

The Senate

Standing Committee on Economics

Financial Sector Legislation Amendment
(Enhancing Supervision and
Enforcement) Bill 2009 [Provisions]

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Senate Standing Committee on Economics

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Chapter 1

Introduction

Background

1.1 Australia's financial system remained stable during the current global financial crisis when many international banks have suffered serious difficulty or even collapsed. It is generally accepted that an important reason for this is the supervisory framework that successive governments have put in place. The Australian Prudential Regulation Authority (APRA) is well respected for its supervisory role.

1.2 This is a cause for satisfaction but not complacency. There are still areas for improvement. In particular, there is currently a gap in Australia's framework regarding non-operating holding companies (NOHCs) of life insurance companies.

Purpose of the bill

1.3 The Financial Sector Legislation Amendment (Enhancing Supervision and Enforcement) Bill 2009 seeks to align the regulation of holding companies of life insurance companies with the regulation of general insurers and financial intermediaries. It gives APRA the necessary powers to regulate the NOHCs in such a way as to avoid giving rise to unacceptable risks to the operations of the life insurance companies themselves.

1.4 As the Minister remarked when introducing the bill:

International experience has demonstrated the interconnection between companies in a corporate conglomerate, including between prudentially regulated entities and unregulated entities. This measure will strengthen the prudential regulation of life insurance conglomerates in line with the regulation of other financial conglomerates.¹

Conduct of the inquiry

1.5 The bill was introduced into the House of Representatives on 19 March 2009. On 19 March, on the recommendation of the Senate Selection of Bills Committee, the Senate referred the provisions of the bill to the Economics Committee for inquiry and report by 7 May.

1.6 The Committee advertised the inquiry in *The Australian* and on its website, and wrote to a number of relevant peak organisations inviting submissions. The Committee received four submissions (see Appendix 1), which are available at http://www.apr.gov.au/senate/committee/economics_ctte/inquiries.htm.

The Committee thanks submitters for their contribution.

1 The Hon. Chris Bowen, Minister for Competition Policy and Consumer Affairs and Assistant Treasurer, *House of Representatives Hansard*, 19 March 2009, p 3238.

Chapter 2

Issues concerning the bill

Regulation of non-operating holding companies of life insurers

2.1 The bill amends the *Life Insurance Act 1995* to regulate the non-operating holding companies (NOHCs) of life insurers.

2.2 The prudential requirements that will apply to life insurance NOHCs are consistent with those that apply to life insurers. The scope of the prudential regulation is closely modelled on the existing regulation of the NOHCs of general insurers and authorised deposit-taking institutions (ADIs).

2.3 Life insurance NOHCs will be required to be registered under the *Life Insurance Act 1995* and will be subject to supervision by the Australian Prudential Regulation Authority (APRA). They will be required to comply with prudential standards, reporting obligations, directions issued by APRA and investigations authorised by the Act. APRA will be able to seek the disqualification of the holders of specified positions in the companies.¹

2.4 The Government says that 'APRA is expected to consult with industry before determining or amending prudential standards.'²

Need for, and urgency of, the bill

2.5 Two companies to whom the bill will apply have questioned the need for it. AXA Asia Pacific Holdings Ltd (AXA) claims that the *Life Insurance Act* already gives APRA sufficient powers to protect the interests of policyholders.³ ING Australia Ltd (ING) argues that regulation of life insurers is already considerably stricter than regulation of general insurers - for example, in the rules about statutory funds, and the requirement for directors to give priority to the interests of policyholders over the

1 The phrase 'will be required' is used in the second reading speech and the explanatory memorandum. The bill itself gives APRA the discretion, but not the duty, to register NOHCs (clause 15: APRA *may* make registration of a life company conditional on its NOHC being registered). APRA said that it proposes to exempt NOHCs from registration in certain circumstances: *Submission 3*, attachment, p2.

2 The Hon. Chris Bowen, Minister for Competition Policy and Consumer Affairs and Assistant Treasurer, *House of Representatives Hansard*, 19 March 2009, p 3238.

3 AXA APH, *Submission 1*, p3.

interests of shareholders. ING claims that the proposed regime fails to recognise the nature and effectiveness of the present controls.⁴

2.6 ING also believes the bill has been introduced hastily with inadequate consultation with stakeholders. It calls for a six-month consultation period followed by a transitional period of at least two years.⁵

2.7 In response, Treasury pointed out that the 1997 Wallis Review of the financial system recommended allowing NOHCs to head financial groups, but subject to the regulator having suitable power to monitor the group as a whole. Treasury also noted there were comparable provisions for policyholder protection in the *Insurance Act 1973* and depositor preference in the *Banking Act 1959*. This principle is supported by recent statements by international bodies.⁶

2.8 Treasury also stressed that consistent regulation across industries was desirable to avoid regulatory arbitrage.⁷

2.9 Treasury noted that principles-based legislation allows scope for application by APRA in a way that is appropriate in the circumstances and for the entity.⁸

2.10 Treasury noted that the Treasurer's press release 61 of 2 June 2008, and the Minister for Superannuation and Corporate Law's press release 18 of 2 March 2009 announced the intention to introduce prudential regulation of life insurance NOHCs.

2.11 Treasury said that APRA has indicated that it intends to undertake industry consultation on proposed amendments to its prudential standards for life companies. APRA expects to issue a consultation package in May or June 2009. Any future reviews or proposed changes to the prudential group-level supervisory arrangements are expected to be undertaken through consultation that would provide sufficient opportunity for all players to put forward their views.⁹

2.12 APRA also supports the bill. APRA regards the amendments as essential for the prudential supervision of life companies and the protection of policyholders. In particular, the amendments are critical for the development of a consistent and workable regulatory framework for the supervision of conglomerate groups which may include one or more life companies as part of their business.¹⁰

4 ING Australia, *Submission 2*, p2.

5 ING Australia, *Submission 2*, p1.

6 Treasury, *Submission 4*, pp 1-3.

7 Treasury, *Submission 4*, p4.

8 Treasury, *Submission 4*, p4.

9 Treasury, *Submission 4*, p5.

10 APRA, *Submission 3*, p1.

2.13 APRA points out that all APRA prudential standards, being legislative instruments, are subject to a due process that involves: a period of public consultation; a cost benefit analysis; and the possibility of disallowance by Parliament.¹¹

Definition of NOHCs

2.14 AXA regards the definition of an NOHC as too narrow and inflexible. It may result in AXA being required to divest assets and cease certain activities. This would be costly. AXA also believes the meaning of 'carry on a business' (the core concept in the definition) is not clear enough.¹²

2.15 Treasury submitted that the definition follows that for ADIs and general insurers. APRA's authorisation guidelines for general insurance NOHCs provides guidance on APRA's view of the definition. There is some flexibility in the proposed framework that enables APRA to apply the NOHC supervision at a level that is appropriate to the corporate structure.¹³

Compliance costs

2.16 ING argues that compliance costs are likely to be substantial.¹⁴

2.17 In response Treasury quoted additional material from the regulatory impact statement:

The prudential standards for fit and proper and governance would be as similar as possible to those that apply to life companies and NOHCs of ADIs and general insurers. The prudential standard on capital would be different to that applying to NOHCs of ADIs and general insurers reflecting the different risks facing the industry. While the exact costs cannot be quantified it is expected that the costs will not be significant as well run NOHCs of life insurance groups are already likely to meet most of the requirements....All NOHCs of life companies would be regulated thereby providing a level playing field. That is, NOHCs regulated by APRA under the Banking and Insurance Acts would no longer be at a competitive disadvantage compared to unregulated NOHCs.¹⁵

11 APRA, *Submission 3*, p5.

12 The relevant test of a registrable NOHC is that it 'does not carry on a business (other than a business consisting of the ownership or control of other bodies corporate): clause 184 of the bill.

13 Treasury, *Submission 4*, p 6. *Insurance Act 1973*, s3. *Banking Act 1959*, s5.

14 ING Australia, *Submission 2*, p1.

15 Treasury, *Submission 4*, p4-5.

Regulation of subsidiaries

2.18 Where appropriate, prudential standards and reporting obligations will also apply to the subsidiaries of NOHCs and life insurers. AXA opposes this on the grounds that it will greatly increase the regulatory burden (as it will cover subsidiaries that have nothing to do with insurance) without additional protection to policyholders.

2.19 Treasury submitted that the provision is consistent with recommendations of the Wallis Review and with internationally accepted principles. Treasury submitted that the provision ensures timely information flow to the regulator:

For example, related entities in a corporate group may move capital within the group to support a subsidiary, and this may have an impact on the life insurer's capital adequacy or liquidity. Deterioration in a subsidiary's financial position may prompt an examination of intra-group financial or risk management.¹⁶

2.20 Treasury noted recent reforms to the notice of breach requirements, made by the *Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007*, to ensure that only significant breaches must be reported. Treasury said that the breach reporting framework introduced by this Act will be applied to the breach reporting obligations of life insurance NOHCs and the subsidiaries of life insurers and their NOHCs.¹⁷

APRA's power to make standards

2.21 APRA will be able to make prudential standards for life companies, their NOHCs and the subsidiaries of NOHCs.¹⁸ AXA argues that the power to make standards for NOHCs should be limited to standards relating to governance, fitness and propriety.

2.22 Treasury submitted that prudential standards for NOHCs of life insurers and their subsidiaries are expected to be similar to the existing prudential standards for NOHCs and subsidiaries of general insurers and ADIs (except in relation to capital). The present standards for general insurance NOHCs and subsidiaries refer to group level matters.

2.23 Treasury noted that existing group level prudential standards for general insurers and ADI groups were finalised after extensive consultation with the industry:

16 Treasury, *Submission 4*, p8.

17 Treasury, *Submission 4*, p8.

18 This power would be exercised under clause 131 of the bill, amending section 230A(3) of the *Life Insurance Act 1995*.

APRA has indicated that it would prepare a consultation package in relation to the proposed changes for life insurers, their NOHCs and subsidiaries.¹⁹

Provisions on directions

2.24 APRA may give directions to a life company on any of ten specified grounds.²⁰ Under the bill this will also apply to their NOHCs. Decisions made on the first four grounds, but not the others, are reviewable by the Administrative Appeals Tribunal.²¹

2.25 AXA regards the grounds on which APRA can make directions as various and speculative. In AXA's view, directions should be limited to actions that will protect the interests of policyholders, and all directions should be reviewable by the Administrative Appeals Tribunal. Directions should only be published where the subject does not seek review (given the possible damage to reputation).²²

2.26 Treasury submitted that the provisions on directions, and the scope of merits review, is consistent with that applying to life companies, general insurers and their NOHCs, and ADIs and their NOHCs. This scheme dates from 2008 amendments made by the *Financial Sector Legislation Amendment (Review of Prudential Decisions) Act 2008* (before then APRA's power to give directions was narrower, and was not subject to merits review). The 2008 amendments were developed in response to *Rethinking Regulation: report of the taskforce on reducing regulatory burdens on business*, and were the subject of industry consultation.

2.27 Treasury submitted that the scope of merits review aims to balance procedural fairness with the need to ensure that APRA can act promptly and decisively when policyholders' or depositors' interests or the stability of the financial system are at risk.²³

2.28 APRA submits that it needs the power to issue directions, which is used in situations where risks to policyholders have emerged.²⁴

19 Treasury, *Submission 4*, p9.

20 *Life Insurance Act 1995*, section 230B(1).

21 *Life Insurance Act 1995*, section 236(1)(zq).

22 AXA APH, *Submission 2*, p 3.

23 Treasury, *Submission 4*, p11.

24 APRA, *Submission 3*, p5.

Investigatory powers

2.29 ING questions the need for APRA to have a broad power to investigate the business of a registered NOHC if it is satisfied it is 'in the public interest'.²⁵ ING argues that this should be restricted to refer to the interests of policyholders.²⁶ A similar view is expressed by AXA, who adds that an NOHC would be an 'associated company' which could already be investigated under section 138 of the *Life Insurance Act 1995*.

2.30 Treasury noted that the provision mirrors existing provisions of the *Insurance Act 1973* and the *Banking Act 1959*. The scope of the 'public interest' will be limited by the objects sections of the *Life Insurance Act* and the *APRA Act*.

2.31 Treasury submitted that:

The 'public interest' trigger for commencing an investigation is intended to create a broad but appropriate trigger where the other, more specific triggers under section 230B of the *Life Insurance Act* may not cover all situations where the interest of the Australian public requires APRA to investigate. The key policy considerations are balancing the rights and interests of the regulated entities with avoiding inappropriately proscribing the circumstances in which an investigation may be undertaken.²⁷

2.32 APRA submitted that most of the investigation powers are intended to be available to APRA only when risks to policyholders have already been identified. The powers are constrained by procedures which APRA must already follow, including the 'show cause' notice.²⁸

Strict liability offences

2.33 AXA argues that strict liability offences do not promote business taking sensible commercial risks, but rather encourage a risk-averse and overly cautious approach. AXA believes that failure to comply with a direction under s230B should not be a criminal offence.²⁹

2.34 Treasury submitted that the penalty provisions in the bill reflect existing provisions that apply to life insurers and general insurance/ADI NOHCs, to maintain consistency:

25 Clause 108 of the bill, replacing section 137(2)(d) of the *Life Insurance Act 1995*.

26 ING Australia, *Submission 2*, p2.

27 Treasury, *Submission 4*, p11.

28 APRA, *Submission 3*, p5. The 'show cause' provisions are in Sections 135 and 136 of the *Life Insurance Act 1995*.

29 AXA APH, *Submission 2*, p 9.

This approach maintains consistency for the life industry, as it applies the same offence to equivalent breaches that may be committed by a NOHC under the proposed Bill, and makes the same defences available for the equivalent breaches. Some holding companies of life insurers are also the authorised NOHC for a general insurer and/or an ADI, and the proposed Bill seeks to maintain consistency in the offences and defences for offences across the prudentially regulated industries where it is appropriate to do so.³⁰

Injunctions in prudential legislation

2.35 Schedule 2 of the bill amends the *Banking Act 1959*, *Insurance Act 1973*, *Life Insurance Act 1995* and *Superannuation Industry (Supervision) Act 1993* to provide harmonised power for APRA to seek court injunctions against breaches or contraventions of a provision of these Acts or breaches of conditions or directions issued under these Acts.³¹ These provisions were not mentioned in submissions.

Committee comment

2.36 The Committee notes that the overriding policy of the bill is to align regulation of life insurers with regulation of general insurers and ADIs. To amend the bill in the ways suggested by the submitters would fundamentally conflict with this.

2.37 The Committee is sympathetic to the submitters' concerns about the lack of stakeholder consultation before the bill was introduced. However it understands why, in the current economic environment, the Government may want to act promptly to fill gaps in the prudential architecture. The Committee also notes the Government's undertakings that APRA will undertake industry consultation on consequential changes to prudential standards.

Recommendation 1

2.38 The Committee recommends that the Senate pass the bill.

Senator Annette Hurley

Chair

30 Treasury, *Submission 4*, p12.

31 Explanatory Memorandum, p 25.

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	AXA Asia Pacific Holdings
2	ING Australia
3	Australian Prudential Regulation Authority
4	Department of the Treasury