CHAPTER 10: REGULATORY IMPLICATIONS

Overview

- The viability of any guarantee scheme depends heavily on the prudential framework and its ability to avoid and manage failure. Introducing a guarantee would appear to warrant some improvement of the failure management powers of the Australian Prudential Regulatory Authority (APRA). Regulatory definition of the scope of the guarantee's application would be necessary.

- A guarantee scheme may, in certain circumstances, complement the prudential framework by providing the resources necessary to implement resolution strategies other than closure of a troubled institution. This would need to be carefully considered.

- The cost of any guarantee scheme, and its distribution between internal and external stakeholders of a failed firm, is directly related to the priority in insolvency of insured customers. More effective targeting of stakeholder preference arrangements could be analysed.

- There is merit in addressing the question of whether the State-based insurance regulatory framework could move towards a national approach over time.

- An associated issue is what general rules or principles might need to be satisfied before any guarantee could extend to products associated with statutory classes of State insurance.

- It may be possible for administration of the existing compensation arrangements under Part 23 of the *Superannuation Industry (Supervision) Act 1993* (covering fraudulent conduct and theft) to be vested in any independent body established to administer guarantee schemes.

Regulatory implications

10.1 Introducing an explicit guarantee would raise some complex regulatory issues at the core of the prudential, insolvency and consumer protection frameworks applying to financial institutions. Any decision to introduce a guarantee could also have implications for a range of regulatory matters associated with State and Territory banking or insurance.

10.2 This Chapter broadly assesses the scope of these possible regulatory implications.

10.3 By its nature, a limited explicit guarantee would provide a level of protection for certain products and customers. It would not be designed to protect financially sophisticated customers or other creditors. Non-guaranteed stakeholders would continue to rely on the existing regulatory framework. This Study has not been commissioned to directly assess the effectiveness of the existing regulatory framework. However, it has been requested to consider the implications for the regulatory framework of introducing a limited explicit guarantee.

10.4 The regulatory implications can be assessed in two possible categories — pre-failure and post-failure. The more complex implications for the regulatory framework appear to arise in respect of the post-failure environment, that is, in relation to the insolvency framework. Nonetheless, the introduction of a guarantee would introduce some important issues for consideration in the pre-failure context.

Implications for the prudential framework (pre-failure)

Need to clarify the objectives of prudential regulation and consumer protection

10.5 Considering the introduction of a guarantee requires some assessment of the objectives and best means of delivering prudential oversight and consumer protection.

10.6 The prudential framework provides only an indirect means of delivering consumer protection. In a competitive market, and where responsibility rests with private stakeholders for meeting promises, there can be no certainty in terms of consumer outcomes.

10.7 While the design of the prudential framework intentionally reflects differences in the operating environment for various categories of financial institution; it might equally be argued to provide for a different level of consumer protection for financial promises of a similar intensity.

10.8 As noted in Chapter 3, an objective of the prudential framework is to reduce the probability and associated impact of the failure of financial institutions. Whereas the motivation is to avoid socially undesirable consequences of financial market failure, indirectly, prudential regulation serves to protect customers of those institutions. It generates benefits for other stakeholders (including other institutions in the regulated sectors, other creditors, employees and if one were introduced, a guarantee scheme itself). It is much broader in its objectives and coverage than a safety net designed to protect the most vulnerable consumers.

10.9 The insolvency framework is generally intended to provide an efficient means of dealing with the failure of firms and distributing remaining resources among what is usually a diverse range of claimants. In the case of financial institutions, the insolvency framework can also recognise that there may be relatively homogenous classes of creditors (for example, depositors or policyholders) and that the failure is likely to involve the resolution of a complicated array of financial assets and liabilities. Again, the framework exists to serve a range of interests. It is not designed to deliver particular outcomes to a limited category of consumers.

10.10 A guarantee scheme could ensure resources are available to provide prompt consumer redress and define, more specifically, the impact of a financial institution’s failure on particular categories of customers. This could allow prudential and insolvency processes to proceed somewhat independently of these considerations. Additionally, it is possible that the resources available to the manager of the guarantee scheme could be used for some limited prudential purposes, such as in managing failure (for example, in facilitating a transfer of business) if that were possible at a lower cost than liquidation. (See Box 10.1 for an overview of some alternative resolution processes). As noted previously, this may present a preferable course of action, needing to be judged against some specific criteria, to formal liquidation. It would, however, raise a number of complications for scheme governance, since those responsible for the scheme would need information to assess whether this was, in fact, the least cost response for the scheme.

10.11 A guarantee may achieve more uniform protection for retail customers of different institutions, while allowing the prudential framework to remain tailored to the different risks and characteristics of the component industries and the probability of failure and the impact on the financial system of the component firms. However, the prudential framework needs to include an appropriate range of tools that can be employed to avoid and manage failure to ensure the cost of any guarantee scheme is sustainable.

10.12 The issue of the appropriate scope of any guarantee and its associated delivery of consumer protection might be informed by considering the similarity in the intensity of promise across products and how serious the consequences of a financial institution's failure may be for individuals.

10.13 By focussing on each of these elements separately (the prudential framework, the insolvency framework and any guarantee scheme), the expected contribution and design of each of these components of the regulatory framework could be brought into sharper relief.

Establishment of a new agency or agencies with appropriate powers

10.14 As noted in Chapter 9, implementing a guarantee may well involve the creation of a new agency that could occupy a special position in the overall regulatory system. The Australian Prudential Regulation Authority (APRA) could continue to regulate and supervise financial institutions broadly in accordance with the existing prudential framework.

10.15 The guarantee scheme and those parties who were liable to contribute to it, could rely on APRA's abilities to detect problems in troubled financial institutions, ideally resolving any problems prior to the point of insolvency. In this sense, there could be heightened scrutiny and increased reliance on APRA's effectiveness.

10.16 The guarantee scheme would require appropriate powers to support its dealings with financial institutions, reflecting its likely objectives of protecting targeted consumers whilst minimising the cost to the fund over time. These might include information sharing and gathering powers; the ability to establish appropriate premiums or charges; and possibly the ability to participate as a prospective creditor in certain aspects of the managing failure process.

Coordination between APRA and the guarantee scheme

10.17 If a separate body were created, the ability of APRA and the guarantee scheme to share and request information of each other and coordinate their respective activities would be critical. It would be necessary to carefully design this aspect of the prudential-guarantee interface to avoid unnecessary duplication of resources, undue complexity or conflict of objectives, thereby avoiding the associated costs.

10.18 At the same time, it could be desirable for each of APRA and the guarantee scheme to pursue independent objectives. For example, the guarantee scheme could have an independent capacity to decide upon whether its resources should be available to assist in prudential resolutions.[1]

Pressure for strengthening the prudential framework

10.19 By reducing the likelihood of costly failure, the prudential framework would be an important source of cost mitigation. The insolvency framework (discussed below) also provides a number of options for reducing the expected costs of a failure to external parties, particularly in terms of the efficiency with which it allows failure resolution. The insolvency framework, through any priority arrangements, also serves to reallocate costs among parties.

10.20 A guarantee, through its funding requirement, has the potential to transmit the cost implications of a financial institution's failure to other participants. This would increase both their dependence on and the importance of the rest of the regulatory system, including the prudential framework.

Implications for specific prudential requirements

10.21 At a more detailed level, the implications for the prudential framework will depend on the actual design of any guarantee. Decisions concerning the scope of coverage across industries and products and associated benefit thresholds could have a number of consequences — particularly in relation to competitive neutrality between similar products.

1 This possibility would appear to depend on a pre-existing pool of funding.

10.22 Another central consideration would be each financial institution's potential liability in funding the guarantee. Under either a pre-funded or a post-funded model, there may be consequences for the amount of capital that financial institutions would be required to either contribute or set aside. Under a post-funded scheme, APRA may find it necessary to reflect this appropriately in prudential standards concerning capital adequacy or risk management. There may also be a need for annual limits on any post-funding arrangement to allow the risk to be managed.

10.23 The fact that a guarantee involves potential costs to other industry participants has, in some countries, led to a more rules-based approach to prudential supervision. This aims to limit the possibility of regulatory forbearance, or excessive costs accumulating to other participants. For example, in the United States (US), the supervisor is required to take action when a member institution's capital ratio falls below a pre-determined level. Resolution procedures are also generally limited to those which present the 'least-cost' to the guarantee fund.

10.24 Finally, consideration would need to be given to the appropriate way of imposing requirements for a financial institution to become a member of, or hold sufficient coverage with, the appropriate guarantee scheme. Such a requirement could be associated with the financial institution's authorisation or mandated by legislation.

Possible need for additional layers of regulation

10.25 The dimensions of a guarantee would need to be explicitly defined according to its preferred coverage, the types of institutions and the types of products captured. An explicit framework would provide certainty. However, this would need to be sufficiently flexible to cope with financial innovation.

10.26 Promoting consumer awareness of the scope of any guarantee's application (and non-application) would be achieved through an appropriate disclosure framework. It is also likely that there would be a need for an educational advertising campaign to promote consumer awareness.

10.27 Critically, consumers will need to understand the distinction between guaranteed products and those falling outside the protection of any scheme.

10.28 In some countries, the introduction of a guarantee appears to have given rise to the need to consider price regulation of guaranteed products. While this is certainly at odds with Australian regulatory philosophy, it appears to be a relevant consideration. It is possible that the existing prudential framework would be sufficient to cope with the risks of serial under-pricing.

Possible to remove some layers of regulation

10.29 The exercise of defining the scope of a guarantee is one of determining which classes of financial assets should be risk-free (or with a degree of coinsurance, relatively low-risk) in the hands of the retail consumer. The working assumption is that the extent of a guarantee, if any, should be tightly circumscribed.

10.30 If the delineation between risk-free and risky financial assets was clarified by introducing a guarantee, and in an environment of appropriate disclosure, there may be other compensating changes that could be made. There may be arguments for allowing consumers to access a wider range of non-guaranteed products, provided disclosure of the non-guaranteed status is sufficient.

10.31 One possible example would be in removing or reducing the restrictions on foreign authorised deposit-taking institutions (ADIs) accepting deposits from retail depositors (that is, the current restriction on branches of foreign ADIs accepting initial deposit amounts less than $250,000 per customer). The objective of this restriction has been to ensure that institutions that are not subject to depositor preference arrangements are inaccessible to financially unsophisticated investors.

10.32 It would be unlikely that deposits with Australian branches of foreign ADIs would be covered by any guarantee arrangement (with coverage limited to deposits with locally incorporated ADIs — see Chapter 6).

10.33 Since an explicit guarantee would probably be set at some amount less than the $250,000 threshold, it may be possible to lower the limit on initial branch deposits to the maximum coverage of any explicit guarantee.

10.34 Alternatively, were consumers able to readily and effectively identify and discriminate between insured and non-insured products, the introduction of an explicit guarantee could allow for the removal of this restriction.

10.35 This could have significant benefits in terms of the level of competition in deposit-taking, although it would increase the possibilities of consumers being exposed to new risks that they may not readily understand.

Implications for the insolvency framework for financial institutions (post-failure)

10.36 Introducing a guarantee would also require certain aspects of the insolvency framework for financial institutions to be addressed. The insolvency framework may have such objectives as providing legal and financial certainty to creditors; maximising the value of the insolvency estate and promoting efficiency in its distribution; and providing for fair and equitable outcomes among creditors.[2]

10.37 In the context of an industry funded guarantee scheme, the insolvency framework may also achieve the additional objective of minimising the cost to parties external to the failed financial institution (for example, other industry participants) in meeting its guaranteed liabilities. This is often embodied as the principle of a 'least-cost resolution'.

10.38 Possible changes might entail a more rules-based approach to regulatory action. This needs to be considered in terms of the potential to minimise the exposure of other industry participants to a guarantee scheme against the risk that it unduly restricts APRA in the actions that it might take.

10.39 Another consideration is how any changes to the insolvency framework affects the relative share of losses in insolvency between the firm's own non-guaranteed stakeholders (for example, unsecured creditors of the failed financial institution) and industry contributors to a guarantee scheme.

10.40 The applicability of these options needs to be considered against the typical profile of liabilities of the institutions concerned and the implications for ongoing access to and cost of capital.

10.41 Where the losses in insolvency can be passed on to other stakeholders (such as non-guaranteed creditors) of the failed firm, thereby increasing their exposures, this may increase the extent of market discipline over the financial institution.

2 See Bank for International Settlements (BIS), Contact group on the Legal and Institutional Underpinnings of the International Financial System, 2003.

Box 10.1: Open and closed resolutions

In some countries, the resources of the guarantee scheme are available for the purpose of assisting in the resolution of troubled financial institutions. The circumstances in which financial resources are available are usually strictly limited, and the particular courses of action may be mandated in legislation.

An ***open resolution*** entails providing resources to the troubled institutions, in the hope that this may enable it to continue in operation. With the limited exception of liquidity support, this is generally accepted to interfere with the appropriate incentives and risk-taking behaviour of the failed firm and is usually either avoided or tightly restricted to the worst systemic cases. Any open resolution addressing solvency concerns should involve ultimate transfer of ownership and control rights from existing owners.

A ***closed resolution***, on the other hand, entails the use of guarantee scheme resources to facilitate the transfer of the failed firms, assets, liabilities and customers to another healthier financial institution. In this sense, the owners and managers of the failed firm do not directly benefit from the rescue. However, it may be the desirable course of action from the perspective of both customers and the guarantee scheme. In effect, this avoids the need for the scheme to compensate customers directly, which may result in lower costs.

Where the resources of the guarantee scheme are available for such purposes, it is usually associated with a mandate that the funds be used to achieve a ***least-cost resolution.***

Role of regulatory system participants in managing liquidation

10.42 In terms of responsibilities for minimising the possible cost of a failure, a question arises as to the nature of the appropriate role for APRA or the guarantee scheme in managing the liquidation of a financial institution.

10.43 Currently, the Australian insolvency framework relies upon Court oversight to ensure that a range of interests are balanced. A liquidator or other insolvency practitioner is appointed to manage the process.

10.44 APRA is currently provided with standing to petition the Court to initiate the liquidation process. The *Corporations Act 2001* permits applicants for winding-up to apply to the Court for interim directions that steps be taken before or after the hearing of the application.

10.45 Also relevant are the various provisions that escalate the interests of depositors, life insurance policyholders and general insurance policyholders with respect to particular assets of financial institutions.

10.46 Liquidation of a financial institution is always likely to be a complex and time consuming exercise — requiring many creditors' interests to be balanced. This is reflected in the fact that a number of alternative mechanisms exist to address failure ideally prior to, but also beyond, the point of insolvency.

10.47 Liquidation of certain types of financial institutions, particularly those with long-term liabilities such as insurance companies, presents special challenges.

10.48 For example, policyholders are by no means a generic category of creditor. It is a matter of considerable practical difficulty to ascertain the value of liabilities across all insurance policies, and to provide a fair and equitable distribution among the parties. This is one reason why a Court-managed process may be preferred to one involving APRA's discretion.

10.49 In other cases, such as for ADIs, it is relatively more straightforward to determine the amount of outstanding deposit liabilities and the identity of the depositors. There, however, the value of some assets such as loans may be more difficult to estimate accurately. This should not complicate the task of compensation, but makes estimating funding requirements *ex ante* quite difficult.

10.50 Whereas APRA may have a specific role to play in a liquidation, for example in representing policyholders as a class, it is not clear it is appropriate for it to manage the liquidation process independently of Court direction; in favour of a particular class of creditor (for example, depositors or policyholders).

10.51 Under an assumption of claims approach (see below), the guarantee scheme would become a major creditor of the failed firm. The nature of this position would need to be closely examined to consider whether the fund should obtain any special rights during the liquidation process. At a minimum its status as a creditor, following assumption of claims, may need to be given legal recognition.

10.52 In a number of international cases, once the decision is made to wind-up a financial institution, this is managed by the guarantee scheme itself (rather than the Courts). In effect, the fund becomes both insolvency practitioner and arbitrator.

10.53 The applicability of this approach would need to be considered against the existing insolvency framework and the need to protect the interests of other stakeholders. In some cases, where the stakeholders are relatively homogenous, such as for a specialist retail deposit-taking institution or superannuation fund, there may be arguments for such an approach.

10.54 However, under a limited guarantee scheme, the fact that there would be other uninsured creditors whose interests must be protected in insolvency, appears to weigh against adopting such an approach.

Priority of claims

10.55 As noted in Chapter 3, a number of provisions already exist that serve to escalate the rights of depositors and policyholders above those of other creditors of a financial institution. Chapter 7 demonstrated how these arrangements affect the distribution of losses among the relative stakeholders of a failed institution.

10.56 The possible implications of revising priority arrangements to accommodate a guarantee scheme might be considered in the context of three broad options:

- Leave existing priority arrangements unchanged.
  - This would mean that a guarantee scheme would benefit from prevailing priority arrangements to the same extent as non-guaranteed depositors and policyholders. It would assume the same rights as those depositors and policyholders that it served to protect;
- Narrow the scope of priority arrangements to apply them only to those liabilities covered by a guarantee scheme.
  - This would place a guarantee scheme ahead of all other non-guaranteed creditors and thereby align the position of non-guaranteed depositors and policyholders with that of unsecured creditors; or
- Remove priority arrangements altogether.

– This would place all unsecured creditors on an equal footing that is improving the situation of those creditors who are not depositors or policyholders.

10.57 The objectives associated with the existing priority arrangements are to increase the probability that depositors and policyholders claims will be able to be met from the assets of their financial institution. In the context of a guarantee scheme, they might also reduce the likelihood that external stakeholders would need to contribute funding to the guarantee scheme.

10.58 It is axiomatic, nevertheless, that granting priority to one class of creditors to an institution can only be achieved at the expense of other creditors to the institution. The potential economic consequences of relegating rights of other creditors, particularly otherwise secured creditors, therefore, needs to be carefully assessed when contemplating such initiatives. For example, it may not be palatable to force even greater losses onto non-guaranteed policyholders of a failed insurer.

10.59 Due to definitional problems, priority arrangements may not be a particularly direct means of targeting assistance to the most vulnerable customers. For example, applied to all policyholders or all depositors, priority confers a proportional benefit on both retail customers and sophisticated customers alike. In the context of insurance, it would confer a proportional benefit to those policyholders who have lost the benefit of cover associated with premiums already paid and those policyholders with existing claims that cannot be met in full. Chapter 5 demonstrated how the consequences of failure may be quite different among these two categories.

10.60 Assigning priority is (*ex post*) only an exercise in reallocating wealth among creditors, and as such, there is no certainty that the firm's assets will be sufficient for even priority liabilities to be met. Hence, when taken alone, priority arrangements do not provide certainty in terms of the level and timing of consumer protection that they may provide. Priority arrangements may also have *ex ante* incentive effects on creditor behaviour, affecting the cost of funding, and can induce development of legal structures to negate priority.

10.61 The applicability of general priority arrangements also needs to be considered against the profile of a financial institutions' liabilities. In addition, the moral hazard implications of conferring protection on creditors that would otherwise have adequate capacity to monitor a firm and exercise market discipline is a relevant concern.

10.62 A general priority for all depositors or policyholders might be contrasted to a more limited priority for those liabilities covered by a guarantee scheme. The consequences of providing guaranteed liabilities a specific priority, that did not alter the general priority for non-guaranteed liabilities, could be expected to be of a lower order of magnitude than a general priority. In effect, it would entail the shareholders and then the other non-guaranteed creditors of the failed firm bearing losses to meet the costs of the guarantee before any external funding is called upon.

10.63 However, despite the illusion, this is not a costless exercise. Because changing priority would impact directly on those creditors of the firm whose priority is made relatively lower, it may reduce the firm's access to such funding or increase the financing costs.

10.64 Two other issues complicate the operation of priority arrangements in practice. One is that creditors who are also in debt to a failed institution might gain a form of priority if they are allowed to net or set-off their debts against monies owed to them. A second issue is that to the extent that security is taken out over the assets of a financial institution (or other similar arrangements), the position of otherwise non-preferred stakeholders might be improved, thereby circumventing the intent of priority. This problem increases in relevance as financial institutions undertake ever-more sophisticated and complex financial transactions in interbank and wholesale markets.

Provide for assumption of claims

10.65 Despite the preferred priority arrangements, it would appear to be necessary to provide a legal basis for the guarantee scheme to assume protected depositors' or policyholders' rights to claim over the assets of the failed firm and take their position in the insolvency queue.

10.66 To the extent that the guarantee scheme were to pay out certain claims, in return it would assume the right to make recoveries against the failed firm's remaining assets, putting it in the original position of the depositor or policyholder.

10.67 When taken in conjunction with the possibility of coinsurance (that is, paying out less than it assumed the right to claim) and prevailing preference arrangements, such an arrangement might reduce the likelihood of external contributions being needed to meet the scheme's costs in any given failure.

10.68 To the extent that retail customers protected by a scheme also had non-guaranteed or uncovered claims against the failed firm, they would retain the right to claim against remaining assets.

10.69 Another relevant, though more specific consideration, is the potential right of any guarantee scheme to become the beneficiary of reinsurance contracts of a failed insurer.

Establish priority thresholds

10.70 The use of monetary thresholds might be associated with both the extent of priority and level of guarantee coverage provided to certain classes of creditors.

10.71 For example, it may be possible to limit the application of the depositor preference arrangements by determining a threshold value of deposits per customer. This may increase the likelihood that the assets of the failed firm are sufficient to meet those protected liabilities in a failure, and would also reduce the expected cost to external stakeholders under any guarantee scheme.

10.72 Depositor preference raises the cost of non-preferred liabilities. If an explicit guarantee were to replace depositor preference as the primary means of protecting retail investors in ADIs, then holders of non-depository liabilities might have better security over the assets of a failed ADI and might therefore be willing to lend more cheaply.

10.73 The protection provided through 'depositor preference' type arrangements in Switzerland is limited through the use of thresholds. In this case, depositor preference provisions apply to a limit of CHF30,000. For amounts above this threshold, the depositor's liabilities rank equally with those owed to other creditors. When compared to an unlimited application of depositor preference arrangements, this would have the effect of reducing the cost of an insolvency on other creditors of the failed financial institution.

10.74 Similarly, in Hong Kong and the US, the concepts of preference and deposit insurance are taken to be complementary. By aligning the thresholds associated with priority and guarantee benefits, the cost of payout under a guarantee scheme could, in many plausible scenarios, be borne entirely by stakeholders of the failed institution.

State and Territory banking and insurance

10.75 The regulatory system, as explained in the Introduction, does not extend to all forms of financial promises. For example, State and Territory governments continue to provide certain financial services, and in doing so are not captured by the same prudential framework as applies to private financial institutions.

10.76 Some interested parties have suggested that implementing a guarantee could be the catalyst for revisiting the scope of Commonwealth prudential regulation, and providing the potential for reducing duplicative State and Territory involvement — particularly in relation to insurance.

State and Territory government involvement in insurance markets

10.77 There are a number of ways in which the State and Territory governments participate in or influence the operation of certain insurance markets.

10.78 Firstly, the State and Territory governments have enacted legislation requiring certain activities or risks to be insured, thereby creating a market for insuring against certain risks. These are known collectively as compulsory classes of insurance. Some common examples are insurance for personal injury in motor vehicle accidents Compulsory Third Party Insurance, Workers' Compensation, and Builders' Warranty insurance.

10.79 The nature of State regulation reflects a number of policy concerns. For example, the government may be concerned to ensure that insurance cover is available and that premiums are fair and reasonable. Requirements for community rating (that is, cross-subsidies between various sections of the community) may also be embedded.

10.80 Given the element of compulsion, the requirement to hold cover is generally accompanied by an additional level of regulation governing the insurance premia that may be charged, the quantum of benefits that may be paid and the circumstances in which benefits are payable.

10.81 In addition, some governments play a role in directly underwriting the risk associated with these categories of insurance. This may be done through a government business enterprise or directly by the government assuming a proportion of the risk faced by private underwriters.

Commonwealth regulation of insurance

10.82 Section 51 of the Constitution prescribes the scope of the Commonwealth's legislative powers. The Commonwealth's responsibilities for regulating the financial system derive from its ability to make laws in respect of certain corporations, in relation to insolvency and for specific matters such as banking, insurance and pensions.

10.83 In relation to insurance, the Commonwealth does not have the Constitutional power to make laws in respect of State insurance. The Commonwealth does not, as a result, regulate the provision of insurance by state-owned enterprises (for example, insurance underwritten by state-government bodies).

10.84 Where private sector insurers underwrite statutory classes of insurance, even under certain State schemes, the Commonwealth corporations and prudential frameworks generally apply.

10.85 This division of responsibilities between the Commonwealth and the States and Territories has the capacity to add to the complexity of the regulatory framework. For example, there are differences between how the various States and Territories regulate or in some cases underwrite statutory classes of insurance. There is also scope for uncertainty as to whether the provision of insurance is prudentially regulated and subject to the current regulatory framework.

10.86 The Commonwealth has passed legislation that facilitates the transfer of responsibility for prudential regulation within State and Territory insurance schemes to APRA with the Treasurer's approval. In order to effect a formal transfer, however, each State or Territory wishing to participate would need to confer functions upon APRA in its own legislation. Alternatively, a less formal approach might entail APRA performing a consulting role to the scheme in question. The latter approach may not be sustained unless it also involved the creation of effective powers.

Application of a guarantee to State and Territory insurance

10.87 The statutory classes of insurance present a special case in terms of considering the potential application of prudential regulation and a limited explicit guarantee.

10.88 To the extent that a State or Territory government were underwriting the risk of compulsory insurance classes, either directly or through a government business enterprise, there should not be the prospect of a commercial insolvency, hence there would not appear to be an argument for the class to be covered.

10.89 State and Territory governments determining insurance premiums or the benefits payable under statutory schemes impacts directly on the viability of the schemes and any private sector underwriters. This has the potential to result in non-commercial or imprudent outcomes. The form of premium and benefit regulation would be an important consideration in deciding whether to extend the guarantee scheme to cover compulsory classes, in so far as it may present a financial risk to any guarantee scheme.

10.90 To the extent that such schemes were underwritten by private sector entities regulated by APRA and are undertaken on a fully commercial and prudent basis, there would appear to be scope for an explicit guarantee to extend to the statutory classes of insurance.

10.91 Alternatively, given the balance of other policy considerations, there may be an equivalent case for establishing separate guarantee arrangements for compulsory classes of insurance.

10.92 Given the element of compulsion and the circumstances insured, there may also be a case for a guarantee to provide a higher level of protection than under other classes of insurance product. Such a distinction between compulsory and non-compulsory insurance classes is evident in a number of international guarantee schemes.

10.93 It is clear that coverage by a guarantee would not fully replace the existing State and Territory nominal defendant/insurer arrangements (where these cover claims against uninsured or unidentified parties).

10.94 To the extent that States and Territories were to rely on a guarantee scheme to protect against insolvency-related losses associated with compulsory insurance classes, there may be a case for them to make an appropriate contribution into any centralised scheme in recognition of the transferred risk.

Part 23 of the Superannuation Industry (Supervision) Act 1993

10.95 Chapters 5 and 6 reviewed the case for providing guarantees over superannuation accounts. In general, since superannuation is a vehicle for employees (or their employers) to invest their savings in a collective investment and take on market risk but no counterparty risk, the case for a guarantee did not appear to be strong. This was contrasted to cases where an APRA-regulated financial institution uses the strength of its balance sheet to make promises to consumers that are not intended to fluctuate in value.

10.96 Should an umbrella body be created to administer a system of guarantees, one issue that does arise is whether it could also assume responsibility for administering arrangements under Part 23 of the *Superannuation Industry (Supervision) Act 1993.*

10.97 That scheme exists to provide compensation in limited circumstances where fraudulent conduct and theft may present significant losses to members or beneficiaries of a superannuation fund.

10.98 Although it does not appear sensible to consider guaranteeing the contribution or market risk associated with superannuation funds, it may be possible for a body administering guarantee arrangements in other prudentially regulated sectors to assume some of the existing superannuation compensation functions. It thus addresses the issue of protecting against agent risk facing these investors.