CORPORATE GOVERNANCE OF INSURERS IN AUSTRALIA

December 2002

Note by the Australian Delegation
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Corporate governance for insurers relies on the general framework that is in place for corporations, overlaid with specific requirements for insurers that reflect obligations to policyholders.

This paper outlines both the general framework and the additional requirements placed on insurance companies.

The Australian corporate governance model

Corporate governance structures in Australia are based on the ‘shareholder approach’ or ‘outsider model’ of corporate control where the achievement of corporate goals and profit maximisation is monitored by the owners of the corporation, its shareholders, to whom corporate management is accountable.\(^1\) Whatever model is used, the central issue for large widely-held companies is to align the interests of those who control the company with the interests of those who own it.

Recognising the important role played by the corporate entity in entrepreneurial, business and investment activity, successive governments in Australia have sought to achieve a balance between effectively regulating (in order to protect the integrity of the financial system) and not hindering the development of an efficient and competitive business environment. An appropriate balance will ensure that efficient mechanisms are established to promote good governance without placing excessive burdens on business.

Australia’s corporate governance framework

Australia’s corporate governance framework consists of a matrix of legislation, accounting standards (which have the force of law), ASX Listing Rules and voluntary self-regulatory codes of practice.

The Corporations Act seeks to ensure that companies adopt best practice corporate governance principles through the establishment of minimum standards for corporate governance.

Unless there is a need to address a particular policy objective or market failure, the Corporations Act does not prescribe detailed governance practices that companies must adopt. Instead, it sets out minimum standards and companies are free to establish higher standards of corporate governance by specifying them in the company’s constitution. The promotion of increased investor and stakeholder awareness of what constitutes good governance practices is based on the rationale that the adoption of higher standards produces tangible benefits. Increased shareholder participation in the market will continue the drive by companies towards adopting best practice governance standards.

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\(^1\) This model applies in common law countries such as England, New Zealand and (generally) the US and Canada. In civil law countries such as France and Germany, the ‘insider model’ applies where, governance structures reflect a model of corporate control that seeks to align the various interests of multiple stakeholders: workers, managers, creditors, suppliers, customers and other members of the community.
The Australian Securities and Investments Commission (ASIC) oversees this matrix of regulation. It has wide ranging information gathering and enforcement powers. Enforcement of the Corporations Act may also be undertaken by private action.

**The elements of corporate governance**

Accountable management and transparent financial information are fundamental tenets of the Australian corporate governance framework.

**Accountability**

In the area of accountability, there are certain minimum obligations and responsibilities directors must fulfil. These are the duty to:

- act in good faith;
- act in the best interests of the company;
- exercise their powers with appropriate care and diligence that is reasonable in all circumstances;
- not make inappropriate use of inside information;
- not misuse their position for their own or a third party’s possible advantage (or to the possible detriment of the company);
- avoid inappropriate related party transactions; and
- avoid insolvent trading.

**Transparency and Disclosure**

Accurate and prompt information is basic to the operation of an efficient market. Accordingly, a theme of amendments to Australian corporate law in recent years has been the improvement of disclosure of relevant matters, rather than directly adjusting the substantive rights of the various parties.

The disclosure philosophy underlying much of the corporate law reform has come about in response to evidence from various corporate failures that the lack of transparency of corporate information had permitted the directors and managers of certain companies to abuse their position and to divert company assets either to themselves or to other companies. The same themes have recurred with succeeding incidents of corporate fraud and collapse.
Among the areas concerning disclosure covered by the Corporations Act are:

- the formulation of Australian accounting standards to ensure consistent accounting treatment;
- prompt and continuous disclosure of events that may affect the share price;
- information about shareholdings and beneficial ownership of shares;
- shareholders’ entitlement to information about the purpose and timing of general meetings;
- shareholders’ entitlement to ask about or comment on the company’s management;
- the provision of information to shareholders in relation to related party transactions;
- notification to ASIC of information relating to directors and company officers including CEOs and company secretaries;
- the maintenance by companies of registers of members, option holders and debenture holders; and
- directors’ remuneration and the number of meetings directors have attended.

**Specific Requirements for the Internal Governance of Insurers**

As outlined above, Australian corporate governance standards are based on the ‘shareholder’ approach; however, in the case of an insurer, consideration must also be given to the rights and expectations of policyholders.

The legislation under which insurers are prudentially regulated in Australia, the *Insurance Act 1973*, was substantially amended in 2001, with new prudential requirements applying from 1 July 2002. The amending legislation had, as one of its stated objectives, to make clear that the purpose of the Insurance Act is to protect policyholders and other beneficiaries of general insurance policies.

Changes to the prudential regime had been discussed for a number of years, but they gained a new sense of urgency following the collapse of Australia’s largest insurer, HIH, in March 2001. The demise of HIH is currently the subject of a Royal Commission that will report in February 2003, so it is not possible to discuss the possible causes at this stage. However, it can be noted that there has been fairly comprehensive discussion of the previous legislation at the Royal Commission.

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3 This includes the Australian Accounting Standard board’s accounting standard AASB 1023 ‘Financial Reporting of General Insurance Activities’ issued in 1996. This standard is expected to be updated for the International Accounting Standards Board’s new insurance contracts standard to be introduced in 2004.

4 For transcripts of evidence see www.hihroyalcom.gov.au
As a result of the amendments to the Insurance Act, a new Part introduced into the Act gives the regulator, the Australian Prudential Regulation Authority (APRA), the power to make and enforce prudential standards. These standards provide the technical requirements that insurers are required to meet. Although APRA makes the Standards, they are ‘disallowable instruments’, which means they are subject to Parliamentary scrutiny. Underlying the Standards are Guidance Notes which essentially set out how the Prudential Standards apply in practice.

Included in the Standards is a Risk Management Standard. The purpose of this Standard is to ensure that an insurer is well managed, has access to appropriate and independent expertise and has systems for identifying, managing and monitoring risks associated with its business activities.

The internal governance structure of an insurer is critical to ensuring that the interests of policyholders are protected. For the internal governance structure to be effective, the Board, senior management and appointed experts of an insurer must have the probity and competence necessary to develop, monitor and review sound systems for managing risk. 5

In relation to governance, the Risk Management Standard covers such items as:

- Fitness and Propriety, which includes a ‘fit and proper’ persons test for the Board and Senior Management;
- The eligibility criteria for Approved Auditors and Actuaries, which require a minimum period of experience, formal qualifications and membership of a suitable professional body;
- Roles and Obligations of Key Positions
  - Boards
  - Senior Management
  - Senior Officer from Outside Australia (for foreign insurers)
  - Approved auditor
  - Approved actuary
- Non-routine reporting by Approved Auditors and Approved Actuaries, and
- Meetings with Approved Auditors and Approved Actuaries (tripartite liaison involving the insurer and the Regulator).

The roles of actuaries and auditors are clearly specified in the Act and are directly related to the requirements of the Prudential Standards.

As part of the transition to the new regime, all authorised insurers that wished to continue operating in Australia were required to be reauthorised under the new rules. In effect, this meant that all insurers were required to meet the new standards of corporate governance by 1 July 2002, irrespective of their past history. (The only provision that was phased-in was the increased capital requirement.)

5 APRA Guidance Note GGN 220.1
The new regime has only operated since 1 July this year, so it is too early to gauge the on-going effects. But the Government and APRA will monitor the operation of the new regime to determine whether further changes are necessary. In addition, there is the possibility that the HIH Royal Commission will recommend further changes that it will be necessary for the government to consider.

**Corporations Law Economic Reform Program**

The Australian Government embarked on a Corporations Law Economic Reform Program (CLERP) in 1997. The purpose of (CLERP) is ‘to review key areas of regulation affecting business and investment activity to ensure that business regulation is consistent with the Government’s wider objectives of promoting a strong and vibrant economy.’\(^6\) This Program has been on-going for several years.

**Auditor Independence**

One of the major current issues in corporate governance is the question of auditor independence.

In July 2001, Professor Ian Ramsay of the University of Melbourne was commissioned by the Government to review auditor independence in Australia. His report, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform*, was released in October 2001.

Key recommendations of the report include that:

- provisions of the Corporations Act restricting employment and financial relationships between an auditor and its client be enhanced, and professional ethical rules restricting business relationships updated;

- professional ethical rules be revised and updated to reflect International Federation of Accountants (IFAC) rules on the provision of non-audit services;

- accounting standards (or if necessary the Corporations Act) be amended to mandate disclosure of non-audit services and fees;

- audit committees be mandated for listed companies under ASX Listing Rules (or if necessary the Corporations Act). The audit committee should recommend appointment and remuneration of the auditor and monitor the auditor’s independence and effectiveness;

- there be mandatory rotation of audit partners; and

- an Auditor Independence Supervisory Board be established to monitor and advise the Government and professional accounting bodies on international developments in auditor independence, monitor audit firms’ processes, and monitor compliance with non-audit service fee disclosure.

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\(^6\) Corporate Law Economic Reform Program Policy Framework (Canberra, Treasury 1996) P.1
Future Directions

The Government has released a policy proposal paper (CLERP 9) for discussion, which includes a response to Professor Ramsay’s recommendations, with the intention of introducing legislation into Parliament in 2003. This timetable will allow any relevant findings from the HIH Royal Commission to be taken into account.

Conclusion

The system of corporate governance in Australia is continually developing in response to the various influences and pressures exerted by the various players in international and domestic markets.

While the responses to the issues in corporate governance will vary, two themes that recur through the changes to the corporate framework are the requirements of transparency and accountability. The ongoing CLERP reforms have sought to improve these aspects and to maintain the Australian framework in accordance with international best practice principles.

Corporate governance is an interactive process between mandatory legal requirements and rights, the enforcement and other activities of the regulatory bodies, and the adoption of international and national best practice standards. The most recent legislative changes are as yet untested, and it remains to be seen whether the legal aspect, or any other aspect of the framework will require modification in light of recent collapses.

The Commonwealth will actively examine any findings of the HIH Royal Commission regarding the Australian corporate governance framework.

Note: This paper draws heavily on the submission by the Commonwealth of Australia to the HIH Royal Commission, October 2002. The complete paper is available from the Commonwealth Treasury at www.treasury.gov.au.