

## APPENDIX 4.2: FINANCIAL INSTITUTION FAILURES IN AUSTRALIA — SOME CASE STUDIES

### State-owned banks

The two most significant banking failures in the 1990s were the failures of the State Bank of Victoria (SBV) and the State Bank of South Australia (SBSA). The banks were owned by the respective State governments and experienced pre-tax losses exceeding three times the 1989 level of shareholders' funds.

#### State Bank of Victoria

The primary source of SBV's problems was losses in its subsidiary, Tricontinental, which were more than 3.5 times greater than the value of SBV's capital. The SBV lost around \$3 billion. The State Government invested \$2.7 billion in the SBV Group largely in connection with Tricontinental. The Reserve Bank of Australia (RBA) was prepared to offer short-term emergency liquidity support to the State Bank (provided the Victorian Government indemnified it against any losses) if the bank were to exhaust its stock of liquid assets. The RBA also offered to help the State Bank sell its portfolio of Commonwealth Government securities if the need arose, either by assisting the sale of those securities in the market or by buying them itself. In the event, no such arrangements were required. In August 1990, the State Bank was sold to the Commonwealth Bank (Fitz-Gibbon and Gizycki 2001).

A Royal Commission was set up by the State Government in early 1990 to investigate the collapse of Tricontinental.

#### State Bank of South Australia

The State Government of South Australia was forced to bail out the SBSA when it lost \$3.3 billion. The cost to taxpayers was in the vicinity of \$2.2 billion. A Royal Commission into the failure was also conducted.

## Rural and Industries (R&I) Bank of WA

The Rural and Industries (R&I) Bank, then owned by the Western Australian Government, became the subject of a brief run in January 1992. The run ended when the RBA Governor issued a statement pointing out that deposits with the R&I Bank were guaranteed by the State Government of Western Australia, and giving reassurance that the RBA would take whatever steps necessary to ensure the bank had adequate liquidity.

## Pyramid Building Society

The Farrow Group was founded in 1959 with the establishment of the Pyramid Building Society. Over the course of the early 1970s and 1980s, the Farrow Group purchased and/or reconstructed two other building societies: the Geelong Building Society and the Countrywide Building Society. These three institutions became known as the Pyramid (or Farrow) Group.

The problems of the Pyramid Group stem from the freedom afforded by the deregulation of the 1980s. The Group went into commercial lending soon after deregulation and grew rapidly from that point. Between 1981 and 1989 assets grew from \$260 million to \$2,900 million. Particular actions by the Group further contributed to its problems. These actions included: borrowing at higher rates than the major banks (between 2 to 4 per cent higher), charging large upfront fees (the fees provided the Group's cash flow), capitalising interest on loans when borrowers were unable to meet repayments and having in place complex lending structures that allowed the Group to lend outside of the State. The most significant action, however, was the misused provision of the 'free tranche'<sup>1</sup> which was permitted by regulations. The Group created a 'free tranche trust' which allowed the top-up of commercial loans beyond the prudential lending limits. This had the effect of exposing the Group to risky commercial borrowers.

The Group began experiencing liquidity problems in late 1989 and early 1990 with a run on deposits throughout February/March 1990 with more than \$200 million being withdrawn. A second run in May/June 1990 led to its ultimate close on 22 June 1990. Two weeks prior to its eventual failure, the Victorian Government assured the public that the Pyramid Group was financially sound.

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1 Societies were permitted to acquire an asset or make an advance not otherwise authorised subject to these assets or advances not exceeding 6 per cent of the society's total value of assets the previous financial year. This discretionary 6 per cent of assets or advances became known as the 'free tranche'.

The estimated total of all deposits of the Group prior to the collapse was \$1,473 million. The Victorian Government ultimately provided financial assistance equivalent to 25 cents in the dollar to depositors to ensure that they received the full value of their deposits. However, some investors, who had non-withdrawable shares, did not receive assistance and lost money. The final cost to the Victorian taxpayer was over \$900 million. The funds were raised through a 3 cent levy per litre on petrol. The levy lasted for 5 years.

## Credit Unions<sup>2</sup>

Since the 1980s the number of credit unions in Australia has declined from over 700 to just under 200. Most of that decline is the result of voluntary mergers between credit unions. Some, however, involved transfers of business required by State regulators in cases where credit unions were in breach of legislative requirements or, in a small number of cases (primarily in the 1980s), were insolvent. In those latter cases, the existence of State-based stabilisation funds (based on contributions from credit unions) provided one mechanism for ensuring that no members of failed credit unions lost money. In another case, the Western Australian Government arranged a take-over of a failed credit union by the Government owned R&I bank at a cost to taxpayers estimated to be in the order of \$220 million. The State based stabilisation funds which operated in several States under State regulators, evolved in some cases from co-operative schemes established by the credit union movement and which had previously operated to stabilise and resolve credit unions in difficulty. The stabilisation funds were wound-up after the introduction of the Australian Financial Institutions Commission (AFIC) as a national regulator in 1992.

### Western Australian Teachers' Credit Society

At the start of the 1980s, Western Australian (WA) Teachers' Credit Society was one of the largest credit unions in Australia and grew rapidly in the first half of the 1980s partly based on commercial lending. In 1987 after several years of difficulty, State government assistance was sought and the Government-owned R&I bank acquired the credit union. That takeover ensured that member's deposits were protected, ultimately by the WA taxpayer. Several other credit unions in WA also experienced problems and experienced runs by depositors. Support by credit union associations from

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<sup>2</sup> This section is primarily sourced from G Lewis *People before Profit: The Credit Union Movement in Australia*, Wakefield Press, Kent Town, 1996.

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outside the State enabled the problems to be overcome, and subsequent legislation saw the development of a savings protection (stabilisation) fund.

### Moe and District Community Credit Union

In 1989 the Moe community credit union was placed under administration by the State regulator following discovery of large losses due to inappropriate lending practices. Other credit unions were required to inject additional funds into the State stabilisation fund to meet the losses, and the Moe community credit union was merged with the SEC Credit Union. Shortly thereafter, in the wake of this publicity and that surrounding the Pyramid collapse, several credit unions experienced liquidity problems due to member withdrawals. The Victorian government commissioned a review of credit union legislation, which was ultimately overtaken by the introduction of AFIC.

### Occidental Life and Regal Life

Occidental Life was a medium-sized life insurance company which specialised in term and disability insurance and investment products, both capital guaranteed and investment linked. Investment business was predominantly superannuation for individuals and small schemes. The company had experienced strong growth in its term, life and disability portfolio and had a single market share in this area ranking in the top five life companies. Risk insurance was its core business and its primary source of income.

Regal Life was a Melbourne-based, small life insurance company which had previously been Royal Life Insurance Limited but had changed its name to Regal when it was acquired beneficially by Battery Group Limited. Battery Group Limited was also the beneficial owner of Occidental. The removal of \$65 million of statutory funds occurred during the aborted sale of the two companies in 1990. The ISC had inadequate powers to take any action to interfere with or forestall completion of the transaction. Following the transaction, a Judicial Manager was appointed to report on the course of action most advantageous to the general interest of policyholders. An examination of the Judicial Manager's various reports during the course of the judicial management indicated a number of problems with the companies, particularly in relation to the investment of assets, the preservation of policyholder funds in statutory funds and dealing with those funds.

To ensure that consumers were protected, the Government introduced legislation to impose a levy to recover 90 per cent of policyholder benefits.

In 1991 the Mercantile Mutual Life Insurance Company Limited bought Occidental Life's risk insurance portfolio. Following the successful transfer of the portfolio, most policyholders received full value for their investments. Some of the Regal policyholders, however, did not. Payments by the Bank of Melbourne to remedy the problems which occurred in the settlement process during the aborted sale substantially eliminated any shortfall in assets.

The Government's levy legislation was not required and the levy legislation was subsequently repealed.

### HIH Group of Companies — HIH Support Scheme

On 15 March 2001 the HIH Group of Companies (HIH) was placed in provisional liquidation. In May 2001 the Australian Government announced a package of up to \$640 million to assist eligible policyholders.

In July 2001, the Commonwealth entered into agreements with HIH Claims Support Limited (HCSL), a wholly owned subsidiary of the Insurance Council of Australia, to administer the Government's HIH Claim Support Scheme (HCSS). In turn, HCSL entered into tripartite agreements with the Liquidator of HIH and insurer managers. Under the scheme, policyholders assign their rights under their HIH policy to HCSL.

Eligible policyholders are individuals who meet an income test based on family taxable income, small business (of less than 50 employees) and charitable enterprises.

The Scheme pays 100 per cent of the amount which the insurer would have been obliged to pay, under the relevant policy (the policyholder must still pay the excess, where applicable, and all of the terms, conditions and limits of the policy will still apply) in the case of salary continuance, disability or income protection claims made by Australian citizens or permanent residents; personal injury claims where the insured is an Australian citizen, permanent resident or small business; claims under home building or home contents policies where there is a total loss involving a primary place of residence where the insured is an Australian citizen or permanent resident; and claims where the policyholder is an Australian not-for-profit organisation.

HCSS pays 90 cents in the dollar support for other claims where the insured is subject to an income test as follows. Where the family taxable income is less than \$77,234 (increased by \$3,139 for each additional child), a policyholder qualifies regardless of the size of the claim. Where family taxable income is

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more than \$77,234 (increased by \$3,139 for each additional child), a policyholder qualifies for assistance if the claim is more than 10 per cent of family taxable income. Eligible claims also include those where the insured is an Australian small business that has 50 employees or less.

By March 2004, over \$340 million had been paid out to, or on behalf of, policyholders.<sup>3</sup>

## Commercial Nominees of Australia Ltd (CNAL)

Commercial Nominees of Australia Limited (CNAL) was the trustee of 22 corporate and public offer superannuation funds, around 500 small APRA Funds (SAFs) and 13 non-superannuation funds.

CNAL established the Enhanced Cash Management Trust (ECMT) in the second half of 1998. The assets of the ECMT included loans which would not normally be the investments of a cash management trust. This raises the concern that these transactions may not have been negotiated on an arm's-length basis. In March 2000, two newly appointed directors of CNAL advised APRA that there was a possibility that assets held by the ECMT and the Enhanced Equity Fund (EEF) were impaired. APRA was informed that at least three superannuation funds (the Network Superannuation Fund, the Midas Superannuation Fund and the Australian Workforce Eligible Rollover Fund), of which CNAL was the trustee, had invested in ECMT and/or the EEF, and were, as a result, exposed to the impaired assets.

In April 2000, APRA required CNAL to engage an investigator (PricewaterhouseCoopers (PWC)) to undertake an independent review of the financial position of the three affected funds. It was anticipated that attempts to recover these loans from the related parties, coupled with the inquiries of the investigator, would produce the required evidence of any transactions undertaken at non-arm's length. In November 2000, PWC reported on the financial position of the three funds. The Board of CNAL froze all withdrawals from the ECMT on 7 November 2000.

In February 2001 APRA revoked CNAL's approval as an APRA-approved trustee, and removed CNAL as the trustee of around 500 SAFs.

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3 A number of State-based schemes were put in place for the compulsory classes of insurance which are regulated by the States. The overall cost of the HIIH 'bailout' by the Australian taxpayer therefore is greater when combined with State financial responses.

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The failure of CNAL in 2000 resulted in an estimated 25,000 investors losing some proportion of their superannuation saving, which together amounted to a loss in the order of \$25 million to \$30 million or around 8½ per cent of CNAL's funds under management.<sup>4</sup> Applications for payments under Part 23 of the *Superannuation Industry (Supervision) Act 1993* are still being processed.

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<sup>4</sup> The estimated cost to date of rehabilitating CNAL's funds is around \$17.5 million.

