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The Evolution of Solvency and Disclosure Standards in the Australian Life Insurance Industry

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Abstract

The Curious Case of the Occidental and Regal: The Evolution of Solvency and Disclosure Standards in the Australian Life Insurance Industry

In 1990 the Australian life insurance industry was rocked by scandal which threatened to destabilise consumer confidence in the ability of insurance providers to meet policy holder liabilities. The incident highlighted the nature of the agency problems which arise when conditions of asymmetric information exist. It revealed systemic weaknesses in accounting, solvency and disclosure standards as they applied to life insurers. This paper uses an evolutionary concept of agency to analyse government and industry responses to this event. It is argued that initial adaptive responses stabilised the industry and averted a more serious crisis. Longer term innovative responses led to the introduction of a new and more rigorous approach to reporting and solvency standards which has improved information flows and agency outcomes.

Introduction

The spectacular collapse of several insurance companies in recent times has put the spotlight on the issues of corporate governance which arise from the activities of financial institutions and the regulatory environment in which such institutions operate. The Australian life insurance industry provides an interesting case study giving insight into the manner in which markets react to financial shocks. The crisis in this instance was an attempted fraud perpetrated against the Occidental Life and the Regal Life insurance companies in 1990. Analysis of this event provides an explanation of how financial shocks precipitate responses that contribute to changes in the nature of regulation in the industry and approaches to solvency standards and reporting requirements

In tracing the evolution of regulatory control of the life insurance industry it is possible to determine the pattern and motivation underlying the development of accounting and solvency standards in that industry. Prior to 1995 the extent of control of the life insurance industry within Australia was relatively light in comparison to other parts of the financial sector. Despite this, there had been very few crises in confidence in the industry. In fact, in the 45 years since the first federal act was promulgated no registered Australian life insurer had reneged on its obligations to policy holders or faced the prospect of insolvency. It is argued that one reason for this was that the mutual heritage of the industry was associated with a level of self regulation which influenced industry standards. Self regulation, whilst not explicit as it was in the general insurance industry, nevertheless established an implicit industry code which influenced the behaviour of firms within the market. This code was broken in 1990 when the statutory funds of two insurance companies, the Occidental Life and the Regal Life were plundered in an aborted attempt to sell the two companies. The incident sent shock waves through the financial community. It not only highlighted flaws in the regulatory requirements imposed on the industry, but also standards of accounting and solvency practices employed by life insurers. It resulted in immediate action both by government and the

industry to contain the impact of the crisis and ensure that confidence in the sector was maintained.

This event occurred at a time when the financial sector and the life insurance industry were experiencing a period of significant upheaval associated with the adjustments inspired by the general lifting of regulatory controls by successive Australian governments. It is argued in this paper that the changing environment in which life insurers operated impacted on the existing form of regulation and weakened the implicit regulatory code of behaviour which had influenced the conduct of life insurance business in Australia. This created opportunities for avoidance and abuse that were highlighted in the case of the Occidental and Regal. The crisis in the industry which the attempted sale of these companies inspired initiated a series of institutional responses that changed the manner in which life offices operated and were regulated.

The aim of this paper is to review the regulatory framework within which the life insurance industry operated and analyse the response to a shock to the system that challenged the foundations of the structure of rules which governed industry conduct. The implications for the management and control of solvency standards will be discussed. The paper will proceed by considering a theoretical framework by which to evaluate the challenge to established rules. It will then discuss the approach to regulation in the life insurance industry and the crisis which precipitated the change in this approach. Finally it will evaluate the outcomes in terms of the responses and implications for agency arrangements.

Theoretical Frameworks

Various interpretative frameworks may be adopted in analysing responses to pressures for change in organisational or management procedures. The work of Alfred Chandler for example, suggests that the nature of the firms capabilities and skills are the most important factor in determining the types of opportunities the firm can utilise within its environmental context. The development path of firms provide the key to

understanding the behaviour of markets and the pattern of broader economic growth (Chandler, 1992,p. 99).

New institutional theory, with its emphasis on transaction cost economics, points to the reasons why firms adopt certain strategies. The problems of asymmetric information and bounded rationality influence the outcome of the firms activities. A result of this is that the organisation which develops is argued to be that which deals with transactions costs most efficiently. In this respect the emphasis is placed on the transaction as the focus of analysis (Chandler, 1992, p.85). An alternative explanation of the behaviour of firms is to view them as a 'nexus of contracts' which evolve to resolve the specific problems associated with the divisions between principals and agents. Agency theory assumes that organisational forms which evolve are the outcome of attempts to resolve issues arising from the relationship between the principal and the agent. Again the problems of asymmetric information and opportunistic behaviour must be resolved. The organisation which results is deemed to be efficient otherwise it would not continue to exist in the competitive environment (Douma and Schreuder, 1992, p.101). Unlike the transaction cost analysis, the emphasis here is on the firm.

A limitation of these approaches in analysing the historical development of a particular industry or sector is that they focus on changing strategies within the confines of existing institutional parameters. Evolutionary theory on the other hand, considers the impact of the institutional setting. It suggests that firms adapt overtime in reaction to their environment (Westall, 1997, p.56). Firms learn strategies and processes which they are constantly adapting to improve organisational capabilities. In this way firms, and the markets in which they operate expand and grow (Nelson, 1991, pp.66-9; Chandler 1992, pp.86-7).

The difference between the two approaches can best be described as the difference between process and content. Evolutionary theory may be classified as a process theory, describing the manner in which the strategies of the firm evolve. New institutional theories at the opposite end of the

spectrum, emphasise the content of those strategies and their likely outcome (Douma and Schreuder, 1992, p.170-1). Both approaches have much to add to the analysis of particular aspects of the behaviour and development of organizations. In recent times attempts have been made to synthesise these approaches and move towards more dynamic explanations of why firms respond and evolve as they do. Casson (1997) and Lazonick (2002) develop theoretical extensions of the models which expand on the basic principles of the institutional and evolutionary approaches.[1] Knutson (1999) and Chandar and Miranti (2005) have applied synthesised models to specific examples of adaptive responses to changing environmental factors. The approach taken in this paper is to apply a similar methodology when investigating the processes of change, both institutional and firm specific, inspired by the Occidental and Regal affair.

Corporate governance problems have often been associated with the existence of agency problems. Within the financial sector agency issues have been said to permeate the entire structure of financial firms (Davis, 1995, p.44). Problems are compounded because there are a number of stakeholders involved. In the life insurance industry this includes shareholders, policy holders, management and government regulators. Agency problems arise within these groups because the responsibility for decision making is delegated from one set of stakeholders to another under conditions of asymmetric information (Davis, 1995, p.44). Conventional analysis of such problems would focus on the short term responses assuming the institutional responses remained constant. This point is made by Chandar and Miranti (2005, p. 10), who argued that in a period of economic transition the role of institutions cannot be assumed to be passive. To gain a greater appreciation of the impact of agency problems Chandar and Miranti place them within the context of an evolutionary interpretation. The methodology they employ considers the process of institutional change and its relationship with changes in business models and practices. This approach is of relevance when applied to a specific crisis and its implications for the environment in which firms operate. Taking the

example of the bankruptcies which occurred in the American railway industry in the 1890s Chandar and Miranti demonstrate how innovative regulatory institutions emerged to reduce agency risks and improve corporate governance systems (Chandar and Miranti 2005, pp. 25-26). A similar approach is taken in this paper. An evolutionary concept of agency is used to analyse the responses and outcomes of a shock to the financial environment in which life insurance firms operated and the implications for the development of solvency standards. Such an approach allows a distinction to be made between the initial adaptive response to a crisis and a later innovative response leading to improvements in agency relationships.

Approaches to Life Insurance Regulation

The basis of regulation of the Australian life insurance industry had its origins in the British Life Insurance Companies Act of 1870. In this respect a crisis precipitated by the collapse of two companies, the European and the Albert in 1869, acted as a spur for legislative action. The failure of these insurance companies highlighted the agency problems associated with life insurance. The regulatory response in reaction to these problems influenced not only the future institutional/firm relationships in Britain but also in Australia for the next century and more. The significance of the British act was that it established the principles upon which regulation was undertaken. The prime purpose of insurance regulation was to protect the solvency of companies and in so doing, guarantee that contracts made between policy holders and insurance firms could be met.

A regulatory approach may be either active with strong supervisory provisions, or passive relying on the market to self regulate to a large extent. The method enshrined in the British Act of 1870 relied on passive methods of control. The principle of 'freedom with disclosure' established with the Act of 1870 allowed firms to conduct their business in an unrestricted manner. The only proviso being they published enough information to enable the regulator, and the public, to establish the financial position of the company. The alternate philosophy underlying life insurance

legislation was that of supervision or public disclosure. Such an approach was adopted by European and American regulators who played a more active role in ensuring solvency requirements were met (Royal Commission 1910,p.8: Westall, 1991, p.144).

Prior to 1945 life insurance regulation was both weak and unco-ordinated. Each of the six states pursued their own regulatory agenda. The earliest and most comprehensive legislation was enacted in Victoria in 1873. Other Australian parliaments followed suit, with the exception of NSW which did not enact any direct legislation covering the life insurance sector. Public disclosure was the basic control mechanism adopted by the various states to ensure that firms conformed to a certain set of standards with respect to the protection of policy holder rights. The main thrust of the various forms of legislation was to ensure that life insurance funds were kept separate from other company funds and to establish a minimum deposit requirement to be held with a specified government office. General supervision was very light relying on the publicity provision to ensure firms conformed. The only state with a statutory solvency requirement was Victoria which required the company to be wound up if it was proved to be insolvent (Keneley, 2005, p.8).

In 1945 the Australian government legislated to introduce national regulation of the industry. The Life Insurance Act 1945 superseded all state legislation and brought the industry under one regulatory umbrella. The significance of the Act lay in establishing a uniform regulatory environment that set minimum standards of probity and business conduct. These standards included deposit requirements, prescribed forms of annual reporting and the setting of a minimum valuation standard. This standard set the minimum interest rate for discounting future liabilities and contributions and formed the basis for solvency calculations. To facilitate the operation of the Act, each life insurance company was required to apply for registration to the Office of the Life Insurance Commissioner, established to ensure statutory requirements were met. The regulation of the industry was centred on three measures. First, that a firm's life insurance be separated from other

insurance business. Firms were required to establish a statutory fund for all life insurance funds received. Second, that the firm conduct its business according to a set of standards. These standards were monitored indirectly through a comparative reporting system which required the firm provide specific details to the Life Insurance Commissioner annually. Solvency was assessed on the basis of the firm maintaining a required excess of assets over liabilities. This was measured according to the minimum valuation basis mentioned above. The third measure gave the Life Insurance Commissioner the power take action if warranted. However this authority was not direct. To intervene in the operation of the firm the Commissioner could apply to the Federal Court for an order for the judicial management or winding up of the company (Caffin, 1955 p.158; Joske, 1948, p.136). Supervision of the industry became more comprehensive after the Life Insurance Act 1945 but it by no means monitored every aspect of the company's affairs, or imposed strict solvency requirements. Nevertheless the approach was remarkably successful in attaining stability within the industry. It was not until 45 years after the Act was introduced that the first real crisis in confidence occurred and the Life Insurance Commission was called upon to use it powers of judicial management. This event occurred in 1990 when a case of fraud committed against the policy holders of the Occidental Life Insurance Company of Australia Ltd. and the Regal Insurance Company Ltd posed a serious challenge to the efficacy of the regulatory provisions. The timing of this incident, during a period of substantial change within the financial sector, was significant. It points to a reason why such an event occurred when it did. Changes in fundamental relationships between government, banks and other parts of the financial sector, as a result of the deregulatory push, altered agency associations. This is in turn opened the door to certain types of opportunistic behaviour which had not been countenanced before. Davis (1995, pp.45-46) argues that financial deregulation reduced constraints on managers. Moreover, it was not accompanied by improvements in corporate governance which realigned the interests of managers and stakeholders. This in turn led to

failings in managerial decision making and corporate governance resulting in financial failures in the 1980s. The case of the Occidental and Regal is an example of how such behaviour was manifest in the life insurance industry.

The Pattern of Development in the Life Insurance Market to 1990

The explanation of why there was no financial crisis in the life insurance industry until 1990 lies in the nature and structure of the industry to that point. Traditionally the life insurance market had been dominated by a group of large mutual insurers which had historically been market leaders that set the standards by which the industry operated. A feature of the development of the Australian life insurance industry which distinguishes it from experiences in other countries is the significance of mutual associations (Keneley, 2001, p.146). Although there were only a small number of mutuals they traditionally accounted for a substantial share of assets and premiums sold. Mutual associations captured and retained a large market share from a very early stage in the development of the industry. Up to the 1990s the top five firms which were all mutual insurers had held in excess of 70 per cent of industry assets (Keneley, 2002, p.67).

The existence of large mutual firms in the industry had important bearings on agency relationships and repercussions for the conduct of the market. These firms were the overseers of an informal system of self regulation which established the codes of conduct by which life offices abided. This system evolved from the early development of life insurance and actuarial practice which resulted in the introduction of professional associations such as the insurance institutes and actuarial organisations. The Life Offices Association of Australia was a more recent incarnation of these associations. From an early point in the history of the industry, the managers of major mutual funds had been instrumental in determining standards of practice and codes of behaviour as well as actuarial conventions. So much so, that by the 1950s the chief executive officers of organisations such as the Australian Mutual Provident (AMP) and the

National Mutual Life (NML) were recognised industry leaders not only in Australia but internationally. The life insurance community in Australia was a small and tightly knit group and the executives of the leading offices played an influential part in the associations and organisations which set industry standards. Actuaries from the AMP for example, were instrumental in founding the Actuarial Society of New South Wales (later Australasia) and the state based insurance institutes. They also played a leading role in establishing the system of examination used for the accreditation of insurance officers (Bellis, 1997, p.57; Wickens, pp.41-47).

The dominance of mutual firms in this hierarchy meant that underlying mutual philosophies that determined the approach to business also became the standard by which the industry operated. This approach upheld the interests of policy holders over shareholders. Under this type of system the need for active as opposed to passive government regulation was seen as unnecessary. The industry demonstrated that it was effectively self regulating under the influence of the large mutuals.

The environment in which life insurers operated was altered permanently with the progressive move to deregulate the financial sector which gained momentum in the 1980s. The influence of the large mutuals in the life insurance industry was weakened as new players entered the market and competition altered the status quo. The dismantling of regulatory controls began in the early 1980s. During this time, restrictions on the commercial activities of banks were abolished and 'captive' market requirements on banks and life insurers were removed (Davis, 1997, p. 4). Deregulation had far reaching implications for the structure and conduct of financial markets. With this opening up of the sector, barriers to entry and the segmentation of markets were reduced promoting an industry reorganisation. The number of registered life insurers increased from 45 in 1980 to 58 in 1990 and was also accompanied by a shift in market power amongst these firms. Historically the industry had been highly concentrated with the top three firms accounting for in excess of 70 per cent of industry assets. Notably these firms were all mutuals. Whilst the number of foreign

owned companies had increased since the 1980s they had not succeeded in capturing a significant market share. Levels of concentration began to fall in the decade from 1980 when the deregulation of the financial sector occurred. The industry percentage of assets held by the top three mutual insurers had fallen to 55 per cent in 1990 (ISC, 1990-1). The decline in mutual representation was associated with an increase in bank owned insurers share of assets. The rise in the influence of banks within the industry occurred as deregulation allowed banks to market life insurance products directly instead of the previous indirect practice of selling life insurance products though a subsidiary arrangement. The first bank to enter the life market directly was the National Australia Bank in 1985 and over the next three to four years the other major banks followed suit.

In addition to increased competition from banks, life insurers faced a number of other pressures at this time. The unbundling of insurance products, a trend which began in the 1970s, had brought life companies into more direct competition with other savings and investment institutions. The separation of life insurance products between mortality risk and investment earnings led to the creation of a whole range of investment linked products and placed a much greater emphasis on short term performance than had previously been the case in the life insurance industry. This trend was reinforced in the uncertain financial climate of the late 1980s. Life insurers came under pressure to subsidise short term returns with either injections of capital, forgoing dividends or the use of reserves. Major life offices also suffered losses after the stock market crash of 1987 through the activities of their affiliated companies. The AMP for example, lost over $75 million through the Chase AMP bank's dealings with the Quintex group (Blainey, 1999, p.300). Other insurers were also caught up in the corporate excesses of the 1980s through their subsidiary companies.

Concurrent with the greater emphasis on short term results, continually high inflation was leading to expense overrun and placing pressure on traditional life insurance business where the margin for expenses allocated from premium income was not sufficient (ISC,1990-1).

The restructuring of the financial sector inspired by the lifting of regulatory controls on banks altered the nature of agency relationships. Banks were now able to compete directly in the same markets as other financial service providers. Life insurers responded by diversifying into other financial markets. This broadened the risks associated with the delegation of decision making processes by policy holders to life office management. Competitive forces and market instability combined to impact on the mutual structure which had been the backbone of the industry for nearly 150 years. The market was undergoing a transition which would eventually lead to a organisational restructuring of the leading life offices and the disappearance of the mutual life insurer. The transition period was associated with a weakening of the influence of the large mutuals within the industry and the effectiveness of the self regulatory system associated with them. Davis (1995, p.46) points out that deregulation was not accompanied by any improvements in corporate governance or market discipline which realigned managerial interests with other stakeholders. This opened the door for potential mismanagement and abuse of corporate responsibility. The fraud perpetrated against the policyholders of the Occidental and Regal insurance companies was an outcome of this trend. The mismanagement of the affairs of these two companies exposed a major weakness in the supervisory framework under which life insurance in Australia was conducted and presented a systemic threat to the financial services sector (Glading, 1991, p.18).

The Incident

The Occidental Life insurance company was a medium sized firm which specialised in term and disability insurance as well as some investment products. The Regal was a small life insurance company, previously known as Royal Life Insurance Ltd. Both companies were owned by the Battery group. The major shareholders of the Battery group came under pressure to reduce their gearing and the decision was made to sell the two companies. The buyer was Heath Holdings a shelf company

said to be representing a group of American investors. The agreed price for sale was $132 million Australian, $65 million of which was to be paid up front in the form of two cheques payable to the Battery group bankers. It was the intention of the Battery group management to apply these funds directly to the repayment of company debt. The transaction took place on the evening of Friday 28th of September 1990. The following Monday it was discovered that $65 million of the two life insurers statutory funds were missing. It had apparently been used to finance the transaction (Manson, 1990, p.22). This incident threatened the solvency of the two companies and its ability to meet policy holder liabilities.

The audacity of this scam sent shockwaves through the insurance sector. It pointed to shortcomings in the informational structures used by life insurers in reporting financial details and upon which agency contracts were based. It exposed serious deficiencies in the information available to policyholders and in the safeguards protecting their assets.

Two central problems highlighted the weaknesses in the informational structure upon which contracts between company management and policyholders were based. Firstly, there were no accounting standards for life insurers. The manner in which life insurance revenues were invested and the fees and charges applied could not be determined by the policy holder. It was also not possible to analyse the expenses of the company to gauge whether such costs could be recovered in the long run. Furthermore, life insurers were exempt from the accounts and disclosure requirements of the Companies Act. This meant that published accounts did not show a 'true and fair' view of their financial position. The second problem arose from the inadequacy of solvency disclosure requirements in the 1945 Act. The Life Insurance Act 1945 did not contain any clear definition of solvency. The statutory reporting requirements under the Act provided for two sets of returns or schedules. The first schedule contained the balance sheet and revenue account of the firm. The second detailed the returns of the company relating to new policies sold and policies in force. This schedule represented information about the liabilities

to policy holders. In addition, periodic actuarial investigations were conducted into the value of the firms policy liabilities according the specified standard of evaluation. The information contained in these returns was meant to indicate the solvency margins of the firm. However the required presentation of the information made it very difficult to determine precisely the extent of reserves or margins. One commentator summed up the position in stating that the two schedules were 'virtually meaningless in assessing the true financial position and profitability of life companies' (Findlater, 1990,p.70).

Adaptive Responses

The initial response to the crisis engendered by the fraud perpetrated on the Occidental and Regal companies was the appointment of a judicial manager. Under Sections 59-60 of the Life Insurance Act 1945, the Life Insurance Commissioner could apply to the Federal Court for the appointment of a judicial manager to take over control of the company. This occurred for the first time in 1990. The reports of the judicial manager at this time highlighted a number of problems with the companies in respect to the preservation of policyholder assets and their dealing with their statutory funds (Davis, 2004, p.244). Serious concerns were expressed regarding the solvency of the statutory funds of these two companies (ISC 1990-91 p.18; Australian Financial Review 8.11.1990, p.4).

The reports of the judicial manager also reinforced the concern over deficiencies in the existing Act. Even if the Insurance Commissioner suspected that there may be an underlying problem with the solvency of a firm's statutory funds he had little power to question the directors' valuations of assets. In addition the Act did not require that the Commissioner be given notice in advance of any proposed takeover or change in control. He was unable to ensure the protection of policy holder assets in this regard. The Act relied on the co-operation of life insurers in this respect (Glading, 1991,pp.17-19).

Whilst the specific issue of the missing funds of the two companies became tied up in the courts, the government moved to ensure that policyholder funds were protected in the future. Four Acts were passed in 1991. These were the: Insurance Supervisory Levy Bill, the Insurance Acquisitions and Takeover Bill, Life Insurance Policy Holders Protection Levies Bill and the Life Insurance Policy Holders Protection Collection Bill. These acts were designed to achieve two basic outcomes. Firstly to raise revenue from the industry to provide a degree of protection for the policy holders of the Occidental and Regal. Secondly to broaden the powers of the Life Insurance Commissioner with respect to changes in ownership and control of life insurance companies and the rights of policy holders. These actions represented modifications to existing practices in the industry. They did not address the more fundamental informational problems revealed by the crisis.

The industry itself adopted a similar approach. The peak industry association, the Life Insurance Federation of Australia, resolved to cover the $65 million loss from the two companies' statutory funds. They also committed the industry to working towards an outcome which would insure policyholder rights were protected. Although it took three years for the issue to be fully resolved, the result was an industry/regulator negotiated solution which obviated the need to impose harsher regulatory penalties on life offices. The business of the Occidental and Regal was transferred to a major life insurer allowing most policy holders to receive the full value of their policies (ISC,1993-94 p.42). The Levies Acts were never implemented and the legislation was subsequently repealed in 1995.

The adaptive response of government and industry averted a major loss of confidence and crisis in the life insurance sector. It reinforced the ability of the industry to maintain standards and protect policy holder assets once an event had taken place.

Innovative Responses: Reform of the Life Insurance Act 1945

The immediate changes implemented to deal with the results of the Occidental and Regal case did not improve the informational aspects upon which policy holders made decisions and agency relationships were formed. Measurement and reporting of solvency standards had not altered and there were still no generally accepted accounting standards for life insurers. Many companies had adopted a modified versions of accounting reporting practices but these were designed more for internal reporting and were not a legislative requirement. The fundamental problems highlighted by the Occidental and Regal incident remained. However, the case confirmed amongst many in government and industry the need for an overhaul of the 1945 Life Insurance Act. It was from this belief that further more fundamental responses evolved.

Reform and the implementation of more fundamental change occurred with the passing of the Life Insurance Act 1995. Whilst the essential philosophy underpinning the approach to regulation remained the same, the manner in which it was implemented altered. The focus of reform with respect to the issues raised by the Occidental and Regal incident centred on three main areas. These were the responsibilities of directors to protect policy holders' interests, reporting requirements and solvency requirements. Improvements in these three matters led to upgraded informational flows. The net effect of these changes was to improve the agency relationships between the stakeholders involved by increasing transparency and standardising solvency accounting procedures.

The approach taken in reforming prudential supervision of the life insurance industry was to continue with the basis on which the Life Insurance Act 1945 was written. This approach reinforced the self regulatory role of the market in placing the responsibility for the health of the company with its directors and advisors. Direct intervention was viewed as a last resort, the emphasis being on the company to resolve issues which threatened the stability of the firm (Thorburn, 1995, p.59).

Changes introduced clarified the obligations of firms and their directors. The Act required that an insurer give priority to the interests of policy holders in respect to the management, administration and investment of statutory funds. The Act further specified that the directors should, with reasonable care and due diligence, protect the interests of policy holders above the interests of shareholders (Sutton,1995,p.481). Further clarification was made with respect to the assets of the company and statutory funds. A point of confusion, which was highlighted by the Occidental and Regal case, was who was directly accountable to policy holders and the regulator for the management of statutory funds (Klumpes, 1991, p.41). The 1995 placed responsibility to protect policy holder interests with the directors of the company.

To insure that directors were in a position to represent the interests of policy holders, increased responsibilities were proscribed for actuaries and auditors in the management of the firms affairs. Included in these responsibilities was a ‘ whistle blowing role’ to the regulator. Actuaries and auditors were obliged to report activities within the firm which may prejudice the interests of policyholders (Thorburn, 1995).

To further improve information available to and provided by life insurers the Act established the Life Insurance Actuarial Standards Board (LIASB). The Board was appointed by government and its function was to support a new financial reporting regime which reflected methods of realistic valuation and transparency of disclosure. The LIASB was charged with responsibility for establishing six main actuarial standards. These were in relation to valuation of policy liabilities, determination of solvency and capital requirements, capital requirements for shareholder funds, calculation minimum surrender values and valuation of performance guarantees in investment linked funds. Previously these matters had been handled by the office the Insurance Commission with the issuing of periodic directives and circulars. The 1995 Act established a much more formal reporting regime in which companies were judged against a specific set of standards as determined by the LIASB. The ‘appointed actuary’ of each company was

required to report to the Australian Prudential Regulation Authority (APRA) annually on the company's financial position with particular reference to the actuarial standards.[2]

The most significant and innovative changes introduced by the Act related to capital and solvency requirements. A two tier solvency requirement was imposed on statutory funds. The first tier established a Solvency Standard aimed at ensuring existing liabilities could be met as they fell due. The second tier introduced a Capital Adequacy Standard intended to ensure the financial soundness of the firm (LIASB, 2003, p.3). The solvency requirement determined by the standard included a solvency liability, expense reserve, resilience reserve and inadmissible assets reserve. The capital requirement included a new business reserve, inadmissible assets reserve, resilience reserve and capital adequacy liability. The capital requirement reserve was deemed to be at least equal to the solvency reserve. In this context the solvency reserve provides an early warning indicator to any potential problems the viability of the firm's operations (APRA, 2003).

In valuing assets and liabilities to determine solvency and capital adequacy reserves firms are required to use a 'best estimate' or market value basis approach. The previous Act had specified a Minimum Value Basis for the valuation of the liabilities of statutory funds. The information flowing from this method made it very difficult to establish relevant data on solvency margins. The solvency requirement is published in the financial statements of the life insurer and is a public indicator of the financial strength of the firm. The capital requirement is reported confidentially to the government regulator who makes an assessment on the soundness of the firm (LIASB, 2002, p.4).

The changes made to prudential supervision of life insurers with the 1995 Act introduced a number of measures which have contributed to reducing agency risks in the relationship between policy providers and policy holders. This has been achieved by the clarification of the obligations of specific parties, particularly directors, chief executive officers, actuaries and auditors. Specific reporting requirements which allow improved flows

of information have been formalised and standardised. More rigorous solvency and capital adequacy requirements have provided a basis upon which the financial soundness can be judged. These measures will not prevent deliberate fraud occurring, as happened in the case of the Occidental and Regal. However they have introduced a number of innovative measures which protect and strengthen the position of life insurers in the financial sector.

Conclusion

Agency problems are an inherent part of financial markets where decision making responsibilities are delegated under conditions of imperfect information. Recognition of this fact has led to the development of regulatory regimes which offset and limit the worst outcomes of these relationships. However during periods of transition and institutional change existing governance processes may become weakened, opening the door to opportunistic behaviour with the potential to destablise the sector.

The case of the Occidental and Regal is an illustration of how this may occur. Aside from the illegality of the fraud against the Occidental and Regal the incident revealed more fundamental problems with the informational structures upon which life insurance contracts were based. There were no clearly established accounting standards for life insurers. Furthermore solvency requirements and disclosure standards were inadequate, making it very difficult for policy holders to make informed decisions. The innovative responses sparked by the incident lead to a major overhaul of the life insurance act in which these issues were directly addressed. Whilst the underlying approach to regulation did not alter, government and the industry worked together to develop a new set of standards within which the industry would operate. The new act clarified the responsibilities of directors, agents and actuaries and established common sets of actuarial and accounting standards. It reformed solvency requirements and introduced improved reporting and disclosure of financial information. Improved agency relationships resulted by increasing accountability and informational structures.

The case points to a dynamic and regenerative process which allows institutions to react and build on experience. The evolutionary approach adopted in this analysis suggests that responses will develop over time. Initial adaptive responses will be designed to stabilise the industry, limit contagion and protect stakeholders assets. Later innovative responses will lead to more fundamental improvements in information flow which improve agency outcomes. The analysis sheds light on how markets adapt and react to changing competitive environments. It suggests that the nature of agency relationships are continually evolving over time in response to a past experience and future improvements in information flows.

Endnotes

[1] Casson (19970 explores the notion of information costs as a broader extension of transaction costs. Lazonick (2002) introduces the concept of an historical transformation methodology to provide an understanding of innovative enterprises.

[2] Each company was required to employ an 'appointed actuary' who was approved by APRA to evaluate the financial position of the life insurer.

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