

PRESENTATION TO THE INSURANCE COUNCIL OF AUSTRALIA:
2009 REGULATORY UPDATE

Professor Deborah Ralston
Melbourne Centre for Financial Studies
Wednesday 4th February 2009

Many thanks for the invitation to participate in this forum. The topic for this session is *Market conduct – what are the likely supervisor arrangements in the future*. Before looking at likely future directions, however, I am going to take a few moments to review some pivotal events in insurance regulation over the past decade or so as they have ongoing ramifications for the industry, namely:

- The Wallis Inquiry
- Financial Services Reform Act
- HIH Inquiry
- Taskforce on Reducing Regulation for Business, and most recently
- Failure of AIG and the Global Financial Crisis

The Wallis Inquiry

In 1996, after a decade of deregulation, and in response to concerns about the dynamics of the rapidly changing financial system, the federal government commissioned the Financial Services Inquiry. Changing customer needs and profiles, technology and globalisation had delivered new products, services and competitors and some demonstrable inefficiencies and inequities in regulation.

Consequently many of the recommendations from the 1997 Wallis Report were aimed at:

- Promotion of a level playing field for all financial services firms
- Enhanced competitive neutrality
- Adoption of consistent flexible regulation

It was against this background that the Insurance and Superannuation Commission (ISC), was disbanded and regulatory responsibilities for the insurance industry allocated to APRA and ASIC, establishment in 1998.

APRA became a unified prudential regulator taking on prudential regulation responsibilities from the ISC for insurance firms, from the RBA for banks, and from AFIC for building societies and credit unions.

After reviewing legislation pertaining to the regulation of all financial services firms, including the insurance industry, the Committee also recommended that a range of industry specific pieces of legislation be repealed and replaced with broad-based financial services legislation aimed at disclosure and consumer protection.

To implement this legislation the Committee recommended the establishment of a single market conduct and disclosure regulator for the financial sector. Subsequently ASIC, a reformatted version of the ISC, was established with its current responsibilities as the corporate regulator, market regulator and financial services regulator.

As the corporate regulator, ASIC ensures that directors and officers of companies carry out their responsibilities honestly, diligently and in the best interests of the company. As the market regulator it ensures that authorised financial markets are complying with their legal obligations and are operating fairly, orderly and transparently, and as the financial services regulator ASIC licences and monitors financial services firms to ensure that they operate efficiently, honestly and fairly.

At the same time the ACCC retained its responsibilities for consumer protection, competition policy and mergers etc under the Trade Practices Act.

With APRA undertaking prudential regulation and ASIC market conduct, the “twin peaks” approach to regulation of the financial services industry was established. The division of responsibilities between APRA and ASIC took a while to settle between the two organisations, with responsibilities requiring careful definition, to remove duplication and to ensure that nothing “falls between the cracks”.

Financial Services Reform

With respect to the insurance industry, ASIC regulates through the Corporations Act 2001, the Australian Securities and Investments Commission Act 2001, Insurance Contracts Act 1984 and the Financial Services Reform (FSR) legislation.

The Financial Services Reform Act, contained in Chapter 7 of the Corporations Act, specifies comprehensive market conduct rules for financial services firms and was introduced as a direct response to the Wallis Inquiry’s concerns for consumer protection and disclosure. FSR legislation oversees the licensing of financial markets and clearing and settlement facilities, product disclosure and the licensing and conduct of financial services providers.

FSR has undergone significant modification over recent years including consequential provisions in 2001 and 2002, and an Amendment Act in 2003. The constant tension between ensuring a consistent competitive neutrality approach across various forms of financial services and the need to tailor the implementation of legislation to specific products and markets has dogged FSR ever since its introduction.

In May 2005, a Proposals Paper entitled Refinements to Financial Services Regulation was specifying 25 proposals for refinement was released for public comment. The Refinement Process is intended to ensure tailoring and rationalisation of disclosure requirements to consumers, to reduce the regulatory burden for industry and to clarify the intent of some aspects of the legislation.

Now, some 8 years after its original implementation, the FSR is still undergoing review and modification. In February 2008, the Government announced the formation of the Financial Services Working Group (the Working Group) dedicated to looking at the key issues associated with financial services advice and disclosure. The Working Group comprises senior officials from the Department of Treasury, the Australian Securities and Investments Commission (ASIC) and the Department of Finance and Deregulation. Stay tuned!

The HIH Royal Commission

HIH started to experience difficulties in the mid to late 1990s, and was eventually placed in provisional liquidation in **March 2001**. In some ways the timing for the

HIH collapse was unfortunate for APRA as it coincided with the relocation of the insurance regulator from Canberra to Sydney, leading to loss of some key expertise, further complicated by the multi-skilling approach taken in the new organisation. Nevertheless the HIH failure provided an excellent means of testing the new “twin peaks” regulatory regime in its early days and provided much valuable insight that allowed deficiencies in the conduct and oversight of insurance regulation to be identified and corrected.

After the HIH collapse the case for prudential regulation of insurance companies was greatly strengthened. In banking, prudential regulation is directed at protecting depositors, and in avoiding the risk of contagion and system risk which can arise through a run on the banks. HIH illustrated that the danger in an insurance failure lies in terms of the costs it imposes on the rest of the economy, and in the significant economic and social costs that can be imposed on individuals, who may have no direct relationship with the insurer, but who suffer from the failure of workers compensation, compulsory third party injury and product liability insurance.

By the time the Final Report of the HIH Royal Commission was released in **April 2003**, the industry was already on its way to regulatory reform. A review of insurance regulation started in 1995 by the ISC and carried through by APRA and the Commonwealth government, had led to the passage of the General Insurance Reform Act on **19 September 2001**. With an emphasis on capital adequacy, risk management and better governance, this Act increased the minimum capital requirement for general insurers to \$5 million, up from the \$2 million it was at the time of the HIH collapse.

One of the major issues that concerned the Royal Commission was the roles played by the regulators, APRA and ASIC, and the effectiveness of this “twin peaks” approach to regulation. While Justice Owen stopped short of recommending the amalgamation of the two regulators, he drew attention to the need for a much better definition of responsibilities between the two and a closer working relationship. The Report also drew attention to the duplication of prudential insurance regulation between APRA and state and territory agencies, and inconsistencies in state and territory statutes.

Task Force on Reducing Regulatory Burdens on Business

This matter of duplication between states and territories and federal government regulation was very much to the fore in the report of the Task Force on Reducing Regulatory Burdens on Business, titled *Rethinking Regulation* and released in **January 2006**. A major outcome of the Taskforce was the definition of 6 principals of good regulatory process accepted and endorsed by the Commonwealth Government: the need for both an evidence-based and cost-benefit tested approach to regulation, clarity in the intentions of regulations, regular review and appropriate consultation with the regulated parties.

The principals also enshrine the need for a broader range of regulatory tools such as self regulation and co-regulation, reiterating the sentiments of the Wallis Report that industry codes of conduct play a vital role in ensuring effective consumer protection.

The net effect of the adoption of these principals should be greater transparency in regulatory policy development, greater consultation, and accountability of legislators and regulatory bodies. However, that being said, these matters are no where near as simple and straight forward as the principals might suggest. Measuring costs and

benefits is no small task. In a recent report commissioned by ASIC, (*A Report on Costs of Financial Services 2007*), many industry members admitted that while they were concerned about compliance costs, few measured them. Similarly, while freely admitting that cost of regulation are often compensated by benefits such as an improvement in organisational reputation and industry standards, market stability, better business processes and a more level playing field, these benefits also can be very difficult to quantify.

In the first instance, however, the government accepted around half of the 178 Task Force recommendations, including a significant number directed at enhancing the cooperation and coordination, streamlining and standardising processes, and improve the flexibility and responsiveness of regulatory agencies, particularly APRA and ASIC. With respect to general insurance the Taskforce reiterated the HIH Royal Commissions recommendation that state taxes and levies on general insurance should be removed (rejected by the states), and that a nationally consistent framework be developed for state statutory insurance classes, such as workers compensation, under the COAG Agenda.

As of **1st July 2008** capital levels of insurance and ADIs have been harmonised, and although there has been some adverse industry comment on this move, according to the Regulatory Impact Statement which assessed the costs and benefits of the legislation, on average general insurers had more than twice the required capital level as of June 2007. These prudential amendments also included the regulation of Direct Offshore Foreign Insurers (DOFIs).

Recent Financial Crisis

In the light of the recent global financial crisis the world's attention has been drawn to the issue of insurance regulation with the spectacular failure of AIG. Unlike the failure of HIH, the source of risk in this scenario was all about the asset side of the balance sheet, rather than its liabilities.

Post deregulation there has been a blurring of the lines between the products offered by banks and those offered by insurance companies. In many ways the credit default swap market represented a logical end result with insurance companies taking on the risk that banks traditionally manage – credit risk i.e. the risk that their customers might default. Some insurance concerns such as AIG and the monoline insurers were prepared to bet that they could manage that risk better than the banks who sold it to them. With the cheap capital it worked for a while and we all wondered at how efficient the capital markets had become in distributing risk to those best apparently able to bear it. But we now know how that hubris came back to haunt a few big name firms in 2008. It has to be expected that here will be moves by governments and regulators to put in place rules that prevent such concentration of risk occurring again.

The failure of AIG's parent body as a consequence of the UK subsidiary's activities has also drawn attention to the difficulties and potential cross-border risks implicit in regulating insurance groups. It is clear that the International Association of Insurance Supervisors (IAIS) will play a major role in these issues in the future. As the latest of the international regulatory bodies, formed only in 1994, this body is less well known than agencies such as the Bank of International Settlements but it is now "front and centre" in the debate on international regulation. IAIS has released principles for insurance regulation including those relating to cross-border activities, mutual

recognition of reinsurance, capital adequacy and solvency, and supervision of insurance activities on the internet.

The credit crisis will of course also affect the liability side of insurance company balance sheets. It is likely that there will be a surge in claims against D&O (Directors and Officers) policies of poorly performing companies as shareholders seek redress for inadequate disclosure of timely debt and solvency information. This will be reinforced by the recent emergence of class action litigation funding in Australia.

The Future of Insurance Regulation

As to the future of regulation in the insurance industry it is difficult to imagine any widespread changes as the current system has stood up well to pressure. That being said there are a few obvious trends;

- Highly interventionist federal government policy stance,
- Initiatives to reduce the burden of regulation through COAG,
- Simplification of disclosure requirements under the FSR,
- Possible rationalisation of agencies, and
- International harmonisation of regulation.

It is clear that the federal government policy is taking a more interventionist stance than we have seen in the past. The global credit crisis has drawn attention to weaknesses in international financial services regulation, and the need to harmonise across international borders and coordinate on a wider scale. Under this direction one might expect to see an increased level of regulation, however at the same time, mitigating against that is the widespread reforms that have taken place domestically over the last decade, putting the industry on the solid footing it enjoys today.

Further, the undoubted commitment of the federal government to the outcomes of the Taskforce on Reducing Regulatory Burdens on Business and the clear intention to streamline business regulation under the COAG Agenda bodes well for the future. As the latter progresses, the removal of duplication and inconsistencies in financial services will be welcome. This agenda will assist with the Insurance Council's Policy goals on the standardisation of workers compensation policy and the removal of state and territory taxes on insurance. This will not be an easy objective, however, but hopefully through the Henry Review, a creative means of replacing current state and territory revenue streams on taxes, fire levies and stamp duty can be achieved.

Further refinements to the FSR will also have to yield some benefits in terms of simplifying disclosure requirements and clarifying some of the remaining complexities in implementation of the legislation. It is a shame that this is still taking place 8 years after its introduction!

Another implication of the Global Financial Crisis will be the need to severely reign in government spending. With the estimated cost to government of maintain regulatory agencies at \$2billion (without the ATO) in 2003-4 (PC), one might also expect that some rationalisation of regulatory agencies could be seen as expedient, possibly bringing the future of APRA and ASIC as two separate bodies into question. When introduced, APRA was to be the "light touch" regulator while ASIC was to be more heavy-handed. As things have transpired this differentiation has been somewhat

eroded and as both the Royal Commission and the Regulatory Taskforce have indicated, there have been many frustrations in the lack of coordination and duplication between these two bodies. A lot of work has been done on this, however, and the agencies have established a Working Group to take this further. Notwithstanding these efforts, an obvious and expedient area for reducing regulatory costs would be to consolidate the two agencies into a single body, as indeed has happened in the UK. The downside of this may be that either prudential or market conduct regulation struggles to maintain a sufficiently strong focus in the combined organisation.

Following the Global Financial Crisis one might expect more emphasis on international coordination of insurance regulation. I am aware that despite the inclusion of DOFIs in the new domestic regulation there is still a concern that there is no level playing field internationally in insurance regulation – the IAIS is the best avenue for reform in this regard. It might also be expected that in the next round of prudential review, particularly in the light of the AIG situation, APRA will want to constrain use of insurance company balance sheets. One would hope that this does not impede financial innovation in the insurance industry. Innovations such as catastrophe bonds provide another means of diversifying risk on a broader scale, particularly useful when dealing with the various forms of weather risk currently plaguing the industry.

In terms of accounting regulation, work towards the new insurance standard continues. At this stage an International Accounting Standards Board Exposure Draft is anticipated sometime this year with 2010 being identified for delivery of the final standard. Australian standards will closely follow those time lines. These matters don't move fast!

In conclusion, it is evident that the Australian insurance industry stands in a good position in the face of this financial crisis – the disclosure regime is well established and the industry well capitalised with solid risk management practices in place. Many of the benefits promised in the Wallis Review of a level playing field and competitive neutrality have been addressed and largely implemented. It has to be said that, while one would never wish for a disaster such as the HIH Collapse, its timing has stood the industry in good stead, exposing weaknesses in the regulatory system and precipitating reforms that place the industry in the sound position it is in today.