



# Regulation Impact Statement

## Enhanced Supervision of Life Companies

(OBPR ID: 2009/10278)

### Introduction

This Regulation Impact Statement (RIS) follows the previous related preliminary assessment OBPR ID: 2009/10278 on ‘*Enhancing Supervision of Life Companies*’ which was submitted to OBPR on 15 April 2009. The preliminary assessment detailed APRA’s proposals on:

- revising APRA’s prudential standards on audit and actuarial requirements, namely, *Prudential Standard LPS 310 Audit and Actuarial Requirements (LPS 310)*; and
- extending APRA’s Prudential Standards LPS 510 Governance and Prudential Standard LPS 520 Fit and Proper to cover non-operating holding companies (NOHCs).

The first of these proposals is discussed under Part A of this RIS, whilst the second is discussed under Part B.

APRA is primarily responsible for ensuring the safety and soundness of prudentially regulated financial institutions in order that they are able to meet their financial promises to depositors and policyholders. As part of its mandate, APRA has implemented a multi-layered prudential framework that encompasses the industry Acts it administers, prudential standards that set out specific requirements to which the institutions must adhere, and where needed, prudential practice guides designed to clarify APRA’s expectations with regard to prudential requirements.

## Part A – Changes to audit and actuarial requirements

### Background

The *Life Insurance Act 1995 (Life Act)* imposes requirements on life insurance companies to appoint an auditor and an actuary, and imposes requirements on the auditors and actuaries to perform certain functions, as set out in APRA’s prudential standards. APRA’s requirements for auditors and actuaries are set out in *Prudential Standard LPS 310 Audit and Actuarial Requirements (previous LPS 310)*.

In May 2009 APRA released the ‘*Enhancing Supervision of Life Companies*’ consultation package. It detailed proposed changes to:

- *Prudential Standard LPS 310 Audit and Actuarial Requirements* (LPS 310)
- *Prudential Standard LPS 510 Governance* (LPS 510)
- *Prudential Standard LPS 520 Fit and Proper* (LPS 520)

The changes to LPS 310 are discussed separately to LPS 510 and LPS 520 in this RIS. The changes to the life insurance reporting standards that were foreshadowed in the discussion paper have been implemented separately and are not discussed here.

APRA’s existing requirements for auditors and actuaries ensure that the Board and senior management of a life insurance company are provided with impartial advice in relation to its operations, financial condition and internal controls. In order to achieve this, the prudential standards outline certain functions to be undertaken by the Auditor, Board and the life insurance company. These functions assist the Board and senior management in carrying out their responsibility for the sound and prudent management of the life insurance company.

As at June 2009, there were 32 life companies and 19 friendly societies authorised under the Life Insurance Act. The proposed requirements would be applicable to all these entities.

## **Problem**

The *Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007* amended the *Life Insurance Act 1995* (Life Act) as of 1 January 2008 to remove a range of provisions relating to audit and actuarial requirements of life companies. As a transitional measure, these provisions were replicated in the existing LPS 310. This was intended only as an intermediate step, ensuring that the prudential framework continued to operate as intended while APRA undertook a review of these requirements.

APRA completed its review in late 2008, identifying certain deficiencies. These included:

- lack of clarity between those requirements that relate to auditors and those that relate to actuaries of life insurance companies making it difficult for institutions to comply with, and APRA to effectively enforce the requirements;
- lack of alignment of the requirements of auditors of life insurance companies with the requirements of auditors of general insurers and authorised deposit-taking institutions making it inefficient and unduly difficult for auditors to audit across industries, and more complex for APRA to regulate. To the extent possible, APRA’s prudential framework is intended to be the same where the risks are applicable to each prudentially regulated industries;
- lack of alignment between the requirements of actuaries of life insurance companies with the requirements of actuaries of general insurers – APRA’s

requirements for each actuary are intended to be the same, and differences between the requirements for actuaries between industries causes confusion in interpretation and possibly application;

- lack of clarity in relation to the levels of assurance provided by auditors – this may result in incorrect levels of assurance being provided, compromising the audit of the APRA annual returns; and
- gap in APRA’s monitoring and investigation powers in not being able to request a special purpose review of a company to be undertaken by an auditor or actuary, making it inefficient to undertake such a review under existing legislative provisions.

## **Objectives of APRA’s initiative**

APRA’s objectives are to have prudential standards that are clear, transparent, and that use consistent language across prudentially regulated industries. It is important for life insurance companies, auditors and actuaries to be clear on their individual responsibilities in relation to their own and each other’s duties under the Life Act. It is also important that the prudential standards clearly articulate APRA’s expectations in respect of auditors and actuaries appointed under the Life Act. This includes that the life company ensures that:

- the auditor and actuary have access to all relevant records;
- the auditor and actuary are fully informed of the prudential requirements applicable to the life company; and
- certain information is provided to the Board or Board Audit Committee, and to APRA where requested to do so in writing by APRA.

## **Options**

### **Option 1 – Implement recommended changes**

This option is to implement the recommended changes by separating the audit and actuarial requirements into separate prudential standards. Specifically, this involves revoking LPS 310 and replacing it with:

- *Prudential Standard LPS 310 Audit and Related Matters (LPS 310)*; and
- *Prudential Standard LPS 320 Actuarial and Related Matters (LPS 320)*.

These proposed requirements change very little of the requirements currently in force for life insurance companies and auditors. Most changes are to language and form to improve clarity and consistency with APRA’s other regulated industries.

### ***LPS 310 Audit and Related Matters (LPS 310)***

The elements of the revised LPS 310, including an explanation of the key changes is provided below.

#### *Special purpose engagements*

The proposed LPS 310 provides that an appointed auditor, when required by APRA to do so, must supply a report on a particular aspect of the life company's prudential reporting, risk management systems or financial position.

These special purpose reviews are typically targeted towards a particular area of prudential interest to APRA. For consistency with APS 310, the proposed LPS 310 also allows that the special purpose review could be undertaken by a suitably qualified auditor, other than the appointed auditor. This also allows a suitably qualified auditor to conduct a review or provide a different perspective.

Special purpose reviews have been utilised in other APRA-regulated industries and APRA envisages that special purpose reviews of life companies would be commissioned and undertaken in a similar way. For special purpose reviews, APRA will typically specify the scope and form of the report required from the auditor.

This is a new requirement for a prudential standard. APRA has broad powers to investigate life insurance companies under Part 7 of the Life Act, as well as direct a life insurance company to order an audit under section 230B, by an auditor chosen by APRA, and at the expense of the company. Under Part 7, APRA may require the life insurance company to give information about any matter relating to the company's business and produce any records relating to the affairs of the company.

The difference between the two powers is practical. Under the powers in the Life Act, APRA would assess the need for an investigation, then ask for information and records under Part 7 of the Life Act. APRA would then review the material and determine if further information is required, until either the issue is resolved, or APRA feels the need to order an audit under section 230B.

Under the new requirements, APRA would assess the need for a specific audit, and then request that the auditor, or another auditor that satisfies the independence requirements<sup>1</sup>, conduct an audit of that particular issue. This would allow APRA to respond early and directly to arising issues and would also allow APRA to narrow the investigation to a specific area. In most cases it would also allow the investigation to be done by the appointed auditor. Only in special circumstances, where APRA feels the life insurance company would benefit from the perspective of a different auditor or a specific area of expertise is required would the appointed auditor not undertake the audit. This is a much more efficient process that reduces costs and time on both APRA and the life insurance company. It also allows issues to be identified earlier, which will reduce their severity and impact.

#### *Actuarial Advice regarding policies*

This reiterates the requirement that actuaries are required to provide actuarial advice under paragraph 20 of the previous LPS 310.

However, there has been uncertainty around the requirements for providing that advice. In order to resolve this uncertainty, APRA now requires that the Board of a

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<sup>1</sup> As set out in paragraph 25 of LPS 310

life insurance company have a policy in place that sets out the types of situations where an appointed actuary is to prepare such advice and to whom it is to be provided.

The remaining elements of LPS 310, some of which have been amended to provide clarification are:

- *Obligations of a life company* – this section has been amended to reaffirm the fit and proper requirements imposed on the appointed auditor under *LPS 520 Fit and Proper*, reiterates the principles in LPS 510<sup>2</sup> on the responsibilities of the Board of a life company and the responsibilities of the life company to the auditor under the Life Act<sup>3</sup>.
- *General requirements* - these requirements clarify existing requirements and current requirements under professional auditing standards. Under this section, auditors will be required to retain all working papers in relation to the life company for a period of seven years. This requirement currently exists in the *Corporations Act 2001*.<sup>4</sup>
- *Annual returns* - auditors are currently required to complete annual returns under paragraph six of the existing LPS 310. Under the proposed LPS 310, auditors are required to ‘audit’ the annual returns. The wording has been changed to clarify the level of assurance to be provided by the auditor on the data submitted.
- *Systems, processes and internal controls* - This requirement has been moved from the life insurance reporting standards, which the auditor must comply with under the *Financial Sector (Collection of Data) Act 2001*. It is placed in LPS 310 to emphasise that it is part of the annual returns. This part also clarifies the level of assurance to the review of control policies and procedures and data reliability.
- *Duty to inform under the Act* - this section reiterates the requirements under section 88 of the Life Act.
- *Income and outgoings of a statutory fund* - the definition of income and outgoings is required to be defined in APRA’s prudential standards under section 47 of the Life Act. It was defined in the previous LPS 310 at paragraph 22.
- *Adjustments and exclusions* - this section reiterates the requirements under section 230A of the Life Act.

### ***LPS 320 Actuarial and Related Matters (LPS 320)***

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<sup>2</sup> paragraph 3 of the previous LPS 310.

<sup>3</sup> section 83 of the Life Act.

<sup>4</sup> section 307B of the *Corporations Act 2001* applies to all companies that are publicly listed or are ‘large proprietary companies’. This currently includes all life insurance companies and two friendly societies.

The new LPS 320 can be broken down into these areas:

*Obligations of a life company*

This section does not include new requirements on actuaries or life companies. It:

- reaffirms that an appointed actuary must be fit and proper, as required by LPS 520 and satisfy the independence requirements set out in LPS 510;<sup>5</sup>
- reiterates the principles in LPS 510 on the responsibilities of the Board of a life company;
- reiterates the responsibilities of the life company to the actuary under the Life Act<sup>6</sup>.

*Special purpose review*

The proposed LPS 320 provides that an appointed actuary, when required by APRA to do so, must supply a report on a particular aspect of a life company's operations, risk management or financial affairs. These special purpose reviews are typically targeted towards a particular area of prudential interest and may be conducted by an actuary other than the actuary appointed under section 93 of the Life Act.

For these reviews, APRA will typically specify the scope and form of the report required from the actuary.

The proposed LPS 320 generally requires such reports to be submitted by the actuary to APRA and the life company within three months of the date of the notice commissioning the report.

This is a new requirement for a prudential standard. APRA has broad powers to investigate life insurance companies under Part 7 of the Life Act, as well as direct a life insurance company to order an audit under section 230B, by an actuary chosen by APRA, and at the expense of the company. Under Part 7, APRA may require the life insurance company to give information about any matter relating to the company's business and produce any records relating to the affairs of the company.

The difference between the two powers is practical. APRA would assess the need for an investigation and then request information and records under Part 7 of the Life Act. APRA would then review the material and determine if further information is required, until either the issue is resolved, or APRA feels the need to order an audit under section 230B.

Under the new requirements, APRA would assess the need for a specific actuarial investigation, and request that the actuary, or another actuary that satisfies the independence requirements<sup>7</sup>, conduct an actuarial investigation of that particular issue. This would allow APRA to respond early and directly to arising issues and would also allow APRA to narrow the investigation to a specific area. In most cases it would also allow the investigation to be done by the appointed actuary. Only in

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<sup>5</sup> paragraph 10 of the previous LPS 310

<sup>6</sup> section 97 of the Life Act.

<sup>7</sup> As set out in paragraph 22 of LPS 320 Actuarial and Related Matters

special circumstances, where APRA believes that the life insurance company would benefit from the perspective of a different actuary or where a specific area of expertise is required, would the appointed actuary not undertake the investigation. This allows issues to be identified earlier, which will reduce their severity and impact and is likely to reduce costs and time on both APRA and the life insurance company.

The remaining elements of LPS 320, some of which have been amended to provide clarification are:

- *Financial Condition Report* - actuaries are already required to undertake an investigation into the financial condition of the life insurance company, and provide a financial condition report under paragraphs 11 to 13 of the previous LPS 310.
- *Obligation to report to APRA under the Act* - this section reiterates the requirements under section 98 of the Life Act.
- *General Requirements* - the new requirement to hold working papers for a period of seven years is designed to ensure that matters concerning the financial condition of the company are properly recorded and retained. The requirement to retain working papers already exists in the Corporations Act for auditors. The papers required to be retained by the Corporations Act is quite broad and would include a portion of the papers under this requirement. In response to feedback from industry APRA has further limited this requirement to working papers ‘in relation to the requirements of the life company under the Act’ to clarify the requirement and reduce resulting costs to the life insurance company.
- *Adjustments and exclusions* - this section reiterates the requirements under section 230A of the Life Act.

## **Option 2 – Maintain the status quo**

This option would involve leaving LPS 310 as it currently stands.

## **Impact analysis – costs, benefits and risks**

### **Impact group identification**

The parties impacted by the identified options are life companies and their auditors and actuaries, policyholders and APRA.

### **Assessment of costs and benefits**

At present, APRA does not have data to perform a detailed quantitative cost-benefit analysis on the proposed options. Impacted parties were asked to provide details of the impact and invited to use the Business Cost Calculator. However, no such data in

relation to these proposals was provided in submissions received as part of the consultation process. Some general views on costs and benefits have been noted but this is not sufficient to allow an accurate determination of quantitative estimates of costs and benefits.

## **Option 1**

### **Stakeholders**

#### *Industry - Life insurance companies and auditors and actuaries – Costs*

Industry includes the 32 life companies and 19 friendly societies that are registered under the Life Act. It also affects the auditors and actuaries of these life insurance companies. It may also affect any life insurance companies looking to enter the Australian market.

In APRA's consultation with industry of the proposed changes, APRA requested information from industry on the costs of the proposed changes. There was no quantitative information supplied to APRA to allow us to reliably measure the costs of the proposed changes. Accordingly, APRA has attempted to identify and estimate the costs involved in complying with the new requirements.

The main areas that are likely to impose costs on entities to comply are the:

- (a) requirement to retain working papers;
- (b) special purpose engagements and reviews; and
- (c) the development of a policy setting out the circumstances in which the Board will seek actuarial advice.

The most significant cost is likely to be the retention of working papers. However, these costs will not be as great for companies that are already required to retain papers under the auditor requirements of the *Corporations Act 2001*<sup>8</sup>. For these entities, the new requirements on the auditors would already be met. For actuaries, it is likely that a document storage procedure and facility would already be in place. Additionally, the *Corporations Act 2001* requires that '*all audit working papers prepared by or for, or considered or used by, the audit firm in accordance with the requirements of the auditing standards*'.<sup>9</sup> This would already include some of the actuarial papers required to be retained in LPS 320.

For entities that aren't currently required to comply with the retention requirements of the Corporations Act, which on review appears to be the mainly the friendly societies, these costs could be higher<sup>10</sup>. However, these entities are likely to have their own document retention policy system in place as part of their internal document management procedures. It will be a matter of amending that policy to retain papers for the set time of seven years rather than a discretionary time chosen by the entity. A

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<sup>8</sup> Section 307B of the *Corporations Act 2001*.

<sup>9</sup> Section 307B(3)(b) Corps Act

<sup>10</sup> APRA has determined that all life insurance companies and two friendly societies are subject to this requirement, with 17 friendly societies not currently required to comply.

consulting firm provided submissions in relation to friendly societies on behalf of their clients. This submission did not provide information on costs, and did not comment on the costs that would be incurred by the friendly societies. Other submissions, while providing no quantitative data, have requested that the working papers requirement be limited by either a commencement date for the start of the requirement, and words that limit the type of papers required to be retained. APRA assumes that this could be at least partly in response to the costs involved. APRA has acted by limiting the working papers to papers that are 'in relation to the requirements of the life company under the Act' and by clarifying that this requirement applies only to documents created after the commencement date of 1 July 2010.

Special purpose engagements and reviews supplement existing powers under the Life Act. APRA believes these powers will act to reduce costs when they are used compared with using the equivalent powers under the Life Act. For APRA to obtain the same information, it would need to request the information and records, review them, and continue requesting information and records until the issue is resolved, or until it is apparent that APRA will require an investigation under Part 7 or an audit under section 230B of the Life Act. It is expected that this cost is much greater than the cost that would be incurred from the appointed auditor or actuary undertaking a more specific review even taking into account the compensation allowance under section 131(4) (the life insurance company would still bear the costs of an investigation and the audit).

Therefore, the cost of complying with a special purpose engagement or review under LPS 310 and LPS 320 is expected to replace the costs of APRA obtaining the information under its other powers. In any event, the associated costs of such engagements will not have an ongoing effect, only when additional information is required by APRA. This is expected to occur on an infrequent basis and only where APRA was concerned about a specific aspect of a life company's operations.

The cost of creating an actuarial advice policy is expected to be a once-off cost. Since life insurance companies are already required to obtain actuarial advice on its new policies, this will most likely only require formalising an existing procedure.

The costs of compliance are not expected to affect the auditors and actuaries, as they are expected to be borne by the life insurance company. The costs are not expected to be significant enough to affect the role of auditors and actuaries within a life company.

APRA also does not expect any costs associated with the new requirements to affect the entry of new insurance companies into the Australian market.

#### *Industry – Life insurance companies and auditors and actuaries - Benefits*

Increasing APRA's supervisory effectiveness is a benefit to industry. It assists in maintaining a stable insurance industry, and increasing certainty and clarity of APRA's requirements on life insurance companies.

Separating the audit and actuarial requirements into separate standards assists differentiating the roles of an auditor and actuary and streamlines the relevant standards that auditors and actuaries should be aware of.

The special purpose engagement or review also allows APRA to identify risks earlier, before they have a chance to escalate. This will assist in reducing rectification costs of the life insurance companies.

A formal policy for requiring actuarial advice will benefit life insurance companies by providing certainty on when advice is required from the appointed actuary. This will increase efficiency and therefore reduce costs of ongoing compliance with the requirement.

#### *Policyholders – Costs*

There is a chance that some or all of the increased costs will be passed onto the policyholder by way of increased fees and premiums. However, these should be offset by competition in the market, as well as any increases in efficiency from the changes.

#### *Policyholders – Benefits*

Policyholders benefit from all changes that increase APRA's supervisory effectiveness. This is strengthened by APRA's proposal that a life company maintains a written policy that sets out the situations for which actuarial advice should be sought. Such a policy will form part of the life company's risk management framework and assist in mitigating the risk that new or modified policies are not priced correctly, where, in certain situations may place the company's financial soundness at risk.

#### *APRA - Costs*

APRA would incur implementation costs in advising companies of the new requirements however these are expected to be marginal.

The ongoing costs of the new requirements are expected to be nil, as they would complement APRA's existing supervision techniques. As the changes improve efficiency, APRA may see a small reduction in its supervision costs.

#### *APRA – Benefits*

The benefits of the new requirements, including splitting audit and actuarial requirements include improving efficiency and clarity of the requirements. This assists APRA in its supervision of life insurance companies.

The special purpose engagement or review would allow APRA to identify risks earlier, before they have a chance to escalate. This reduces the overall costs of investigation and enforcement. It is a more efficient way to identify risks and issues.

A formal policy on actuarial advice will decrease costs of supervision as APRA can trust that the Board of the life company will seek actuarial advice on new or amended products in line with their policy where appropriate.

## **Option 2**

### **Stakeholders**

Maintaining the status quo will still leave the problems identified in the early part of this RIS unaddressed. Additionally, if APRA relied on its existing powers under the Life Act, it would incur the additional costs associated with using a less efficient mechanism to supervising entities. Under this option all stakeholders will continue to incur the costs and benefits of complying with the previous LPS 310.

### **Consultation**

Draft versions of the standards and a discussion paper explaining the changes, were released in May 2009 and were available for comment from the public from 9 May 2009 to 30 June 2009.

The discussion paper requested comments on the proposed changes, and specifically requested information on the costs that were likely to be incurred as a consequence of complying with the changes.

APRA received seven responses from the consultation with industry, including responses from professional bodies; the Australian Auditing and Assurance Standards Board, the Institute of Actuaries of Australia, and the Institute of Internal Auditors. The eight responses largely supported the changes; three specifically highlighting the benefits of clarifying requirements that would come from splitting audit and actuarial requirements into separate standards.

APRA has also provided clarification on the new standards in the form of a response paper '*Response to Submissions - Enhanced supervision of life companies*' that accompanies the new standards, as well as some minor wording changes to clarify APRA's requirements.

A concern that arose from the consultation was the requirement to retain working papers under LPS 320. APRA will clarify in its response paper that that this requirement will only apply to papers created after the effective date of the prudential standard. In response, APRA has reduced this requirement by limiting the requirement to working papers that are 'in relation to the requirements of the life company under the Act'.

### **Conclusion and recommended option**

APRA recommends that Option 1 is undertaken. It is the only option that allows APRA's objectives to be met. While it does create some costs in implementation, and ongoing compliance, they are not significant, and are outweighed by the increased efficiency they bring, as well as the increased effectiveness of APRA's supervision, which benefits industry as well as other stakeholders.

Option 2 creates the same costs of compliance, as special purpose reviews can be undertaken (in the form of an investigation or direction) through the Life Act already. It also has none of the benefits of clarifying requirements, and clearly separating the functions of audit and actuarial.

For these reasons, APRA does not recommend this option.

## **Implementation and review**

APRA intends to release the final prudential standards towards the end of 2009, with effective date to be 1 July 2010. This will allow several months of preparation by APRA and industry to familiarise themselves with and adapt to the new requirements.

Review of the standards will be undertaken on an as-needed basis, following legislative or other developments in APRA-regulated industries.

## Part B Governance and Fit and Proper

### Background

APRA is primarily responsible for ensuring the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors and policyholders. This mandate has recently been expanded to include registered NOHCs of life insurance companies, with the passing of the *Financial Sector Legislation Amendment (Enhancing Supervision and Enforcement Act 2009*<sup>11</sup>. APRA is now responsible for ensuring that any chance of a life company failing due to the activities of its related NOHC are minimised.

In order to fulfil this responsibility, APRA has powers under the Life Act that include monitoring and investigation powers, powers to issue directions and prudential standards that registered NOHCs must comply with.

Fit and proper and governance requirements under APRA's prudential standards that apply to all APRA-regulated institutions have been in place since 2006, including NOHCs authorised under the Banking Act and Insurance Act.

#### *Number of affected entities*

There are 32 life companies and 5 friendly societies registered under the Life Act that are part of corporate groups. This represents the maximum number of NOHCs that may be registered. The actual number is expected to be smaller than this. Reasons for this include (a) some potential non-operating holding companies have multiple life company subsidiaries (b) the life insurance companies have NOHCs registered under other APRA-regulated industries, and (c) the lack of a holding company in the corporate structure. On this basis, APRA's analysis indicates that there appear to be 20 life insurers and 5 friendly societies that could potentially have NOHCs registered, and this number will also decrease if APRA has grounds to give an exemption from registration.

APRA has stated that it does not envisage registering every life NOHC, but proposes to assess the need for exemption from registration on a case-by-case basis. However, APRA has assessed the impacts of its proposed changes on the basis that the maximum number of life insurance companies apply to APRA to register NOHCs under the Life Act.

It is possible that future entrants to the market will increase the number of affected entities, but APRA sees the additional costs imposed by these changes as insignificant compared to the existing requirements for a life insurance company and its Life NOHC.

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<sup>11</sup> A Regulatory Impact Statement concerning these legislative changes was submitted to the OBPR by Treasury in 2008.

## Problem

Life insurance companies which are part of corporate groups can be exposed to risks from within the group. Risks arise particularly where decisions that affect life companies are made by its parent.

Prudential supervision of NOHCs and their encompassing corporate groups was a recommendation to come out of the HIIH Royal Commission<sup>12</sup>, and was also previously identified in the Wallis Report. Prudential supervision of NOHCs authorised under the *Insurance Act 1973* (Insurance Act) has been in force since 2002, and under the *Banking Act 1959* (Banking Act) since 1998.

Stand-alone life companies are subject to prudential requirements on statutory funds, that quarantine policyholders' funds, and on directors to give priority to policyholders' interests. However, life companies are often part of corporate groups. As such, they may be exposed to risks that stem from other companies within the group. Furthermore, within such structures, decisions that potentially affect the operation of the life company, and ultimately the policyholders, may be made by the parent entity i.e. the NOHC. These risks can be mitigated through the prudential supervision if the parent NOHC is subject to prudential supervision.

With the passing of the *Financial Sector Legislation Amendment (Enhancing Supervision and Enforcement) Act 2009* (FSLA Act), APRA now has the power to regulate NOHCs of life insurance companies (**Life NOHCs**) in the same manner as NOHCs of ADIs or general insurers.

This involves the power to authorise, determine standards and request information from ADIs or general insurers, the authorised NOHCs of those entities and subsidiaries thereof — that is, the ADI or general insurer and the group that it operates within.

The explanatory memorandum noted “*International experience has demonstrated the interconnection between companies in the conglomerate, including between prudentially regulated entities and unregulated entities*”. Most life companies operate as part of a financial conglomerate or corporate group, with decisions affecting a life company often made at the group level. Many businesses are structured with an unregulated holding company owning and controlling the life company. NOHCs' decisions about the conglomerate can have significant impact on the policyholders of the life company in the conglomerate.

In line with the regulatory framework that applies to conglomerates containing an ADI or general insurer, subsidiaries of life insurance NOHCs and life insurers have been brought within APRA's regulatory scope. These changes ensure that APRA has access to relevant information about the conglomerate's financial health and conduct, where its conduct or activities can impact on the life insurers and their policyholders. This has brought the regulation of life insurance NOHCs into line with the regulation of ADI and general insurance NOHCs.

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<sup>12</sup> Recommendations 38 and 39, HIIH Royal Commission

However, there is still a regulatory gap in that NOHCs of life insurance companies registered under the Life Act are not subject to the same ‘fit and proper’ and governance requirements of NOHCs authorised under the Banking Act and Insurance Act. This uneven playing field is especially apparent when comparing NOHCs that own both general insurers and life insurance companies and NOHCs that only own life insurance companies where one NOHC is subject to APRA’s fit and proper and governance requirements, and the other is not, irrespective of the risks that may exist in each group. The effectiveness of APRA’s prudential framework would be reduced as the persons required to implement it are not fit and proper to hold their positions. The continual occupation of roles by persons who are not fit and proper of responsible person positions will jeopardise the positions of policyholders, who would be exposed to an increased risk of financial loss due to mismanagement within APRA-regulated institutions, which in turn will affect financial system stability and public confidence in the financial system.

The lack of alignment between industries will also add administrative complexity, and difficulties in enforcement as time and resources are spent on different supervisory actions for different institutions.

APRA has broad powers to investigate life NOHCs under Part 7 of the Life Act. Under Part 7, APRA may require the life NOHC to give information about any matter relating to the company’s business and produce any records relating to the affairs of the company. Whilst this power can assist APRA to supervise life NOHCs it is generally an inefficient and less timely means of supervising life NOHCs.

Additionally, under s254A of the Life Act, APRA may apply to the Court to disqualify a person from being or acting as a director, principal executive officer, appointed actuary or auditor of a life NOHC. Existing LPS 520 sets out the criteria to determine whether a responsible person is fit and proper and other requirements. If these requirements are not also applied to life NOHCs, the absence of a clear framework defining ‘fitness and propriety’ for life NOHCs could cause ambiguity amongst these institutions and make it difficult for life NOHCs to comply with, and APRA to enforce.

## **Objectives of APRA’s initiative**

It is now APRA’s responsibility to regulate life NOHCs in order to protect policyholders of related life insurance companies. APRA’s objectives are to ensure that the NOHCs have in place appropriate decision making procedures and policies and that persons making decisions that may affect the related life insurance companies and their policyholders are fit and proper.

APRA’s primary objective in regulating life NOHCs is to promote confidence in the financial system by reducing the likelihood of instability or financial stress that could result from mismanagement or misconduct in APRA-regulated institutions.

APRA also intends to ensure that NOHCs of life insurance companies are subject to the same standards as NOHCs of general insurers and ADIs, to discourage any regulatory arbitrage or unfairness between holding companies of APRA-regulated institutions.

These changes to APRA's prudential standards will align the life insurance Fit and Proper and Governance requirements with the existing requirements for authorised NOHCs of ADIs and general insurers.

## **Options**

### **Option 1**

*Extend Prudential Standard LPS 510 Governance and Prudential Standard LPS 520 Fit and Proper to NOHCs registered under the Life Act.*

The key requirements of LPS 510 and LPS 520 are:

- life NOHCs will have specific requirements with respect to Board size and composition, including a majority of independent directors;<sup>13</sup>
- the chairperson of the Board must be an independent director;
- a Board Audit Committee must be established;
- life NOHCs must have a dedicated internal audit function;
- the Board must have a policy on Board renewal and procedures for assessing Board performance;
- life NOHCs must have and implement a written fit and proper policy;
- the fitness and propriety of a responsible person must generally be assessed prior to initial appointment and then re-assessed annually (or as close to annually as practicable);
- life NOHCs must take all prudent steps to ensure that a person appointed to, or continues to hold a responsible person position is fit and proper;
- additional eligibility requirements must be met for responsible auditors of life NOHCs; and
- information must be provided to APRA regarding responsible persons and the life NOHC's assessment of their fitness and propriety.

### **Option 2**

*Maintain Status Quo – do not extend Fitness and Propriety or Governance requirements to life NOHCs.*

Under this option APRA would not impose any new requirements on life NOHCs. It would maintain current requirements that APRA supervise the life NOHCs under the mechanisms provided for in Part 7 of the Life Act, and use those powers of monitoring and investigation to gather information on the fitness and propriety of the

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<sup>13</sup> The purpose is not to require directors of NOHCs to also be independent of the related life company, and as such, independent directors of the related NOHC may also fulfil the independence requirements of directors of the life company subsidiary. This is consistent with the independence requirements of authorised ADI and general insurance NOHCs.

persons in responsible positions, and the governance arrangements; and powers of directions to enforce APRA's requirements.

## **Impact analysis – costs, benefits and risks**

### **Impact group identification**

The parties impacted by the identified options are regulated institutions and their responsible persons, policyholders and APRA.

### **Assessment of costs and benefits**

At present, APRA does not have data to perform a detailed quantitative cost-benefit analysis on the proposed options. Impacted parties were asked to provide details of the impact on them and invited to use the Business Cost Calculator. However, no such data in relation to these proposals was provided in submissions received as part of the consultation process. The following analysis is based on evidence supplied to APRA by regulated institutions. Some general views on costs and benefits have been noted but this is not sufficient to allow an accurate determination of quantitative estimates of costs and benefits.

### **Costs and Benefits of Option 1 on stakeholders**

#### *Industry - Regulated institutions and their responsible persons – Costs*

APRA has attempted to identify the costs involved in complying with the new requirements. As Life NOHCs are part of a corporate group that are already subject to APRA's prudential requirements on governance and fit and proper, the cost of familiarising oneself with the new requirements, which will be made easier with the release of a response paper with the final standards will be marginal.

Life NOHCs that don't currently meet the requirements will incur compliance costs. There may be costs associated with ensuring that the Board has a majority of independent directors and an independent chairperson, and for educating the Board members and senior management about their new responsibilities. Life NOHCs will need to create or review their fit and proper policies and procedures.

Costs would also be incurred on an ongoing basis for the maintenance of the new policies and procedures, and ongoing compliance with the requirements.

The costs of ensuring independent directors will be reduced where independent directors of the life insurance company also sit on the board of the related NOHC already. Under APRA's proposed requirements, independent directors of the life company may also fulfil the independence requirements of directors of the life NOHC.

Of the life companies that may potentially have a related life NOHC registered, 15 have identical Board members to the related life NOHCs, or significant crossover between the Board members. This means that those Board members will already be familiar with APRA's governance and fit and proper requirements, decreasing the costs of compliance, as well as already satisfying many elements of the governance and fit and proper requirements.

Costs will be reduced for companies that are already subject to corporate governance requirements and guidance under other laws. Life NOHCs that are listed on the ASX (of which there are six) may already be complying with the *ASX Corporate Governance Principles and Recommendations*, as well as requirements under the *Corporations Act 2001*. These recommendations include having a majority of independent directors.

In relation to costs for life NOHCs in complying with the proposed fit and proper requirements, as a general rule, most institutions go through some sort of fitness and propriety process when choosing new staff, and when conducting performance reviews. These would only need to be adapted to also comply with APRA's requirements. APRA does not foresee these costs to be significant. Each NOHC will also be able to draw from the existing fit and proper policy of the related life insurance company.

Costs will be further reduced for life NOHCs where the group already operates under a group fit and proper policy, as allowed for under LPS 520. This group policy may need only minor amendment, if any at all. If the group decides to create a group policy, this group policy will be able to replace the life insurance company's individual policy. APRA has estimated that four life NOHCs already operate under their life company's Fit and Proper Policy.

Paragraph 28 of LPS 510 also allows other group policies (such as those used for governance functions) to be used across the life insurance company and other companies in the group, provided they satisfy APRA's requirements. For NOHCs that are part of such a group policy, the policy may need no or very little modification to ensure registered NOHCs are compliant.

Responsible persons of life NOHCs should not incur any direct costs as a result of these changes. Prospective staff should already be going through a selection process that includes assessment of their fitness and propriety. For current employees that are required to be fit and proper who are not fit and proper, additional costs may be incurred by them. This is an unavoidable consequence of setting a minimum standard. APRA does not expect there to be many, if any, responsible persons of life NOHCs that will incur significant costs.

A concern expressed during consultation on the draft legislation was that the cost of all subsidiaries of a NOHC having to comply with the fit and proper requirements would be substantial. APRA disagrees with that submission, as the fit and proper requirements apply only to the registered NOHC and life insurance company, not the subsidiaries of either. Furthermore, as stated earlier, a form of fitness and proprietary assessment would be carried out already as part of any hiring and promotion process.

Costs incurred are expected to be mitigated by the reduction in intensity of supervision by APRA once sufficient governance and fit and proper policies and procedures are in place.

Institutions that bear the greater costs will be those that have inadequate fit and proper and governance procedures and policies in place. However, these institutions are also the ones that will benefit most from the new requirements, as described below.

#### *Industry - Regulated institutions and their responsible persons – Benefits*

Life NOHCs will benefit from the governance requirements in ensuring that the Board conducts its affairs with a high degree of integrity and transparency, and considers the effect of those decisions on all its stakeholders, including policyholders. Life NOHCs will also benefit from the broad range of skills, experience and knowledge that independent directors may bring to the company.

Individual institutions will benefit from the reduced risk of failure. APRA has seen a number of cases where the absence of clear fit and proper risk management has jeopardised the safety of an institution or has had the potential to cause material losses to the institution. By applying the fit and proper requirements to Life NOHCs, APRA is able to set minimum criteria, based on its experience in supervising other APRA-regulated institutions to ensure that responsible persons have the necessary probity, competence and independence to manage the Life NOHC and indeed the wider group, in a sound and prudent manner.

The life insurance industry as a whole should be strengthened if persons who have inadequate skills and experience, or who have otherwise demonstrated that they are not fit and proper, are prevented from working in responsible person roles. The prudential requirements would create strong incentives for APRA-regulated institutions to conduct their businesses in a safe and sound manner.

Responsible persons of life NOHCs will benefit from the reduced likelihood that other persons are not fit and proper, such as reduced risk of reputational damage and job instability. The responsible person should also enjoy increased performance and efficiency from other responsible persons and the company as a whole.

#### *Policyholders – Costs*

There is a chance that some or all of the increased costs will be passed onto the policyholder by way of increased fees and premiums. However, these should be offset by competition in the market, as well as any increases in efficiency from the changes.

#### *Policyholders – Benefits*

Policyholder benefit from all changes that reduce the likelihood of an institution failing. Policyholders would benefit from the new prudential framework as the enhanced fit and proper requirements should serve to strengthen the overall quality of management in APRA-regulated institutions.

The interests policyholders would be further safeguarded since responsible persons of APRA-regulated institutions would be obliged to ensure that the outcome of their actions is not to the detriment of policyholders. Failure by a responsible person to properly exercise their responsibilities would require the regulated institution to re-assess the fitness and propriety of that person, and would also lead APRA to reconsider their fitness and propriety.

Policyholders will also benefit from the increased efficiency and performance of institutions that have responsible persons that are fit and proper to hold their positions, and proper risk management practices.

#### *APRA – costs*

APRA will incur some costs to update its supervisory approach and framework. These costs will be nominal, as supervisory staff are already trained in assessing fit and proper policies and governance requirements, and can be done as part of regular supervisory review of the institution. These costs will also replace costs incurred under the other two options.

#### *APRA – benefits*

Extending the requirements to life NOHCs significantly reduces the risk of institution failure due to ineffective governance practices and incompetent, reckless or improper management by responsible persons. By extending its minimum expectations for fitness and propriety and governance into its prudential standards to life NOHCs, APRA would increase the transparency of its requirements. This will add to APRA's supervisory efficiency and effectiveness. Aligning the requirements to other APRA-regulated institutions will further increase this efficiency.

Creating a requirement for a Board Audit Committee will ensure the life NOHCs have appropriate arrangements covering independent oversight of the institution. This, in turn would help to reduce the intensity of supervisory oversight by APRA.

Improving the way the Board and senior management govern the life NOHC will increase the safety and soundness of the financial system, allowing earlier and intervention, if needed, and minimise contagion risk to the life insurance company and its policyholders.

### **Costs and Benefits of Option 2 on stakeholders**

#### *Industry – regulated institutions and their responsible persons – Costs*

Life NOHCs under this option would continue to incur potential costs as the increased risk of mismanagement, incompetence and fraud continue. They would also incur costs from an increase in intensity of APRA's supervision. Institutions would also face uncertainty as to the minimum criteria for assessing fit and proper, and will incur costs in investigating this. (APRA may seek disqualification of persons who are not fit and proper under section 245A of the Life Act)

Responsible persons who are fit and proper would not experience the benefit of reduced likelihood of persons acting improperly, and the subsequent risks to their reputation and job stability.

*Industry – regulated institutions and their responsible persons – Benefits*

Under this option, life NOHCs would not need to comply with governance and fit and proper requirements, they would not need to incur costs in complying with the new governance requirements, such as creating a Board Audit Committee and ensuring the Board meets independence requirements, or costs in creating and reviewing a fit and proper policy, and ensuring responsible persons meet these requirements. However, they could still be disqualified on grounds of not being fit and proper under section 245A of the Life Act.

*Policyholders – Costs*

This option would create opportunity costs by foregoing the opportunity to improve the overall quality of management of life NOHCs, as well as increasing the likelihood of the failure of a life insurance company by failing to hold the responsible persons of the life NOHCs to a minimum standard of fitness and propriety.

*Policyholders - Benefits*

Benefits to policyholders would be unchanged from the status quo. The chance that costs of compliance would be passed down to policyholders would be removed, though other costs could potentially be passed on.

*APRA – Costs*

There will not be any costs for implementation of new requirements. However, supervision expenses would be expected to increase as APRA increases its supervision of institutions where persons who are not fit and proper undertake improper activities.

The effectiveness of APRA's prudential framework will be reduced as the persons required to implement it are not fit and proper to hold their positions. The continual occupation of persons who are not fit and proper of responsible person positions will jeopardise the position of policyholders, who would be exposed to an increased risk of financial loss due to mismanagement within APRA-regulated institutions, which in turn will affect financial system stability and public confidence in the financial system.

The lack of alignment between industries will also add administrative complexity, and difficulties in enforcement as time and resources are spent on different supervisory actions for different institutions.

*APRA – Benefits*

The main benefit would be the avoidance of costs that would be incurred in creating and implementing the new requirements.

## Consultation

Draft versions of the standards, and a discussion paper explaining the changes were released in May 2009 and made available for comment from the public from 9 May 2009 to 30 June 2009.

The discussion paper sought comments on the proposed changes and specifically requested information on the costs that were likely to be incurred as a consequence of complying with the changes.

APRA received seven responses to the 'Enhanced supervision of life companies' consultation package. Of these responses, none commented on the expansion of fit and proper and governance to NOHCs of life companies.

The consultation undertaken by the Senate Economics Committee (SEC) is also relevant to this proposal, as fit and proper and governance requirements were identified as specific areas that APRA would extend to NOHCs of life companies in the accompanying Explanatory Memorandum for the *Financial Sector Legislation Amendment (Enhancing Supervision and Enforcement) Act 2009* introduced on 19 March 2009.

In response to the legislation, the SEC received two submissions from industry.

Both submissions commented specifically on the extension of fit and proper and governance requirements to NOHCs of life companies.

One submission specifically supported the extension of fit and proper and governance requirements to registered NOHCs. It expressed concern of the costs that would be involved in its numerous subsidiaries having to comply with fit and proper requirements. APRA believes it has alleviated these concerns, as the requirements are stated to only apply to registered NOHCs and registered life insurance companies.

The other submission requested that the consultation on the costs of compliance with fit and proper and governance requirements be extended so that they may assess their costs in relation to the new requirements. However, when APRA undertook consultation on the fit and proper and governance requirements and requested information on expected compliance costs, this institution failed to submit any information.

## Conclusion and recommended option

APRA recommends that option 1 is adopted. This option allows APRA to consistently supervise non-operating holding companies of life companies across APRA-regulated industries, and ensure that NOHCs have the correct procedures and policies in place to protect policyholders and potential policyholders of related life insurance companies.

Fit and proper and Governance requirements have been applied to NOHCs of general insurers and ADIs since 2006. Under option 2 NOHCs of life insurance companies would be treated differently from NOHCs of general insurers or ADIs. Accordingly, APRA does not recommend this option as it is not consistent with other APRA-regulated industries of general insurance and banking. It would also hinder APRA from fulfilling its obligations under the Life Act to supervise life NOHCs in order to protect policyholders.

Additionally, whilst under option 2 APRA would be fulfilling its obligations under the Life Act to supervise NOHCs and protect policyholders, it would create a bigger burden on APRA and industry in using its powers to gather information and enforce requirements. Use of prudential standards allows clarity and certainty of requirements, and the standards provide an efficient means of communication of these requirements to industry. APRA believes that issuing prudential standards that clearly shows APRA's expectations is a more efficient approach than the uncertainty of option 2 described above.

APRA also believes that preventative action described above is more effective in protecting policyholders, and imposes fewer costs in the long term.

## **Implementation and review**

APRA intends to release the final prudential standards towards the end of 2009, with effective date to be 1 July 2010. This will allow several months of preparation by APRA and industry to familiarise themselves with and adapt to the new requirements.

Review of the standards will be undertaken on an as-needed basis, following legislative or other developments in APRA-regulated industries.