



Australian Prudential Regulation Authority

The Regulatory Environment – A Brief Tour

JOHN TROWBRIDGE

Executive Member
Australian Prudential Regulation Authority

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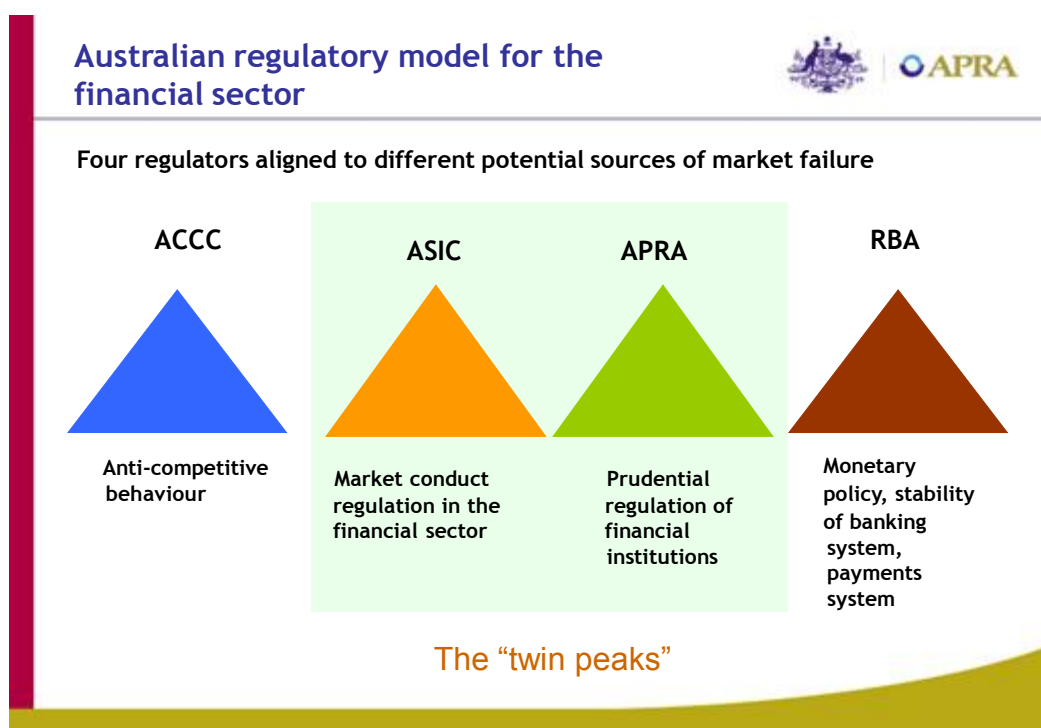
I will talk today mainly about *regulatory matters* but I also will cover briefly two other topics, namely *broker data collection* relating to UFI, and *remuneration*.

Regulatory matters

For the last year or so, we at APRA have frequently been asked two questions:

1. Why has the Australian system, and banking in particular, stood up so well?; and
2. What are you doing in response to the GFC? i.e. what extra regulation will you be imposing on financial institutions?

The regulation we are referring to here is **prudential regulation**. Many of you will be familiar with this topic but many will not. So by way of introduction, let us first note that in Australia we have four government agencies involved in the financial system, namely the ACCC, ASIC, APRA and the RBA, and we have a “twin peaks” model for the banking, insurance and superannuation industries, whereby APRA is the prudential regulator and ASIC the market conduct regulator.



This arrangement also applies in a few other countries, e.g. the Netherlands and Canada, but it is more common to see a ‘single peak’, such as in the UK or the US where these two regulators are wrapped into one. In the UK it is the FSA. In the USA it is one of a dozen or so banking regulators or one of 50 State insurance regulators.

On the question of the stability of the financial system, there are normally two players, the central bank and the prudential regulator, but during the last year or so there have been three key players in each country. The third is the government.

Usually the government doesn’t get a mention in this context but the combination of institutions themselves, prudential regulation and central banks was not powerful enough to respond to the pressures that developed in 2007 and 2008. Hence the intervention of

governments, in Australia's case to guarantee bank deposits and wholesale funding of banks, in some other countries capital support and more.

I give you this introduction in order to give some insights into the possible factors that have contributed to system stability in Australia and, more particularly, to indicate why APRA's response to the GFC will be modest and there will be little new regulation in response to the GFC. And why not? Because, as I see it, in Australia we have been successful in navigating through the worst of the financial crisis and it is because we have been on the right side of several important success factors. Some of these factors are not directly attributable to the regulatory environment, for example the underwriting standards and business models of our lenders who, on the whole, were never tempted to engage in residential sub-prime lending.

There are also, however, some distinguishing features between regulatory regimes that work well and regulatory regimes that do not work so well. They include:

1. regulatory agency structure;
2. powers of the regulator;
3. scope of regulations; and
4. quality and depth of supervision or surveillance of institutions.

The first three are *enabling*, and the fourth is about *accountability*.

Our system is able to work effectively because:

1. we have a good structure: we have a single national integrated regulator who is a specialist prudential regulator – our 'twin peaks' model, where the specialisation is, I believe, a signal virtue;
2. APRA has, on the whole, adequate legislative powers to do its job, including the power to make its own prudential standards; and
3. APRA has developed a suite of regulatory requirements (in the form of prudential standards) with which we are largely satisfied because they give us the framework or regulatory underpinning we need to do our supervisory job.

Accountability: the quality and depth of supervision

Our prudential standards are built around capital adequacy, effective risk management and good governance. A fundamental plank of our approach is that we hold the boards of regulated institutions accountable for meeting the standards. We normally work through management but we reserve the right to deal directly with the board and we do so whenever we think we need to.

As I see it, our system *does* work effectively because APRA is a vigilant and effective supervisor. It was not always so, but APRA now has the resources comprising the experience, culture, competence and strategy to operate effectively.

The quality of active supervision of individual institutions is a critical success factor. Prevention is not only better than cure, it is also better than punishment after a failure. Active supervision is a pre-requisite and a *sine qua non* of an effective prudential regulatory system.

In summary, our agency structure, with its national specialist prudential regulator with suitable powers and suitable regulations along with, above all, active supervision, are all well suited to the task. We believe we will continue to be effective as long as APRA

remains competent in supervision and vigilant. And that is our primary response to the GFC.

By comparison, many other governments and regulators have much to do to meet these criteria. And my biggest concern is that, in the debates that are currently occurring around the world on financial regulation, faith in regulation itself is far too often taking precedence over the importance of effective supervision.

International insurance regulation

Internationally, one major regulatory problem has surfaced in insurance as part of the GFC. It is the problem of effective group supervision. It is typified by the AIG experience where, on the one hand, not one policyholder has been denied benefits in any of the hundred plus subsidiaries of AIG in the US or elsewhere but, on the other hand, a single unregulated subsidiary of the group has made claims on the parent which the parent could not meet because the insurance supervisors around the world were effective in quarantining the assets of each insurer. The US government had to either let the company fail or give support to the parent in order to prevent the collapse of the group.

The international insurance supervision challenge  

“The AIG problem”

How to maintain integrity of solo insurer supervision + undertake effective group supervision?

Two critical features of the AIG experience -

- Extraordinary strength of solo supervision**
 - US and elsewhere
- Absence of effective group supervision**
 - could have happened in many countries

Effective group supervision is not an easy thing. We now have it in Australia but, until it is achieved in the major jurisdictions, there is a risk of “another AIG”.

Broker Data Collection

A topic that I assume everyone in the room well understands is that the Insurance Act was changed such that, from 1 July 2008, insurers cannot conduct business in Australia unless they are authorised by APRA to do so. So we now have a level playing field for local and foreign-based insurers. But there is an exemption regime that allows insureds in special cases to purchase cover from UFIs (unauthorised foreign insurers). In these special cases, which include certain large company covers and some specialist covers, brokers are obliged to document the case supporting the exemption.

This exemption regime needs to be monitored, for it may need to change over time, and so a data collection is being instigated. The data collection is essentially a joint venture between the Treasury, ASIC and APRA.

- Treasury is administering the exemption regime.
- ASIC licenses brokers.
- APRA will collect the statistics.

Last week Treasury issued a discussion paper which can be found on both the Treasury and APRA websites. It proposes that:

- Every broker prepare regularly a single table, (Form 1 as shown below, to summarise all business of the broker – For brokers who do no Lloyds business and no UFI business, the table is extremely simple, for there are only two columns to complete (which are gross written premiums and number of policies by class of business).

Form1: Aggregate data on intermediated business



	GENERAL INSURERS		LLOYD'S UNDERWRITERS		UFIs	
	PREMIUM	POLICIES	PREMIUM	POLICIES	PREMIUM	POLICIES
HOUSEOWNERS/HOUSEHOLDERS						
COMMERCIAL MV						
DOMESTIC MV						
TRAVEL						
FIRE AND ISR						
MARINE						
AVIATION						
MORTGAGE						
CONSUMER CREDIT						
OTHER ACCIDENT						
OTHER						
CTP MV						
PUBLIC & PROD. LIAB.						
PROF. INDEMNITY						
EMPLOYERS' LIAB.						
TOTAL BUSINESS						

4

- For those brokers doing business with UFIs, a policy by policy record also needs to be completed.

It is Form 2 and comprises each of the policy items shown below. This is also a single form because individual policy information (which incidentally, does not include the name of the insured) is far easier to collect and submit than summary tables of policies.

1.	Client code	9.	UFI name
2.	Policy code	10.	UFI country code
3.	Policy date	11.	Exemption type
4.	APRA class of business	12.	HVI limb
5.	Layer	13.	HVI value
6.	Insurer share (%)	14.	Atypical risk class
7.	Premium (\$)	15.	Customised reason
8.	Insurer class		

- The data collection is to be a twice yearly event, each June and December, with the forms to be submitted to APRA within 20 working days of the end of the half-year.

The first data collection is to be on a 'best endeavours' basis for the two months to 31 December 2009 and thereafter each June and December.

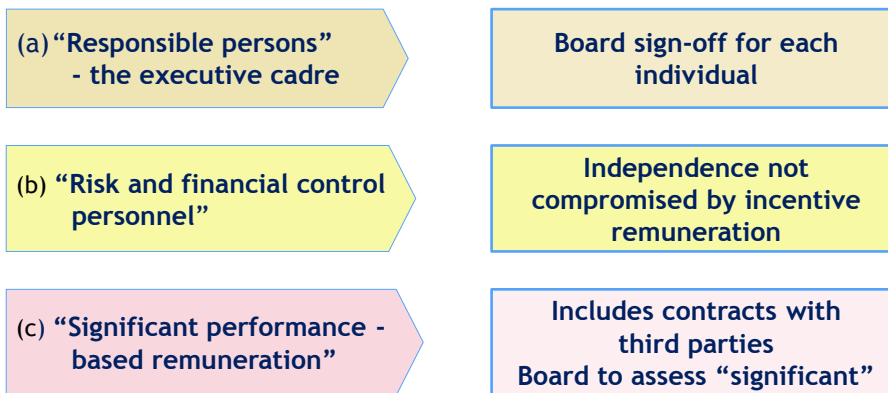
Submissions are now being sought by Treasury and close on 8 October.

Remuneration

Finally, a word on remuneration. APRA's principles-based approach parallels our approach to other matters of governance and risk management.

We are relying not on disclosure but accountability by boards to APRA for meeting APRA's principles. We will concentrate on the substance not the form. Within a framework that involves some constraints, APRA has gone out of its way to avoid stifling innovation and ham-stringing boards. We expect companies to design their own remuneration structures within the general parameters nominated by APRA, with APRA's role being to scrutinise plans to see that they conform to our principles.

There is one particular aspect I'd like to bring to your attention because it may affect many of you in this room. It is the scope of coverage that APRA is specifying for each company's Remuneration Policy.



APRA is interested not only in executives but in all parties who have significant performance-based remuneration and that includes third party contractors such as insurance brokers and agents, financial planners and mortgage brokers. Boards of insurers will in future be taking a direct interest in these arrangements. I am sure they will be looking closely at such matters as over-ride commissions and any other arrangements that may adversely influence the quality of the bonus that I being underwritten.