Chapter 9: Governance and accountability

Overview

- Introducing a limited explicit guarantee would necessitate explicit articulation of the degree of separation, governance arrangements and allocation of powers and functions between a guarantee scheme and existing regulatory authorities.
- Key objectives would include:
  - avoiding duplication and establishing clear lines of responsibility and accountability;
  - avoiding the more serious potential conflicts of interest;
  - minimising the administrative costs of the scheme;
  - minimising compliance costs for industry;
  - harnessing industry expertise and involvement, where appropriate; and
  - ensuring an appropriate incentive structure for regulatory authorities.
- Choices concerning appropriate governance arrangements and the allocation of functions should probably flow from decisions about the scope of any guarantee, particularly the question of whether it will extend across a number of prudentially regulated sectors, and whether it is pre-or post-funded.

Functions and objectives

9.1 In addition to the broad choices about whether to create a public or private scheme, and the nature of the scheme body, there are broadly six key functions relevant to the operation of any industry funded guarantee scheme. These are:

- premium pricing and/or levy setting;
- asset and/or debt management;
- claims assessment and payment;
- prudential regulation and supervision; and
- failure management and managing insolvency.

These are presented in Table 9.1 as a visual guide to the issues discussed in this Chapter.

9.2 In considering the possible allocation of functions, the existing role various entities play in the Australian context must be recognised including:

- the role of the Australia Prudential Regulation Authority (APRA) in providing prudential regulation and supervision and its powers relating to failure management; and
- the role of insolvency practitioners and the Courts in managing insolvencies.

9.3 International practice (see Appendix 7.1) in relation to functional allocation is rather mixed. In some cases the guarantee scheme performs only limited functions in relation to claims assessment or claims payment — in the latter case acting solely as a 'cash box'. In other cases, schemes have broader functions, including aspects of prudential supervision, acting as liquidator or determining the failure resolution process.

9.4 Garcia (1999) identifies a number of best-practice principles for the governance of deposit insurance schemes. These include that the scheme be operationally independent but accountable; that the private sector is not represented on the main board of the body; and that close relations are ensured with other safety net participants.

9.5 Clearly, much depends on how broader aspects of a country's safety net are structured and administered. How guarantee schemes themselves are structured is also important. For example, whether schemes are structured under a single agency administering guarantees across a number of sectors, or multiple bodies operating sector-specific schemes and whether they are government or privately run will potentially influence choices about functional allocations and governance arrangements.

9.6 Another interesting consideration is the extent to which a scheme might be created as a 'standby' arrangement, with all details specified but remaining inactive until being brought 'off the shelf' following a failure.

9.7 Taking these issues into account, the key objectives would include:

- avoiding duplication and establishing clear lines of responsibility and accountability;
- avoiding the more serious potential conflicts of interest;
- minimising the administrative costs of the scheme;
- minimising compliance costs for industry;
- harnessing industry expertise and involvement, where appropriate; and
- ensuring an appropriate incentive structure for regulatory authorities.

Table 9.1: Functions of an industry funded guarantee scheme

	Public Sector Options			Joint Options	Private Sector Options		
	Minister/ Department	New statutory authority	Australian Prudential Regulation Authority (APRA) or new body within APRA	Body combining both public and private sector directors and service providers	Industry service provision of specific functions	Industry body with independent board and member service provision	Industry body with independent board and service provision
Scheme governance	B	A	B	B		B	B
Pricing / levy setting	B	A	B			B	B
Asset / debt management	B	A	B	B		B	B
Claims assessment and payment		B		B	A		B
Prudential regulation and supervision		B	A			B	B
Failure management		B	A				
Insolvency[1]		B	A				B

A The central option reflected in the discussion, which is considered to meet the objectives to a considerable extent.

B Feasible alternatives, some of which have been flagged in the discussion, but which do not appear to be preferable when measured against the objectives.

1 In this context, the issue of which agency or agencies should have the capacity to apply to a Court that a financial institution be wound-up is considered. Under Australian law, the process of managing insolvency is a separate issue.

Legal form of a guarantee scheme

9.8 A guarantee scheme could assume a range of legal forms, and could be either publicly or privately constituted.

9.9 Among the principal options are to establish any scheme:

- as part of an existing independent statutory authority such as APRA, or as an entity under its administration with possibly an independent charter;
- as a government-authorised scheme run by a privately constituted entity. Under this model, for example, the Government could establish the objectives, functions and powers of the scheme through legislation, but may vest operational responsibility in an industry body or private third-party operator;
- as a specific-purpose statutory authority, similar to the recently established Australian Reinsurance Pool Corporation; or
- under an existing agency, for example as a part of an existing government agency such as the Department of the Treasury.

9.10 Obviously there are a range of possible variations to these approaches which could also be considered. In particular, adopting a publicly constituted option would not preclude private sector involvement in aspects of the scheme's operation.

9.11 In choosing among the options outlined, a key factor would be the scope of any guarantee. Applying guarantees across a number of sectors, for example, may provide greater weight to arguments for a single, independently constituted public body than would a decision to implement a single sector-specific scheme. Whether a scheme or schemes are to be pre- or post-funded would also be an important determinant.

Location within APRA

9.12 The principal advantages of locating any guarantee scheme within APRA are that it would eliminate the prospect of regulatory duplication and APRA would already have most of the required information about the relevant institutions.

9.13 A risk with any scheme constituted separately from the prudential regulator, is that the scheme's management will feel obliged to monitor the financial soundness of the entities offering the products that the scheme guarantees, potentially duplicating APRA's role. Such duplication could be reduced through effective cooperation in information sharing between APRA and the scheme's administrators.

9.14 Location within APRA may avoid the need to separately establish and administer many of the information systems required to operate a guarantee scheme. It could also avoid a potential problem of blurring of responsibilities for failure management which could occur where schemes are separately managed.

9.15 There are also potential difficulties with locating any scheme in APRA. Principal among them are that it could give rise to a conflict of interest and encourage greater regulatory forbearance than might otherwise be the case. APRA's responsibilities, in particular, are to all depositors or policyholders in prudentially regulated institutions. The responsibilities of any scheme, on the other hand, would be to a potentially much narrower range of protected consumers.

9.16 Regulatory forbearance can arise because prudential regulators hope or believe that prolonging the life of a troubled institution will ultimately lead to a recovery which protects claims of all stakeholders and the reputation of the regulator. Less palatable is the possibility that regulatory forbearance reflects regulatory capture or private interest benefits to regulators. On the other hand, systemic concerns may cause a different approach to dealing with a large troubled institution than would be adopted by a scheme simply concerned with minimising cost.

9.17 An independent guarantee scheme with a mandate to minimise scheme costs could bring pressure to bear against such regulatory forbearance. To be effective in this role, however, a scheme would require its own investigative/supervisory functions or be able effectively to access information that the prudential regulator gains in performing these functions.

9.18 The effects on regulatory forbearance of locating a scheme within the prudential regulator and thus providing it with access to a pool of resources which can mitigate the consequences of failure for some stakeholders are less straightforward, but have been a concern internationally. In many cases the result has been a separation of guarantee scheme and prudential regulator. In others (such as the United States (US)) an alternative approach of legislating to mandate least cost resolution of financial failure or impending failure has been taken to inhibit forbearance.

9.19 Given Australia's strong regulatory framework, the risk of regulatory forbearance appears relatively low.

Location within an industry body

9.20 An industry operated scheme may have the advantage that it could readily draw on whatever expertise is needed to assess and pay claims (which is important particularly in the general insurance sector, for example, where assessing long-tail liabilities can be quite complex); and that it could facilitate industry acceptance or 'ownership' of the arrangements. However, private sector expertise can be drawn upon as needed under any management model. This has been demonstrated in the operation of the support scheme for the failure of the HIH Group of Companies, for example.

9.21 An industry operated scheme could, however, give rise to conflicts of interest. For example, there could be less resolve by industry managers to force or support early corrective action in regard to a failing institution in the hope that its recovery will stave off a guarantee levy (*ex post*) or perhaps a rise in premiums (pre-funding).

9.22 From a public policy perspective, industry management means less government control, notwithstanding that the government would almost certainly be required to underwrite a scheme's viability.

Location within a new statutory authority or Government Department

9.23 The principal benefits of either of these options are that they would allow for comprehensive government oversight and control of schemes and would avoid potential conflicts inherent in either the APRA or private sector models. Although any guarantee scheme is likely to be funded by industry participants, the costs are ultimately borne by the consumers, and the government would be expected to underwrite the viability of the scheme. As such, the government would have an on-going, legitimate role in ensuring that any scheme is effectively and efficiently managed.

9.24 Whether it is appropriate that a scheme be administered by a statutory body or an existing government agency with relevant expertise largely depends on the scope and funding arrangements. There are significant fixed costs involved in operating a statutory authority and these might only be justifiable where a scheme has broad sectoral scope and/or where significant pre-funding is envisaged.

9.25 Under a post-funded model, the administrative responsibilities could reside with an existing agency. This would take into account Australia's long history of infrequent financial institution failures. Under such an approach, the agency would activate a more formal pre-specified arrangement and industry expertise could be drawn on as required. However, for cost and other reasons, it may still be desirable to establish some arm's length 'off the shelf' management vehicle which could be activated as and when required.

Allocation of functions

9.26 The legal form of any scheme would largely determine the governance and accountability arrangements; for example, whether responsibilities and accountabilities would reside in an independent board, with commissioners or directly with government. The principal issue then is how the six broad functions relevant to the operation of a guarantee scheme should be allocated between the scheme and other bodies, particularly APRA.

Pricing/levy setting, asset/debt management and claims assessment and payment

9.27 Premium pricing or the setting of levies, the management of assets or borrowings and claims management are all functions that logically would fall within the responsibilities of a scheme's management. Nevertheless, the performance of these functions would require, or benefit from, close cooperation with the prudential regulator and the liquidator of a failed institution.

9.28 As noted in Chapter 8, for example, if it was intended to implement some form of risk-based pricing, it is likely that a scheme would need to rely on APRA information and institution risk assessments. There might also be scope for any scheme to utilise APRA's existing systems to invoice and collect premiums/levies, similar to the arrangements which apply in the United Kingdom (UK) between the Financial Services Compensation Scheme (FSCS) and the Financial Services Authority.

9.29 Under a pre-funded scheme, contributions would need to be invested in an appropriate portfolio of liquid assets whilst remaining available to pay claims as they accrued. Under a post-funded scheme, it would be necessary to maintain a facility to borrow sufficient funds to pay out eligible claims and to manage the servicing and retirement of these debts over time. It may not be necessary for the scheme to administer this aspect of the arrangements itself. To avoid duplication, an existing body with similar responsibilities could do so (for example, the Reserve Bank of Australia or the Australian Office of Financial Management).

9.30 The assessment and payment of claims would need to be undertaken in accordance with commercial practice and harmonise with the roles and responsibilities of the liquidator. The issues become particularly difficult in relation to claims by insurance policyholders where reinsurance arrangements and valuation difficulties can complicate the payments process. Normally, a liquidator would rely on usual claims management processes to determine the value of claims. Having made payments, the scheme would assume the place of those that it has compensated in the insolvency process. Additional questions relate to whether the scheme might be granted any priority relative to other remaining creditors for those claims that it has assumed.

Prudential regulation and supervision

9.31 As highlighted earlier, a significant risk in constituting any guarantee scheme separate from the prudential regulator is that this could lead to regulatory duplication. At present, APRA is the prudential regulator responsible for monitoring and supervising the institutions that would be covered by any guarantee scheme.

9.32 The best approach therefore, and one that appears to be successful (for example, in the UK) is for any scheme to rely on the information and assessments of the prudential regulator to the extent required for its effective operation. Needless to say, the practical success of such an approach would depend heavily on appropriate communication, coordination and sharing of this information between the two agencies.

9.33 Internationally, a significant proportion of guarantee schemes undertake monitoring and, in some cases, prudentially supervise participating institutions to some degree. This is sometimes in addition to, or complementary to, the role of the prudential regulator. To some extent, this appears to reflect the way guarantee schemes have evolved (the US Federal Deposit Insurance Corporation, for example, was established prior to modern approaches to prudential regulation of banks). It also suggests that in Australia a very robust framework of cooperation between any scheme and APRA would be needed to avoid additional regulatory compliance costs for participating institutions.

Failure management

9.34 In parallel to the function of prudential regulation and supervision, it would be necessary to address the involvement of the various parties in preventing or managing the failure of a financial institution.

9.35 APRA's failure management powers were documented in Chapter 3 and a discussion of possible implications for its powers is canvassed in Chapter 10. The key issue is whether a separate guarantee scheme should have any special powers to intervene or bring about the winding-up or resolution of a financial institution in financial difficulties.

9.36 Consistent with the premise that there is little justification in the Australian context for any guarantee scheme exercising monitoring and prudential supervisory functions (a necessary prerequisite to failure management), there also seems to be little logic in any scheme having failure management powers additional to those vested in APRA.

9.37 It is important that the allocation of powers to intervene and bring about a resolution or winding-up of an institution in financial difficulty is placed with the organisation which has an incentive structure best suited to achieving the public policy objectives involved. APRA would exercise its powers on behalf of a broader range of stakeholders than those likely to be covered by any limited explicit guarantee. APRA, the relevant external administrator and where applicable, a Court, therefore, appear better placed to consider and balance the broader range of interests involved in a failure management exercise.

9.38 Nonetheless, managers of any guarantee scheme would be concerned that APRA should intervene on a timely basis in the operations of a troubled institution.

To allow for this concern to be addressed, one possibility would be to establish a set of transparent criteria that define the situations where APRA must take particular action, akin to the US 'prompt corrective action' formula. This would be a more 'rules-based' approach than currently exists under the

Australian prudential framework, however, and may undesirably limit APRA's flexibility.

9.39 A less rigid option may entail both APRA and any guarantee scheme being responsible for, among other objectives, minimising the costs to the guarantee fund over time. Other options include a guarantee scheme being given the ability to petition APRA to take supervisory action, or, perhaps as a potential creditor, to independently apply to Court that a financial institution be wound-up.

9.40 As shown in Chapter 7, the degree of insolvency required before a scheme incurs costs from a failure may be quite large whereas APRA's intervention would be triggered by any tendency towards insolvency. Consequently, there may be less reason for concern with a scheme relying on APRA's failure management powers.

Insolvency

9.41 Chapter 5 of the *Corporations Act 2001* governs insolvent corporations including voluntary administration, receivership and liquidation. As noted, APRA has the power to apply for the winding-up of financial institutions and also has powers relating to the external administration of authorised deposit-taking institutions (ADIs), life insurance companies and superannuation funds. A further key question is whether a guarantee scheme should have powers in relation to external administration and liquidation processes.

9.42 In the Australian context, the liquidation of insolvent companies is managed by an insolvency practitioner, who is subject to the direction of the Court.

9.43 The Australian Securities and Investments Commission is responsible for the registration of insolvency practitioners. Under the Corporations Act a person may not undertake the functions and duties of a receiver, receiver manager, administrator or liquidator unless the person is a registered liquidator or has leave of the Court. A person also must be an official liquidator to undertake duties of a provisional liquidator and a liquidator appointed by the Court.

9.44 International practice is diverse. Both the US and Canadian deposit insurance schemes, for example, have powers to act as liquidator, whereas the UK scheme does not. In practice, however, the Canadian scheme has not exercised its power because it has usually been one of the largest creditors of failed institutions and hence, would have faced a significant conflict of interest had it done so (Canada Deposit Insurance Corporation 2001).

9.45 It is likely that any guarantee scheme constituted in Australia would face a similar conflict, and this presents a very strong case for not providing any scheme with power to manage the external administration/liquidation process, although it could be granted leave to participate as a prospective or actual creditor.

9.46 Nevertheless, as possibly the most significant creditor following the failure of a financial institution, there may be certain roles that a guarantee scheme could play to expedite the liquidation process and improve the level of recoveries.