

Submission to Financial System Inquiry Interim Report

August 2014

Introduction & overview

The strength of the Financial System Inquiry (FSI) Interim Report is its clear recognition that general insurance (GI) is fundamentally distinct in its business model from banking and other sectors of the financial system. The ICA welcomes this understanding and believes it should set the direction for policy making into the future. Due to the absence of liquidity risk, GI institutions pose limited threats to financial stability and the risk of contagion – a matter that has occupied the attention of regulators, in particular international regulators, post the global financial crisis. As such, the regulatory settings for GI can be developed in a manner that is clearly distinguishable from those that may apply to banking and other financial services. The ICA contends that recognition of this distinction should set the direction for the FSI and policy makers to consider and develop GI policy and regulatory settings in their own explicit terms unburdening the GI sector from regulatory arrangements designed for other sectors yet misapplied for general insurance.

In other respects, the FSI Interim Report represents a subtle, albeit significant shift, in the understanding of financial services issues post Wallis. While Wallis examined the macro institutional environment that would strengthen the financial promise, the FSI interim report tackles some of the more micro considerations associated with promise making, such as information asymmetry (for instance, the task of estimation between the parties), problems associated with agency (including how to arrive at “better” advice and addressing consumer biases) and the role of technology in facilitating and distributing financial promises. As Wallis looked to improve and strengthen institutional arrangements to enable stronger financial promises (thereby facilitating intermediation), the FSI could be said to be targeting the micro matters that serve to improve efficiency in the *exchange* of financial promises. In contrast to Wallis, which focussed on *institutional* regulatory reform, the FSI asks what, if any, *non institutional* interventions can be applied to financial markets that improve financial decision making.

As mentioned above, this represents a subtle but important development for GI. This approach by the FSI reinforces the scope for GI to be evaluated within the terms of its own unique offer. Importantly, the FSI framework supports recognition that general insurance markets *are* well advanced and the industry has in place many long standing practices and approaches designed to address the challenges outlined in the FSI interim report. These approaches were outlined in the ICA’s first round submission. Nevertheless, the FSI does raise a number of important issues for consideration by the sector and stakeholders more broadly. The ICA submission is primarily focussed on these matters including consideration as to whether direct policy intervention is required to address the observations made.

Given the importance of GI in the economy the ICA suggests the FSI could give further consideration to the development of a framework for GI to establish an understanding of how future policy makers should observe risk across the wider economy and society. Most importantly how insurable risk can be extended to relieve pressures on individuals and the government. This concept was given considerable attention in the original submission of the ICA. The ICA suggests this is an important aspect of the effective operation of financial systems and fundamental to understanding the role insurance markets play in managing risk and how market and regulatory settings should develop to accommodate the efficient bearing of insurable risk. The ICA considers that many of the GI issues given airing in the Interim Report should also be examined in the context of how insurable risk is allocated across society. This includes such issues such as non insurance, affordability, risk pricing and technology. This is particularly so given the FSI terms of reference makes mention of the need to refresh the principles under which financial risk is allocated. The ICA suggests the framework outlined in its original submissions bears further attention.

Consumer outcomes

Under insurance

The FSI interim report outlines a number of the key considerations when assessing the extent and impact of underinsurance in the community. As the FSI suggests, the issue of non insurance manifests itself largely following total loss events which typically follow catastrophes. In these circumstances, factors exogenous to the insurance process, such as post event claims inflation and changes to building and planning codes quite often result in insurance coverage “gaps”.

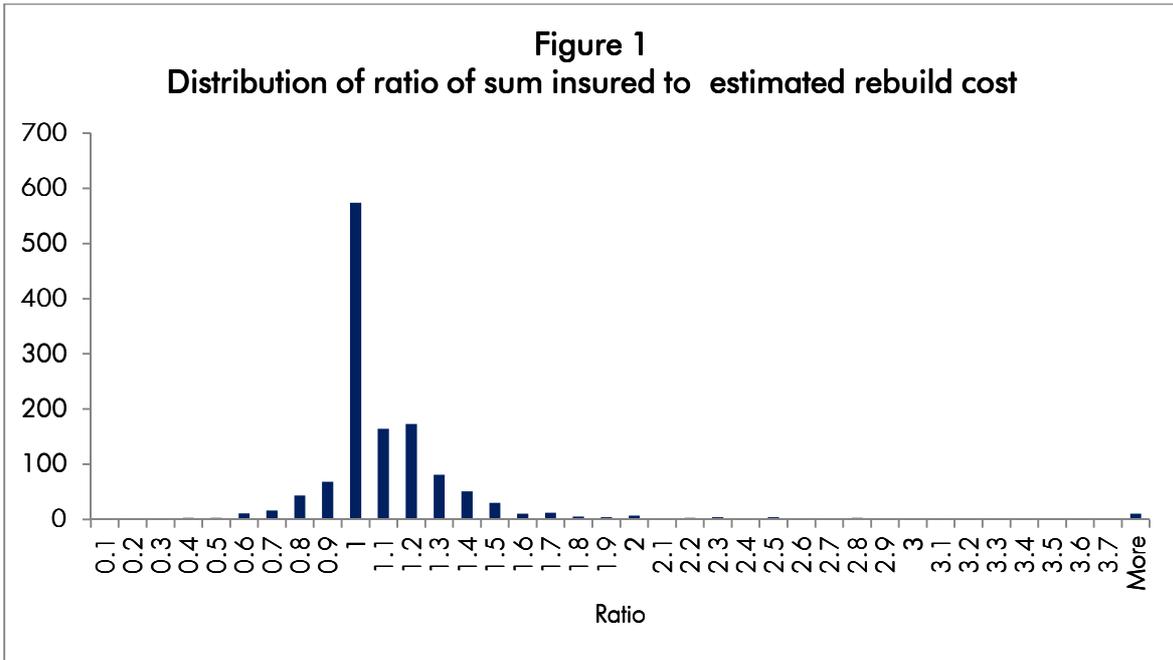
Typically, Australian home and contents policies are capped replacement covers, although some uncapped replacement covers (colloquially known as total replacement policies) exist in the marketplace. In recognition of the impact of such exogenous “shocks”, the general insurance market has developed targeted instruments and tools that address estimation risk, for instance providing “uplift” factors to sums insured (“top up” covers); indexation or inflation adjustments to sums insured and technological tools designed to assist consumers “frame” their sums insured (such as comparative information on neighbouring sums insured). In many ways, these market innovations represent the very essence of “nudges” designed to address some of the common biases identified by behavioural economists that would erode sums insured due to inertia or inaction on the part of the householder.

Understandably however, the FSI questions whether the insurance market based tools identified above are sufficient to tackle the residual underinsurance problem and from that, with stakeholder submissions and anecdotal evidence provided to the FSI, whether underinsurance is significant enough to merit more explicit policy/regulatory intervention. The ICA contends that although community concerns and anecdotal evidence of underinsurance inevitably arise following total loss catastrophe events (typically fire related events) the evidence of a manifest problem (or rather, an issue sufficient to warrant direct intervention) has not been adequately made. Moreover, as the FSI itself concedes, estimating the extent of under insurance *ex ante* remains a problem for policy makers and accordingly, policy makers should be cautious in recommending regulatory action in the absence of clear empirical evidence.

A holistic picture of under insurance is difficult to ascertain. In a 2010 household survey¹ of 2,156 participants drawn across the states of NSW, Queensland, Victoria & WA² conducted by the ICA, households were asked to *estimate* the cost of rebuilding their home to an equivalent standard with this estimate assessed against the *actual*/sum insured for the home insurance policy. The intention behind the survey was to assess *ex ante*, whether households believed they were adequately insured for their circumstances. The survey was conducted using an online questionnaire with survey participants having access to their actual home insurance policies for their principal place of residence. The survey indicated that, *ex ante* of a total loss event, the majority of households believed they had purchased adequate levels of cover to accommodate the complete rebuild of their home. This is shown in figure 1 below where the modal ratio value is 1 and the distribution is positively skewed.

¹ The internet based survey was of owner occupiers in their principle place of residence with responsibility for insurance purchasing decisions. The survey was conducted in May/June 2010 by Roy Morgan Research on behalf of the ICA.

² Households were selected from both metropolitan and regional areas of NSW, Victoria, Queensland and Western Australia.



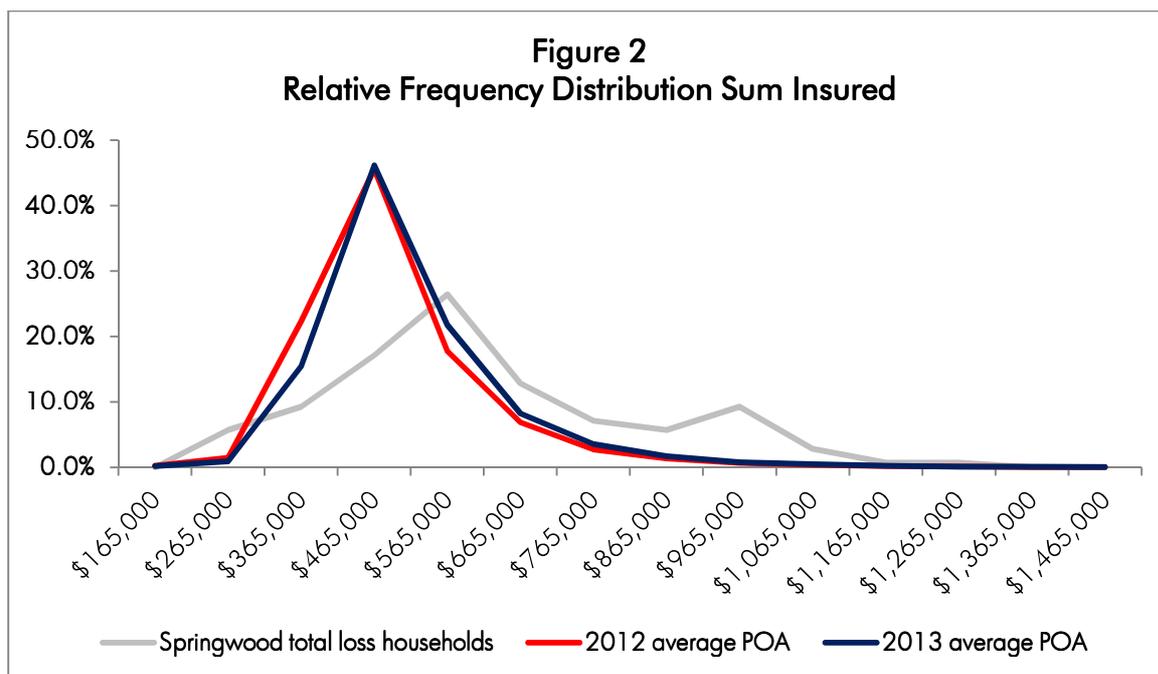
Source: Insurance Council of Australia from Roy Morgan Survey 2010

As mentioned, the ability to measure under insurance *ex post* is severely constrained by the extent to which information on final rebuild costs are available to allow comparisons between sums insured and any final cost of a rebuild. Nevertheless, data captured as part of the recent bushfire event in the NSW Blue Mountains in 2013 assists in providing some insight into the extent in which households that suffered total losses were adequately insured vis a vis the total Australian population.

Of the 190 households that suffered a total loss in the 2013 Blue Mountains bushfires, some 18 households had building only insurance with an average sum insured of \$551,079, some 122 households had both building and contents insurance with an average sum insured of \$596,491 and some 19 households had total replacement policies.³ Comparing the sums insured distribution of the Blue Mountain’s total loss households against those of the total Australian population suggests that the Blue Mountains households had sums insured greater than that of the total Australian population.

A comparison of the sums insured distributions is shown in figure 2.

³ The remaining households were unable to identify described as “unknown” their insurance policy.



Notes: POA denotes Post Office Area

Source: Insurance Council of Australia

As submissions to the FSI have expressed, concerns over underinsurance present themselves following a significant catastrophe when households and business suffer total losses. Yet the number of insurance claims that arise from total loss events represents a marginal component of all insurance claims. As such, caution needs to be exercised when considering the scope for any regulatory intervention designed to address residual under insurance but which may ultimately disrupt efficient insurance markets. The ICA is aware of proposals that would seek to mandate total replacement policies (in other words, regulating for uncapped total liability policies in the Australian home and contents market) thereby transferring the *estimation* risk of post event rebuilding and construction cost to the insurer. The ICA contends that the second round effects of such interventions would have a major impact on general insurance markets. The evidence for this can be seen from the experience of New Zealand insurance markets post the Christchurch earthquake.

As the recent New Zealand experience has demonstrated, upon a large scale event, total replacement policies have knock on effects on reinsurance arrangements, impacting both future pool pricing and solvency. The lesson for Australia is that while superficially attractive, the medium to long term effects of measures that mandate total replacement may be to reduce medium to longer term insurance uptake as reinsurance arrangements adjust to the absence of limitations inevitably flowing through to retail pricing and potential crowding out cover. Although community concerns on under insurance are valid, existing market tools that assist in minimising estimation risk (such as sums insured indexation, up lift cover etc) remain appropriate given that any efficiency trade off associated with more interventionist considerations would significantly disturb GI markets. In addition, recognising the need to inform and resource consumers with tools that assist in better understanding their insurance needs, the industry has applied itself to financial literacy initiatives in general insurance including the establishment of a web based tool on general insurance⁴ and participation in financial literacy programs and initiatives.

⁴ See for example, www.understandinsurance.com.au

Risk based pricing & technology

The Interim Report has raised poignant questions as to the role of risk based pricing and the role that technology is playing in facilitating this trend in insurance markets. As the original ICA submission outlined, risk based pricing is providing relief and access for significant consumer segments. However as the FSI contends, technology can also result in additional costs for some consumers particularly for those in high risk zones absent of suitable mitigation.

In the broader economy, risk based pricing is integral in ensuring that resources are allocated efficiently and that behaviours are adjusted in response to the price signal. In the case of natural peril risk, risk based pricing motivates land use managers and owners to adjust planning and development arrangements to mitigate against future risk and thereby reduce the overall cost of natural disaster perils. Risk based pricing in personal injury provides the basis under which firms and households adjust their practices to limit injury and the overall social cost of disability and injury.

Nevertheless, the ICA acknowledges that the introduction of risk based pricing is gaining pace with the advent of technological improvements and this is resulting in the trade off between risk and mitigation becoming more acutely apparent to businesses and households. This is particularly the case for those households and firms afflicted with legacy planning issues and predictable peril risks. The ICA also acknowledges that for some insurable risks, such as social risks in motor injury and workers compensation, society has determined for social policy reasons that measures be undertaken to smooth risk based pricing to assist accessibility.

The ICA contends that the process to assist households and firms with managing price shocks from risk based pricing is not through adjustments to GI policy and regulatory settings. To the contrary, the appropriate manner in which insurer consumers can be assisted is through stronger partnerships and processes in mitigating insurable risk and through measures that assist consumers adapt to their circumstances. This approach is consistent with existing policy and industry initiatives including the partnerships that the industry is developing with local government and land use managers to better understand the linkages between mitigation and insurable risk.⁵

Disclosure in general insurance

The ICA notes that several submissions to the FSI raised concerns with the existing disclosure regime and in some cases, suggested that the current disclosure arrangements had reached their useful limits.⁶ The ICA also notes that since the Wallis review, developments in behavioural economics and finance have pointed to a range of consumer biases that lead individuals to depart from the purely “rational” behaviours that provide the foundation of market economics and therein, the bedrock philosophy of the current disclosure regime. This research and understanding has subsequently invited policy makers and regulators to reassess the effectiveness of disclosure arrangements encouraging several of the proposals evident in the FSI interim report, such as layered disclosure and greater risk profile disclosure, as potential policy instruments.

Although acknowledging current disclosure arrangements have limitations, the absence of a coherent philosophical framework that would replace the current disclosure settings has yet to be adequately advanced. In several respects, stakeholder proposals/measures on disclosure, some of which are outlined in the FSI, represent a mere *extension* of disclosure obligations to a further point *beyond* the current perimeter and to the contrary, are not a fundamental departure from the philosophical framework of today. Proposals for change in the FSI interim report suggest that the current disclosure regime is necessary but *insufficient* and that far from the need to start afresh on disclosure, the measures presented in the FSI entail further *additions* to the current regime. The challenge for policy makers in these circumstances is that embracing critiques of

⁵ See ICA submission to the Productivity Commission Review of Natural Disaster Funding Arrangements (June 2014)

⁶ See Treasury and ASIC submissions to the first round of FSI consultations

disclosure in the absence of a clear philosophical alternative can lead to further fragmentation and ad hoc measures, with the resultant impacts on regulatory cost and system wide efficiency.

Nevertheless, and as mentioned previously, the objective in the FSI to examine the micro elements of promise making provides scope to address financial disclosure issues. In particular, notwithstanding the obvious goal that a system wide approach to disclosure is preferred, flexibility needs to be retained so as to recognise that not all financial service products are alike and at a fundamental level, they vary in terms of their risk to the consumer when purchased. The risk to a consumer from the purchase of a GI product is clearly lesser than for a complex financial product and to emphasise the differences further, the risk of consumer losses largely apply in the *absence* of a general insurance product purchase (especially in the property and personal injury liabilities). Further, general insurance products are a long standing, well understood product characterised by their customariness and commonplaceness. Regulatory (for example, prudential and statutory) and self regulatory settings (such as the General Insurance Code of Practice) add to the wide protections available to consumers when purchasing general insurance products contrasting them sharply from other financial services sold at the retail level. It could also be argued that the *Insurance Contracts Act 1984*, particularly its Standard Cover provisions, represents an early experiment with the consumer “nudges” later associated with behavioural economics.

This theoretical understanding of disclosure in GI is supported by empirical research. In the aforementioned 2010 Roy Morgan study, 40% of respondents indicated that they read an insurer PDS prior to purchase of a policy, with only 23% suggesting they do not read the PDS at all. Furthermore, highlighting the importance of the PDS to their purchase decision, respondents observed that reading a PDS was considered more important in circumstances when the insurance company was less well known to them or when they had plans to switch insurers.⁷

Additional quantitative and qualitative research by the ICA into the product information needs of consumers in the home and motor markets ⁸ indicated that over 50% of consumers surveyed had referred to a PDS *prior* to purchasing an insurance policy. The number of consumers having referred to a PDS following the purchase of a policy increased to nearly 70%, suggesting that a significant proportion of consumers do utilise PDSs for their product information needs. Over 50% of consumers indicated that they found PDSs very easy or somewhat easy to understand while only a very small proportion of consumers (less than 5%) found PDSs very difficult to understand. The research, which indicated that consumers use a range of information sources in making product choices with 58% of consumers indicating that insurers’ websites were the most important source of information in their decision on which insurer to choose.

Given the above, the ICA suggests that the FSI should be cautious in setting a financial disclosure framework on a one size fits all basis and without reference to a set of over arching principles. Preferably any future disclosure framework would be adaptable enough to accommodate judicious application of behavioural insights but that would also be cognisant of those financial products that offer little potential harm to consumers. The ICA contends that a flexible, principles based disclosure framework that facilitates better choices would represent a more useful progression in disclosure than arriving at a set of fixed policy solutions. The ICA and its members would be willing to lead a targeted project examining directly how disclosure documents in GI could be improved or supplemented to achieve better consumer outcomes at the lowest regulatory cost.

Advice

The ICA concurs with the observations made in the Interim Report that it would be beneficial to reconsider how some activities currently seen as general advice are regulated. Consequently, we support a thorough examination of the option posed in the Report to rename general advice as ‘sales’ or ‘product information’.

⁷ Source Roy Morgan Research

⁸ The research was conducted between July and September 2010.

We suggest that any such examination should be guided by an overriding objective of ensuring that consumers are able to obtain the information they need to make a well considered decision in the simplest and most accessible manner. The experience of our members as general insurers is that the current regulatory framework unnecessarily constrains the ability of licensees to provide simple product information.

The current personal advice regime requires that a complex needs analysis be undertaken and that any recommendations be comprehensively documented, even though Statements of Advice are not required for most general insurance products. This expensive and time consuming process, which makes sense for investment products, seems overly cumbersome for general insurance. Consequently, the majority of general insurance is sold on a 'no advice' business model, or where advice is provided, care is taken that it falls within the less onerous definition of 'general advice'.

Inevitably, the focus of training for employees and agents is on phrasing information so as to allow them to remain within the definition of the advice model they are operating under, rather than on delivering information that is of the most assistance to the customer's inquiry.

Where, prior to introduction of the current FSR regime, simple insurance products could be offered with some basic advice around product information and needs, the legal requirements now attached to the provision of advice, personal or general, have resulted in the consumer being provided with limited or no advice at all. The ICA considers that this lack of simple product advice has hindered consumers in choosing policies with cover suited to the risks they face.

Consumer compensation and professional indemnity insurance

The ICA recognises the limitation of consumer compensation arrangements as evidenced by the level of unpaid Financial Ombudsman Service (FOS) determinations. While we support a solution being sought to this problem, the ICA considers that the analysis for the need of a last resort scheme has been appropriately addressed by the 2012 Report by Richard St John, 'Compensation arrangements for consumers of financial services' (St John Report). The St John report made a number of important recommendations that the FSI should take into account. In particular, we agree with the St John Report's conclusion that a last resort scheme for compensation cannot currently be justified and that further rigour should first be introduced into the current regulatory regime to ensure Australian Financial Services (AFS) licensees are held responsible for holding current and adequate professional indemnity (PI) insurance cover.

The ICA considers a last resort scheme would not address the underlying problems and would compel responsibly managed AFS licensees to cover the cost of bailing out the obligations of failed licensees. Any solution must be proportionate to the size of the problem. In this regard, the ICA notes that the amount of outstanding FOS determinations of \$10.2 million between 1 January 2010 and 30 June 2014 is relatively small in the context of the size of overall industry and that these unpaid determinations relate to only 22 of FOS's 4,900 AFS licensee members.

A key question that the FSI should consider is who should bear the risk of consumer loss, which could be placed on a range of parties namely the product issuer, financial advisor (or professional indemnity insurer), government or consumer. The FSI should also keep in mind that the primary purpose of PI insurance is to protect the financial wellbeing of the professional (in this case the financial advisor) providing the service or advice, and is priced according. To most efficiently allocate risk, the ICA argues that it should be allocated to the parties best placed to manage it, which in this instance include both the product issuer and financial advisor.

The ICA supports Recommendation 3.2 of the St John Report, which states that some rebalancing of responsibilities of product issuers and financial advisors towards retail client could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct amongst those AFS licensees involved. The ICA understands that FOS considers

that its current Terms of Reference do allow for this already but the ICA suggests that this should be made explicit.

The ICA notes that allocation by FOS of responsibility has fallen heavily on financial advisors, supported by their PI requirements. This does not take into account the role of the product issuer who has the greatest proximity to the product and therefore likely to be a determinant of the potential harm and associated risk. As a result, we recognise a limitation of external dispute resolution (EDR) schemes to apportion responsibility for misconduct. A more equitable allocation by FOS of responsibility to compensate for investor losses as between financial advisers and product issuers should result in financial advisers bearing less of a burden for financial compensation. This would facilitate a reconsideration of PI insurers of their willingness to offer cover to financial planners and at what premium.

In order to improve consumer outcomes, the ICA recommends that ASIC monitor AFS licensees more closely to ensure that PI insurance cover is current and is appropriate for their business needs. We understand that, after an AFS licence is issued, ASIC currently rarely checks the adequacy of PI arrangements. The ICA also suggests that it would be useful for the FSI to consider whether financial planning AFS licensees should maintain a certain level of capital to ensure that can meet liabilities which may arise after they cease to trade.

Competition outcomes

The role of price comparison tools in the general insurance sector

The FSI indicates few submissions raised issues with the extent of competition in the general insurance sector concluding that despite evidence of concentration, the general insurance market is contestable with new entrants and multiple brands providing a competitive injection to market participants. The conclusion of the FSI is consistent with recent research prepared by Finity/Deutsche Bank which suggests that competition in personal lines is growing, with challenger brands and those of the major banks estimated to have a 16% market share currently, up from an estimated share of 10% three years ago.⁹ The FSI also observes that, where they exist, barriers to entry for the GI sector are largely commercial (as opposed to regulatory) and that incumbent advantages tend to arise from well established brands; existing customer bases/loyalty programs and the availability of distribution networks. Again, this conclusion is consistent with ICA customer research that suggests customer switching in GI is low with 80% of households retaining cover with their existing insurance provider in the last two years and that brand and reputation and value of cover for risk representing the two principal factors in choosing an insurance provider.¹⁰

Notwithstanding the observation that the GI market is competitive, the FSI speculates on the merits of facilitating an enhanced role for price comparison web sites (PCW's) or aggregators in strengthening competition. Further the FSI raises the complimentary question as to the merits of regulatory intervention to *support* development in PCW's.

Although the case for PCW's as a means to drive greater competition and transparency in GI services has been raised by stakeholders¹¹, the *facilitated* development of PCW's through explicit government intervention would represent a significant enlargement of policy in this area. The ICA notes that the FSI has received submissions from stakeholders suggesting that PCW's should have regulatory access to insurance product information and further, that policy makers should consider whether there is a case for government "creation"

⁹ See Finity/Deutsche Bank; "Industry Pendulum" (25 July 2014) at page 3.

¹⁰ The internet based survey was of owner occupiers in their principle place of residence with responsibility for insurance purchasing decisions. The survey was conducted in May/June 2010 by Roy Morgan Research on behalf of the ICA.

¹¹ See for example, The Victorian Fire Services Levy Monitor "Enhancing the consumer experience of home insurance: Shining the light into the black box" (July 2014)

of price comparison websites.¹² The ICA contends that irrespective of the market virtues of price comparison web sites, the case for either regulatory intervention to *facilitate* PCW development or even government *ownership* of these tools is misplaced. The ICA submits that active interventions on both fronts represent a form of “infant industry” defence for PCW’s not afforded to other forms of intermediation. Overseas experience in such technological platforms firmly suggests that PCW’s have the capacity to grow and develop of their own accord and without clear government assistance. Further, the experience of policy makers with equivalent price comparison sites in other markets (for example in grocery and petrol) clearly suggests that these instruments are best left for the private market to adopt.

When considering the future of PCW’s in general insurance, the FSI would be well placed to draw conclusions of the experience of price comparison web sites in general insurance from recent research and work undertaken in the United Kingdom. The UK Financial Conduct Authority (FCA) thematic review into PCW’s¹³ concluded that such sites have increased in popularity markedly and that technology has clearly expedited this process. The FCA review observed that PCW’s provide consumer choice and reduce the transaction cost of search for consumers although the FCA also observed that without appropriate regulation, particularly around measures to address agency issues (such as ranking regimes, supplier arrangements, distribution and third party commissions etc), the clear risk is that consumers may be dissuaded from purchasing the appropriate product and at worse may be misled. The FCA review settled upon measures – both regulatory and self governing – designed to ensure that PCW’s reform their practices to ensure positive consumer outcomes.

The approach of the UK FCA is consistent with the approach adopted by the European Insurance and Occupational Pensions Authority (EIOPA)¹⁴ where EIOPA acknowledged that comparison web sites are expected to be an increasing source of information on insurance products. EIOPA usefully distinguished between commercial PWC’s which are remunerated in some fashion and non commercial PCW’s that collect information for users without a profit making purpose. (The long standing PCW for motor CTP policies in NSW operated by the Motor Accidents Authority is a case of the latter). After substantial consultation with member agencies/nations, EIOPA derived a set of broad principles for national regulators to apply in managing the risks observed with PCW’s such as over reliance on price, management of conflicts of interest and disclosure.

The UK Competition & Markets Authority has also observed practices with PCW’s particularly as they relate to competitive practices in the private motor insurance market. The Authority has observed that in some cases, contracts between PCW’s and insurers contain measures that limited price comparison, reduced innovation and restricted entry. The Authority has also indicated that PCW’s exercised a degree of market power through single homing arrangements and/or “most favoured nation” (MFN) clauses resulting in consumers paying higher motor insurance premiums.¹⁵

The UK and European experience with PCW’s helps to steer the relevant pathway for domestic policy makers as they assess how they to regulate PWC’s in the Australian insurance market. Regrettably however, stakeholders have tended to recommend PCW’s as a panacea to particular general insurance market conditions with respect to pricing and access, without appropriate regard to the lessons to be learnt from the long lived UK/European experience. Also it is clear from this experience of the need to ensure the appropriate regulatory settings for the operation of PCW’s are in place to address the fundamental agency issues identified.

The challenge in developing policy settings for PCW’s in GI is reconciling the objective of consumer sovereignty with consumer protection needs, particularly in the face of agency issues. As virtual

¹² This is also the subject of the Treasury Discussion Paper.

¹³ See UK Financial Conduct Authority “*Price comparison websites in the general insurance sector*” (July, 2014); Atticus Research “*Price Comparison website: Consumer market research. Prepared for the Financial Conduct Authority*” (June 2014)

¹⁴ See European Insurance and Occupational Pensions Authority “*Report on Good Practices on Comparison Websites*” (January, 2014)

¹⁵ See UK Competition & Market Authority “*Private Motor Insurance Market Investigation*”

intermediaries, it is worthy of reminder that PCW's experience the same agency and potential conflict issues that characterise "non virtual" intermediaries in financial services. In order to circumvent the risks associated with agency, conflicts and conduct in the selling or distribution of financial products, Australian regulatory settings have developed well settled arrangements for the licensing of financial services participants. The ICA contends that irrespective of how a product is distributed or marketed (that is, whether in the real or virtual world) distributors should have equally applied to them this regulatory and supervisory framework. In this regard, the challenge for policy makers is not one of whether regulation *should* promote PCW's (which should remain the prerogative of the market) but rather, the regulations under which PCW's themselves are promoted.

Competition in statutory schemes

The ICA notes the FSI Interim Report observations on state and territory based statutory insurance schemes. The Interim Report notes that submissions argue that consumer value could be improved by introducing competition from the private sector. The specific question posed by the FSI is whether opening up state and territory insurance schemes to competition improve value for consumers.

On 10 June 2014, the ICA made a submission to the Competition Policy Review.

This submission noted the following matters:

- The ongoing existence of government monopolies in workers compensation, and personal injury motor accident insurance schemes is contrary to National Competition Policy
- Governments providing insurance should do so in a competitive market, and subject to the prudential requirements of the *Insurance Act 1973* (Cth) (in accordance with the principle of competitive neutrality)
- The advantages of private sector underwriting insurance should be considered by the Review
- Private sector insurers are best placed to underwrite well designed statutory insurance schemes to avoid:
 - Financial risk to governments, taxpayers and future policyholders
 - Inherent volatility in the financial performance of government monopoly schemes
 - Political interference with pricing of risk; and
 - Government reliance on premiums collected for a mandatory, personal injury insurance scheme as a source of general revenue

Referring to prior recommendations of the Industry Commission (1994), the Productivity Commission (2004), and the National Commission of Audit (2014), the ICA submission to the Competition Policy Review outlined the benefits of, and a pathway to a competitively underwritten national workers compensation scheme.

In generally addressing the question posed by the FSI Interim Report about the value to consumers of private sector provision of statutory insurance, it is important to note the finding of the Productivity Commission in 2004 in its Report of its inquiry into National Workers' Compensation and Occupational Health and Safety Frameworks. On page 323 of this Report, it is noted that:

"The literature does not provide a powerful case for either public monopoly or competitive private provision of workers' compensation insurance. However, the Commission considers that, on balance, private provision is preferred on grounds that: private capital is directly at

risk; competition in the marketplace is likely to generate incentives for efficiency and innovation; and there is greater transparency of any governmental influence over premiums. Further, the risk of private insurer failure can be reduced by prudential regulation. However, even in competitive schemes, the Commission notes that pressure can be applied to governments as funders of last resort in the case of significant market failure.”

In response to the final comment in the paragraph quoted above, it is worth noting that this report of the Productivity Commission was released only three years after the collapse of HIH. Since 2001 (when HIH collapsed), the prudential regime for general insurers in Australia has been significantly enhanced. The prudential regime was further strengthened again with new requirements in effect from 1 January 2013.

To address the question posed by the FSI Interim Report, we ask the FSI to consider the following specific benefits for consumers of competition in statutory insurance schemes.

We define “consumers” of statutory insurance schemes as policyholders and claimants. As statutory insurance schemes are frameworks for mandatory insurance for a class of policyholders (motorists or employers), it could also be argued that “consumers” of these schemes include the jurisdiction’s taxpayers, and the community at large.

The points made above as to why private sector insurers are best placed to underwrite statutory insurance schemes articulate the broad benefits to consumers.

The following benefits also flow to consumers of competitively underwritten workers compensation schemes, and personal injury motor accident schemes.

- Competition among insurers encourages innovation in risk management and claims management
- Private sector insurers are subject to the detailed prudential requirements under the *Insurance Act 1973* (Cth), and prudential oversight by APRA, leading to risk pricing that fully funds longer tail liabilities. This provides consistent protection for policyholders and third party claimants
- Competitive underwriting between private sector insurers enables governments to de-risk balance sheets, and to concentrate on the role of regulator of insurers licensed to operate in a scheme
- Competitive underwriting between private sector insurers removes the pressure on governments to price premiums to meet political objectives. Political pricing of risk can lead to significant under- or over-pricing of risk by government, inefficient cross-subsidies between policyholders, and inter-generational inequities for policyholders
- Risk identification and proper pricing for risk create strong incentives for policyholders to manage and mitigate risk to reduce premiums. This can lead to an overall reduction of risk in the community (e.g., in workplaces and on our roads)
- Due to the cost of capital for long tail liabilities, it is in the interest of a private sector insurer to effectively manage personal injury claims and reduce average claims duration
- Where an injured person is able to recover and return to work, it is well understood that a person’s financial and personal wellbeing is best served by returning to work as soon as possible.¹⁶ In this way, effective claims management and reduction of average claims duration by an insurer is directly aligned with the best interests of a claimant who can return to work

¹⁶ Refer 2011 *Consensus Statement on the Health Benefits of Work*, The Australasian Faculty of Occupational and Environmental Medicine (AFOEM) and The Royal Australasian College of Physicians (RACP)

- Private sector insurers highly value their reputation and brand. Competing insurers will aim to provide the best service, innovative products (for example, at fault driver cover in third party personal injury motor accident schemes, and multi-product discounts) and risk based pricing. Motorists and employers have choice in selecting an insurer based on pricing, products, performance and customer service

Competitive dynamics in the Australian general insurance market have been canvassed in the Deutsche Bank/Finity *General Insurance Review 2014*, "Industry Pendulum", published on 25 July 2014. On page 21, this report notes that "growth moderated in 2013 and we expect the trend to continue into the future, leading to low single-digit growth of 2-3% as increased competition and lower RI costs pressure premium rates."

The "Industry Pendulum" Report further notes at page 22 that "while privately underwritten Workers' Compensation in WA will see rates fall 6.7%, ongoing competition in Liability should also see growth remain low in 2014. CTP should remain more stable."

In workers compensation schemes, greater rigor of pricing to risk provides strong incentives to employers to improve risk management and workplace safety – and to promote early return to work for workers. With greater rigor of risk pricing, inefficient cross-subsidies can be removed and employers with better safety practices and more effective return to work programs will be rewarded with lower premiums.

In privately underwritten workers compensation schemes, employers may gain the benefit of risk management advice, expertise and assistance from an insurance broker who understands the employer's business.

The workers compensation scheme in WA is competitively underwritten by private insurers. In 2011, WorkCover WA conducted a survey of employers. The Executive Summary of this survey noted that "Two thirds of employers surveyed buy their policy through a Broker – making Brokers a very important channel." The Executive Summary also noted that "Both Brokers and Insurers perform exceptionally well during the purchase and claims process. They should be congratulated."

Regulatory architecture

Regulators to undertake more appropriate consultation with industry on international standards

The ICA believes that the FSI should recommend that financial services regulators be required to undertake meaningful and timely consultation with industry when they are participating in the negotiation of international regulation. APRA and ASIC often play important roles in the development of global regulation for the insurance and wider financial services sectors. Examples of this include the International Association of Insurance Supervisors (IAIS) consultation on proposed options for the development of global Basic Capital Requirements (BCR) for Global Systemically Important Insurers (G-SIIs) and the Financial Stability Board's (FSB) consultation on Principles for an Effective Risk Appetite Framework (Consultative Document).

In contrast to Government requirements in relation to consultation prior to new domestic regulatory initiatives, regulators rarely consult the general insurance industry before taking positions in international discussions. International standards agreed by organisations such as the FSB, even if only advocated as best practice, are likely to be adopted by national regulators. Consequently, lack of consultation by Australian regulators during the early stages of international regulatory development, can lead to them eventually implementing inappropriate regulatory requirements in the Australian insurance sector. An example of this can be seen in the recent application by APRA of harmonised cross sectoral requirements on risk management which drew significantly on FSB principles heavily influenced by thinking from the banking sector.

We consider that, without timely and fulsome industry consultation, regulators may not take full account of the differences between individual financial services sectors and the way they interact with the other component parts of the financial system, in its involvement with the development of international regimes.¹⁷ The ICA therefore advocates that the FSI recommend that regulators undertake more meaningful consultation with industry during its involvement in developing international regulatory regimes

The role of boards and management

The ICA welcomes the discussion of corporate governance in the Interim Report, particularly the need for a clear delineation of the roles of a regulated entity's Board and management. The ICA considers that APRA's requirements for Boards have become overly prescriptive and do not take into account the appropriate division of responsibilities between Boards and management. While APRA considers that it follows 'principles based' regulation, there is little evidence in current prudential standards to support this view.

ICA members are finding that Boards are spending increased time on compliance issues. The degree of oversight and verification that the Board of a regulated entity is expected to have over management handling of day to day operational matters diverts the Board's attention from the broader strategic issues. It is reported by our members that agendas for Board meetings are dominated by compliance matters at the expense of giving strategic issues adequate consideration. An ICA member which is a significant financial institution estimates that over 75 per cent of its Board's time is now spent receiving and reviewing reports for compliance purposes.

The ICA acknowledges that the Board is ultimately responsible for a company's operation and careful oversight by Directors is necessary. However, the level of detail to be absorbed and duplication involved for a Board in reviewing, checking and confirming what is management activity as required by APRA, risks unduly narrowing the focus of the Board's deliberations and potentially missing the broader, strategic and macro-economic issues relevant to policy holders and the commercial success of the business. ICA members advise that while the additional obligations and ad hoc requests made to Boards by APRA are often incremental, this can result in a significant unchecked increase in compliance overheads over the medium to long term.

The ICA therefore supports the Interim report's recommendation that there be a thorough independent review of prudential requirements on Boards to ensure that they do not draw Boards into operational matters.

Regulator mandates

Given the effective performance of regulators such as ASIC and APRA has a direct impact on the commercial success of its members, the ICA would like to register its views on several issues examined by the Interim report in the section devoted to regulatory architecture.

The ICA understands and endorses the need for the operational independence of regulators. However, in a democracy such as Australia, we find it strange that there should be any question at all whether any regulator should be subject to Ministerial direction as to the policies they should pursue or the priorities they

¹⁷ As a consequence the insurance sector does not require the same regulatory approach as that applied to banking which is heavily influenced by the goal of promoting systemic stability. Similarly, it is widely recognised that, if despite a stringent regulatory regime, a general insurer gets into financial difficulty, it is not susceptible to sudden collapse as a bank would be. There is time to take recovery action and, if this is ultimately unsuccessful, to manage the insurer's orderly resolution. In contrast, bank failures occur much faster and have the scope to be more disorderly than insurance failures (there can't be a "run" on an insurance company). Furthermore, the failure of a general insurer has less severe and more delayed consequences for the wider economy than of a bank so the need to guard against failure is lower.

should follow. The ICA would therefore not support any change to the current legislative provisions providing Ministers with this ability.

In view to the benefits of society overall of a well functioning financial system, the ICA is not convinced that financial services regulators should be funded by industry levies rather than through the general Commonwealth budget. However, we acknowledge that globally this is the case and is unlikely to change in Australia. The ICA therefore reiterates the view put in its submission on the most recent setting of the Financial Sector Levy. This was along the same lines as the Interim Report's proposal for APRA to publish a comprehensive budget proposal with associated levy proposals and business plans each year ahead of the Government's annual budget process. This enhanced external consultation would promote more effective planning and greater accountability for the industry money spent by APRA.

If the FSI sees logic in ASIC moving to industry funding, given the complex range of activities it undertakes, the ICA urges careful consideration be given to how the cost of ASIC activities are divided amongst industry segments.

The ICA places great importance on regulators fully considering the likely costs and benefits of their actions on regulated entities. In this regard, the ICA welcomes the commitments made by ASIC and APRA in their recent Statements of Intent to:

- Look for opportunities to reduce compliance costs for business and the community, helping the Government reduce red and green tape by \$1 billion
- Comply with the Government's enhanced Regulatory Impact Analysis requirements for all regulatory proposals
- Act in accordance with regulatory best practice in decision-making, policies, processes and communication practices to maximise effectiveness, efficiency and transparency, and minimise compliance costs; and
- Have an open and sound working relationship with the entities that they supervise

However, given the concerns noted in the Interim Report about the role of competition vis a vis system stability in regulator mandates, the ICA would have liked to have seen a greater commitment to competitive markets in the Statements of Intent from both regulators.

Concluding remarks

The ICA welcomes the assessment in the FSI Interim Report that general insurance products are distinct in their offer and that the sector overall does not represent a threat to financial stability. With this assessment as the underpinning, the FSI Interim Report raises a number of contemporary and topical issues pertinent to general insurance products and to what are likely to be future developments in general insurance markets. These issues, such as non insurance, the role of technology and the future of disclosure share common elements especially as they pertain to the decision making process consumers use when purchasing a GI product and the impacts to consumers and society when insurance take up is inadequate for purpose.

The ICA submission to the FSI suggests that the fundamental response to these contemporary insurance challenges rests with the affirmation that GI is distinct from other financial services and that regulators and policy makers should utilise this understanding to develop regulatory responses that recognise this uniqueness. Although the FSI Interim Report outlines issues with general insurance markets raised in submissions, fundamentally, general insurance markets operate efficiently and effectively serving both consumer and economic objectives well. Accordingly, the challenge for policy makers in these circumstances is to manage contemporary GI issues within a framework that does not fundamentally disturb the efficient insurance markets

of today and as far as possible, looks to widen the opportunities available from extending these markets further. The ICA contends that the FSI should build and develop recommendations for general insurance within this broad framework and in particular, that the policy issues raised in submissions to the FSI be considered on such a basis.

The ICA welcomes the opportunity of continuing to work with the FSI and regulators on many of the issues raised in the FSI Interim Report. In many respects, several of the issues raised in the FSI interim report will remain ongoing in their development and will require close collaboration with the industry. The ICA looks forward to working with policy makers, regulators and stakeholders in this respect.