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The Regulatory Framework

(extracted from pages 73 – 77 of Volume I of the HIH Report)

Private sector general insurers are regulated under the *Insurance Act 1973*. Organisations wishing to provide general insurance products in Australia are required to meet certain minimum standards of solvency, behaviour and corporate structure in order to be and remain licensed by the Commonwealth prudential supervisor. At the time HIH failed, in March 2001, the minimum solvency standards required general insurers to have total assets exceeding total liabilities by not less than \$2 million, 20 per cent of net premium income, or 15 per cent of net outstanding claims, whichever was the greatest. In addition, reinsurance arrangements had to be approved by the prudential regulator.

For insurers incorporated in Australia, these tests had to be met on both an ‘inside Australia’ and a global basis. Branches of foreign insurers were required to meet the tests as they applied to their Australian business.

Until 1998 the prudential regulator was the Insurance and Superannuation Commission, whose responsibilities included the licensing and supervision of general insurers. The Insurance Act provided the ISC with various licensing and investigative powers, along with the ability, in certain circumstances, to give insurers directions in defined areas of their operations. The ISC was also responsible for advising government on prudential and other matters related to the insurance sector, such as disclosure standards and market conduct. It was also responsible for handling consumer complaints and for the licensing of insurance agents and brokers.

In 1998, in response to the report of the Financial System Inquiry—the Wallis report—the Commonwealth established the Australian Prudential Regulation Authority to be the sole body responsible for the prudential regulation of entities providing deposit-taking, general insurance, life insurance and superannuation services in Australia. APRA began operations on 1 July 1998 and took over the prudential supervisory roles previously handled by the Reserve Bank of Australia and the ISC. In late 1998, APRA’s head office was established in Sydney. Responsibility for state- and territory-regulated deposit-taking institutions (such as building societies and credit unions) was transferred to APRA on 1 July 1999.

APRA was established by the *Australian Prudential Regulation Authority Act 1998* as an independent statutory authority with a governing board. It is responsible for the prudential regulation of financial institutions and for developing policy to be applied in performing that role. The Act requires APRA to balance the objectives of promoting financial safety and efficiency, competition, contestability and competitive neutrality.

4.3.1 Changes to the regulatory regime

A review carried out by the ISC in 1995 (and carried forward by APRA and the Commonwealth government) led to the passage on 19 September 2001 of the General Insurance Reform Act, which brought marked changes to the prudential regulatory regime applying to general insurers. The new regime came into effect on 1 July 2002. Among the more important changes were the following:

- an increase from \$2 million to \$5 million in the minimum capital requirement for general insurers
- the introduction of risk-weighted capital solvency requirements such that high-risk activities would need to be supported by more capital
- the imposition of a conservative insurance liability valuation standard, including the requirement for a prudential margin. Previously, general insurers followed accounting standard AASB 1023 and provisioning practices varied
- a requirement that the board of each insurer approve an appropriate, formal reinsurance-management strategy. The previous requirement for formal approval of reinsurance arrangements by the regulator was dropped
- a general tightening of corporate governance and other management requirements—such as the requirement for insurers to adopt formal risk and other management strategies and more stringent ‘fit and proper person’ tests for directors, senior managers, auditors and actuaries
- for auditors and actuaries, the imposition of greater controls and requirements.

4.3.2 The Corporations Law

A national system of law and regulation for corporations and the securities market was introduced by the Commonwealth, with effect from 1991; it replaced the previous cooperative Commonwealth–state scheme and arrangements. The new Corporations Law regulated the operation and market conduct of corporate entities, and the Australian Securities Commission was established with regulatory powers.

The Corporations Law—now the *Corporations Act 2001*—underwent a number of amendments during the 1990s, as a result of various review processes. Following the Wallis report, the corporate regulator, the Australian Securities Commission, became the Australian Securities and Investments Commission as from 1 July 1998 and was given additional responsibility for the consumer protection–related functions of the ISC and the Australian Payments System Council (a non-statutory body responsible for advising the Treasurer on the development of the payments system).

ASIC is an independent statutory agency headed by an executive commission of up to eight members, although it normally operates with three members. It is required under its legislation to monitor and promote market integrity and consumer protection across the financial system. It is also responsible for the registration of auditors and liquidators and the regulation of financial services organisations and professionals who deal in and provide advice on investments, superannuation, insurance, and deposit-taking and credit services.

4.3.3 The Australian Stock Exchange

The Australian Stock Exchange supervises companies (including private general insurers) that are listed on the exchange. Listed companies are required to comply with the ASX Listing Rules, which have statutory authority. The ASX has a particular focus on the disclosure practices of listed entities, including through the continuous disclosure regime. These arrangements are designed to ensure that the market is well informed and efficient. The ASX does not have a role in policing statutory financial reporting or accounting standards.

4.3.4 Accounting and auditing standards

The Corporations Act lays down financial reporting requirements for companies; one such requirement concerns compliance with relevant accounting standards in the preparation of financial statements. The purpose of the accounting standards is to ensure that companies report financial information that is accurate, reliable and comparable (both between companies and over time) so that, among other things, people and organisations can assess the performance and financial position of the reporting entity. Responsibility for the development and promulgation of accounting standards lies with the Australian Accounting Standards Board.

The Corporations Act stipulates that companies must keep financial records that allow true and fair financial statements to be prepared and audited. The financial statements must comply with accounting standards and give a true and fair view of the financial position and performance of the entity.

The Act also imposes on most companies a requirement to have their financial statements audited by a registered auditor. This process involves the examination of records or financial accounts—to determine their accuracy and whether they comply with relevant standards and give a true and fair view of the financial position of the company. Auditing standards are set by the Auditing and Assurance Standards Board, which is supported by the Australian Accounting Research Foundation, a private sector body established in 1996 by CPA Australia and the Institute of Chartered Accountants in Australia. Unlike the accounting standards, auditing standards do not have the force of law.

4.3.5 Actuarial standards

In almost all cases the primary liability of a general insurer is its outstanding claims provision. Broadly speaking, this provision is an estimate of the cost of the outstanding claims that an insurer is liable to meet under existing contracts. The accuracy or otherwise of the estimate can have a significant effect on an insurer's reported profit; it is also important for use in pricing and designing insurance products.

Before 1 July 2002 general insurers were not required to use an actuary to estimate the outstanding claims provision, although it was becoming a common practice. From that date, however, using the services of an approved actuary has been mandatory, unless an insurer is granted an exemption by APRA.

Under APRA's prudential standards, the approved actuary is generally expected to be a member of the Institute of Actuaries Australia (a private professional body of actuaries) or a similar professional body. The standards also impose a professional responsibility on the approved actuary to provide advice that complies with the institute's professional standards. The institute has issued professional standard PS 300 'Actuarial reports and advice on general insurance technical liabilities', which its members are expected to meet in calculating the outstanding claims provision and other technical liabilities of an insurer.

4.3.6 State and territory regulation

In addition to Commonwealth legislation, all state and territory governments operate statutory insurance arrangements—for example, requiring relevant people and organisations to take out compulsory third party motor vehicle insurance, builders warranty insurance, and workers compensation. Insurance is provided under these schemes through a mix of state-owned and -operated insurers and private general insurers.

In some cases where insurance is provided through a private general insurer, a state or territory government will maintain some form of prudential regulation to provide its own assurance that the insurer remains able to meet its obligations to its statutory policyholders. This regulation is additional to APRA's supervision. Further, where private general insurers provide statutory insurance, state and territory government bodies usually regulate or license those insurers in relation to contract conditions, coverage, reporting and pricing.

Chapter 8 of this report discusses the regulation of general insurance in terms of future policy directions. Chapter 24 discusses the role of the regulators in connection with the failure of HIH.