or (b) is referable in part to a statutory fund but is also related to business, other than life insurance business, carried on by the

	<p>to be given notice of any application made by a liquidator with respect to applying the surplus assets of a statutory fund after meeting the claims of secured and unsecured creditors. It is expected that the Court would require and give weight to a submission from APRA as to the fairness of any proposed distribution of surplus assets (<i>s187 of LIA</i>).</p> <p>Government, on the advice of the CFR, decided not to apply the FCS to life insurance policies because it had concluded that a number of features of life insurance products would make the FCS a less effective, and potentially more costly, means of protecting the interests of life insurance policyholders than alternative resolution options. The CFR considered that the preferred means of resolving a distressed life insurer in Australia is to either facilitate a transfer of business to another insurer or require a run-off of the portfolio over time.<sup>60</sup></p> <p>The CFR noted that the general insurance FCS is a closed resolution scheme, where an insolvent general insurer is closed and liquidated, with valid claims being paid by the FCS. While a closure and compensation model could cover life policyholders who had a valid claim pending before or immediately after the collapse of a life insurer or pay the applicable surrender values, the CFR opines that this would not address the needs of policyholders who required ongoing cover. The concern is that some individuals, due to health, age or other reasons, may have difficulties finding replacement covers either in totality or on equivalent terms to the original cover. A further complication is that the long-term nature of life insurers' liabilities could require the FCS to remain in activation for many years, or even decades.<sup>61</sup> The CFR does not, therefore, consider an FCS to constitute a least-cost resolution option.</p> <p>The transfer of policy liabilities would generally be funded by the transfer of some or all of the distressed life insurer's assets to the acquiring life insurer. It would also be necessary to have regard to the statutory fund requirements, i.e., assets held within statutory funds must first be applied to the policy owners whose policies are referable to that fund. If these assets were not sufficient to cover the liabilities, or the acquiring life insurer did not want the assets, then there is scope to fund the transfer of liabilities using public funds. In either case, a standing legislative appropriation provides funding of A\$10 billion for such a purpose. If such funding were used, the Government would seek to recover the funds from the failed insurer in the liquidation process (<i>s251A of LIA</i>).</p>
Assessment	Largely observed.
Comments	Insolvency is defined in the CA and APRA has extensive powers to take timely intervention by requiring the discontinuance of insurance business, and the orderly exit of an insurer. The winding-up of insurers is based on the procedure set out in the CA, subject to certain insurance specific modifications set out in IA and LIA.

company; the liquidator may apportion the liability so as to determine the part of the liability that is to be borne by each of the statutory funds or by the statutory fund, as the case may be.

<sup>60</sup>APRA can require a failing life insurer to be placed into run-off by imposing conditions on its authorization prohibiting the writing of new insurance business, but allowing it to maintain operations for the sole purpose of meeting its obligations under existing policies.

<sup>61</sup>The assessors noted that long-tail general insurance business may also result in the FCS being held open for a number of years until all claims are settled.

	<p>There is no formal requirement under the Insurance Act that policy liabilities of a general insurer must be met ahead of liabilities to other unsecured creditors. However, the requirement that an insurer must hold assets in Australia of a value which equals or exceeds its liabilities in Australia, gives a large measure of protection to policyholders. This protection is supplemented by the establishment of the Policyholder Compensation Facility.</p> <p>Life policyholders have priority of claims over unsecured creditors in the same statutory fund. Capital requirements must be met for each statutory fund. However, where their policy liabilities cannot be met from that fund, policyholders may rank behind the unsecured creditors of another statutory fund that has surplus assets. The Court may take into account the interests of policyholders in deciding on the distribution of the surplus assets of any fund that has first met its obligations to the unsecured creditors of that fund. The authorities may also consider invoking appropriate resolution measures, including the use of public funds available under the LIA to fund a transfer of a life insurance portfolio to protect policyholders.</p> <p>The authorities should consider providing for the legal priority of claims by policyholders of general insurers over unsecured creditors, as well as greater legal priority of life policyholders' claims to the assets of other statutory funds, ahead of unsecured creditors.</p>
<b>ICP 13</b>	<p><b>Reinsurance and Other Forms of Risk Transfer</b></p> <p>The supervisor sets standards for the use of reinsurance and other forms of risk transfer, ensuring that insurers adequately control and transparently report their risk transfer programmes. The supervisor takes into account the nature of reinsurance business when supervising reinsurers based in its jurisdiction.</p>
Description	<p>Standards for the use of reinsurance are set out in the APRA prudential standards on Risk Management (GPS 220 for general insurers, LPS 220 for life insurers, and GPS 221 for Level 2 general insurance groups), Reinsurance Management (GPS 230), Reinsurance (LPS 230), and Actuarial and Related Matters (LPS 320). Reinsurance must be considered under the wider risk management framework of an insurer, and reinsurance arrangements must be prudently and soundly managed having regard to the size, business mix, and complexity of the insurer's operations.</p> <p>General insurers are required to have a specific reinsurance management framework to manage the selection, implementation, monitoring, review, control and documentation of reinsurance arrangements. It must be documented as a Reinsurance Management Strategy (REMS), which must be approved by the Board and submitted to APRA. The REMS is required to 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.</p> <p>The REMS for subsidiaries or branches of foreign entities must include a summary of the group policy objectives and strategies relating to reinsurance, linkages between the local and group reinsurance arrangements, details of where elements of an insurer's reinsurance management framework are controlled by another entity in the corporate group, and specify any intra-group reinsurance arrangements.</p> <p>Life insurers are prohibited from entering into, modifying or terminating a reinsurance arrangement unless the Appointed Actuary has given the insurer written advice as to the likely consequences of taking such action. Life insurers are required to annually report on their reinsurance arrangements, including an overview and assessment of</p>

the reinsurance arrangements that must be part of the Financial Condition Report prepared by the Appointed Actuary.

Capital requirements take into account the characteristics of reinsurance arrangements and reinsurance counterparties, and an insurer is required to take the effects of reinsurance into account in its capital management strategies (see ICP 17).

Reinsurance is a key topic in APRA's prudential supervision framework. It assesses the adequacy of an insurer's reinsurance strategy, policies, systems and controls through both offsite analysis and onsite reviews. The assessment considers the structure and comprehensiveness of the reinsurance program, the structure of the reinsurance function and how reinsurance is managed. While on site, APRA reviews reinsurance documentation, the results of reinsurance audits, financial reinsurance arrangements (if any) and the insurer's monitoring of reinsurance counterparties. These assessments are supported by supervisory guidance.

APRA's offsite analysis includes thematic reviews. For example, in response to an unprecedented series of large natural catastrophes in 2010 and 2011, APRA reviewed the reinsurance arrangements of all major property insurers. This review compared the performance of reinsurance arrangements against capital management plans. Reviews have also been conducted on the reinsurance exposure of groups and the exposure of general insurers to particular reinsurers. Findings from such reviews have helped to focus other supervision activities, including a proposed data collection of reinsurance counterparty information.

Insurers report on their reinsurance arrangements in various contexts.

- a) APRA receives reinsurance accounting information through regular reporting. Such reports include premiums ceded and recoveries by class of business and reinsurance recoverable against insurance liabilities. For general insurers, information is also split by APRA-authorized and other reinsurers.
- b) General insurers must provide details on their reinsurance arrangements at least annually, in the form of a Reinsurance Arrangements Statement (RAS). The RAS contains details of the current year's reinsurance arrangements, including schematics, reinstatements, limiting clauses, counterparties, classes of business, and details of any Limited Risk Transfer Arrangements (LRTA).
- c) Life insurers must report on their reinsurance arrangements annually, and the Appointed Actuary of a life insurer must also report on reinsurance arrangements in the Financial Condition Report.
- d) Insurers must submit to APRA details of all proposed LRTAs for prior approval as either a reinsurance arrangement or a financing arrangement.
- e) Supervisors also request a variety of reinsurance-related information, such as policies, procedures, renewal information, contracts, audit reports, modeling reports, and details of any retrocession covers and parent reinsurance placements, as part of onsite reviews.

APRA factors its understanding of the nature of supervision of reinsurers and other counterparties who may be assuming risk from insurers into its assessments of the reinsurance programs of insurers. There are no supervisory recognition arrangements in place. Although general insurers are required to hold additional capital for exposures to non-APRA authorized reinsurers, which can be as much as 100 percent of the reinsurance asset exposure, the requirement does not differ among foreign jurisdictions. Life insurers can only take credit for reinsurance arrangements with reinsurers that are either parents or related entities to authorized life insurers and have been approved by APRA. In approving such reinsurers, APRA

considers the jurisdiction of the parent or related entity and the relevant supervisor. Reinsurance placed with any other non-authorized life reinsurer is given no credit. APRA has also analyzed the jurisdictions in which reinsurance is being placed, which showed that Australia, Bermuda, Germany, the United States of America, and Switzerland, accounted for 93 percent of all reinsurance expenses (12 months to June 2010).. APRA's understanding of the nature of supervision of foreign reinsurers is further developed through its engagement with supervisors in other jurisdictions in the licensing process (see ICP 4), on prudential issues on an ongoing basis, including through supervisory colleges (see ICP 25), and through its representation on the IAIS reinsurance committee.

Prudential standards require insurers to document and formalize reinsurance arrangements in a timely manner. For general insurers, within two months from the inception date of a reinsurance arrangement, the insurer must have a placement slip or cover note summarizing the reinsurance contract terms and conditions signed and stamped by all participating reinsurers; within six months from the inception date, the full treaty contract wordings must be signed and stamped by all contracting parties.

Reinsurance contracts of a general insurer that are entered into after 31 December 2008 must specify Australian law as the law of the contract and must provide that any dispute under the contract is to be determined by a Court in Australia. If such requirements are not complied with, the relevant reinsurance assets will be deducted from the insurer's Tier 1 capital. Similar penalties apply to any reinsurance recovery from non-APRA authorized reinsurers after the second balance date following the date of loss, unless secured by suitable collateral. General insurers must also submit a Reinsurance Declaration annually, which has been signed by the Chief Executive Officer and the Chief Reinsurance Officer, stating that the insurer has placed its reinsurance arrangements and that they are legally binding and satisfy the "two-month rule" and the "six-month rule".

For life insurers, prudential standards require that for an insurance or reinsurance arrangement to qualify as an admissible asset it must, subject to a six-month grace period from risk inception, comprise an executed and legally-binding contract. The Appointed Actuary must sign-off on the accuracy of the financial position resulting from these placements.

APRA assesses compliance with the jurisdiction and documentation requirements through such reporting requirements and by reviewing a sample of treaty and facultative reinsurance contracts.

Prudential standards require insurers to manage liquidity risk and various prudential practice guides indicate the need for policies and procedures that consider whether reinsurance assets can be realized and potential sources of reinsurance funding, as well as for providing for the processing of reinsurance premiums and the collection of reinsurance recoveries arising under those arrangements. The Australian insurance industry has not had any significant liquidity problems in recent years, in spite of the Global Financial Crisis and major natural catastrophes in Australia and New Zealand.

APRA assess liquidity risk, including that related to reinsurance, through offsite analysis and onsite reviews. Assessment is supported by internal supervisory guidance, for example, on the need to consider the nature of projected cash outflows and inflows, including projected policyholder claims, and the extent to which an insurer's liquidity risk management considers crisis situations. In onsite reviews of reinsurance contracts, supervisors assess the adequacy of liquidity provisions, such

	<p>as cash calls.</p> <p>Insurers are not prevented from transferring insurance risk to capital markets. However, where such transactions meet the definition of an LRTA, they must be reviewed by APRA specialists to assess the level of risk transfer and ensure they are transparent, have adequate controls, are accounted for correctly and constitute reinsurance. Only with APRA's approval can an insurer take credit for an LRTA for capital adequacy purposes. There has been limited use of such arrangements in Australia to date.</p>
Assessment	Observed.
Comments	Australia's exposure to natural catastrophes makes strong reinsurance coverage essential to the insurance market and overall economy. APRA reviews the reinsurance strategies and programs of insurers, and assesses the exposure of both individual insurers and the industry to the various reinsurers that are providing coverage.
<b>ICP 14</b>	<p><b>Valuation</b></p> <p>The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes.</p>
Description	<p>Reporting standards made under the FSCODA require general and life insurers to meet relevant prudential and Australian accounting standards. Requirements for the valuation of assets and liabilities for capital adequacy and solvency purposes are set out in prudential standards. The requirements in the prudential standards are based on relevant Australian accounting standards, which in turn are based on International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Unless otherwise stated under the prudential standards, insurers are required to follow the valuation approaches prescribed under the Australian accounting standards.</p> <p>The valuation requirements address recognition, derecognition and measurement. The IA defines assets and liabilities in Australia for general insurers, while the LIA defines the assets and liabilities of statutory funds of life insurers. Such assets must be valued using a fair value approach, which implicitly considers the risks of realizing the asset. The prudential standards also address the recognition of assets, including capital instruments, for capital adequacy and solvency purposes. Insurance liabilities are recognized based on the inception date of the contract, although general insurers are required to hold sufficient capital for all general insurance contracts for which the general insurer is committed, regardless of when the contract incepts.</p> <p>Liabilities of general insurers are determined both gross and net of reinsurance recoverables and non-reinsurance recoveries. Life insurers are also allowed to calculate insurance liabilities net of reinsurance, but reinsurance that does not involve the transfer of insurance risk is to be explicitly recognized and measured separately according to relevant standards. Contracts are derecognized when an insurer is no longer exposed to obligations thereunder.</p> <p>Assets and liabilities are valued in a consistent and decision-useful manner. Generally, assets are valued using a market value, risk neutral approach, while liabilities are valued using a market derived risk free discount rate with additional margins for the uncertainties of the liabilities. Life insurance liabilities are made up of best estimate liability and a present value of future profit margins, which has the effect of eliminating profits at the point of sale.</p>

Insurance liabilities must be valued by the insurer's Appointed Actuary. While the valuation requires the exercise of judgment by the Appointed Actuary on the appropriate assumptions and methods, the combination of accounting standards, prudential standards, reporting requirements, professional actuarial standards and various review requirements promote consistency, transparency and reliability. For example, the method of determining discount rates is set out in these standards. The Appointed Actuary must also report on the assumptions and methods used in the valuation in the report on the valuation of liabilities (the Insurance Liability Valuation Report (ILVR) for general insurers) and in the FCR. These reports are subject to review by APRA's actuarial unit, and for general insurers an actuarial peer review of the ILVR is required. For all insurers, the auditor must provide a certificate stating their level of satisfaction with both the reliability of information and adherence to relevant prudential standards and laws.

Insurers are subject to disclosure requirements under the CA and Australian accounting standards. They are required to submit annual financial reports to ASIC, which must include information on the valuation of general insurer policy liabilities or the balance sheets of life insurer statutory funds (see ICP 20).

The valuation of assets and liabilities is an economic valuation. Fair value is defined in the accounting standards as "the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction". Prudential standards indicate that the valuation of liabilities is to be based on an estimate that is intended to be the mean of likely future experience.

The economic valuation of assets and liabilities reflects the risk-adjusted present values of their cash flows. For the valuation of assets backing insurance liabilities, the fair value methodology used in the valuation inherently accounts for all relevant information about market assessments of value and risk. For the valuation of other assets, accounting standards do not prohibit the use of amortized cost where this would give a more accurate valuation than the fair value approach, for example, because of the absence of an active market for the asset. The valuation risks that might arise through market distortions are addressed through the capital charges applied to assets for general insurers and reserves for asset risks of life insurers (see ICP 17).

Liabilities are largely valued using a discounted cash flow calculation, representing the net present value of expected future cash flows based on assumptions determined by the Appointed Actuary, and discounted using risk-free discount rates. General insurers must use a risk free discount rate that is based on current observable, market-based and objective rates for sovereign risk securities that directly relate to the nature, structure and term of the future obligations. In valuing life insurance liabilities the gross rate used to discount expected future cash flows must, to the extent the benefits under the policy are contractually linked to the performance of the assets held, reflect the expected investment earnings applicable to the assets backing the benefit being valued. Otherwise, a risk-free discount rate is to be used. When valuing liabilities for solvency purposes (solvency liabilities or capital adequacy liabilities), the discount rate used by life insurers is subject to a maximum of the mid-swap rate.

For general insurers, a central estimate must be measured as the present value of the future expected payments, and a risk margin is required to account for the inherent uncertainty associated with the central estimate. Life insurers must calculate liabilities under both the solvency and capital adequacy requirements. The capital

adequacy liability is measured as the present value of future cash flows allowing for both guaranteed obligations and policyholder reasonable expectations, using the discount rate described above and best estimate assumptions plus a margin selected from a prescribed range. For the solvency liability, mortality assumptions are based on a prescribed table, which has been set conservatively and must be adjusted for policies issued on sub-standard or non-underwritten terms. Other solvency assumptions, such as total permanent disability and trauma incidence, are equal to the best estimate assumption plus a prescribed margin. The prudential standard also requires the Appointed Actuary to ensure that the insurer holds additional reserves where the standard would otherwise be deficient.

The valuation of technical provisions and other liabilities does not reflect the insurer's own credit standing.

Prudential standards generally require the valuation of technical provisions to exceed the current estimate by a margin. For general insurers, a risk margin must be included that would value insurance liabilities at a minimum 75 percent level of sufficiency. For life insurers, a solvency liability must be calculated, which involves revaluing insurance liabilities using a more conservative assumption basis. The solvency liability is not allowed to be less than the best estimate liability.

The current estimate reflects all future cash flow obligations of the insurer to fulfill the insurance contract, and as such must consider all contractual cash flows. The uncertainty associated with cash flows are reflected in probability weightings as part of the discounted cash flow valuation. The policy liability for life insurance policies with participating benefits must include a value for future best estimate bonuses. However, in the context of the solvency liability, operating profits are likely to be depressed and so any further participation benefit would be of reduced or immaterial value.

For general insurers, the actuary is required to review the assumptions used for determining the best estimate of insurance liabilities at least annually and disclose any information regarding changes made to these assumptions from those of the last period. Liability valuation methods and assumptions are required to be in line with the experience of the insurer and the industry.

For life insurers, the actuary is required to make best estimate assumptions using professional judgment, training and experience having regard to reasonably available statistics and other information. The assumptions are to be neither deliberately overstated nor deliberately understated. Most life insurers are large enough to generate adequate business volumes for the assessment of their own lapse and expense experience for the purpose of setting assumptions. Assumptions for mortality will be based on the insurer's own experience but will also be informed by broad based industry studies. Life insurers must at a minimum separate acquisition expenses from non-acquisition expenses, as the standards allow acquisition expenses to be deferred and expensed over the life of the policy.

For general insurers, risk margins must be determined according to the uncertainty of the gross insurance liabilities, and uncertainty regarding both reinsurance and non-reinsurance recoveries. To ensure that portfolio-specific risks are taken into account, risk margins must be determined for each class of business for general insurance. General insurers are permitted to account for diversification benefits in the calculation of the risk margins.

For life insurers, the best estimate liability is determined as the value of the expected

	<p>future benefit payments and expenses, less the value of expected future receipts over the full time horizon of the policy. The solvency liability is determined by using the methods used to determine the best estimate liability, but adopting prescribed solvency assumptions and allowing for both current and future bonuses subject to the appropriate application of discretions. If there are material risks associated with the assets or liabilities that are not allowed for under the prescribed solvency assumptions, the actuary must allow for them in considering scenarios of adverse experience and adopting a basis for the solvency requirement. Life insurers are required to report separately on each statutory fund and to perform calculations at a related product group level. Diversification benefits are provided for in the calculation of solvency requirements, through the determination of resilience reserves, rather than in the calculation of the risk margin.</p> <p>As noted above, the valuation of technical provisions allows for the time value of money. The selection of discount rates must relate to the nature, structure and term of the future obligations. Where insurance liabilities are not able to be matched with assets of the appropriate term, extrapolation or interpolation can be used, along with appropriate adjustments. In very short-tail lines where the effect of discounting is likely to be immaterial relative to the overall insurance volatilities, general insurers are permitted to not discount the liabilities.</p> <p>The valuation of technical provisions is required to make appropriate allowance for embedded options and guarantees. Such features are generally not found in general insurance contracts. For life insurance, embedded options may either be valued in accordance with a suitable option pricing method, or the best estimate assumptions may be appropriately adjusted to capture the value of the options. Accounting standards require an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in the statement of comprehensive income. This applies to derivatives embedded in a life insurance contract, unless the embedded derivative is itself a life insurance contract, and unless it meets certain criteria relating to the nature of the surrender terms.</p>
Assessment	Observed.
Comments	<p>The risk margins in general insurance liabilities are calculated to meet a specified level of uncertainty. However, the risk margins in life insurance solvency liabilities are calculated using specified assumptions, which means that the risk margins can vary depending on the current best estimate assumptions. The risk margins in life insurance capital adequacy liabilities are explicit, but can be selected from prescribed ranges, which means that the level of uncertainty provided for by the margins can vary.</p> <p>APRA should consider specifying the level of certainty to be provided for by the risk margins in life insurance liabilities.</p>
<b>ICP 15</b>	<p><b>Investment</b></p> <p>The supervisor establishes requirements for solvency purposes on the investment activities of insurers in order to address the risks faced by insurers.</p>
Description	<p>The IA, LIA, CA and various prudential standards establish requirements applicable to the investment activities of insurers and general insurance groups. The requirements are supplemented by prudential practice guides.</p> <p>Prudential standards on risk management include requirements applicable to the</p>

management of investment risk. The Board has overall responsibility for risk management and APRA assesses the effectiveness of investment risk management (see ICP 8).

The IA requires a general insurer to maintain assets in Australia of a value that equals or exceeds the total amount of its liabilities in Australia. For a branch insurer, the assets in Australia must exceed liabilities in Australia by at least the amount of its minimum capital requirement.

Capital adequacy requirements are also designed to reflect the risks associated with the investment activities of insurers. For general insurers, prudential standards provide for an investment risk charge, which is intended to address the risk of an adverse movement in the value of a general insurer's assets and off-balance sheet exposures. The capital factors are risk-based and certain assets attract a 100 percent capital charge (for example, loans to directors, unsecured loans to staff and pledged assets) or are subject to deduction from the capital base (for example, intangible assets, the intangible component of an investment in a subsidiary and investments in subsidiaries not held at fair value). There is also an investment concentration risk charge for large exposures to an asset or counterparty (including related counterparties). Where an insurer has a counterparty exposure that exceeds prescribed thresholds, which decrease with the level of security of the asset, it must hold 100 percent of the additional exposure in capital. APRA may require a general insurer to hold additional capital against derivatives, where the insurer enters into significant derivative transactions or makes extensive use of derivatives for other than hedging purposes.

General insurance groups are broadly subject to the same risk management and capital requirements in respect of investments as individual general insurers.

For life insurers, requirements regarding the safeguarding of assets and investments backing policy liabilities are focused on the operation of statutory funds. The IA requires a life insurer to establish statutory funds to relate solely to the life insurance business of the company or to 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 insurer arising out of the conduct of the business of the fund. The IA prescribes various requirements of a life insurer related to the investment, administration and management of the assets of a statutory fund, in which the life insurer is to give priority to the interests of policyholders. The IA also prohibits the mortgage or charging of any assets of a statutory fund, controls the movement of assets in and out of a statutory fund, provides a definition of restricted investments (which relates to related-party dealings) and requires the reporting of restricted investments.

Various features of the life insurance capital adequacy and solvency requirements are designed to influence investment activities. They prescribe the methodology and basis for determining the investment-related reserves and risk charges for non-investment-linked business. An inadmissible asset reserve allocates additional capital to certain assets whose valuation is dependent on the continued viability of the life insurer (for example, investments in subsidiaries and associates, and intangible assets). A resilience reserve provides for the exposure to asset-liability management (ALM) risk due to shocks in equity and property prices, credit spreads, interest rates and foreign currency risks. They also prescribe single asset exposures thresholds (based on the type and the value of the assets of the statutory fund) which if exceeded lead to the excess attracting a 100 percent capital charge. Where investments are made through investment vehicles, the exposure will generally be assessed on a look-through basis, requiring knowledge of the underlying assets.

The requirements related to investment activities are transparent, with prudential standards and practice guides being published on APRA's website. Additional guidance is provided to insurers through APRA's onsite reviews and prudential consultations. There is also ongoing liaison between APRA, the industry associations and individual insurers, which enables parties to clarify any issues. The above-noted regulatory requirements address the security, liquidity and diversification of an insurer's investments. In addition, the prudential standards on outsourcing, a prudential practice guide on custody (GPG 232) and a cross-industry circular on custodian requirements reinforce the need to ensure the secure custody of investments.

APRA assesses market and investment risk as part of the onsite review process. This includes an assessment of the insurer's investment portfolio and any custodian arrangements in place. APRA reviews whether an insurer takes into consideration security, liquidity and diversification when setting its investment strategy. It also reviews the frequency and method by which the insurer reviews its investment strategy. APRA's assessment of the diversification of an insurer's investment portfolio considers the combination of different classes of assets with less-than-perfect correlation, diversification by geography, counterparty, industry, risk type and duration, as well as the controls in place to limit concentrations. Reviews of liquidity include an assessment of the nature of liabilities, relative ease of salability of assets, cash flow, lock-up periods, and the insurer's process for reviewing its liquidity position.

Various aspects of the requirements influence an insurer to invest in a manner appropriate to the nature of its liabilities. They include the valuation requirements, in which both assets and liabilities are based on fair values, and the capital adequacy and solvency requirements (in particular, the resilience reserve for the ALM risk of a life insurer). Prudential standards require all insurers to consider ALM risk as part of their risk management framework. APRA's supervision activities, in particular onsite reviews assessing market risk, also cover ALM risk. Internal assessment guidance is available to assist supervisors in the assessment process, and a specialist market risk unit participates in the more complex assessments.

Prudential standards require insurers to have effective systems of risk management and internal controls to manage all material risks, including investment risk. Insurers are expected to make a comprehensive assessment prior to entering into any investments in assets with complex or opaque structures or that may carry excessive risks.

APRA assesses whether insurers have in place effective controls to assess and manage all of their investments. If an insurer has outsourced some or all of its investment activities to a third party, APRA assesses the investment manager selection process, the process for manager reviews, the selection of appropriate benchmarks for assessing manager performance, and the circumstances under which continued investment through a manager will be reconsidered or terminated. APRA makes similar assessments where an insurer is investing in unlisted assets through a fund-of-funds structure. Where an insurer chooses to invest in securities directly (rather than through a collective investment vehicle), APRA reviews the insurer's methodology for selecting securities within various asset classes. The assessments are supported by internal guidance material and a specialist market risk unit. APRA issues requirements to any insurer or general insurance group investing in assets where the risks are not being adequately assessed or managed.

	<p>For general insurers, the use of complex and opaque investments may result in a supervisory adjustment to required capital. A general insurer is also required to:</p> <ul style="list-style-type: none"> <li>a) apply to APRA prior to entering into an investment through a Special Purpose Vehicle (SPV) or other related entity where it wishes to look through the vehicle to the underlying assets for large exposures and capital calculation purposes;</li> <li>b) not be exposed to an obligor for an unlimited amount (for example, a general guarantee) or an unlimited time period and notify APRA of an off-balance sheet arrangement with an obligor that does not have appropriate limits;</li> <li>c) consult with APRA prior to entering into derivatives not in respect of contracts other than those over equities, interest rates and foreign exchange; and</li> <li>d) discuss with APRA the reasons for entering into any derivative contracts at off-market prices and the consequences for the insurer's MCR.</li> </ul> <p>For life insurers, the Appointed Actuary must assess the complexity and risks of the assets and investments of the insurer and adjust the reserve for inadmissible assets, for example, where the overall portfolio of assets of the statutory fund has too little diversification, is too illiquid or has too great an exposure to obligors of low credit standing. Lower limits also apply to the inadmissible assets reserve for less-liquid assets, such as certain non-traded securities. The resilience reserve will be adjusted where the Appointed Actuary is of the view that the statutory fund is materially exposed to changes in investment market conditions that are not captured by the application of the prescribed rules.</p> <p>The related-party balances for the life insurance industry as at 30 June 2011 were A\$ 26 billion, or about 161 percent of shareholders' funds. APRA noted that it is common for Australian life insurers to invest in unit trusts that are managed by a corporate trustee related to the life insurer. As the underlying assets of these unit trusts (e.g., shares, bonds, property, etc.) are not related to the life insurers, APRA considered these balances to be no more risky than if the portfolio was outsourced to an investment management firm or managed internally by an in-house investment department. APRA regularly analyzes insurers' investment portfolios to ensure that there are no excessively risky exposures. During its onsite reviews, APRA also develops an understanding of the structure of the relevant group, the intra-group relationships and the insurers' involvements with related parties. Any balances that exceed concentration limits or in the Appointed Actuary's view are of concern would attract capital charges. Further, a 100 percent capital charge is applied to assets whose valuation is dependent on the continued viability of a life insurer, which includes investments in subsidiaries and associates (<i>LPS 2.04 Para. 5.1.1.b</i>).</p> <p>APRA's onsite reviews of market risk cover assets that are complex and less transparent, such as options, unlisted infrastructure investments and structured portfolios. Few insurers in Australia have invested in such assets. However, where they have done so, APRA assesses the adequacy of the insurer's due diligence process.</p>
Assessment	Observed.
Comments	<p>Insurers have a very broad choice of investment assets and many of the requirements are qualitative and principles-based in nature. Responsibility for the proper management of investment risks lies with the insurer, supported by adverse treatment under the capital adequacy standards in respect of risky or concentrated investments, along with rigorous supervisory assessments. Such a regime is appropriate for a developed market and supervisory system like Australia, but some additional quantitative restrictions might nevertheless be useful.</p>

	<p>APRA should consider the establishment of additional quantitative restrictions, for example, on large exposures, investments with related parties, more-complex and less-transparent classes of assets, and investments in markets or instruments that are subject to less governance or regulation. Such restrictions might be useful in the supervision of both insurers and insurance groups.</p> <p>As noted under ICP 23, APRA should also formally extend its supervision to life insurance groups, which would include relevant investment requirements.</p>
<b>ICP 16</b>	<p><b>Enterprise Risk Management for Solvency Purposes</b> The supervisor establishes enterprise risk management requirements for solvency purposes that require insurers to address all relevant and material risks.</p>
Description	<p>As noted under ICP 8, risk management requirements are set out in the APRA prudential standards on Risk Management (GPS 220 for general insurers, LPS 220 for life insurers, and GPS 221 for Level 2 general insurance groups), supplemented by a number of other prudential standards and practice guides that deal with various risks and controls. They cover such areas as capital adequacy, business continuity, outsourcing, reinsurance, information technology security, insurance, credit, and balance sheet and market risk.</p> <p>An insurer is required to establish a risk management framework and strategy that are appropriate to the nature and scale of its operations. The risk management framework is required to address all material risks likely to be faced by the insurer, which must include specified risks such as strategic risk, insurance risk and operational risk. As noted under ICP 17, APRA has a range of prudential standards related to capital adequacy, which require insurers to identify and quantify risks for solvency purposes when calculating their regulatory capital requirement. The risk management framework must include, among other things, a written business plan, documenting the insurer's approach to capital management and to determining target and trigger capital ratios above the regulatory minimum that are appropriate for the nature, scale and complexity of the insurer and its risk appetite.</p> <p>APRA is currently revising its capital requirements in the Life and General Insurance Capital (LAGIC) project, due for implementation in 2013. Also being introduced is a formal Internal Capital Adequacy Assessment Process (ICAAP). This will establish a clear link between an insurer's risk appetite and its risk and capital management framework, including the target capital levels determined as part of the insurer's ICAAP. Under the proposed requirements, the existing capital management plans will be subsumed into the ICAAP. Insurers will continue to be required to develop a business plan, which should be consistent with the ICAAP of the insurer (The proposed requirements arising from the LAGIC project have not been considered in this assessment).</p> <p>APRA assesses the adequacy of risk management frameworks and the effectiveness of their implementation as a key element of its supervisory framework. This is done through both offsite analyses, for example, of risk management strategies, and onsite reviews. Specialist resources are sometimes involved in these reviews. The effectiveness of tools used for the identification and measurement of risk is a particular focus of review, whether these are quantitative or qualitatively-based. For example, APRA assesses the reasonableness of stochastic and deterministic financial models used for business and capital planning purposes, including the methods for setting assumptions and any qualitative inputs. APRA also assesses how the insurer's enterprise risk identification and assessment processes feed into relevant stress and scenario tests, such as those related to catastrophe</p>

modeling and reinsurance planning.

The same risk management requirements apply at the general insurance group level. In making its assessments in the context of group-wide supervision, APRA focuses on the group enterprise risk management framework, as well as the risks and risk management processes relevant at the group level.

Prudential standards require an insurer to document its approach to risk management in material risk areas, including the processes for identifying and assessing risk, although they do not explicitly require documentation of the measurement approaches used and the key assumptions made. APRA assesses the adequacy of such documentation through its onsite and offsite supervisory activities. However, insurers currently working through the internal model accreditation process must explicitly recognize the linkages between risk and capital management, including the measurement approaches and key assumptions made.

Prudential standards require insurers to have risk management policies and procedures to identify, assess, monitor, report on and mitigate all material risks, financial and non-financial, likely to be faced by the insurer. These policies and procedures describe the key day-to-day elements of the risk management framework, which give effect to the strategy for managing risk. Further guidance on risk management policies is provided in the various prudential practice guides.

Prudential standards require an insurer's risk management framework to include the insurer's risk appetite and capital management processes in place for monitoring and reporting of risk issues (including communication and escalation mechanisms). The insurer's approach to risk and capital management will be documented in the risk management strategy, risk appetite statement, capital management plan and other risk management policies. The prudential standards do not explicitly require an insurer to measure economic capital or, if it does so, to describe the relationship between economic capital and other elements of its risk management policy.

APRA assesses the effectiveness of an insurer's risk management framework through onsite and offsite reviews, which include review of the alignment between an insurer's risk appetite, capital position and approach to capital management (including monitoring). This includes review of the processes for monitoring risk and the use of risk tolerances. A key linkage between an insurer's risk appetite and management of capital are the target or trigger capital ratios set by the insurer. In assessing an insurer's capital management framework, APRA may require an insurer to alter its capital management processes or target capital ratios where concerns exist over the capital ratios set by the insurer.

Prudential standards require all insurers to consider ALM risk as part of their risk management framework. Prudential practice guides provide guidance to insurers on asset and liability management controls and processes, the role of investment strategy in product development and pricing and the need to consider the quantum of additional capital required to satisfy their internal capital management assessment in relation to ALM risk. APRA's supervision activities, in particular onsite reviews assessing market risk, also cover ALM risk.

Prudential standards on risk management include requirements applicable to the management of investment risk. The Board has overall responsibility for risk management, including the risk management policy, which must deal with investment risk. Prudential standards establish additional requirements on the use of more complex and less transparent classes of assets and investment in markets or

instruments that are subject to less governance or regulation (see ICP 15). APRA assesses investment risk as part of its offsite and onsite supervisory processes.

Prudential standards require insurers and general insurance groups to cover insurance risk under their risk management framework. This includes the risks associated with underwriting, pricing, claims, reinsurance, product design and distribution. Prudential practice guides provide guidance on insurance risk, including underwriting risk, with examples of the elements needed to be included in risk management frameworks in order to control and manage the risks associated with underwriting. APRA assesses insurance risk as part of its offsite and onsite supervisory processes. Such assessments include the review of an insurer's FCR and, for general insurers, ILVR, the latter of which may help to monitor claims inflation or escalating claims handling expenses. Supervisors are supported in these assessments by internal supervisory guidance and a specialist insurance risk unit.

Prudential standards require insurers and general insurance groups to document their risk appetite in their risk management strategy. APRA has reinforced the importance of high-quality risk appetite statements that are embedded in the risk management frameworks through discussions with the Boards of major insurers and speeches. However, the prudential standards do not require insurers to establish quantitative and qualitative risk tolerance levels and defines risk tolerance limits which take into account all relevant and material categories of risk and the relationships between them, or to make use of such limits in their business strategy and day-to-day operations. In practice, some insurers do take such steps. APRA assesses how well an insurer's risk management framework, including its risk appetite statement, is embedded throughout its operations.

Prudential standards require an insurer to review its risk management strategy in the event of a material change to its operations and to notify APRA of changes that materially affect its risk profile. Insurers are also required to regularly review various aspects of their risk management framework, including the risk management strategy. APRA assesses the responsiveness of an insurer's risk management framework to changes in its risk profile through offsite and onsite supervisory activities.

Prudential standards require an insurer's risk management strategy to describe the process for monitoring and reporting risk issues, including communication and escalation mechanisms. Prudential practice guides provide additional guidance on these issues. Such requirements, together with those noted above regarding review of the risk management strategy, are intended to provide a feedback loop to facilitate action by the insurer. APRA assesses this aspect of an insurer's risk management framework through its supervisory activities, including through onsite reviews. For example, supervisors assess management information systems and the associated quality of recording, analysis and reporting of information needed to maintain control over and to monitor the performance of an insurer's business activities.

Requirements for an insurer to perform an own risk and solvency assessment (ORSA) are currently embedded within the prudential standards' requirements for risk management frameworks and for capital management as part of the Board-approved business plan. These plans must include actions and procedures to avert any breaches of regulatory capital requirements. An insurer's approach to capital management should reflect the size and complexity of its business. For example, larger or more complex insurers would be expected to have reasonably sophisticated approaches to capital management, including stress testing. However, there is currently no explicit requirement for insurers to perform stress testing as part of their

	<p>annual capital planning unless they are applying for accreditation of an internal capital model, and APRA indicates that it is not widely used.</p> <p>The Board of an insurer is responsible for its risk management framework and strategy, while the day-to-day management is the responsibility of senior management. Such responsibilities would include the ORSA.</p> <p>Prudential standards require the insurer's risk management framework to encompass all reasonably foreseeable and relevant material risks including, underwriting, credit, market, operational and liquidity risks and additional risks arising due to membership of a group. However, there is no explicit requirement that the ORSA identify the relationship between risk management and the level and quality of financial resources needed and available. APRA assesses how an insurer sets its triggers and targets for capital management, including how it incorporates, on a current and prospective basis, the risks to which it is exposed.</p> <p>Prudential standards require an insurer's capital management plan to consider the strategy for setting and monitoring capital resources over time and for managing them above the statutory minimum. An insurer must hold a surplus over the minimum to ensure it can meet targets and objectives in its business plan and absorb some uncertainty. This requirement is typically achieved by the establishment of target capital levels or capital triggers to alert management to and avoid breaches, set in line with the insurer's risk appetite. Insurers are not explicitly required to consider economic capital unless they are applying for accreditation of an internal capital model. APRA assesses the effectiveness of an insurer's capital management and its relation to risk appetite through onsite and off-site reviews.</p> <p>Prudential standards require an insurer to document a business plan, which must include consideration of capital management on a rolling three-year basis. APRA assesses the effectiveness of the insurer's business and financial planning, including how the business plan incorporates such elements as financial projections and key financial and prudential ratios. As part of the risk management framework, the business plan must also consider the risks faced by the insurer and include sensitivity analysis covering up-side and down-side scenarios, based on those risks. However, there is no explicit requirement that an insurer prepares quantitative projections of its future financial position and analyses of its ability to meet future regulatory capital requirements using, for example, stress testing. Where concerns exist, APRA will focus on the insurer's strategies to address the risks and require that robust triggers and contingency plans are put in place.</p> <p>Review of risk management processes and financial condition are fundamental parts of APRA's supervisory assessment (see ICPs 8 and 9). Where necessary, APRA requires improvements to risk management practices and capital planning, and may require additional capital resources to be obtained.</p>
Assessment	Largely observed.
Comments	<p>Enterprise risk management is an evolving field, both in Australia and internationally. Some Australian insurers have sophisticated enterprise risk management systems, while others are at earlier stages of development. The LAGIC project is intended to strengthen the regulatory framework in areas relevant to enterprise risk management and its implementation should be helpful in that regard.</p> <p>Whether through LAGIC or otherwise, APRA should enhance the requirements on</p>

	<p>enterprise risk management. In particular, insurers should be required to explicitly describe the relationship between their risk tolerance limits, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk. They should be required to document their approach to measuring risks, to establish quantitative and qualitative risk tolerance levels and defines risk tolerance limits which take into account all relevant and material categories of risk and the relationships between them, and to make use of such limits in their business strategy and day-to-day operations. APRA should also provide more explicit guidance regarding the performance of own risk and solvency assessments.</p>
<b>ICP 17</b>	<p><b>Capital Adequacy</b> The supervisor establishes capital adequacy requirements for solvency purposes so that insurers can absorb significant unforeseen losses and to provide for degrees of supervisory intervention.</p>
Description	<p>The regulatory capital framework for life and general insurers is currently undergoing a comprehensive review, i.e., the LAGIC project. Changes stemming from the LAGIC project are expected to be implemented in January 2013. The LAGIC project will align, where appropriate, the definition of the elements eligible to be considered as capital, and general insurers and life insurers will be subject to capital charges for a common range of risks: insurance risk, insurance concentration risk (particularly relevant for general insurers), asset risk (incorporating asset and liability mismatch risk), asset concentration risk and operational risk. Where appropriate, common methodologies will be adopted across life and general insurance. This assessment is based on the capital adequacy requirements applicable at the time of the assessment.</p> <p>The current requirements are set out in prudential standards GPS 112 Capital Adequacy: Measurement of Capital (for general insurers), LPS 2.04 Solvency Standard (for life insurers) and LPS 3.04 Capital Adequacy Standard (also for life insurers). Although the structure and details of the requirements differ, a total balance sheet approach is used for both general and life insurers. It takes into account all of the assets and liabilities of the insurer and their interdependence. The framework sets requirements for minimum levels of capital, requirements for capital resources and requires all risks to be appropriately recognized. The starting point is the balance sheet determined in accordance with Australian accounting standards and APRA prudential standards (see ICP 14).</p> <p><b>General Insurance</b> For general insurers there is a defined capital base, with GPS 112 setting out the requirements to be met by elements of the capital base. This includes the assessment of capital into two tiers, composition requirements and deductions from capital for certain types of assets.</p> <p>This capital base is compared to a defined minimum capital requirement (MCR) to calculate a solvency coverage ratio. The MCR may be determined using an internal model developed by an insurer, subject to APRA approval, or using the prescribed method.</p> <p>The three components of the prescribed method for determining the MCR are the investment risk charge, insurance risk charge and insurance concentration risk charge. These separately apply risk-based capital charges to the assets, off-balance sheet obligations and insurance liabilities of the general insurer and specify the determination of a capital charge in relation to exposure to concentrations of insurance risks (such as natural perils or accumulations of liability risk). Additional</p>

charges apply where aggregate exposures to assets or groups of related counterparties exceed specified thresholds.

In addition, certain assets are either deducted from capital (for example, intangible assets) or receive a 100 percent capital charge (for example, unsecured loans to staff) where the realization of their value is dependent on the continuation of business.

The insurance risk charge is designed to raise the liability valuation to a 99.5 percent level of sufficiency. The insurance concentration risk charge assesses a general insurer's exposure to a concentration of insurance claims from a common source, in most cases natural catastrophes.

For general insurance groups, the requirements are similar to those applicable to a general insurer, but are based on consolidated accounts and take into account insurance diversification and aggregations across the group. Level 1 and Level 2 capital requirements must be complied with at all times by insurers and insurance groups.

### **Life Insurance**

The LIA requires a life insurer to establish statutory funds that relate solely to the life insurance business of the company or a particular part of that business. A statutory fund includes all the assets 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. In the assessment of solvency, the total assets of a statutory fund are required to meet a minimum "solvency requirement", which is a measure of the liabilities and required capital for the statutory fund under a wind-up or run-off scenario. The total assets of a statutory fund are also required to meet a minimum "capital adequacy requirement", which is a measure of the liabilities and required capital for the statutory fund under a going-concern scenario.

The solvency requirement broadly comprises the solvency liability, other liabilities, a resilience reserve, an inadmissible assets reserve and an expense reserve. The solvency liability is the value of the guaranteed obligations to policyholders on the basis of prescribed assumptions, which are more conservative than the best estimate assumptions. The resilience reserve addresses asset liability mismatch risks and is determined as the amount required to be held before the happening of a set of changes in the economic environment such that, after the changes, the statutory fund is able to meet the (post-stress) solvency and other liabilities. The inadmissible asset reserve addresses the risks associated with certain assets and their ability to support policy liabilities by treating them as inadmissible. Assets that are treated as inadmissible include intangible assets, assets that depend on the continuation of the business, asset values in excess of prescribed asset concentration limits, illiquid assets and assets that are used to support capital requirements of subsidiaries. The expense reserve allows for costs that would be incurred in putting the fund into run-off.

The capital adequacy requirement is made up of the capital adequacy liability, other liabilities, a resilience reserve, an inadmissible assets reserve and a new business reserve. The capital adequacy liability is the value of policy liabilities allowing for both guaranteed obligations and policy owner reasonable expectations valued using the best estimate assumption plus a margin selected from a prescribed range. The market and credit stresses assumed for the resilience reserve are greater than those applying for the equivalent solvency test. The new business reserve is held so that the insurer has the ability to write new business with an expectation of remaining

solvent into the future.

As statutory fund solvency and capital adequacy requirements incorporate a value for the liabilities and are compared with total assets of the statutory fund, there is no explicit definition of eligible capital. Instead, the attributes associated with capital, that is permanency and loss absorption capabilities, are assessed in relation to the assets. Assets that do not meet the requisite attributes are treated as inadmissible assets.

To ensure that life insurers are adequately capitalized outside the statutory funds, they are required by prudential standards (LPS 6.03 and LPS 3) to hold sufficient assets in the General Fund, which must be no less than \$10 million.

APRA does not set group-wide capital adequacy requirements for life insurance groups. However, the structure of Australian groups is such that for all relevant life insurers, APRA undertakes an assessment of capital adequacy of the group. Capital requirements at the banking or general insurance group level, along with the power to regulate and set requirements for life insurance NOHCs, would enable APRA to rectify any concerns it may have with capital adequacy within a group. APRA is currently consulting on the establishment of a prudential framework for conglomerate groups, which will include capital requirements.

Prudential standards require each insurer to maintain sufficient capital to enable its insurance obligations to be met under a wide range of circumstances, placing ultimate responsibility on the Board to ensure that capital adequacy requirements for regulatory purposes are met. Insurers are expected to have capital management processes in place as part of their risk management framework (see ICP 16). The capital requirements for general insurers have been calibrated to a 99.5 percent level of sufficiency over one year. For life insurers, the solvency requirement is calibrated to a 99.5 percent level of sufficiency on wind-up and the capital adequacy requirement is calibrated to a 99.75 percent level of sufficiency on a going-concern basis.

The requirements do not prescribe specific solvency control levels. Instead, each insurer is required to set its own capital management plan, including capital targets and triggers above the minimum levels and capital management actions for each trigger. These plans must be agreed with APRA (GPS 220 and LPS 220). The capital management plans are thus linked to the insurers' respective risk appetites. APRA regularly reviews insurers' capital management plans, which includes reviewing the reasonableness of target and trigger capital ratios and corrective action to be taken by the insurer should its capital level approach or fall below these targets. Where there are concerns over the capital ratios set by the insurer, APRA may require the insurer to alter its capital management processes or target capital ratios. APRA will review the insurer's capital targets and triggers to assess their suitability for prudential purposes, to help ensure that corrective action by the insurer will pre-empt the need for significant supervisory intervention from APRA. Insurers are required to advise APRA when the capital level of the insurer falls, or is expected to fall, below its capital triggers. In 2011, following the impact of a number of catastrophe events, the capital position of some general insurers dropped below target operating levels and actions were taken to restore capital levels to the desired ongoing position.

As noted above, the requirements do not prescribe a solvency control level above which the supervisor does not intervene on capital adequacy grounds, which is referred to in ICP 17 as the Prescribed Capital Requirement (PCR). In effect, each

insurer sets its own PCR, which is subject to APRA's review. The general insurance capital requirements and life insurance solvency requirements described above set the minimum solvency control level, referred to in ICP 17 as the MCR below which APRA invokes its strongest intervention in the absence of appropriate corrective action by the insurer. Holding capital below this level indicates a lack of ability to operate effectively. Also, the LIA provides that a breach of the capital adequacy requirement means APRA approval is required for a profit distribution from a statutory fund and no approval can be given if the distribution would result in a breach of the solvency requirements. In practice, however, APRA would likely use its other powers to seek recapitalization before this point is reached; based on the PAIRS rating and SOARS stance of an institution, APRA's intervention intensifies as an insurer approaches the MCR. The same approach to solvency control levels used for general insurers is also applied to general insurance groups.

Regulatory capital requirements are contained in prudential standards, which are publicly available on APRA's website, as are prudential practice guides. APRA consults extensively with insurers, industry bodies and other interested stakeholders in the development of prudential standards, as evidenced most recently by the consultations on the LAGIC project. APRA has been explicit in outlining the bases for its regulatory capital requirements, for example, in the various discussion and response papers and draft prudential standards pertaining to the LAGIC project. As noted above, the current prudential standards also set out the target sufficiency level for the minimum capital requirements.

Standardized methods are used to calculate the capital requirements. Alternatively, the general insurance prudential standards allow the use of internal models, subject to APRA's approval. The standard framework that applies for life insurers is relatively sophisticated, requiring recalculation of the liabilities using conservative assumptions and modeling the impact of prescribed market stresses on both the assets and liabilities.

APRA has established prudential standards outlining where and how risks are addressed. This includes permitted diversification both within the components of the minimum capital requirement and, where relevant, across these components. The various risk categories within the capital requirements, as well as the treatment of correlations and diversification, have largely been described above. In addition, it can be noted that operational risk is currently subject to qualitative control requirements rather than quantitative financial requirements, except for investment-linked business, where a margin of 0.25 percent of funds under management is required to be held in respect of operational risk. APRA includes qualitatively-assessed risks such as operational risk, strategic risk and reputational risk when reviewing an insurer's approach to enterprise risk management for solvency purposes and the establishment of the insurer's capital targets and triggers.

The calibration of regulatory capital requirements under the standardized approaches is described above. General insurers and general insurance groups would be required to calibrate their internal models to the same levels of sufficiency. Prudential standards give APRA the power to adjust a general insurer's MCR where it believes that the amount determined by the insurer does not adequately reflect the risk profile of the insurer. Various criteria govern the exercise of this discretion, which in practice has been used infrequently and through the formal exercise of delegations and with necessary internal consultation. This aims to achieve a consistent approach across the industry. There is no ready mechanism to adjust the current solvency or capital requirements for life insurers, although under exceptional circumstances, the LIA gives APRA the ability to issue a direction to a life insurer to

hold a specified amount of capital. Instead, APRA uses its normal supervision processes as described above.

As noted above, prudential standards provide for the classification of the capital resources of a general insurer into two tiers. A general insurer's capital base is the sum of Tier 1 and Tier 2 capital, net of all specified deductions and amortization, subject to various limits. Tier 1, or core capital, comprises the highest quality components of capital that fully meet all the essential characteristics of capital prescribed in the standard. Tier 2, or supplementary capital, includes other instruments that, to varying degrees, fall short of the quality of Tier 1 capital but nonetheless contribute to the overall financial strength of an insurer, such as term subordinated debt. Contingent assets or capital instruments based on a future event cannot be counted as capital until such time as the future event occurs, the future sale or conversion has irrevocably taken place and the proceeds have been irrevocably received by the insurer. Deductions are made from Tier 1 capital to adjust for balance sheet elements such as intangible assets (such as goodwill) that are not recognizable as supporting assets for regulatory capital. Any component of capital that APRA believes does not represent a genuine contribution to an insurer's financial strength will be excluded from the capital base of the insurer. The treatment of assets for capital adequacy purposes is based on a combination of deduction and capital charge approaches.

Similar principles apply to general insurance groups, with additional consideration for key group-wide factors, such as the ability for the parent entity to readily transfer capital from entities within the group should the need arise to recapitalize the parent entity or any group entity. In the event that capital support from within the group is not available, APRA may require the parent entity to adjust its MCR to reflect the lack of available capital.

For life insurers, assets that do not meet the requisite attributes are included in an inadmissible asset reserve that forms part of the solvency and capital adequacy requirements. Approved subordinated debt, within prescribed limits, is recognized as a capital resource by excluding it from the liabilities.

For general insurers, a prudential standard specifies permanency, availability, absence of encumbrances and mandatory servicing costs and subordination as criteria for assessing the quality and suitability of capital resources. The capital tiers described above are divided into sub-categories, which are subject to quantitative limits. For general insurance groups, other controls are in place to ensure that group capital represents a genuine contribution to the financial strength of the group. For life insurers, prudential standards specify that the availability of capital should be considered in the context of an extended run-off situation or an active and viable going concern, for the solvency and capital adequacy requirements, respectively.

There are specific criteria and eligibility limits around subordinated debt based on the term of the instrument. Repayment of such debt on maturity will not be permitted if it would lead to a breach of the capital adequacy requirement, and payment of interest can only be made where, after the payment, the solvency standard is met.

A prudential standard and practice guide outline specific criteria that must be met by a general insurer or general insurance group seeking APRA's approval to use an internal model for setting the regulatory capital requirement. No internal models have yet been approved, but a small number of general insurers are currently seeking approval.

	<p>The prudential standard sets out the model approval process with respect to three main criteria:</p> <ul style="list-style-type: none"> <li>a) Model Governance – approval will not be provided unless APRA is satisfied with the governance arrangements for the internal model;</li> <li>b) Model Use – approval will not be provided unless APRA is satisfied that the internal model plays an integral role in the insurer’s management and decision-making processes, and that this use is embedded in its operations; and</li> <li>c) Model Sufficiency – approval will not be provided unless APRA is satisfied that the internal model is sufficient to give a reliable measure of required capital. This includes an assessment of the technical sufficiency of the internal model and how the capital requirement is calculated from the model output.</li> </ul> <p>All of these areas are assessed as part of the approval process and would also be assessed on subsequent review, drawing on information gathered as part of APRA’s normal supervision processes.</p> <p>APRA will not approve the use of the Internal Model-Based (IMB) Method unless it is satisfied that the internal model gives a reliable measure of required capital and meets the model sufficiency criteria, which is essentially a statistical quality test. The model sufficiency criteria include the documentation and justification of the inputs, assumptions and structure of the internal model. The internal model must adequately capture all the material risks of the insurer’s portfolio and business, and that these risks are appropriately modeled both individually and jointly with due consideration given to tail characteristics. An independent review covering technical sufficiency also needs to be conducted as part of the application process and on an ongoing basis at least once every three years.</p> <p>APRA requires the insurer to meet a calibration test for the internal model against the criteria in the prudential standard as part of the assessment of model sufficiency. To simplify somewhat, the insurer’s MCR is the amount of capital sufficient for it to be 99.5 percent confident of being able to run off its liabilities to extinction, paying them in full as they fall due, after allowing for one year of new written premium (with some risks modeled over a one-year time horizon).</p> <p>APRA will not approve the use of the internal model method unless the insurer passes a use test set out in a prudential practice guide and meets the model governance criteria set out in a prudential standard. The prudential standard also requires the insurer to have comprehensive documentation of the internal model.</p>
Assessment	Largely observed.
Comments	<p>APRA’s requires insurers to establish their own solvency control levels, which must be agreed with APRA, rather than defining solvency control levels as part of the requirements. This approach helps to ensure that insurers are actively involved in assessing their capital needs and developing appropriate capital plans. However, the resulting solvency control levels are not transparent to the market and might not provide a consistent level of sufficiency at which intervention would be triggered.</p> <p>APRA should take steps to increase the transparency and ensure the consistency of the solvency control levels.</p>

<b>ICP 18</b>	<p><b>Intermediaries</b> The supervisor sets and enforces requirements for the conduct of insurance intermediaries, to ensure that they conduct business in a professional and transparent manner.</p>
Description	<p>Insurance intermediaries who provide advice on general or life insurance are deemed to be carrying on a financial services business<sup>62</sup> and must hold an AFSL under the CA. An insurance broker is, therefore, required to hold an AFSL. While life and general insurers are also required to hold AFSLs, the supervisory role of ASIC is restricted to their conduct of business (See ICP 19).</p> <p>The employees of an insurer are deemed to be its representatives. In addition, an insurer can authorize representatives (i.e., agents) to act on its behalf. Agents are exempted from the requirement to hold AFSLs. Agents may act for more than one insurer, but each of the insurers must give its consent for the multiple representations and ASIC holds all the insurers jointly responsible for supervising the agent. ASIC must be advised within 15 business days of the appointment of an agent by an insurer. Some insurance agents hold AFSLs, which allows them to act for more than one insurer (<i>s911A (1) (a) s916C and s916F of CA</i>).</p> <p>The CA specifies the circumstances in which ASIC must or must not grant an AFSL. ASIC assesses whether an applicant has the ability to comply with statutory requirements. These include: ensuring financial services are provided efficiently, honestly and fairly; arrangements for managing conflicts of interest; compliance with licensing conditions and relevant financial services law; ensuring that representatives comply with financial services law; adequate financial, technological and human resources; appropriate competence level and training of representatives; dispute resolution process for retail clients; adequate risk management; and compensation arrangements if financial services are provided to retail clients (<i>s912A and s913B of CA</i>).</p> <p>ASIC has issued guidance on its approach to licensing and the minimum financial requirements that an AFSL holder is expected to meet. ASIC's regulatory guides on licensing are published on its website. ASIC recognises that the licensing regime applies to small sole traders through to large international banks. Thus, the licensing regime treats like applicants on a consistent basis, while allowing ASIC to make allowances for differences in the scale and complexity of the applicants' businesses (<i>RG 104 Licensing: Meeting the general obligations and RG 166 Licensing: Financial requirements and s914A of CA</i>).</p> <p>Applicants for an AFSL must submit the following information: the (business) name of the company/partnership/person; name and address of directors/partners and secretaries; principal business address; Australian Business Number; description of the proposed financial services; and the arrangements to comply with the obligations under the CA. Details of the roles of each responsible officer must also be provided including their Statement of Personal Information.<sup>63</sup> ASIC has developed an on-line licensing system to facilitate electronic submission (<i>Regulation 7.6.03</i>).</p>

<sup>62</sup>—“Financial services business” includes providing “financial product advice” and dealing in “financial product”. The definition of “financial product” includes the management of financial risk, which in turn includes the management of the financial consequences to a consumer of particular circumstances happening. (*s.761A and s.763A of CA*)

<sup>63</sup>The following proofs are to accompany the Statement of Personal Information: certified copy of criminal history check; certified copy of bankruptcy check; and certified copies of two business references.

	<p>The minimum financial requirements are included as a specific license condition, which must be met on an ongoing basis. The base level financial requirement<sup>64</sup> is designed to require all AFSL holders to: be solvent at all times; have total assets that exceed total liabilities; meet ASIC's cash needs requirements<sup>65</sup>; and meet audit requirements. Additional financial requirements are imposed where the AFSL holder: is a responsible entity (i.e., manages a collective investment scheme); operates an investor-directed portfolio service; operates custodial or depository services; holds client money or property; or transacts with clients as principal.</p> <p>Intermediaries must notify ASIC promptly if they have breached or are likely to breach significant license obligations. ASIC is also required to impose the following notification requirements under the licensing conditions for intermediaries: any event that has material impact on their financial position, any changes in material particulars entered in the ASIC Register of AFSL holders, and changes in control. External auditors are required to report to ASIC if they become aware of any matter that has adversely affected the ability of an intermediary to meet its obligations (<i>s912D and s990K of CA and Regulation 7.6.04</i>).</p> <p>ASIC formally assesses every complaint it receives to determine whether there are breaches of the relevant legislation. All complaints and breach notifications received are registered in ASIC's internal and confidential national complaints management database. All complaints are acknowledged and allocated to an appropriate Misconduct and Breach Report analyst or lawyer for assessment. As a result of the analysis, complaints are classified as: a) serious matters to be escalated to an ASIC Deterrence Team, b) systemic misconduct to be referred to a Stakeholder Team for surveillance or consideration of compliance action; c) not able to take action (e.g., lack of evidence or jurisdiction); and d) no further action. ASIC is committed to finalize 70 percent of complaints received within 28 days of receipt.</p> <p>It is an offence for intermediaries to deal in an unauthorized insurance product (including insurance business placed offshore). Intermediaries authorized to deal with UFIs are required to submit data to APRA, which will then be provided to ASIC.</p> <p>The responsible officers of intermediaries must be of good fame and character. Senior management must meet requirements on competencies, including knowledge and skill. ASIC may still grant an AFSL even if one of the responsible officers is not of good fame and character if it is of the view that this does not affect an intermediary's ability to provide the financial services. However, this has not occurred in practice (<i>s913B(3) of CA</i>).</p> <p>ASIC has issued guidance on monitoring and supervising of representatives, including monitoring their compliance with financial services laws. Training requirements are also specified, including minimum training standards for staff or agents providing advice to retail clients (<i>s913B and of CA; RG 105 Licensing: Organisational Competence; RG 104; and RG 146 Licensing: Training of Financial Product Advisers</i>).</p>
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<sup>64</sup>Positive net assets and cash to cover three months' operating expenses.

<sup>65</sup>There are five Options. Option 1 is the "reasonable estimate projection plus cash buffer" method. Option 2 is the "contingency based projection" method. Options 3-5 do not involve individual cash flow projections and are generally only available to AFSL holders within corporate groups or with financial support from an Australian ADI or foreign deposit-taking institution. (*RG 166-166.35*).

	<p>While there are no explicit corporate governance requirements for intermediaries, they are required to ensure: competencies of responsible persons; adequate resources to carry out supervisory arrangements, including appropriate compliance measures; and adequate risk management systems. The compliance measures should ensure compliance with all relevant financial services laws and take into account specific compliance risks having regard to the nature, scale and complexity of the business. An intermediary is expected to identify and manage the risks to: consumers using its services; and the integrity of the insurance market. The risk management systems must be reviewed and updated regularly and supported by adequate resources (<i>PS 164 Licensing: Organisational Capacities, Part C and D of RG 104, s912A(1) of CA</i>).</p> <p>Intermediaries must provide a Financial Services Guide (FSG) to retail clients to assist them in deciding whether to acquire a financial service. The information to be disclosed in a FSG includes: name and contact details of the intermediary; the financial services that the intermediary is authorized to provide; who the intermediary acts for; relationship between the intermediary and the issuer of any financial product; and details of the binding agreement, if applicable (<i>s941 and s942B of CA</i>).</p> <p>An authorized representative must disclose additional information including: name and contact details; a statement that it is authorized by an insurer to provide the financial service; the financial services authorized to be provided; who the authorized representative acts for; and any relationship between the authorized representative and the issuer of any financial product (<i>s942C of CA</i>).</p> <p>The CA establishes statutory safeguards relating to the segregation, use, withdrawal, and distribution of client money/assets held in the accounts of a financial intermediary in the event that an intermediary becomes insolvent or ceases to carry on business. An intermediary may maintain a single trust account for all client monies. If an intermediary becomes insolvent, its client money account (whether it is a trust account or a segregated account) is taken to be subject to a trust in favor of each client, i.e., not available to satisfy the debts of an intermediary in the event of winding-up. Additional financial requirements are imposed where an intermediary holds funds or property on behalf of clients (<i>s981A, s981B, s981E, s981H, s984A, s984B of CA, Regulation 7.8.07 and 7.8.01, RG166</i>).</p> <p>A person who carries on a financial services business without an AFSL, and is not acting as an authorized representative of an AFSL holder, contravenes the CA. ASIC can apply for an injunction to restrain such a person from continuing to engage in unlicensed activities (<i>s911A and s1324 of CA</i>).</p> <p>ASIC has a comprehensive range of powers that it can use to enforce the requirements relating to the conduct of insurance intermediaries. These include powers to gather information, conduct surveillance, obtain search warrants, and impose sanctions. ASIC has a range of graduated sanctions at its disposal that allow it to take enforcement measures commensurate with the seriousness and consequences of the misconduct in question. Its sanctions powers include suspending/cancelling an AFSL, banning or disqualifying individuals, applying for a winding-up order, and financial penalties. ASIC imposed sanctions on a few brokers in 2009 (<i>s912A, s915C, s920A, s461 and s 911C of CA</i>).</p>
Assessment	Observed.

Comments	<p>The regulatory regime for insurance intermediaries is mature, well-understood and has a broad coverage. ASIC has established clear licensing guides and regulatory guides on the supervision of representatives by AFSL holders, including minimum training standards. The CA gives ASIC adequate powers to take action in relation to breaches. However, to supervise the large numbers of licensees with limited resources, ASIC has adopted a more reactive approach to supervising intermediaries (see ICP 19). There is also scope to have explicit and more comprehensive corporate governance requirements for intermediaries.</p>
<b>ICP 19</b>	<p><b>Conduct of Business</b></p> <p>The supervisor sets requirements for the conduct of the business of insurance to ensure customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied.</p>
Description	<p>Australia's consumer protection framework seeks to ensure the fair treatment of customers through a combination of legislative requirements, external dispute resolution schemes, and ASIC supervision.</p> <p>The ASIC Act: a) prohibits misleading and deceptive conduct; b) prohibits unconscionable conduct; c) prohibits undue harassment or coercion; and d) requires services to be rendered with due care and skill.</p> <p>The CA requires regulated parties to act efficiently, honestly and fairly.<sup>66</sup></p> <p>The ICA: a) requires insurers to act with utmost good faith; b) provides that unusual terms included in insurance contracts are not effective unless the insured is clearly informed in writing of the effect of the provision; c) requires questions to the insured to be clear and unambiguous and interpreting ambiguous questions in favor of the insured; d) regulates contract terms and disclosure requirements; and e) prevents refusal of claims for breaches of contract by the insured where that breach has not contributed to the loss.</p> <p>ASIC supervises a large population of AFSL holders and representatives operating in the insurance industry. The licensees in the insurance sector as at end-2011 comprised:</p> <ul style="list-style-type: none"> <li>• 55 general insurers with 5,874 authorized representatives;</li> <li>• 28 life insurers with 618 authorized representatives; and</li> <li>• 1,477 insurance brokers or agents, with 34,473 authorized representatives. The top 10 insurance brokers or agents, as measured by the number of authorized representatives, have around 40 percent of the total number of authorized representatives.</li> </ul> <p>As some representatives are authorized by more than one AFSL holder, the number of representatives may be overstated.</p> <p>ASIC's supervisory approach to monitoring intermediaries' compliance with financial services laws within its purview is both reactive and proactive. ASIC may undertake surveillance visits to intermediaries in response to self-notification of breaches, third-party reporting (e.g., complaints), statistics on claims disputes, or systemic issues notified by the FOS. Proactive surveillance includes mystery shopping and thematic review of selected issues, e.g., the use of the word "independent" by intermediaries in April 2012.</p> <p>During 2010/11, there were 20 full-time staff from the Deposit Takers Credit and Insurers Team responsible for supervising insurers' conduct of business, including</p>

<sup>66</sup>Except for claims handling, which is excluded from the CA (but not the ASIC Act).

both surveillance as well as policy and advice work (see ICP 9).

The financial adviser surveillance part of the Consumer and Retail Investors (CARI) Team of ASIC is responsible for the oversight of intermediaries' conduct of business. In 2009/10, financial adviser surveillance part of the CARI Team started with 31 staff, which fell significantly to 11 in 2010/11 and had 16 staff at the time of assessment. The CARI team conducted 42 reactive surveillance and 2 proactive surveillances in respect of insurance intermediaries in 2010/11. Overall, CARI supervises 3,345 AFSL holders providing financial product advice.

The LIA imposes a duty on directors to take reasonable care and use due diligence in the investment, administration and management of the assets of the statutory funds. In particular, in the event of conflict between the interests of policyholders and shareholders, a director's duty is to see that the insurer gives priority to the interests of policyholders. However, this provision relates to the administration of the statutory funds and does not go as far as requiring insurers and intermediaries to "establish and implement policies and procedures on the fair treatment of customers that are an integral part of their business culture," (ICP Standard 19.2). There is no similar provision under the IA (*s48 of LIA*).

Under the CA, AFSL holders are required to:

- a) do all things necessary to ensure that the financial services are "provided efficiently, honestly and fairly";
- b) comply with the financial services laws;
- c) take reasonable steps to ensure that their representatives comply with the financial services laws;
- d) maintain the competence to provide those financial services; and
- e) ensure that their representatives are adequately trained, and are competent, to provide those financial services.

ASIC interprets the above statutory obligations as meeting ICP Standard 19.2 (*s912A of CA*).

ASIC has provided guidance on minimum training requirements, including the knowledge and skill requisites for financial advisers (FAs) who provide personal advice to retail clients. Financial products are as categorized as either Tier 1 or Tier 2. General insurance products, except for personal sickness and accident insurances, are classified as Tier 2 while life insurance products are categorized as Tier 1. Tier 2 products are generally simpler and better understood than Tier 1 products and are subject to lighter training standards (*Appendices A and B of RG 146 Licensing: Training of Financial Product Advisers*).

The Ripoll Report stated: "The major criticism of the current system is that licensees' minimum training standards for advisers are too low, particularly given the complexity of many financial products".<sup>67</sup> Industry feedback also suggested that there are merits to strengthening the minimum training standards for insurance intermediaries (brokers and agents) and representatives of AFSL holders selling insurance products. Recognizing the need for enhancements, ASIC is reviewing its approach to assessment and professional development.

<sup>67</sup>Consultation Paper 153-Licensing: Assessment and professional development framework for financial advisers. Following the collapse of financial service and product providers in 2008 and 2009, the Parliamentary Joint Committee on Corporations and Financial Services established an inquiry into the issues associated with these collapses, which issued the Ripoll report in November 2009.

Insurers and intermediaries are subject to disclosure requirements at the point of sale, particularly with respect to retail clients. Specifically, they must provide comprehensive information that enables their clients to make sound investment decisions. This includes information about the product being recommended, including the benefits and risks (a Product Disclosure Statement), the person providing the financial services (a FSG), as well as the basis upon which an advice was given to the client (a Statement of Advice<sup>68</sup>).

Insurers/intermediaries and their representatives are required to ensure that there is a reasonable basis for the advice provided to retail clients. They must, therefore, determine the relevant personal circumstances of the client and make reasonable inquiries to establish a reasonable basis for the advice. This includes understanding a client's knowledge, experience, needs, priorities and circumstances. Where applicable, they must warn a client that the advice is based on incomplete or inaccurate information and that the client should consider the appropriateness of the advice (*s945A, s945B of CA*).

If insurers/intermediaries and their representatives provide 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. In practice, staff of insurers (or banks) who sell insurance products typically do not provide advice. ASIC Consultation Paper 164 on Scaling Advice provides some helpful examples that demonstrate the distinction between factual information, general advice, and personal advice.

ASIC does not have the regulatory mandate to supervise the development of insurance products. However, it has a role to supervise the marketing practices of insurers/intermediaries. False or misleading statements or information that is likely to induce the public to apply for, dispose of, or acquire financial products is an offence (*s1041E of CA, Part 2 Division of ASIC Act*).

While the disclosure requirements at the point of sale are generally adequate, there is no requirement for insurers to service policies appropriately through to the point at which all obligations under the policies have been satisfied. This is a pertinent consideration for the legacy portfolios of life insurers.

"Handling insurance claims" is excluded from the definition of a financial service in the CA and hence ASIC's powers generally do not apply to claims handling. Proposed amendments to the ICA would introduce new powers in relation to claims handling for ASIC if brought into law. Claims handling is also an essential element of the General Insurance Code of Practice, which provides that claims handling and the management of complaints will be conducted in a fair, transparent and timely manner. As set out below, the Code has been adopted by the majority of general insurers (*s766A (2)(b) and Reg. 7.1.33*).

The CA requires AFSL holders to protect consumers by having arrangements to: manage conflicts of interest; compensate people that have suffered loss or damage where the AFSL holder has breached its legal obligations; and provide internal and external dispute resolution for retail clients. Insurers are required to provide details about how a consumer can access the relevant dispute resolution scheme in the FSG and PDS. ASIC oversees the external dispute resolution arrangements,

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<sup>68</sup>Not required for general insurance.

including by licensing dispute resolution providers and approving their terms of reference (*s912A of CA, RG 165 Licensing: Internal and external dispute resolution and AS 4269 1995: Complaints Handling*).

Internal dispute resolution procedures must satisfy ASIC's Essential Elements of Effective Complaints Handling: commitment, fairness, resources, visibility, access, assistance, responsiveness, charges, remedies, data collection, systemic and recurring problems, accountability, and reviews. The key principles that external schemes must address are: accessibility, independence, fairness, accountability, efficiency, and effectiveness. ASIC has released a publication-“You can complain”, which is a guide to dealing with disputes over financial products<sup>69</sup> (*RG 165, AS 4269 and RG 139*).

The FOS is a national service which assists in resolving disputes between consumers and financial service providers, including insurers, which are members of the FOS. The FOS determines the vast majority of disputed claims (very few being determined by the courts) and looks at all stages of insured and insurer dealings including claims handling.

Furthermore, the majority of the general insurers has adopted the General Insurance Code of Practice that aims to raise the standards of practice and service. The Code is administered by the FOS. The larger life insurance companies are members of the Financial Services Council and are expected to comply with its Industry Code of Ethics and Code of Conduct which requires members to be fair.

ASIC reviews sales practice to ensure that the consumer protection provisions are complied with. A person is prohibited from offering a financial product during an unsolicited meeting (e.g., cold calling or door-to-door sales) with a consumer unless certain conditions are complied with (*s992A of CA and Regulatory Guide 38 The hawking provisions*).

Currently, insurance contracts are excluded from the unfair contract terms provisions of the ASIC Act, on the basis that insurers are already required to act with utmost good faith under the ICA. The Australian federal government has issued a consultation on whether the unfair contract terms provisions of the ASIC Act should apply to insurance contracts (*s13 and s15 of ICA*).

Insurers who wish to provide home building insurance that derogates from standard cover (for example, through exclusions and limitations) can only rely on such an exclusion or limitation where it proves that, before the insurance contract was entered into (or renewed), the insurer has clearly informed the insured in writing or the insured knew, or a reasonable person in the circumstances could be expected to have known, about the exclusion or limitation (*s35 of ICA*).

ASIC has issued guidance on the statutory obligation of insurers/intermediaries to manage, control/avoid, and disclose conflicts of interests. In particular, conflicts-management arrangements must enable insurers/intermediaries and their representatives to identify those conflicts of interest that must be avoided. ASIC recognises that what constitutes adequate conflict management arrangements will depend on the nature, scale, and complexity of their business (*RG 181: Licensing: Managing conflicts of interest*).

In Australia, the collection and handling of personal information is governed by the

<sup>69</sup>Available on the MoneySmart (<http://www.moneysmart.gov.au>) website.

*Privacy Act 1988* and ten National Privacy Principles (NPPs). The Privacy Act applies to private sector organisations, including insurers and intermediaries, which have an annual turnover of greater than A\$3 million. While most insurers would have annual turnover of more than A\$3 million, intermediaries with lower annual turnover are not bound by the Privacy Act. The NPPs must be followed by private sector organisations. The NPPs address data security, restricted use and disclosure, including trans-border information flows, and prohibit the collection of sensitive information, except in certain circumstances.

The Government has introduced the Privacy Amendment (Enhancing Privacy Protection) Bill 2012 on 23 May 2012. This Bill will create a single set of privacy principles applying to both Commonwealth agencies and private sector organisations. These will be structured to reflect the 'life cycle' of personal information more accurately. The Bill also introduces additional safeguards for the protection of privacy, including enhanced notification, quality, correction, and dispute resolution mechanisms for individuals.

APRA supervisors may examine how an insurer protects the confidential information it holds on policyholders. Issues examined include who has access to the information, how is it secured, and whether electronically stored information is controlled by user name and password. The outsourcing prudential standards require outsourcing agreements to address confidentiality, privacy, and security of information.

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 promote financial literacy in the community. Since July 2008, ASIC has been the government agency with overall responsibility for financial literacy. In March 2011, ASIC released "Report 229: National financial literacy strategy" detailing its financial literacy strategy.

In March 2010 ASIC launched the MoneySmart website that provides general information on the benefits, types and operation of different financial products and services, as well as consumer tools such as calculators and tips to help consumers make better financial decisions and information on how consumers may make a complaint. ASIC also released the following reports related to insurance: a) Response to submissions on CP 144 Giving a PDS in telephone sales of general insurance products; b) Consumer credit insurance: A review of sales practices by authorized deposit-taking institutions; and c) Review of general insurance claims handling and internal dispute resolution procedures.<sup>70</sup>

The Future of Financial Advice (FOFA) reforms have been introduced to Parliament. The reforms will commence from 1 July 2012, but do not become mandatory until 1 July 2013. The FOFA reforms are directed to removing conflicts of interests in the financial advice industry and ensuring that advisers give priority to the interests of the clients over any other interest. To this end, the reforms introduce a duty for advisers to act in the best interests of clients and ban conflicted remuneration structures for investment and superannuation products. In addition, the reforms ban commissions on insurance products to the extent the product is bundled with a default superannuation product or is a group policy within any superannuation

<sup>70</sup>The review involved consideration of claims handling and Internal Dispute Resolution statistics and documents from eight different general insurers, with a focus on key motor vehicle brands and markets. While the high-level findings of the review were generally positive, ASIC has made nine recommendations to improve claims handling practices.

	<p>product. There is no ban on commissions for insurance products held outside of a superannuation product.</p> <p>In 2009, the government issued a Proposals Paper on Product Rationalization of Managed Investment Schemes and Life Insurance Products. Product rationalization is a process of converting or consolidating products of a similar nature into a single product with equivalent features and benefits. The stated objective is “to remove economically inefficient products (‘legacy products’) by transferring beneficiaries into new, more efficient products”. It was estimated that the total amount of funds under management in legacy products might amount to A\$ 221 billion. The proposals were still under consideration at the time of assessment.</p>
Assessment	Partly observed.
Comments	<p>The current regulatory regime, which sets high-level principles for conduct of business in the area of fair treatment of customers, should be supported by clearer regulatory guidance in line with international best practices. In particular, the current minimum training and competencies standards for intermediaries should be strengthened. Gaps in ASIC’s legal authorities and regulatory requirements, e.g., to supervise insurers’ claim practices and policy servicing, dilute the effectiveness of the conduct of business supervision. Partly due to limited supervisory resources, ASIC’s supervisory approach is predominantly based on desk-top review and relies heavily on self-reporting of breaches of regulatory requirements or third-party notifications (ICP 9).</p> <p>To enhance protection of policyholders, there is scope to broaden ASIC’s authority in ensuring fair treatment of customers, e.g., supervising insurers’ claims handling practices; requirements for servicing of policies until their expiries; and product development. It is also critical for ASIC to be adequately resourced to supervise the conduct of business of about 1,560 AFSL holders.</p> <p>The authorities should strengthen the current regime for conduct of business by:</p> <ol style="list-style-type: none"> <li>implementing the enhanced training and competencies standards proposed by ASIC;</li> <li>requiring insurance intermediaries to ensure the privacy protection of customers;</li> <li>empowering ASIC to establish or enforce regulatory requirements to ensure fair treatment of customers and product development; and</li> <li>ensuring that ASIC is adequately resourced to conduct proactive supervision to prevent misconduct instead of the current more reactive approach to deal with identified breaches and shortcomings.</li> </ol>
<b>ICP 20</b>	<p><b>Public Disclosure</b></p> <p>The supervisor requires insurers to disclose relevant, comprehensive and adequate information on a timely basis in order to give policyholders and market participants a clear view of their business activities, performance and financial position. This is expected to enhance market discipline and understanding of the risks to which an insurer is exposed and the manner in which those risks are managed.</p>
Description	<p>Disclosure by insurers is required by Australian Accounting Standards, the CA, APRA prudential standards on capital adequacy and, for listed insurers, the reporting requirements of the ASX. In addition, insurers that are listed are subject to the continuous disclosure requirements of ASX. APRA’s statistical publications on general and life insurance, available on APRA’s website, provide additional</p>

information at both an aggregate and insurer level. Policyholders have the right to receive the financial statements and annual returns submitted by a life insurer to APRA, which maintains a register of returns for individual life insurers for inspection by the public.

Australian insurers, including branch insurers, operate through company structures and, unless very small and operated through proprietary companies, are classified as “reporting entities” and required by the CA to prepare and submit audited annual financial reports to ASIC. These financial reports are required to comply with accounting standards that are consistent with IFRS, but include some additional requirements (see ICP 14). The accounting standards include requirements regarding the information to be disclosed in the financial reports. Such information includes the results of a liability adequacy test and the solvency position of a life insurer, as well as balance sheet and income statement information for each life insurance statutory fund. Many insurers make the financial statements freely available on their websites, and they are also accessible through ASIC or information brokers at a cost.

The CA requires each insurer, as an AFSL holder, to submit an audited annual true and fair profit and loss statement and balance sheet to ASIC. In the case that the AFSL holder is not a reporting entity, the financial statements must nevertheless be prepared in accordance with recognition and measurement requirements of the accounting pronouncements, and in accordance with the disclosure requirements of those pronouncements. Annual reports of AFSL holders are on the public record if they are also subject to the separate financial reporting requirements applying generally to companies, registered schemes and disclosing entities.

Accounting standards require insurers to disclose qualitative and quantitative information about the determination of technical provisions. General insurers must disclose the following information in relation to claims liabilities: the central estimate of the expected present value of future payments for claims incurred; the component related to the risk margin; the percentage risk margin adopted in determining the outstanding claims liability; the probability of adequacy intended to be achieved through adoption of the risk margin; and the process used to determine the risk margin, including the way in which diversification of risks has been allowed for.

Life insurers are required to disclose information that identifies and explains the amounts in its financial statements arising from life insurance contracts, including related liabilities. They must also disclose the effect of changes in assumptions used to measure life insurance assets and life insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements. Such disclosures would, by their nature, be expected to be by product group and relating to individual statutory funds. Accounting standards also require all financial reports under the CA to disclose information about the assumptions an entity has made about the future. This general requirement would also be expected to lead to disclosure of assumptions by product (where applicable) and relating to the assets and liabilities of the individual statutory funds.

Accounting standards require life and general insurers to disclose qualitative and quantitative information that will enable users of general purpose financial statements to evaluate the entity’s objectives, policies and processes for managing capital. Such disclosures include its compliance with externally imposed capital requirements (for example, APRA requirements) and if relevant the consequences of non-compliance with such requirements. For general insurers and general insurance groups, prudential standards require additional disclosures regarding capital

adequacy, including the information regarding the eligible capital in each tier, the minimum capital requirement and the capital adequacy multiple. If an insurer uses an internal model to calculate the minimum capital, the disclosure must include a statement to that effect, and the relevant MCR calculations using both the internal model method and the prescribed method.

Accounting standards require insurers to disclose information about financial instruments and other investments, both those backing insurance liabilities and others. This includes information on the risks relating to investments and financial instruments and how they have been managed. For each type of risk (for example, credit risk, liquidity risk and market risk) arising from an investment or financial instrument, an insurer is required to disclose the exposures to risk and how they arise, its objectives, policies and processes for managing the risk, the methods used to measure the risk and any changes in these matters from the previous period. In addition, for each type of risk arising from financial instruments, an insurer is required to disclose summary quantitative data about its exposure to that risk at the end of the reporting period, specific information concerning credit risk, liquidity risk and market risk, and information about concentrations of risk. If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an insurer's exposure to risk during the period, the insurer must provide further information that is representative. The results of a sensitivity analysis for each type of market risk to which the insurer is exposed at the end of the reporting period, including the relevant methods and assumptions used and the changes therein must also be disclosed. APRA publishes individual insurer-level information on investment income and values.

Insurers are not required to publicly disclose qualitative or quantitative information on either enterprise risk management or all reasonably foreseeable and relevant material insurance risk exposures, although they do provide such information to APRA (see ICP 16).

Accounting standards require insurers to disclose qualitative and quantitative information regarding their financial performance, some of which must be provided on a segmented basis. The required disclosures include both basic and diluted earnings per share, profit or loss for each reportable segment, and information related to the nature and extent of risks arising from insurance contracts, such as claims development tables and a comparison of actual claims to previous estimates.

Insurers are required to disclose the effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements, as well as information on returns on investment assets and components of such returns. APRA publishes individual insurer-level information on financial performance, including underwriting performance, investment earnings and operating profit or loss.

Under the CA, a directors' report must accompany the annual financial report. The report must include: a review of operations; the principal activities; the names of the directors; and likely developments in operations. For listed companies an operating and financial review covering operations, financial position, business strategies and prospects is also required. However, information on likely developments in operations, business strategies and prospects is not required where it would be unreasonably prejudicial to the company. ASIC is concerned that some listed companies (in general, rather than specifically insurance companies) are overusing this exception, and intends to issue guidance to limit its use.

	<p>Listed insurers are subject to the Principles of Good Corporate Governance and Best Practice recommendations of the ASX, and are required to disclose in their annual reports the extent to which they have followed these best practice recommendations. For other insurers, there is no requirement to disclose the key features of the insurer's corporate governance framework and management controls and how these are implemented.</p> <p>As noted above, insurers are required to produce, at least annually, audited financial statements. The financial statements are available to market participants, in many cases at no cost on the websites of the insurers and, in any case, at a cost through ASIC or information brokers.</p>
Assessment	Partly observed.
Comments	<p>Public disclosure is receiving increasing emphasis internationally as key element of the framework for supervising financial institutions. It is one of the main elements of the IAIS Framework for insurance supervision and the requirements under this ICP were considerably strengthened in the 2011 revisions. The disclosure requirements applicable to insurers in Australia have not kept pace with these developments. Some of the types of disclosures called for by ICP 20 are required only of listed insurers in Australia, while some of the specific items are not required to be disclosed at all.</p> <p>This situation, at least in part, arises from a gap in supervisory responsibilities and powers. ASIC does not have the power to impose disclosure requirements beyond those set out in the CA or the accounting standards, while APRA has not issued disclosure standards other than on capital adequacy.</p> <p>APRA and ASIC should cooperate to identify and deal with the shortcomings in the disclosure requirements. As noted in the description, the shortcomings include:</p> <ul style="list-style-type: none"> <li>a) the exemption of small and unlisted insurers from many disclosure requirements;</li> <li>b) the limited detail disclosed on the capital adequacy of life insurers;</li> <li>c) the need for disclosure of an analysis of sources of earnings; and</li> <li>d) the need for comprehensive disclosures on corporate governance, risks and risk management.</li> </ul> <p>The authorities should consider requiring all insurers to make their audited financial statements and required disclosures available to the public at no cost.</p>
<b>ICP 21</b>	<p><b>Countering Fraud in Insurance</b></p> <p>The supervisor requires that insurers and intermediaries take effective measures to deter, prevent, detect, report and remedy fraud in insurance.</p>
Description	<p>Fraud in insurance is addressed through a range of offenses, which are punishable under the ASIC Act, the CA, the ICA, the Proceeds of Crime Act 2002 (PCA) and relevant State criminal codes. In particular:</p> <ul style="list-style-type: none"> <li>a) Under the ASIC Act, misleading representations, misleading or deceptive conduct, false or misleading representations, and unconscionable conduct are punishable through the imposition of penalties, fines, injunctions, punitive and non-punitive orders, imprisonment, and such orders as the court thinks fit.</li> <li>b) Under the CA, 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</li> </ul>

grounds; and false or misleading statements are also punishable through the imposition of penalties, fines, injunctions, punitive and non-punitive orders, imprisonment, and such orders as the court thinks fit.

- c) The CA requires AFSL holders, which include insurers and insurance intermediaries, to ensure that financial services are provided honestly and fairly, to ensure that representatives are adequately trained and competent, and to be of good fame and character. ASIC can refuse, suspend or cancel an AFSL, without affording a person a hearing, if the AFSL holder is convicted of serious fraud (among other things).
- d) Under the ICA, breaches may be punished through the voiding of insurance contracts; restitution (only in relation to general insurance); or varying the contract (only in relation to life insurance).
- e) Under the PCA, the DPP has the power to restrain assets and/or confiscate assets that are believed to be the proceeds of fraud (or other crime). ASIC refers matters to the DPP in circumstances where it believes that action may be appropriate.

Both ASIC and APRA have developed an understanding of fraud risks and fraud risk management frameworks, including through their supervisory activities. While ASIC does not have a program of periodic onsite inspections directed at identifying fraud risks, it may undertake surveillance visits where it becomes aware of any deficiencies in an AFSL holder's compliance function (for example, in relation to identifying and managing fraud risk).

Issues of concern are typically resolved by the participant rectifying the problem and putting in place agreed remediation plans. These plans are received by ASIC and reviewed, with implementation confirmed by a third-party review or a further review visit by ASIC. These plans may include changes to compliance structures, processes or procedures to address fraud risk. Also, ASIC can (and does) impose license conditions on AFSL holders, and enters into enforceable undertakings with them, that require them to do specific things over and above legislative requirements, such as strengthening procedures around the handling of client funds.

APRA assesses insurers' fraud risk management frameworks (including their preventive, detective, and response strategies), determining their appropriateness and effectiveness for managing the fraud risk exposures. Supervisors receive training and guidance material on fraud risk management. APRA also has specialist insurance and operational risk units that assist and provide support to frontline supervisors, for example, in an onsite review. These units evaluate a wide-range of practices across the industry, including in the area of fraud risk management, and have close links with persons in the industry, access to relevant risk information, and attend specialist fraud risk conferences. This helps ensure that APRA is aware of any emerging fraud risks and stays abreast of industry trends in countering fraud. Areas that are typically considered in an onsite review include risk and fraud-related policies and procedures covering segregation of duties, financial accounting controls, and staff training and awareness. Where deficiencies are noted, APRA will ensure these areas are reviewed and, as appropriate, addressed by the insurer.

In addition to the above, the supervisory framework includes various mechanisms that assist in monitoring and enforcing compliance by insurers and intermediaries with the requirements to counter fraud in insurance. For example:

- a) ASIC has prescribed recordkeeping, disclosure, corporate conduct and licensing requirements designed to ensure insurers and intermediaries maintain a high standard of integrity within their businesses.
- b) Any money paid by, or on behalf of, a client to an AFSL holder must be held in

	<p>trust by the AFSL holder for the client, where that money was paid in connection to a financial service or for a financial product.</p> <p>c) The CA requires an AFSL holder, other than one that is regulated by APRA, to have adequate risk management systems in place. ASIC has issued a regulatory guide on such systems, which are required to identify the risks to consumers using the licensee's services and to the integrity of the market. AFSL applicants must demonstrate to ASIC that they have adequate processes for managing risks associated with their business, including fraud risk.</p> <p>d) APRA's prudential standards impose risk management requirements on insurers, including the need to counter internal and external fraud. Such entities would be required to comply with the risk management obligations imposed by APRA.</p> <p>ASIC has a general power under the ASIC Act to commence investigations where there is a suspected contravention of the CA 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. Under the ICA, 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.</p> <p>The enforcement powers of ASIC and APRA have been described under ICP 11. Such powers apply to enforcement of the requirements to counter fraud.</p> <p>ASIC checks the effectiveness of internal processes and training including fraud prevention measures when conducting surveillances of licensees.</p> <p>ASIC and APRA have mechanisms in place, which enable them to cooperate, coordinate and exchange information with other competent authorities, such as law enforcement authorities (see ICP 3). These mechanisms extend to activities to deter, prevent, detect, report and remedy fraud in insurance. Of particular relevance to dealing with fraud in insurance are the following mechanisms:</p> <p>a) ASIC liaises closely with the DPP in respect of prosecutions.</p> <p>b) ASIC has MoUs with APRA and AUSTRAC, enabling timely exchange of information and facilitating cooperation in the detection and investigation of fraud in the financial system.</p> <p>c) ASIC is empowered by the ASIC Act to cooperate with a government or an agency of a foreign government by sharing confidential information.</p> <p>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.</p>
Assessment	Observed.
Comments	<p>Fraud in insurance is an illegal act punishable by law. APRA assesses insurers' fraud risk management frameworks, determining their appropriateness and effectiveness for managing the fraud risk exposures. ASIC may undertake surveillance visits where it becomes aware of any deficiencies in an insurer's compliance obligations in relation to identifying and managing fraud risk. ASIC and APRA cooperate, coordinate and exchange information with other competent authorities, including foreign supervisory authorities.</p>

	<p>Consistent with the recommendations under ICP 9, ASIC might further strengthen its oversight of the fraud controls of AFSL holders by adopting a more proactive inspection program.</p>
<b>ICP 22</b>	<p><b>Anti-Money Laundering and Combating the Financing of Terrorism</b>  The supervisor requires insurers and intermediaries to take effective measures to combat money laundering and the financing of terrorism. In addition, and the supervisor takes effective measures to combat money laundering financing of terrorism.</p>
Description	<p>AUSTRAC is Australia's anti-money laundering and counter-terrorism financing (AML/CTF) regulator and specialist Financial Intelligence Unit (FIU). AUSTRAC reports to the Minister for Home Affairs and Justice on the operations of the agency.</p> <p>The Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF Act), administered by AUSTRAC, applies to life insurance. General insurance is not considered by Australia to pose a significant ML/TF risk because the nature of general insurance policies is significantly less suited to money laundering or terrorism financing. Therefore, general insurers are not covered by the AML/CTF Act. However, general insurance providers and intermediaries are subject to reporting and recordkeeping requirements, and AUSTRAC oversight, under the Financial Transactions Report Act (FTR Act). The FTR Act imposes a less-comprehensive range of AML/CTF measures than the AML/CTF Act.</p> <p>APRA and ASIC are aware of and understand the money laundering and financing of terrorism risks to which insurers and intermediaries are exposed. APRA advises AUSTRAC should it encounter situations where it appears that a regulated entity is potentially in breach of the law. Further, AML/CTF issues arising at an insurer may be symptomatic of wider compliance issues. Information relating to AML/CTF will therefore be considered by APRA in the assessment of the insurer's risk management and compliance framework and controls, as part of its regular supervisory activities. APRA expects the risk management systems of insurers to consider risks arising from criminal activities and to ensure compliance with all legislative and regulatory requirements.</p> <p>APRA liaises with and obtains information from AUSTRAC on a regular basis. Information exchanged includes regulatory information relating to the compliance of entities as well as Suspicious Matter Reports (SMRs). The volume of SMRs from the insurance sector is low. Information is also exchanged in relation to enforcement matters undertaken by AUSTRAC over entities supervised by APRA.</p> <p>Life insurers are required to complete and submit a SMR to AUSTRAC if they form a suspicion at any time while dealing with a customer (from the enquiry stage to the actual provision of a designated service or later) on a matter that may be related to an offence, tax evasion, or proceeds of crime. AUSTRAC forwards these reports to relevant agencies including APRA, ASIC and the Australian Tax Office (ATO). SMRs are passed on to central contacts in the supervision areas through a secure platform, with strict confidentiality conditions attached, and then forwarded to the relevant supervisor for consideration. Documented internal processes and other controls exist within APRA to satisfy confidentiality requirements. Information provided by AUSTRAC can be used by ASIC to help focus an investigation, and can assist ASIC to build an asset profile for a person or organization of interest. General insurers and intermediaries are required to submit Suspect Transaction Reports (SUSTRs) to AUSTRAC in accordance with the FTR Act. AUSTRAC processes SMRs and SUSTRs in the same manner, according to risk rules generated on established</p>

money laundering and terrorism financing typologies and ongoing liaison with law enforcement and other partners.

ASIC and APRA have mechanisms in place, which enable them to cooperate, coordinate and exchange information with other competent authorities, such as law enforcement authorities (see ICP 3). These mechanisms extend to AML/CTF purposes. Of particular relevance to dealing with AML/CTF matters are the following:

- a) Under the APRA Regulations, APRA may disclose protected information to a number of entities, including AUSTRAC. 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.
- b) Under the AML/CTF Act, AUSTRAC is permitted to share AUSTRAC information with domestic supervisors.
- c) Under the AML/CTF Act, APRA may share AUSTRAC information with foreign Governments, or authorize the Australian Federal Police or the Australian Crime Commission to communicate AUSTRAC information to any foreign law enforcement agency, provided appropriate undertakings and safeguards in relation to the protection and control of information are agreed.
- d) There is no restriction on the type of foreign law enforcement agency with which AUSTRAC can authorize the disclosure of information, although in practice such agencies generally comprise AUSTRAC's FIU counterparts and follow the establishment of a formal exchange instrument.
- e) APRA has entered into a number of MoUs with domestic and overseas supervisors, including AUSTRAC. Guidelines have also been developed between AUSTRAC and APRA for the provision of non-public information, and these are available on the APRA intranet.

In practice, AUSTRAC and APRA have a collaborative working relationship. In 2006 APRA and AUSTRAC established a joint Co-ordination Committee that meets twice a year to facilitate the cooperation between the two agencies. Formal minutes of meetings are made and are readily available to relevant staff. The Committee is responsible for ensuring appropriate arrangements are in place for information sharing and referral of matters between the agencies as well as the provision of mutual assistance in relation to such matters as: facilitating the on-going professional development of staff in jointly relevant areas; promoting coordinated responses in relation to supervisory, educational and enforcement programs; and seeking to ensure that inconsistencies and regulatory overlap between the agencies are minimized and unnecessary compliance burdens are avoided.

Liaison in respect of routine operational matters also occurs on an as-needed basis between designated staff of the two agencies. For example, in cases where APRA becomes aware of money laundering or financing of terrorism risks or where AUSTRAC notifies APRA it will be taking action against an insurer.

To assist AUSTRAC assess its effectiveness in achieving the objectives of the AML/CTF Act, APRA also prepares an annual report of the utility of AUSTRAC information.

ASIC also has an MoU with AUSTRAC to facilitate the exchange of information and assistance between the agencies. ASIC and AUSTRAC meet semi-annually, at both the senior management and operational levels. As noted above, AUSTRAC information can be used by ASIC to help focus an investigation, and can assist ASIC to build an asset profile for a person or organization of interest. Also, staff members of the two agencies sometimes work together on task forces and specific

	enforcement matters.
Assessment	Observed.
Comments	<p>APRA and ASIC are aware of the money laundering and terrorism financing risks of the insurance industry and have effective mechanisms to cooperate, coordinate and exchange information with both domestic and foreign supervisors/FIUs.</p> <p>Financial Action Task Force (FATF) standards apply at a minimum to the underwriting and placement of life insurance and other investment-related insurance. However, in some jurisdictions, money laundering activities have extended to the general insurance sector. Accordingly, where the non-life sector, or part of that sector, is assessed by a jurisdiction as posing a ML/FT risk the FATF standards require that the jurisdiction considers applying the FATF standards to that sector. In Australia, general insurance is subject to the FTR Act, but is not subject to the more comprehensive requirements prescribed by the AML/CTF Act.</p> <p>The authorities should periodically reconsider whether or not general insurance should be subject to the more comprehensive requirements prescribed by the AML/CTF Act.</p>
<b>ICP 23</b>	<p><b>Group-wide Supervision</b></p> <p>The supervisor supervises insurers on a legal entity and group-wide basis.</p>
Description	<p>Arising from the collapse of the HIH Insurance Group in 2001, the Australian Government gave APRA the power to authorize NOHCs for general insurers in 2002. The same legislative power was extended to the life insurance industry in 2009. APRA introduced group supervision for general insurers in 2009. As a result, there are two levels of supervision, namely:</p> <ol style="list-style-type: none"> <li>Level 1-applies to insurers on a stand-alone entity basis; and</li> <li>Level 2 (general insurance only)-operates at a consolidated group level incorporating all entities in the group conducting insurance business or insurance-related business, both domestic and international.</li> </ol> <p>APRA is well in advance in its plans to introduce a Level 3 supervision framework for supervising financial conglomerates and in March 2010 has issued a consultation paper on formalizing a prudential and reporting framework for Level 3 groups.<sup>71</sup> A Level 3 group refers to a conglomerate group that has material operations in more than one APRA-regulated industry and/or has one or more material unregulated entities. The proposed framework applies a group-wide approach to risk and capital management to address potential contagion and other risks associated with insurers' membership in a Level 3 group. In the interim, APRA applies Level 3 supervision to certain groups informally, where it deems appropriate.</p> <p>APRA proposes two high-level principles in determining whether a group will be subject to Level 3 supervision: Principle 1-If a group has operations predominantly within a single APRA-regulated industry, Level 2 supervision will apply. In such cases, the capital of any APRA-regulated entities in a different industry from the</p>

<sup>71</sup><http://www.apra.gov.au/CrossIndustry/Documents/Discussion-paper-Supervision-of-conglomerate-groups-March-2010.pdf>

primary business of the group, and of certain unregulated entities, is deducted from group eligible capital; and Principle 2-if a group has material operations in more than one APRA-regulated industry and/or has one or more unregulated entities, it may be supervised at Level 3 if APRA considers that Level 1 and Level 2 do not adequately capture the risks of the group or provide an adequate view of the overall financial and operational soundness of the group.

#### General Insurance

A Level 2 insurance group is defined as:

- a) where there is no authorized NOHC and an insurer has controlled entities-the consolidation of the insurer and its controlled entities; or
- b) where there is an authorized NOHC-the consolidation of the authorized NOHC and its controlled entities; or
- c) where there is no authorized NOHC and an insurer does not have controlled entities-the consolidation of the insurer and any entity that meets the following criteria:
  - the entity is subject to control by an entity or group of related entities that are the same as or very similar to those that control the insurer;
  - the entity conducts insurance business or insurance-related business; and
  - APRA determines that the entity is to be consolidated.

APRA may, however, determine that a group that meets subparagraph a) or b) above is not to be treated as a Level 2 group (*Paras 6 to 12 of GPS 001 Definitions*).

The definition that identifies the scope of a Level 2 insurance group provides flexibility to APRA to adjust the structure of the group for regulatory consolidation. In line with APRA's risk-based approach to supervision, the scope of each insurance group is considered on a case-by-case basis. A key factor considered is whether the application of Level 2 requirements is of material benefit from a supervision perspective.

APRA receives information from related entities to assist in determining the appropriate scope of an insurance group during the licensing process, and based on its on-going supervisory activities. Where relevant, APRA liaises with other supervisors when setting the scope of group supervision. APRA has formal and informal mechanisms for facilitating this cooperation (refer to ICP 3 and ICP 25).

The legislative definition requires all entities conducting insurance business-both regulated and unregulated-to be consolidated. Consolidation at Level 2 must be in accordance with the requirements of Australian Accounting Standards for preparing consolidated financial statements except where APRA determines that an additional entity is to be consolidated or where an entity is to be treated as a non-consolidated subsidiary (*Para 7 of GPS 001 Definitions*).

Some controlled entities are to be treated as non-consolidated subsidiaries unless APRA determines otherwise: a) prudentially regulated entities that are neither insurers nor entities carrying on international business; b) entities acting as manager, responsible entity, approved trustee, trustee or similar role in relation to funds management (including superannuation or pension fund business); c) entities involved in non-financial (commercial) operations; d) securitization special purpose vehicles; and e) an entity which APRA has determined to be deconsolidated because APRA is satisfied that its principal business is not related to any insurance business of the group or is immaterial to the group's total business (*Para 9 of GPS 001 Definitions*).

The parent entity of a Level 2 insurance group is: a) where the Level 2 insurance

group is headed by an authorized NOHC, the authorized NOHC; and b) where the Level 2 insurance group is headed by an insurer, the insurer. "Authorized NOHC" does not refer to the ultimate holding company of a wider corporate group, which includes the Level 2 insurance group. Typically, such ultimate parents are either foreign entities or non-financial entities (*Para 10 and 11 of GPS 001*).

APRA will look through to the underlying structure of an insurance operation in setting the scope of a Level 2 insurance group. Where appropriate, APRA has encouraged the restructure of groups to facilitate supervision and reporting. In some cases, APRA requires an authorized NOHC be inserted between the group and the parent, e.g., in the case where the group is owned by a foreign parent. This "allows the financial group to be identified and supervised as an integrated whole that is financially and legally separated from the unregulated parent".<sup>72</sup> At the time of this assessment, all the Level 2 insurance groups are headed by authorized NOHCs.

In practice, the scope of the Level 2 insurance group has generally been aligned (either at inception or as a result of restructure) with the structure of the corporate group. There are, however, instances where APRA has required entities that may not be captured by the definition to be consolidated. APRA may also determine the deconsolidation of other entities if they are not related to insurance business or are immaterial to the group's total business. Supervisors review the materiality and risks of any deconsolidated subsidiaries regularly to ensure that they understand the potential sources of contagion risk.

In identifying an insurance group, APRA takes into account the significance of an entity to the overall operations of the insurance group, which includes: interconnectedness (e.g., shared back-offices, distribution networks, branding, etc.), risk exposures, risk transfers (e.g., intra-group reinsurance), risk concentration, and intra-group transactions (e.g., related-company loans).

Some examples of decisions made in relation to defining the scope of groups include:

- a) not requiring Level 2 supervision based on the relatively small insurance operation compared to that of the conglomerate group;
- b) allowing the deconsolidation of entities conducting certain insurance-related business (e.g., insurance broker) from the insurance group, due to the operational and business separation of those entities from the remainder of the insurance group; and
- c) exemptions from group supervision for Australian run-off and captive insurers, due to the nature of the insurance business. There is no exemption for an insurance group captive domiciled in another jurisdiction.

APRA is in regular contact with other involved supervisors to support effective group supervision, through direct engagement with home/host supervisors in other jurisdictions, domestic/international MoUs, and arranging supervisory colleges for Australian insurance groups and participating in overseas supervisory colleges.

The Level 2 capital adequacy requirements are broadly consistent with the prudential requirements that apply to Level 1 insurers, with additional or alternative prudential requirements established in a separate prudential standard to address group issues. Any internal or group captive is eliminated upon consolidation so that only external reinsurance recoveries remain on balance sheet (*GPS 111 Capital Adequacy: Level*

<sup>72</sup>The Architecture of Group Supervision, John Trowbridge (Executive Member APRA)

*2 Insurance Groups).*

APRA has also established supervisory standards on: group-wide governance, risk management and internal controls. APRA holds the Boards of Level 2 insurance groups responsible for meeting the prudential requirements on risk management. APRA allows a Level 1 insurer to rely on a Level 2 requirement if such requirements are adequate to address the requirement at Level 1. Examples include the Group Business Plan, Group Risk Management Strategy and Group Reinsurance Arrangement Statement (*GPS 221 Risk Management: Level 2 Insurance Groups*).

The supervisory approach at Level 2 is similar to that adopted for Level 1 (ICP 9). APRA has sufficient authority to effectively supervise Level 2 groups, including non-regulated entities with the groups. Examples of measures covering non-regulated operating entities include:

- a) Governance requirements apply to the head of the group (authorized NOHC or insurer), including fit and proper and Board composition;
- b) The power to obtain information from general insurers, authorized NOHCs, life insurers, registered NOHCs or subsidiaries of any of the above;
- c) Risk management requirements at both the group and insurer level, which include risks associated with related parties;
- d) The requirement for a Level 2 group to assess the adequacy of capital levels of non-consolidated subsidiaries in the business plan<sup>73</sup>;
- e) Power to adjust Level 2 group capital due to undercapitalized non-consolidated subsidiaries or intra-group transactions; and
- f) Controls to ring-fence insurers from the capital needs of non-regulated operating entities, such as the requirement to seek APRA approval for a capital reduction<sup>74</sup>, or the ability to impose more punitive controls on funds moving out of the insurer or group.

Supervisory reporting for a Level 2 group includes the regular submission of financial returns, Group Risk Management Strategy, annual Risk Management Declaration, business plans, Reinsurance Management Strategy, and Insurance Liability Valuation Report. APRA may obtain information from groups on a needs basis, including special purpose reviews conducted by the Group Auditor or Group Actuary (*GPS221*).

In practice, supervisory activities undertaken for an insurer often feed into Level 2 assessment. Group-specific issues are also considered, including: the assessment of group investments where the objectives might differ from that of individual insurers; the correlation and aggregation of insurance portfolios across the group; reputational risks due to common branding across a group; intra-group liquidity facilities which may not be effective in a group liquidity crisis; and the allocation of reinsurance recoveries to individual insurers within a group following a major catastrophic event.

ASIC's supervision of market conduct is focused on the specific legal entity holding the AFSL. There are no explicit market conduct requirements covering group issues.

The Level 2 supervision framework is subject to on-going review and enhancement. For example, APRA recently reviewed reporting alignment between Level 1 and Level 2, and revised GPS 001 to address issues identified in the implementation of the Level 2 group framework. APRA found that the implementation of Level 2 supervision has had a positive effect on the protection of policyholders, through:

<sup>73</sup>GPS111, paragraph 61

<sup>74</sup>GPS111, paragraph 43

	<p>a) group restructures to separate insurance operations from other risk-taking activities;</p> <p>b) the unwinding of complex intra-group transactions to enhance accountability and transparency;</p> <p>c) conversion of debt to equity due to the expanded application of capital requirements; and</p> <p>d) extension of risk management to entities which had previously been subject to no or lower risk-management requirements.</p> <p><u>Life Insurance</u></p> <p>APRA does not currently propose to implement a Level 2 framework for life insurers as doing so is not viewed as having material benefit because:</p> <p>a) The majority of the larger life insurers are part of a conglomerate group. As at June 2011, seven of the eight largest Australian life insurers (by asset size) were part of a conglomerate group. These life insurers are supervised under Level 1 and subject to either informal Level 3 assessments or Level 2 supervision of the general insurance or banking groups of which they are members;</p> <p>b) As the solvency position of a life insurer is determined at the statutory fund level (ICP 17), APRA considers that the consolidation of life insurers adds limited insight or policyholder protection for life policyholders;</p> <p>c) Supervisory risk assessments at Level 1 include consideration of contagion and related-party risks commonly associated with group supervision. Further, governance and fit and proper requirements apply to life insurers and their NOHCs (some life insurers have established NOHCs); and</p> <p>d) APRA is empowered to issue group-specific prudential standards on life insurers and would take such action if its concerns could not be addressed by other means.</p> <p>While APRA does not have a Level 2 supervision framework to life insurers, in practice it applies some of the Level 2 elements of supervision at Level 1. For example, APRA's supervision activities take into account risks associated with potential contagion, intra-group transactions and other group activities, including recognition through capital adjustments for certain subsidiaries.</p>
Assessment	Largely observed.
Comments	<p>APRA has established an effective and efficient framework for supervision of general insurance groups. The Level 2 supervision framework has been designed to enable better understanding of group risks and address potential contagion from both regulated and non-regulated entities. APRA has adequate powers and flexibility to determine the scope of Level 2 groups and to effectively supervise insurance groups and has exercised sound supervisory discretion in applying the framework. While Although APRA has powers to set requirements for life insurance groups including on an individual group basis, an equivalent Level 2 supervision framework has not been developed for life insurers. This will be largely addressed by the impending Level 3 supervision of financial conglomerates.</p> <p>ASIC's supervision of market conduct is at the legal entity level and there are no group-wide market conduct requirements.</p> <p>The impending introduction of Level 3 supervision of financial conglomerates will formalise group regulatory requirements for life insurers. The authorities should incorporate group-wide market conduct requirements in both Level 2 and Level 3</p>

	supervision frameworks.
<b>ICP 24</b>	<p><b>Macroprudential Surveillance and Insurance Supervision</b></p> <p>The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that may impact insurers and insurance markets and uses this information in the supervision of individual insurers. Such tasks should, where appropriate, utilize information from, and insights gained by, other national authorities.</p>
Description	<p>APRA's mandate includes protecting the interests of beneficiaries and promoting financial stability, both of which require systemic issues to be taken into account. APRA uses a variety of processes and analytical tools to identify, monitor and analyze market and financial developments and other environmental factors that may impact insurers and insurance markets. It also has processes to use this information to inform its supervision of individual insurers.</p> <p>APRA collects, monitors and analyzes a wide range of quantitative and qualitative information relating to insurers and the insurance industry. This information feeds into external publications and internal reports and tools, analyzing industry trends and emerging or potential industry risks. Insurers report extensive data to APRA under FSCODA (see ICP 9) and APRA publishes key financial and solvency data at both individual insurer and aggregate levels. External publications include Quarterly Performance Statistics, Half Yearly Life Insurance Bulletin, General Insurance Company Level Statistics and APRA Insight, which is a statistical publication that contains editorial articles and industry statistics for both general and life insurance.</p> <p>Data reported to APRA is available to supervisors from a range of internal applications such as MicroStrategy, which enables supervisors to create customized analyses of trends in financial data, including for peer groups of insurers.</p> <p>APRA has established an industry group for each industry it supervises, including each of the general and life insurance industries. An industry group is the key forum for addressing and seeking APRA-wide consensus on emerging industry issues. Each industry group is a cross-divisional forum with senior representatives from supervision, industry technical services, industry analysis, policy, statistics and legal. They play a key consultative and coordination role, including in identifying emerging industry issues, reviewing risk registers and providing advice on industry trends. The industry groups meet no less than once every two months and have formal terms of reference, agendas and minutes, which are available to all staff through the APRA intranet. Regular updates on key developments are provided through the weekly internal APRAnews publication.</p> <p>The APRA Committee on International Insurance Developments provides a forum for identifying and seeking an APRA-wide consensus on emerging issues affecting life and general insurance in an international context.</p> <p>The Industry Analysis unit, embedded within APRA's supervisory divisions, has as one of its primary responsibilities to conduct analysis and research on current and emerging industry risks and disseminate relevant and useful information to APRA supervisors. It prepares comprehensive reviews, at least annually, for each industry sector, which are available to APRA Members, senior management and staff. The reviews cover industry developments in all relevant areas of prudential risk, provide additional analysis and commentary on the trends indicated through various quantitative reports, and examine topical issues that pose actual or potential risks to the industry.</p>

For general insurance, a quantitative dashboard report is prepared on a quarterly basis. Industry data is presented to indicate trends and includes tables showing performance against risk tolerances and comparisons across peer groups including across insurance groups. The dashboard includes data sourced from other agencies such as the RBA and international regulators and standard-setting bodies, such as the IAIS data on systemic default risk of reinsurers. The dashboard is produced for an internal audience, most importantly the frontline supervision teams. There is also a quarterly qualitative general insurance report, which provides an update on industry developments and includes an analysis of the external environment.

For life insurance, a quarterly dashboard has a similar purpose and audience to that of the general insurance dashboard. It reports in the form of charts and tables on a variety of industry metrics. A Life Insurance Capital Monitoring Team is activated as required to monitor and scrutinize the capital adequacy of life insurers; for example, in response to a market disruption. It has also prepared a quantitative market monitoring tool to help assess the status and outlook of the external risk drivers for the industry.

Supervisors have access to a range of financial, industry and economic information and data through a research resources portal on APRA's intranet. The portal includes Science Direct, a database of banking and finance journals, and EBSCO, a database of magazines and newspapers, which enables supervisors to see how an entity has been reported in the media or search for the latest coverage on a topic such as credit default swaps. It also provides access to Moody's KMV and Bloomberg tools.

APRA staff has access to an extensive program of learning and development, which includes: courses on broader industry and macroeconomic risks; a simulation training exercise; training on the use of analytical tools; a series of Chief Executive Officer seminars, which provide industry perspectives on macroeconomic and regulatory issues; and seminars on a range of topics.

Entity risk assessments are completed by frontline supervisors using PAIRS assessment methodology, which lead to SOARS stances and SAPs (see ICP 9). In using these supervisory tools, supervisors are expected to take into account the insurer, the group context, the insurance industry and the broader environment. Quarterly risk reviews are conducted for insurers and insurance groups, which include the analysis of a wide range of industry and economic information relevant to the entity.

A range of regular reports are discussed at APRA's Management Group and Executive Group meetings to monitor industry trends and emerging and potential risks at senior levels. For example, APRA's Management Group receives an annual update from each industry group on its activities.

Many of the processes described above are intended to consider not only past developments and the present situation, but also trends, potential risks and plausible unfavorable future scenarios. In addition, APRA uses an industry risk management framework, risk registers and stress testing to contribute to forward-looking analyses. The goal of the industry risk management framework is to identify thematic or macroprudential risks and develop an appropriate response that mitigates the risks, prioritizes the use of resources and facilitates consistent treatment across institutions. The aim is to be forward looking and to deal with identified risks before they become less-easily manageable by both APRA and the industry.

Industry risk registers any emerging concern or business practice common to more than one institution in the industry that, over the risk assessment horizon, has a heightened possibility of posing significant adverse prudential consequences. The risk registers are intended to consider elevated risks not normally seen in the industry, whether driven by internal or external factors, rather than normal or idiosyncratic risks facing an institution. Nor does it include risks that are perennially high, which are dealt with in APRA's broader supervision framework. The definition of each industry risk is kept sufficiently specific such that it is possible to develop meaningful responses in relation to the risk. Only risks rated as high or medium are reported on risk registers, and the addition or removal of a high risk must be approved by APRA's Management Group. The Industry Analysis unit maintains the risk registers and has a specialist for each industry, including general and life insurance industries. There is a process for addressing cross-industry risks in the industry risk management framework. Each risk is allocated a risk owner whose responsibility it is to ensure the management of the risk. Supervisors use the risk register in setting SAPs, to the extent that the risk is relevant to the circumstances of each entity. Risk registers also provide details of expectations on supervisors in regards to each risk.

Stress testing is used by some insurers as part of their capital management processes. APRA sometimes interacts with insurers to perform industry-wide stress tests. For example, during the global financial crisis, APRA conducted two life insurance industry-wide asset stress tests and a survey of stress testing undertaken by non-life insurers, while in 2006, APRA provided a set of pandemic stress test parameters to all life and general insurers in Australia and asked for estimates of the potential claims impacts on their businesses.

APRA uses public communication as one method of ensuring industry focus on key areas of concern to APRA. Communication vehicles used by APRA include: speeches; its annual report and APRA Insight publication; letters to an industry on specific issues, which are often published on APRA's website; and a regular series of meetings with auditors, actuaries and industry bodies. These communication mechanisms supplement APRA's regular dialogue with each insurer, which is ongoing and conducted at a range of levels including at Board level. As a matter of course, supervisors initiate communication with senior levels within insurers on issues of concern. APRA's powers to take action on prudential matters are described under ICPs 1 and 10.

As noted above, APRA performs both quantitative and qualitative analysis and makes use of both public and other sources of information. In addition to the above-mentioned sources of information, APRA obtains information from annual reports and company announcements, broker reports, legislation, ratings agency information, news and journal articles and market data. APRA's Information Services unit provides library and research services to supervisors; it has access to a number of public information sources.

APRA has the power to request reviews of insurers by third parties. It sometimes uses this power to obtain an independent review across an industry on a particular topic. For example, in 2007 and 2008, such a tripartite review looked at reinsurance documentation in general insurers.

APRA also undertakes its own horizontal reviews of the insurance industry. Recent examples of such reviews include:

a) In response to large natural catastrophes in 2010 and 2011, APRA reviewed the

- reinsurance programs and catastrophe modeling methodologies of all general insurers with material property exposures;
- b) In response to concerns raised at the General Insurance Industry Group, APRA's actuarial unit has undertaken horizontal reviews of general insurance pricing methodologies annually over the past three years;
  - c) In response to the specialized nature of the lenders' mortgage insurance (LMI) business, and its potential systemic impact on the economy, APRA has established an LMI forum that meets quarterly to monitor trends and prudential issues in the LMI industry. An annual review of LMI business, which assesses key financial trends and industry developments, is also reported to APRA Management Group;
  - d) In its supervision of life insurers APRA has identified potential risks associated with group life business. In response, APRA has intensified its supervision in this area, for example, by requiring the reporting of all major group life tenders through its Life Insurance Industry Group. Discussions have also been held with relevant life insurers and reinsurers on group business, in particular on the decision making process, and the timing and quality of actuarial reports;
  - e) APRA's Executive Group regularly reviews a selection of SAPs with similar characteristics (for example life insurers above a certain asset size). The respective supervisors participate in these reviews and the PAIRS assessment is used as the foundation for the discussion; and
  - f) PAIRS benchmarking sessions are undertaken on a regular basis, with key issues, outcomes and actions items reported to APRA's Executive Group on a six monthly basis. In addition to promoting consistency, these benchmarking sessions are an opportunity to identify systemic issues that need to be addressed or analyzed further, and to recognize emerging risks and trends and how these are being addressed.

APRA regularly uses market-wide data to analyze and monitor actual or potential impacts on the financial stability of insurance markets and takes appropriate action. Recent examples described above include the industry-wide analyses of general insurers following recent natural disasters, and of life insurers following recent financial market disruptions.

APRA acts as a national statistical agency for the Australian financial sector, collecting data not only for its own use but also on behalf of the RBA and the Australian Bureau of Statistics. APRA's statistics unit provides information that is used by many decision-makers in the Australian financial system, including policy-makers, market analysts, researchers and senior management of financial institutions.

The information collected and the reporting of that information are regularly reviewed and amended as warranted. For example, in response to concerns regarding the stability of the professional indemnity and public liability classes of business, APRA in 2004 began collecting detailed policy and claims information. The data collected feeds into the National Claims and Policies Database, from which standardized reports are publicly available after being sufficiently aggregated to ensure confidentiality.

In addition, APRA is able to collect additional information from supervised entities on an ad-hoc basis. An example of such an initiative was the collection from general insurers of disaggregated data on reinsurance exposures by counterparty in response to some major international reinsurers having their credit ratings downgraded in 2009. APRA used this data to analyze any market concentrations to individual reinsurers, and the risk to general insurers and the insurance industry of a

	<p>reinsurer defaulting. APRA is giving consideration to collecting this information on a more permanent basis going forward.</p> <p>The processes and tools described above help APRA to assess the extent to which macroeconomic vulnerabilities and financial market risks impinge on prudential safeguards or the financial stability of the insurance sector and to take appropriate supervisory or policy action. Additional mechanisms that are relevant in this regard include:</p> <ol style="list-style-type: none"> <li>a) Annual general and life insurance supervisors' conferences provide a forum to raise and debate potential macroeconomic vulnerabilities and financial market risks within APRA. These internal conferences include internal and external speakers on key topics of interest for the relevant industry;</li> <li>b) Supervisors hear first-hand an insurer's views of the key macroeconomic risks facing industry through onsite prudential consultations and risk reviews;</li> <li>c) In relation to cross-sector risks, as an integrated supervisor of banking, insurance and superannuation, APRA considers risks arising through these sectors and the impact of these risks on other sectors as a matter of course. Multi-sector groups are supervised by a common unit within a single division. Senior supervisors can also have responsibility across multiple sectors, developing awareness of industry risks in each industry.</li> <li>d) There are also multiple arrangements where key issues and risks are discussed at a range of levels between APRA and the other financial market agencies. The RBA, in particular, monitors the health of the financial system and provides warnings about potential risks and vulnerabilities. The results of this analysis are published half-yearly in the RBA's Financial Stability Review. Comments from APRA on the draft Financial Stability Review are sought prior to its release and the RBA provides a presentation on the final version to APRA supervisors following its release. APRA also has regular high level liaison meetings with the RBA where any relevant issues are discussed.</li> </ol> <p>APRA's PAIRS methodology provides a structured approach to assessing the probability of an insurer failing and its impact in the event of failure, which can be linked to systemic importance. While APRA does not explicitly designate specific insurers as being of systemic importance, PAIRS assessments operate to identify those insurers with higher risk and greater impact of failure. The PAIRS assessments and SOARS stances help to ensure that an appropriate supervisory response is taken, commensurate with the nature and degree of risk.</p>
Assessment	Observed.
Comments	APRA has a comprehensive set of processes and tools that support its ability to perform macroprudential surveillance and insurance supervision. Its plans to make increasing use of stress testing in the future should further strengthen its quantitative analyses of industry-wide risks.
<b>ICP 25</b>	<p><b>Supervisory Cooperation and Coordination</b></p> <p>The supervisor cooperates and coordinates with other relevant supervisors and authorities subject to confidentiality requirements.</p>
Description	<p><b>Domestic Arrangements</b></p> <p>Domestically, the three regulatory agencies (APRA, ASIC and RBA) have separate functional responsibilities and are jointly responsible for the stability and integrity of the Australian financial system. The regulatory agencies coordinate with the</p>

Treasury through the CFR, a coordination platform with the objectives of contributing to the efficiency and effectiveness of regulation and the stability of the Australian financial system. The CFR worked well during the global financial crisis in 2008/09.

Inter-agency coordination and cooperation are based on a structured coordination process involving meetings between staff at different operational levels, both formally and informally. There are also designated individual liaison officers and, in some cases, information systems (e.g., the AUSTRAC gateway) that provide effective interaction.

The CFR agencies have executed the following MoUs to formalize some of the cooperation and coordination arrangements:

- a) MoU on Financial Distress Management between the CFR members. The MoU sets out the objectives, principles and processes for dealing with stresses in the Australian financial system. The objectives are: a) protecting depositors, policyholders or superannuation fund members; b) maintaining the stability of, and confidence in, the financial system; c) resolving the distress situation effectively and as quickly as practicable; d) ensuring that the owners, directors and management of a distressed or failed institution bear appropriate responsibility; and e) minimizing the economic and fiscal impacts of any financial distress resolution arrangements, and maintaining appropriate market disciplines. Private sector or market-based solutions are generally the preferred means of responding to financial system distress. The MoU also covers cross-border crisis management (see ICP 26).

The implementation of a response to resolve a distressed institution or broader financial system stress will be coordinated between the CFR members. Where the Treasurer or the Government makes a decision on a response, the Treasury will inform the other CFR members of that decision. The CFR members work together to implement the Government's decision.

- b) MoU between APRA and ASIC. The MoU covers co-ordination on regulatory and policy development, mutual assistance, coordination (e.g., administrative arrangement to avoid duplication and joint media releases), information sharing subject to appropriate confidentiality safeguards and provision of unsolicited assistance to each other.
- c) MOU between APRA and the Treasury on policy and operational coordination. It provides that "senior executives of APRA and Treasury will meet regularly to co-ordinate and give effect to the consultation processes agreed". In practice, APRA liaises closely with the Treasury on legislative initiatives. Senior APRA and Treasury officials hold regular liaison meetings. Recent agendas have included global regulatory reform initiated by the G-20 and the Financial Stability Board (FSB).
- d) MoU between APRA and RBA aimed at promoting financial stability. The MoU provides for information sharing subject to appropriate confidentiality safeguards, identification and notification of potential threats to financial stability as well as consultation on regulatory policy changes. The Assistant Governor (Financial System) of RBA chairs a joint Co-ordination Committee established under this MoU.

The relationship between APRA and ASIC is maintained through three primary contact points. Firstly, *Ad hoc* high-level discussions are held between the APRA Members and the ASIC Commissioners on emerging issues of mutual concern. Secondly, regulatory liaison meetings focus on policy issues or operational

supervision matters. Finally, deterrence liaison meetings are held to discuss broad enforcement-related issues, coordinate specific actions related to jointly regulated institutions, and consider cases identified by one agency that may have relevance to the other.

In addition, APRA has regular liaison arrangements and information exchange with AUSTRAC, PHIAC and the state based motor accident and workers' compensation authorities. APRA and ASIC have entered into an MoU with AUSTRAC and guidelines have been developed to share non-public information amongst the three agencies. APRA and PHIAC regularly exchange information on jointly supervised institutions and discuss common issues. The Motor Accidents Authority and the Motor Accident Insurance Commission provide information and consult with APRA on the financial condition of the Compulsory Third Party insurance providers and APRA provides these bodies with solvency data on these providers. APRA also liaises with WorkCover State authorities on prudential matters relevant to workers' compensation insurance.

The authorities have considered the 2006 FSAP recommendations to adopt a more formal mechanism to: a) ensure that ASIC's policy inputs are appropriately addressed by APRA in a timely manner; and b) consult on licensing issues. The authorities have decided that a formal arrangement is unnecessary because the current informal regular meetings and processes have worked well.

#### **International Cooperation**

Consistent with a risk-based approach, APRA is guided by materiality of cross-border risks and exposures in the coordination arrangements it makes. APRA has executed MoUs or other equivalent arrangements with relevant prudential supervisors in jurisdictions with material cross border operations.

To enhance risk assessment of insurers with cross-border operations, APRA cooperates with relevant overseas counterparts and routinely furnishes/requests relevant information to/from them. The exchanges of information take place irrespective of whether there is any formal agreement in place and are not limited to home/host supervision obligations, but extend to host/host relationships and prudential policy development issues.<sup>75</sup> APRA informs the relevant supervisors when it plans to review the overseas operations of Australian-domiciled groups and meets with these supervisors where possible to discuss pertinent issues. As a host supervisor, APRA informs the home supervisor of proposed action to be taken where this would have an impact on the parent company or group, where appropriate.

APRA has a close and cooperative relationship with the Reserve Bank of NZ (RBNZ) on a range of supervisory issues. This reflects the high degree of interconnectedness between the Australian and New Zealand (NZ) financial systems. For example, NZ provides an important source of premium income for some of the larger Australian insurers. The APRA Act provides for Trans-Tasman cooperation and formally requires APRA to consult with relevant NZ authorities (to the extent reasonably practicable) if APRA proposes to take an action that is likely to have a detrimental effect on financial system stability in NZ (*s8A of APRA Act*).

<sup>75</sup> APRA's discussions with relevant supervisors in other jurisdictions cover a broad range of topics, including: key issues and risks facing an insurer or group (e.g., audit findings, unfavourable performance, etc.); potential acquisitions in the region; coordinating supervisory involvement in cross-border activities; agreeing on scope of information sharing; and facilitating better understanding of the respective regulatory regimes and emerging developments.

There is regular liaison between APRA and the RBNZ on matters relating to the supervision of the major Australian banking groups, which also have insurance operations. During 2010/11, APRA provided advice and assistance to the RBNZ on matters relating to insurance supervision, as the RBNZ takes on its new role in this area.

APRA also participates in a number of supervisory colleges as both a host and home supervisor. It hosted one and attended nine supervisory colleges for insurers over the past four years. APRA is one of the signatories to the IAIS MMoU (See ICP 3).

APRA's International Relations unit is responsible for coordinating liaison with international regulators and provides a centralized initial point of contact. Frontline supervisors and relevant subject matter experts carry forward the operational relationships.

APRA meets with representatives of insurance groups when they visit Australia and APRA also seeks to visit them when APRA is undertaking overseas reviews. In addition, APRA seeks information and periodic updates via the local entity.

#### **Group-wide Supervision Arrangements**

Domestically, APRA as an integrated supervisor is the group-wide supervisor where a group is identified. APRA has developed a Level 2 insurance group prudential framework for general insurance. No life insurer operates as the head of a group within Australia and most life insurers operating within broader Australian groups form part of an existing banking or general insurance group. APRA is also currently developing a Level 3 conglomerate group framework (refer to ICP 23). APRA has effective agreements and procedures for cross-border group supervision, particularly through bilateral agreements and supervisory colleges, both as the group-wide and host supervisor.

Where APRA is the group-wide supervisor, it takes responsibility for initiating discussions on suitable coordination arrangements, including establishing a supervisory college where appropriate. APRA determines whether a supervisory college is necessary based on an institution's level of overseas operations and the materiality and strategic importance of these operations to the group. In particular, APRA considers whether group entities in other jurisdictions can impact the overall financial stability of the group.

In canvassing potential participants for a college, APRA considers insurance and other supervisors from jurisdictions in which the insurer undertakes material activities. The timing and frequency of meetings are typically negotiated with involved supervisors and the insurer. The structure of a supervisory college takes into account the nature of the insurance group, as well as the need for participants to better understand the major risks of the group.

APRA's general objectives for supervisory colleges are to: provide a forum where regulators from various jurisdictions can share views and assessments of significant risks facing an insurance group; develop a broader understanding of the group's risk profile; and discuss approaches to supervisory activities. Colleges also serve to increase engagement between APRA and other regulators, and lay the foundations towards establishing a framework for increased supervisory cooperation in relation to the different entities within an insurance group.

APRA takes responsibility for the key functions of a supervisory college as the designated group-wide supervisor, including: a formal invitation process; agreement of objectives and agenda by involved supervisors; agreement of the nature of involvement (for example, presentations) by involved supervisors; exchange of

	<p>information between involved supervisors on the entity in each region; arranging for executives of the supervised insurer to directly engage with the various involved supervisors; a post-college discussion on key issues, and agreement on common themes; and agreement on actions flowing from the college, and mechanisms for delivery of those actions.</p> <p>APRA prudential supervision of insurers and insurance groups includes an assessment of the structure and operations of the whole group. This assessment is made through risk-based reviews in Australia and other jurisdictions. As a host supervisor, APRA considers the wider group structure and operations in its assessment of the Australian insurer's operations, e.g., group risk management policies and governance structures in the group, etc. In undertaking group supervision, APRA takes into account the views and assessment of other relevant supervisors where appropriate (see ICP 9 and ICP 23).</p>
Assessment	Observed.
Comments	<p>APRA has in place coordination arrangements with other involved domestic and foreign supervisors that facilitate effective prudential supervision on a legal-entity and a group-wide basis. Where appropriate, APRA coordinates with relevant agencies from other sectors, including central banks and government ministries. Domestically, APRA liaises closely with all relevant agencies involved in Australia's financial sector supervision, bilaterally and at the CFR level, and has formalised some of the arrangements through bilateral and joint MoUs.</p> <p>At the international level, APRA has established coordination arrangements and regularly shares information with relevant foreign regulators, particularly with RBNZ in view of the significant operations of a few Australian insurers in NZ. Where APRA is the designated group-wide supervisor, it establishes the key functions of supervisory colleges and other coordination mechanisms as the key coordinator or chairman of the supervisory college.</p>
<b>ICP 26</b>	<p><b>Cross-border Cooperation and Coordination on Crisis Management</b></p> <p>The supervisor cooperates and coordinates with other relevant supervisors and authorities such that a cross-border crisis involving a specific insurer can be managed effectively.</p>
Description	<p>The existing arrangements in relation to cross-border cooperation and information exchange provide the appropriate platform for engagement in a crisis situation. APRA's power to share information with relevant supervisors extends to crisis resolution matters (see ICP 3 and ICP 25).</p> <p>The CFR agencies have signed an MoU on financial distress management (ICP 25).<sup>76</sup> Each CFR agency has responsibility for liaising and coordinating responses with its equivalent agencies in other countries if a financial stress has cross-border implications. CFR members will endeavor to assist each other in meeting cross-border cooperation obligations. While the "response to financial distress will take into account cross-border implications where relevant", this is "subject to ensuring that the outcome meets the needs of the Australian financial system and depositors,</p>

<sup>76</sup>The circumstances covered include: a) financial distress in an ADI, general insurer, life insurer, or superannuation fund; b) disruption to financial markets; and c) interruptions to the smooth functioning of financial system infrastructure (including payments and settlement systems).

policyholders and fund members in Australia.” APRA keeps foreign home and host supervisors apprised of relevant developments relating to its crisis management preparations.

The responsibilities of the four CFR agencies are:

- a) APRA-the lead for prudentially regulated entities and responsible for administering the FCS;
- b) ASIC-the lead for securities market participants and financial market licensees;
- c) RBA-the lead for payment system providers and clearing and settlement licensees. It also has responsibility for providing liquidity to the markets and as a lender of last resort to a distressed financial institution.
- d) Treasury-has principal responsibility for liaising with Department of Finance and Deregulation on the possible use of public funds in the resolution of a financial crisis.

In the case of New Zealand, the Memorandum of Cooperation (MoC) signed by APRA, the other CFR agencies, the Reserve Bank of New Zealand and the New Zealand Treasury in 2010, sets out a framework for cooperation and coordination in trans-Tasman crisis resolution. Although the MoC was drafted in the context of trans-Tasman bank crisis resolution, it is also applicable to a large extent to the resolution of trans-Tasman insurance crises.

APRA has not established Crisis Management Groups for any of the financial institutions for which APRA is the home supervisor. However, APRA maintains close working relationships with host authorities in the jurisdictions in which Australian-based financial institutions have substantial operations, particularly New Zealand. These relationships facilitate effective cross-border coordination. Where practical barriers were identified, APRA would seek to remove these in consultation with other supervisors.

In the case of foreign insurers with a substantial presence in Australia, APRA regularly liaises with the relevant home supervisors, to enhance understanding of the global operations and prudential soundness of the insurers and to provide the home supervisor with APRA’s assessment of the insurers’ activities and prudential condition in Australia.

For Australian insurers with substantial operations in another jurisdiction, APRA exchanges information with the relevant host supervisors to facilitate sound understanding of the global operations of these insurers. APRA conducts periodic onsite reviews to substantial foreign operations of Australian insurers as part of its routine supervision of general insurance groups. APRA also meets with the host supervisors to brief them on APRA’s findings.

APRA is empowered to require insurers to provide timely information, including information necessary to manage a crisis. The PAIRS and SOARS framework enables APRA to be proactive in responding to emerging stress in an insurer and to respond quickly to any distress event (ICP 9). APRA has a wide range of statutory powers to respond to distress in supervised financial institutions. These include powers to enforce compliance with prudential requirements and to investigate and obtain information, as well as a range of resolution powers such as run-off and portfolio transfer (ICPs 10 to 12).

Portfolio transfers would generally be funded by the transfer of some or all of the distressed insurer’s assets to the acquiring insurer. If these assets were not sufficient to cover the liabilities, or the acquiring insurer did not want the assets, there is scope

	<p>to fund the transfer of liabilities using government funds. A standing legislative appropriation provides funding of A\$ 10 billion for such a purpose. If such funding were used, the Government would seek to recover the funds from the failed insurer in the liquidation process. There is no specific statutory basis for the Government claiming on the balance sheet of the failed insurer; it would need to do this through contractual arrangements.<sup>77</sup> If there were a shortfall in assets to repay the Government, there is currently no statutory authority to levy the insurance industry, unlike in the case of the FCS (<i>s131A of IA and s251A of LIA</i>).</p> <p>The authorities may also consider transferring the business of a distressed insurer, partially or substantially, to a bridge insurer established by the government. This is a temporary solution pending the eventual sale of the bridge insurer to another party. This option may be considered where closing the insurer is likely to pose significant risks, such as adversely impacting on the real economy due to the lack of substitutability of certain lines of insurance, risks of contagion, adverse impact on market confidence, concerns over market concentration, or where no other insurers have the capacity or appetite to acquire the distressed insurer. This option is subject to the consent of the Treasurer. Funding under this option could be sourced either through a special appropriation through Parliament or via the existing standing appropriations under the IA or LIA of up to A\$ 10 billion respectively. This option could be implemented with or without a judicial manager having been appointed (<i>Part 4 of the Business Transfer Act, s131A of IA and s251 of LIA</i>).</p> <p>Another option is to recapitalize the insurer itself using government funding, either through a special appropriation or through the IA or LIA.<sup>78</sup> This option could be considered where the failure of the insurer may have significant and broader adverse effects, either on other parts of the financial system or on the real economy, and where none of the other resolution options are feasible or appropriate. This option could be implemented by APRA giving a direction under the IA or LIA, dispensing with the need to comply with the CA and ASX requirements for shareholder consent to facilitate a faster recapitalization process. Alternatively, recapitalization could be achieved by seeking the appointment of a judicial manager and then using the powers available under judicial management to recapitalize the insurer. Potentially, this could include cancelling existing shares and issuing new shares, thereby facilitating a transfer of ownership as part of the recapitalization (<i>s131A of IA and s251 of LIA</i>).</p> <p>APRA has developed internal guidance on insurance crisis resolution:</p> <ol style="list-style-type: none"> <li>a) the Financial Crisis Management Plan sets out the triggers, procedure and options to manage an insurance crisis;</li> <li>b) guidance on implementing the FCS with respect to general insurance; and</li> <li>c) guidance on the powers available to resolve a general insurer in financial distress and the options and strategies available.</li> </ol> <p>APRA is in the process of implementing a range of operational requirements for the</p>
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<sup>77</sup>If a business transfer is applied, it would be necessary to ensure that liability claimants on the failed insurer are left no worse off than had a conventional winding up been applied. In this respect, the ranking of claims under the CA, IA and LIA would need to be observed. (see ICP 12)

<sup>78</sup>Recapitalization could be implemented in a number of ways, including through a rights issue to existing shareholders, underwritten by the Government, or a direct issuance of ordinary or preference shares to the Government. In either case, existing shareholders would be treated in a manner consistent with the principle of “just terms”, with any dilution of their shares, or cancellation and compensation, being based on an independent valuation of the shares. Any support provided by the Government, including underwriting, indemnities and guarantees would be priced on commercial terms and accompanied by measures to protect the taxpayer.

FCS.

APRA has held a workshop on general insurance crisis resolution in 2010 for its staff and staff in the other CFR agencies to assist in building capacity in this area. It plans to develop further guidance on the resolution of general insurers, which may include details on early intervention, transfers to a third party and funding options. A similar workshop is planned for 2013 for life insurance.

APRA has established a pilot program on recovery planning for a number of the larger ADIs and will be extending that to medium-sized ADIs later in 2012/13. APRA is considering whether to extend recovery planning to the larger general and life insurers, modified to suit the nature of their business. However, given the other initiatives under way in the insurance sector, including the implementation of major reforms of capital requirements, it is unlikely that the recovery planning requirements will be applied to insurance until 2013/2014. This will be followed by consideration of possible requirements in relation to insurer-specific resolution planning.

In its onsite supervision activities, APRA has encouraged the Boards of a number of larger insurers to consider the “living will” concept as a means to further assess the adequacy of existing risk management frameworks, business structures, separation arrangements, intra-group contagion and capital adequacy.

As a host supervisor, APRA contacts home supervisors to better understand the emerging stresses in a global insurance group. As a home supervisor, APRA has stated that it would take the lead in facilitating a group-wide resolution, with a view to ensuring that any resolution protects the interests of policyholders in a manner consistent with the continued development of a viable, competitive and innovative insurance industry in Australia.

APRA recognises the importance of internationally coordinated crisis resolution for any insurer with significant cross-border operations. The combination of APRA’s working relationships with the relevant foreign home and host supervisors, existing MoUs, and the regular exchange of information provide the framework needed for close coordination and cooperation in cross-border crisis resolution.

In cross-border crisis resolutions, APRA would engage, and has engaged, cooperatively with foreign supervisors to identify and seek to satisfactorily address jurisdictional issues, including potential obstacles to a fully coordinated resolution. This includes consideration of the measures needed to facilitate a well-coordinated and least-cost resolution across the jurisdictions that meet the key resolution objectives. In Australia’s case, these objectives mainly relate to protecting policyholders of insurers that operate from Australia and maintaining the stability of the Australian financial system.

Where APRA is the group-wide supervisor, it would take the lead in coordinating across jurisdictions to ensure that public communications are made in a timely and coordinated manner at each stage of the resolution process. In particular, it would seek to ensure consistency of key information being released across the relevant jurisdictions. As a host supervisor, APRA would look to the home supervisor to coordinate public communications as part of an internationally coordinated resolution process, but would issue relevant public communications in respect of the Australian operations.

Internal procedures such as the FCMP, together with the CFR and the Trans-Tasman MoC, provide a structure for communication. Each CFR member will

	<p>develop and implement communications with stakeholders, including public communications, in its respective areas of responsibility. Where the response involves actions by more than one CFR member, communications are to be coordinated across CFR members, and with the Government.</p>
Assessment	Largely observed.
Comments	<p>APRA maintains effective working relationships with relevant foreign home and host supervisors, particularly in jurisdictions where the cross-border insurance activities are systemically important. These relationships assist in facilitating effective, coordinated cross-border crisis resolution in the event of need. The MoU on financial distress management executed by the CFR agencies also applies to cross-border financial stress. APRA is well equipped with the necessary statutory powers and tools to respond to cross-border crisis involving insurers effectively. There is currently no requirement for insurers to maintain recovery or resolution plans.</p> <p>The authorities should implement the requirement for insurers to establish and maintain contingency plans and procedures for use in a going- and gone- concern situation.</p>