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# THE TREASURY

## ECONOMIC ROUNDUP

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# **Australia's Economic Policy Challenges**

Address to the Committee for Economic Development of Australia  
(CEDA)

John Fraser | Secretary to the Treasury | 27 February 2015

## Introduction

Lee and Nick, thank you for that kind introduction and for hosting today's event.

Over the past two decades, I have observed the performance of the Australian economy and the debates about fiscal policy and structural reform largely from afar.

My outsider's perspective was that, while our economy was performing comparatively well and our levels of government debt were well below those of most other advanced economies, this owed much to the hard decisions on structural reform made through the 1980s and 1990s, the fiscal repair of the late 1990s and the good fortune of being endowed with commodities that have been in high demand by China since the early 2000s.

Now, there is a real question as to where our future prosperity will come from as the growth dividend of past reforms fades and growth in demand for our natural resources eases, especially against the headwinds of a weak global economy and an ageing population.

It is hard not to think that the proceeds from the resources boom may have led to reform complacency and, just as importantly, those proceeds financed government decisions that are now harming the structural integrity of the budget.

More than ever Australia's future economic prosperity lies in our own hands.

## Economic Outlook

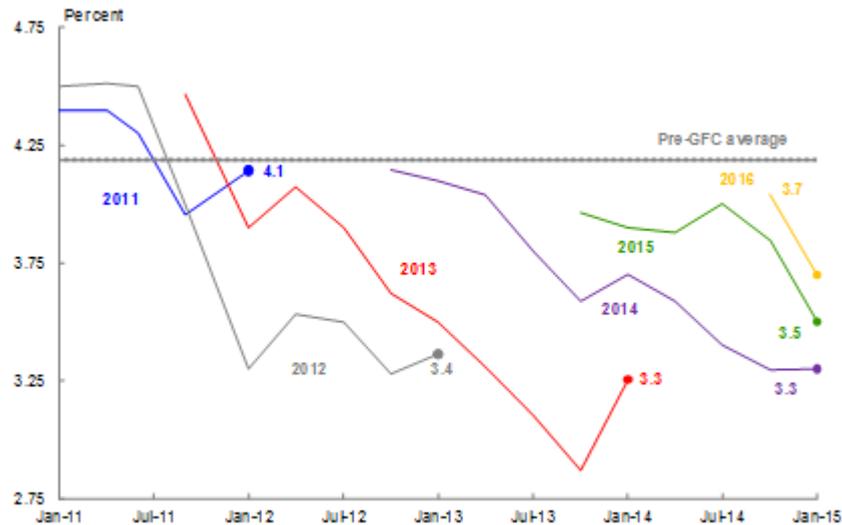
I'll start by providing you with my assessment of the current economic backdrop, both globally and domestically.

Seven years after the collapse of Lehman Brothers and the attendant ravages of the global financial crisis, the global economic environment remains very challenging.

Indeed, the period of weakness following the crisis has significantly exceeded the average experience since World War 2 between the depths of a recession and the subsequent cyclical peak, highlighting the severity of the damage.

We have seen hopes for a return to stronger global growth dashed by a series of setbacks, evident in the long succession of downgrades to the IMF's global growth forecasts shown in this chart.

## IMF Global Growth Revisions



For most major advanced economies, extremely easy and, frankly, experimental monetary policy settings have failed to generate a significant recovery in household spending and business investment.

The US, which was at the epicentre of the crisis, is now emerging as a bright spot in the global economy.

While the US economy is still operating below its potential and a sizable percentage of the population remains disconnected from the labour market, there are reasons to be cautiously optimistic that the US economy may have turned the corner and that sustained strong growth will start to reduce excess capacity.

To my mind, this owes as much to the remarkable flexibility of labour and product markets in that nation as to policy interventions since the global financial crisis.

Growth is becoming increasingly broad-based and the labour market continues to strengthen.

If this continues, the conditions will be in place for the Federal Reserve to continue unwinding monetary stimulus.

While the adjustment period may present its own challenges, this would start to reduce the serious risks inherent in a prolonged period of very low interest rates.

Unfortunately though, downside risks continue to dominate in other major economies.

## Australia's Economic Policy Challenges

Despite the benefits of the fall in oil prices over the past year and very low interest rates, persistent economic weakness continues to plague large parts of Europe and Japan.

Key for Australia, the IMF also recently downgraded its outlook for China's growth to reflect its ongoing transition to more moderate but sustainable growth.

This brings the IMF's forecasts for China in line with those published in the Mid-Year Economic and Fiscal Outlook in December last year.

Recent Chinese data support this revised outlook.

Although there are concerns about the extent of China's slowdown and the potential risks arising from the rapid expansion of credit over the past decade.

The moderation in China's growth prospects was one factor driving the rapid reduction in prices we receive for our key commodity exports through last year.

Subdued growth prospects leave the global economy vulnerable to a range of potential shocks.

Stress testing highlights the vulnerability of some financial institutions in Europe.

Recent developments with regards to Greece are a reminder that the structural shortcomings of the Eurozone also remain a significant threat.

And geopolitical risks loom large in many parts of the world, most notably Eastern Europe, the Middle East and Asia.

That said, the Australian economy has performed well by the standards of our peers since the global financial crisis.

There are few, if any, developed countries that would not trade their circumstances for our own.

We avoided the increases in unemployment and substantial loss of productive capacity experienced by most other developed nations.

But we did not emerge from the global financial crisis unscathed.

Our economic growth has been below its long run average in 5 of the past 6 financial years, weighing on job creation and contributing to a gradual upward drift in unemployment.

Critically important for Australia's near term growth prospects is that we must now secure stronger growth in non-mining business investment as the resources investment boom fades.

Cheap credit, lower fuel prices and the depreciation of the exchange rate will assist, although weak demand is weighing on confidence and current investment plans.

This is reducing the preparedness of businesses to invest in future capacity and take on additional workers.

Treasury's forecasts are for the Australian economy to grow at a below-trend rate over the next two years, making significant inroads into unemployment unlikely.

In my view, one factor not fully recognised as constraining growth - both in recent years and in the future - is the tighter regulatory requirements on major global and some national banks, as well as the more conservative risk appetites of global financial institutions.

During the 1990s and first half of the 2000s, the balance sheets of global financial institutions expanded at a rapid pace.

This was an important driver of the strong growth in real GDP and employment experienced by most major advanced economies prior to 2008.

But at the same time, it also drove a significant increase in private sector indebtedness and far greater risk in the financial sector.

This was unsustainable.

The tighter regulatory and capital rules introduced since the global financial crisis will lead to a more stable financial system over time but they have resulted in financial institutions becoming more circumspect.

This has made it more difficult for businesses to gain access to bank balance sheets, weighing on investment to the detriment of potential growth.

In a world where many economies have struggled to generate growth, we have also seen countries seemingly engaging in the zero sum game of competitive currency depreciation.

The US is an example of an economy that appears to have benefitted from exchange rate depreciation in some past episodes.

The flexibility of US product and labour markets has meant that the relative price signals sent by a decline in the exchange rate have been effective in shifting resources to export and import-competing industries in support of stronger growth.

Similarly, with the euro, Germany has also benefitted from being a member of a currency bloc with weaker peripheral economies that suppress Germany's effective exchange rate.

The flip side though is that Germany's participation in the currency bloc may have supported the euro to the detriment of the peripheral economies.

While a lower exchange rate can support growth, currency depreciation is not a badge of honour.

## Australia's Economic Policy Challenges

In Australia's case, we have benefited enormously from our flexible exchange rate.

It has served as an important shock absorber and was a key reason why the most recent commodities price boom did not generate the kind of macroeconomic instability that we saw when the terms of trade peaked in the 1970s.

But we cannot rely on a lower exchange rate to solve our growth challenges.

As evidenced in the 1980s, a lower exchange rate must go hand in hand with good structural and fiscal policy.

We need to start now - not leave it to the next generation to pick up the pieces and face even tougher choices in the years ahead.

## Fiscal Repair

An immediate priority is to repair the fiscal position.

Since 2007-08, the Australian Government's fiscal position has deteriorated from surpluses in the order of 1½ per cent of GDP to deficits in the order of 3 per cent of GDP.

Commonwealth Government net debt has increased from negative 3.8 per cent of GDP to positive 12.8 per cent of GDP in 2013-14 and continues to rise.

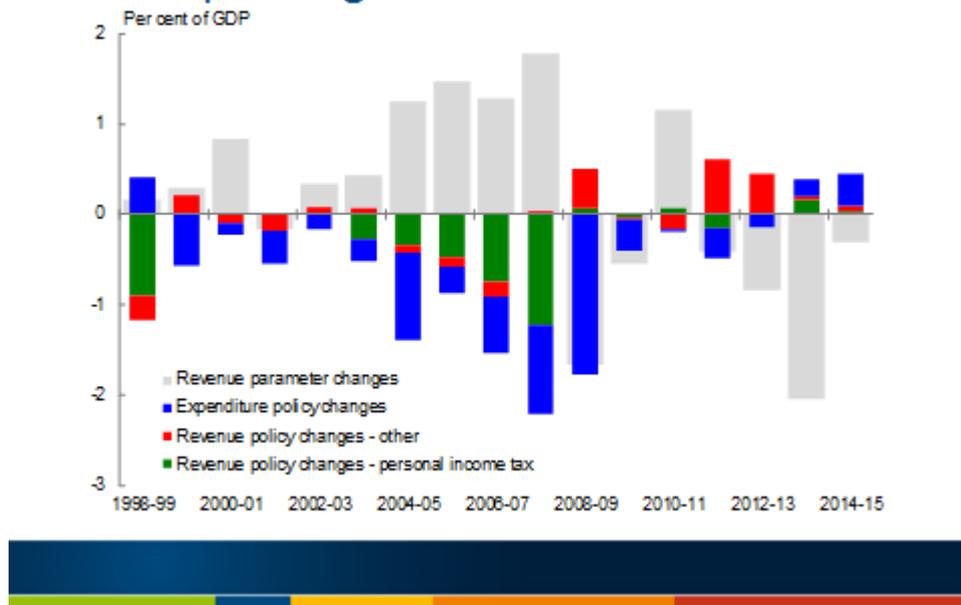
Net debt is approaching the levels that we last saw after the recession in the early 1990s, which at that time was the highest we'd seen in Australia since the years following World War 2.

Importantly, this debt is currently being serviced with interest rates at a little under 3 per cent.

The debt burden is growing with each budget deficit and will grow even faster when interest rates rise.

The start of the structural deterioration in the Commonwealth's budget position began before the global financial crisis.

## Net impact of unexpected revenue windfalls, spending decisions and tax cuts



This chart shows the impact on the budget bottom line of unexpected revenue parameter changes (the grey bars), personal income tax cuts (the green bars), other revenue policy changes (the red bars), and new expenditure decisions (the blue bars).

The grey bars above the line show that the Government received positive revenue surprises at successive budget updates from around 2002-03 to 2007-08, primarily due to the terms of trade persistently exceeding Treasury's forecasts.

The green and blue bars below the line show that these positive revenue surprises were largely handed back through personal income tax cuts or spent.

In real terms, Commonwealth Government spending grew at an average annual rate of around 3½ per cent between the start of the terms of trade boom in 2003-04 and the start of the global financial crisis in 2007-08, while taxes fell as a share of GDP.

Some of the proceeds of our once-in-a-generation commodity price boom were used to pay down debt and set against future liabilities through the creation of the Future Fund.

There was also some increase in infrastructure investment.

But a very substantial amount was spent, including on untargeted transfers (so called middle class welfare) without sufficient regard to the future prospects for servicing those ongoing transfers.

## Australia's Economic Policy Challenges

Generous income testing arrangements for Family Tax Benefits in the early 2000s and access to million dollar contributions to tax-preferred superannuation through 2006-07 were notable examples of middle or higher income welfare that contributed to the problem.

It is my strong belief that as a society we have a moral obligation to assist the worst off, including the disabled and those who are not in a position to provide a basic standard of living for themselves and their families.

The tax and welfare systems are a means of doing this but we must ensure that fiscal transfers are well-targeted.

Not only did we enter the global financial crisis with a Commonwealth Government budget that was structurally weaker than the budget balance suggested but the pace of Government spending growth has remained high since.

Initially this could be attributed to fiscal stimulus measures.

But while many of these measures were subsequently unwound, growth in Commonwealth Government spending continued apace.

As you can see from the chart, it wasn't until 2013-14 that expenditure policy decisions started to make a positive contribution to the budget bottom line.

Commonwealth Government spending has grown at an annual average of more than 4 per cent in real terms since 2007-08, compared with 3 per cent during the 1980s and 1990s.

As a result, spending in 2013-14 was around 2½ percentage points higher (as a proportion of GDP) than it was 6 years ago.

This strong growth in expenditure highlights that weakness in revenue is only partly to blame for the current state of government finances.

The reality is that Australia has spent its way to a structural budget problem. Government payments are growing faster than government revenues and without action, this trend will continue.

Why do I place such an emphasis on fiscal sustainability?

The importance of fiscal sustainability for Australia was spelt out long ago in a 1993 report to former Treasurer Dawkins on National Savings, prepared with the very considerable assistance of the Treasury.

The argument at the time, which is as relevant now as it was then, is that we cannot continue to finance recurrent expenditure by continuing to increase our debt.

The result would be increasing exposure to external shocks, an erosion of intergenerational equity and a rising premium on our borrowings that would reduce our long run growth potential.

The Report highlighted the importance of public saving to Australia's national savings and the need for a strong government balance sheet given Australia's relatively high levels of private indebtedness by international standards.

This remains the case today.

The Report made an important contribution to the establishment of a medium term framework for setting fiscal policy in Australia, centred on the Commonwealth achieving budget surpluses on average over the economic cycle.

It argued that the States should also run fiscal surpluses on current spending but small deficits overall that they would use to finance productive infrastructure investment.

This remains a sound framework for setting fiscal policy in Australia today.

It supported reductions in government debt during the second half of the 1990s and early to mid-2000s, providing an important buffer when the global economy was hit by crisis.

But seven years after the start of the crisis, our fiscal buffers have been eroded and we need to undertake fiscal repair.

I would also like to emphasise that it would be naïve to rely on a short term boost in economic activity to address Australia's fiscal challenge.

Returning the budget to a modest surplus by 2017-18 (the end of the forward estimates period in the Mid-Year Economic and Fiscal Outlook) would still require real GDP growth to average around 4 per cent over the next five years – compared with Australia's trend growth rate of around 3 per cent.

And this calculation assumes that the measures – or those of an equivalent order of magnitude – announced in last year's budget that remain before the Parliament are implemented.

If they're not, real GDP growth would need to average roughly 4½ per cent to return the budget to surplus by the end of the forward estimates period.

Even putting to one side whether sustained 4 per cent growth is realistic, given the significant headwinds – it's not clear that the economy could sustain the pace of demand growth necessary to return the budget to surplus by the end of the forward estimates period without generating significant inflation or pressure on available skills.

The more sophisticated advocates of the growth strategy argue that spending should be boosted on productive infrastructure investment.

My assessment is that the key to solving Australia's infrastructure challenge is far more to identify projects with a demonstrated high rate of economic return.

Where such projects exist, there is no shortage of private sector financing.

## Australia's Economic Policy Challenges

More fundamentally, those that say the government should spend its way to stronger growth in the near term tend to ignore the costs to growth in the medium to long term of higher government debt or higher average tax rates.

My view is that we need to address Australia's structural budget problem through greater expenditure restraint, where the international experience shows what can be achieved over relatively short time periods.

By way of comparison, the UK has reduced their budget deficit by a cumulative 4.6 per cent of GDP since the peak in 2010 to a deficit of 5.6 per cent of GDP.

The US budget deficit has been reduced by a cumulative 7.0 per cent of GDP since the peak in 2009 to a deficit of 2.8 per cent of GDP.

A key difference for Australia of course is that our economy was not as hard hit by the global financial crisis as the US and UK and we are not experiencing the same rebound in our growth.

But it's also the case that the US and UK have been more successful in reigning in the growth of government expenditures than we have been in Australia since the global financial crisis.

Over the past five years, general government expenditure has declined in real terms in both the US and the UK.

As I mentioned earlier, this compares with annual growth in real Commonwealth Government expenditure of more than 4 per cent on average over the same time period.

For any realistic assessment of future growth prospects, the only way that significant fiscal repair will be achieved in Australia is committing now to savings measures that build over time to deliver a return to surplus over the medium term.

## Long Term Growth Drivers

The Treasurer will have more to say about Australia's fiscal position when he releases updated 40 year projections in the Intergenerational Report (IGR).

This will be an opportunity for a discussion about Australia's medium term fiscal position and the policy changes needed to provide for the sustainable provision of essential government services.

I will spend a few minutes reflecting on the trends that we're seeing in the three drivers of long term economic growth - population, participation and productivity - and the implications for policy.

Before I do, one point to note is that - when we project forward the economy's productive potential - we are presenting one possible outcome based largely on a set of assumptions.

The IGR will present sensitivity analysis showing the impact of changes in the economic assumptions on the fiscal projections, recognising that relatively small changes in important assumptions can have a major cumulative impact over a 40 year period.

These bands of uncertainty don't in any way detract from the IGR projections.

Quite the opposite.

They all highlight the importance of placing our policy frameworks in the strongest possible position to meet whatever challenges the future may bring.

Where we can be confident is projecting long term demographic drivers in the economy and here it is clear that the ageing of Australia's population will weigh heavily on Australia's potential growth rate and long term fiscal position.

Where there is more uncertainty is projecting future trends in productivity.

An assumption that has been used in successive IGRs is that Australia's labour force productivity is assumed to grow at its long run average.

This long run average growth rate includes the period of strong productivity growth following the reforms of the 1980s and 1990s.

We should not take for granted that productivity growth of this order will be repeated, particularly in the absence of a reinvigorated structural reform effort.

We should also not interpret the IGR projections of long term 3 per cent growth as suggesting that this growth will somehow come from the heavens.

For the economy to operate at its productive potential at any point in time requires matching growth in demand.

This can only be achieved if households and businesses are sufficiently confident about the future direction of the economy to increase spending and investment.

And we must also see international demand growth.

With those caveats, the first key driver of economic growth in the medium term is population.

In recent years, Australia's population growth has been amongst the fastest in the developed world, driven by migration.

A growing population can be a source of dynamism for the economy.

It provides a larger domestic market for business, increases the size of the labour force and facilitates the injection of new ideas.

## Australia's Economic Policy Challenges

But it also places additional demands on government budgets in areas such as infrastructure, health and education.

I have seen this firsthand in the United Kingdom where the results are very sobering.

The population projections in the IGR will provide a basis on which governments can plan for the future.

The second key driver of medium term economic growth is workforce participation.

Over the next 40 years, Australia's population will continue to age as the baby boomer generation grows older and this will place downward pressure on workforce participation.

This is because, while the labour force participation rates of older workers are rising - reflecting both advances in health and the less physically demanding nature of new jobs being created in the economy today - participation in the workforce still tends to decline as people approach retirement.

This means that, as the population ages, declining workforce participation will be a drag on Australia's economic growth.

It also means that there will be a greater burden on a smaller proportion of working individuals to raise the revenue to support government services.

This highlights the importance of policies that aim to increase labour force participation, where the focus should be on embracing the potential of older Australians and encouraging the participation of younger Australians, particularly women.

The third key driver of economic growth is productivity.

Indeed, just as productivity was the main driver of growth in per capita income over the past 40 years, our success in raising Australia's productivity performance will largely determine Australia's growth and prosperity over the next 40 years.

For Australia's per capita national income to grow at the historical average of 2.2 per cent per annum over the next decade, annual labour productivity growth would need to increase to around 2.7 per cent to counteract the effects of population ageing and a falling terms of trade.

This is well in excess of what has been achieved in the past 50 years - and almost double what was achieved in the past decade.

These statistics really frame the challenges to our economy and need to be taken seriously.

## Structural Reform Priorities

We remain the envy of most of Europe and the global economy generally because we completed important reforms in the 1980s and 1990s that drove productivity growth.

Reform stalled in the 2000s but incomes rose with historic rises in the terms of trade and mining investment.

We need to reinvigorate structural reform to boost productivity growth and sustain increases in living standards.

## Structural Reform

- 1990s – Competition enhancing reforms underpinned strong productivity growth
- 2000s – Reforms stalled, living standards rose with terms of trade and mining investment
- Today – Structural reform required to sustain growth in living standards into the future



Boosting productivity will require improvements across all markets – input markets such as the labour market, financial markets, and infrastructure markets as well as final goods and services markets.

Failure to undertake necessary reforms in related markets will mean that the potential benefits of reform in any single market are not realised.

The Government has commissioned a number of policy reviews that will recommend ways to enhance Australia's economic prosperity.

Making the most of these reform opportunities is essential, where three areas stand out as priorities for raising Australia's productivity performance.

The first is tax reform.

Studies have consistently shown that tax reform offers one of the largest policy opportunities to increase incomes and living standards.

## Australia's Economic Policy Challenges

And the fact is that the structure of our tax system today looks remarkably like it did back in the 1950s – but our economy looks very different.

That may tell us something.

Tax reform can promote strong investment and encourage workforce participation.

Our company tax rate is high by international standards.

In the context of far more mobile capital, high tax rates are dampening investment and productivity, while continuing personal income tax bracket creep would have negative impacts on workforce participation and incentives.

An important criterion for a well-functioning tax system is fairness, where there are some contentious and important issues that need to be explored.

For example, substantial tax assistance is provided to superannuation savings.

We need to consider whether the level and distribution of these concessions remains appropriate.

These are the types of issues that will be considered in the upcoming Tax White Paper.

A second priority is continuing to modernise the workplace relations system.

Workplace regulation has been progressively and substantially reformed in recent decades.

Many of the fundamental reforms were undertaken in the 1980s and 1990s, in particular the shift from centralised wage fixing to enterprise bargaining.

These reforms have delivered substantial benefits.

But elements of our workplace relations system may need to change to fit the workplaces of our future.

The Productivity Commission's Inquiry into the Workplace Relations Framework to be delivered later this year will be an important opportunity to create a modern system that will support jobs, promote productivity and lift living standards.

A more flexible workplace relations system that supports the economy will help Australia respond to the challenge of lifting productivity growth.

The rise of Asia, the ageing of the population and the transition away from resource-led growth will require significant adjustment.

It is especially important that workplace laws are not impeding workplace transformation.

A third priority area for structural reform is driving greater competition in goods and services markets.

Previous product market reforms, and those associated with the Hilmer review in the 1990s, pushed competition into non-tradable sectors like electricity, telecommunications and rail freight.

These were important changes, contributing to a GDP increase of around 2½ percentage points over the course of that decade.

The proposals in Ian Harper's draft report released in late 2014 provide the opportunity to boost Australia's productivity performance.

The final report will be released in March.

Ian Harper proposes that we apply competition law and a new set of competition principles to all purchasing activities of government such as health, education and aged care.

Even small improvements here, where government has a large footprint and where Australia's population will impose greater demands on health and aged care, can deliver big benefits over time.

The importance of strengthening competition was also a theme of the Financial System Inquiry.

The Inquiry concludes that competition and competitive markets are at the heart of the philosophy of the financial system and the primary means of supporting the system's efficiency.

We must ensure that our banking and financial system more generally are more competitive.

The Inquiry also recognised that, as the financial system becomes increasingly sophisticated and innovative, the importance of receiving appropriate financial advice and access to appropriate and competitively priced products has increased.

These are challenging issues and will require the Commonwealth and the State governments to work together.

## Concluding Remarks

We live in a great country.

But we now face challenges generating growth and a budget position that will deteriorate further if not acted upon.

Government debt is not at crisis levels and public debt interest remains low as a share of both nominal GDP and government expenditure.

But no action to stem the growth of government debt and/or any substantial rise in interest rates threaten to make net debt a bigger issue in future.

## Australia's Economic Policy Challenges

If we set ourselves on a path of sensible fiscal repair and lay out credible plans for structural reform that address our long-term growth challenges, then the consumer, business and investor sentiment that is critical to lifting economic activity in the near-term will materialise.

We face many challenges that can only be addressed through considered and informed public debate.

We live in a country where the media and others have a voracious appetite for driving wedges between our elected officials that only serves to kill debate.

While this is the case in most countries, my sense is that it's especially acute in Australia.

Policy proposals are too often demonised and effectively ruled out.

It's important that we focus in a mature way on the policies that will maintain Australia's status as one of the world's leading economies.

Thank you for your time today.

I welcome any questions.



## Shared Learnings: Indonesia's and Australia's Current Account Balances

Blake Ford<sup>1,3</sup>, Luky Alfirman<sup>2,3</sup> and Ferry Irawan<sup>2,3</sup>

Indonesia is currently experiencing its most sustained stretch of current account deficits (CADs) since the Asian Financial Crisis. This fact has generated much discussion within policy circles.

Yet CADs are not inherently harmful – Australia has sustained CADs for much of the past 150 years with little harm to the economy. As in Australia, Indonesia's CAD is structural in nature. This reflects the fundamental features of the Indonesian economy, such as a relative abundance of investment opportunities. As such, short-term, 'tactical' policies designed to counter the CAD may inadvertently generate long-term distortions. Where they increase the risk of investing in Indonesia, they may even reduce the stability of the external position.

This paper highlights how, through a long process of reforms, Australia has improved the stability of its external position while also running a persistent CAD. Indonesia can also continue to promote stability and economic growth more broadly through further structural reforms that would liberate it from short-term management of its CAD.

The paper was prepared collaboratively by officials from the Indonesian Fiscal Policy Agency and the Australian Treasury and finalised in January 2015.

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<sup>3</sup> The views in this article are those of the authors and not necessarily those of the Indonesian Fiscal Policy Agency or the Australian Treasury. The authors would like to thank Yoopi Abimanyu and Rudi Handoko of Indonesia's Fiscal Policy Agency, Michele Savinizangrandi, Elitza Mileva, Masyita Crystallin and Alex Sienaert of the World Bank, Helmi Arman of Citibank, Roland Rajah of the Department of Foreign Affairs and Trade, and Natalie Horvat, Joanne Evans, Jenny Wilkinson, David Gruen, Sandra Roussel, Jason Allford, John Swieringa, John Burch, Iyanoosh Reporter, Nathan Wonder, Alex Beames and Moira Byrne of the Department of Treasury, for their comments and contributions to this paper.

## Introduction

Indonesia is experiencing its most sustained stretch of current account deficits (CADs) since the Asian Financial Crisis, with twelve consecutive quarters of deficits. Even so, this series of deficits is relatively brief compared to its stretch of CADs before the crisis. Since then Indonesia has undertaken significant reforms aimed to mitigate some of the vulnerabilities that affected it so severely in the Asian Financial Crisis. Those reforms likely contributed to its comparatively robust performance during the Global Financial Crisis.

Australia, by comparison, has run a CAD for the majority of the statistical record, weathering both the Asian and Global Financial Crises without significant capital flight or serious impediments to real economic performance. The perception of Australia's CAD has changed over this time. Australia's current account position in recent decades was not a significant concern, due to the move away from a fixed exchange rate and a trade deficit that was unmatched by capital inflows. Empirical experience suggested that under a fixed exchange rate regime with limited capital mobility, large and persistent CADs were unsustainable, and left the economy vulnerable to changes in market perceptions of risk.

During the 1980s, various arms of macroeconomic policy in Australia were partly targeted toward managing the CAD, under the assumption that foreign borrowings were unsustainable. These policies ultimately proved to be an inefficient means of managing the economy. After the floating of the dollar, academics such as Makin (1988), Pitchford (1989) and Corden (1991) challenged the view that Australia's persistent CAD was 'unsustainable'. Instead, they argued that the CAD was a result of optimal consumption and investment decisions made by 'consenting adults'.

In considering Indonesia's current account position, Indonesia's policymakers today face many of the same concerns that Australian policymakers faced in the 1980s. The continued normalisation of global monetary policy is likely to see markets re-evaluate Indonesia's external position. At worst, a possible consequence of this normalisation would be a sharp reversal of capital flows. The Indonesian government recently demonstrated its commitment to managing currency stability during periods of volatility, at least in the short run.

This paper, posits that a CAD itself is not necessarily 'bad'; rather it is the fundamental factors that drive a CAD that determine whether or not it is a 'sustainable' position for a country. Moreover, considerations of the stability of the external position are more relevant to Indonesian policymakers than notions of sustainability. The paper begins by outlining some key concepts characterising the CAD, followed by a description of the makeup of Indonesia's recent stretch of CADs. It then examines the drivers of the stability of the external position – especially its financing – and the relevance to Indonesia.

Maintaining stability is a function of managing perceptions of the riskiness of investing in a country. Frictions between theoretically stable long-run CADs and the realities of perceptions about Indonesia's CAD mean that there is a short-term role for mitigating risks to stability. It is widely acknowledged however that such measures have a limited effective lifetime and come at a direct cost to economic growth.

Indonesia's and Australia's current account positions are viewed differently by markets today (and indeed there is ample research on the vulnerability of emerging market economies running CADs to volatility). It is not the purpose of this paper to outline a series of 'tactical', short-run responses to threats to the stability of Indonesia's CAD, and indeed, Indonesia has been proactive in managing the risks to the stability of its external position brought about by recent global monetary policy changes. In this paper, lessons are drawn from Australia's experience in running prolonged CADs, while

maintaining high investment flows – an experience that highlights the importance of a commitment to long-term reforms, as a way of promoting the stability of the external position over a long horizon. In this vein a series of policy recommendations for Indonesia are outlined towards the end of the paper.

## Definitions and perspectives on the drivers of CADs in Indonesia

### Fundamental current account concepts

The current account balance is defined as the sum of the trade, net income and unilateral transfers balances:

$$CA = (X-M)+NFI+UT$$

where CA is the current account, X is exports, M is imports, NFI is net foreign income (essentially the net 'returns' paid to foreigners' investments in the home country) and UT is unilateral transfers (such as aid to foreign Governments and remittances by immigrants to their former home countries). The current account balance can also be described as the difference between the acquisition of foreign assets by domestic parties and the acquisition of domestic assets by foreigners. Note that in order to run a CAD, it is necessary to run a capital account surplus of the same magnitude (in the absence of currency intervention):

$$KA = FDI+PI+OI+R$$

where KA is the capital account, FDI is net foreign direct investment, PI is net portfolio investment, OI is other net investment and R is the change in foreign exchange reserves.

Thinking about it from a different perspective, a CA that is in deficit reflects a situation where domestic investment exceeds domestic saving, and the shortfall is financed by foreign investment:

$$KA = I-S$$

where I and S are domestic investment and savings, respectively. While this relationship appears relatively simple at first glance, it encapsulates the complexity of the current account as a figure reflective of underlying macroeconomic trends (and determinants of both investment and savings behaviour), as opposed to a variable that can be controlled in a direct way. The relationship between domestic saving and investment opportunities also determines the extent to which foreign capital will flow into a country (FDI and portfolio investment), in the absence of policy intervention. The trade balance (X-M) and the net income balance (NFI+UT) are effectively the 'balancing items' when considered from this perspective.

Looked at this way, efforts to reduce a CAD as an explicit goal may constrain the development of productive projects – and harm the long run growth potential of an economy. For example, policies that distort consumption or production decisions mean that aggregate national savings are being diverted to less productive endeavours, compared to what might have otherwise occurred. Similarly, limiting restrictions to capital flows in a country will optimise investment into a country – both foreign and domestic.

Generally speaking, a CAD itself is merely reflective of the economy-wide set of investment and consumption possibilities and is not inherently problematic. When viewed in this light, the issue of the 'sustainability' of the CAD is moot – as long as it is the result of productive consumption and investment decisions then, in aggregate, the external position ought to be 'sustainable'. Indeed, it is

the case that, either through exchange rate adjustment or other means, the external accounts will balance and solvency would be preserved even if the adjustments are economically painful.

Obviously, there are situations where balancing of the external accounts in this way is not desirable and would have severe consequences for the macro-economy. These are the situations that Indonesia is seeking to avoid – and is managing through currency stabilisation. But market perceptions about sustainability inevitably influence the stability of the external position. This highlights the importance of the 'stability' of the external position – which is determined by perceptions of risk.<sup>4</sup> Risks can be exogenous to the economy, such as oil price shocks, or changes in foreign monetary policy. For the most part, there is little that can be done to guard against a sudden reversal of capital flows stemming from exogenously determined factors. However, risks can also be endogenous to the economy, with policy decisions having a potentially significant bearing on the country-specific risks of investing in a country – in turn making the task of currency stabilisation inherently more difficult. Reducing these risks contributes to the stability of the external position.

### The basic makeup of Indonesia's CAD

There are two main developments relevant to the recent widening of Indonesia's CAD – the export performance of its mining and manufacturing industries, and the offsetting effects of energy imports and other inputs into production. Though these developments have driven Indonesia's trade balance into deficit recently (Chart 1), the underlying drivers of Indonesia's CAD are structural in nature – and not the result of a temporary 'gap' that can be quickly and easily filled. As such, Indonesia's CAD is likely to persist beyond the range of short-term macroeconomic management tools and the CAD should therefore not be continually targeted by short-term measures.

The main driver of the initial widening of the CAD in 2012 was a significant deterioration in Indonesia's terms of trade. Highly dependent on commodity exports (around 60 per cent of total exports), Indonesia's CAD is particularly vulnerable to swings in international commodity prices. Prices for key exports such as coal, rubber and palm oil began falling in 2012 following weakening global demand, especially from China, and have continued to weigh on export earnings through 2014.

Until the second half of 2014, the deterioration of export prices was exacerbated by persistently elevated fuel prices, of which Indonesia is a net importer. With fuels accounting for almost 10 per cent of 'raw material' inputs into production, this has hampered the ability of the manufactured exports to capitalise on currency depreciation and offset reduced commodity export earnings. In short, rising input costs to manufacturing production have eroded the ability of the sector to generate trade returns. Exacerbating this effect is the fact that around half of Indonesia's consumption goods imports have been fuels – encouraged by generous fuel subsidies.<sup>5</sup> In the first half of 2014, the deteriorating terms of trade was accompanied by a fall in export volumes of unprocessed ores as the minerals export ban came into effect. Late 2014 and early 2015 has seen the new administration in Indonesia introduce welcome reforms that completely overhaul fuel subsidy arrangements. Indonesians now pay the market price for gasoline as the subsidy has been removed. Gasoline accounts for about 65 per cent of the total fuel subsidies. For diesel, the Government has moved from a capped price (and associated risks to budget) to a fixed subsidy arrangement of Indonesian 1,000 Rupiah per litre.

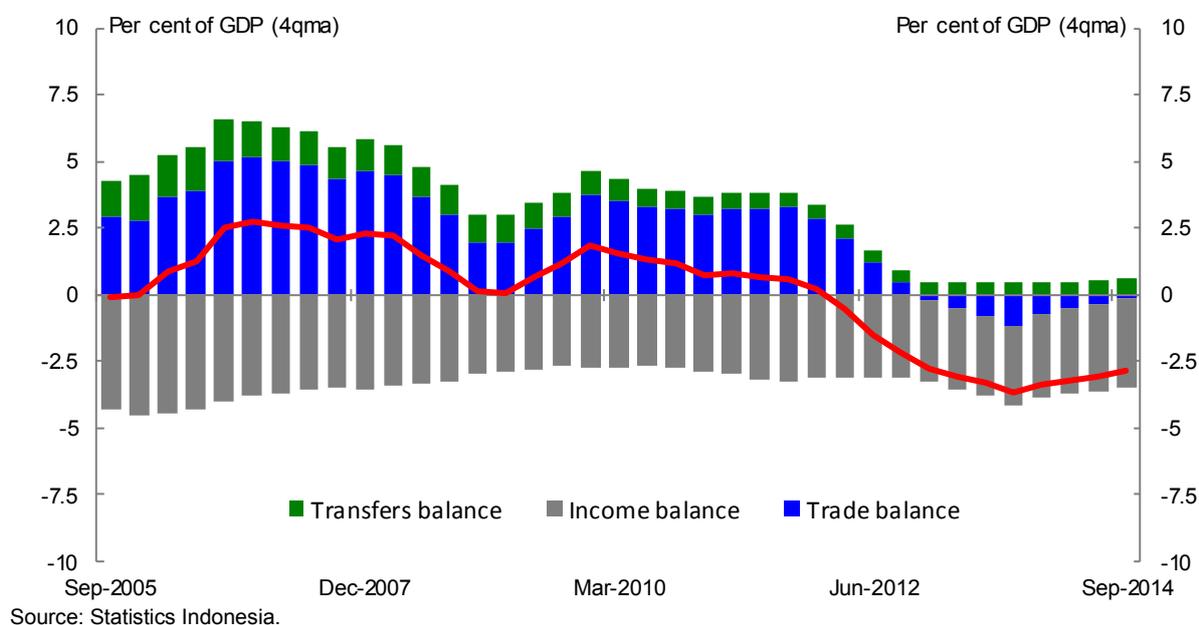
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<sup>4</sup> Note that this is the distinction between a 'sustainable' CAD, and a particular level of the CAD being sustained.

<sup>5</sup> Admittedly, Indonesia's consumption goods imports are reasonably low, averaging around 13 per cent of total goods and services imports over the past five years.

Finally, Indonesia has a persistent services trade deficit (which is driven primarily by transportation and business services deficits). It is important to note that these factors are endemic to the present structure of Indonesia's economy – the far-reaching effects of the commodity cycle on Indonesia's economy, and deficits in tertiary industry trade (to be expected in a rapidly developing economy) suggesting that Indonesia's CAD is inherently structural, at least for foreseeable future.

**Chart 1: Breakdown of Indonesia's current account balance**



Data for the net income deficit (the NID) in Indonesia reflect the net income flows out of Indonesia that are the returns paid on domestic investment, offset by returns made on Indonesians' investments overseas. This confirms that the shift into CAD that Indonesia is currently experiencing is related to the trade balance – with the returns paid on investments in Indonesia largely unchanged over the duration of Indonesia's recent CAD. For the first time after 50 years, Indonesia's (goods) trade balance has been back to deficit since 2012. Even so, as much as the commodity-driven shortfall in the trade balance is an obvious cause of the current CAD, it should not be forgotten that investment opportunities in Indonesia are now necessarily exceeding the capacity of domestic savings to finance them (Chart 2), and represent the aggregate consumption and investment decisions of individuals. This is an experience familiar to Australia, which has seen investment as a share of GDP exceed saving for a considerable period of time.

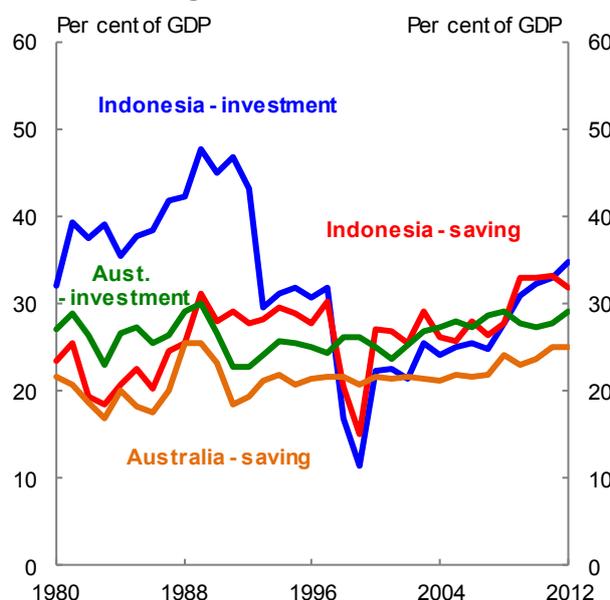
### The makeup of Indonesia's capital account

The capital account data available for investment in Indonesia indicate that, generally, Indonesia attracts more foreign direct investment relative to portfolio investment than its ASEAN peers, as a result of the run-up in FDI flows into Indonesia in recent years (Chart 3).

That said, while Indonesia is the third-largest destination for FDI in the ASEAN region, when the relative size of its economy is taken into account, its FDI flows are comparatively low (Chart 5). Over the past five years, Indonesia's communications industry, mining industry, pharmaceuticals and machinery manufacturing industries, and electricity, gas and water provision have attracted an average of almost 60 per cent of total foreign investment (both FDI and portfolio investment, Chart 6). The next five largest industries attracted an average of an additional 26 per cent of total foreign investment over the past five years. Turning to portfolio flows, around 57 per cent of portfolio flows into Indonesia are in the form of equity investments, while the remaining 43 per cent are invested into

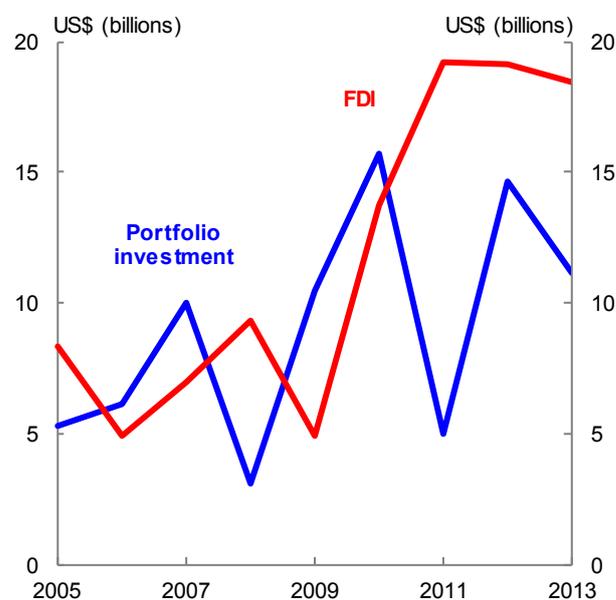
Indonesian debt securities. Of Indonesia's debt securities, most foreign portfolio investment flows into government bonds (around 89 per cent of all debt securities investment), with almost all of the remainder of debt security investment seemingly invested into corporate bonds. Indonesia's equity securities are similarly distributed, with around 70 per cent of portfolio equity investment destined for corporate equities, while banks attract the remainder.

**Chart 2: Gross investment and gross savings as a share of GDP**



Source: IMF April 2014 *World Economic Outlook* database.

**Chart 3: Indonesian net FDI and portfolio investment**



Source: Statistics Indonesia.

It is difficult to determine the true extent to which portfolio investment flows into Indonesian debt securities are reflective of wider financing patterns in Indonesia. Nonetheless, the primary destination for credit in the wider Indonesian economy has been retail businesses, manufacturing, dwelling investment, personal credit and the forestry industry – which have collectively accounted for almost 60 per cent of financing over the past five years (Chart 7). That said, Indonesia's financial markets are relatively shallow, which exacerbates its vulnerability to exchange rate fluctuations. Additionally, given the constrained financial system, many businesses in Indonesia will seek foreign financing directly, rather than intermediated finance through the banking system – which is often unhedged, creating further risks from currency volatility.

## Assessing the sustainability and stability of Indonesia's current account position

Chart 1 clearly shows that the fall in Indonesia's trade balance has been a primary contributing factor to the widening of Indonesia's CAD since early 2012, with the exogenous downturn in the global commodities cycle having a large part to play in this development. Indonesia's policymakers have long been aware that fuel subsidies have contributed to this pressure on the trade balance. By diverting national savings toward the subsidisation of energy consumption, they have distorted consumption and investment decisions and weighed on growth. Accordingly, the 2015 structural reforms removing the government subsidy on gasoline and changing to a fixed diesel subsidy will contribute positively to perceptions about Indonesia's growth potential and the sustainability of the CAD.

Even so, as Chart 2 shows, there also appears to be an emerging trend of investment opportunities in Indonesia exceeding the capacity of domestic savings' to satisfy these opportunities. Indeed, Indonesia's savings and investment rates currently exceed those in Australia and most of ASEAN (Chart 2, Chart 4), and if Indonesia's CAD is considered to be structural in nature, then so too is this relationship between savings and investment.

As noted in the previous section, close to 60 per cent of foreign investment in Indonesia appears to be directed toward sectors of the economy that are either directly related to utilising Indonesia's most prominent comparative advantages and factor endowments (mining and machinery manufacturing are the second- and fourth-largest foreign investment destinations by industry), or cater to Indonesia's exceptionally large and growing consumer market (communications, pharmaceuticals and utilities). Financing statistics for the Indonesian economy in general show a similar pattern, with credit being most prominently extended to similar sectors of the Indonesian economy.

While it is certainly the case that higher FDI typically results in a higher CAD, FDI offers many collateral benefits, such as the transfer of skills through 'learning-by-doing'. The behaviour of portfolio flows – as a barometer of perceptions about Indonesia's CAD – has much more direct implications for Indonesia's economic stability.

As alluded to earlier, the perceptions of both exogenous and country-specific risks will influence the volatility of portfolio flows. When viewed from a savings/investment perspective, it is clear that the only way to eliminate the possibility of the vulnerabilities of capital flight arising from a CAD in the short term would be to deliberately prevent productive investments from being undertaken in the economy, by only funding investment to the level of domestic savings' capacity. This would result in reduced productive capacity and growth potential for the Indonesian economy. And indeed, it is clear that there are plenty of productive investment choices available to foreign investors in Indonesia. To be clear, this savings-investment imbalance in Indonesia is not the result of a deficiency of domestic savings.<sup>6</sup>

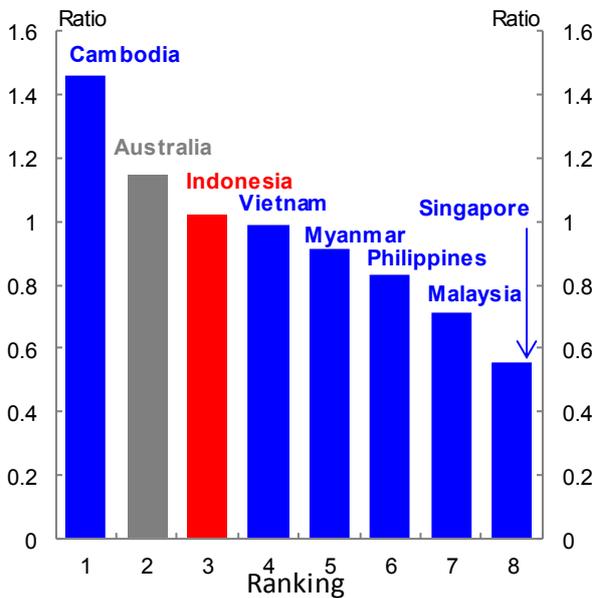
Mitigating country-specific risks need not be so damaging to economic performance. In a situation where markets will increasingly be re-evaluating the riskiness of investments as global monetary policy normalises, then there is a role for policy to provide transparency and clarity with regard to the macro-economy – to avoid contributing to further instability.

Let's take as a specific example Indonesia's banking system. Although it is significantly improved since the Asian Financial Crisis, it does not appear to have the capacity to intermediate all of the investment requirements of domestic businesses. As a result, businesses have resorted to seeking unhedged finance directly on the open market, creating currency risks. Microeconomic reform of the banking sector could thus have far-reaching benefits to Indonesia's economy. In this respect, the way Australia managed perceptions about its CAD during the 1980s – a period of market concern about Australia's CAD – is instructive as a basis for designing a longer-term strategy to improve the 'stability' of perceptions about Indonesia's external position.

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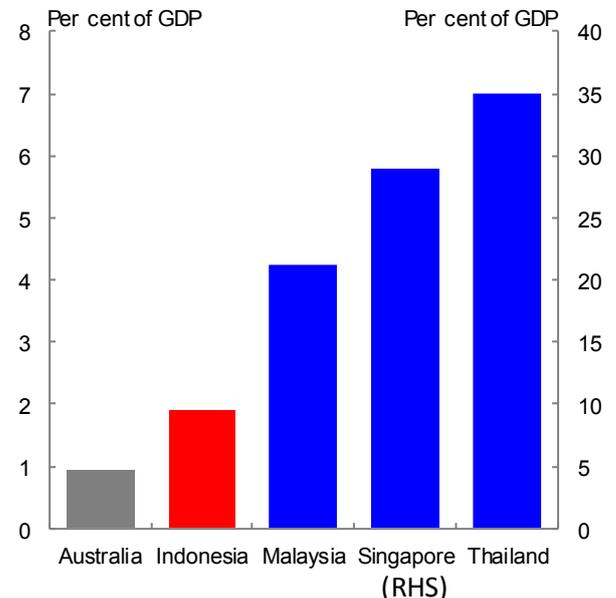
<sup>6</sup> While efforts such as recent mooted tax incentives for retained investment earnings may artificially raise the savings rate in Indonesia, it could come at the cost of stability – with these tax-incentivised savings being directed into relatively volatile portfolio investments, possibly adding to the present instability of capital flows.

**Chart 4: Gross investment/gross savings ratio — ASEAN region (2008-13 average)**



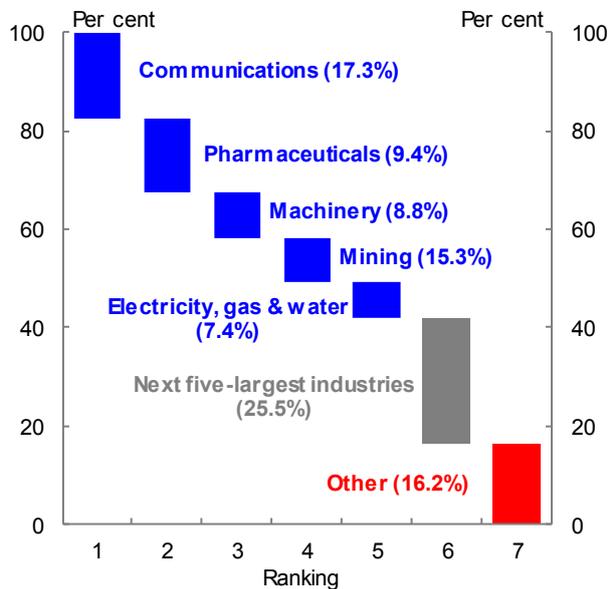
Source: IMF April 2014 World Economic Outlook database

**Chart 5: ASEAN region FDI inflow-to-GDP shares (2013)**



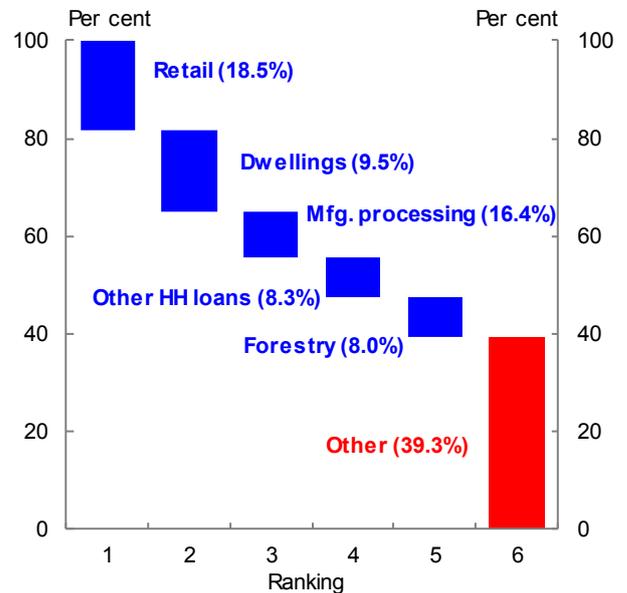
Source: National statistical agencies. Note: Thailand's data are for 2012.

**Chart 6: Share of foreign investment by industry (5-year average)**



Source: Statistics Indonesia.

**Chart 7: Indonesia — share of financing by sector (3-year average)**

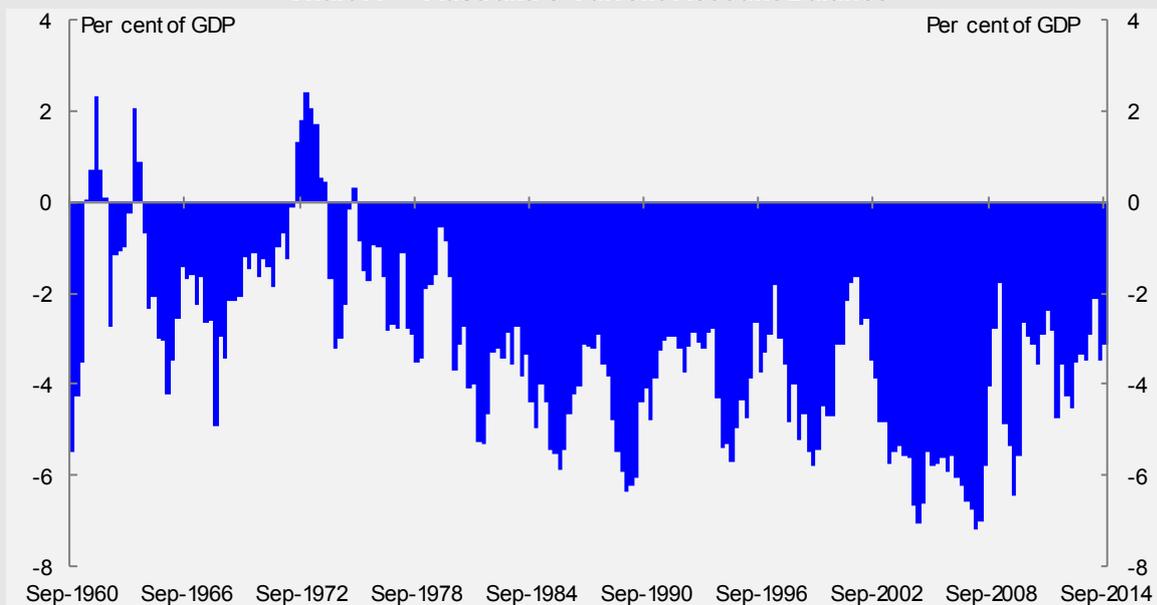


Source: Statistics Indonesia.

### Box 1: Australia's experience with CADs

Australia's current account has been in deficit almost continually since official statistics began in the late-1950s (Chart A), though research by the Reserve Bank of Australia points to the current account being more often in deficit as far back as the mid-1850s (Belkar, Cockerell and Kent, 2007).

Chart A — Australia's Current Account Balance



Source: ABS cat. no. 5302.0 and 5206.0.

Despite Australia's prolonged CADs, periods of capital flight have been limited. The most notable occurred during the 1890s depression after significant inflows had contributed to a property bubble. When it burst, foreign capital retreated for much of the decade — except for inflows related to the West Australian gold rush — which contributed to a banking crisis that resulted in the closure of roughly half the nation's banks (Belkar et al. 2007). Capital inflows also slowed during the 1930s depression but less dramatically than in the previous episode. Fears that Australia would be unable to meet repayments on Treasury bills issued in London and due in mid-1931 dissipated following a raft of measures, many of which entailed greater austerity, coming out of a conference of federal and state ministers that became known as the Premiers' Plan (Giblin, 1951, Gruen and Clark, 2009).

There was less concern with the current account during the period of capital controls enacted during the Second World War, which lasted into the 1970s. As the controls were progressively removed, the CAD increasingly became problematic due to the fixed and subsequent crawling peg exchange rate regimes, given the finite level of foreign exchange reserves and periods of intense speculation that the currency would have to be devalued. After the floating of the Australian dollar in December 1983, the CAD increased, with the government focusing on fiscal consolidation and microeconomic reform to improve Australia's international competitiveness, though only in part because of their concerns about the balance of payments. Meanwhile, for a brief period in the 1980s, the balance of payments became one of several explicit targets of monetary policy.

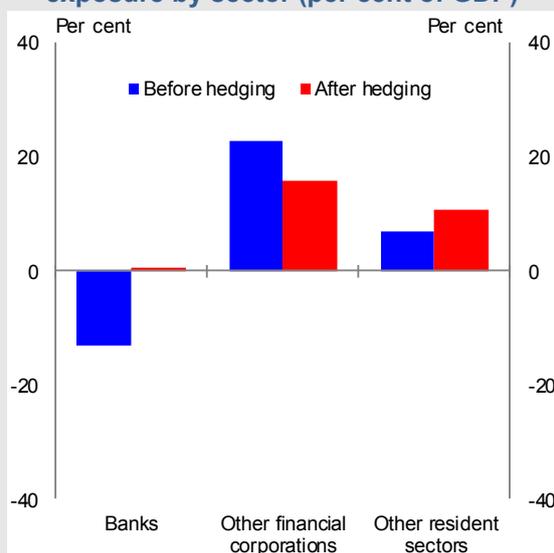
### Box 1: Australia's experience with CADs continued

As the economic reforms of the 1980s began to reduce rigidities within the economy, concerns about the CAD gradually diminished. The steady reduction in tariffs and other trade barriers exposed domestic industries to greater international competition, labour market reforms and subsequent policies enhanced labour market flexibility, and financial deregulation (including by allowing foreign owned banks to compete for corporate and (eventually) deposit taking business) along with reforms to the financial regulatory framework provided an environment for the private sector to manage its own financing risks.

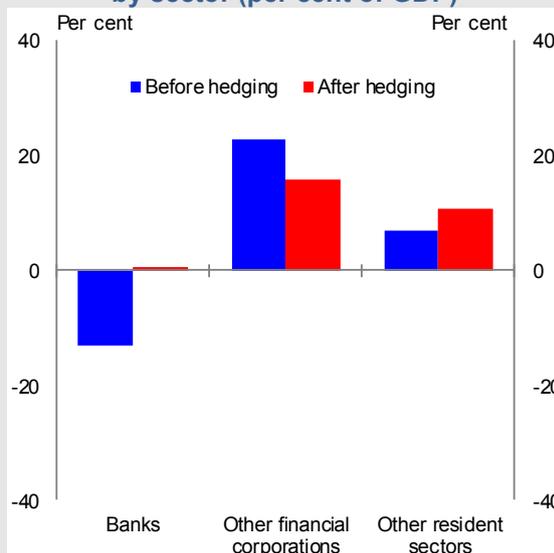
Monetary policy eventually moved to an inflation targeting regime and the benefits of a freely floating exchange rate in absorbing some of the impact of international shocks became apparent. Through time, fewer official foreign exchange reserves were required, though there were still episodes of heavy intervention in 2001 and 2008. In recent years, Australia has had relatively high levels of saving in comparison to other developed economies, with household savings increasing since from the mid-2000s. In addition, Australia's CAD has been one of the drivers for running conservative fiscal policy – ensuring the public sector does not exacerbate the private sector position. As such, rather than being the product of insufficient domestic savings, Australia's CAD is better characterised as being the result of ample investment opportunities attracting foreign capital (Gruen and Sayegh, 2005 and Debelle, 2011), which became particularly apparent during the commodities boom.

Concerns about Australia's current account are still periodically raised by international organisations, such as the International Monetary Fund, and the credit rating agencies, though these concerns mainly focus on how Australia's current account and the accumulated net foreign liabilities from past CADs are financed. The Australian banking system has traditionally intermediated a significant proportion of the CAD, though the recent mining investment boom saw an increase in direct investment by mining companies. While a significant proportion of Australian bank funding is sourced offshore, the foreign exchange risk is almost completely hedged (Charts B and C).

**Chart B — Gross foreign currency exposure by sector (per cent of GDP)**



**Chart C — Net foreign currency exposure by sector (per cent of GDP)**



Source: Bank for International Settlements and ABS cat. No. 5206.0.

### Box 1: Australia's experience with CADs continued

Moreover, net of hedging, Australia's foreign currency exposures are on the asset side of the balance sheet, in part reflecting the benefits of international diversification and Australia's expanding pool of superannuation assets. Accordingly, Australian dollar depreciation improves the net position. Since the global financial crisis, Australian banks have increased their sources of domestic funding, mainly in the form of deposits, and have retired some of their foreign debt.

This shift has taken place even though Australian banks have had little difficulty in accessing foreign funding – with the exception of the height of the GFC. Over this time, the term to maturity of foreign debt has been lengthened, which has increased the stability of banks' foreign funding and reduced rollover risk. In addition, the share of foreign debt denominated in Australian dollars has been increasing, though diversity in funding sources by currency remains.

## Current accounts — a macro phenomenon with strong microfoundations

With the prospect of further re-evaluations of risk as global monetary policy begins to slowly normalise, the sustainability of Indonesia's current account will be an ongoing concern, as exogenous shocks may still present themselves. The roots of Australia's success in managing market confidence in Australia's external position in similar situations lie in a long process of economic reforms, acting to mitigate the country-specific risk component of the stability of the CAD over the long term.

Part of the difficulty of dealing with the negative perceptions of the CAD lies in its apparent simplicity. Yet, as an aggregate figure reflecting a wide range of different drivers in the economy, the CAD is not necessarily 'good' or 'bad'. As such, policies targeted at the headline figure risk having unintended consequences. 'Tactical' responses to short-term CAD concerns may exacerbate wider macroeconomic imbalances that are collectively contributing to external vulnerabilities in the first place, or in the case of Bank Indonesia's stabilisation efforts, have the side effect of reducing economic growth.

Instead, longer term policies that are beneficial to the structure of the economy in general – can in turn either mitigate the potentially damaging effects of an unsustainable/unstable CAD, or contribute to reducing the CAD altogether. The key point is that the structure of the economy should be developed in such a way that natural comparative advantages are allowed to assert themselves, and that policy is transparent and foreseeable to investors through a shared understanding of the 'rules of the game'. A well-articulated and transparent framework for policy (and its formulation) is important in this regard.

Policy reforms undertaken by Australia and outlined in Box 1 have had direct implications for the sustainability and stability of the current account. The floating of the dollar reduced the need for intervention into the external account to relieve internal pressures on the domestic economy. Additionally, Australia's commitment to robust prudential regulation and comparatively low government borrowing has encouraged a favourable perception of its economy that might otherwise be incongruous with the running of persistent CADs.<sup>7</sup>

There have also been many instances where other reforms, not explicitly targeting the CAD, have nevertheless improved the external position. For example, liberalising the banking sector has contributed to the development of Australia's financial system which has helped Australia's financial markets to absorb and manage portfolio flows in a transparent and credible manner – contributing

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<sup>7</sup> Moreover, the majority of Government debt is denominated in Australian dollars, thereby avoiding duplication of banks' currency exposures.

to the stability of Australia's current account position. Improvements to the external position were unintentional and secondary benefits to a productive series of microeconomic reform.

Even further removed from concerns over the external sector was the implementation of the Higher Education Contribution Scheme (HECS)-HELP program, and its antecedents. Initially targeting productivity gains by improving the structure and functioning of the economy, these higher-education reforms have, subsequently and unintentionally, had positive effects on the trade balance and the CAD by boosting the capacity of Australia's tertiary education sector in the face of rising demand for education services exports.

## Options for Indonesia

There are a number of similar opportunities for reform available to Indonesia, with direct and indirect effects on the sustainability of the external balance. This paper offers a set of policy options under three broad categories that would improve the stability of Indonesia's CAD: (i) fiscal reform; (ii) using investment to promote stability; and (iii) a transparent, productivity-led growth strategy.

### Fiscal reform

In terms of direct measures to influence the CAD, Indonesia has already made progress to improve the sustainability of the CAD by significantly reducing fuel subsidies. Broadly speaking, reducing recurrent Government expenditures like the fuel subsidy will reduce the public sector call on the CAD. It is important to note that a fiscal deficit led by productive public investment is not inconsistent with a stable CAD, but expenditures that distort private consumption and investment decisions do not enhance the sustainability or stability of the CAD.

The recently announced fuel subsidy reforms will provide fiscal relief allowing for much needed infrastructure, health and education spending and is a very positive first-step in reforms. Further to this, a clear, credible medium term fiscal strategy would also assist by signalling a more coherent strategy for the future. Further reforms should also incorporate fiscal targets that distinguish between infrastructure spending, social spending and tax reform objectives. Tax reform as part of the fiscal strategy will be essential. Efforts to broaden Indonesia's tax base using efficient taxation mechanisms such as reforms that maximise revenue from existing consumption taxes would contribute to market confidence. Further, efforts by Indonesia to improve compliance of personal taxpayers have the potential to deliver significant revenue gains.

Increasing revenues would also have potentially beneficial effects on Indonesia's CAD. Efforts to broaden the tax base in Indonesia, particularly via personal income tax and consumption taxes, would firstly contribute towards market confidence in the Government's ability to more credibly guarantee any foreign debts incurred in financing the CAD. Secondly, broadening the tax base could potentially lean against consumption somewhat – having a commensurate effect on imports. The type of revenue broadening is important. Selecting the most efficient, least-costly-to-growth taxation strategies are crucial.

This could also reduce market anxieties about a 'twin deficits' scenario.<sup>8</sup> While Indonesia's budget deficit rules are an important existing feature of the policy landscape that promote confidence in the Government's ability to manage shocks, limited revenue-generating capacities will eventually curtail the ability of the Government to undertake productive investment that would benefit growth.

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<sup>8</sup> Where public expenditure is contributing directly to the CAD, placing the risk of capital flight and currency volatility on the public balance sheet and thereby risking the solvency of sovereign borrowing.

Australia has allayed such market anxieties through public commitments to fiscal prudence, such as the *Charter of Budget Honesty* (similar to Indonesia's deficit limit, in its intent), coupled with various public mechanisms for evaluating fiscal sustainability and economic/budgetary pressures (such as the *Intergenerational Report* and the *Tax Expenditure Statement*).

### Investment to promote stability

As noted earlier in this paper, one of the most important things that can be done to mitigate the risks of capital flight is to reduce the country-specific risks of investing in a country. Indonesia will remain an attractive destination for investment for the foreseeable future, and it would be detrimental to Indonesia's growth potential to leave investment opportunities unfulfilled for the sake of trying to reduce the risks of capital flight.

There are examples where a lack of principle-based policy changes and uncertainty surrounding policymakers' reactions contributes to uncertainty for both foreign and domestic investors in Indonesia. For example, new industry and trade laws enable Ministerial authorities to act independently to significantly intervene in markets. There would be benefits from the adoption of a coordinated and strengthened policymaking and regulation process. Aside from allowing all senior Government Ministers to consider new regulations and policies, Indonesia may also benefit from adopting strong, statutorily independent institutions such as Australia's Productivity Commission, which has a role to play in generating support for the settings of the macroeconomy and the importance of reform at the microeconomic level. This would be somewhat different to Bappenas' (the National Development Planning Agency) remit, with Australia's Productivity Commission having deliberate independence, and requirements for the dissemination of a policy narrative based on productivity, rather than broad-ranging policy delivery.

Economic reforms are generally not easy – a move toward greater efficiencies will typically involve depriving one or many interest groups of resources for the good of the wider economy. Thus, it takes political commitment and consensus building to achieve these goals. In Indonesia's case, there is a role for institutions to establish a coherent policy narrative between regional governments and the central Government.

More broadly, investors need to have faith that their legal contracts and property rights will be binding and upheld in the Courts of Indonesia. A veritable tome of economic literature and international experiences shows that property rights, investor protection and legal enforcement of these are an essential part of well-functioning markets, particularly when making long-term financial decisions.<sup>9</sup> Reforms such as those included in Indonesia's new land acquisition law, if well implemented and enforced, are a step in the right direction. Another key factor for business and employees is conducive and supportive labour market policy that is supported by a strong legal framework.

Recent experiences with currency volatility driven by volatile portfolio investment flows reflect some of the uncertainties investors face when undertaking investments in Indonesia. Promoting an environment of increased policy certainty would, encourage investment into Indonesia and not necessarily at a greater risk of capital flight.

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<sup>9</sup> Dam (2007) presents such a comprehensive tome, though the work of Gould and Gruben (1996) and Levine (1998,1999) focus on specific aspects of the relationship between property rights, law enforcement and economic growth, while and Mahoney (2001) examines the influence of different legal traditions on the development of financial markets.

Removing impediments to longer-term investments in Indonesia (such as FDI) would also promote stability. Recent amendments to the Negative Investment List (the list of business areas closed to foreign investment, or otherwise restricted) appeared to reduce FDI access to a number of markets, which arguably adds to uncertainty about future investment opportunities – influencing perceptions about the riskiness of investing in Indonesia, and biasing investment toward short-term, flightier portfolio investment. Allowing more FDI to occur in conjunction with a deepening of Indonesia's domestic financial markets, and increasing the capacity for the banking sector to intermediate such investment (and manage currency risks) would also mitigate risks associated with capital flight. This could be achieved by financial sector deregulation, consolidation and the encouragement of foreign entry to boost competition.

### Transparently-formed, productivity-led growth strategy

Concerns about the CA position highlight the importance of wide-ranging and comprehensive policy reforms to improve the structure of the economy. In the medium to longer term, building a stronger more flexible economy can help achieve prosperity and equality, and avoid the middle-income trap.

Indonesia's demographic dividend, which will continue over the next decade, provides an opportune time for substantial reforms to be undertaken. It can also be viewed as impetus for reform – future prosperity will be more difficult to achieve as the demographic dividend wanes.

One of the primary means through which Australia has achieved successes in policy transparency has come through enshrining the independence of key bodies, such as the Reserve Bank of Australia and the Productivity Commission. Additionally, commitments to comprehensive and forward-looking public documents such as the *Intergenerational Report* unambiguously highlight challenges and risks that extend beyond the immediate political cycle.

Considering areas of policy reform, Indonesia's policymakers are well-aware of the importance of ongoing infrastructure investment to economic growth. Strengthening mechanisms for independent assessment and prioritisation of infrastructure needs, coupled with rigorous economic assessments to advise the Indonesian Government on projects would likely improve the cost-effectiveness of infrastructure delivery, as well as improve Indonesia's external competitiveness by removing internal impediments to growth.

In terms of education policy, attendance rates have improved dramatically over the past decade. The next step in enhancing Indonesia's considerable human capital is to focus on improving the quality of education outcomes, while maintaining quantity, perhaps with a focus on facilitating cooperation between the education sector and industry. The IMF has recently noted the importance of education as a 'bridging' element between the present and future sources of economic growth and competitiveness. Improving the link between tertiary education and training, and the needs of industry may assist this transition.

Finally, beyond encouraging more deeply-integrated foreign investment into Indonesia as a source and signal of stability, there is evidence that Indonesia's capital market lacks diversified financial products and depth to support the growth of its industries and services. As the World Bank has noted, there is significant evidence that enterprises in Indonesia are credit constrained – limiting their ability to expand and drive growth. Current efforts by the Indonesian Government to better clarify and coordinate linkages between financial authorities should be welcomed. Seeking to strengthen the bank and non-bank financial system, they recognise that the Indonesian banking industry could benefit from deregulation and, in particular, increased competition from foreign banks. Beyond this, the Government could assist in building a capital market with more diverse

products by considering investment requirements, high underwriting costs and weaknesses in the execution regime (which may be addressed through bank consolidation, where appropriate). As with Australia's experience, an Indonesian banking sector that is strong enough to intermediate a significant share of the CAD can directly increase its stability by ensuring positions are hedged.

## Conclusions

There are obvious differences between Australia's and Indonesia's experiences with their CADs. However, there are also some similarities. Indonesia faces many of the same perceptions about the riskiness of the CAD such as fears around capital flight, exchange rate volatility and fiscal sustainability that Australia experienced in the 1980s.

Since the GFC, Indonesia has proved to be an attractive destination for international investment as perceptions of risks have been offset by the market's search of higher returns. This investment has produced the financial inflows, particularly portfolio inflows, necessary to finance Indonesia's CAD. However, the eventual normalisation of global monetary policy is likely to prompt markets to re-evaluate riskiness of various investments. In this environment, Indonesia may be subject to periods of investment withdrawal, subsequent currency volatility and uncertainty about financing its CAD – similar to that experienced in mid-2013.

Indonesia has shown that it is well equipped to use monetary policy and currency reserves to counter short-term risks to its economic stability. In the longer-term, these approaches will have limited effectiveness. By generating imbalances elsewhere in the real economy they are likely to unintentionally worsen the CAD, distort investment and counter Indonesia's objective of avoiding the middle income trap insofar as they weigh on economic growth. In contrast, measures that improve an economy's efficiency, such as the recent decisions taken by the Indonesian Government to reduce the diesel subsidy and remove the gasoline subsidy, will have long-term positive effects on economic growth and the CAD. They also send a clear signal to investors on the Government's genuine intent to transform the Indonesian economy.

Australia's experience of policy reform demonstrates that there are further strategies that Indonesia can adopt to mitigate possible instability arising from its CAD, removing the need for continual short-term management aimed at the headline figure itself. Australia has improved market perceptions by an extensive agenda of general economic reform, which does not include policy measures to target its external position. While some of these reform measures helped to reduce Australia's CAD, many did not – though all contributed to the flexibility and productivity of the macroeconomy. This ensured that the CAD was driven by sound foundations. These reforms provided the freedom to sensibly exploit Australia's comparative advantages which contributed to the sustainability and stability of the external position.

It is important that the Indonesian economy is allowed to develop in such a way that natural comparative advantages assert themselves, and at the same time policy is transparent and foreseeable to investors. A well-articulated and transparent framework for policy (and its formulation) is crucial to facilitating this.

Many general macroeconomic reforms are available to Indonesia – some of which may contribute to reducing the CAD in the short-term. Recent developments relating to fuel subsidies are an impressive and substantial first step. Taxation reform (such as the removal of unnecessary tax incentives and strengthening both tax policy and administration) and the balancing of the Government's budget are steps that can be taken in the short-term and which will further build on the recent reforms to fuel subsidies. Such reforms would provide investors with confidence in the Government's approach to domestic and international investment. This certainty will be important to change market's perceptions about the risk of investing in the Indonesian economy. Such commitments and reforms will benefit the CAD, benefit the Indonesian economy through providing further fiscal space for

needed infrastructure and social spending, and benefit market perceptions of the Indonesian Government and economy.

In the longer term, while the process of reform may be difficult, promoting structural reform to build a flexible and productive economy will be crucial to prevent the CAD from becoming a restraint on growth. Through this lens, while the CAD is not a problem in itself, it can be an important motivation for reforms that are worth doing in their own right – be it financial system reform, prudent fiscal policy or improving the quality of public and private investment. Through these reforms, Indonesia can building a stronger more flexible economy, achieve prosperity and avoid the middle income trap.

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# The HIH Claims Support Scheme

Claudio Damiani, Naomi Bourne and Martin Foo<sup>10</sup>

The collapse of the HIH Insurance Group in 2001 was a watershed for Australia's financial sector. The combined government and industry response to its collapse was swift, with the establishment of the HIH Claims Support Scheme to restore confidence to the market and protect a large number of HIH policyholders from potential financial hardship. Despite its rapid development and implementation, the scheme operated effectively and successfully met its objectives.

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## Introduction

The collapse of HIIH Insurance Limited (HIIH) in 2001 was a critical event in the evolution of Australia's financial system. HIIH's failure was the catalyst for substantial policy reform, notably in the regulation of Australia's general insurance industry, but also in areas as diverse as tort law, corporate governance, audit standards and policyholder protection. Even today, almost 14 years since its collapse, the ghosts of HIIH continue to resonate with policymakers and regulators.

From humble beginnings in 1968, HIIH grew to become the second-largest general insurer in Australia. In addition to extensive Australian operations covering all major general insurance product classes,<sup>11</sup> HIIH operated a myriad of subsidiaries across the world. However, in its pursuit of domestic and global expansion, HIIH sacrificed prudence in risk management and suffered from under-pricing, under-reserving, corporate governance failures, and mismanagement. These mistakes were to have disastrous consequences for the company and its employees, shareholders, and those policyholders not protected by government intervention.

In the wake of HIIH's collapse, the Government moved to restore confidence in Australia's general insurance industry. The industry, with the imprimatur and financial backing of the Government, worked to develop a support scheme for many of HIIH's most vulnerable policyholders, who were left holding worthless policies. The scale of the collapse and its wide-ranging ramifications also motivated the Government to establish a Royal Commission.<sup>12</sup> The Commission's report outlined a litany of failures and questionable business dealings on the part of certain senior HIIH personnel.

The HIIH Claims Support Scheme (the 'HIIH Scheme') commenced on 7 June 2001, less than three months after HIIH was placed into provisional liquidation. First operated as a subsidiary of the Insurance Council of Australia (ICA), the peak body representing the general insurance industry in Australia, and later as a company directly controlled by the Treasury, the HIIH Scheme saw a number of refinements and restructures over its more-than-decade-long lifespan. Throughout this time, the HIIH Scheme continued to successfully provide financial protection to eligible policyholders who made valid claims under their HIIH policies. Its success was in no small part due to the cooperation and trust developed between the general insurance industry, the Liquidator and the Government, the initiative of industry in managing the HIIH Scheme in its early years, and the professionalism of the Treasury staff who were instrumental in its development and operation.

This paper briefly details the rise and subsequent collapse of HIIH, considers the consequences of its demise, and outlines the Government's response. The primary focus of this paper is the HIIH Scheme itself – its structure (and restructure), mechanics, eligibility criteria, and operation under the ICA and later under the stewardship of the Treasury. The paper concludes with an analysis of the HIIH Scheme's final statistics, and a discussion of the main lessons learned.

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<sup>11</sup> General insurance includes, *inter alia*, home and contents insurance, motor vehicle insurance, business insurance, workers' compensation and travel insurance. It excludes life insurance and health insurance.

<sup>12</sup> The Australian Securities and Investments Commission (ASIC) commenced an investigation into the collapse of HIIH but the Government was persuaded to establish a Royal Commission after receiving legal advice that the ASIC Chairman's dual role as a member of the Australian Prudential Regulation Authority (APRA) Board constituted a technical conflict of interest.

## The rise and fall of HIH Insurance Group

The origins of HIH Insurance Limited can be traced back to 1968 with the establishment of M W Payne Liability Agencies, a workers' compensation underwriter. Subsequently acquired by a United Kingdom (UK) insurer, the company was restructured and later renamed CE Heath International Holdings, and partially listed on the Australian Stock Exchange (ASX) in 1992. The partial float was the first by a general insurer on the ASX.<sup>13</sup>

In 1995, the company entered into a merger with Swiss-owned CIC Insurance Group and soon after was renamed HIH Winterthur. The company then experienced rapid growth through a series of acquisitions, including: Heath Cal and Great States Insurance in the United States (US); Colonial Mutual General Insurance in Australia and New Zealand (NZ); Solart in Argentina; and Cotesworth Group in the UK. Some of these offshore businesses were to later encounter financial trouble.

Concerned about HIH Winterthur's performance and financial position, Winterthur, the Swiss-based majority shareholder in HIH Winterthur, decided to divest its 51 per cent stake through a public share offer on the ASX.<sup>14</sup> The offer was fully subscribed and the offering took place in August 1998. Two months later, the company changed its name to HIH Insurance Limited (HIH). Shortly afterward, the now fully publicly-owned HIH acquired UK insurer World Marine & General Insurance and Australian insurer FAI Insurance (the latter for \$295 million);<sup>15</sup> FAI being a company which was under intense financial pressure at the time, unbeknownst to the directors of HIH.

Not long after the acquisition of FAI, HIH's aggressive growth strategy began to falter, with losses reported in its UK and US businesses (which together contributed nearly 30 per cent of HIH's total Group-wide income).<sup>16</sup> Its NZ business was also losing money and its Australian operation, which generated the bulk of its revenue, was struggling, recording a \$21 million loss for the 18 months to 31 June 1999. In order to stem its losses, HIH placed its UK operations into run-off.<sup>17</sup>

Financial analysts grew uneasy about HIH's performance, and some were blacklisted (frozen out of access to the management team) by HIH because of their negative assessments of the company. The market responded, with the price of HIH shares falling precipitously (Figure 1).

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<sup>13</sup> Clarke (2007), page 434.

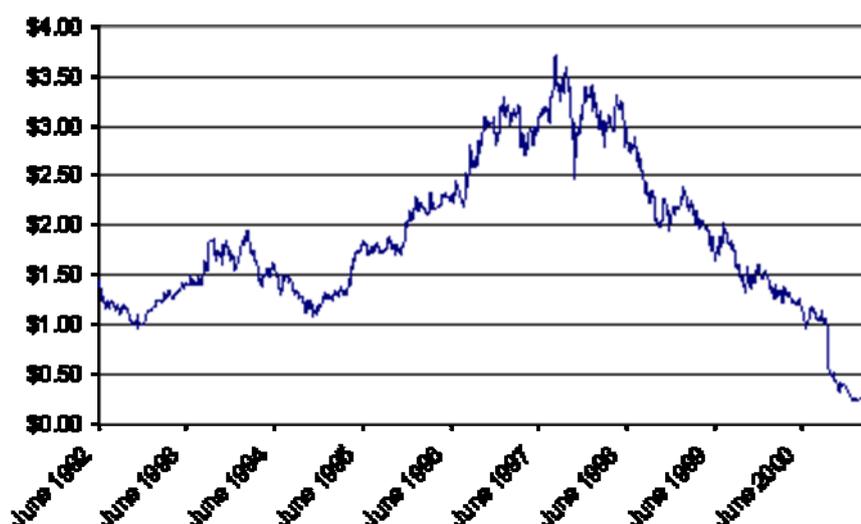
<sup>14</sup> Winterthur commissioned independent reports to assess the UK branch and its activities. Concerned with some of the findings (conflicts of interest, lax guidelines, poor financial reporting, huge losses in aviation and marine insurance) it decided to divest its interest in HIH Winterthur (see Australian Broadcasting Corporation (2001). The offering memorandum contained a claims-development table that was the first public revelation of HIH's historical under-reserving. Nevertheless, the response from the investment community was favourable and the public offering was oversubscribed (see HIH Royal Commission (2003), Vol. 2, Chapter 12.

<sup>15</sup> Kehl (2001). See Box 1 for further discussion of the FAI acquisition.

<sup>16</sup> At this time, HIH's Australian portfolio accounted for 64 per cent of HIH Group revenue, the Americas 16 per cent, the UK 13 per cent, NZ 4 per cent and Asia 3 per cent.

<sup>17</sup> During run-off, an insurer ceases to write new policies, and any existing liabilities are 'run off' to conclusion.

Figure 1: HIH's share price



Source: HIH Royal Commission, Final Report, Vol. 1

Following the April 2000 release by APRA of draft reforms to the prudential regulation of Australia's general insurance industry (proposing stricter standards for capital adequacy, liability valuation, reinsurance and risk management),<sup>18</sup> HIH sought to bolster its regulatory capital levels by entering into strategic joint ventures and selling off some of its underperforming businesses and property assets.<sup>19</sup> Parts of HIH's Argentinian and Asian operations were sold off.

A routine external audit completed in July 2000 by Arthur Andersen failed to raise alarm bells, instead concluding that HIH was in a healthy financial state. At this time, HIH accounted for 9.3 per cent of all gross written premiums in Australia by Australian Prudential Regulation Authority (APRA) regulated general insurers – it wrote \$1.65 billion out of an industry total of \$17.7 billion, for the financial year to 30 June 2000.<sup>20</sup> Its annual report for that financial year showed total assets of \$8.3 billion and total liabilities of \$7.4 billion, a net asset position of \$900 million.

In September 2000 it announced it had entered into an agreement to sell, for \$200 million, a 51 per cent share of its domestic personal lines business,<sup>21</sup> excluding its workers' compensation, travel, professional indemnity, public liability and corporate broking lines, into an unincorporated joint venture with German-owned insurer Allianz Australia called Allianz Australia Advantage.<sup>22</sup> HIH's share price dropped sharply following the announcement. Its troubled US operation was placed into run-off the following month.

<sup>18</sup> Australian Prudential Regulation Authority (2000). This discussion paper followed three previous policy discussion papers released by APRA in September 1999 setting out the scope for modernising the prudential supervisory requirements for general insurers in Australia.

<sup>19</sup> Now-defunct US investment bank Merrill Lynch analysed HIH's financial position and concluded that under APRA's proposed new capital standards for general insurers, HIH would be 'significantly capital deficient'. See Australian Broadcasting Corporation (2001), *op. cit.*

<sup>20</sup> Australian Competition and Consumer Commission (2002), page 101.

<sup>21</sup> This was a largely profitable business acquired from FAI, and included home, home and contents and motor vehicle insurance.

<sup>22</sup> The joint venture company issued private motor, compulsory third party, private pleasure craft, home building and home contents insurance policies. It also issued small business packages, rural packages and small commercial insurances (such as commercial motor, fleet motor less than 150 vehicles, property with asset value less than \$20 million, public and product liability policies with turnover of less than \$5 million, and marine) previously arranged by HIH through distributors other than international brokers. HIH would later sell its remaining 49 per cent stake for \$125 million.

Concerned about its exposure to HIH, Westpac, HIH's banker, requested in October 2000 that the company appoint Ernst & Young to conduct an audit of its finances. The audit report, presented to HIH a month later, concluded that its financial position was 'delicately poised'. Apprehensions about HIH's financial troubles intensified when it announced that its interim result to 31 December 2000 was likely to be a loss, coupled with its failure to lodge its December 2000 quarterly statement with APRA.

The final months of 2000 and the early months of 2001 were a tumultuous period, with a number of HIH's directors resigning from the Board, including the company's founder and Chief Executive Officer, Ray Williams. The company's share price, and credit rating (Table 1), continued to decline.

**Table 1: Standard & Poor's rating of HIH, February 1997 to March 2001**

Date	Credit rating
17 February 1997	AA-
15 August 1997	AA-
27 February 1998	A: credit watch developing
24 September 1998	A: credit watch negative
22 January 1999	A-: off credit watch
22 August 2000	A-: credit watch developing
13 September 2000	A-: credit watch negative
2 November 2000	BBB+: credit watch negative
26 February 2001	BBB-
15 March 2001	B: lowered and withdrawn

Source: HIH Royal Commission, Final Report, Vol. 1

The commencement of the Allianz Australia Advantage joint venture on 1 January 2001 marked the beginning of the end for HIH. The structure of the joint venture required that HIH's share of the premium income earned by the joint venture be placed under trust. Excess funds were to be distributed on a quarterly basis to the joint venture partners according to their ownership shares, but only after an actuarial assessment confirmed that there were sufficient funds over required reserves. The first actuarial assessment was due in May 2001. Needing to pay claims arising from business written prior to the commencement of the joint venture, HIH, already short of money, was deprived of desperately-needed funds. Soon after, it was forced to delay paying some claims as its liquidity problems became acute.

On 22 February 2001, at the company's request, trading in HIH shares was halted on the ASX. Trading briefly resumed on 26 February, but was halted again on 27 February. Around the same time, the Australian Securities and Investments Commission (ASIC) served a notice on HIH concerning its investigation of a suspected contravention of HIH's obligation to disclose price-sensitive information to the market. HIH shares were suspended from trading a final time on 1 March 2001.

On 6 March 2001, HIH announced that it would establish a joint venture company with QBE Insurance (QBE), QBE Corporate Insurance, which would offer to renew all corporate insurances written through major brokers by HIH and QBE in both Australia and NZ. The joint venture would

see QBE, which had management control of the joint venture company, in effect take over 60 per cent of all of HIH's corporate insurance business written in Australia and NZ.<sup>23</sup>

On the same day as the QBE announcement, HIH formally appointed KPMG to undertake a review of its financial position. Armed with the findings of this review, the Board of HIH took the decision on 15 March 2001 to place the company into provisional liquidation, only days after it sold the remaining 49 per cent stake of its domestic personal lines business to Allianz Australia and one day after selling its workers' compensation business to NRMA Insurance. On appointment, the Provisional Liquidators, Messrs AG McGrath and ARM Macintosh, estimated that HIH had lost over \$800 million over the six months to 31 December 2000. The Provisional Liquidators also declared that each of the major Australian insurance licence-holding companies within the HIH Group was clearly insolvent.<sup>24</sup>

At the time of its failure, the HIH Group consisted of more than 240 individual companies, of which eight were licensed or formerly licensed general insurance companies incorporated in Australia. The majority of the remainder were holding and investment companies, or in some cases licensed insurance companies incorporated in other jurisdictions.<sup>25</sup> On 27 August 2001, the Australian companies in provisional liquidation were placed into formal liquidation, with Messrs AG McGrath and ARM Macintosh taking on the role of Liquidators (hereafter 'the Liquidator'). By then, the deficiency in the HIH Group was estimated to be between \$3.6 billion and \$5.3 billion, making it the largest corporate failure in Australian history.

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<sup>23</sup> Profits from the joint venture company would be split according to ownership stakes, with QBE receiving 60 per cent and HIH 40 per cent. Soon after HIH was placed into provisional liquidation, and following discussions with the Provisional Liquidators, QBE decided to absorb 100 per cent of the joint venture business, thereby assuming HIH's entire corporate insurance book.

<sup>24</sup> Kehl (2001), *op. cit.*

<sup>25</sup> HIH Insurance (2013). For a corporate chart of the companies in liquidation, visit: [www.hih.com.au/pdf/HIH%20Corporate%20Chart.pdf](http://www.hih.com.au/pdf/HIH%20Corporate%20Chart.pdf).

## Aftermath of the HIH collapse

### 3.1. Community impacts

The collapse of HIH had far-reaching consequences for Australian communities and a negative impact on consumer confidence in the insurance industry. Thousands of employees working at HIH lost their jobs, tens of thousands of HIH shareholders were left holding worthless equity, and HIH policyholders were left unsure whether their insurance contracts would continue to be honoured.

Stories of personal hardship emerged almost immediately. Sick or disabled policyholders claiming on salary continuance policies with HIH stopped receiving ongoing payments (which they often relied on for day-to-day living expenses). In Queensland alone, car accident victims insured with HIH were left waiting for operations and other medical procedures worth \$190 million.<sup>26</sup> Without HIH insurance cover, the Australian Rugby Union had to cancel games across the country until replacement cover could be procured.<sup>27</sup> Injured players were left stranded without compensation.<sup>28</sup>

**Table 2: HIH market share (by Australian premium revenue) for selected insurance classes, 30 June 2000**

Class of business	Market share (%)
<b>Professional indemnity</b>	35
<b>Travel</b>	28
<b>Compulsory third party (CTP) motor vehicle</b>	19
<b>Public and product liability</b>	15
<b>Employers' liability</b>	12
<b>Other accident</b>	7

Source: Australian Competition and Consumer Commission (2002)

As Australia's dominant professional indemnity insurer, HIH's collapse had a major effect on professional service providers. Services were suspended by many of Australia's 150 community legal centres after their professional indemnity insurance was put under a cloud.<sup>29</sup> Other professionals, such as accountants and engineers, were also impacted by the loss of cover. Without public liability cover, councils and not-for-profit organisations became reluctant to hold community and sporting events. In New South Wales (NSW), local councils were left with \$65 million of uncovered public liability claims.

HIH was the only provider of certain niche insurance products in the Australian market. As a result, some niche policyholders were forced to look offshore for cover at higher premium rates. HIH also held substantial market shares in a number of insurance product classes. For instance, as one of the largest, if not the largest, builders' warranty insurers, the collapse of HIH left thousands of builders without insurance cover (which was mandatory in most states and territories). Almost \$2 billion of construction activity was placed on hold while builders sought replacement cover.<sup>30</sup> For many, this was not a quick process as the few remaining builders' warranty insurers were flooded with applications.

<sup>26</sup> Wenham (2001).

<sup>27</sup> The Australian Rugby Union was able to arrange temporary replacement cover with QBE later in March 2001.

<sup>28</sup> Dore *et al.* (2001).

<sup>29</sup> *ibid.*

<sup>30</sup> Wenham (2001), *op. cit.*

The number of affected policyholders would have been far higher had HIH not sold most of its personal lines and compulsory third party (CTP) businesses to Allianz Australia<sup>31</sup> and its workers' compensation business to NRMA Insurance, and had QBE not offered renewal policies to most of HIH's former corporate insurance policyholders.<sup>32</sup> In addition, after negotiating with the Liquidator of HIH, QBE acquired HIH's travel insurance business, further reducing the number of exposed policyholders. These transactions, facilitated by APRA, resulted in the business of over 90 per cent of HIH's estimated one million policyholders (covered by two million policies) being transferred away immediately before (to Allianz Australia and NRMA Insurance) and shortly after (to QBE) HIH's collapse.

### 3.2. Insurance market pricing impacts

HIH's collapse catalysed large premium increases in certain insurance classes, most notably in professional indemnity and public liability insurance.<sup>33</sup> For example, the Victorian Government received representations from accountants highlighting how the diminished availability of professional indemnity insurance had driven premiums to increase by as much as 1,000 per cent in a year.<sup>34</sup> Six tourism and heritage rail and tram societies in South Australia faced public liability insurance premium increases ranging from 55 to 900 per cent. As a result, one rail society ceased its operations, unable to afford the requisite insurance.<sup>35</sup>

A 2002 review of insurance industry market pricing by the Australian Competition and Consumer Commission (ACCC) concluded that the HIH collapse had led to large and sustained insurance premium increases.<sup>36</sup> This was, in part, because HIH had significantly under-priced risks. After its collapse, the majority of HIH's competitors, along with new entrants into the market, offered insurance at more sustainable rates that were markedly above those charged by HIH. This repricing occurred against the backdrop of a global 'hardening' in insurance markets triggered by the events of 11 September 2001 in the US, a series of large-scale natural disasters, and the bursting of the 'dot-com' bubble – which in turn fostered a decline in global equity markets and in the investment returns earned by insurers.<sup>37</sup> The Government's response to the sharp rises in premiums for certain insurance product classes is covered in Subsections 3.4.2 and 3.4.3.

### 3.3. HIH Royal Commission

Shortly after announcing that it would implement a support scheme to assist affected HIH policyholders (the HIH Scheme is covered in detail in Section 4), the Government established a Royal Commission 'to inquire into the reasons for, and the circumstances surrounding, the failure of HIH prior to the appointment of the Provisional Liquidators on 15 March 2001'.<sup>38</sup>

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<sup>31</sup> The sale also included the transfer of HIH's small business packages, rural packages and most small commercial insurances (such as commercial motor, fleet motor less than 150 vehicles, property with asset values less than \$20 million, public and product liability policies with turnover less than \$5 million, and marine) arranged through distributors other than international brokers. These insurance lines were covered under the joint venture established between Allianz Australia and HIH.

<sup>32</sup> HIH's corporate insurance policies included professional indemnity, public and product liability, directors' and officers' liability, group salary continuance, trade credit and builders' warranty insurance.

<sup>33</sup> Productivity Commission (2010), Chapter 10.

<sup>34</sup> Dutton (2006), page 11.

<sup>35</sup> *ibid*, page 8.

<sup>36</sup> Australian Competition and Consumer Commission (2002), *op. cit.*

<sup>37</sup> International Association of Insurance Supervisors (2011), page 48.

<sup>38</sup> Howard and Hockey (2001).

In April 2003, Commissioner Justice Neville Owen delivered his report on the findings of the Royal Commission. Justice Owen identified a litany of failures at HIH which led to its collapse. The findings were damning (Box 1).

Box 1: Major causes of HIH's collapse <sup>39</sup>	
Under-pricing and under-reserving	HIH grossly underestimated its liabilities, overestimated its assets, charged premiums that were too low, and under-reserved (under-provisioned) for future claims, particularly 'long-tail' claims. Past claims on policies that had not been properly priced had to be met out of present income. This was a spiral that could not continue indefinitely.
Corporate governance failures	The Board of HIH was unduly influenced by, and failed to monitor the performance of, senior HIH management. It also: failed to subject management proposals to sufficient scrutiny; paid too little attention to strategic matters; failed to implement mechanisms to identify and resolve conflicts; and failed in its stewardship of HIH's assets by not reigning in excessive expenditures, including executive remuneration and termination payments.
Mismanagement	The factors contributing to the mismanagement of HIH were many, varied and complex. They included: a lack of attention to detail; a lack of accountability for performance; and a lack of integrity in the company's internal processes and systems. Combined, they led to a series of business decisions that were poorly conceived and executed.
Acquisition of FAI	HIH's acquisition of FAI Insurance for \$295 million was a poor business decision. FAI was itself in serious financial trouble, and its true value was significantly lower than the acquisition price. HIH later acknowledged that it had overpaid for FAI. Having borrowed heavily to fund the acquisition, HIH subsequently wrote off its entire investment in the company. It was later revealed that no due diligence was performed by HIH directors on the financial status of FAI.
Ill-fated international ventures	HIH's UK and US operations generated combined losses estimated at around \$2.4 billion. Its UK operations, initially underwriting public liability and professional indemnity insurance, branched out into areas that HIH had little experience in, including marine reinsurance and film financing. Large losses followed, and were not stemmed due to inadequate reporting systems that impaired Australian management's ability to effectively control the UK operations. In the US, a combination of deteriorating market conditions and significant mispricing of risk led to substantial losses. Losses were also recorded in some of HIH's other international operations.
Inadequate auditing	Internal auditors focused too heavily on the accounts and not enough on the poor risk management frameworks employed by HIH. Additionally, external audits which were not rigorous enough in questioning HIH's financial position and accounting treatments and relied too heavily on HIH's internal audit documents. In some instances, HIH's auditors were misled by HIH and some of its counterparties.

In addition to the factors listed in Box 1, the Royal Commission uncovered evidence of complex and questionable reinsurance arrangements<sup>40</sup> and aggressive accounting methods used to disguise the true (precarious) financial position of HIH. It also uncovered evidence that some senior HIH personnel may have contravened corporations laws. Subsequent investigations by authorities led to charges being laid against a number of HIH directors, senior managers and associates. Convictions followed, resulting in custodial sentences and other severe sanctions.

### 3.4. Post-HIH collapse reforms

Justice Owen's report delivered 61 wide-ranging policy recommendations that addressed issues impacting on the prudential, legal and regulatory regime governing the general insurance industry in Australia. They focused on: corporate governance; financial reporting; the conduct and approach of the prudential regulator, APRA; the scope of the principal piece of general insurance legislation, the

<sup>39</sup> Adapted from the findings of the HIH Royal Commission (2003), *op. cit.*

<sup>40</sup> HIH entered into reinsurance arrangements where it agreed to not make claims against its reinsurers. Under these arrangements, first used by FAI and later HIH, the reinsurance was booked as an asset, even though risk was not in effect ceded to the reinsurers. FAI's use of financial reinsurance (as such transactions are known) helped conceal its financial problems at the point HIH acquired the company.

*Insurance Act 1973* (the 'Insurance Act'); state and territory regulation of insurance; and taxation of general insurance products.<sup>41</sup>

The failure of HIH also spurred changes in a number of related areas, including tort law and the introduction of support schemes for medical indemnity insurance.

Five main areas of post-HIH general insurance industry reform are discussed below.

### 3.4.1. Prudential regulation

Changes to the legislative framework were already underway at the time of HIH's failure, but the collapse accelerated reform, escalated its perceived importance and public profile, and caused an expansion of the focus on aspects of regulation that were viewed as requiring attention.<sup>42</sup> Minimum entry-level capital requirements for general insurers were substantially increased. Reforms were also introduced to enable APRA to make prudential standards for general insurance. This made standard setting a faster and more flexible process and allowed the prudential regime to more easily accommodate market developments. The current regulatory framework applying to general insurance in Australia is largely the product of these reforms.

Although the Royal Commission found that APRA did not cause or contribute to the collapse of HIH, a number of shortcomings in its supervisory practices were identified.<sup>43</sup> APRA eschewed 'light touch' supervision in the wake of the collapse, and it has significantly strengthened its supervisory practices since then. In APRA's view, its most enduring contribution to the resilience of Australian financial institutions through the Global Financial Crisis (GFC) came from its 'close touch' efforts to promote their financial health prior to the crisis, and to deal conclusively with struggling institutions.<sup>44</sup>

The Royal Commission recommended that APRA develop 'a more sceptical, questioning and, where necessary, aggressive approach to its prudential supervision of general insurers'.<sup>45</sup> This recommendation referred to general insurance, but APRA took the message to heart more broadly.<sup>46</sup> From that point, APRA increased the frequency of its on-site visits to and regular liaison and follow-up with regulated institutions, and began to engage directly with boards on matters of prudential concern.

John Laker, the recently-retired chairperson of APRA, noted in 2010 that:

Because of the forces of history and the reality of HIH, [APRA] took advantage of Australia's benign economic environment in the early and middle years of this decade to build the foundations for a strong regulator.<sup>47</sup>

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<sup>41</sup> Carrigan (2004).

<sup>42</sup> *ibid*, page 4.

<sup>43</sup> These shortcomings may have been exacerbated by the fact that APRA had to respond to a number of other general insurance near-failures in the years leading up to HIH's collapse. Two other large Australian insurers, GIO and MMI, were reportedly on the brink of collapse in 1998 before they were taken over by AMP and Allianz Australia, respectively. In addition, Palmer (2002) noted that the loss of corporate memory and industry expertise in creating APRA had an inevitable short-term impact on the quality of supervision in APRA.

<sup>44</sup> Australian Prudential Regulation Authority (2014), page 6.

<sup>45</sup> HIH Royal Commission (2003), *op. cit.*, Recommendation 26.

<sup>46</sup> Australian Prudential Regulation Authority (2014), *op. cit.*, pages 19-20.

<sup>47</sup> Bles (2010).

According to Jeffrey Carmichael, the inaugural chairman of APRA, Australia is living proof of the Old Regulator's Prayer: 'God, let there be a failure, but a small one'.<sup>48</sup> The failure of HIH was hardly small, but HIH was certainly not large or interconnected enough to trigger a systemic crisis like that seen in other jurisdictions in the 2000s, and its failure helped to instil in APRA a supervisory culture that was a contributing factor to Australia's strong economic performance during and after the GFC.

### 3.4.2. Tort law reform

In late 2001 and during 2002, a combination of forces resulted in a severe 'hardening' of premium rates for liability insurance in Australia. The collapse of HIH, increasing compensation payments for bodily injury, increasingly litigious community attitudes, and changes in the way courts were prepared to extend liability for negligence combined to impact heavily on the cost of insurance.<sup>49</sup> Consumers were confronted with significant premium increases in the previously under-priced lines of public liability and professional indemnity insurance.

It was also apparent that claims costs, and in particular the cost of personal injury claims, had escalated. In the 10 years to 2002, inflation in Australia had averaged 2.5 per cent per year while awards for personal injury had increased at an average rate of 10 per cent per year. When looking at large claims, the comparison was even more startling. Between 1979 and 2001, the highest award for personal injury grew from \$270,000 to \$14.2 million, an increase of over 5,000 per cent.<sup>50</sup>

In insurance law, jurisdictional powers are split between the states, territories and the Commonwealth. The Federal Minister for Revenue and Assistant Treasurer thus convened a series of meetings with ministers from all jurisdictions to tackle the problem. The result was a succession of changes, implemented by all jurisdictions, which can be broadly grouped into three types:<sup>51</sup>

- establishing liability – changes to the law governing decisions on liability, including contributory negligence<sup>52</sup> and proportionate liability;
- damages – changes to the amount of damages paid to an injured person for personal injury claims or for economic claims against a professional;<sup>53</sup> and
- claims procedures – time limits and methods for making and resolving claims, including court procedures, legal conduct and legal costs.

This extensive program of law reform in a limited timeframe was described as unprecedented in the history of Australian insurance law and, taking into account the complexity of Australia's multiple

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<sup>48</sup> Cornell (2009).

<sup>49</sup> Coonan (2004), page 3. As noted in Subsection 3.2, the hardening of insurance markets more broadly was driven by a series of natural disasters and a decline in equity markets and investment returns for insurers, due to the bursting of the 'dot-com' bubble and the 11 September 2001 terrorist attacks.

<sup>50</sup> *ibid*, page 4.

<sup>51</sup> In addition, ministers at the ministerial meeting on insurance issues in May 2002 agreed to the ACCC monitoring costs and premiums in public liability and professional indemnity insurance on a six-monthly basis. In 2006, this practice was suspended in light of the more comprehensive data that became available from APRA's National Claims and Policies Database (NCPD).

<sup>52</sup> An important contribution to the reforms was a report commissioned by ministers to review the law of negligence. An expert panel, chaired by Justice David Ipp, made 61 recommendations to governments on a principled approach to reforming the law. In November 2002, ministers formally agreed on a package of reforms implementing the Ipp Review's key recommendations.

<sup>53</sup> For instance, professional standards legislation allows professionals to limit their liability in exchange for risk management, compulsory insurance and other consumer protection initiatives.

jurisdictions, perhaps a first for the common law world. In 2006, the Government reported that there was evidence of the above reforms achieving their goal of improving the availability and affordability of public liability insurance.<sup>54</sup>

### 3.4.3. Medical indemnity insurance

The problems experienced in the medical indemnity insurance sector were similar to those found more broadly in professional indemnity insurance. From the mid-1990s, the sector experienced a dramatic increase in the frequency and severity of claims. HIH was a major reinsurer of United Medical Protection Limited/Australasian Medical Insurance Limited (UMP/AMIL), then Australia's largest medical defence organisation.<sup>55</sup> HIH's failure, coupled with the events of 11 September 2001 and the resultant downturn in financial markets, did irreparable damage to UMP/AMIL and it was placed into provisional liquidation in May 2002.<sup>56</sup> Doctors threatened to cease work in hospitals in response to concerns about the availability and affordability of medical indemnity insurance.<sup>57</sup>

Shortly after UMP/AMIL's collapse, the Commonwealth Government established a number of schemes to subsidise premiums for medical practitioners in Australia and provide financial assistance to medical indemnity providers and medical practitioners for high-cost claims. These schemes were consolidated (along with a number of professional indemnity programs for midwives) into the Indemnity Insurance Fund in 2011. The total value of funds available under the Fund is \$427 million over 2012-13 to 2015-16.<sup>58</sup>

In February 2014, the National Commission of Audit (NCOA) found 'strong evidence' that the market for medical indemnity insurance is normalising. Average premiums have fallen since 2003-04 and major firms in the medical indemnity sector have reported healthy profits.<sup>59</sup> Recommendation 48 of the NCOA was that the Commonwealth scale back its subsidies. The Government responded to the NCOA findings on 13 May 2014, noting that reforms to medical indemnity would be considered following the 2014-15 Budget.<sup>60</sup>

### 3.4.4. Discretionary Mutual Funds and Direct Offshore Foreign Insurers

Discretionary cover is an insurance-like product that involves no legal obligation by the provider to meet the costs of an 'insured' event. At the time of the failure of HIH, doubts were raised about whether discretionary cover was subject to provisions under the Insurance Act and therefore APRA's regulatory regime. The Royal Commission found that consumers would be unwilling to accept the

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<sup>54</sup> Dutton (2006), *op. cit.*, page 64. Similarly, in 2009, the ICA reported that it was clear the objectives of the tort law reforms had been met. In contrast, Wright (2006) argued that litigation rates generally had not increased in the period leading up to the Ipp Review and that there was no foundation for the premises underlying tort law reform as a strategy for addressing the insurance 'crisis'.

<sup>55</sup> Before 1 July 2003, medical indemnity protection was traditionally offered by medical defence organisations (MDOs). Cover provided by MDOs was discretionary – that is, the medical practitioner had no contractual right to be indemnified by the MDO. MDOs operated mainly along state lines and were outside APRA's prudential framework. These arrangements changed on 1 July 2003, when the Commonwealth passed legislation to require that medical indemnity cover must be provided by an insurer authorised by APRA.

<sup>56</sup> Toh *et al.* (2009), pages 11-12.

<sup>57</sup> Coonan (2004), page 10.

<sup>58</sup> The MIIF includes the following schemes: Exceptional Claims Scheme; Run-off Cover Scheme; High Cost Claims Scheme; Premium Support Scheme; Incurred-But-Not-Reported Indemnity Claims Scheme; Midwife Professional Indemnity (Commonwealth Contribution) Scheme; and Midwife Professional Indemnity Run-off Cover Scheme. The MIIF was established in 2011 through the consolidation of a range of existing medical indemnity and professional indemnity for midwives programs. See Department of Health (2014).

<sup>59</sup> National Commission of Audit (2014), Appendix: Volume 2, pages 118-123.

<sup>60</sup> Hockey and Cormann (2014).

failure of a provider of discretionary cover, and therefore recommended that the Insurance Act be amended to extend prudential regulation to all discretionary insurance-like products.<sup>61</sup> Discretionary mutual funds (DMFs)<sup>62</sup> at the time represented less than one-half of one per cent of the Australian general insurance market.<sup>63</sup>

The Royal Commission also examined the insurance of risks in Australia that were underwritten by direct offshore foreign insurers (DOFIs), today known as unauthorised foreign insurers. It found that in many instances it might be unnecessary to regulate offshore insurance, as much of this business was likely to involve large commercial contracts (where the purchaser would normally be considered able to judge for itself the risks involved in the transaction).<sup>64</sup> On the other hand, the Royal Commission also considered suggestions that offshore insurance might constitute a 'gap' in APRA's regulatory regime.<sup>65</sup> It made no formal recommendations on this matter.

In response to the Royal Commission's findings, the Government commissioned an independent review of DMFs and DOFIs.<sup>66</sup> The review recommended that discretionary mutual cover be offered only as a contract of insurance under the Insurance Act,<sup>67</sup> and that DOFIs be exempted from prudential regulation if they were domiciled in a country APRA considered to have comparable prudential regulation to Australia (subject to a market significance threshold).

In 2007, the Minister for Revenue and Assistant Treasurer announced reforms to 'address the risk to Australian consumers and businesses from unauthorised DOFIs that are unscrupulous or that fail'.<sup>68</sup> Any person or company wishing to undertake insurance business in Australia must now obtain an authorisation from APRA.<sup>69</sup> The Government also decided that, in the absence of appropriate data, it would not (yet) subject DMFs to prudential regulation. However, it did legislate to require DMFs to provide detailed data on their operations to APRA.

The Minister announced that within three years of the start of the DMF data collection regime, the Government would review the data to determine whether there was a need for prudential regulation to apply to DMFs. This data collection period has been extended three times: to the end of the 2010-11 financial year; again to the end of the 2011-12 financial year; and then once more to the end of the 2012-13 financial year. At the time of writing, there has been no further progress on analysis of whether DMFs should be subject to prudential regulation.

### 3.4.5. Financial Claims Scheme

The Financial System Inquiry of 1997 (the 'Wallis Inquiry') examined the question of depositor and policyholder protection, but did not recommend an explicit protection scheme. Later, in 2003, the Royal Commission concluded that the time was right to re-examine whether there should be a safety

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<sup>61</sup> HIIH Royal Commission (2003), *op. cit.*, Recommendation 42.

<sup>62</sup> A DMF may be a trust, mutual, company limited by guarantee or other structure.

<sup>63</sup> Treasury (2005), page 28.

<sup>64</sup> Most of the business placed with unauthorised foreign insurers, notably including professional indemnity and public liability insurance, was classified under the *Corporations Act 2001* as 'wholesale' business. This meant that the intermediaries offering these products to consumers were not subject to the conduct and disclosure requirements introduced by the *Financial Services Reform Act 2001* for 'retail' business.

<sup>65</sup> HIIH Royal Commission (2003), *op. cit.*, s.8.8.4.

<sup>66</sup> Potts (2004).

<sup>67</sup> Unless APRA considers in the case of an individual entity that there is no residual contingent risk.

<sup>68</sup> Dutton (2007).

<sup>69</sup> Limited exemptions are granted for insurance business that cannot be appropriately placed in Australia.

net for holders of general insurance policies (and for third-party claimants against such policies).<sup>70</sup> It went on to recommend that the Commonwealth ‘introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company.’

At the time, policyholder support schemes were widely used in other countries. At the end of 2000, there were 21 OECD countries – including the US, the UK, Canada, Germany, France and NZ – with one or more protection schemes covering insurance companies. Without a policyholder support scheme in Australia, in the event of the failure of an APRA-authorized general insurer, policyholders would simply be pooled with other unsecured creditors in a wind-up process that in most cases would be complex and lengthy.<sup>71</sup>

Worries that an explicit policyholder support scheme could create moral hazard had persuaded previous Australian governments not to introduce such a scheme. However, the collapse of HIH and the establishment of the HIH Scheme had the effect of challenging the credibility of government statements that there were no implicit guarantees for policyholders. Concerns that an *explicit* scheme could create moral hazard became of less import if there was widespread public belief that *implicit* guarantees existed.<sup>72</sup>

The Government responded to the Royal Commission’s recommendation by commissioning a technical study to consider the merits of introducing an explicit guarantee for part or parts of the Australian financial system. The technical study, which reported on 26 March 2004, found that the costs and benefits of adopting a guarantee scheme appeared to be finely balanced.<sup>73</sup>

In 2005, the Council of Financial Regulators<sup>74</sup> completed a comprehensive review of Australia’s failure and crisis management arrangements.<sup>75</sup> The Council recommended that the government consider a compensation scheme that would apply to retail deposits in authorised deposit-taking institutions (ADIs) and the policyholder claims of life and general insurers. The Council noted that, given the lengthy nature of the wind-up process for a financial institution, it could take many months, or even years, before funds are made available for distribution. This could create financial hardship for households and businesses, generating pressure on the government to make an ad hoc response.

Three years later, at the height of the GFC, legislation was passed introducing a Financial Claims Scheme (FCS) to protect depositors of ADIs and policyholders of general (but not life) insurers in the

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<sup>70</sup> HIH Royal Commission (2003), op. cit., Chapter 11.

<sup>71</sup> With the collapse of HIH, policyholders (apart from those transferred to Allianz Australia, QBE or NRMA Insurance) would have ranked with other unsecured creditors in relation to valid policy and premium refund claims. The Provisional Liquidators announced that it was unlikely that the distribution of any available assets, either through liquidation or a Scheme of Arrangement, would occur for at least nine months. See HIH Insurance (2013b).

<sup>72</sup> Davis and Jenkinson (2013), page 9. In addition, there is strong community expectation of government assistance in the event of the failure of a general insurer. In 2006, the Reserve Bank of Australia (RBA) commissioned a survey on public attitudes regarding what would happen if a general insurer was to fail. Around 50 per cent of respondents believed either that their policies were guaranteed by the government, or that the government would step in to protect them in the event of a failure, despite the fact that no explicit guarantee existed. See Treasury (2012), page 7.

<sup>73</sup> Davis (2004).

<sup>74</sup> The Council is the coordinating body for Australia’s main financial regulatory agencies. It consists of the RBA, APRA, ASIC and the Treasury.

<sup>75</sup> Council of Financial Regulators (2005).

event of an insolvency of an APRA-authorized ADI or general insurer.<sup>76</sup> The FCS ensures that protected depositors and policyholders receive early access to funds, providing certainty and economic stability whilst the formal liquidation of a failed institution is carried out.<sup>77</sup>

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<sup>76</sup> Australian Prudential Regulation Authority (n.d). Note: The FCS is entirely post-funded and is intended to have few other compliance costs for general insurers in normal circumstances.

<sup>77</sup> To date, the FCS Policyholder Compensation Facility has been activated only once (in 2009) for a small general insurer, Australian Family Assurance Limited, which had been in run-off since 2002. See Bowen (2009).

## HIH Claims Support Scheme

It was immediately apparent that the provisional liquidation of HIH would have wide-ranging ramifications, particularly for HIH policyholders left uninsured for claims made by or against them. This led to calls for immediate government action to assist policyholders experiencing hardship as a result of the failure.

The Insurance Council of Australia (ICA) proposed to provide industry expertise and resources to operate a policyholder support scheme. It further proposed that the scheme be funded through the introduction of a one per cent levy on all general insurance policies issued in Australia, coupled with an appropriate contribution from governments,<sup>78</sup> with the levy offset by a reduction in existing taxes on insurance (fire services levies, stamp duties and GST).<sup>79</sup> The levy proposal was not adopted.<sup>80</sup>

Following advice from the Provisional Liquidators that the financial situation at HIH was worse than first thought,<sup>81</sup> the Government announced, on 14 May 2001, that it would move to help HIH policyholders suffering hardship by setting up an assistance package. The Government stated that it was 'concerned for the welfare of the current 28,000 people who have HIH claims, and any people who might have claims in the future'.<sup>82</sup> This was followed by an announcement that it would fast-track legislative changes to the prudential regulatory regime for the general insurance industry. Foremost among these changes was a new condition that all authorised general insurers must meet risk-based capital requirements, and a minimum entry-level capital requirement of \$5 million (raised from the previous level of \$2 million).<sup>83</sup>

Following extensive consultation with industry, the Government and the ICA announced on 17 May 2001 the formation of a not-for-profit company to oversee and administer the assistance package for affected HIH policyholders. HIH Claims Support Limited (HCSL) was registered as a company on the following day. Its sole share, with a notional value of \$1, was owned by the ICA.

In announcing that HCSL would, on the Commonwealth's behalf, administer the HIH Scheme, the Minister stated that:

Unlike the States, the Commonwealth Government has no existing infrastructure that is able to process the tens of thousands of claims from existing HIH policyholders. The non-profit corporation gives us a practical framework using existing industry infrastructure and expertise to help HIH victims.<sup>84</sup>

On 21 May 2001, the Government announced a HIH policyholder assistance package valued at more than \$500 million, alongside the establishment of the Royal Commission.<sup>85</sup> The Government's

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<sup>78</sup> Insurance Council of Australia (2001).

<sup>79</sup> Australian Broadcasting Corporation (2001b).

<sup>80</sup> The New South Wales Government did, however, impose an Insurance Protection Tax (IPT) to fund the payment of claims (in relation to CTP and builders' warranty schemes) and repay any borrowings made after the collapse of HIH. \$65 million per year was levied on general insurers registered with APRA, with the remainder contributed by a one per cent ad valorem tax on overseas general insurers and domestic insurers not registered with APRA. The IPT was abolished in 2011. See Australia's Future Tax System (2009), E8-1.

<sup>81</sup> Hockey (2001).

<sup>82</sup> Hockey (2001b).

<sup>83</sup> Hockey (2001c).

<sup>84</sup> Hockey (2001d).

<sup>85</sup> Howard and Hockey (2001), *op. cit.*

announcement followed declarations by the NSW and Victorian Governments<sup>86</sup> that they would fund support packages, totalling \$50 million and \$35 million respectively, for affected HIH policyholders in their respective state-regulated statutory insurance schemes (for CTP motor vehicle, workers' compensation and builders' warranty insurance).<sup>87</sup>

#### 4.1. HIH Claims Support Limited

HCSL was established as a wholly-owned subsidiary of the ICA, with a board composed predominantly of independent non-executive directors. A five-year Commonwealth Management Agreement (CMA) signed between HCSL and the Government set out how HCSL would manage and administer the HIH Scheme on behalf of the Commonwealth. This included: receiving applications and assessing eligibility for claims; managing a call centre and operating a website; coordinating the claims management and payment processes; and reconciling assistance payments with the records of the Liquidator.

The CMA also set out a range of rigorous and regular disclosure obligations on HCSL (Box 2) and specified how the Commonwealth would provide the necessary funding to meet claims made by and against eligible applicants, as well as the administration and other costs and expenses of HCSL.

##### Box 2: Disclosure obligations on HCSL

Under the CMA, HCSL was required to provide the Commonwealth, via the Treasury, with:

- monthly reports on payments into and out of accounts dealing with HIH Scheme payments and management expenses;
- a monthly reconciliation of the account forming the Trust;
- a monthly operation report dealing with issues of significance, including the status of applications and payments made;
- quarterly internally audited accounts;
- annual externally audited accounts, together with the auditor's report, and full financial statements each year;
- reports on performance reviews conducted by independent organisations (approved by the Commonwealth);
- any other reports in relation to matters of significance, at any time as HCSL considered necessary; and
- any reports requested by the Commonwealth.

In addition, the Commonwealth could, at its own expense, periodically examine or audit HCSL's books and financial records or conduct a performance review. To facilitate this, it was provided access rights to HCSL's premises.

In order for funds to be made available for HCSL to efficiently meet its obligations under the CMA, the HIH Claims Support Trust (the 'Trust') was established with HCSL as trustee. The Commonwealth appropriated initial funds for the Trust through the *Appropriation (HIH Assistance) Act 2001*, which provided for up to \$640 million<sup>88</sup> – this was the Provisional Liquidator's initial actuarial estimate of the funds necessary to cover expected eligible claims arising through the HIH Scheme. The Trust would also receive a share of recoveries made from third parties to be used for the HIH Scheme. The Commonwealth was the ultimate beneficiary of the Trust, ensuring that it would be entitled to any residual balance of the Trust after the collection of recoveries and making of payments to claimants.

<sup>86</sup> The Queensland Government also later announced a rescue package for CTP insurance, and the WA and Tasmanian Governments did likewise for workers' compensation. See Davis (2004), *op. cit.*, Chapter 2.

<sup>87</sup> Auditor-General of Victoria (2001).

<sup>88</sup> The Consolidated Revenue Fund was appropriated for the purposes of providing financial assistance to eligible claimants under the HIH Scheme and meeting associated administrative costs.

As part of its responsibilities for administering the day-to-day operation of the HIH Scheme, HCSL contracted claims management specialist Wyatt Gallagher Bassett (WGB) to operate the call centre and perform eligibility assessments on its behalf.<sup>89</sup> HCSL also entered into tripartite Claims Management Agreements with the Liquidator and four ICA member insurers – Allianz Australia, Royal & Sun Alliance,<sup>90</sup> QBE and NRMA Insurance (the ‘Claims Managers’) – under which those insurers would, on a cost-only basis:

- act as the Liquidator’s agent in providing claims management services – involving the examination, verification, adjustment, assessment, management and settlement of claims, including the determination of coverage entitlement in accordance with the terms of the HIH insurance policy;<sup>91</sup> and
- act as the agent of HCSL in providing payment management and recovery services to those claims assessed as eligible by HCSL (via WGB) – involving arranging payment to related parties, establishing a bank account to deal with HIH Scheme transactions, calculating claims estimates, reporting to HCSL as per the terms of the CMA, identifying and pursuing recoveries from third parties, and accounting to HCSL and the Liquidator for their proportion of sums recovered.<sup>92</sup>

Each Claims Manager was engaged to provide services for different classes of insurance, with Allianz Australia handling retail, rural and small business claims excluding professional indemnity; Royal & Sun Alliance handling salary continuance claims; QBE handling corporate, professional indemnity, public liability and product liability claims;<sup>93</sup> and NRMA Insurance handling claims for which the other Claims Managers held a conflict of interest. The four Claims Managers were selected by the ICA on the basis that they had expressed a willingness to participate in the HIH Scheme.<sup>94</sup>

One stakeholder commented that the numerous checks and balances built into the HIH Scheme revealed an interesting *quid pro quo*. The Government maintained a very low appetite for risk even though the structure of the HIH Scheme required the disbursement of large sums of taxpayer money through private-sector Claims Managers. To make this compromise viable, it instituted an extremely rigorous audit and performance review program on the HIH Scheme.

### 4.2. Eligibility for the HIH Scheme

On 21 May 2001, the Government announced the criteria for determining which HIH policyholders were eligible to receive assistance through the HIH Scheme. In making its decision, the Government considered the need to balance equity and simplicity,<sup>95</sup> to ensure the HIH Scheme assisted ‘those people most in need’.<sup>96</sup>

Eligible policyholders were to receive either 90 or 100 per cent of the claim they would have received through HIH, depending on the type of policy and, in some cases, income level (Box 3). Any excess under each policy still applied, as did all the other terms, conditions and limits of the policy. In order to meet eligibility, an insurable event had to take place on or before 11 June 2001, regardless of when

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<sup>89</sup> WGB also performed proof of debt reconciliations (see Section 4.3 for further information).

<sup>90</sup> Royal & Sun Alliance changed its name to Promina in 2003. Promina was acquired by Suncorp in 2007.

<sup>91</sup> Australian National Audit Office (2004).

<sup>92</sup> *ibid.*

<sup>93</sup> As well as a range of specialist lines including marine, aviation, livestock and bloodstock insurance.

<sup>94</sup> *ibid.* Note: Some Claims Managers employed subcontractors to assist with claims management.

<sup>95</sup> *ibid.*

<sup>96</sup> Howard and Hockey (2001).

the claim was made. The few weeks between the 21 May announcement date and the 11 June cut-off date allowed for HIH policyholders to find alternative cover for their ongoing insurable risks.

Box 3: Eligibility criteria and maximum payout amount under the HIH Scheme <sup>97</sup>	
Australian citizen or permanent resident (including NZ citizens)	<ul style="list-style-type: none"> <li>• 100 cents in the dollar for salary continuance, disability and income protection policies, as well as for claims of total loss on a primary place of residence.</li> <li>• 90 cents in the dollar for other insurance policies if, for year 1999-2000:</li> <li>• individual or family taxable income (one child, with \$3,139 added for each additional child) was less than \$77,234; or</li> <li>• a claim was more than 10 per cent of a family's taxable income.</li> </ul>
Small business	<ul style="list-style-type: none"> <li>• 90 cents in the dollar.</li> <li>• Australian owned with fewer than 50 full-time equivalent employees and carrying on a business as at 21 May 2001.<sup>98</sup></li> <li>• Not a related entity to a larger organisation.</li> <li>• If operated through a trust, the trust instrument must confer on the trustee the power to carry on a business; and the trustee must be the policyholder, or a third party with relevant cut-through rights.</li> </ul>
Not-for-profit organisation	<ul style="list-style-type: none"> <li>• 100 cents in the dollar.</li> <li>• Australian based.</li> <li>• If structured as a trust, the trustee must be the policyholder, or a third party with relevant cut-through rights.</li> </ul>
Lot owner in owner's corporation <sup>99</sup>	<ul style="list-style-type: none"> <li>• Criteria relating to individuals or small business.</li> <li>• The owner's corporation has levied a contribution in respect of the uninsured loss, and the contribution relates to the lot owner's share of an amount that would have been paid to meet the uninsured loss.</li> </ul>
Trust (including family trust) <sup>100</sup>	<ul style="list-style-type: none"> <li>• Trustee is an Australian citizen or permanent resident, or Australian company; and is the named policyholder or named insured.</li> <li>• The trust must have assets equal to or less than \$1.386 million as at 3 June 2001.</li> <li>• The trust's total income in 1999-2000 was less than \$80,373, or the claim is more than 10 per cent of net income for the trust for that year.</li> <li>• Claims covered on a one-for-one cost sharing basis with the respective state and territory governments.<sup>101</sup></li> </ul>

Policyholders or claims which were not covered under the HIH Scheme included:

- claims arising from HIH employees or directors, or individuals or associates who were in a position to influence HIH;

<sup>97</sup> Australian National Audit Office (2004), *op. cit.*

<sup>98</sup> In early 2002, the eligibility criteria for small businesses was refined to include an explicit statement of a requirement that applicants must have been carrying on a business as at 21 May 2001.

<sup>99</sup> This category was not part of the original eligibility criteria announced in the 21 May 2001 press release. After the legality of treating owners' corporations as small businesses was raised, the Government approved additional eligibility criteria and assessment guidelines for residential owners' corporations in February 2002 and for lot owners in commercial owners' corporations in May 2002.

<sup>100</sup> The Government agreed to eligibility criteria and assessment guidelines for small businesses operating through trusts and not-for-profits structured as trusts in February 2002, and for other types of trusts in May 2002.

<sup>101</sup> The Australian Government consulted with the states and territories on the nature and timing of assistance from June 2001. The Government agreed to allow the HIH Scheme to cover claims from exposures incurred on or before 30 June 2005. This timeframe would give state and territory governments sufficient time to put in place contingency arrangements to manage any HIH-related liabilities which incurred after this date.

- claims arising from reinsurance contracts; and
- claims relating to insurance mandated by state and territory governments, including CTP motor vehicle, workers' compensation and builders' warranty insurance.<sup>102</sup>

### 4.3. The HIH Scheme mechanics

The HIH Scheme formally commenced operating on 7 July 2001. However, the Treasury, with approval from the Prime Minister, had earlier entered into an agreement with the Provisional Liquidators to resume payments to salary continuance claimants whose claims had already been approved by HIH.<sup>103</sup>

Applicants seeking assistance under the HIH Scheme were required to apply to HCSL for assistance and lodge with HIH, which was then in liquidation, a claim under an HIH policy relating to an incident in the period prior to 11 June 2001. Initially, applicants were required to contact the HCSL call centre (operated by WGB) to lodge an application. Application forms were then mailed out. During this time, the ICA and HCSL were finalising development of the HCSL website. Once the website was fully operational, applicants were able to download their own application forms and mail them to the eligibility processing centre run by WGB in Sydney. At its peak, this processing centre employed 32 staff with financial services or customer service experience.<sup>104</sup>

The WGB team worked with applicants to assist them in finalising their applications, requesting additional information as required. WGB then determined whether an application for assistance met the eligibility criteria. If eligible, an Eligibility Confirmation Certificate was generated and sent to the relevant Claims Manager, depending on the type of policy, to allow the claim to be managed under the HIH Scheme. The Claims Manager would in turn request the relevant file from HIH.<sup>105</sup>

Applicants assessed by WGB as ineligible for assistance could apply to have their application internally reviewed by the Managing Director of HCSL. In the event this internal review was unsuccessful, applicants could appeal the decision through the HIH Assistance Review Panel (HARP). The Panel, consisting of independent members appointed by the Minister for Financial Services and Regulation and assisted through secretariat support from the Treasury, was set up to review applications which did not meet the eligibility criteria due to particular anomalies.

Upon receipt of an eligible application from HCSL and the relevant claim file from HIH, the Claims Manager would assess the claim according to the applicant's insurance policy. In this role, the Claims Manager acted as an agent of HIH (and its Liquidator) and was bound by the claims management processes of HIH. It was important that the Claims Managers complied with all the terms and conditions of the insurance policies and the claims management processes of HIH, and operated at

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<sup>102</sup> States and territories funded 'rescue packages' for their various mandatory insurance schemes through levies on general insurers (NSW), the building industry (Victoria), CTP insurance premiums (Queensland), workers' compensation premiums (Western Australia, Tasmania and ACT), or through government funds (Victoria and Northern Territory). See Kehl (2001), *op. cit.*

<sup>103</sup> Australian National Audit Office (2004), *op. cit.*, page 31. This continuation of payments was important to protect sick or disabled salary continuance policyholders who depended on the regular payments for day-to-day living expenses.

<sup>104</sup> WGB developed an intensive training package, call centre scripts and operational processes to ensure a consistent message and process was delivered to applicants. WGB's team also worked with a software developer to create a bespoke eligibility database which contained the necessary business rules and a comprehensive file note function, so that all activity in the processing of an application could be recorded.

<sup>105</sup> Commonwealth of Australia (2002), Attachment J.

arm's length from government, in order to preserve HIH's reinsurance arrangements and protect the rights of other creditors to HIH's estate. Payments to eligible claimants were made, with the Claims Managers then recovering those payments on a monthly basis from a central HCSL account funded by the Treasury.

If a Claims Manager rejected a claim for payment, the claimant received no assistance under the HIH Scheme. The claimant would have the recourse normally available to policyholders of general insurance companies – an appeal to Insurance Enquiries and Complaints (IEC) or to a court. Disputed claims in relation to salary continuance could be appealed to the Financial Industry Complaints Service (FICS).<sup>106</sup>

A crucial element of the HIH Scheme was the assignment to HCSL of an eligible policyholder's rights under their HIH policy. The assignment of rights was a pre-requisite for assistance. On assignment, the rights to pursue the Liquidator, through a proof of debt, for a recovery under the policy passed from the policyholder to HCSL. HCSL, as trustee of the Trust, would in turn have the right to line up as a creditor of HIH to pursue the recovery of monies owed to eligible policyholders through the liquidation process. In this way, the Commonwealth, as ultimate beneficiary of the Trust, became the largest creditor of HIH.<sup>107</sup>

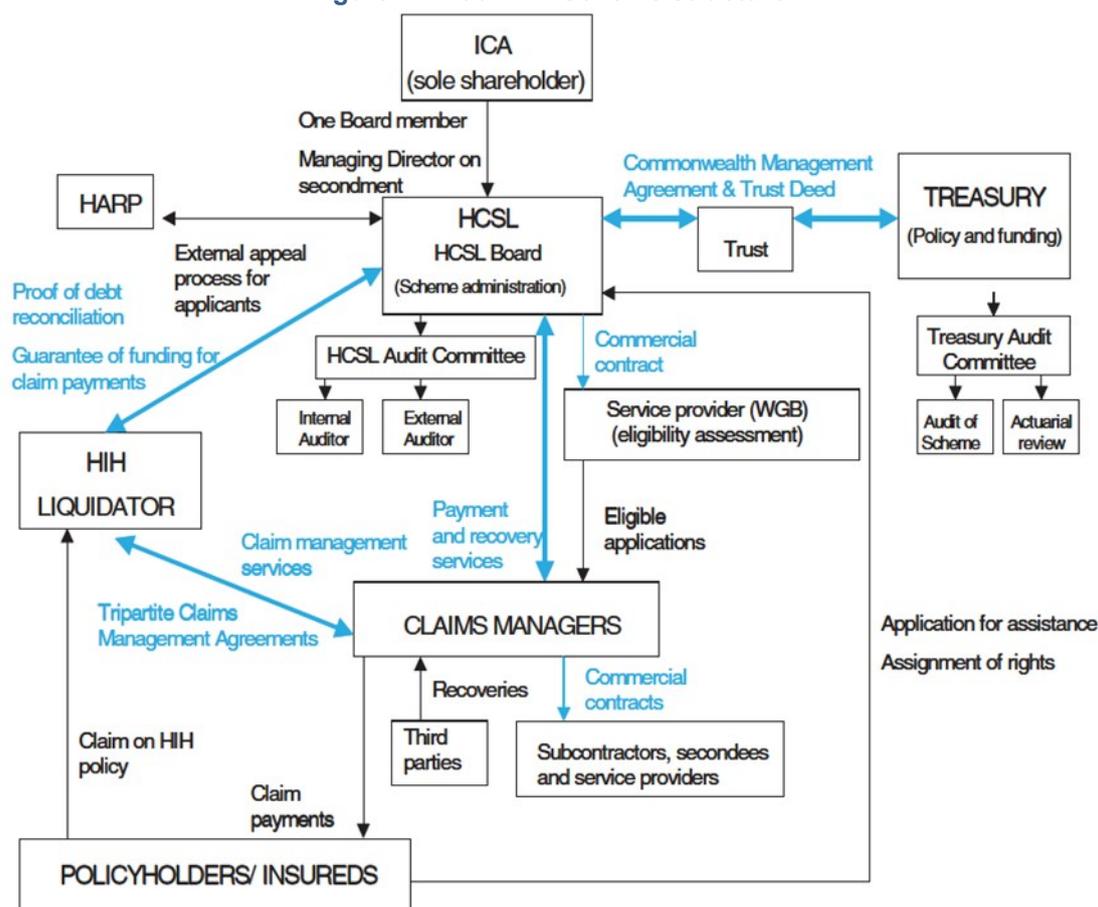
Overall, the Treasury maintained responsibility for the implementation of the HIH Scheme. It was responsible for policy development and for providing advice to HIH Scheme participants, namely HCSL and the Claims Managers, on the interpretation of that policy. Monthly Strategy Management Committee meetings involving the major parties in the HIH Scheme ensured a formal communication channel to discuss issues as they arose.

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<sup>106</sup> In 2008, the IEC and FICS, along with the Banking and Financial Services Ombudsman, merged to form the Financial Ombudsman Service.

<sup>107</sup> The Commonwealth is represented by the Treasury on creditors' committees, which serve to protect the interests of creditors of the companies in liquidation. The committees provide oversight of the liquidation process, including the Liquidator's remuneration, and vote on motions that relate to the operations of the liquidation, including the release of dividends.

Figure 2: Initial HIH Scheme structure



Source: Australian National Audit Office (2004)

#### 4.4. The HIH Scheme in its early years

A little over a year after the HIH Scheme commenced operating, it was announced by the Minister for Revenue and Assistant Treasurer<sup>108</sup> that over \$100 million in funds had been disbursed to (or on behalf of) eligible policyholders through the HIH Scheme.<sup>109</sup> Over that time, HCSL had received more than 9,500 applications for assistance, with 6,200 being processed and referred to Claims Managers and 1,900 receiving payment.

Around 39 per cent of all applications received by HCSL during its first year were for liability, 21 per cent professional indemnity, 13 per cent motor vehicle, 11 per cent property, commercial and household building, and the remaining 16 per cent spread across a number of other insurance product classes. In terms of applicant type, 58 per cent were from small businesses, 31 per cent from individuals and 11 per cent from not-for-profits.<sup>110</sup>

A performance audit of the HIH Scheme, completed in August 2002, found that it was meeting its objectives by assisting eligible policyholders facing hardship from the collapse of HIH and minimising risks to the Commonwealth. Additionally, the performance audit noted that the HIH

<sup>108</sup> The Minister for Revenue and Assistant Treasurer assumed responsibility for the HIH Scheme following the November 2001 federal election.

<sup>109</sup> Coonan (2002).

<sup>110</sup> *ibid.*

Scheme provided a good example of how industry and government can work together constructively to produce mutually beneficial outcomes.<sup>111</sup>

#### 4.5. HIH Scheme review and announcement of restructure

The number of applications received by HCSL slowed over time, particularly after the first year of operation. With evidence indicating that the bulk of applications had likely already been received, coupled with apprehensions about the HIH Scheme's administrative costs<sup>112</sup> and complexity, the Government agreed to a Strategic Review to consider whether the existing HIH Scheme structure was the most appropriate going forward. In December 2002, the Government commissioned Deloitte Touche Tohmatsu to report on:

- options for closing the HIH Scheme to new applicants;
- assessment of the ongoing role of HCSL and Claims Managers;
- identification of the political, operational and financial risks involved in changing the HIH Scheme;
- recommendations for the best structure for the HIH Scheme on a go-forward basis; and
- an updated assessment of the HIH Scheme's liabilities.

The Strategic Review was completed in March 2003. Following consideration of the report's recommendations, the Minister for Revenue and Assistant Treasurer agreed to restructure and streamline the administrative arrangements for the HIH Scheme. Under the new arrangements, applications for assistance would cease to be accepted after 27 February 2004. HCSL would be wound out of the HIH Scheme, with the Claims Managers phased out by 31 August 2004. The Treasury would assume HCSL's role as HIH Scheme manager and in the place of the original Claims Managers would be a single firm that would undertake both eligibility assessments and claims management functions. The call centre would also be closed, given that the bulk of applications had already been received.

A 'Gateway Facility' for special circumstances claims was to be established, to be operational immediately after the HIH Scheme closed to new applications. Applications through the Facility would be considered by the HARP. Applications would only be accepted through the Facility under special circumstances, where an applicant, through no fault of their own, did not know and could not reasonably have known that they had a right to make a claim under an HIH policy or, alternatively, that a claim would be made against them.<sup>113</sup>

Following the Government's announcement of streamlined administrative arrangements, the Treasury selected Gallagher Bassett Services (GBS, formerly WGB<sup>114</sup>) to perform both the eligibility assessment and claims management functions until August 2008, with an option to extend the contract to February 2009. Claims files were transitioned from the Claims Managers to GBS prior to

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<sup>111</sup> Australian National Audit Office (2004), *op. cit.*, page 33.

<sup>112</sup> As at April 2004, \$35.9 million had been paid out for administrative expenses incurred by HCSL and the Claims Managers. See Australian National Audit Office (2004), *op. cit.*, page 97.

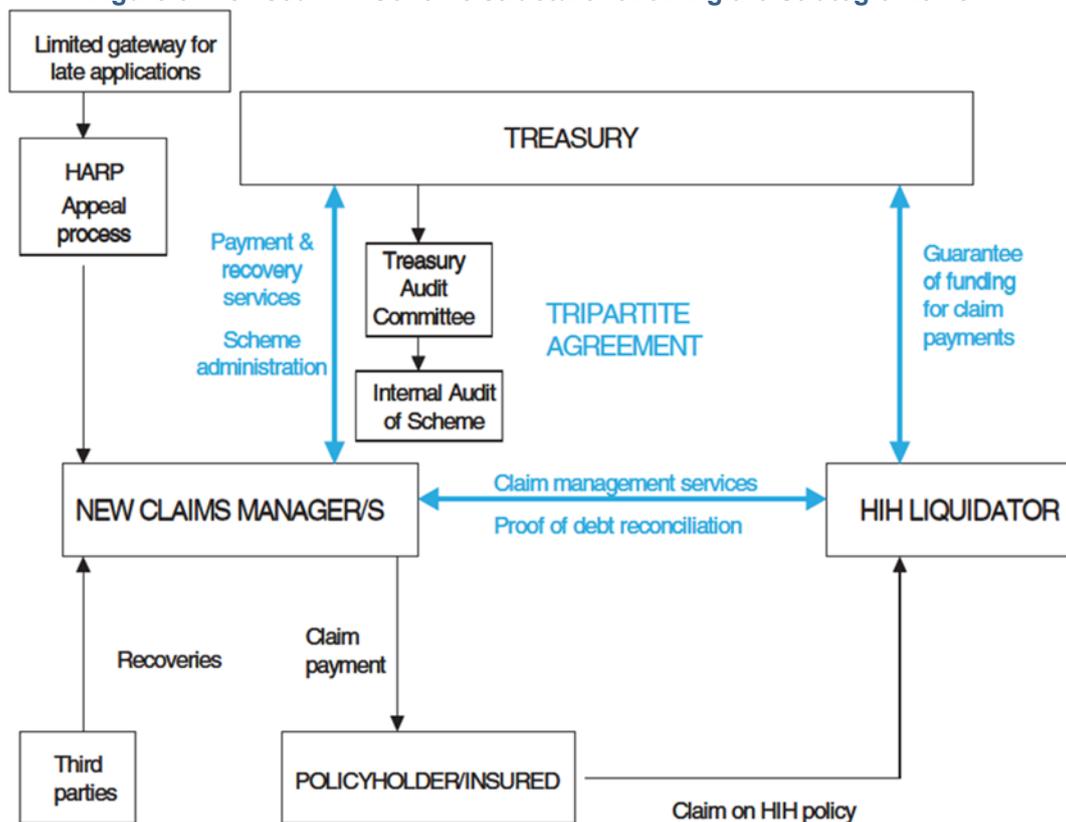
<sup>113</sup> Coonan (2002), *op. cit.*

<sup>114</sup> US-based Gallagher Bassett Services acquired the remaining 50 per cent stake in its Australian joint venture, Wyatt Gallagher Bassett, in 2004.

the 31 August 2004 deadline, although HCSL would continue to wrap up outstanding issues, such as reconciling proof of debt with the Liquidator and litigation management, for some months afterward.

Under the new arrangements, WGB would assess applications and make payments to eligible claimants. WGB would have access and authority to make payments direct from an HIH Scheme financial account at the Reserve Bank of Australia (RBA).

**Figure 3: Revised HIH Scheme structure following the Strategic Review**



Source: Australian National Audit Office (2004)

#### 4.6. ANAO audit of the HIIH Scheme

A performance audit of the HIIH Scheme was undertaken by the Australian National Audit Office (ANAO) and released on 10 June 2004. The audit found that the HIIH Scheme exhibited many of the elements of good public sector governance, as identified in its publication *Better Practice Guide on Public Sector Governance*. It also found that: the HIIH Scheme's risk management frameworks were generally sound (having regard to the high level of inherent risk associated with its operation); it employed strong financial management controls; there was clear evidence of an ongoing commitment by participants to manage the HIIH Scheme in an efficient and effective manner; and the HIIH Scheme had successfully delivered assistance to a large number of Australian individuals, small businesses and not-for-profit organisations affected by the collapse of HIIH.

Overall, the audit concluded that:

... the [HIIH] Scheme has achieved the Government's objective of assisting policyholders affected by the collapse of HIIH. This has been done in a manner that has, in the main, provided appropriate standards of public governance and stewardship.<sup>115</sup>

Despite this positive overall assessment, the ANAO audit found that it was not all smooth sailing during the early stages of the HIIH Scheme. Frustrations between parties arose from time to time, in part because of the administrative complexity of the HIIH Scheme and differing views on the most appropriate means of resolving certain issues. The ANAO audit noted the finding of the August 2002 performance audit that:

Given that one of the underlying objectives of the [HIIH] Scheme was cooperation between the Commonwealth, the ICA and all participants administering the [HIIH] Scheme, evidence suggests that the relationship amongst management is sometimes strained and this at times impacts the [HIIH] Scheme's performance.<sup>116</sup>

However, the ANAO also reported that as the HIIH Scheme transitioned into a more mature and stable phase, the working relationship between HCSL and the Treasury improved.

There was a high level of awareness of the need to provide a sound governance framework for the significant sums of public money involved in the HIIH Scheme. Separate, but related, fraud risk assessments prepared at the time revealed very high levels of inherent fraud risk.<sup>117</sup> Similarly, the risk of ineligible claims being paid was inherent in the eligibility assessment process itself. The ANAO reported that the number of applicants assessed as eligible, who subsequently had been found to have provided incorrect information on their application form, represented a very small percentage of the over 10,000 applications that had been accepted by October 2003.<sup>118</sup>

The ANAO went on to make six recommendations to further strengthen the HIIH Scheme's governance and operational frameworks. The Treasury agreed with all six recommendations, many of which had been identified during the course of the audit process and rectified by the time the ANAO publicly reported its findings.

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<sup>115</sup> Australian National Audit Office (2004), *op. cit.*, page 19.

<sup>116</sup> *ibid*, page 38.

<sup>117</sup> *ibid*, page 42. The ANAO noted one case of possible fraud involving false statements on a statutory declaration, which was referred to the Australian Federal Police for investigation.

<sup>118</sup> *ibid*, page 47.

## 4.7. Treasury's stewardship of the HIH Scheme

### 4.7.1. Schemes of Arrangement

By the time the Treasury formally assumed stewardship of the HIH Scheme on 1 September 2004, the number of new applications (via the Gateway Facility) had slowed significantly. HCSL continued to operate as part of the HIH Scheme, winding down its involvement while arrangements for the sale and transfer of its sole share from the ICA to the Treasury were being finalised. Following a due diligence review and conditions precedent being met, the sale and transfer of HCSL to the Treasury for the nominal value of \$1 took place on 1 August 2005. Upon HCSL's transfer, the operation of the Trust effectively ceased and the members of the Board of HCSL resigned. In their place, three senior Treasury officials were appointed to serve as the HCSL Board. Their initial responsibilities included overseeing the wind-up of HCSL.

The following year, the Australian Liquidator (now comprising Messrs AG McGrath and CJ Honey)<sup>119</sup> convened meetings of creditors of the eight Australian HIH subsidiary companies that formerly held Australian general insurance licenses<sup>120</sup> to consider and vote upon Schemes of Arrangement (SoAs).<sup>121</sup> The SoAs would benefit claimants against the insolvent insurers by allowing for more efficient claims agreement and earlier final closure. Without an SoA, liquidation could continue for 20 years or more in order to protect the interests of creditors with long-tail insurance claims. The SoAs included an estimation mechanism whereby creditors of HIH with potential claims not yet agreed would receive payment based on an actuarial estimate of their claim after eight years.<sup>122</sup>

Following court approval, the HIH companies were placed into SoAs in Australia on 30 May 2006. Four of the companies were also placed into SoAs in the UK, on 13 June 2006. Under the terms of the SoAs, 2 September 2013 (midnight, British summertime) was the deadline for creditors to submit final estimations of claims against these companies.

### 4.7.2. Closure of the Gateway Facility

By early 2006, the number of applications being received was less than 10 per month on average. Many of these applications were exploratory in nature and ineligible for assistance. Given the expense of maintaining the Gateway Facility for few genuine applications, the Government agreed to close down the Facility. An announcement of the closure, effective 17 November 2006, was made in a 5 October 2006 press release by the Minister for Revenue and Assistant Treasurer.<sup>123</sup> The announcement was also communicated across the Australian community through advertisements in major national newspapers. Additionally, GBS wrote to all people who had made enquiries to the Gateway Facility but had not yet lodged an application to advise them of the imminent closure.

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<sup>119</sup> Messrs AG McGrath and ARM Macintosh, partners of KPMG Sydney, were appointed as Provisional Liquidators of HIH Insurance Limited and many of its subsidiaries in Australia. On 1 July 2004, the Corporate Recovery divisions of KPMG Australia separated to form an independent entity, McGrathNicol and Partners. On 1 July 2005, ARM Macintosh retired as Liquidator of the Australian HIH Group companies and was replaced by CJ Honey. AG McGrath and CJ Honey (both now of McGrathNicol and Partners) are the current Liquidators and Scheme Administrators of the HIH companies in Australia.

<sup>120</sup> These companies were: HIH Casualty & General Insurance Limited; FAI General Insurance Company Limited; CIC Insurance Limited; FAI Insurances Limited; FAI Reinsurances Pty Limited; FAI Traders Insurance Company Pty Limited; HIH Underwriting & Insurance (Australia) Pty Limited; and World Marine & General Insurances Pty Limited.

<sup>121</sup> A Scheme of Arrangement is a scheme put in place to bind a company's creditors and/or members to some form of rearrangement of their rights and obligations. The arrangement must be approved by a court as well as the creditors and/or members of the company, or any class or classes of them.

<sup>122</sup> HIH Insurance (2013c).

<sup>123</sup> Dutton (2006b).

The announcement of the closure included a proposal that exceptional applications could continue to be made after the closure date, although each application would need to show that the applicant was genuinely not aware of a claim made against them prior to 17 November 2006 and had received no prior notice of the claim, and the claim satisfied all normal eligibility criteria. The Treasury's Insurance Programs Unit became the point of contact for any enquiries and assumed responsibility for assessing individual applications and providing a recommendation to the Minister for Revenue and Assistant Treasurer's consideration. GBS continued to manage the HIH Scheme's shrinking claims portfolio, although HCSL would continue to exist until all contractual obligations related to these claims (given they were entered into with HCSL) had been discharged.

#### 4.7.3. Wind-up of the HIH Scheme

With the claims portfolio winding down and very few applications being received, the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs<sup>124</sup> announced on 20 June 2008 that the Government expected claims to be finalised by the end of the year. The Government intended to wind up the HIH Scheme (and not accept new applications) once these claims had been finalised.<sup>125</sup> At the time of this announcement, more than 16,000 applications for assistance under the HIH Scheme had been received, with approximately 10,900 having been assessed as eligible and less than 280 remaining to be finalised.

Of these 280, a cohort of around 50 salary continuance claimants remained. This insurance class represented the longest-tail portion of the HIH Scheme portfolio, and there were claims within that cohort with liability exposure for benefits to continue through to 2035. In order for the HIH Scheme to be wound up, the Government agreed in late 2008 to offer the salary continuance claimants an incentivised commutation package<sup>126</sup> as an alternative to their expectation of continuing (monthly) payments under their HIH policy, and therefore the HIH Scheme.

Each individual claimant was contacted, interviewed and provided with the benefit of separate legal advice regarding their specific financial circumstances. After careful negotiation, all of the affected HIH salary continuance policyholders accepted a commutation package. Payments were made in 2009. This was a major step towards facilitating the closure of the HIH Scheme.

Despite the 20 June 2008 announcement foreshadowing the HIH Scheme's wind-up, a number of claims continued to be unresolved for the next three years. By mid-2011, less than 25 claims remained to be settled (about half of these arose from exceptional circumstance applications). The Government agreed to bring forward a resolution of these remaining claims to allow the HIH Scheme to be finally wound up.<sup>127</sup> Commercial settlement packages were negotiated with most of the remaining claimants.

With no further applications being accepted by the HIH Scheme, there was no need for HCSL to continue as a registered company. HCSL was formally deregistered in April 2013.

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<sup>124</sup> The Assistant Treasurer and Minister for Competition Policy and Consumer Affairs assumed responsibility for the HIH Scheme following the November 2007 federal election.

<sup>125</sup> Bowen (2008).

<sup>126</sup> A commutation is a commercial agreement between two parties, in this case the Commonwealth and the HIH salary continuance policyholder, whereby, subject to the payment of a mutually agreed sum to the policyholder, the Commonwealth is discharged of all past, present and future liabilities arising from the policy. The commuted value is essentially the net present value of the future payments which would have been made under the policy.

<sup>127</sup> The Government sought to wind up the HIH Scheme and establish the final liability of the claims portfolio before the Liquidator commenced the estimation process, which was scheduled to begin on 26 May 2013.

At the time of writing, only one residual claim remained under the HIH Scheme. This claim was settled, subject to the approval of the Supreme Court of Tasmania, at mediation in June 2014. Court approval of the settlement is expected to occur in December 2014. Once this claim is finalised, the entire HIH Scheme portfolio will have been definitively wound up. All other claims management activities have been completed and all physical files and related materials (along with the Commonwealth's final proof of debt) have been returned to the Liquidator.

#### 4.7.4. Final HIH Scheme statistics

Regular actuarial assessments of the HIH Scheme's claims portfolio were undertaken by Trowbridge Deloitte (which was later spun off to form Finity Consulting) in early years and by the Australian Government Actuary (AGA) since 2005-06 (Table 3 and Chart 1). These estimates incorporated an allowance for future inflation and covered the expected cost of past and future claim payments and the associated expenses of managing the HIH Scheme.<sup>128</sup> In the early years, these assessments were highly uncertain, because of the relative immaturity of the HIH Scheme and because a significant portion of claims were yet to be reviewed by the Claims Managers.<sup>129</sup>

A major reason for the substantial increase in estimated total liabilities from the initial estimate of \$640 million was a larger than expected volume of claims arising. Others included the expansion of the HIH Scheme's eligibility criteria to include lot owners, and an unexpected increase in the cost of liability and professional indemnity claims. Actuarial estimates then remained relatively conservative for a number of years. In 2006, the Government agreed to increase the HIH Scheme appropriation to a total of \$861 million (from the initial appropriation of \$640 million) to meet the actuarial estimate for that year. This additional funding was provided through annual appropriations.<sup>130</sup>

In later years, as the HIH Scheme matured and an increasing number of claims were finalised, the uncertainty in the estimated total liabilities reduced significantly. The most recent actuarial assessments indicate that the overall lifetime cost of the HIH Scheme has settled at a final figure of around \$731 million in undiscounted terms (Table 3 and Chart 1).

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<sup>128</sup> Treasury (2013), *op. cit.*, page 162.

<sup>129</sup> Treasury (2002), page 139.

<sup>130</sup> Treasury (2013), *op. cit.*, page 162.

**Table 3: HIH Scheme payments and actuarial estimates of total liabilities\***

Date	Payments in financial year (\$m)	Cumulative payments to date (\$m)	Estimated total liabilities (\$m)**
<b>Initial estimate</b>			640
<b>2002-03</b>	163.4***	248.4	812
<b>2003-04</b>	141.6	390.0	897
<b>2004-05</b>	130.7	520.7	859
<b>2005-06</b>	41.0	561.7	861
<b>2006-07</b>	64.1	625.8	843
<b>2007-08</b>	14.7	640.5	769****
<b>2008-09</b>	60.3*****	700.8	739
<b>2009-10</b>	4.1	705.4	740
<b>2010-11</b>	2.8	708.7	731
<b>2011-12</b>	3.6	712.3	731
<b>2012-13</b>	11.7	724.1	731

Source: Australian Government Actuary

\* These figures include administrative and claims management costs as well as assistance payments to local councils.<sup>131</sup>

\*\* Estimates are provided on a gross undiscounted cost basis.

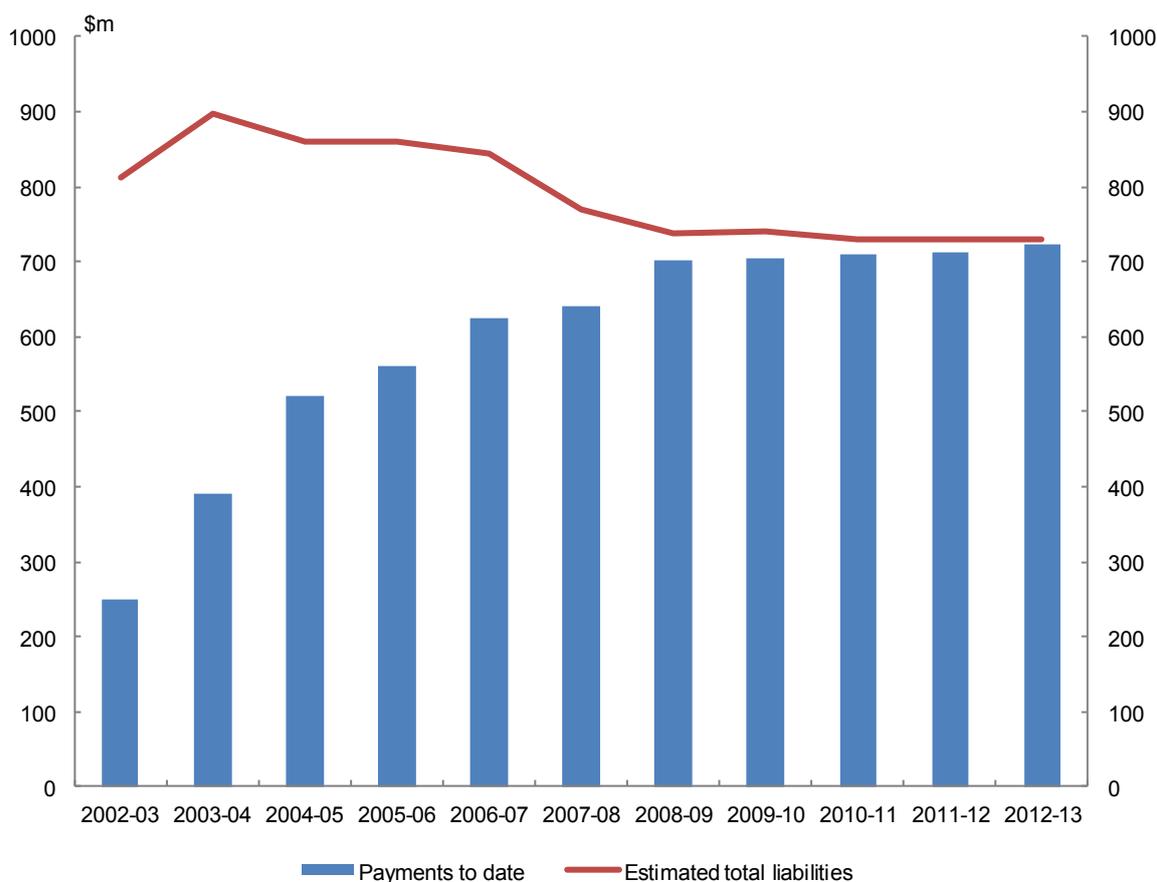
\*\*\* Estimated from Figure 3.2 in Australian National Audit Office (2004).

\*\*\*\* Prior to 2008, actuarial estimates appeared to include Treasury expenses (pertaining to the costs of consultants, auditors, performance reviews, HARP and so on). From 2008 onwards, the AGA began excluding these expenses, which it estimated to be approximately \$24 million, from its actuarial estimates.

\*\*\*\*\* The relatively large outflow of payments in this financial year is mostly attributable to the salary continuance commutation project.

<sup>131</sup> The Commonwealth offered to assist local councils suffering financial hardship as a result of the collapse of HIH. Calculations were based on a hardship threshold, defined as 15 per cent of a council's Ordinary Rates Base. The HIH Scheme would meet 50 per cent of the amount of the deficiency above this hardship threshold, provided it was matched by funding from the respective state or territory government. The process for eligibility assessment and claims management was unique (eligibility was determined by Treasury, rather than WGB, and claims were managed by the council or its appointed manager). As such, local councils are not described in any of the eligible categories in Subsection 4.2.

**Chart 1: HIH Scheme payments and actuarial estimates of total liabilities**

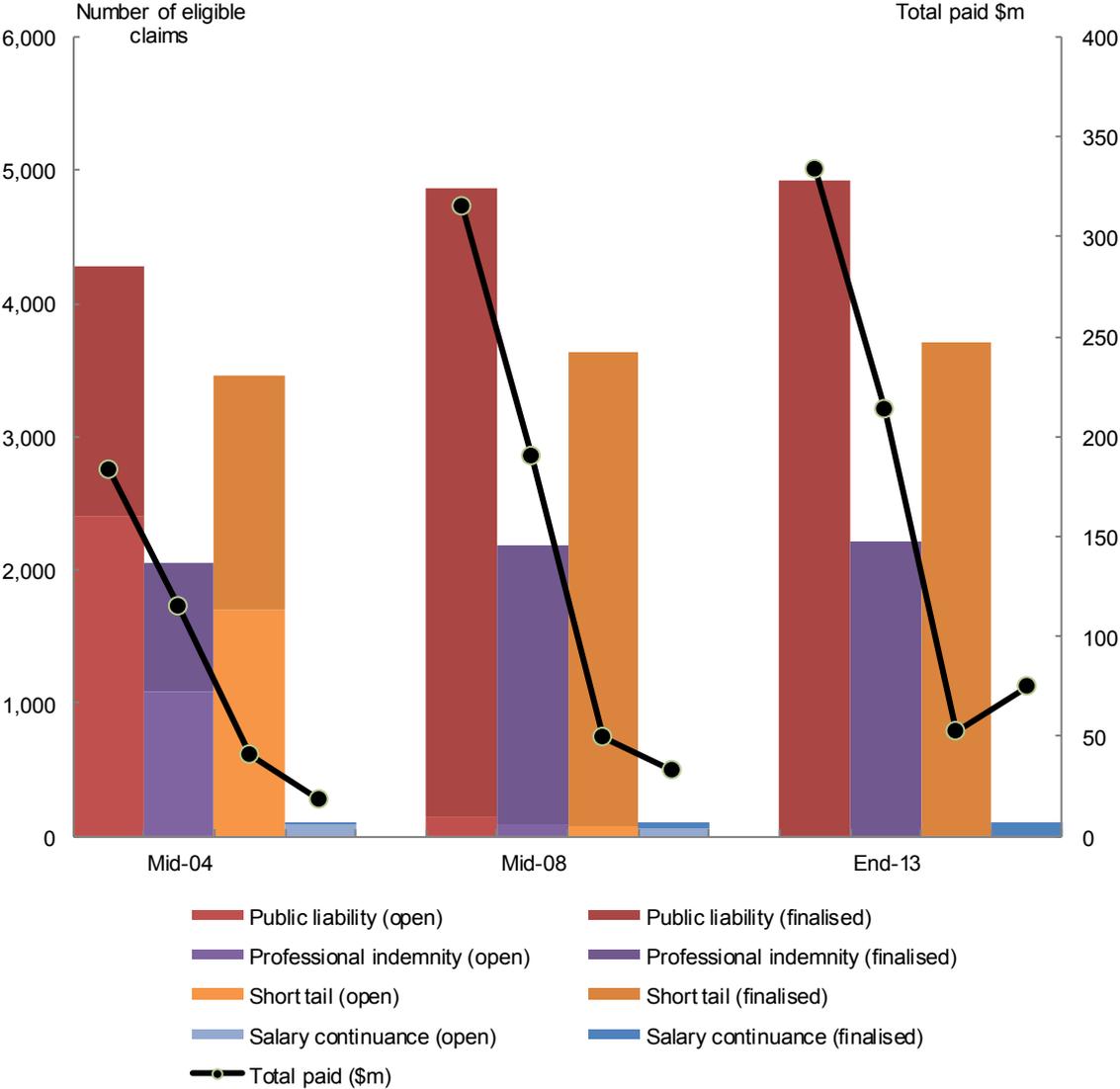


Source: Australian Government Actuary

The HIH Scheme was most active in its early years. By mid-2004, approximately half of the 10,953 eligible HIH Scheme claims had been finalised. By mid-2008, the vast majority of claims that the HIH Scheme would receive over its lifetime had already been both received and finalised (Chart 2).

Of the 10,953 eligible claims finalised by the HIH Scheme, 4,922 were for public liability, accounting for \$334.3 million (or 45 per cent) of total payments. Professional indemnity claims totalled 2,213 (20 per cent), and property, motor vehicle and WorkCover top up claims (all short-tail claims) accounted for 1,588 (14 per cent), 1,195 (11 per cent) and 630 (6 per cent) respectively, or 3413 (30 per cent) combined (Chart 2 and Table 4). Of interest is the fact that although there were just 105 eligible salary continuance claims, the HIH Scheme paid out \$74.8 million to salary continuance policyholders, more than the payments made under all of the short-tail classes combined. The uptick in the value of payments made for salary continuance claimants between mid-2008 and the end of 2013 reflects the completion of the commutation project.

**Chart 2: Evolution of the HIH Scheme claims portfolio over time**



Source: Australian Government Actuary

The HIH Scheme delivered assistance payments to 10,953 eligible claimants (Table 4). Public liability represented the largest class of claimants, with 45 per cent of the final HIH Scheme claims numbers, followed by professional indemnity at 20 per cent.

**Table 4: Final HIH Scheme claims numbers as at December 2013**

Loss type	Final number of eligible claims	Share of total claims (%)
<b>Public liability</b>	4,922	45
<b>Professional indemnity</b>	2,213	20
<b>Property</b>	1,588	14
<b>Motor</b>	1,195	11
<b>WorkCover top up</b>	630	6
<b>Salary continuance</b>	105	1
<b>Lot owners*</b>	59	0.5
<b>Trade credit</b>	51	0.5
<b>Sports injury</b>	42	0.4
<b>Income protection</b>	2	<0.1
<b>Other</b>	146	1
<b>Total</b>	<b>10,953</b>	<b>100</b>

Source: Gallagher Bassett Services

\* For lot owners' claims, Table 4 includes only those claims that were managed by GBS. Lot owners' claims managed by Allianz Australia were not captured in the relevant data collection system.

#### 4.7.5. Final phases of HIH's liquidation

Eighty-two HIH Group subsidiary companies in Australia have been subject to liquidation. At the time of writing, the liquidations of 54 companies have been finalised, with a further 28 Australian subsidiary companies yet to be fully liquidated.<sup>132</sup> The Liquidator has conducted approximately 350 commutations with HIH's reinsurers, resulting in reinsurance asset recoveries to the HIH estate of approximately \$850 million. The Liquidator has also settled, on a confidential basis, two major litigation claims against HIH's former directors, auditors and advisors, resulting in substantial returns for creditors.<sup>133</sup>

From time to time through the liquidation process, distributions have been made to creditors of the eight Australian general insurance companies covered under the SoAs. Estimated final recoveries through the liquidation process vary greatly for different creditors of different companies (Table 5) and range from 11 cents in the dollar through to full recovery (100 cents in the dollar). To date, the Commonwealth, the largest creditor by way of HIH Scheme liabilities, has received payments from the HIH estate totalling approximately \$318 million.<sup>134</sup> This represents a recovery rate of approximately 44 cents in the dollar on the Commonwealth's expected lifetime HIH Scheme outlays of \$731 million.

<sup>132</sup> McGrathNicol (2014).

<sup>133</sup> McGrathNicol (2014b).

<sup>134</sup> Sum total of HIH Group liquidation proceeds, unadjusted for inflation, calculated from the Treasury's annual reports as follows: \$26.356 million in FY2005-06; \$43.646 million in FY2006-07; \$55.271 million in FY2007-08; \$22.860 million in FY2008-09; \$53.776 million in FY2009-10; \$62.244 million in FY2010-11; \$23.479 million in FY2011-12; \$4.045 million in FY2012-13; and \$26.257 million in FY2013-14.

**Table 5: Scheme Administrators' estimate of ultimate Scheme of Arrangement payments, extracted from annual reports to creditors as at 30 June 2014**

Scheme company	Estimated final (%)	To date (%) <sup>135</sup>
<b>HIH</b>	31 to 47	31 and 39.97 <sup>(a)</sup>
		28 and 37.36 <sup>(a)</sup>
<b>FAIG</b>	60 to 68	57 and 59.15 <sup>(b)</sup>
<b>CIC</b>	65 to 91	63 and 64.48 <sup>(c)</sup>
<b>FAIT</b>	16 to 18	10
<b>FAIR</b>	100	100
<b>FAI</b>	11 to 71	7, 10 and 55 <sup>(d)</sup>
<b>WMG</b>	100	100
<b>HIHU</b>	29 to 35	18

Source: McGrathNicol and Partners

<sup>135</sup> (a) HIH Casualty & General Insurance Ltd creditors with insurance claims in Australia have been paid 39.97 cents in the dollar, and creditors with insurance claims that are not in Australia have been paid 37.36 cents in the dollar. HIH Casualty & General Insurance Ltd creditors with non-insurance claims in Australia have been paid 31 cents in the dollar, and creditors with non-insurance claims that are not in Australia have been paid 28 cents in the dollar.

(b) FAI General Insurance Ltd creditors with insurance claims worldwide have been paid 59.15 cents in the dollar, and all other FAI General Insurance Ltd creditors have been paid 57 cents in the dollar.

(c) CIC Insurance Ltd creditors with insurance claims in Australia have been paid 64.48 cents in the dollar and creditors with non-insurance claims in Australia have been paid 63 cents in the dollar.

(d) FAI Insurances Ltd creditors with insurance claims in Australia have been paid 55 cents in the dollar, and creditors with insurance claims that are not in Australia have been paid 10 cents in the dollar. Creditors with non-insurance claims in Australia have been paid 10 cents in the dollar.

## Conclusion

The collapse of HIIH increased awareness of the significance of insurance to the wider economy. Insurance is socially valuable. It promotes financial security and personal responsibility. The insurance market generates price signals, helping to allocate resources to productive uses. Most fundamentally, the availability of insurance enables risk-averse individuals and entrepreneurs to undertake higher risk, higher return activities than they would in the absence of insurance, promoting higher productivity and growth.<sup>136</sup> HIIH's collapse demonstrated that without insurance, a range of essential activities in commerce, trade and community life can simply grind to a halt.<sup>137</sup>

The collapse also served to boost recognition of the ways in which insurance markets can 'fail', and what regulatory interventions are needed to improve their functioning.<sup>138</sup> For instance, the fact that insurance services are only produced and delivered *after* they are purchased by policyholders (an 'inversion of the production cycle') can create incentives for poor underwriting, under-reserving and insufficient capitalisation.<sup>139</sup> In the case of long-tail classes of insurance, of which HIIH was a significant provider, it is often possible to conceal past underwriting losses or management mistakes for long periods of time. The failure of HIIH thus underscored the importance of management discipline and sound prudential supervision.

With the advent of the Financial Claims Scheme (FCS), the need for a general insurance policyholder support mechanism like the HIIH Scheme is unlikely to arise again. In the case of HIIH, if not for the introduction of the HIIH Scheme, policyholders would have been pooled with other unsecured creditors in a complex and uncertain wind-up process and would have waited many years before any funds became available. Not only did the HIIH Scheme expedite payments to eligible policyholders, it also significantly compensated them for financial losses, as assistance payments of 90 or 100 cents in the dollar were, in most cases, significantly higher than the recovery that policyholders would have received pursuant to Schemes of Arrangement. Formal policyholder protection schemes like the FCS are now considered international best practice.

Establishing the HIIH Scheme was a unique response to an exceptional event. At the time, the need to develop a support scheme rapidly was imperative, to ensure that HIIH policyholders (or claimants against HIIH policyholders) with valid claims were not left in financial distress. However, the government had limited capability and infrastructure to support the management of claims. Recognising this limitation, it worked closely with the general insurance industry to ensure that the latter's expertise formed the bedrock of the HIIH Scheme's structure. As recognised by the ANAO in its 2004 performance audit, this harnessing of private expertise was sufficient to not only:

... provide industry best practice in dealing with claimants, but also to satisfy the needs of the liquidator of HIIH and provide confidence to the Commonwealth in proving its debts.<sup>140</sup>

The Government of the day noted that, 'Without this partnership, the [HIIH] Scheme could not have been so successful'.<sup>141</sup> The close collaboration between the general insurance industry, the Liquidator and the Government was instrumental in establishing the HIIH Scheme within just weeks of its

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<sup>136</sup> Brainard (2008), page 1.

<sup>137</sup> Shorten (2011).

<sup>138</sup> Insurance Council of Australia (2014).

<sup>139</sup> Baltensperger *et al.* (2008), pages 8-9.

<sup>140</sup> Australian National Audit Office (2004), *op. cit.*, page 41.

<sup>141</sup> Coonan (2003).

announcement.<sup>142</sup> The role of industry should not be understated. According to the current Government, the industry showed ‘terrific initiative’ in coming together to address the temporary crisis in insurance affordability and availability post-HIIH.<sup>143</sup>

Creating the HIIH Scheme under the umbrella of a formal agreement (the CMA) and Trust Deed – rather than through legislation – assisted in establishing it quickly and affording it the flexibility to evolve over time. While it lacked many of the controls that might ordinarily apply over the expenditure of taxpayer money, the HIIH Scheme structure gave Claims Managers the autonomy to deliver efficient services, the Liquidator confidence that claims on the HIIH estate were properly handled, and the government assurance that taxpayer dollars were disbursed in a judicious manner. Furthermore, the extensive (and at times, arduous) legal design process resulted in the HIIH Scheme being established on a secure legal footing, with clear roles, accountabilities and relationships between the different parties. The only legislation necessary was the Appropriations Bill, which provided initial funding.

Ultimately, the HIIH Scheme’s success demonstrates that industry and government can work together to deliver mutually beneficial outcomes. Future industry-government collaborations would be well informed by the success of the HIIH Scheme.

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<sup>142</sup> Bowen (2008), *op. cit.*

<sup>143</sup> Sinodinos (2014).

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