



Preventative, Corrective and Remedial Actions

HIH Lessons: Reform & Prevention

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International Insurance Seminar

Beatenberg, Switzerland

7-11 August 2006



1. Reform of the Regime
2. Reform of the Regulator
3. Early Warning Signs
4. Supervision Actions Targeting Problem Entities

- Amended Insurance Act took effect July 02
- More stringent provisioning requirements - mandatory compliance with Liability Valuation Standard
- New risk-based capital standard - asset side risk now considered
- Upgraded role for actuaries - Each insurer now has an APRA approved Actuary
- More stringent reinsurance controls - Reinsurance Management Strategy submitted to APRA
- Upgraded risk management requirements
- All non-life insurers re-authorized by APRA. Post July 2002 some were not authorised or obtained only limited authorisation
- Implementation of these reforms commenced in 1999

- There is a need to get high quality personnel into the industry's senior management ranks, and to remove lax personnel who slip through undetected
- Under APRA's regime, a financial entity's board & senior management have prime responsibility for ensuring their key personnel are fit & proper
- However, APRA can also disqualify personnel whose dishonest, reckless or negligent conduct has severely damaged an entity's financial condition
- Over the past 4 years, APRA has removed by disqualification or enforceable undertaking around 110 (25 from insurance) unfit personnel (some are currently under legal challenge)



- Criminal conviction or bankrupted
- Bad business reputation
- Not honest, open & cooperative with authorities
- Disciplined or banned by an authority
- Refused a commercial or professional licence
- Breached a fiduciary obligation
- Lacks relevant technical or commercial expertise
- Involved with a mismanaged entity that failed
- Failed to manage material conflicts of interest
- Disregard for compliance with laws & regimes

These criteria are not codified

APRA requires that the board establish an audit committee and appoint an external auditor (approved by APRA) to independently test adherence to:

- *Reliable financial reporting*
- *The regulator's prudential requirements*
- *Other relevant statutes & standards*
- *The entity's internal risk controls*
- *An adequate internal control environment*

- During 2001, APRA commissioned former Canadian regulator John Palmer to provide a frank assessment of its performance - Palmer noted some difficulties facing APRA, but was quite critical (available at www.apra.gov.au)
- the Royal Commissioner said that he placed great weight on the Palmer Report, and that he appreciated the open and candid way in which APRA had responded to criticism of its performance

- Additional resources
- Recruitment of insurance risk experts
- Robust and sophisticated supervision framework including a risk rating system
- More sceptical Supervisors and improved in house training
- Swifter and stronger enforcement action
- Changed governance structure from Board of Directors to 3 full time Commissioners

- Market intelligence, customer complaints
- Whistle-blowing
- Dominant personality
- Rapid growth
- Diversification into new products & markets
- Major transactions without due diligence
- Performance out of line with benchmarks
- Poor information systems

Examples of Weaknesses



- Information flow to board censored & controlled by CEO and senior management
- Board not fully informed on high-risk transactions - management advice not tested
- Financial reporting not accurate & reliable - board, CEO & CFO fail to accept accountability
- Inadequate controls apply to related party transactions and conflicts of interest
- Independence of audit committee, internal & external auditors & advisers compromised
- Major transactions not properly researched, reviewed, authorised & documented

- Policies, procedures, review modules and guidelines for Supervisors
- PAIRS - Probability and Impact Rating System
 - Inherent risk of business - management & control - capital support = probability rating (i.e. risk grade) x impact of failure = PAIRS supervisory attention index
- SOARS - Supervisory Oversight And Response System
 - Supervisory attention index mapped to one of four supervisory stances; Normal, Oversight, Mandated Improvement or Restructure
- AIMS - Activity and Issue Management System
 - Records, manages and reports on supervision activities undertaken and mandated by supervisory stance

Inherent Risk

- Counterparty Default Risk
- Balance Sheet & Market Risk
- Insurance Risk
- Operational Risk
- Liquidity Risk
- Legal & Regulatory Risk
- Strategic Risk
- Contagion & Related Party Risk

Management and Control

- Board of (Directors or Trustees)
- Senior Management
- Operational Management
- MIS / Financial Control
- Risk Management
- Compliance
- Independent Review



Capital Support

- Current Coverage/Surplus
- Earnings
- Access to Additional Capital

Probability rating

X

Impact Rating (based on asset size)

-> SOARS supervisory stance

Entity Impact rating	<i>Extreme</i>	Normal	Oversight	Mandated improvement	Restructure	Restructure
	<i>High</i>	Normal	Oversight	Oversight	Mandated improvement	Restructure
	<i>Medium</i>	Normal	Normal	Oversight	Mandated improvement	Restructure
	<i>Low</i>	Normal	Normal	Oversight	Mandated improvement	Restructure
		<i>Low</i>	<i>low Medium</i>	<i>high Medium</i>	<i>High</i>	<i>Extreme</i>
		Entity Probability rating				

- **Normal** - routine information gathering from off-site analysis & cyclical on-site inspections determined by size
- **Oversight** - not at material risk of failure, but there are issues requiring closer attention; frequent monitoring, clear expectations
- **Mandated improvement** - unlikely to fail, but outside APRA's tolerable risk range - vigorous APRA intervention to get problems resolved and return to 'Normal' or 'Oversight' or 'Restructure' if unresolved
- **Restructure** - APRA has lost confidence and will take action to contain losses and transfer the business. Usually managed by Enforcement Unit



- *Investigations - fact finding, evidence gathering*
- *Directions & conditions - eg, freezing assets, stopping new business*
- *Orderly exits - eg trade sales, run-offs*
- *Sanctions - eg fines, bans, prosecutions*
- *Compensation arrangements*



Questions?