# CONTROL OF THE AUSTRALIAN LIFE INSURANCE INDUSTRY: AN EXAMPLE OF REGULATORY EXTERNALITIES WITHIN THE AUSTRALIAN FINANCIAL SECTOR 1870-1945

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*The regulatory environment in which the Australian life insurance industry operates has its antecedents in the two major periods legislative intervention. The first occurring in the 1870s established the principle of 'freedom with disclosure' which has formed the basis of the regulatory approach since. The second in the 1940s refined the concept in the context of a general recognition of an interventionist approach to financial markets. It is argued that regulation of the life insurance market in Australia came about not in response to problems associated with market failure but in reaction to external influences not directly related conditions in the Australian life insurance industry. This has impacted on not only the timing of intervention but the approach taken.*

The Australian life insurance industry provides an interesting case study into the evolution of a regulatory framework for financial institutions. Whilst the banking sector in Australia has a reputation for being one of the most highly regulated in the Western world, this has not been the case in other parts of the financial sector. At a time when banks were a focus of Australian government's regulatory zeal, the insurance industry, including both life and general insurance, was largely neglected. Federal legislation to regulate the general insurance industry was passed in 1932.[1] Whilst that relating to the life insurance industry was not passed until 1945, This paper focuses on the evolution of regulation in the life insurance industry and places it within the context of the regulatory framework of the Australian financial sector. It seeks to establish the motivation behind regulatory controls and investigate why it took so long for a consistent regulatory approach to industry to emerge. It is argued that regulation of the life insurance market in Australia came about not in response to problems associated with market failure but in reaction to external influences not directly related conditions in the Australian life insurance industry. This has impacted on not only the timing of intervention but the approach taken.

[1] This legislation was influenced by other motives aside from correcting market failure in that industry. It was one of several pieces of legislation pushed through parliament in a bid to thwart the plans of the N.S.W. premier Jack Lang to raise money from the insurance and banking industries. Benjamin, *Private and Public Regulation,* pp.144-67.

Theoretical explanations for the introduction of regulation follow several lines of debate. Public choice theory for example, argues that people and firms will demand regulation that makes them better off. This demand is expressed through the political system. Politicians on the other hand, have the ability to supply regulation but will do so in a manner that reinforces their own political interests of achieving and staying in office. The outcome of this process depends on whose interests are served by regulation. Stigler argues that regulation may be acquired by an industry, or an interest group and used for its own benefit.[2] The principle of the capture thesis is that, as the costs of regulation are high, it will only be supplied if it benefits specific cohesive groups whilst imposing small costs on the rest of the community.[3] The implication of this approach is that the degree and type of industry regulation will be determined by the power of sectional interests in lobbying government for a particular desired outcome. Further refinements of this model suggest that political expediency will ensure that the benefits of regulation are not necessarily confined to one single group.[4]

An alternative approach is to view regulation as part of an ongoing process or cycle. Kane introduces the notion of the 'regulatory dialectic' which sees the development of a regulatory environment as a response to economic and political pressures.[5] In this context the process follows a pattern where regulatory rules are imposed in reaction to economic and political pressures. These regulations generate their own response in the form of avoidance or market distortion which in turn brings about another round of regulatory change. This response occurs in a cyclical manner as the stakeholders react to changes occurring in the financial system.[6] These changes may result from the impact of regulation but also from changes in other variables such as technology. Regulation of financial systems, according to this scenario, is not so much part of a coherent planning

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[2] Stigler,' The Theory of Economic Regulation' p.3.

[3] McTaggart, Findlay and Parkin, *Economics,* p.367.

[4] Peltzman 'Toward a more General Theory of Regulation' , p.21; Benjamin, *Private Regulation*, p. 313

[5] Kane, *Accelerating Inflation,* pp.355-57.

[6] Thomson and Abbott, 'Banking Regulation', pp.69-70.

process, as a reaction to the changing market environment.[7] Thomson and Abbott have applied this concept of the regulatory dialectic to the Australian banking system and conclude that it provides some useful insights into the changing relationship between banks and regulatory environment within which they operate.[8] One factor which has not been considered is the extent to which this regulatory cycle spreads over into other parts of the financial sector. It is argued in this paper that the advent and timing of federal life insurance regulation was not so much to do with the conditions within the industry but more to do with the spill over effects from bank regulation. Commonwealth life insurance leglisation was passed in 1945 after nearly fifty years of debate and several previous attempts. There is little evidence to suggest that the industry, as a key interest group, had significant political influence on either the content or timing of the Act. Instead, it is perhaps no co-incidence that the federal Life Insurance Act was passed at a time when the government was preparing to use wartime regulations imposed on banks as the basis for the extension of peacetime controls.

## THE PATTERN OF REGUALTION

The foundations regulatory control of the Australian industry have been based two main periods of legislative intervention. The first occurred in the 1870s when the Australian colonies enacted separate pieces of legislation to cover life insurers within their jurisdiction. The second occurred in the 1945 when the Commonwealth government assumed the regulatory mantle given to it under Section 51 (XIV) of the constitution. The Life Insurance Act passed in that year superseded all State acts and for the first time provided a consistent approach to regulation of the industry. In each instance the approach taken was strongly influenced by contemporary reaction to problems in other sectors or other countries.

[7] Thomson and Abbott, 'Banking Regulation', pp.69-70.
[8] Thomson and Abbott, Banking Regulation, p.86.

The basis of regulation of life insurance companies in the Australian colonies has its origins in the British Life Insurance Companies Act of 1870. The catalyst to the passing of this Act was the spectacular collapses of several British insurance companies in the 1860s. In particular the failure of two companies, the European and the Albert in 1869, acted as a spur for legislative action.

The significance of this Act was that it established the principles upon which regulation of both British and Australian life insurers was undertaken. The prime purpose of insurance regulation was to protect the solvency of companies and in so doing guarantee that contracts made between consumers and insurance firms could be met.

The regulatory approach may be either proactive with strong supervisory provisions, or passive relying on the market to self regulate to a great extent. The method enshrined in the 1870 Act relied on passive methods of control. The principle of 'freedom with disclosure' established with the Act of 1870 allowed firms to conduct their business in an unrestricted manner as long as they published enough information to enable the regulator and the public to establish the financial position of the company. In this respect, companies had to publish an annual expenditure and revenue account in which life insurance business was separated from other insurance. In addition they had to undertake and publish the results of an actuarial investigation into their life insurance business every five years.[9] The alternate philosophy underlying life insurance legislation was of supervision or public disclosure. Such an approach was adopted by American regulators who played a more active role in ensuring solvency requirements were met.[10]

Legislation which dealt specifically with the regulation of the life insurance industry was enacted in most colonies, with the exception of N.S.W., in the 1870s. The timing of legislation was directly related to

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[9] R*oyal Commission Into Life Insurance*, pp.8-10; Tapp, 'Regulation of the UK Insurance Industry', p.29.

[10] Ro*yal Commission on Life Insurance*, p. 8; Westall, 'The Assumptions of Regulation, p.144.

events in the British market. The collapse of the European and Albert insurance companies were explicitly cited as reasons for the legislative action in the colonies.[11] The approach taken was to mirror that of the English legislation passed in 1870. Of all the colonial Acts, that of Victoria was one of the earliest and most comprehensive. It was a direct reaction to the impact of the demise of the Albert. Referring to this, in introducing that colony's legislation, and conceding that such an event was unlikely to occur in the colony, the Victorian treasurer stated. 'I think it will be submitted that it is a most prudent course to deal with this question early, before the colony gets larger and before many of the inconveniences experienced in England can be felt here.[12]

The other colonies, with one exception followed suit in the passing of similar legislation. The basic provisions in respect to solvency protection in each of the colonies are summarised in Table 1. This table highlights the emphasis on public disclosure as a means of regulatory control in the colonies. It also points to the lack of a cohesive approach between the colonies. Whilst some requirements directly mirrored the English Act others were subtly different. A major point of discrepancy was the issue of deposit requirements. All were significantly less than that required by English law, but within the colonies there was also a marked inconsistency. The Victorian Act for example, was originally proposed without deposit requirements on the grounds that it acted as a barrier to the foundation of mutual firms. Subsequent amendments to the proposed Act resulted in the upper house of parliament insisting on a clause requiring deposits be made by life insurance firms. The sum of £5,000 was considered large enough to deter 'professional company makers' but not sufficient to impede the formation of mutual societies.[13]

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[11] *Victorian Parliamentary Debates,* May 20 1873, p.79.
[12] *Victorian Parliamentary Debates,* May 20 1873, p.79
[13] *Victorian Parliamentary Debates,* May 20 1873, p.80; November 5 1873, p. 2207

Table 1:Life Insurance Solvency Legislation in the Australian Colonies

| Regulation | England | NSW | Victoria | Queensland | S.Australia | W.Australia | Tasmania |
|---|---|---|---|---|---|---|---|
| Relevant Acts | Life Insurance Act 1870, 1871,1872 | Life, Fire and marine Insurance Act 1902 | Life Assurance Companies Act 1873, 1890,1896,1900 1903 | Government Annuities and Assurance Act 1865, Life Insurance Companies Act 1901 | Life Assurance Companies Act 1889, Policies Protection Act 1887 | Life Assurance Companies Act 1889, Amended 1905 | Life Assurance Companies Act 1874, Amended 1885,1889, 1906 |
| Deposit Requirement | £20,000 refundable funds reach £40,000 | Nil | £5,000 refundable funds reach £15,000 | £10,000 | £5,000 | £10,000 | £5,000 refundable funds reach £15,000 |
| Periodic returns to government | Annual reven account, annual balance sheet, quinquennial report | Nil | Annual revenue account, annual balance sheet, quinquennial report Foreign companies statement | Annual revenue account, annual balance sheet, statement of policies, quinquennial report Foreign companies statement | Annual revenue account, annual balance sheet, quinquennial report Foreign companies statement | Annual revenue account, annual balance sheet, quinquennial report Foreign companies statement | Annual revenue account, annual balance sheet, quinquennial report Foreign companies statement |
| Separation of Funds | Life funds kept separate from other funds | Nil | Life funds kept separate from ofther funds | Life funds kept separate from ofther funds | Life funds kept separate from ofther funds | Life funds kept separate from ofther funds | Life funds kept separate from ofther funds |
| Supervision by government | None | None | None | None specifically but generally by Treasurer | Public Trustee | Treasurer | None |
| Publcity Provisions | Shareholders address book, annual report | None | Shareholders address book, companies not registered under *Companies Act* to provide copy of constitution on request | Shareholders address book companies not registered under *Companies Act* tp provide copy of constitution on request | Shareholders address book companies not registered under *Companies Act* tp provide copy of constitution on request | Shareholders address book companies not registered under *Companies Act* tp provide copy of constitution on request | Shareholders address companies not registered under *Companies Act* tp provide copy of constitution on request book |
| Statutory Solvency requirement | none | none | If company is proved to be insolvent it may be wound up | none | none | none | none |

Source: Collated from Royal Commission into Life Insurance, Appendices E & F

New South Wales was the only colony that did not provide direct legislative provisions relating to the solvency of life insurers.[14] This was of significance because as the oldest and one of the most populated colonies, it

[13] The Life, Fire and Marine Insurance Act of 1902 provided protection for policyholders against creditors and lost policies.

was home to the head office of many of the major life insurers. Legislation could not be applied beyond colonial borders. This meant that unless a company traded in other colonies, it was not subject to other regulatory regimes. On the other hand, the multitude of differing legislation created complications for those companies that did trade beyond colonial borders. If these companies wanted to expand beyond colonial boundaries they had to conform to the legal requirements in other colonies. Inconsistency between colonies inevitably led to market distortions as new entrants were naturally attracted to the colony no legislative requirements. Although this did not happen immediately, it became a problem in later decades.

This complicated web of legislation provided the basis of life insurance regulation until after the second world war. The regulatory framework, in responding to an external influence, did not accurately reflect the market conditions in the colonies. Instead it was a reflection of a market which operated in a very different manner. The foundations of the British life insurance market were embedded in the development of composite insurance companies with a long history of self regulation. In this respect the explicit collusion of insurance British companies under the auspices of the tariff system formed the basis of a private regulatory system. Westall argues that the shape of the British regulatory framework was determined by the existence of self regulation.[15] The manner in which rates and policy conditions were managed under this system provided sufficient control to promote industry stability.

The evolution of the life insurance market in the Australian colonies stemmed from a very different heritage to that in Britain. In Britain, the growth of the life insurance market was very rapid in the first half of the nineteenth century. Industrialisation and the emerging middle class provided the basis for this expansion. In 1830 there were around 50 life companies, by 1850 this had risen to nearly 200.[16] Many life insurers were branches of fire insurance companies. Competitive market pressures in the

[15] Westall, 'The Assumptions of Regulation', p.156.
[16] Supple, ' Insurance in British History', p.5.

insurance market led to the emergence of large insurance companies after 1850. This resulted in the development of composite companies which sold a number of insurance products.[17] Mergers and amalgamations further promoted market concentration so that by the 1870s a strong insurance oligopoly had emerged. Oliver Westall suggests that in the London market and three other important markets, seven or eight of the largest companies accounted for at least half the insurance business.[18] The dominance of these companies provided a powerful incentive for collusion and rate fixing to occur. The establishment of the Fire Offices Committee in 1868 provided the organisational structure for formal collusive agreements to be implemented in the fire insurance market. The significance of these agreements for the life insurance was that it further supported the concentrated nature of the insurance market and interdependent market behaviour. Life insurance was tied to the fire insurance and later general insurance market by virtue of the rise of the composite company. The few specialist firms that existed were in a minority and had few resources to counter the economies of scale that the large composite firms could rely on. The large fire insurers such as the Sun, the Royal or the Phoenix could make use of their extensive networks of agencies and branches not only domestically, but internationally to sell life insurance.[19]

In this respect the development of the life insurance industry in Britain was significantly different to that in Australia where there was a distinct difference between the major life insurers and the major fire insurance firms. As a result the rationale for regulation should necessarily have been different. Within the composite firm the demarcation between the different types of business had the potential to become blurred. The prospect for cross subsidisation of unprofitable business by profitable business was enhanced under this type of structure. In 1870 the British parliament passed legislation to ensure that insurance companies kept their life insurance funds separate from other insurance business. In Australia this

[17] Supple, 'Corporate Growth', p. 74.
[18] Westall, 'David and Goliath' ,p.131.

was not an issue of any significance as very few life insurers sold other types of insurance. Whilst the British life insurance heritage was grounded in the rise of fire and general insurance, in Australia it was linked to the emergence of mutual societies which had more in common with friendly societies than other types of insurance.

## THE ORIGINS AND DEVELOPMENT OF LIFE INSURANCE IN AUSTRALIA

The first life insurance companies which appeared in Australia in the 1830s were branches of British companies. The business of selling life insurance in the infant colonies of Australia was difficult and not surprisingly these companies did not do well. Within a short time many had disappeared.[20] It would be over a century before British companies became firmly established in the industry. The supply of life insurance needed certain prerequisites before it could thrive. These included a growing economy with an expanding population base and an emerging middle class with increasing levels of disposable income. These conditions were not met until the advent of the gold rushes provided the catalyst for economic growth. The significance of the gold rushes for the life insurance industry was twofold. Firstly, they led to a rapid expansion in population, particularly in the well established colonies of N.S.W. and Victoria. Secondly, the rushes provided the capital base upon which the colonies began to industrialise and urbanise.[21] It was in this environment that the Australian life insurance industry emerged.

The development of the Australian life insurance industry is unique in that mutuals have played a significant role in its evolution, The first Australian mutual life office (the AMP) was formed in 1849 and from that point grew steadily to become the leading life insurance provider in the country, a position it held for over 150 years. For the next two decades after

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[19] Supple, 'Insurance in British History', p.5
[20] Gray, *Life Insurance in Australia,* p.20.
[21] Butlin, *Investment in Australian Economic Development*, p.32;Sinclair, *The Process of Economic Development,* pp.80-6.

its inception, the AMP shared the life market with a number of other general insurers who sold life insurance as well as other types of insurance. The market was very unstable with firms entering and leaving the industry in quick succession. Four Australian companies which entered the market in the 1850's and 1860s had all ceased to sell life insurance by the 1880's. Similarly, there were 18 British firms with life insurance agents in Australia in the 1860's. This number had halved by the 1880's and no British companies sold new policies by the 1890's.[22]

The establishment of an Australian life insurance industry as such, took place in the 1870's. During this decade ten new local life insurers entered the market. Most within a three year period from 1869 to 1872. Significantly all these new entrants were mutual offices. By 1880 mutual firms accounted for eighty-one per cent of new policies sold, by 1890 this had risen to ninety per cent.[23] The growth of the industry at this time was quite rapid in comparison to the markets in other countries. In 1880 for example, £4.4 million was generated from the sale on new policies. In 1890 this had increased to £8.4 million.[24] A comparative study published in the *Australasian Insurance and Banking Record* in 1880 indicated that AMP sold more new policies and generated more premium income than any British company in that year. [25] The expansion of the market and its rapid growth was not associated with an influx of stock companies. Only four Australian proprietary companies of any substance operated in the life insurance market after the 1870s. These were the Australian Insurance Company, Victoria Life and General Co., Australian Alliance Assurance and Adelaide Life Assurance and Guarantee Co.[26] In addition there were several British and American companies with agencies in the colonies. However the extent of business they conducted was variable. Gray counted sixteen British firms that conducted some life insurance business between 1870 and 1879. By the 1899 this had fallen to three and it is unlikely that

[22] Gray, *Life Insurance,* pp.22-23.
[23] *Australasian Insurance and Banking Record,* (AIBR)1882, 1891.
[24] AIBR, 1882, 1891.
[25] AIBR, 10 March 1881, p. 97.

they had sold new policies in the past decade. This is supported by the claim by Richard Teece, general manager of the AMP in 1893, that no English companies attempt to do life business in Australia.[27] A snapshot of the sector in 1885 illustrates the concentrated nature of the market and the dominance of the mutuals.

Table 2 Australian Life Insurance Firms 1885

| 1885 | Date Established | Head Office | No. Of New Premiums | % of New Premiums |
|---|---|---|---|---|
| AMP | 1849 | Sydney | 8,857 | 30.8 |
| National Mutual Life | 1869 | Melbourne | 4,512 | 15.7 |
| Australian Widow Fund | 1871 | Melbourne | 3.705 | 12.9 |
| Colonial Mutual Life | 1874 | Melbourne | 3,563 | 12.4 |
| Mutual Assurance of Vic | 1870 | Melbourne | 3,052 | 10.6 |
| Mutual Life of Australasia | 1869 | Sydney | 2,624 | 9.1 |
| City Mutual Assurance Ltd | 1878 | Sydney | 1,823 | 6.3 |
| T&G Mutual Life | 1876 | Melbourne | 250 | 0.9 |
| Australasian Alliance | 1862 | Melbourne | 365 | 1.3 |
| Adelaide Life& Guarantee | 1866 | Adelaide | 1 | 0.0 |
| Citizens Life Assurance Ltd | 1886 | Sydney | N/A | |
| Vic Life and General | 1859 | Melbourne | N/A | |
| Total | | | 28,751 | |

Source: AIBR 1885.

Most of these firms established before the introduction of regulatory controls in the early 1870s. Their head offices were generally located in Melbourne. The lack of legislative control in the colony of N.S.W. does not appear to have led to any immediate significant locational distortion after 1872 when the Victorian act was passed. In fact, of the three new life insurers to establish after that date, two were based in Melbourne.

The growth in number of Australian life insurance offices stagnated after the mid 1870s. One reason for this was the dominance of the major offices in the sale of new policies In 1885 the top five firms, all of which were mutual, accounted for over eighty-two per cent of new premiums. This was a well established trend which was not challenged until the 1950s.[28] The proprietary firms did not flourish at all. The Victoria Life and General, is reported to have had 837 policies on its books in 1882. The Australian

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[26] Gray. *Life Insurance,* p.24; AIBR, 8 January 1880, p.22.
[27] Gray, *Life Insurance,* pp.22-23.
[28] Keneley, ' Evolution of Australian life insurance', pp.161-2.

Alliance experienced a serious decline in new policies sold between 1888 and 1896. In that year it recorded 8 new policies. The Adelaide Life and Guarantee ceased to sell new policies after 1888.[29] The failure of private companies to thrive may be accounted for in a number of ways. Gray argues it was because they were not in the business of 'selling' life insurance but rather waited for business to come to them.[30] Whilst this may go part of the way to explaining the pattern which developed, a deeper analysis would tie it back to the state of the colonial economy at the time. It is notable that Australian fire insurers did not thrive during this period either. In this case the market was dominated by the same large British companies which had risen to prominence in their country of origin[31] In both these cases insurers were attempting to sell insurance in a very small market, dominated by a few very large firms. The population centres of Sydney and Melbourne provided the largest pool of potential buyers. With populations of around 250,000 in each city in the 1880s, the market was limited.[32] Regional and inter colonial markets were also small and very expensive to service.

By the 1890's the structure of the industry which was to dominate for the next seventy years was clearly visible. By is point in time the market share of the top five firms had increased to 88 per cent of new policies sold.[33] As with the British market, the Australian market emerged as a highly concentrated oligopoly, although in this case it was the mutual firms which dominated the market. Whilst mutual life insurers had originally formed as philanthropic institutions in response to the failure of the private sector to provide the service, they soon moved to operate on a business footing.[34] The regulatory framework under which they operated was weak and unco-ordinated. Yet the life insurance market proved to be very stable and displayed few of the competitive weaknesses which were to become

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[29] Gray, *Life Insurance,* pp.26-28.
[30] Gray, *Life Insurance,* p.26.
[31] Keneley, 'The Origins of Collusion', p.63.
[32] McCarty, 'Australian capital cities', estimated the population of Melbourne to be 268,000 and Sydney 225,000 in 1881, pp.32-33.
[33] AIBR 17 January 1891, p.52.
[34] This point was made in the AIBR in 1882, cited in Gray, *Life Insurance,* p.9.

apparent in the fire insurance and for that matter, banking sectors in the 1890s.

## CHALLENGES TO REGULATORY EFFECTIVENESS

Between the 1870s and 1945 there were two periods when challenges to the regulatory thesis created the potential for further intervention in line with Kane's regulatory dialectic. The first occurred with the of the 1890's depression. Whilst this laid the philosophical foundations for the development of banking regulation, it did not have the same impact on insurance legislation.[35] The second period occurred in the 1920s when an influx of new competitors created the potential for market destabilisation. Neither threats to the stability and solvency of the industry led to legislative action.

The depression of the 1890s led to a dramatic decline in the fortunes of other financial intermediaries. In these markets the ineffectiveness existing regulatory provisions, or lack of them, became glaringly apparent.[36] This was not the case in the life insurance industry. The magnitude of the depression was heightened by the collapse of the Victorian land boom in 1888 throwing the financial sector into disarray. The public experience of the crisis resulted in a profound lack of confidence in the financial sector. The reputation of banks for example, was permanently tarnished as a result of the crash.[37]

In the decade before speculative investment in land and housing in the Victorian economy fuelled a boom unprecedented in the colony's history. Much of the funding for this expansion was obtained by Australian financial institutions borrowing overseas. In addition a plethora of building societies and land and mortgage firms emerged to channel public funds into real estate. Banks, building societies and other insurance institutions joined

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[35] Schedvin, *The Growth of Bank Regulation*, pp.5-6.
[36] Merritt notes that whilst this period was known as a period of 'free banking', there were elements of regulation of financial institutions in existence. Merrett, 'The State and the Finance Sector, p.270.

the speculative bandwagon channelling funds into property and other increasingly dubious mortgages. Life offices were not quarantined from this speculative bubble. In 1890 the major offices held nearly sixty per cent of their assets in mortgages and a further seventeen per cent in loans on policies and private security. [38]

The first sign of the impending collapse of the boom came in 1889 with the failure of a major building society. From that point closures followed in quick succession. Between 1891 and 1893, fifty-four deposit taking financial institutions had closed.[39] The first of the banks failed in January 1893 and within five months a further twelve of the twenty-two trading banks had collapsed.[40] The fire insurance industry experienced a similar fate. Between 1891 and 1900 twenty-three of the thirty-four local companies exited the market or were absorbed by other firms.[41]

The life insurance sector did not emerge from the financial crisis unscathed. As they were not deposit taking institutions they were not threatened by runs on their resources as were banks and building societies. The illiquid nature of life societies funds protected them from immediate impact of the economic crash and allowed them time to reconstruct their investment portfolios. The two main threats came firstly, in the decline of new business and the lapse of policies. Secondly, in the default on mortgages and the lost income earned from interest.

New policies sold began to decline after 1887.[42] Whilst a slowing down in the growth of sales was inevitable after a period of strong growth from the 1870s, it is clear that the economic climate of the 1890's had an impact on the premium income of life insurance offices. Surrenders and

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[37]Banks forfeited a position of trust for one of suspicion. Public antagonism towards banks during the 1930's had its origins in the crash of 1893, Schedvin, *Australia and the Great Depression,* pp. 80-1.
[38] AIBR, 1891, p. 52.
[39] Pope, 'Bank Regulation', p. 24.
[40]Nearly all those banks which closed their doors were eventually able to re-open. Merrett, 'Australian Banking Practice', p. 61.
[41]Pursell, Development of non-life insurance, p.159.
[42]New policies sold declined from 34,547 in 1887 to 30,427 in 1888 sales increased slightly in the following two years but then fell again. AIBR, 1893, p.45.

lapses in the payment of premiums increased between 1890 and 1893.[43] The ratio of the increase in the renewal of premium income to new annual premiums was 53.5 per cent between 1881 to 1884, it had fallen to thirty-four per cent between 1889 to 1892[44]

The financial crisis did not lead directly to the demise of any life insurance offices. However, it was the catalyst for the restructuring and further concentration of the market. Several of the smaller societies found it difficult to keep going in the deteriorating economic conditions. Three small associations amalgamated with the Australasian Temperance and General between 1889 and 1890.[45] In 1896 the Mutual Assurance Society of Victoria amalgamated with the National Mutual Life Association.[46]

It is doubtful that the existence of regulatory provisions had any influence over the manner in which market adjustments were made. The tendency to amalgamation rather than liquidation has been a characteristic of the Australian industry. Existing firms had a vested interest in supporting amalgamations. It was a method of increasing market share and the benefits associated with takeovers could be assumed to outweigh the risks in this highly concentrated market.[47] Amalgamation was also a popular trend in the British market. Less scrupulous company directors could use it as a method of avoiding embarrassing demands from creditors if the company was wound up.[48] There is little evidence to suggest that this was the case in the colonies. The experience of the bank crashes in 1893 highlighted the effect of a loss of public confidence in financial markets. The nature of selling life insurance was based on building consumer trust in the product and its providers. The larger firms were concerned to preserve market stability.[49] The liquidation of even a small society and the associated loss of policy

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[43]Surrenders increased from 8.9 per cent of premium income to 13.9 per cent between 1887 and 1892. AIBR, 1893, p.47.

[44] AIBR, 1893, p. 45.

[45]These were; the Post Office Mutual Life Society, the South Australian Mutual Life and the Federal Mutual Assurance Association, Gray, *Life Insurance,* pp. 106-7.

[46]Two later amalgamations, the Mutual Life Association of Australasia with the Citizens Assurance Co in 1907 (known as the MLC) and the Australian Widows Fund with the MLC in 1910 further reduced the number of life offices in the market.

[47]This was certainly the case with the National Mutual after the amalgamation of the Mutual Assurance Society of Victoria, AIBR 1898, p.35.

[48] *Victorian Parliamentary Debates,* 1872, pp.78-79.

[49] AIBR, 1893, p. 1115.

holder rights may have been enough to shake confidence in the industry as a whole, particularly in the economic climate of the 1890's.[50]

The second challenge to the efficacy of regulatory arrangements occurred in the 1920s with an influx of small, undercapitalised companies. In the first decades of the twentieth century the life insurance industry had continued to grow and expand. In 1900 there were eleven life insurance associations operating in the Australian colonies. By 1905 this had risen to twenty and remained at this level until the 1920's. Between 1920 and 1925 the number of firms had risen to thirty-five. All of these new companies were proprietary companies, and several were composite firms transacting other forms of insurance besides life. Not surprisingly many of these new firms were located in N.S.W. which had still not legislated to regulate life insurers. Of the twenty-three new companies which entered the market between 1920 and 1928, twenty were based in N.S.W.[51]

The gap between the top five insurance firms and the rest of the market continued to be substantial. The new entrants made little impact on the distribution of market share. In 1925 the top five firms in the industry accounted for eighty-two per cent of ordinary business and seventy-eight per cent of industrial business.[52] New companies were established either as a branch of an existing general insurance firm or as a new business through the issue of shares. The slice of the market available to new entrants was small, restricting their ability to generate premium income. In addition, new firms faced several other impediments which limited their ability to compete with established firms. Lack of adequate capital and the high cost of selling new policies were two such barriers to success. These firms faced a cost disadvantage in that the ratio of costs to income was higher for new firms. Much of the cost of selling life insurance was incurred in the sale of new policies. P. H. Morton estimated that the expenses attached to selling a

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[50]Confidence in the industry had been shaken in 1870 with the failure of the two British societies, *Victorian Parliamentary Debates,* 1872, pp.79-80.
[51] Gray, Life Insurance, pp.142
[52]These firms were; the AMP, National Mutual, Colonial Mutual, Mutual Life, and the Temperance and General. AIBR, 1927, p. 509.

new policy were about ten times those attached to renewals.[53] This obviously put new companies at a disadvantage especially if a large proportion of new policies were not renewed in following years.

The influx of new companies in the early 1920's had slowed by 1925 and was followed by exits and amalgamations by the end of the decade. Between 1922 and 1934, twenty-six companies had left the industry.[54] Gray estimated the average life of new entrants in the 1920's to be five years.[55] Certainly by the onset of the depression the industry had started to reorganise and the number of companies decline. In general, restructuring took place through the merger of companies or the transfer of business. This was an ongoing adjustment through the late 1920's and 1930's as companies with inadequate capital faced the reality of their position. Of the twenty six companies which ceased operation seventy per cent of their business was transferred to other firms in the industry.[56] Lack of consistent regulatory approach was made glaringly apparent in this period. In N.S.W., where most of the new entrants were located, there was no legal requirements imposed on the amalgamation or transfer of business. This led to some nefarious practices between firms. In some cases liabilities were transferred between companies without a corresponding transfer of assets. In other cases companies even received a payment for goodwill on the transference of liabilities.[57] In the other states the legal requirements in regard to amalgamations were very weak. The regulations in regard to amalgamation or the transfer of business was based on the British life insurance act of 1870. Essentially the Supreme Court in each state was able to approve the transfer of business if it was satisfied that there were no major objections by policy holders. If policy holders representing more than one fifth of the amount insured dissented then the amalgamation could not be approved. [58] The onus was on the policy holder to demonstrate why the

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[53] Morton, ' Life Assurance Companies in Australia', p.634.
[54] Life Insurance Commission *Report*, 1985.
[55] Gray *Life Insurance*, p. 146.
[56]Calculated from the Annual Report of the Life Insurance Commissioner 1985.
[57] Gray, *Life Insurance*, p.147; AIBR 1925, p.145; 1927, p.715.
[58] *Royal Commission Into Life Insurance*, 1910, Appendix F, p.160.

proposal should not be sanctioned. The 'freedom with disclosure' approach assumed policyholders could make informed decisions about the solvency of the company they dealt with. The Courts were not asked to assess the merits of the proposal but merely to ensure that policy holders did not object. [59] The case of the Co-operative Assurance Company illustrates the point. This company was formed in N.S.W. in 1911 but also traded in other states. In 1923 the company applied to have the transfer of its life and general insurance business to the Australian Provincial Assurance Association before going into voluntary liquidation. The Supreme Court in three state sanctioned the application. Under the agreement the Australian Provincial paid £10,000 to the Co-operative Assurance for business and goodwill. Policyholders were effectively transferred to the other company, however the funds accumulated from their contributions were retained by the liquidating company for distribution to shareholders.[60] The security of policy holder contracts was determine by the ability of the purchasing company to meet its liabilities. Existing regulation was totally ineffective in preventing this type of occurrence.

The deficiency in regulatory controls was of concern to established firms.[61] The need for Commonwealth legislation was a platform that was championed throughout the 1920s through venues such as the *Actuarial Society of Australasia* and in publications such as the *Australasian Insurance and Banking Record*.[62] Despite this lobbying, neither the federal or state governments responded to industry calls for a coherent approach. The lax regulatory environment was allowed to continue. One explanation for this may lie in the fact that the firms which left the industry during the 1920s and 1930s were relatively small in terms of market share and largely confined to one state, N.S.W. The number of policy holders affected by the failure of new companies was relatively few especially in the light of the fact that most exits occurred when firms either amalgamated or transferred

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[59] AIBR, 1927, p.506, 1930, p.67: Gray, Life Insurance, p.147.
[60] AIBR, 1925, p. 145.
[61] *Royal Commission Into Life Insurance*, Minutes of Evidence, Question 91.
[62] AIBR, 1928, p.502: AIBR 1923,p.556, 1928, p. 604,1929, p.67,1930, p.506.

their business. Seven firms were recorded as going into liquidation in the 1920s and 1930s. The majority of these companies however, sold very little life insurance in the immediate period before liquidation and as a result there was not a great outcry when they ceased to trade.[63] In the absence of the collapse of a large insurance firm there was little imperative for government to enact legislation. This tends to indicate that the trigger required to initiate a regulatory dialectic, such as that described by Kane, needs to be quite strong and have a powerful or lasting impact on the market involved.

To all intents and purposes the industry remained self regulating. Unlike the fire and general insurance industry there was no controlling organization such as the Fire Offices Committee in Britain or the Fire and Accident Underwriters Association in Australia. The Life Offices Association formed in 1903 acted as more of a political lobby group than trade organization which set rates and policy conditions. A study of life insurers in the 1950s found no historical evidence of any significant price fixing or market sharing agreements in the insurance industry[64] However, this does not imply that implicit arrangements did not exist. Westall argues that the existence of cartels or trade associations are not signs of monopoly power but rather the reverse. They are more likely to arise in markets that are 'weakly collusive' in which the larger firms do not have the market power to halt damaging conduct from competitors.[65] Following this line of argument, there is a case for suggesting that the life insurance market been 'strongly collusive', inferring that there was no need for the type of organization that governed rates and conditions in the fire and general insurance market.

Another explanation for the perpetuation of a lax regulatory environment could be attributed to the dominance of mutual life offices. Hansmann argues that there are two alternatives to dealing with market

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[63] The Victoria Life and General for example had sold no new policies since the 1890s and was working out its existing business before liquidation. AIBR 1928, p.635.
[64] Argy, An Economic Study of Life Assurance, Part 3 Ch.2, p.22
[65] Westall, *The Provincial Insurance Company* p.408.

failure in the life insurance business. The first is regulation and the second is the formation of mutual life insurers. The significance of mutual ownership was that it restricted opportunistic behaviour on the part of sellers. [66] The nature of life insurance means that the policy holder is locked into a contract and has little ability to influence the behaviour of the firm which operates to satisfy shareholder expectations. This creates the potential for conflict between the two interest groups. In a mutual, the absence of distinction between shareholders and policy holders reduces the potential for such conflict to occur.[67] It might be argued that the extent to which the mutual philosophy promoted the public interest provided similar outcome to government regulation in protecting consumer interests.

## THE ADVENT OF FEDERAL REGULATION

The loose regulatory regime continued throughout the inter war period. Although there were repeated calls and several planned attempts to introduce federal legislation it never eventuated. It was not until after the conclusion of the second world war that such legislation finally made it through the federal parliament.

The Australian financial sector in 1945 was relatively unsophisticated. Trading and savings bank comprised the largest share of assets, followed by life insurance companies and funds administered by trustee companies. The relative importance of life insurance offices in evident in Table 3.

[66] Hansmann, ' The Organization of Insurance Companies', p. 133
[67] Hansmann, ' The Organization of Insurance Companies', p. 133

Table 3: Assets of Australian Financial Institutions 1945

| Financial Institution | Assets $m |
|---|---|
| Trading Banks | 2,006 |
| Savings Banks | 1,209 |
| Life Insurance Offices | 615 |
| Funds Administered by Trustee Companies | 577 |
| Pastoral Finance Companies | 80 |
| Building Societies | 51 |
| Friendly Societies | 42 |
| Trustee Companies | 5 |

Source: Pope, *Australian Money and Banking Statistics*, p.11.

As the third largest group within the financial sector the significance of life insurance was not lost on legislators. Parliament was told that the life insurance industry was '…an integral part of the economy' and '…it is essential that it be on a stable basis.'[68]

Commonwealth life insurance legislation was passed only months after the Banking Act 1945. The inspiration for the introduction of life insurance legislation drew heavily on this influence and legislators certainly had the wording of the Banking Act in mind.[69] The motivation for government regulation of life insurance was to stabilise the industry in a similar manner to the way in which regulation was used to stabilise the banking sector.[70]

The life insurance bill was introduced into parliament at a time when the ruling Labor party was pursuing a platform of policy reform. As part of the preparation for the transition to a peace time economy the government initiated a plan for post war reconstruction. The White Paper on *Full Employment in Australia,* released in 1945 saw the formal acceptance of a Keynesian approach to economic management. This document presents a detailed view of the government plans for post war Australian society based on the assumption that, with the aid of government intervention, it

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[68] *Commonwealth Parliamentary Debates*, 1945, p.3979.
[69] *Commonwealth Parliamentary Debates*, 1945, p.3969.
[70] *Commonwealth Parliamentary Debates*, 1945, p.3979-82.

would be possible to achieve full employment, growth and rising living standards.[71] Whilst the Keynesian approach placed emphasis on achieving ultimate goals by influencing aggregate demand, the ruling Labor party was not convinced that this was sufficient. Cornish argues that in the 1940s the Australian Labor Party was convinced that the economy could not operate effectively without widespread public ownership or a system of direct controls.[72] Bank nationalization became official Labor party policy in the 1930s and was actively pursued in pursued in 1947.[73] It ultimately contributed to the electoral loss of government by the Labor party in 1949. It was in this climate that the Life Insurance Act 1945 was formulated. It was no coincidence that part of the proposed life insurance legislation included the provision for the establishment of a government insurance office. Modelled on the New Zealand and Queensland experience it was intended to compete directly not only with other life insurers but also in other insurance markets. Whilst it was not the intention of government to nationalise the industry as they attempted to do with the banking sector, the legislation was aimed at a perceived failure in the market. It was argued in Parliament, that the establishment of a government insurance office was the only way in which there could be an increase in life insurance business because the of costs and risks involved in establishing private ventures.[74] It was contended that the spirit of competition, resulting from the activities of a government insurer, would lead to a fall in administrative costs and also allow premium rates to fall.[75] A government run life insurance office was seen, not only as a way of increasing competition in the industry, it was also viewed as a means of stabilising the industry. Charles Morgan the Labor member of Reid argued,

> Just as provision has been made for the Commonwealth Bank to absorb or manage financial institutions that might become unstable, so a government insurance office could

[71] Johnson, *The Labor Legacy,* p. 21.
[72] Cornish, 'The Keynesian Revolution in Australia', p.60.
[73] Cournish, The Keynesian Revolution, p.60; Schedvin, *In Reserve,* 73-89.
[74] *Commonwealth Parliamentary Debates*, 1945, p.3980.
[75] *Commonwealth Parliamentary Debates*, 1945, p. 3981.

> control under similar conditions small and unstable insurance companies.[76]

Part VI of the Life Insurance Act made provision for the establishment of a life insurance office but it was never put into effect. The proposal was overtaken by events. The failed attempt to nationalise private banks in 1947 and the resulting High Court decision that such type of legislation was unconstitutional left the Labor government shaken. After its loss of office in 1949 it did not attain government again until 1972. Once again the Labor government made the attempt to introduce a government insurance office. Legislation to establish this office was defeated in the Senate in 1975. Shortly after, the double dissolution of Parliament and the resulting federal election saw the Labor party once again out of office.

The Life Insurance Act of 1945 reinforced the principle of 'freedom with disclosure' enshrined in the English Act of 1870 and the Victorian Act of 1873 with some modification. Life insurers were given the liberty to conduct their business within certain boundaries. The key concern of the Act was to put in place measures that would ensure the minimum standards of solvency were adhered to. It provided for the registration of life companies, the payment of a deposit and the separation of life insurance assets from other company business. It also set out the rights of policy holders in relation to their insurance contracts. The Act created the office of the Life Insurance Commissioner responsible for overseeing the stability and performance of the industry. The Commissioner was given the power to investigate the business and management of any life insurer and take measures to ensure that solvency standards were met. In effect the Life Insurance Commissioner became the overseer of the 'freedom with disclosure' principle.

The Commonwealth Act superseded all State legislation and introduced a standard code of conduct for the management of life insurance business throughout Australia. It was met with the in-principle support of major life insurance companies who welcomed the introduction of uniform regulation.[77] The objectives of the Act in respect to solvency requirements and policy holder rights were relatively modest. In fact, it was recognised at the time that many of the specified conditions for business were already

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[76] *Commonwealth Parliamentary Debates*, 1945, p. 3981.
[77] AIBR ,1945, p.335.

voluntarily in place amongst the larger and more established companies.[78] The significance of the Act lay in establishing a uniform regulatory environment across all States. This brought benefits to the major companies, all of which dealt with several differing sets of state regulations and reporting requirements. It also brought the state of N.S.W. into line with the rest of the country. Companies operating in that state now had to conform to the same set of standards as those in other states. The effect of this was to bring several small recently established firms under the scrutiny of the Life Insurance Commissioner. Three of these went into liquidation almost immediately and one had its business transferred to another insurance office.

The Life Insurance Act of 1945 remained in force with a few minor alterations for the next fifty years. In 1995 the Life Insurance Act was updated and a new approach to prudential supervision with more stringent requirements was introduced. To this date there had been only one serious challenge to the efficacy of regulatory provisions. This was the fraud committed against the policy holders of the Occidental Life Insurance Company of Australia Ltd. and the Regal Insurance Company Ltd. In 1990 these companies were sold to a shelf company and were then divested of funds.[79] The case highlighted a important flaw in control of statutory funds and contributed to the introduction of improved requirements. The significance of this event was in its timing. During this period the traditional ownership structure of Australian life insurers was under increasing strain as the impact of financial deregulation and increasing competitive pressures were felt.[80] The dominance of mutual institutions in the market was waning and most were embarking on the trail of demutualisation.

Up to this point regulation had been imposed on an industry which was to all intents and purposes self regulating. This fact was admitted as much in parliament during the debate on the Life Insurance Bill. In a letter to the Treasurer tabled in parliament from the Life Insurance Offices Association it was stated that the major life offices were prepared to give an undertaking that they would take over the business of any company unable

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[78] *Commonwealth Parliamentary Debates*, 1945, p.2147.
[79].In both cases the Life Insurance Commissioner was successful in ensuring policy holders received the full value of their policies. Insurance and Superannuation Commission, *Report,* 1997-98, p.108.
[80] Keneley, 'Demutualisation, pp.71-72.

to meet its liabilities.[81] In effect this practice had been occurring for a number of years. Although established life insurers had supported the concept of intervention in the past and had previously campaigned for federal legislation they were not active in lobbying at the time the 1945 legislation was introduced. Whilst there is little evidence to support the Stigler hypothesis that regulation is 'acquired' by industry and designed for its own gain, established life insurers did gain through its introduction. Aside from rationalising the difference in regulatory environments between the states, it ensured a greater degree of industry stability. The registration, deposit and reporting requirements introduced with the Act ensured that only those firms able to meet their liabilities could conduct life insurance business. It provided a framework under which the industry could grow in the period of economic expansion which accompanied post war reconstruction. It also contributed to the continuing high level of concentration in the industry and the consolidation of the market power of the major firms. A competitive challenge to established structure of the market did not occur until the late 1950s when an influx of British general insurers altered the status quo.[82]

This legislation was a manifestation of the government's commitment to broader policy objectives as reflected by their experience of wartime controls of major services and a commitment to a particular pattern of post war construction. Thomson and Abbott have argued of the banking sector, that the nature of government regulation was a reflection of the process of Kane's regulatory dialectic.[83] The approach to the banking regulation in the 1940s was influenced by the experience of depression of the 1930s and the growing support for macroeconomic management techniques.[84] The Life Insurance Act of 1945 was also a reflection of this regulatory cycle in that the issues of financial stability and macroeconomic management influenced the timing and approach taken to legislation. However it was a spill over effect. The conditions necessary to initiate the regulatory cycle were not apparent in the life insurance industry.

## CONCLUSION

[81] *Commonwealth Parliamentary Debates*, 1945: 3970.
[82].Keneley 'Adaptation and Change in the Life Insurance Industry'
[83] Thomson and Abbott, Banking Regulation, p.70.
[84] Schedvin, Regulating Commercial Banks, p.10; Thomson and Abbott, Banking Regulation, p.80.

The regulatory environment in which the Australian life insurance industry operates has its antecedents in the two major periods legislative intervention. The first occurring in the 1870s established the principle of 'freedom with disclosure' which has formed the basis of the regulatory approach since. The second in the 1940s refined the concept in the context of a general recognition of an interventionist approach to financial markets. In each case legislation was concerned to pre-empt problems associated with market failure rather than rectify them.

It was not until 1945 that the industry was covered by a single set of regulations. One explanation for why it took so long to achieve a consistent approach across all states was that the market dominated as it was by large mutual offices evolved its own self regulating mechanisms. The problems of prudential management and probity evident in other parts of the financial sector at various times did not manifest in the life insurance industry to the same extent. The bank failures of the 1890s permanently tarnished the reputation of the banking community.[85] Stemming from this grew a public perception that the banking sector should be regulated. Unlike banks, the life insurance industry, dominated as it was by the large mutuals was seen to have the communities interests at heart. From this perspective it could be argued that the strength of mutual firms resulted in performance outcomes which satisfied society's expectations. The not for profit basis of mutuals and their cooperative foundations provided a measure of market stability and consumer confidence that was lacking in the banking sector. It is significant that the first signs of weakness in the regulatory approach occurred at a time when the dominant mutual firms were under pressure and moving into a climate of structural change themselves.

The experience of intervention in the Australian life insurance market in the 1870s and again in the 1940s does not fit the usual theoretical explanations. Whilst the arguments of capture thesis provide some insights into the motives of regulators and regulatees it does not describe its historical development within the life insurance market.[86] Neither does the concept of a regulatory dialectic fully explain the advent of legislation. Kane's model however, does offers insights understanding the regulatory

[85] Schedvin, Australia and the Great Depression, p.80.
[86] Similar conclusions about the banking sector were made by Schedvin, Growth of Bank Regulation, p. 1.

approach adopted. The experience of the life insurance industry suggests that this may occur as a spill over effect from other sectors.

In forming legislation, regulators would appear to have been reacting to changing conditions in other markets, rather than the life insurance sector. This hypothesis is supported by both the approach and timing of legislative intervention.

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