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Policy Recommendations

In Part Three I deal with important matters affecting the regulation and prudential supervision of the general insurance industry. I have made recommendations that have implications for business activity and for the community generally. What follows is a list of the recommendations.

Corporate governance

- 1 I recommend that the disclosure and other requirements of the *Corporations Act 2001*, the relevant accounting standards and the Australian Stock Exchange Listing Rules that relate to directors' remuneration be reviewed as a matter of priority, to ensure that together they achieve clear and comprehensive disclosure of all remuneration or other benefits paid to directors in whatever form.
- 2 I recommend that the *Corporations Act 2001* be amended to repeal the existing legislative provisions relating to the definition of the extended classes of personnel upon whom duties are imposed by the Act and to substitute instead a definition that is clear, simple and certain of application.

The definition would focus on the function performed by the relevant person—not the classification of their legal relationship to the corporate entity—and avoid expressions such as 'employee' in favour of a functional orientation.

The definition would then form the basis of a regime having the following features:

- All the general duties imposed by Chapter 2D of the Corporations Act should be imposed on directors, secretaries and the wider class of personnel encompassed within the functional definition.
- The duties imposed by ss. 182(1), 183(1) and 184(2) of the Act should be imposed on all persons performing functions for and on behalf of corporations, whether employees or suppliers of services under contract.
- The liabilities created by s. 1309 of the Act should be imposed on all persons and not be restricted to a limited class of management personnel.
- The classes of personnel prohibited from acting dishonestly in connection with the performance or satisfaction of any obligation imposed on the company by any written law should be extended.

Financial reporting and assurance

- 3 I recommend that the Commonwealth Government broaden the membership of the Australian Accounting Standards Board to include people with business or professional backgrounds beyond the accounting profession.
- 4 I recommend that Australia participate fully in the development of international accounting standards and pursue the adoption of high-quality, consistent and readily understood accounting standards.

- 5 I recommend that, in adopting international standards, Australia reserve the right to require more stringent standards that are not inconsistent with the relevant international standards. These would generally relate to disclosure requirements.
- 6 I recommend that the Australian Accounting Standards Board alter the Urgent Issues Group or create a separate group that is able promptly to issue binding rulings on important and urgent matters concerning the interpretation and application of the accounting standards.

The board should extend the constitution of the Urgent Issues Group or the separate group beyond accounting professionals and include lawyers and users of financial statements.

- 7 I recommend that the professional accounting bodies develop guidelines to encourage their members to consult independent third parties or the Urgent Issues Group when there is disagreement with the management of companies concerning the interpretation or application of accounting standards.
- 8 I recommend that the Australian Accounting Standards Board amend accounting standard AASB 1023 to include the following:
 - a definition of insurance that includes the requirement for a material transfer of insurance risk
 - a requirement that insurance liabilities be valued at a level of sufficiency of at least 75 per cent, as required by APRA's prudential standards. Companies should be explicitly permitted to set prudential margins in excess of 75 per cent if the company's board considers that appropriately reflects a true and fair view of the financial position of the insurer
 - a requirement that entities disclose in their financial statements
 - the valuation of their insurance liabilities at a central estimate
 - a 75 per cent level of sufficiency
 - the margin ultimately adopted by the entity
 - a requirement that premium revenue and insurance liabilities be recognised on the commencement of a contract of insurance. This will require the recognition of premium liabilities
 - a requirement that, in estimating the present value of liabilities, future cash flows be discounted using a risk-free rate similar to that required by the prudential standards
 - a requirement that companies subject to the standard disclose a 10-year claims-development table that includes past estimates of claims on an undiscounted basis as well as the actual costs of settling claims. This information should be provided both net and gross of reinsurance.

9 I recommend that all standards of independence of auditors in Australia, including those contained in legislation and professional standards such as Professional Statement F1, be consistent with the standard of independence defined as follows:

- An auditor is not independent with respect to an audit client if the auditor might be impaired—or a reasonable person with full knowledge of all relevant facts and circumstances might apprehend that the auditor might be impaired—in the auditor’s exercise of objective and impartial judgment on all matters arising out of the auditor’s engagement.
- A reference to an auditor includes both an individual auditor and an audit firm. In determining whether an auditor or an audit firm is independent, all relevant circumstances should be considered, including all pre-existing relationships between the auditor, the audit firm and the audit client, including its management and directors.

10 I recommend that the *Corporations Act 2001* should be amended to require the board to provide a statement in the annual report that identifies all non-audit services provided by the audit firm and the fees applicable to each item of work and explains why those non-audit services do not compromise audit independence.

11 I recommend that, in implementing the CLERP 9 proposal for restrictions on employment relationships between an auditor and the audit client, the amendments provide for the following:

- a mandatory period of four years following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a senior management position with the client. This restriction should be extended to include key senior audit personnel
- an extension of the restriction to a former partner who was not directly involved in the audit of a client. In my opinion, the current proposed period of two years would be appropriate for such a partner
- a prohibition on any more than one former partner of an audit firm, at any time, being a director of or taking a senior management position with the client

These restrictions should be enforceable against both the audit firm and the relevant former partner or senior audit team member.

12 I recommend that, in implementing the CLERP 9 proposal for rotation of audit personnel, the requirement for rotation of the lead engagement partner and review partner be extended to key senior audit personnel.

13 I recommend that the *Corporations Act 2001* be amended to require the disclosure in audit reports of the following:

- the impact of the position taken by the reporting entity where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material
- the significant matters arising in the audit process.

The Corporations Act should be amended to require audit reports to be presented in plain English and to require the inclusion of an operating and financial review as part of an annual report, which would be the subject of audit.

- 14 I recommend that the *Corporations Act 2001* be amended to require public listed companies to include a brief, plain English summary of the nature and scope of the audit services provided by their auditor each year.
- 15 I recommend that both the Australian Prudential Regulation Authority and the Institute of Actuaries of Australia introduce compulsory certification of the completeness and accuracy of data.
- 16 I recommend that the Institute of Actuaries of Australia and the Australian Prudential Regulation Authority introduce a requirement for more detailed disclosure of the exercise, incidence and impact of subjective judgment and departure from historical experience.
- 17 I recommend that the Australian Prudential Regulation Authority extend the qualifications of the approved actuary to require that they not be an employee or partner of the organisation to which the approved auditor belongs.

Regulation of general insurance

- 18 I recommend that the *Australian Prudential Regulation Authority Act 1998* be amended to replace APRA's non-executive board with an executive group. This group would comprise the chief executive officer and two or three executive commissioners and would carry the responsibility, and account to government, for the operation and performance of APRA.
- 19 I recommend that the *Australian Prudential Regulation Authority Act 1998* be amended to provide the chief executive with the power to establish an advisory board.
- 20 I recommend that the direct involvement of representatives of the Australian Securities and Investments Commission and the Reserve Bank of Australia in the governance of the Australian Prudential Regulation Authority be discontinued. This will require amendment of the *Australian Prudential Regulation Authority Act 1998*.
- 21 I recommend that the Australian Prudential Regulation Authority chief executive instigate, as a matter of urgency, a review of APRA's organisational structure. The object of the review should be to achieve a workable and effective balance between accountability for and knowledge of particular financial services on one hand and cross-sectoral functional skills and perspective on the other. In particular, the review should consider the creation of a specialist team to take primary responsibility for the supervision of general insurers.

The review should report to APRA's board with recommendations on APRA's appropriate internal structure, given its responsibilities across the deposit-taking, insurance and superannuation sectors. The board should publicly respond to its recommendations.

- 22 I recommend that the Commonwealth Government consider removing the requirement for the Treasurer's agreement to operational decisions involving APRA's prudential oversight of general insurers.

- 23 I recommend that, given the inconsistencies between the *Insurance Act 1973* and the *Banking Act 1959*, the Commonwealth Government review the current legislative provisions for merit review of APRA's decisions for the purposes of ensuring consistency.
- 24 I recommend that the Australian Prudential Regulation Authority implement a programme to build the skills of staff involved in the supervision of general insurers. This should involve a review of its human resource management policies to assess APRA's competitiveness in the financial services sector labour market. The review should take account of the adequacy of remuneration, training and career structures as well as other steps to increase APRA's attractiveness as an employer.
- 25 I recommend that the Commonwealth Government adopt a three-year rolling funding arrangement to set the Australian Prudential Regulation Authority's budget.
- 26 I recommend that the Australian Prudential Regulation Authority develop a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision of general insurers. Consultation, inquiry and constructive dialogue should be balanced by firmness in its requirements and a preparedness to enforce compliance with applicable standards. In particular, APRA should take a firm approach to ensuring regulated entities' timely compliance in the lodging of returns and the provision of information.
- 27 I recommend that the Australian Prudential Regulation Authority continue to develop and review processes, guidelines and training to assist its staff in considering the appropriate approach to take towards supervised entities in different situations.
- 28 I recommend that the Australian Prudential Regulation Authority develop systems to encourage its staff and management continually to question their assumptions, views and conclusions about the financial viability of supervised entities, particularly on the receipt of new information about an entity.
- 29 I recommend that the Australian Prudential Regulation Authority develop an internal system for tracking all relevant information concerning regulated entities.
- 30 I recommend that the Australian Prudential Regulation Authority develop mechanisms for investigating the reinsurance arrangements of authorised general insurers on a random but frequent basis.
- 31 I recommend that the effectiveness of the current memorandum of understanding between the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission be reviewed.

The processes for liaison, coordination and exchange of information between APRA and ASIC should be reviewed on a regular basis. To facilitate the exchange of information, the Commonwealth Government should make a regulation specifying ASIC for the purposes of s. 56(5)(a) the *Australian Prudential Regulation Authority Act 1998*.

- 32 I recommend that matters relating to the coordination of Commonwealth regulation affecting the insurance industry be the province of the Commonwealth Treasury.

- 33 I recommend that coordination of the matters related to the regulation of the insurance industry be addressed through the proposed ministerial council.
- 34 I recommend that authorised insurers be required to make greater disclosure of information about their financial position. In particular, all financial and statistical information general insurers currently provide to the Australian Prudential Regulation Authority in their regular returns should be made public.
- 35 I recommend that information that enables external users to make an informed assessment of an insurer's outstanding claims provisions and reinsurance arrangements be published by the insurer or the Australian Prudential Regulation Authority. APRA should develop reporting returns for insurers that would enable this to occur if existing returns are insufficient.

In particular, general insurers should publish:

- material equivalent to the 'schedule P' loss-development data published in the United States
 - a summary of the approved actuary's valuation of the outstanding claims liabilities, including the methodologies and assumptions underlying that valuation.
- 36 I recommend that insurers be required to make greater disclosure of qualitative information relating to their risk- and reinsurance-management strategies. Other qualitative information—where the prospect of disclosure may affect the quality of information provided to companies—need not be disclosed.
- 37 I recommend that the Australian Prudential Regulation Authority identify and make known the kinds of regulatory activities that in its view should be disclosed publicly (whether or not the insurer in question is a listed company) and should specify the process by which such disclosure should occur.
- 38 I recommend that, as a matter of high priority, the Australian Prudential Regulation Authority develop and promulgate a standard for the effective regulation of authorised insurers that operate as part of a corporate group.

The proposed prudential standard on corporate groups should include a minimum capital requirement at the group level as well as the authorised entity level.

- 39 I recommend that the Australian Prudential Regulation Authority monitor the financial condition of corporate groups, including those with foreign operations. Pending the development of the proposed prudential standard on supervision of corporate groups, APRA should use existing powers to require groups to provide any information it considers necessary to perform this role.
- 40 I recommend that the Australian Prudential Regulation Authority take steps to ensure that it effectively exchanges with relevant foreign regulators information and intelligence on the operations of Australian insurers with international operations.
- 41 I recommend that the Australian Prudential Regulation Authority modify the prudential standards to require the annual production by an authorised general insurer's approved actuary of a report on the overall financial condition of the insurer.

- 42 I recommend that the Commonwealth Government amend the *Insurance Act 1973* to extend prudential regulation to all discretionary insurance-like products—to the extent that it is possible to do so within constitutional limits.
- 43 I recommend that s. 462(3) of the *Corporations Act 2001* be amended so that the Australian Prudential Regulation Authority may apply to wind up a company that is an authorised insurer if any of the criteria specified in s. 52(1)(aa), (ab) or (a) of the *Insurance Act 1973* are met.
- 44 I recommend that s. 461 of the *Corporations Act 2001* be amended to specify that the interests of policyholders are interests to which the court should have regard in deciding whether to make a winding-up order.
- 45 I recommend that the Australian Stock Exchange amend Listing Rule 3.1 to require—or publish a guidance note making it clear—that price-sensitive announcements have the approval of either the board or a delegate of the board subject to ratification by the board.
- 46 I recommend that the Australian Stock Exchange amend the Listing Rules to prohibit ‘blacklisting’—defined as exclusion of a person or organisation from briefings by a company or a pattern of such exclusion in the face of negative reports on the company by those analysts over a specific period.
- 47 I recommend that the Australian Stock Exchange clarify Listing Rule 11.1, so that it applies to any significant change in the business or assets of a listed company, whether it be by acquisition, disposal, amalgamation or otherwise. I further recommend that the ASX amend the Listing Rules to define ‘significant change’, so that it encompasses financial and geographic factors as well as the nature and scale of the company’s business.
- 48 I recommend that the Australian Stock Exchange amend Listing Rule 11.2, so that it applies to any disposal of the whole or substantially the whole of the assets or operations of a listed company.

State and territory regulation

- 49 I recommend that the states and territories not undertake any prudential regulation of general insurance. The Australian Prudential Regulation Authority should be the sole prudential regulator in this field.

If such regulation is to continue, state and territory governments should ensure that it is consistent with the requirements of the *Insurance Act 1973*. This is a matter that might properly be referred to the proposed ministerial council.

- 50 I recommend that, to the extent that states and territories continue to involve themselves in prudential regulation, the Australian Prudential Regulation Authority should share all information relating to the prudential regulation of relevant general insurers with relevant state and territory bodies.

The states and territories should provide APRA with all relevant information that may concern the financial condition of relevant general insurers. This exchange of information should proceed through memorandums of understanding between APRA and each relevant state and territory body.

APRA and the state and territory instrumentalities should review applicable secrecy provisions and where necessary seek legislative action to ensure they do not inhibit the free flow of information between APRA and the instrumentalities relevant to the prudential regulation of general insurers.

- 51 I recommend that the states and territories implement a process designed to reduce inconsistencies in their statutory schemes. This is a task that would appropriately be overseen by the proposed ministerial council.
- 52 I recommend that state and territory governments apply relevant prudential requirements to government insurers and statutory fund schemes. This is a matter that would appropriately be overseen by the proposed ministerial council.
- 53 I recommend that the states and territories consider allowing greater price flexibility in their statutory schemes. This is a matter that would be appropriate for consideration by the proposed ministerial council.
- 54 I recommend that the Commonwealth Government move to identify or establish a ministerial council or like arrangement to provide a ready and regular forum for the discussion and resolution by the Commonwealth and the states and territories of matters relevant to general insurance—and perhaps to other financial services.

The ministerial council (or other similar body) should consider measures to:

- avoid duplication in the prudential regulation of general insurers
- remove regulatory inconsistencies
- achieve a consistent approach to the prudent management of state and territory monopolies.

It could also play a part in:

- moves to introduce greater price flexibility in statutory schemes
- the introduction of a policyholder support scheme
- the removal of anomalies in the taxation arrangements applicable to general insurers.

Taxation and general insurance

- 55 I recommend that state and territory governments abolish stamp duty on general insurance products. It would be appropriate for this process to be coordinated through the proposed ministerial council with responsibility for general insurance.
- 56 I recommend that those states that have not already done so abolish fire services levies on insurers.

- 57 I recommend that state and territory governments exclude the cost of the GST for the purposes of calculating stamp duties or any other state or territory levies that are imposed on insurance premiums.
- 58 I recommend that governments avoid imposing on insurers levies and other taxes that cannot be passed on to policyholders.
- 59 I recommend that the Commonwealth Government review the current requirements of the *Income Tax Assessment Act 1936* with a view to changing the Act to bring it into alignment with the modified accounting standards I propose.
- 60 I recommend that the Commonwealth Government amend the income tax regime to encourage the creation and use of catastrophe reserves. Contributions to catastrophe reserves would be tax deductible. Releases from the reserve would be assessable for tax.

A policyholder support scheme

- 61 I recommend that the Commonwealth Government introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company.

[1] Other examples are Reliance Insurance Company in the United States, Markham General Insurance Company in Canada, and Chester Street Insurance Holdings Ltd in the United Kingdom.

[2] This is a comment by Don Argus, as reported in *The Weekend Australian*, 5–6 October 2002.