CHAPTER 5: CONSEQUENCES OF FINANCIAL INSTITUTION FAILURE

Overview

- Assessing the composition of households' and individuals' exposure to financial assets provides some insight into the possible consequences of a financial institution failure. This can assist in consideration of the possible scope of explicit guarantees.
- The available data suggest:
  - Australian households hold the majority of their wealth in assets involving an exposure to market risk;
  - Australian households hold around two-thirds of their financial wealth in the prudentially regulated sector;
  - deposit balances are generally quite small, even for high wealth households; and
  - the value of assets or income protected by insurance policies is significantly higher than deposit balances.

Background

5.1 Before considering the possible scope of explicit guarantees (Chapter 6), it is instructive to analyse the potential exposure of retail customers to financial institution failure across a number of asset or product categories. The nature and value of the loss will vary across different institutions and product types.

5.2 For illustrative purposes, the discussion focuses mainly on the household unit as the most significant category of retail customer. A broader definition of retail customers may well include small businesses and community organisations. The consequences are considered in general terms and across the range of prudentially regulated products. A lack of consistent data across the sectors has made comparisons difficult. Data from a range of sources have been used to overcome inconsistencies.

5.3 Two possible ways of considering the consequences are examined:

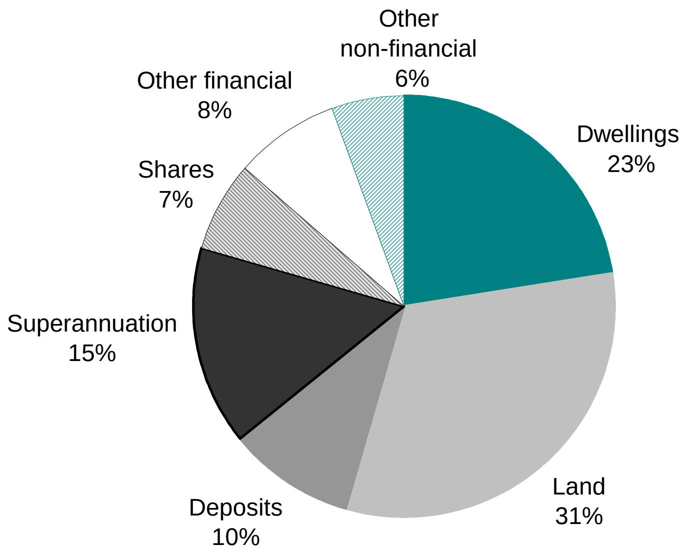
- the nature of the loss; and
- the value of the loss.

Aggregate household exposures

5.4 Chart 5.1 and Table 5.1 provide an overview of aggregate household assets. The Australian Bureau of Statistics (ABS) estimates that as at 30 June 2003, households in Australia had a net worth of $2,516 billion.[1] Total assets amounted to $3,209 billion offset by liabilities of $693 billion. Non-financial assets represented around 60 per cent of total assets ($1,921.6 billion). Within this category, land represented around 53 per cent and dwellings around 38 per cent. Financial assets represented around 40 per cent of total assets ($1,287.4 billion).

1 Per household this equates to $340,000 based on 7.4 million households in Australia (as at June 2001). Source: http://www.abs.gov.au/Ausstats/abs@.nsf/Lookup/F25B71F5D61F5346CA256CAE00053F9B.

Chart 5.1: Aggregate household assets



Source: ABS Cat.No. 5204.0 2002-03, 5232.0 June Quarter 2003.

5.5 Table 5.1 and Chart 5.1 also document the average composition of household wealth across various sectors and asset classes using a range of data sources. These data illustrate how most of an average household's total asset holdings are exposed to some market risk — housing (land and dwellings) and superannuation being the major categories.

Table 5.1: Composition of household wealth (total assets)

	$billion	Per cent of component
Assets	**3,209.0**	
Non-financial	1,921.6	59.9
Financial	1287.4	40.1
Liabilities	**693.4**	
Net worth	**2,515.6**	
Non-financial assets	**1,921.6**	
Land	1,020.7	53.1
Dwellings	723.3	37.6
Financial assets	**1,287.4**	
Non-prudentially regulated	408.0	31.7
Prudentially regulated	879.4	68.3

Source: ABS Cat.No. 5204.0 2002-03, 5232.0 June Quarter 2003.

5.6 Of households' total financial assets, $879 billion or 68 per cent, are held with financial institutions that are prudentially regulated by the Australian Prudential Regulation Authority (APRA).[2] Table 5.2 shows the composition of household wealth across the subset of prudentially regulated assets.

5.7 The two largest household financial assets in the prudential sector are deposits ($315 billion) and superannuation ($494 billion). APRA data show that households hold around 38 per cent of their deposit balances in transaction accounts and 62 per cent in savings accounts. Of the money in savings accounts, 38 per cent is in at-call accounts, 61.5 per cent in term deposits and 0.5 per cent in retirement saving accounts. APRA data show that superannuation funds directly invested 35.5 per cent of assets during the June quarter 2003, investment managers had a similar share of superannuation assets at 35.2 per cent and assets held in statutory funds of life offices represented 29.3 per cent of total superannuation assets.

Table 5.2: Composition of household wealth (prudentially regulated assets)

	Per cent of component of prudentially regulated assets*	$billion**
Prudentially regulated assets		**879.4**
Deposits		**315.3**
Transaction	38.0	
Savings	62.0	
At- call	38.0	
Term	61.5	
Retirement saving	0.5	
Life insurance		**41.1**
General insurance		**29.5**
Superannuation		**493.5**
Directly invested	35.5	
Investment manager	35.2	
Life insurer	29.3	

*APRA data.
** ABS data.
Source: ABS Cat.No. 5204.0 2002-03, 5232.0 June Quarter 2003, APRA (2003).

2 Of that, 35.9 per cent is in deposits and 56.1 per cent is in superannuation.

5.8 Table 5.3 examines how the composition of households' assets varies according to their wealth. Lower wealth households typically hold most of their assets in the form of superannuation. Higher wealth households were found to have considerable equity in land and dwellings and hold relatively diversified financial assets.

Table 5.3: Distribution of household wealth*

Non-financial assets

Wealth Quintile	Home		Rental properties		Total	
	$	Per cent of total wealth	$	Per cent of total wealth	$	Per cent of total wealth
1	1,000	5.9	0	0.0	1,000	5.9
2	38,000	40.9	3,000	3.2	41,000	44.1
3	121,000	61.7	11,000	5.6	132,000	67.3
4	203,000	63.0	17,000	5.3	220,000	68.3
5	415,000	53.8	58,000	7.5	473,000	61.3
Av	**155,000**	**55.4**	**18,000**	**6.4**	**173,000**	**61.8**

Financial assets

Wealth Quintile	Deposits		Shares		Superannuation		Total	
	$	Per cent of total wealth	$	Per cent of total wealth	$	Per cent of total wealth	$	Per cent of total wealth
1	1,000	5.9	0	0.0	15,000	88.2	16,000	94.1
2	4,000	4.3	2,000	2.2	46,000	49.5	52,000	55.9
3	8,000	4.1	4,000	2.0	52,000	26.5	64,000	32.7
4	15,000	4.7	11,000	3.4	76,000	23.6	102,000	31.7
5	58,000	7.5	152,000	19.7	89,000	11.5	299,000	38.7
Av	**17,000**	**6.1**	**34,000**	**12.1**	**56,000**	**20.0**	**107,000**	**38.2**

* The National Centre for Social and Economic Modelling (NATSEM) estimate average household wealth to be $280,000 although they note that this average varies by State and that there is a large dispersion of wealth. To provide a more detailed view of the dispersion, all households have been ranked by wealth and then divided into five equal size groups (quintiles). (NATSEM 2002).
Source: NATSEM 2002.

Authorised deposit-taking institutions (ADIs)

Transaction and savings accounts

5.9 Table 5.2 shows the aggregate composition of household wealth. Table 5.3 disaggregates household wealth by wealth quintile. It indicates that more than 80 per cent of households hold less than $60,000 in deposit accounts.

5.10 The failure by an ADI to honour its obligations on transaction or savings accounts will result in a loss of wealth for depositors and may involve considerable inconvenience due to an inability to participate in the payments system.

5.11 The balance held by depositors in a transaction account is likely to vary considerably over time. At one extreme, it could contain the proceeds of a major asset sale, such as a home, insurance settlements or superannuation rollovers. At the other extreme the balance could be close to zero.

5.12 A transaction account is necessary for effective participation in the modern payment system.[3] Many Centrelink payments recipients are paid into transaction accounts and most employees receive their salaries and wages via transaction accounts. Fees and charges also discourage individuals from holding more than one transaction account. Loss of a transaction account due to ADI failure involves inconvenience costs (as well as wealth loss) associated with opening an account with another ADI, and rearranging direct credit and debit arrangements.

5.13 The failure of an ADI can lead to losses on savings products purchased by depositors.[4] The loss of principal (including accumulated interest) could represent a significant proportion of total wealth for some depositors.

5.14 Loss of savings may mean that an individual's consumption plans have to be delayed or cancelled. For some small businesses, routine operations (such as payment of suppliers and wages, for example) and investment plans could be seriously disrupted.

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3 While a credit card can be used for participation in the payments system, a transaction account is necessary to receive certain payments and settle card accounts. The increased use of Electronic Funds Transfer at Point of Sale (EFTPOS) may also encourage individuals to hold greater amounts to cover transactions.

4 ADIs also offer deposit products with fixed principal but earnings involving exposure to market risk. In some cases this reflects the nature of the interest rate arrangements (fixed or linked to some market rate). It may also arise when the rate of return is linked to a share market index.

5.15 These losses and inconveniences will not necessarily be overcome if depositors are forced to wait for the recovery of the failed ADI's assets as part of a liquidation process.

Life insurers

Risk products

5.16 Risk products are similar to ordinary insurance products, but typically provide a benefit in the event of death, disability or injury. Policyholders pay a premium for insurance cover and receive a lump-sum benefit contingent upon a particular event. The loss to policyholders from the failure of a life insurer will entail non-payment of expected policy benefits and a loss of cover.

5.17 In relation to expected policy benefits, this would entail loss of a lump sum payment or source of income for the policyholder, their dependents or third-party beneficiaries of the policy. Third-party beneficiaries could include the employees of a business that has taken out a group policy.

5.18 Given the nature of the events insured against in income protection products, it is unlikely that affected parties will be able to replace the lost income through a return to work in the short term. Even if some or all of the policy benefit is recovered at a later date, as a result of the sale of the failed insurer's statutory fund assets, this will not overcome the problem of a lack of income in the intervening period.

5.19 Loss of life insurance cover involves some different consequences. One consideration (relevant in all insurance failures) is the replacement cost for the unexpired portion of a policy for which an annual (or more frequent) premium has been paid in advance. This is not likely to be significant relative to the consequences attaching to a loss of an expected policy benefit. However, policyholders may need some time to be able to arrange suitable replacement cover.

5.20 A possibly more significant consideration is the affordability of replacement cover. In the case of many life insurance policies, premiums are determined at the date that the policy is taken out and remain fixed or on a fixed path for the term of the policy (as long as it is renewed). Policyholders may be unable to find replacement cover at the same price (or at all), due to their ageing or an adverse change in their health.

5.21 To reduce the risk that a claim will not be met or their cover interrupted, policyholders must attempt to buy their insurance from the most financially sound life insurer. This can be a difficult task as the long-term nature of many policies means judgements may have to be made now about the likely soundness of the insurer many years into the future.

Savings products

5.22 A number of life insurance products involve a savings element which is exposed to loss if an insurer fails. The savings component will consist of accumulated principal and earnings on the principal. For some products, known as investment-linked products, the value of the policy benefit will be subject to fluctuations due to exposure to market risk, akin to investments. Other products may entail a capital-guarantee or earnings-guarantee on the part of the life insurer, which may be likened to deposits in savings accounts with an ADI. The savings component may be distributed to policyholders as either a lump sum or as an income stream.

Annuity products[5]

5.23 Purchase of an annuity product involves the transformation of savings into a regular income stream. For most people this would occur at retirement using accumulated superannuation savings. The nature of the promise attached to an annuity, in terms of the value of future income, may range from purely investment-linked products (providing exposure to market risk and earnings volatility) to guaranteed income streams (underwritten by the provider).

5.24 Failure of a life insurer to honour its obligations on guaranteed annuity products[6] may mean significant wealth loss for retirees who are unlikely to be able to rebuild these savings and may suffer a reduction in retirement income.[7]

5.25 Policyholders have options to reduce the risk associated with guaranteed annuity products, including purchasing products with multiple insurers. In practice, policyholders face informational and transaction cost difficulties in acting this way.

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5 These are referred to as pension products if offered by superannuation funds. Annuities may also be provided by other registered entities.

6 The life insurer has no 'obligation' in terms of the capital value of investment-linked products.

7 The age pension provides a public form of retirement income for eligible parties, which may provide a partial offset to the loss.

Total exposure

5.26 The ABS estimates that Australian households had claims against the reserves of life insurance companies of $41 billion at end-June 2003 (Table 5.2). This includes savings that have been accumulated or deposited in life insurance statutory funds and reserves for claim payments in excess of savings. In total, these claims represent around 3.5 per cent of household financial wealth. Life insurance policy payments in the year to June 2003 were around $4.5 billion, which is equivalent to less than 1 per cent of household total gross income. While total claims paid are small in household income terms, they are crucial in the relatively few households receiving them.

5.27 Data from an Investment and Financial Services Association (IFSA) survey (IFSA 2003) indicates that approximately 33 per cent of the population hold life insurance risk policies, suggesting that life insurance will be relatively more important for those households with cover than indicated by the average value. The average policy benefit associated with various categories of policies is presented in Table 5.4.

Table 5.4: Life insurance policies — average policy benefits[8]

Policy category	Average benefit per policy
Term life cover	$235,000
Disability cover	$3,500 per month
Trauma cover	$165,000

Source: Investment and Financial Services Association (2003).

General insurers

Risk products

5.28 Similar to the case for life insurance risk products, the loss for policyholders from the failure of a general insurer will entail non-payment of expected policy benefits and a loss of cover. The consequences will vary according to the type of cover.

8 Data is based upon a November 2001 survey of 13 of IFSA's 19 members.

Short-tail classes[9]

5.29 For those policyholders with outstanding or incurred but not reported claims against the insurer, there will be a loss of an expected policy benefit. The magnitude of this loss will depend on the value of the asset protected by insurance and the extent of the claim. The implications may range from severe — for example, where the insured's claim relates to total loss of their house from a fire; to minor — for example, where the insured's claim relates to a damaged windscreen.

Long-tail classes

5.30 Incurred but not reported claims may relate to long-tail classes of insurance such as professional negligence. Such insurance policies may provide future compensation for events that have already occurred but the consequences of which may not yet be apparent.[10] Failure of a general insurer writing such business may involve loss of an expected policy benefit for policyholders for many years to come.

Liability classes

5.31 For liability classes of insurance,[11] failure of the insurer may involve implications for both policyholders and third-party beneficiaries. Loss of an expected policy benefit may leave the insured party exposed to liability and the injured party without compensation.

5.32 Even if some or all of the money is recovered at a later date as a result of the sale of the failed insurer's assets, this will not overcome the problem of the loss of the expected policy benefit in the intervening period.

Loss of cover

5.33 The failure of a general insurer will also mean that policyholders will no longer have insurance cover. The failure of the HIH Group of

9 'Short-tail' business has a well-defined period, normally a year, between when an incident occurs and a claim is settled by the insurer. It usually includes claims against loss or physical damage to goods or property.

10 Generally, the manifestation of an occurrence may take years, for example, the effects of asbestosis. There are some occurrences, however, that may manifest early but have not been reported, depending upon the type of policy coverage.

11 For example, Workers' Compensation, Compulsory Third Party (CTP) Motor Vehicle Insurance, Builders' Warranty insurance, professional indemnity and public liability insurance classes protect both the policyholder (from financial loss in providing compensation) and the injured party (by providing compensation for the injury or loss).

Companies (HIH) demonstrated how certain occupations may be threatened because it is too financially risky or against the law to operate without insurance. Unused premiums lost plus additional costs in arranging alternative cover determine the magnitude of this loss. Policyholders may need some time to be able to arrange suitable replacement cover.

5.34 As with buying products from other types of financial institutions, most retail policyholders are not well placed to assess whether a general insurer will be able to pay its claims in one year from now, let alone in five or ten years' time as may be the case for the long-tail classes. Third-party beneficiaries have very few options available to reduce the risk that an insurer with existing or potential liabilities to them will be unable to meet their rights for compensation under liability classes.

Total exposure

5.35 The ABS estimates that Australian households had claims against the reserves of general (and health) insurance companies of $29.5 billion at end-June 2003 (Table 5.2). These reserves include provisions for outstanding claims and unearned premium. This represents 2.25 per cent of households' financial assets. The ABS Household Income Account shows that households received around $14 billion from general and health insurance claims in 2002-03, representing around 2.25 per cent of total gross income.

5.36 However, the liabilities on general insurers' balance sheets are the expected payouts for claims, which are the product of the sums insured and the probability of a claim. Figures on the value of general insurance policies would provide a better indication of the importance of general insurance to Australians. The Insurance Council of Australia (ICA 2002) has estimated that as at 31 December 2000, the average sum insured (value of assets protected) for all household policies in force at that time was $201,650.

5.37 The failure of HIH illustrates the consequences for policyholders from the failure of a general insurer. Initial estimates put HIH's deficiency in assets compared to liabilities at between $3.6 billion and $5.3 billion.

5.38 Data from the HIH policyholder support scheme provide an indication of the consequences for some of HIH's retail policyholders with outstanding claims. The scheme has received over 14,000 applications for compensation.[12] As at March 2003, the average value of claims by policyholders in the short-tail classes, such as motor vehicle and domestic property insurance, has been around $18,000; for salary continuance it has been around $58,000; for public liability $88,000; and professional indemnity $106,000. The average value of the long-tail classes of claims may rise over time.

5.39 APRA data on general insurers' policies and claims provide an additional indication of the likely number and average value of claims that would be outstanding if an insurer failed. Table 5.5 shows, for the industry as a whole, the number of policies in force at end-June 2002, the number of outstanding claims at that point in time and the provisions for those claims.

5.40 If an insurer writing business that was representative of the industry as a whole failed at end-June 2002, it would have outstanding claims equal in number to 2.4 per cent of its total policies in force. The average claim size would be $22,497 per policy. The proportion of claims outstanding and the average claim size varies considerably by type of insurance. For Compulsory Third Party (CTP) motor vehicle insurance, there are only a small proportion of claims outstanding but the average claim size is almost $133,000. For commercial motor vehicle insurance, there are a relatively large number of claims outstanding but the claim size is quite small. Professional indemnity and employers' liability have both a high proportion of claims outstanding and about average claim size.

5.41 In terms of policyholders' exposure to lost cover, if an insurer writing business that was representative of the industry as a whole failed, its policyholders would have, on average, unused premiums of $258 each. In some categories (professional indemnity and employers' liability), these amounts could be substantial, but generally of very much smaller consequence to affected parties than the loss of benefit to the claimants' policies.

12 The Commonwealth scheme, HIH Claims Support Scheme, was targeted to policyholders suffering hardship so the total number of policyholders with outstanding claims against HIH will be higher than this figure.

Table 5.5: General insurance — claims outstanding and unearned premium (end-June 2002)

	Total number of policies	Outstanding claims	Provisions for outstanding claims	Unearned premium provision	Outstanding claims as a proportion of total policies	Average size of claim	Average unearned premium
	'000		$'000		Per cent	$	
Fire & Industrial Special Risk	2,146	44	1,228,003	882,871	2.1	27,909	411
Houseowners/ householders	10,790	173	832,238	1,425,500	1.6	4,811	132
CTP Motor vehicle	5,813	58	7,709,115	1,116,883	1.0	132,916	192
Commercial motor vehicle	982	91	355,547	605,841	9.3	3,907	617
Domestic motor vehicle	9,203	388	851,227	2,096,661	4.2	2,194	228
Marine and aviation	346	7	237,838	153,835	2.0	33,977	445
Professional indemnity	156	34	1,842,079	310,855	21.8	54,179	1,993
Public and product liabilities	2,520	33	3,665,353	587,211	1.3	111,071	233
Employers' liability	174	29	2,200,597	452,138	16.7	75,883	2,598
Mortgage consumer credit	1,020	8	58,865	252,345	0.8	7,358	247
Travel	945	18	77,738	16,531	1.9	4,319	17
Other accident	1,918	24	494,398	403,862	1.3	20,600	211
Other	1,041	18	281,780	306,788	1.7	15,654	295
Inward treaty	3,098	50	2,111,219	1,332,738	1.6	42,224	430
Total	**41,439**	**978**	**22,002,443**	**10,675,193**	**2.4**	**22,497**	**258**

Source: Australian Prudential Regulation Authority, Selected Statistics on the General Insurance Industry, Year-ending June 2002.

Superannuation[13]

5.42 Financial losses within the superannuation environment could result in a significantly lower standard of living for fund members in retirement. For most workers, compulsory contributions on the part of their employer represent the bulk of their superannuation savings, particularly early in the accumulation phase.

13 This analysis relates to accumulation products offered by superannuation funds. Superannuation funds also offer retirement income products. See section on life insurance failure for an analysis of these products.

5.43 The consequences for individuals from the loss of some proportion of their superannuation savings will depend on the individual's stage of life when the loss occurs. As the sum of money needed to provide for retirement income is many multiples of a person's annual income during their working years, it takes many years to accumulate the necessary savings. A loss of these savings late in a person's working life cannot be made up through contributions at a slightly higher proportion of salary. Should the loss occur early in a person's working life, however, there may be scope to recover these funds.

5.44 It is important to emphasise an important characteristic of some superannuation funds *vis-a-vis* other products discussed earlier.

5.45 In the case of defined contribution superannuation funds, the member has an investment-linked claim over the value of assets managed by the fund. In contrast, deposit and insurance promises are typically 'fixed value' promises. In this sense, the risk associated with accumulation superannuation funds does not generally take the form of a counterparty risk between the fund's trustee and the member.

5.46 It is worth noting, however, that the member's superannuation balances may be placed as deposits with ADIs or used to take out forms of life insurance cover. Moreover, a special form of product, a retirement savings account, involves accumulating a superannuation balance with an ADI. In these special cases, the member's exposure to the ADI or life insurer as a superannuation fund member might be compared to their exposure in an individual capacity outside of the superannuation environment.

5.47 Defined benefit superannuation funds create particular complications. Members are promised (by an employer) a level of retirement benefits to be paid by the fund. If the fund's assets (built up by contributions and earnings) are inadequate to meet those promises, the employer is liable to meet the shortfall. If the scheme is unfunded, members face the counterparty risk of possible failure of their employer. The retirement benefits for members are paid from the market value of the fund's assets; members receive an additional guarantee from their employer that sufficient assets will be available to meet a specified level of retirement benefits. In this case, however, it is the employer and not the fund that makes the promise.

5.48 The consequences of agent risk (such as fraudulent behaviour by the fund manager or imprudent investment strategies) are particularly relevant for superannuation fund members. Prudential regulation of superannuation funds seeks to reduce these risks. An employer's responsibility to make sufficient contributions to a defined benefit fund to meet the promises it makes to its employees is also supported (but not guaranteed) by the prudential framework, contribution rules and accounting requirements. Also, Part 23 of the *Superannuation Industry (Supervision) Act 1993* gives the Minister discretion to provide compensation to fund members that suffer financial losses due to fraudulent conduct or theft.

5.49 As at 30 June 2003, the ABS estimated that households held superannuation assets in pension funds of $493.5 billion, or an average of around $66,800, which is around 15.5 per cent of total household assets and around 38 per cent of financial assets.