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1 May 2013

Dear Mr Douglas

## FINANCIAL INDUSTRY SUPERVISORY LEVY METHODOLOGY

The Insurance Council of Australia (Insurance Council) welcomes the opportunity to comment on the Treasury's Discussion Paper "Financial Industry Supervisory Levy Methodology" (the Discussion Paper).

The design and operation of the Financial Institutions Supervisory Levy is important to the Insurance Council's members, both in terms of the levy's ability to fund effective supervision and also the levy as a significant business cost. Overall, we broadly support the methodology used in the calculation of the levy. However, we would like to reiterate our concerns about the inequitable outcomes which can result from the current treatment of reinsurance recoveries in the methodology. We also reaffirm the arguments made in previous submissions on the annual setting of the levy in favour of greater transparency relating to the costs and performance of supervisory agencies in their work in the general insurance sector.

**Reinsurance recoveries**

The Insurance Council is concerned with the inequitable outcomes which result from the current treatment of reinsurance recoveries in the levy methodology, as raised on three previous occasions with the Treasury (20 July 2012; 13 June 2012; and 26 Sept 2011). We look forward to these concerns being addressed in the current review.

As you are aware, several general insurers are a bearing disproportionate levy costs due to the way reinsurance is used to manage their catastrophe risk. As raised previously, total assets in general insurance increased from March 2010 to March 2011 by 13% for Direct Insurers and 35% for Reinsurers, mostly as a result of recoveries on catastrophic events.[1] The temporary inflation in assets led to an increase in the supervisory levy, which was unwarranted as it does not reflect any additional supervisory activities for regulators.

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[1] Particularly the first New Zealand earthquake (September 2010), Queensland floods and the second New Zealand earthquake (February 2011).

A large part of the $2.6 million over collected from industry in 2011-12 was attributable to the impact of reinsurance recoveries. Given the length of time that it takes to finalise reinsurance claims after an extraordinary catastrophe[2], the Insurance Council remains concerned that over/under recoveries in relation to reinsurance will continue over the coming years if left unaddressed.

While it is accurate as noted by the Discussion Paper[3] that when there is over collection of the levy there will be a proportional reduction in the levy for the next financial year, it is important to note that the result is inequitable. Funds over collected from specific insurers are not repaid to them but the reduction is spread across the entire sector.

The Insurance Council recommends that the Treasury amend the existing methodology to smooth the adverse impact borne by general insurers subject to reinsurance payments. Our preferred method is for the definition of asset used in the calculation (applying to all sectors in the financial industry) to exclude reinsurance recoveries relating to large loss events. The Insurance Council would be willing to undertake further work to determine the appropriate threshold for when a large loss event will trigger a reinsurance payment exclusion. This amendment will ensure that certain institutions do not pay significantly more for their regulatory supervision compared to their peers due to their use of reinsurance.

**Transparency in costs of supervisory activities**

The Insurance Council urges Treasury to ensure that greater transparency exists in how the total funding to be raised is calculated by regulators and also that the money is spent efficiently for the purposes for which it was raised. The money involved is not insignificant: in 2012-13 $266 million for the financial services industry as a whole and $22.3 million for general insurance.

Given that it is funding its own regulation, industry deserves to be able to understand the rationale for proposed supervisory activity. For example, the increased level of supervision which being experienced generally by members through a higher number of site visits and the growth in information requests from APRA stand in contrast both with the Australian general insurance industry's relatively benign experience of the Global Financial Crisis and the length of time since the height of the crisis.

The level of supervisory activity of course is a cost to industry, in terms of the levy raised to fund it and the time and resources a regulated entity must devote to dealing with supervisors. It is therefore beneficial not only to the financial services industry but also all Australians who use financial services if supervision is determined by what is necessary for regulators to fulfil their mandates. The forthcoming report from the Australian National Audit Office should be helpful in considering how greater transparency could be achieved.

This submission reflects the discussions which the Insurance Council has been able to have with members within the short period allowed to develop responses to the Discussion Paper. A consultation period of a little over three weeks was provided. This makes serious analysis difficult given the challenges of responding to other regulatory consultations and the need for

[2] Particularly in the case of the NZ Earthquakes where the uncertainty about future shocks has led to extended times to settle a large number of claims.

[3] Discussion Paper, page 8.

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members to meet the usual business demands on their time. The Government's Best Practice Regulation Handbook suggests that a consultation period of at least six weeks is appropriate[4]. While recognising that a decision will be necessary shortly on calculation of the levy for 2013-14, the Insurance Council urges Treasury not to bring the four yearly review of the levy methodology to a premature conclusion.

The Insurance Council and its members would have liked to explore alternative levy allocation models further, for example the benefits and drawbacks of allocation on the basis of net assets, Gross Weighted Premium, or regulatory capital. However, detailed review and modelling was not possible due to the consultation timeline. Moreover, it would have been helpful if the Discussion Paper had explored the basis on which regulatory costs were allocated amongst industry members in other jurisdictions.

Please see Attachment for specific responses to the questions raised in the Discussion Paper.

If you require further information in relation to this submission, please contact Mr John Anning, Insurance Council's General Manager Policy – Regulation Directorate at janning@insurancecouncil.com.au.

Yours sincerely

Robert Whelan
Executive Director & CEO

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[4] Best Practice Regulation Handbook Appendix C, p57, C45.

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ATTACHMENT

**RESPONSE TO SPECIFIC CONSULTATION ISSUES:**

**6.1 'Is the current setting for restricted (supervisory) and unrestricted (systemic) levy amounts appropriate? Are the current minimum and maximum restricted levy parameters appropriate?**
The Insurance Council supports the supports the current split between restricted and unrestricted levy amounts to apportion the 'cost of supervision' from the 'system impact'. We recognise that the minimum and maximum levy parameters seek to strike a balance between the recovered cost and the time spent by APRA on its supervisory activities. The Insurance Council supports the conclusion of the 2008-09 review of the financial supervisory levy that statutory upper limits should increase annually in line with the indexation factors outlined in the imposition Acts.

**6.2 Is the current levy base appropriate for each industry sector?**
Overall, the Insurance Council is supportive of the current levy base for the general insurance sector. However, the Insurance Council has a specific concern that the use of unadjusted gross asset totals can lead to reinsurance recoveries inappropriately inflating the levy share of general insurers affected by unusually large catastrophic events. We discuss this point further under question 6.5.

It is difficult for members to manage the implications for their budget of an unexpected increase in their levy contributions beyond their previous contribution adjusted for inflation. The Insurance Council therefore submits that where supervisory costs justifiably increase faster than the general level of inflation in the economy, the difference above the previous sector total should be funded from the general budget.

**6.3 Is the levy structure appropriate for regulated institutions within conglomerates?**
After discussion with its members, the Insurance Council is sympathetic to the view that the extent to which APRA supervision of Level 3 groups present more complex regulatory challenges for APRA are counterbalanced by synergies which reduce the supervisory burden. Similar considerations apply to Level 2 groups. It appears therefore that there is no need for Level 2 and 3 groups to bear a greater share of the responsibility for the levy.

In relation to Level 3 groups in particular, the Insurance Council submits that it is premature to reach a conclusion on this question. This is because APRA is consulting throughout 2013 on elements of its framework for the supervision of these conglomerate groups, with the full prudential framework for Level 3 groups to be implemented from 2014. Postponing consideration of this question until finalisation of the Level 3 regulatory regime would enable informed decisions to be made on whether Level 3 institutions require greater or less supervision.

**6.4. Does the current levy methodology provide adequate transparency and is it appropriate for the industry sub-sectors?**
As explained above, the Insurance Council is generally comfortable with the calculations used in the methodology for the allocation of costs. However, we would like to see greater detail and transparency on costs and performance in relation to the supervisory activities in the general insurance sector (the costs totalled $22.3 million in 2012-13). This would enable

the closer scrutiny by industry on the efficiency and efficacy of supervisory activities and incentivise greater value for money.

The annual consultation on the financial industry levy for the forthcoming financial year does disclose levy contributions for each sector. However, the figures tend to be high level and do not specify the amounts to be spent on regulators' specific supervisory functions. Further, financial reports and Cost Recovery Impact Statements do not disclose supervisory expenditure detail to a sufficient level to determine efficient service delivery. We look forward to the release of the Australian National Audit Office's (ANAO) performance audit relating to APRA's supervisory levy. We would expect that any findings or recommendations to improve transparency be closely considered.

Given that it is funding its own regulation, industry deserves to be able to understand the rationale for proposed supervisory activity. For example, the increased level of supervision which appears to be experienced generally through a higher number of site visits and the growth in information requests from APRA stands in contrast both with the Australian general insurance industry's relatively benign experience of the Global Financial Crisis and the length of time since the height of the crisis.

The level of supervisory activity of course is a cost to industry, in terms of the levy raised to fund it and the time and resources a regulated entity must devote to dealing with supervisors. It is therefore beneficial not only to the financial services industry but also all Australians who use financial services if supervision is determined by what is strictly necessary for regulators to fulfil their mandates.

**6.5 Should the current levy methodology take into account reinsurance recoveries and the resultant impact on the levy calculation [Based on Asset Value] for general insurers?**

Reinsurance recoveries and their impact on levy allocation for particular general insurers is a key concern for our members. A number of our members received unusually high reinsurance recoveries as a consequence of the extraordinary natural catastrophes of 2010-11.[5] This temporarily inflated their asset base, and increased their levy contribution above that which reflects the supervisory work that APRA performs in relation to them. Total assets in general insurance increased from March 2010 to March 2011 by 13% for Direct Insurers and 35% for Reinsurers primarily as the result of reinsurance recoveries. The Insurance Council considers this cost to be disproportionate to the amount of supervision these institutions receive.

The Insurance Council requested Treasury to adjust the Levy calculation for 2012-13 so that reinsurance over collections related to 2010-11 were returned to insurers. An amount of $2.6 million was over collected from general insurance industry in 2011-12 with a large part of this attributable to the impact of the reinsurance recoveries, according to our member feedback. After consultation with APRA, Treasury declined to make any adjustments, preferring to consider the issue as part of this methodology review. The Insurance Council remains concerned that the over/under recoveries in relation to reinsurance will continue in future years if unaddressed.

[5] New Zealand earthquake (September 2010), Brisbane Floods and the second New Zealand earthquake (February 2011).

The Insurance Council submits that Treasury should adjust the existing methodology so that general insurers are not inadvertently penalised for using reinsurance to manage the impact of catastrophic events. Accordingly, the Insurance Council recommends that the regulatory asset base for general insurers be:

- Gross assets minus reinsurance recoveries relating to large loss events.

This would ensure that reinsurance recoveries do not temporarily inflate the gross assets total of some insurers.

The Insurance Council considers that it may be appropriate to apply a threshold, whereby only reinsurance liabilities above a percentage of net assets would be deducted from the calculation of gross assets. It is normal for insurance companies to have a proportion of their assets as reinsurance liabilities. However, the problem arises following large catastrophic events, as we have seen in recent years with some members having reinsurance recoveries making a significantly inflated proportion of their assets. The Insurance Council would be willing to undertake further work to determine the appropriate threshold.

**6.6 Is the current levy methodology appropriate for *Pooled Superannuation Trust?***
Not applicable to our members.