

NEW ZEALAND CAPTIVE INSURANCE ASSOCIATION

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Treasury
Insurance Access and Pricing Unit
Langton Crescent
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AUSTRALIA

Attention: DMF and DOFI Review

Dear Sir / Madam

Regulation of Discretionary Mutual Funds and Direct Offshore Foreign Insurers – Discussion Paper – December 2005

Thank you for the opportunity to comment on your DMF and DOFI discussion paper.

The New Zealand Captive Insurance Association is an incorporated society established to represent the captive insurance industry in New Zealand.

We do not seek confidentiality for this submission and Treasury may treat this submission as non-confidential and public.

Both here in New Zealand and overseas, the captive insurance industry, in servicing corporate groups with Australian operations, is very interested in the outcome of any proposal to exempt domestic (i.e. Australian domiciled) and off-shore (including New Zealand domiciled) captives from prudential regulation in Australia.

As the discussion paper suggests, our comments address the specific questions raised by the paper in relation to captives ie questions 17 to 19 on page 18 of the paper.

Question 17

Should offshore captive insurers be exempt from the requirements of the Insurance Act, in line with current proposals to exempt domestic captives?

We support the proposition, mooted in paragraph 70 of the discussion paper, that offshore captive insurers should obtain the benefit of any exemption provided to domestic captive insurers.

We see this as a logical extension of APRA's proposal. The essence of APRA's proposal is to suggest criteria for a captive insurer (which we comment on in response to question 18 below).

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Once those criteria are established, there appears to be no policy basis for not extending the benefit of the exemption to any captive (wherever domiciled) that meets those criteria. To do otherwise does not provide any additional protection for (group) policy holders, but does (unnecessarily) inhibit the flexibility available to global groups who wish (for efficiency and cost reasons) to locate their insurance operations within a single captive, that they may, but equally may not, wish to domicile in Australia.

Question 18

What would be the appropriate criteria for a captive insurer to qualify for an exemption from prudential regulation?

This is obviously the critical question.

As the discussion paper acknowledges (paragraph 72), this issue exposes a tension between "securing appropriate protection for policy holders *but defining captives and their service sufficiently broadly to have some practical benefit*".

Our comments correspond to the six criteria set out in APRA's paper (we note that the Treasury paper only refers to 5 of these – it does not comment on the fifth criteria/condition relating to reinsurance).

However, we make two preliminary comments in relation to the criteria as a whole.

The **first** is that the criteria should only apply to captives in relation to insurance written in Australia for Australian insureds. They should not prevent a captive writing insurance in Australia, **in accordance with the Australian criteria**, simply because the captive also writes insurance in other jurisdictions in accordance with criteria that differ from the Australian criteria. This first general comment is effectively a response to the issues raised in paragraphs 74-78 of the discussion paper. However, accepting this submission does not involve varying the criteria between domestic and offshore captives. It simply means that a captive (whether domiciled in Australia or offshore) should not be prevented from writing insurance in Australia solely on account of what it does (lawfully) in other jurisdictions.

The **second** comment we make, in relation to the criteria as a whole, is that the exemption criteria should work without the need to apply to APRA for the exemption. It defeats a key objective of the exemption i.e. to facilitate business that does not require regulation, to specify exemption criteria, but still require the beneficiary to apply to get the benefit of the exemption. APRA will obviously still police the criteria, even where there is no need to apply for the exemption, but beneficiaries, as is normal with general exemption regimes, should be able to get the benefit of the exemption, without the need for any further application, since they know that they must comply with the criteria in any case if they are to comply with the law.

(a) **The core of the definition – the first 2 criteria – is too restrictive.**

We suggest that the essence of APRA's proposal (contained in its first two suggested criteria) is unnecessarily restrictive.

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These first two criteria restrict captives to: (i) **wholly-owned** companies (ii) within **corporate** groups; (iii) that provide insurance only to other **companies** (iv) that are **wholly owned** within the group.

These criteria restrict the definition of a captive, in effect, to arrangements that (to use APRA's words) are "very closely akin" to self insurance "within a corporate entity".

We submit that a captive is better defined in terms of criteria that satisfy the essence of the following description of a captive, also appearing in the APRA proposal, immediately following the words just quoted:

"Policyholders of an eligible captive which would be exempt are 'wholesale' and are part of the same corporate group. They are therefore likely to have an understanding of the financial standing of the insurer (being part of the same corporate group) and are able to make informed decisions on this basis".

We submit that a captive that meets the essence of this description is one that is defined as including **any entity** so long as that entity is one **that only insures** the risks of **entities that, in terms of International Accounting Standards, are:**

- (b) its parent;
- (c) a related entity (ie under the same control);
- (d) in a (jointly controlled) joint venture with that entity, or an entity of the type described in (a) or (b) above;
- (e) an associate of that entity, or an entity of the type described in (a) or (b) above.

The essence of (a) and (b) is the concept of **control**; the essence of (c) is (obviously) **joint control**; and the essence of (d) is **significant influence** (all of which are defined by relevant international accounting standards).

If one assesses APRA's description of an eligible captive quoted above in terms of the definition that we are suggesting, the following points can be made:

- (f) it is generally accepted that a group can be defined by reference to the concept of "control";
- (g) we see no reason to limit the application of this concept to **corporate** groups;
- (h) **jointly controlled** joint ventures come within the "control" concept and should not be considered to be third parties under any exemption regime (in particular for the purposes of APRA's third possible criterion – see below);

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- (i) associates, whilst not part of a group, must be the subject of significant influence by the group to count as an associate, and therefore should be regarded (to use APRA's words) as "wholesale" policy holders "likely to have an understanding of the financial standing of the insurer", and "able to make informed decisions on this basis"

~~(b) The third criterion – relating to third party insurance – needs to be further defined~~

We wish to make two points in relation to this criterion.

These are:

- (j) a submission that this criterion should not extend to jointly controlled joint ventures – see our comments above;
- (k) a submission that assigned beneficiaries should not be deemed to be third parties.

Taking each of these submissions in turn, **first**, we submit that the third criterion should not extend to a jointly controlled joint venture, on the basis that joint control means that these joint ventures are likely to:

- (a) have an understanding of the financial standing of the captive insurer; and
- (b) be able to make informed decisions on this basis.

We consider, therefore, that jointly controlled joint ventures are bodies that already satisfy APRA's stated policy for granting exemptions to captives.

Secondly, we submit that assigned beneficiaries should not be deemed to be third parties for the purposes of this third criterion, since the primary contract is between the third party and a person insured by the captive, rather than between the third party and the captive itself. Admittedly, a regulator is entitled to assume that a third party will place a value on its insurance, irrespective of whether it is written directly with the captive or by way of an assignment of the benefit of a policy written by the captive. However, it is submitted that in the latter situation a third party can also be assumed to know that it is being offered the benefit of an "as is, where is" contract that has already been negotiated with someone else, ie that such a benefit is something different from an insurance contract that is targeted directly at the third party. We submit that the fact that the primary relationship is between the insured group member and the third party, rather than between the captive and the third party, is sufficient warning, and therefore protection, to the third party.

~~(c) The fourth criterion – relating to statutory classes of insurance – is too restrictive, is unnecessary and should be deleted~~

Given the first three criteria, we submit that the fourth criterion is too restrictive, and unnecessary.

The first three criteria establish an exemption the core of which is predicated on the argument that prudential regulation need not apply to benefit those who can be assumed to understand the insurer and be able to make an informed decision on that basis.

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Such insureds can therefore be expected to make an informed decision in relation to the insurance they take up, irrespective of whether they do it voluntarily or because they are required to do so.

There may be policy reasons for requiring even sophisticated informed insureds to take out insurance with insurers that are subject to prudential regulation. However, decisions as to whether prudential regulation is necessary in relation to statutory insurance are likely to focus on a range of factors. In our view, these decisions are more likely to be based on differentiations between short term and long term insurance, or possibly between investment and non-investment insurance, than on whether insurance is mandatory or voluntary. Instead of imposing an arbitrary restriction in relation to all statutory classes of insurance, we submit that it should be left to the legislature to specify in each particular instance whether it wishes to limit who can provide the particular insurance, particularly since any such specification is likely to differentiate between short term and long term insurance and/or investment or non-investment insurance, rather than whether it is mandatory or voluntary.

In other words, we suggest that the question of who is able to provide statutory insurance be specifically addressed in appropriate cases, rather than by imposing a condition of exemption in relation to captives that precludes a captive writing any statutory classes of insurance, required now or in the future, for any person.

~~(d) The fifth criterion – relating to reinsurance – is too restrictive, is unnecessary and should be deleted.~~

We consider this criterion to be too restrictive.

We submit that this criterion be deleted and that reinsurance be included within the definition of insurance for the purposes of the exemption.

We believe that including a condition relating specifically to reinsurance, particularly one that prohibits reinsurance being provided to any "other" party:

- (l) has the potential to be confusing; and
- (m) implies a distinction between insurance and reinsurance that is not justified for the purposes of the exemption regime.

For instance, the reference in this criterion to any "other" party is presumably intended as a reference to **any** party other than the captive itself – therefore the word "other" adds nothing, but does tend to confuse, and so should be deleted.

Also, and more significantly, we submit that it is inappropriate and unnecessary to restrict the provision of reinsurance to other captive insurers. The criteria to be applied to a captive, whether in relation to insurance or reinsurance should be restricted to the first three criteria (amended in the manner suggested in the earlier part of this submission). These criteria restrict captives to providing insurance to those who can be regarded as not requiring regulatory protection.

To then go on and restrict the provision by captives of reinsurance even further can only be justified on the basis of a perceived need to regulate not only a primary insurer, but also the secondary insurer i.e. the reinsurer.

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It is submitted that this additional restriction on captives is not necessary since ultimately the purpose of any such restriction is to regulate the primary insurance. Where this is considered to be necessary, it can be addressed in the regulatory regime that applies to the primary insurer. We comment on this further in our response to the last criterion (see below).

Even when the matter is looked at from the perspective of the primary insurer, the primary insurer should be assessed for what it is, with decisions relating to reinsurance being left, absent special circumstances, as matters between the insurer and the reinsurer.

This condition would be an unwarranted fetter on global insurance businesses. Other global groups i.e. those not in the insurance business can choose to self insure risk either informally or through a captive. The captive may (or may not) choose to reinsure. However, if the captive's beneficiaries are **themselves** insurers then this criterion, as it stands, will prevent global insurance groups pursuing these options in Australia. Insurers are therefore put at a disadvantage, vis a vis other businesses, in how they manage risk.

In summary on this point, we submit that, in relation to captives, the first three criteria (modified as we have suggested) are a sufficient regulatory regime for captives.

There is no need, in our view, to address any perceived need for prudential regulation of insurers who take out "reinsurance" in the context of an exemption regime that should be directed at captives and the protection of their insureds, rather than at those insureds and the protection of any policyholders they may have.

~~(e) The sixth criterion relating to insurance to APRA-regulated institutions is too uncertain, too restrictive, is unnecessary and should also be deleted.~~

Given the first three criteria, we submit that the sixth criteria is too uncertain, potentially too restrictive, and unnecessary.

This criterion creates uncertainty and the potential for excessive administration, since captives (or APRA) are required to make an assessment, in relation to any potential insured that is an APRA – regulated institution, whether insuring that institution might prejudice the interests of the policy holders, depositors or members of that APRA – regulated institution.

An exemption, to be workable, must be easy to interpret. This criterion does not achieve this objective.

We submit that the objectives of this condition, like the objectives of the fourth condition (relating to statutory classes of insurance), also be addressed on a case by case basis in provisions governing the particular situations at which the condition is directed.

For instance, taking the example provided by APRA of lenders mortgage insurers (LMIs) owned by authorised deposit - taking institutions (ADIs), APRA's objectives here should be addressed:

- (a) in the provisions of the relevant legislation prescribing who can and who cannot be LMIs;

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- (b) in the provisions of the relevant legislation prescribing when and in what circumstances ADIs will be able to claim a concessional risk-weight on loans.

We submit that the presumption should be that where a captive is insuring within the group (defined in terms of the first three criteria) then there is no prejudice to the interests of the policy holders, depositors or members of the APRA – regulated institution, but with the legislature obviously being able to rebut that presumption in appropriate cases by specific legislative provisions.

In other words, as and when the presumption needs to be rebutted, such as in the example provided by APRA, that can be addressed in terms of the statutory provisions that govern the relevant arrangements, in the manner described above.

Adopting our suggestions here will allow captives to know, clearly, what they can and cannot do; without the need for the captive and/or APRA to assess whether policy holders of the insured could be considered to be indirectly affected by internal arrangements made by the insured with a captive.

We submit that our suggestion here facilitates the workability of the exemption, without compromising APRA's objectives.

Question 19

Should criteria for eligibility vary between domestic and offshore captives?

We believe that there is no need for criteria eligibility to vary between domestic and offshore captives.

It is crucial, however, as the discussion paper acknowledges (paragraph 72), that captives and their service are defined sufficiently broadly to have some practical benefit.

This only goes to highlight the importance of Questions 17 and 18 posed by the paper and the need to respond to them so as to give the requisite practical benefit.

Summary

In summary, we submit that captives can be defined so as to have some practical benefit, without compromising protection to policy holders, or the basic policy behind existing Australian prudential regulation, so long as the following approach is adopted in establishing a framework for their exemption from prudential regulation:

- (n) the exemption regime is based on the concept that policy holders have an ability to make an informed decision about captives that are controlled by the same people who control the policy holders, and therefore prudential regulation is not required to protect such policyholders;

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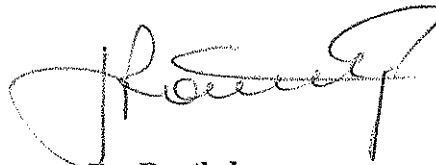
- (o) any conditions attaching to the exemption regime are confined to contracts written by captives for Australian insureds, and do not purport to police contracts that those insureds may write with third parties, since any issues that arise in relation to those contracts should be addressed in their own context, rather than by seeking to impose conditions on the basis upon which captives insure persons within their own corporate groups.

We consider that the demand for captives is set to grow substantially, worldwide. Businesses are looking more and more to enhance both their risk management and financial management programs. Decisions to establish captives are now being made for reasons that go well beyond those that are implicit in traditional justifications for their use i.e. as a form of self insurance. If Australian businesses are to get the benefit of this trend then it is important that the exemption regime for captives not only addresses policy holder protection, but provides a practical benefit to those policy holders.

Yours sincerely



Peter Lowe
President



Jim Routledge
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