

Parliamentary Joint Committee on Corporations and Financial Services

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Inquiry into Corporate Insolvency in Australia

Wednesday, 14 December 2022

Division/Agency: Australian Prudential Regulation Authority

Question No: APRA03QW

Topic: Insurance Insolvency Risks

Reference: Written 23 December 2022

Senator: Deborah O'Neill

Question:

What are the challenges in determining insolvency in the insurance sector—for example, in relation to the uncertainties that arise from long-tail liabilities?

Answer:

The insolvency of any company, including an insurer, is determined by the cashflow test: the ability to pay debts when they become due and payable (s95A Corporations Act).

The determination of insolvency for insurers can be complex and involves a high degree of judgement. The key challenges are:

- lack of clarity as to which insurance liabilities constitute 'debts' under the Corporations Act;
- limited case law in Australia specific to insurer insolvency; and
- the estimation of ongoing insurance liabilities is inherently challenging.

Modelling of future liabilities is particularly difficult for long-tail policies, where claim obligations may not become due and payable for many years after a policy is issued or may be payable over a long and undetermined period. For example, long-tail liabilities may arise from:

- Claims related to bodily injury such as CTP, workers compensation and general liability (e.g. lung diseases caused by exposure to asbestos may not emerge for many years);
- Lenders' mortgage insurance policies commonly have a long duration (e.g. 20-30 years) and a claim event can occur at any point during this period;
- Disability income claims are payable by a life insurer for a prolonged period, potentially extending over many years; and
- Under a lifetime annuity, a life insurer is required to pay an amount regularly for the life of the policyholder and the length of the policyholder's life is unknown.

Consequential issues for APRA's crisis management powers:

- The Financial Claims Scheme (FCS, the Australian Government's policyholder protection scheme) for a general insurer can only be activated upon insolvency as defined in s95A of the Corporations Act (in other jurisdictions, e.g. UK, the balance sheet test is used).
- The uncertainty about what constitutes 'debts' under s95A means it could take additional time to confirm insolvency. This in turn limits APRA's ability to activate the FCS in a timely manner and protect policyholder interests.

Background on APRA's supervision of insurers:

- APRA's mandate is to ensure the financial interests of Australians are protected, including insurance policyholders, and that the financial system is stable, competitive, and efficient.
- APRA sets minimum capital requirements for insurers calibrated such that, in all reasonable circumstances, insurers should be able to pay their liabilities as and when they fall due.
- APRA facilitates the orderly resolution of regulated insurers that are no longer viable. This would typically occur before insolvency.