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Department of Treasury
Langton Crescent
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Dear Matthew

FINANCIAL SYSTEM GUARANTEES

Thank you for the opportunity to comment on the Government Discussion Paper on Financial System Guarantees. The following submission responds to issues raised in the Discussion Paper that will significantly impact the businesses of IFSA members offering life insurance products, if Government imposes a financial system guarantee on industry.

IFSA represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA's members manage and invest approximately $725 billion on behalf of over nine million Australians.

Short Response

IFSA members do not support the setting up of a limited explicit guarantee scheme and endorse Option B ie. a case-by-case discretionary response to financial institution failure.

IFSA members generally endorse the findings on guarantees of the Wallis Committee review of the Australian Financial System. The Committee stated at page 175:

> "……… financial safety regulation ... should be greatest where the intensity of financial promises and hence risks of market failure are greatest.
>
> Governments should not seek to impose safety regulation across the entire financial system. The assurance provided by prudential regulation should not extend to a government guarantee of any financial promises. Obliging financial

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institutions to subsidise some activities through 'community service obligations' compromises their efficiency and is unlikely to prove sustainable in a competitive market.

Regulation imposes costs both directly and on the wider economy. This highlights the need to balance prudential and efficiency considerations.”

Response to Discussion Paper Questions

Q1. If a limited explicit guarantee were introduced, what implications might this have for the safety, efficiency, and competitiveness of the Australian financial system?

IFSA believes that the introduction of any explicit guarantee for life insurance products would have a detrimental effect on the safety, efficiency and competitiveness of the providers of those products and, consequently, the Australian financial system.

As noted in the discussion paper, Australia’s financial services industry is subject to a high degree of regulation for the purpose of limiting the probability of institutional failure. IFSA members accept that the integrity of the regulatory system is dependant on the behaviour and actions of both industry participants and regulators. Industry participants already support this system through the payment of levies to the Government specifically for regulatory purposes.

Institutional failure such as with HIH represents the exception rather than the rule. Institutional failure also represents a systematic failure of prudential regulation. In any prudentially regulated regime, failures such as that of HIH are the outcome of a compounding of mistakes over an extended period and a failure at both a company and a regulatory level. In circumstances where regulatory failure is identified as a significant contributor to institutional failure, Government intervention and support is not an unreasonable community expectation.

Such a position is consistent with the following statement in the OECD comparative analysis of the supervision of insurance solvency.

‘The primary function of an insurer is to manage all these risks in such a way as to be able at all times (or at least in the vast majority of circumstances) to meet its commitments to policyholders and beneficiaries. It is this capability of an insurer to meet its commitments that is known as “solvency”.

Nonetheless, because of the structure, size and complexity of the insurance industry, it is fairly difficult for policyholders or beneficiaries themselves to check their insurer’s solvency. It is, therefore, for the primary purpose of protecting consumers that countries have instituted systems for supervising the

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solvency of insurance companies. Such supervision also makes it possible to guarantee the insurance industry's financial soundness and thus to enhance public confidence, which is vital to the industry's development.'

(refer OECD Insurance and Private Pensions Compendium, *The Supervision of Insurance Solvency: Comparative Analysis in OECD Countries* by Viviane Leflaive 2001)

The imposition of a financial system guarantee on industry will result in additional costs, which will be passed to policyholders. Hence, the net effect of a limited explicit guarantee would be to shift the financial burden to a smaller taxpayer base, rather than a fairer distribution to taxpayers at large. Further, any increase in policyholder fees will have to be disclosed, including the purpose of the increase. The likely effect of such an action will be to increase the risk of 'moral hazard' in consumers, who will either avoid products because of increased fees or make uninformed decisions on the basis that a product is guaranteed.

The existing investor safety net includes:

- depositor preference arrangements for ADIs;
- life insurance statutory funds;
- priority arrangements for insurance policyholders; and
- compensation arrangements under Part 23 of the SIS Act.

Even a partial guarantee will not reduce the potential for systemic risk if a significant player fails. What a guarantee is likely to do is:

- to increase competition from smaller players who are not risk averse;
- provide comfort to investors/policyholders/clients who may be encouraged because of the guarantee to invest with riskier entities; and
- provide support for riskier business activities at the expense of efficient and well run organisations. While this may have the potential to increase competition it is, in fact, anti-competitive.

IFSA members consider that the measures outlined in the paper will limit market efficiency to such a degree that the underlying principles could be considered anti-competitive. The introduction of a financial system guarantee could also have the unintended effect of reshaping the structure of the system. If "capital certain products" are targeted for the levy, they may become unprofitable and be gradually phased out. Hence, those products that provide consumers with "a relatively risk-free option" may no longer be available. Consequently, IFSA supports the recommendations of the Financial System Inquiry to not impose a guarantee system upon the industry.

It should be noted that well run organisations expend a significant amount of time, money and attention on internal systems to comply with industry regulation and meet the needs of their customers. Any intervention by a regulator will generally have a

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commercial impact on business. Likewise, any action by Government to introduce a financial system guarantee will undermine that investment by industry and will, in our view, have the effect of diminishing consumer trust in industry thereby increasing moral hazard.

In summary, the introduction of an explicit financial system guarantee will:

- result in increased cost to customers;
- reduce standards by underwriting inefficiency/complacency;
- increase the risk of failure;
- be anti-competitive;
- result in more claims on a fund because customers have less incentive to be risk averse; and
- diminish trust in the industry.

Q2. Comments are invited on what general approach government should take to reduce the consequences of a financial institution failure.

Of the approaches identified, IFSA considers that Option B: a case-by-case discretionary response, is more appropriate for Government. Caveat emptor would be appropriate only where the public has access to full information and the regulatory system did not provide any implicit guarantee or security.

Under Australia's current prudential regulatory framework, the consumer alone does not bear the responsibility for assessing the quality of their policies. However, greater education and consumer understanding is necessary. Both Government and industry have responsibilities in this area.

Q3. Are you aware of additional international experience that could add to the debate about whether explicit guarantees may be desirable in the Australian context, or how any such scheme should be optimally designed.

IFSA notes the comments made in the OECD Insurance and Private Pensions Compendium, *The Supervision of Insurance Solvency: Comparative Analysis in OECD Countries* by Viviane Leflaive 2001 referred to at Q1 above.

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Q4. Comments are invited on the design principles, the associated institutional, product and consumer coverage or the more specific design features outlined in the Davis Report.

If Government identified an area, sector or type of investment as being appropriate for the introduction of some form of guarantee, the parties promoting and investing in that area, sector or type of investment should underwrite that guarantee. There should not be any cross subsidisation of institutional, product and consumer coverage.

Whilst a financial system guarantee would provide security for consumers, the cost will be borne by them as well. Hence, guaranteed products may become unpopular and be removed from offer in preference for similar but cheaper non-guaranteed products. On a cost basis alone, the majority of consumers may be prepared to take the investment risk.

In relation to investment products, IFSA considers that the current regulatory design for a disclosure based system with provision of appropriate penalties for product issuers and remedies available to consumers is appropriate.

Q8. The Davis Report explored some of the alternative approaches for funding explicit guarantees. Comments are invited on which approach should be favoured, and why.

IFSA does not support the introduction of explicit guarantees. If, however, a guarantee scheme was introduced by Government:

- we note that there are difficulties with levy estimation for a pre-funded scheme and potentially significant revenue difficulties with a post-funded scheme given that institutional failure is more likely to occur at times of difficult economic conditions;
- it would result in additional bureaucracy, and added administration for our members, both of which will further add to the recurrent cost of any scheme; and
- any scheme should be risk based. That is, the quantum of any levy imposed should take into account a risk rating of the product provider.

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Q10. The Davis Report outlined some possible governance arrangements to support an explicit guarantee scheme if one were to be introduced. Comments are invited on which approach should be favoured, and why.

As stated previously in this submission, IFSA's members represent one of the most regulated industry sectors. Additional regulation in this area is not warranted. The

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creation of a new statutory authority or statutory responsibilities for an existing regulator, would inevitably lead to increased administrative costs.

Q.12 The Davis Report examined a number of possible regulatory implications that may arise from introducing any guarantee scheme. The Government invites comments ...

As stated in the Report of the Wallis Committee into the Australian Financial System: "The principles of regulation ... are competitive neutrality, cost effectiveness, transparency, flexibility and accountability." IFSA members consider that the introduction of a financial system guarantee scheme for prudentially regulated products would fail these principles of regulation.

Conclusion

Any proposal for the introduction of a financial system guarantee will have significant financial and financial reporting consequences for product issuers. We would be pleased to discuss further any aspect of our submission.

Yours sincerely

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