

International Symposium

Enhancing

Life Insurance Regulatory Regimes in **ASIA**

**EMERGING GLOBAL AND REGIONAL FACTORS - IMPLICATIONS FOR
REGULATION**

AN AUSTRALIAN PERSPECTIVE

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Symposium Organisers
Australian APEC Study
Centre

**The Australian
APEC
Study Centre**

November 16-18 1999
Windsor Hotel
Melbourne



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Wednesday, 17 November 1999

1. Introduction

Good morning and welcome to my regulatory colleagues. I hope your visit to Australia is both fruitful and enjoyable.

I would like to talk, first, about some of the key “drivers for change” in regulation of life insurance. Then I will say a few words about the Australian Prudential Regulation Authority – APRA - and our general approach to supervising life insurance in Australia.

I should emphasise that I will be talking mainly about prudential regulation. Regulation of market conduct and disclosure to customers in Australia falls to the Australian Securities and Investments Commission, and Alan Cameron will be talking about that in his presentation to follow.

2. Change drivers

Three important factors driving change are:

- Regulation is becoming more international;
- Traditional boundaries are becoming blurred; and
- Aggregation and rationalisation in the insurance industry.

- *Internationalisation of regulation*

For many years now, banking sector supervision has operated in an international environment. This has reflected the greater significance of international banking operations, the potential for international contagion through the payments system and the status of the Basel Committee on Banking Supervision.

Pressures for a similarly international approach to insurance regulation are now emerging.

First, the International Association of Insurance Supervisors (IAIS) has moved quickly from early informal structures to being a substantially more active organisation with a strong interest in promoting improved standards in insurance supervision.

This development is something that we, in Australia, have supported through our own membership and active involvement. We recognise that the IAIS has limited resources, but it is able to marshal significant expertise and much enthusiasm.

Second, in the wake of recent financial disturbances, we are seeing various international Groups and agencies focus more on international financial stability and best practice standards in prudential regulation. Their interest is extending now beyond banking to insurance and reinsurance. While non-life lines of business have no doubt excited some of this attention, it encompasses all insurance sectors. The international agencies are concerned with both raising the standard of prudential regulation and with promoting transparency in the marketplace about the condition of insurers. Their ultimate interest is in the contribution that these can make to the overall health of financial systems.

This increased focus on insurance is adding momentum to the work already begun by the IAIS and others.

Third, there is the development of international accounting standards by the International Accounting Standards Committee. While progress with these is clearly going to be measured rather than speedy, the forces for reform are powerful. And it is significant that this impetus for international accounting standards goes hand in hand with that attention being given in other quarters to greater transparency.

These various forces are all pushing toward a more consistent and improved regulation of insurance around the world. A clear implication is the need for national supervisors to take close account of this international environment in designing their own policies, standards and procedures.

- ***Blurring of traditional boundaries***

Internationally and domestically, we see ongoing “convergence” in the financial sector.

This does not yet mean that an insurance company’s balance sheet is indistinguishable from a bank’s – far from it.

But previously quite sharp distinctions are being eroded by changes in institutional structures, shifting legal barriers and product innovation. Most of the large retail banks in Australia now operate a funds management business that includes licensed life insurance and retirement savings subsidiaries. Some of the big insurers now offer deposit-taking and payment services either through subsidiaries or in conjunction with established banks.

These conglomerate arrangements raise questions for supervisors about regulatory arbitrage, group-wide risk management, double-gearing of capital and cross-selling of products.

At the same time we have seen changes in product mix within insurance companies. Most companies still have significant books of traditional whole-of-life and endowment business in force, but the main focus of new business is on investment products, extensively provided via retirement plans, often without any investment guarantees. In Australia, 80 per cent of the liabilities of the life insurance sector is now superannuation related and 60 per cent of liabilities is investment linked. Investment account, annuities and risk insurance remain as the main forms of more capital-intensive business.

(One interesting consequence of these changes is a gradual lessening in the extent of guaranteed products provided by life companies and a corresponding reduction in the overall capital required to support these.)

Such a product mix is increasingly comparable for consumers with that of providers outside the life industry. Short-term annuities compete with the term deposits of banks while unit-linked savings and investment contracts compete with mutual funds.

These trends will create pressure for supervisors to adopt similar regulatory approaches across industry boundaries – in the interests of efficiency and reducing scope for regulatory arbitrage.

Whilst it is early days for APRA’s work in this area, we have adopted the broad objective of harmonising regulatory requirements across different institutions that provide like products. In other words, “similar regulation for similar risks”.

- *Aggregation and rationalisation in the insurance industry*

A third change driver is industry rationalisation.

In Australia we have seen a good deal of aggregation over the past couple of years in the life insurance sector. This development had been long predicted, but only recently has much of it come to pass. In the past year the number of licensed life insurers has fallen from 50 to 44, and there are a couple of other business transfer processes nearing completion.

Technology costs and globalisation will push trend this further.

Bigger organisations present particular challenges - and opportunities - for prudential regulators. In some ways, they are more difficult to supervise because they tend to be more complex and diverse.

On the other hand, with greater institutional size and sophistication come more resources for risk measurement and management. And, usually, more capable and professional managers. The internal capacities of large organisations tend to be more advanced and rigorous as their business operations and aspirations expand.

It then becomes possible, in principle, for the regulator to place more reliance on the internal risk management systems of financial institutions as an aid and support to prudential supervision. Such systems, if well designed, are likely to be better tailored to the profile of risks in each company's business than any standard, "one-size-fits-all" model.

Australia's regulatory regime has always emphasised that the management and Boards of licensed insurers and banks are primarily responsible for their prudent operation. We do not regulate insurance policy terms and conditions or pricing in any detail. Instead we require a demonstration of ongoing solvency and capital adequacy, evidence of sound risk management systems and a process of clear provision of written advice to Boards on product developments.

We have been supportive of recent developments in banking supervision that recognise internal models of banks for market risk. We are proposing the same approach – endorsement and reliance on internal processes that are rigorous – in our current review of general insurance supervision, while our present reliance on the Appointed Actuary and external auditor for life insurers is also in line with this view.

Giving weight to internal risk management systems necessarily includes paying more attention to the suitability of the Boards and management of companies. It also means taking more interest than might otherwise be the case in vetting changes in control, acquisitions, and new business ventures.

3. About APRA

I will now say a little more about APRA and how we are approaching the prudential supervision of life insurance.

APRA was formed out of the Government's 1996 Financial System Inquiry. In July 1998, APRA brought together the prudential supervision functions of the Insurance and Superannuation Commission (ISC) and the bank supervision role formerly with the Reserve Bank of Australia (the central bank). In July this year, the State-based supervision of smaller regional institutions was also transferred to APRA.

The result is that we are now prudential supervisor of all financial institutions in Australia that are prudentially regulated.

Consumer protection became a responsibility of ASIC. To assist with the necessary coordination of our responsibilities, Alan Cameron as Chair of ASIC is a member of our Board.

Because we have such responsibility across the whole financial system we believe APRA is well placed to respond to some of the changes occurring in insurance and other sectors.

Commencing in August of this year we adopted a radically new organisation structure that mixed supervisory staff from different backgrounds into teams. The team orientation of the new structure is quite different to the orientation of both the RBA and ISC. Each team supervises either a small number of conglomerate groups or a larger number of stand-alone, specialist institutions from more than one industry sector.

We have organised these resources into two front-line supervisory divisions. The first, called Diversified Institutions Division, contains the teams that supervise conglomerate or complex financial groups and those with international links. The second, called Specialised Institutions Division, has the teams that supervise the stand-alone, or specialised, institutions. Life insurers fall into both categories.

Our policy development and corporate services people support these front-line supervisory teams. We have located our risk management specialists with the research and policy people, with the idea that they will support all front-line supervisors across APRA – effectively as expert consultants.

One of the motivations for this new structure was, of course, to create a more functional approach to supervision. As noted earlier, we will be aiming for consistency in the way we treat similar functions and risks across different industries. The structure has been designed to maximise cross-fertilisation of specialist ideas and practical experience and to integrate the staff from the several predecessor agencies into one new organisation. It has also been designed to improve the cost-effectiveness of supervising conglomerates, with a single contact point for each group.

It is encouraging that the sophisticated statistically-based models now being used for market and credit in banking bear a close resemblance to the models used in insurance. It seems that there is a growing recognition that risk means essentially the same thing in different industries, and can be measured in essentially the same way, regardless of where it appears in the balance sheet. It is this convergence that holds out the long-term prospect of a single supervisory framework, based on application of essentially the same methodology across different industries.

At the same time, of course, we recognise that many issues in supervision remain industry-based. So we have formed cross-divisional groups to keep on top of such matters and to ensure the consistent application of policy across the Diversified and Specialised Divisions. To a large extent we also still have 'silo' or industry-specific legislation to administer, which also constrains the scope for progress toward a generic supervision model. Even so, we are finding that we are able to make substantial progress.

Our new structure has been well received by institutions. In particular, the opportunity for APRA to view conglomerate organisations as a whole is likely to deliver more effective supervision at lower overall cost to the industry.

Australia has had an advantage in making these changes I have described. We were not responding to crisis – a situation that often leads to review and restructure of regulatory arrangements. Instead, we have been able to consider realigning our regulatory structures with an element of anticipation of change. In other words, the initiatives have been pro-active rather than reactive.

Our arrangement may not suit all regulatory agencies and it is, of course, not available where there are specialist industry regulators. In looking around the world it is hard to identify any best practice organisation structure for regulators. The paramount requirement is a regulatory system with integrity and power, and a close understanding of current developments in financial markets.

4. Conclusion

I have canvassed just a subset of the current challenges faced by regulation. These will, no doubt, continue to challenge us. And others - such as rapid growth in e-commerce and out-sourcing of key business activities - will join them.

The management of financial risk in economies is an important contributor to robust economic development. Our key challenge is always to enable this function to be carried out taking advantage of the opportunities for innovation and effective cost delivery while maintaining a sound prudential regime for the protection of the interests of the general public.

I hope that the discussions at this Symposium will help us to refine our philosophies and our methods in the interests of the policyholders, investors and the broad communities that we ultimately serve.