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Policy-only liability insurance as alternative to prudential regulation

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Abstract

In the wake of the collapse of the insurer, HIH, this article proposes for discussion an alternative method of enforcing prudential regulations, especially in light of the admission by APRA before the HIH Royal Commission, and the commission's own findings, which confirmed that APRA failed to adequately enforce existing prudential regulations - regulations which are designed to prevent fragility and ultimately collapses in the insurance and banking sectors. This article aims to investigate the feasibility of policy-only liability insurance for direct insurers as a market-based mechanism to replace prudential regulation in the wake of the failure of APRA to adequately regulate HIH. The hope of this writer is to encourage debate on alternative methods of prudential regulation and regulatory enforcement.

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Policy-only liability insurance as alternative to prudential regulation

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Introduction

This article explores an alternative method for the enforcement of prudential regulation in the Australian insurance sector. It is not envisaged that the relevant authorities adopt this proposal, for it is precisely that: a proposal. This article does not include details of the collapse of HIH or of the prevalent malpractices within that entity, or of the chronic failure of the Australian Prudential Regulatory Authority (APRA) to regulate HIH. For information on those issues the reader is referred to the HIH Royal Commission website, which contains substantial amounts of detail on the collapse of HIH and the factors which precipitated HIH's demise.[1] Readers are encouraged to contact the writer with their critiques of this proposal.

Direct-policy-only insurance

How it would work

Why regulators can no longer do the job, not that they ever could

This proposal is based upon the assumption that prudential regulators are incapable of adequately and reliably regulating insurers.[2] There is a theoretical basis upon which this proposal is based, and this article will investigate those

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1 See, further, <www.hihroyalcom.gov.au>.

2 This article will focus on direct insurers and the problems associated with regulating their conduct. A direct insurer is one who contracts directly with the insured parties either as individuals or as commercial entities, and may or may not work through an insurance intermediary, such as an insurance broker. Direct insurers are also known as 'direct writers',

arguments below. There is also a practical aspect to this proposal in light of the recent collapse of HIH and the apparent failure of APRA to avert that collapse.

Attempts at prudential regulation, even in countries such as Australia and the United States, where rule of law exists and where there exists a rich commercial and insurance law jurisprudence, are littered with examples of regulatory failure. Examples of which include the collapse of the Savings and Loan industry in the United States[3] in the early 1990s; and the insolvency of the State Bank of South Australia, Pyramid and the merchant bank, Tri-Continental, in Australia.[4]

Moreover, it is argued that government regulators are not fully capable of regulating large multi-national insurers. Insurers operate in multiple jurisdictions using increasingly sophisticated products. In response to which regulators are most often confined to enforcing regulations enacted in response to prior crises — effectively leaving regulators stuck fighting the last war.[5]

'direct insurers', 'primary underwriters', or that they are engaged in 'primary business'. This article will use the term 'direct insurer' throughout.

3 G J Benston and G G Kaufman, 'FDICIA After Five Years' (1997) 11(3) *Jnl of Economic Perspectives* 141, cite the example of the S&L crisis in the United States, where Savings and Loans companies would attract deposits by offering high interest rates, and would then use those funds to make high-risk loans on the philosophy that the S&L could appropriate any gains, while losses would be passed along to FSLIC (The United States Federal Savings and Loans Insurance Corporation). 'Heads, the S&L owner would win; tails, the deposit insurance fund would lose.' The authors continue at 142/3 to argue that by the late 1980s, numerous studies had identified federal deposit insurance as the primary cause of the banking and thrift crises. 'Most of these studies emphasized "gamble-the-institution" behavior [sic] by depository institutions as the chief culprit . . .'. See also T F Huertas, 'A Market Paradigm' (1993) *IFLRev Special Supplement* 97, who asserts further that [initially] restrictions on the ability to pay market rates of interest on deposits and charge variable rates of interest on mortgages effectively forced savings and loan associations to assume massive amounts of interest rate risk; and further that government's failure to close insolvent institutions further compounded the problem.

4 See further C W Calomiris, 'Is Deposit Insurance Necessary? A Historical Perspective' (1990) L(2) *The Jnl of Economic History* 283, where the author argues that there exists historical evidence, flowing principally from the savings and loan collapse in the United States, that [government] deposit insurance creates perverse incentives when it is not fairly priced. I argue below that only commercial insurance firms can fairly price insurance, and that government insurance agencies cannot. Principally, Calomiris points out that insurance removes the discipline of the market. Moreover, he argues that insurance has the potential to encourage excess risk-taking by existing banks, especially those banks that have little capital remaining due to past losses. I would argue that this is equally true for insurers as it is for banks. Furthermore, such insurance also encourages unscrupulous or inexperienced entrepreneurs to enter banking in order to finance their risky enterprises. Again I would argue the same would hold true of insurance. This is often the case with *one-size fits all* government regulation and guarantees, but would not be the case with insurance fairly priced by a commercial enterprise, and tailored to the specific risk profile of the client bank, in the case of Calomiris' example, or in the case of a direct insurer, in respect of the examples used in this article.

5 This aspect is of particular concern when one considers how quickly insurance is changing under the impact of electronic commerce and communication. Rupert Pennant-Rea, the Deputy Governor of the Bank of England, quoted in T Petri and B Ely, 'Cross Guarantees: A Horse of a Different Color' available at <http://www.ely-co.com/horse.htm>, admitted that regulators are always five years behind, and further that that was good, because according to Pennant-Rea, if regulators tried to stay abreast of technology they would stifle innovation. But the time lag results in regulations which are not only inadequate in evaluating new risks,

> The traditional approach to financial regulation is bankrupt. It sought to assure stability by providing guarantees . . . The result was a system of regulation that increased both risk and cost.[6]
>
> Regulation . . . [is] not the problem . . . Government regulation . . . [is] the problem.[7]

Lastly, regulators are not themselves at risk when the entities, which they regulate, fail.[8] The regulator may come under criticism, as has been the case with the Royal Commission into the collapse of HIH. However, the regulator itself will not suffer financial harm. The argument will be made below that in the case of an offshore insurer undertaking to honour the liabilities on the policies written by a direct insurer which it undertakes to insure, the offshore insurer stands to lose considerably if that direct insurer becomes insolvent and the premiums charged for that insurance were not accurately priced.

It is asserted that a large multinational insurer is far more likely to have the manpower, experience, resources, and acumen to adequately perform the task of supervision than is a government regulator. Moreover, an offshore insurer would in effect be severely punished if it did not perform the task of insuring the liabilities of the direct insurer efficiently. A failure by the offshore insurer to properly assess the risk of failure posed by the direct insurer, and a concomitant failure to price the premium correctly, would result in premium income failing to match the amount of the claims levied against the offshore insurer when the direct insurer covered by the policy failed. This would lead to losses being incurred by the offshore insurer.

> The buck will stop with the guarantors.[9]

Why policy-only?

The proposal argues that instead of a government regulator attempting to monitor and gain from a domestic insurer compliance with prudential regulations which comport with world's best practice, private offshore insurers could fulfil the task of monitoring domestic Australian insurers.

The proposal recommends that offshore insurers undertake to honour whatever policies are in force if and when the direct insurer collapses. In return for this undertaking, the offshore insurer would be paid a premium by the direct insurer.

In order to determine the quantum of the premium the offshore insurer

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but because of their anachronistic nature will inevitably distort banking, in the example put forward by Pennant-Rea, or equally in the case of insurance, as put forward by this article. In fact one could argue that the more anachronistic the regulation, the greater the market-distortion in banking; and similarly, insurance. In the view of this writer, Pennant-Rea does not adequately address the problem of a failure to regulate other than retrospectively.

6 Huertas, above n 3, at 97.

7 Petri and Ely, above n 5.

8 The greater efficacy of the market as a regulator was confirmed by the US Treasury Department in a report by R E Litan and J Rauch, 'American Finance for the 21st Century', *The United States Department of the Treasury*, 17 November 1997, (no page numbers), available at <http://www.treas.gov/press/releases/97report.htm>, quoted by Ely, above n 5, p 5: '[m]arkets tend to be less forgiving than regulators, who may be more willing to give a troubled institution time to work through its problems.'

9 Petri and Ely, above n 5.

would seek to determine what the likelihood is of the direct insurer collapsing. To do this the full spectrum of the direct insurer's business would be investigated in order to determine the health of the company and, by implication, the likelihood of the direct insurer remaining solvent during the currency of the contract.

It is envisaged further that the offshore insurer would undertake to honour only the direct insurer's liabilities under the policies which the direct insurer had written prior to becoming insolvent.

There are, it is argued, compelling reasons why the offshore insurer should limit its undertakings to honour only the liabilities on the direct insurer's existing policies which had been written by the direct insurer prior to its collapse. These include an avoidance of moral hazard,[10] which might arise if shareholders are protected as well. Furthermore, there are compelling reasons why creditors should not receive any protection under this scheme. Creditors of an insurance company should not receive protection from the vagaries of doing business; protections which do not apply to creditors of other firms. There are several reasons for this, namely, that there are, it is argued, important benefits to be gained from creditors exercising a measure of supervision over to whomever they grant credit. Should this benefit be removed, creditors will be subject to moral hazard.[11] Secondly, Australia is possessed of a substantial insolvency law and corporations law jurisprudence, which, it is argued, is sufficient to protect creditors.[12]

A further benefit in failing to protect shareholder's funds would be that they

10 Moral hazard is the creation of a situation, which effectively encourages precisely the types of practices, which the measures are meant to combat, by unintentionally encouraging behaviour which is directly opposite to those intended. So, for example, if insurance provided to a direct insurer was extended to shareholders' funds, then shareholders would be encouraged to take ever-higher risks in the hope of attaining ever-higher returns. Because their funds would be guaranteed by the offshore insurer, in the event that the direct insurer, in which they hold shares, were to collapse, the shareholders would be encouraged to 'bet the firm'. Put differently, if the offshore insurer were to guarantee shareholders' funds it would lead to a case of 'heads the shareholder wins, tails the offshore insurer loses!' This would result in an almost limitless up side, with no downside. The effect would be to encourage behaviour more likely to cause the direct insurer to collapse, instead of discouraging excessively risky behaviour. See further Calomiris, see above n 4, at 283, where the author argues that there exists historical evidence, flowing principally from the savings and loan collapse in the United States, that [government] deposit insurance creates perverse incentives when it is not fairly priced. I argue below that only commercial insurance firms can fairly price insurance, and that government insurance agencies cannot. Principally, Calomiris points out that [government] insurance removes the discipline of the market. Moreover, he argues that insurance has the potential to encourage excess risk-taking by, in the case of his example, banks, especially those banks which have little capital remaining due to past losses. I would argue that the same can be said of the effects of government insurance on the liabilities of direct insurers. This is the case with *one-size fits-all* government insurance, but would not be the case with insurance fairly priced by a commercial enterprise, and tailored to the specific risk profile of the client direct insurer. The arguments which Calomiris makes in respect of the creation of moral hazard by insuring banks is in my view analogous to that which would apply to insurers.

11 By insuring creditors' funds, creditors will be encouraged to extend excessive amounts of credit to insurers in the belief that either the direct insurer will repay them, or failing which the offshore insurer will repay them in the event that the direct insurer becomes insolvent.

12 Moreover, creditors have at their disposal a raft of measures which they can use to ensure

would serve as a deductible in the event of the direct insurer's failure.[13] This would have further positive implications in respect of moral hazard, or the prevention thereof.

It is argued that the group of stakeholders least able to protect themselves against the bankruptcy of an insurer is individual policyholders, in that they lack the means and skills needed to monitor their insurer. Even if they were able to engage in such monitoring their recourse is limited. They are not creditors properly so-called, so creditor's remedies are not available to them. They are not shareholders, and so shareholder's remedies are not available to them. Furthermore, because of the very nature of insurance, especially life or disability insurance, and unlike shareholders, the policyholder cannot remove the policy to another insurer should they lose confidence in their direct insurer.[14] United States Senator Tom Petri's argument about depositor's inability to monitor banks is in this writer's view equally valid for the inability of policyholders to monitor an insurer:

> For most people, though, and even for many businesses, closely monitoring their bank, and therefore exercising 'depositor discipline' over it, is about as practical as suggesting that people train to perform surgery upon themselves.[15]

Why offshore insurers would assume the risk?

Insurers are in the business of providing insurance. The very nature of insurance implies a number of variables: uncertainty[16] and a pooling function being primary.[17]

In order for insurers to be profitable they must, of necessity, continue to seek risk-worthy clients in traditional insurance markets; and in order to remain competitive and provide a satisfactory return to shareholders, insurers are under pressure to continually seek new clients through new types of cover.

Before the counter-argument is made that an offshore insurer would shy away from such a risk, it would be of note that insurers regularly provide

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repayment, including purchasing their own insurance against their debtors becoming insolvent, or ensuring that they are secured creditors, or for instance by obtaining a charge over the direct insurers assets.

13 A 'deductible on the policy' and an 'excess on the policy' are synonymous.

14 There exists in Australia limited scope to call an insurer to account by engaging in alternate dispute resolution, such as having recourse to an ombudsman. However, this still does not allow the insured the ability to remove to another company their policy should they lose confidence in their direct insurer.

15 Petri and Ely, above n 5.

16 Every form of insurance includes a measure of uncertainty, including life insurance. While it is a certainty that every person will die, the uncertainty inherent in life insurance is 'when'. The insurer effectively takes a bet that the insured will die later rather than sooner. The insured bets that he or she will die sooner rather than later. If the insurer is correct, the insured will pay a greater amount in premiums for the same death pay out. If the insured is correct, the insurer will pay out the same amount on death but will have collected fewer premiums. In the case of car insurance, the insured bets that the car will be lost, the insurer bets that it will not. If the insurer is correct, premiums will be paid and no claim will result. If the insured is correct, he or she will receive a payout far greater than the amount of premiums paid.

17 Insurers make a profit from providing insurance to a pool of people or entities provided that on aggregate more premiums are paid in terms of value than the value of claims lodged against the insurer. It is for this reason that individuals cannot adequately self-insure because there is no spreading of the risk function.

insurance and reinsurance for risks, which may be very difficult to quantify, such as the risk posed by earthquake damage. Such a risk, it is argued, would be more difficult to quantify than the risk of a direct insurer becoming insolvent.

In order, therefore, for offshore insurers to be attracted to policy-only liability insurance for direct insurers, offshore insurers would need to be able to quantify the extent of their liability under the policy.[18] Once they have evaluated the extent of their potential liability under the policy,[19] they would then want to determine how likely would be a claim under the policy? It is here that the premium function begins to work.

How the premium function would work?

Having determined the extent of their liability under the policy,[20] an offshore insurer would then have to assess the risk of insolvency posed by the particular direct insurer. Put differently, the offshore insurer having determined the extent of the liability under the policy would then want to determine how likely it would be that a claim would arise under the policy? Put even more simply: enquiry one would be 'how much will we have to pay?' and enquiry two 'what's the chance we'll have to pay?'

In order to determine the answer to enquiry two, the offshore insurer would engage in an investigation of the inherent stability of the company by investigating such criteria as the company's capital adequacy ratio,[21] whether the company has exposure to foreign currencies, and if so whether those liabilities are hedged,[22] the quality of the company's management, the quality of the company's assets and whether those assets are correctly valued, quality of the direct insurer's risk assessment procedures and its ability to accurately price the premia which it charges its clients for cover on the policies which it sells, the extent and adequacy of its reinsurance[23] arrangements, the growth or, alternately, decline in its premium income,[24] perhaps the extent of its goodwill, and so forth. In addition, there would be scope for negotiation

18 Which would in large measure already have been quantified by the direct insurer as part of its normal management function. However, that would not preclude the offshore insurer from determining an adjusted level of liability as part of its enquiries into the liability posed by the direct insurer. Determining the value of a direct insurer's policies, which are still in effect, is a routine actuarial function conducted in the insurance industry regularly.

19 The 'policy' referred to here is that provided by the offshore insurer to the direct insurer, whereby in return for a premium the offshore insurer would undertake to assume all the liabilities flowing from whatever policies are in force against the direct insurer, at the time when, or if, the direct insurer becomes insolvent. By that it is not meant that the offshore insurer would assume the liability for whatever policies had been written by the direct insurer and against which the insured had made a claim. Rather, what is meant is that ALL policies would be ceded to the offshore insurer — those against which claims had been made, and those still running, but against which claims had not been, and arguably may never be, made.

20 See above n 18.

21 The extent of the company's paid up share capital relative to liabilities.

22 A hedging contract functions by providing a guarantee from the guarantor that if the guaranteed's foreign exchange liabilities increase beyond a certain level due to exchange rate fluctuations, then the guarantor will make good the difference. This guarantee is provided in exchange for the payment of a premium.

23 An examination of reinsurance will be provided below.

24 As an indicator of whether the company itself is growing or shrinking.

between the offshore insurer and the direct insurer in respect of extending or even limiting the scope of which factors should be investigated. In return for taking an approach, which tends towards transparency, the direct insurer could be offered a reduction in premium as a reward.

Put differently, the offshore insurer would in essence be conducting in large measure an examination that would be almost identical to that which a prudential regulator would be expected to conduct. However, the offshore insurer would have a strong incentive to conduct the investigation diligently. If the investigation was inadequate, the offshore insurer would stand to lose potentially a considerable amount if the direct insurer which the offshore insurer had agreed to insure, became insolvent. A prudential regulator however stands to make no such loss.

Furthermore, in determining the premium, the offshore insurer would be conducting a risk assessment of the direct insurer which would not be dissimilar to the manner in which a sponsoring broker would conduct a due diligence of an insurance company prior to its listing.

In order to reduce the cost of the premium, the domestic insurer would be encouraged to engage in practices which are more prudent and less risky. If the domestic insurer fails to avert unnecessary risk, or engages in practices which are more likely to cause the domestic insurer to suffer instability or possible collapse, then the premium would increase. It is here that the premium function is at its most compelling: instead of punishing the direct insurer with criminal sanctions for non-compliance with prudential regulations, as a prudential regulator would do, the offshore insurer will punish the direct insurer with higher premiums if it engages in unnecessarily risky behaviour; or, alternately, reward the direct insurer with lower premiums if it averts unnecessarily risky behaviour. The choice is left to the direct insurer. And the implications of the direct insurer's choice are monetary — in this writer's view a more effective incentive or disincentive than criminal sanctions. And, secondly, increases or decreases in premia are easier to implement than obtaining a criminal conviction for breach of prudential regulations or a breach of the common law or statute, which requires proof beyond reasonable doubt. In essence, an offshore insurer need give no reasons for its premium levels. The direct insurer can opt to accept the policy and pay the premium, or look elsewhere. However, a prosecutor demanding a criminal conviction does not posses such a luxury. He or she would have to build a strong case, complete with exhaustive reasoning, and then may find insufficient evidence to gain a conviction.

In order to gain compliance with this model, each Australian direct insurer[25] would be required to obtain a certificate of direct-policy-only insurance. This would include all insurance companies operating in Australia as direct insurers, whether Australian by nationality or not. It may be necessary to require all insurers that wish to operate in Australia as direct insurers to incorporate their Australian division under Australian laws. That way all direct insurers, whether Australian or wholly owned subsidiaries of non-Australian insurers, would encounter a level playing field, in that they would all have to

25 Direct insurer differentiates an insurer, which writes policies with the direct insured as distinct from a reinsurer, which writes insurance policies covering the risk of other insurers.

comply equally with the provision that they acquire policy-only liability insurance.

This would guarantee policyholders that should the direct insurer with which they are party to a policy fail, then the insurer which undertook to accept whatever liabilities were outstanding on any of the failed direct insurer's policies at the time of its collapse, would take over those policies and assume the role played by the failed insurer, as if it had never collapsed.

In addition, insurers would only be permitted to obtain insurance from a pre-approved list of 200 of the world's largest insurers; with a further proviso that none of them be an Australian insurer. This would be aimed at ensuring that the problem of the collapse of one insurer in Australia did not cause other Australian insurers to collapse, thereby causing widespread upheaval in the domestic insurance sector. Put differently, the safety mechanism of requiring the insurer who assumes the policy-only liabilities of the direct insurer to be an offshore insurer is designed to prevent contagion, and a situation seen more often in banking, that of a bank run.[26]

Why multi-national insurers are the only entities capable of regulating one another

Offshore insurers can better monitor direct insurers which operate in many countries and through highly sophisticated and innovative products, than can public functionaries operating only in one country, and who are often under-resourced and ill-equipped to understand leading edge insurance products, some of which are designed by the world's most competent actuaries and mathematicians.

Moreover, due to the spreading and pooling of risk through the writing of multiple policies, and further by way of reinsurance, it is argued that multi-national insurers are more likely to possess the capacity to withstand such potentially large claims than any other commercial entity.

In addition, it is insurers who would be best equipped to understand the nature of the business in which their clients — namely, direct insurers — operate. Having such a detailed and nuanced understanding of insurance, it is argued, is better possessed by insurers than by any other commercial entity.

Lastly, due to the areas where policy-only liability insurance overlaps with

26 I acknowledge however that this may not be as serious a risk in insurance as it may be in banking. Bank runs occur because of panic, and evidence themselves in the form of depositors withdrawing their funds from healthy banks en masse, thereby causing healthy banks to fail. However, it is not possible, even in times of panic, to withdraw en masse life insurance policies, or claim, en masse, simply because panic has set in, on, for example, car insurance. Either the car has been lost or it has not. The collapse of a competitor insurer would have no bearing on that factual situation. Moreover, if the provider of the policy-only liability insurance were adequately managed, there is no reason in principle why that company could not also be a domestic insurer. Provided it has adequately assessed the risk, priced the premium correctly, and obtained adequate reinsurance, there is no reason in principle why the collapse of a domestic direct insurer should lead to the collapse of a domestic policy-only liability insurer. However, what this safety mechanism would prevent is a worst case scenario where the domestic direct insurer is poorly managed and collapses, causing a claim to be made against the secondary insurer, which in a worst case is also poorly managed, is unable to cope with the claim made by the direct insurer, and also collapses, thereby causing a doubling-up of distress to the local economy.

reinsurance it is argued that insurance companies which are active in the field of reinsurance, will posses many of the tools and skills needed to operate in the field of policy-only liability insurance.

Jurisdiction

It is common practice in many commercial contracts to avoid potential conflict of laws, or for that matter, forum shopping, by stipulating beforehand in which jurisdiction parties agree to settle their disputes. It is not within the ambit of this article to recommend a forum which would be best suited for the settlement of disputes arising out of a policy-only liability insurance contract — if such a recommendation were even possible to make. Parties to such a contract may wish to decide for themselves where to settle such disputes. But typically in a contract for policy-only liability insurance underwritten by, for example, Lloyds of London and in favour, say, of AAMI, the parties would negotiate on a jurisdiction for the settlement of disputes, which in such a case would typically either be the High Court in London, or the Supreme Court of New South Wales. This not only protects the direct insurer against having to pursue an offshore insurer across what may be a hostile jurisdiction, or a jurisdiction whose laws unfairly favour the underwriter, but this also protects the offshore insurer against being sued in a jurisdiction which unfairly favours the insured.

Potential shortcomings

The cost

The most obvious shortcoming lies in the fact that this model would represent a potentially sizeable operating expense for direct insurers — something that would in all likelihood engender significant resistance. A potential solution to which may lie in a recognition by the Federal Government that this model would constitute a direct saving to the taxpayer, equivalent to the costs of maintaining APRA, as that institution would no longer be needed. There would also be potential ancillary savings — the costs to the taxpayer of the insolvency of companies such as HIH, and the attendant costs associated with a Royal Commission. These savings could potentially be passed onto insurers by providing them with a lower tax rate in recognition of the increased costs to them of having to assume the responsibility for the costs of their own supervision.[27]

27 There is an argument, which could be made, that insurers pay taxes, which in turn fund the commons. Maintenance of law and order is a commons, and so in return for paying tax, insurers should be regulated by the State at no additional cost. If this responsibility is then to be subcontracted to an offshore insurer at a cost to the direct insurer, then that would constitute a further and indirect tax. If such a further tax is levied only against insurers, then it may be argued that that is unfair. This may form the basis of a claim by the insurance industry as a whole to be taxed at a different rate from other commercial entities. A similar argument could be made that a stable insurance industry is a commons — something which we all need, but which only the government can supply by enforcing prudential regulations. Consequently, if an insurance company is required to pay tax, then it may reasonably expect the government to provide a regulatory authority. If the government no longer provides such an authority and instead seeks to maintain the commons of a stable insurance sector by shifting the onus — and the costs — for conducting such regulation onto the insurers

However, it must be stated that for this model to operate optimally it is vital that where a direct insurer is unable to pay the premium for policy-only liability insurance, the direct insurer must not receive assistance. It must be allowed either to fail, or must be forced to allow itself to be taken over. This forms an important cleansing role, whereby insurers, which are so ill that they are unable to obtain policy-only liability insurance, or cannot afford the premium, must be removed from the economy so that they do not become a contaminant and cause instability if and when they fail.

Loss of sovereignty

There is a loss of government control of the oversight of the insurance sector, and this may aggravate insecurities about loss of sovereignty.

I would suggest however that as Australia is not a *dirigeste* economy, and as the insurance sector is not regarded as a strategic industry needing special protection, this concern may be of minor importance.

Industrial espionage

It remains a deficiency of this model that it would set competitors to monitor one another. This may make possible industrial espionage.

However, there are several factors in mitigation.

Firstly, many insurers have close relationships with other insurers, which may constitute competitor companies, through the function of reinsurance.

Secondly, there exists the possibility for the use of Chinese Walls, as is common practice in accounting, law and stock brokerage firms, in order to ensure that clients are not prejudiced by virtue of the fact that the firm represents competitor firms.

Moreover, if the policy-only liability insurance market grew to be of significant size, then the providers of such insurance would in all likelihood wish to protect their reputation as honest and trustworthy providers of such insurance, in order to ensure that they are able to sell policies to direct insurers for policy-only liability insurance in the future. A reputation as a sneak would damage an offshore insurer's ability to sell such policies more quickly and effectively than possibly any other deficiency, which an offshore insurer could display.

Monitoring the policy

It is envisaged that the only role which would be played by State functionaries in such a model, would be to verify that a certificate of policy-only liability insurance had been issued in favour of each direct insurer in Australia and that the certificate was current. This is a fairly simple task and could be performed by the registrar of companies.

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themselves, then it may be argued that insurers are being taxed twice. Once when they pay tax to the government, and again when they pay for a service, which the government should supply — in this case prudential regulatory enforcement. So the argument could be made that if the government is no longer going to provide for prudential regulation, but is instead going to shift the responsibility — and the costs — for such regulation to the individual participants in the insurance industry itself, that those participants should enjoy a measure of tax relief commensurate with the amount of money the government stands to save by no longer providing a prudential regulator.

However, what is more complex would be to ensure that each contract of policy-only liability insurance adequately insures the direct insurer's policyholders and does not contain exclusion clauses which would essentially render the protection envisaged by this model meaningless. As a starting point though it may ameliorate this problem if the registrar of companies in ascertaining whether each direct insurer in Australia had a certificate of policy-only liability insurance, determined that as a minimum each certificate of policy-only liability insurance provides an obligation by the offshore insurer to cover whatever obligations lie against the direct insurer if and when the direct insurer collapses.

Another possible alternative is a standard form contract to which all offshore insurers who agree to provide policy-only liability insurance must adhere. This would still allow room for negotiation and adjustment up or down of the premium. All that would be precluded from becoming a variable would be the nature of the obligation to provide policy-only liability insurance. But the costs of providing insurance under such a standard form contract would provide fertile ground for negotiation and adjustment of errant behaviour by the direct insurer in return for a lower premium.

It must be noted also that the insurance sector nationally and internationally subsists of a pervasive culture, which tends to be less conflictual and more cooperative. This is evidenced by the fact that insurers regularly make substantial claims against one another and against their reinsurance partners; however, it is seldom that these transactions end up in court. It is therefore possible that direct insurers could be left to negotiate policy-only liability contracts with offshore insurers without a need for either government monitoring or a standard form contract to ensure that insurers are not contracting out of their obligations to protect policyholders through policy-only liability insurance in order to save on premium costs.

Why this is not reinsurance

What is reinsurance

Reinsurance is the process by which direct insurers mitigate their potential losses by themselves purchasing insurance against the policy, which they have written.

In this manner, reinsurance provides the same benefits to insurers which insurance provides to consumers — principally, the pooling of risk. Stenhouse lists these advantages as follows:

- there is a greater independence in the pool of reinsured risks through risk diversification.
- there is further mitigation of risk through a geographical spread of otherwise similar risks. This risk spreading may take place regionally, nationally and internationally.
- there is inherently greater stability by way of a larger scale risk pool.[28]

Reinsurance does not only allow insurance companies to spread the risk,

28 R Stenhouse, 'Background Paper — Reinsurance', *Submission to the Insurance Council of Australia*, for the HIH Royal Commission, January 2002, p 4.

which they assume when writing an insurance policy, it also allows insurance companies to write more business, because reinsurance has the function in practice of substituting capital. The capital substitution argument relates both to more business being written, where capital relates to solvency; but also allows larger risks to be assumed, where capital relates to capacity.[29]

Types of reinsurance

A list of types of reinsurance of relevance to this article, but not exhaustive includes:

- Proportional covers, where the insurer and the reinsurer share the loss payments in the same ratio as they shared the premium.
- Non-proportional covers, which is determined on a case-by-case basis, with the reinsurer paying all losses above a set deductible to a certain limit.
- Financial reinsurance, described by Stenhouse[30] as having been developed as a response to the insurance market's commercial needs and the growing attention to whole of balance sheet risk management. Stenhouse[31] asserts that these products are a natural parallel to the more general development of financial derivatives. He cites as examples derivative instruments to hedge interest rate and foreign currency exposures. What is of relevance in this type of reinsurance to this article is that already forms of insurance exist of which the sole purpose is to insure against unforeseen yet perfectly foreseeable business risks which are not hazardous in the sense of a fire, a heart attack or an act of terrorism, but are instead part of a normal business environment, but which may adversely affect profits. Examples of such a peril would include the appreciation of one national currency against another national currency, beyond a certain range. The timing and extent of the appreciation may be unforeseen, but the concept of free-floating currencies appreciating against one another is easily foreseeable.[32]

Activation is the key

What causes activation of policy-only liability insurance is the most marked point where this proposal differs from reinsurance.

Put simply, reinsurance is activated by a claim on the underlying policy which exists between the direct insurer and the consumer. What activates policy-only liability insurance is the insolvency of the direct insurer, not a claim on the underlying policy.

I shall illustrate this by way of an example: let us assume that I purchase $20,000 worth of car insurance from AAMI. My car insurance policy is reinsured with Swiss Re on a proportional cover of 25%. AAMI itself has 100% policy-only liability insurance with Lloyds of London.

In the first permutation, my car is stolen. AAMI pays me $20,000, of which it is able to claim back $5000 (or 25%) from Swiss Re.

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29 See ibid, p 5.
30 Ibid, p 7.
31 Ibid.
32 A so-called 'hedging contract'.

In the second example, my car is safely in the garage, but AAMI becomes insolvent. At which stage the liability on my policy is assumed by Lloyds of London. Still my car is safe in the garage so I file no claim against Lloyds. However, if at any stage during what remains of the currency of my contract my car is stolen, my claim will no longer lie against AAMI, which by then is defunct, instead my claim lies against Lloyds. Conversely, Lloyds will insist that henceforth I pay to them all outstanding premiums as and when they fall due, and Lloyds may claim against Swiss Re if and when my car is stolen, because its predecessor in title, AAMI, paid reinsurance premiums to Swiss Re. This leads to the third possible permutation.

In the third example, my car is stolen and shortly afterwards AAMI becomes insolvent. Lloyds of London pays me $20,000, and is able to claim back $5000 from Swiss Re. Should I wish to continue with my insurance after I buy a replacement car I will be able to do so with Lloyds of London, provided I pay to them my premium.

The Ely-Petri model

In the model proposed by US Senator Tom Petri and economist Bert Ely, banks guarantee banks in a cross guarantee model. Banks would then supervise one another, and guarantee one another's depositor's funds.

My model differs from theirs in that I envisage direct insurers being supervised by offshore insurers. This provides my model with two distinct advantages. Firstly, my model does not allow a supervisory relationship by direct competitors, but rather by arms-length competitors.

Secondly, my model removes the consequences of a bail out to other countries and other economies, by prohibiting the use of an Australian insurer as guarantor of policy liability. This insulates Australian insurers from one another.

Conclusion

This proposal would replace government and the regulator as the overseer of prudential regulations in the insurance industry. As a requirement for operation as an insurer, each insurance company would have to be able to display in its head office a certificate of policy-only liability insurance, issued by an approved insurer. Approved insurers would be drawn from a list of the world's 200 largest insurers by market capitalisation, and would not be Australian.

In this way the regulator could enforce compliance with this arrangement, without having to enquire into any of the underlying aspects of the direct insurer's health or its compliance with prudential regulations. That task is left to the offshore insurer, on the understanding that the offshore insurer will need to make these enquiries in order to ascertain the financial viability of the direct insurer which is a candidate for policy-only liability insurance.

Should the direct insurer fail to cooperate with the offshore insurer it will risk an increase in premiums — or worse, a failure to obtain cover. A failure to obtain cover will preclude the direct insurer from continuing to operate.

In assessing the direct insurer's financial viability both insurers will be able to negotiate with one another as to which factors to investigate and which

factors to leave aside, perhaps for reasons of commercial confidentiality. However, the less forthcoming the direct insurer is with information, the less comprehensive will be the picture which the offshore insurer is able to build of the financial viability of the potential client. That may result in an increase in the premium. So the direct insurer will have to determine whether on any given potential factor of investigation it is a greater priority to save on the costs of the premium, or keep the information private.

Essentially, however, it is envisaged that the offshore insurer would use as a starting point many, if not all, of the factors which the prudential regulator would typically investigate as part of its obligation to monitor and enforce prudential regulation.

The alternative — a government regulator — would not tackle what, in my view, are the systemic failings of the existing paradigm. APRA failed in respect of HIH, in spite of excellent rule of law conditions in Australia, a highly developed commercial, corporate and insurance jurisprudence, a good skills base, and a market economy. Add to the systemic failings of a government regulator paradigm the fact that regulators often enforce regulations enacted in response to the last corporate collapse, and one begins to appreciate why some argue that regulators tend to fight the last war. This is in my view one of the reasons why government enforced prudential regulation is a story littered with reoccurring failures. Tri-continental, Pyramid and the State Bank of SA being but a few examples.

In addition, by removing the State from the function of regulating the insurance industry, potential political interference is removed, along with what often accompanies such interference: distortion of the market, moral hazard and 'one-size fits all' regulation.

Instead of ensuring compliance through criminal sanctions, and thereby relying on the criminal justice system with its higher burden of proof, compliance under this model will be encouraged by market mechanisms — specifically, lower premia. Disputes may be resolved by recourse to the jurisdiction of civil courts.

Should an insured direct insurer fail to honour the liabilities on the policies it has written, the obligation to make good to policyholders will fall to the offshore insurer, not the taxpayer. Furthermore, while policyholders' rights would be guaranteed under this model, it is important to re-emphasise that shareholders' funds would not. This acts as an incentive to shareholders to exercise supervision over their managers. Thus, shareholders' funds act as a deductible or excess on the policy and prevent the creation of moral hazard, which would otherwise be created if shareholders' funds were protected.

In addition, while it would doubtless be a significant claim on any insurer to honour all existing policies written by a failed direct insurer (although no greater than an earthquake or large hurricane), it should be noted that this risk can and would be mitigated through reinsurance; although it must be stressed that this model itself is not one of reinsurance.

Moreover, unlike the case of a major natural disaster, such as an earthquake, a claim on a policy-only liability policy would not necessarily result in the offshore insurer having to pay out large amounts almost immediately, as they would have to do with, for example, an earthquake. The reason for this is that in the case of insurance against earthquake damage, the insurer will face a

very large number of claims for compensation following an earthquake. However, in the case of policy-only liability insurance the offshore insurer will only face claims on whatever underlying policies have ripened into giving rise to a claim, at the moment when the offshore insurer assumes responsibility for the liability on the policies written by the (now) failed direct insurer. This may not represent anything more than the normal number of claims which could be expected against the direct insurer in the course of its everyday operations.

As a legitimate operating expense, Australian insurers would be able to make any premium they paid to an offshore insurer tax deductible, and furthermore there is almost limitless scope for negotiation between the direct insurer and the offshore insurer to reduce the premium. So, for example, a direct insurer could offer an offshore insurer a seat on the board of directors, or control of the direct insurers treasury or foreign exchange room in return for a reduced premium.

Finally, it should be noted that while this model represents a risk, in the sense that it is untried and unproven, the alternative is a regulatory model which is tried and has been proven. Unfortunately, it has proven to have failed.