22 December, 2003

Professor Kevin Davis
Study of Financial System Guarantees
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Dear Professor Davis,

Insurance Australia Group (IAG) welcomes the Study of Financial System Guarantees announced by the Federal Treasurer, the Hon. Peter Costello. IAG is particularly encouraged by the fact that the purpose of preparing the technical study is to provide a balanced analytical framework against which interested parties can consider the issues and formulate their views in relation to the issue of financial system guarantees. IAG's believes the precise design of any financial system guarantee, its incentive properties and its associated financial costs warrants closer consideration by the Federal Government.

IAG is the largest general insurance group in Australia and New Zealand (by reference to premium written in these countries). It provides personal and commercial insurance products under some of the most respected and trusted retail brands including NRMA Insurance, SGIO, SGIC, CGU and Swann Insurance in Australia, and State and NZI in New Zealand.

IAG's core lines of business include:

- Home insurance
- Motor vehicle insurance
- Business insurance
- Consumer credit insurance
- Extended warranty insurance
- Compulsory third party (CTP) insurance
- Workers' compensation insurance
- Retirement financial advice
- Professional risk insurance

Should there be Financial System Guarantees?

As you are aware, the Treasurer, when announcing the Government's response to the recommendations of the HIH Royal Commission, stated

"….The Government has supported the development of a safe and efficient financial system by implementing path-breaking reforms to the prudential regulation and corporate governance frameworks. Underlying these frameworks is the principle that the health of a financial institution is primarily the responsibility of its board and management. Market discipline and prudential regulation reinforce this

responsibility. The Government is not, and should not be, responsible for the financial promises of these institutions…."

IAG agrees strongly with this statement. Similarly, IAG is not, and should not be, responsible for the financial promises of its competitors. We believe that the introduction of financial system guarantees to cover the costs of the failure of a general insurer would in effect impose a tax on viable insurance businesses to cover the failures of their competitors. This is

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inconsistent with a market competing for the delivery of a product to consumers. IAG does not support the introduction of financial systems guarantees for the Australian insurance industry.

The Operation of the Market

As the Commonwealth noted in its submission to the HIH Royal Commission:

> *"…Government regulation is not intended to, and cannot effectively, remove risk for either financial institutions or consumers. There needs to an appropriate balance between regulation designed to promote financial safety and transparency, whilst still allowing for innovation and the development of new products…." (Commonwealth Submission to the HIH Royal Commission, October 2002).*

Importantly, the Commonwealth highlighted that "…Risk is an important element of market development, and risk also means that institutions may fail". The failure of a financial institution may reflect a range of factors, including poor or inappropriate management, exogenous shocks, strong competition or adverse economic conditions. The Commonwealth stated that "…as sound management is encouraged through an appropriate regulatory framework and cannot be legislated, it follows that regulation cannot guarantee absolutely against institutional failure. Ultimate responsibility for the management of a business rests with the board of directors and senior management, not with the regulator or the Government. This is consistent with the Wallis Inquiry view on the extent of regulatory assurances…"

IAG believes the strengthening of the Australian Prudential Regulation Authority's (APRA) supervisory capacity following the introduction of the new prudential regime in general insurance in July 2002 properly provides a more rigorous framework for addressing insurance company risks and will make a failure of another insurer very unlikely. The new supervisory framework provides APRA a greater flexibility to intervene early in response to warning signals in the industry and a wider range of powers for such intervention.

Additional regulatory reform in relation to entities operating outside the current regulatory regime, for example, discretionary mutual funds and direct offshore foreign insurers, will inevitably lead to a more robust and secure insurance marketplace for the greater benefit of both consumers and the Australian economy as a whole. (See Appendix 1 – IAG submission to review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers). As such, we do not see merit in establishing systematic arrangements to protect policyholders when an institution fails. Competitive markets experience failures. Regulation of providers of financial services should provide for failures to be infrequent and provide for warnings, rather than guarantee that there will be no failures.

As IAG highlighted in its submission *(Future Policy Directions – Submission to the HIH Royal Commission, Insurance Australia Group, September 2002)* to the HIH Royal Commission, in a competitive market economy such as Australia, consumers have choice of products based on price, quality of product, service levels, and credentials of the company they transact with. The community expects that their legitimate claims will be paid, but there is also the realisation that in a market economy a company failure may occur. This imposes responsibility on the company to ensure it fulfils its obligations to the customer, and on the Government to provide support to the community when the market fails.

In the corporate sector, the unexpired liabilities of a failed company are met by the liquidator from realisable assets. The shortfall is a loss borne by the employees, customers, suppliers and shareholders of the failed company. Since the failure of HIH, with all the attendant publicity, a flawed line of reasoning has developed to the effect that the broader general

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industry should carry this loss because it benefits from the demise of the 2nd largest player. Other arguments such as the need to engender an attitude of community responsibility within insurers have also been used to buttress this contention.

The reality is that insurers price their product according to the risk appetite they individually have, not according to the risk profile of the whole industry. Their individual risk appetite is then reflected in their return on equity and in the demand for their shares. Thus the shareholder invests with a company on the basis of how well it performs relative to the industry sector and the broader investment alternatives. Other stakeholders may also differentiate between companies on the basis of their market conduct.

Suggestions that the insurance industry should be responsible for funding the failure of another industry participant should be cognisant of extra cost already borne by companies that have a relatively lower risk profile (through greater capital requirements), and the security this affords customers, employees, suppliers and shareholders. Transacting with a low risk insurer thus rewards the community. If the Government forces all other companies to subsidise the loss of a high-risk company then the stakeholders of other companies are all penalised for being risk averse. This creates a perverse result, as it is in the interest of the community to reward prudence and penalise excesses.

The OECD (*Insurance Regulation, Liberalisation and Financial Convergence, No.3, 2001, Policyholder Protection Funds: Rationale and Structure*) notes that under this situation,….”prudently managed companies, which avoid effectively being in financial distress, need not only to contend with reckless competitors that offer aggressive pricing to attract customers, but also to compensate for the eventual failures of such competitors. This situation could seriously undermine sound and fair competition in the industry”.

Moral Hazard

The OECD also argues that the most important argument against policyholder protection funds is the "…moral hazard problem that they may raise for policyholders, insurers and supervisors. When there is a safety net, consumers may be less inclined to assess the financial situation of the insurer that they contract with and to make a prudent selection. Even worse, they may seek the cheapest products regardless of the risk associated with the insurer, because of the belief that they will not suffer from the negative consequences of their choice in the event that the risk materialises, ie the insurer goes bankrupt".

The OECD suggests that the lack of "risk averse behaviour on the part of consumers is likely to give incentives to insurance companies for increased risk-taking…. Moreover, some observers stress the moral hazard in the supervisors. When there is a safety net to protect the interests of policyholders faced with insurance insolvency, the insurance authorities may feel less pressure for strict supervision to avoid any possibility of insolvency".

The Commonwealth also noted in its submission to the HIH Royal Commission, the rationale for not providing a guarantee is to mitigate the moral hazard risk. Moral hazard "…. may exist when individuals have an incentive to change their behaviour and undertake riskier activities – or fail to undertake risk mitigation activities – as a result of a guarantee. Without a guarantee, policyholders are required to actively consider the risks and behave accordingly".

"For example, consumers may have less incentive to take into account the risk associated with the insurance provider when taking out insurance cover – consumers may opt for the most inexpensive insurance product regardless of the risk, confident they will not suffer any negative consequences from that choice should the company become insolvent".

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The HIH Royal Commission Report stated: "Another important consideration in connection with policyholder support is the question of what would normally occur if no such scheme existed. As has been seen, governments do come under intense pressure to fund ad hoc compensation arrangements when a large insurance company collapses.

Ad hoc responses offer governments the flexibility to deal with circumstances as they arise. They might also involve less moral hazard because policyholders, insurers and regulators will be unsure whether governments will provide compensation if an insurer fails. On the other hand, it may be that policyholders and others already expect governments to compensate them in response to a failure."

What if a Financial Systems Guarantee Scheme were introduced?

As stated, IAG does not see merit in the establishment of financial systems guarantees for the insurance sector. However, should a financial systems guarantee scheme be established in the future, IAG contends that such a scheme should only be considered in relation to the package of reforms proposed by the HIH Royal Commission Report and be funded on a post-hoc basis. It would be the worst possible outcome if a scheme were established without other regulatory reforms being undertaken, such as to discretionary mutual funds and direct offshore foreign insurers, and without the removal of State taxes on insurance as recommended by the Royal Commission.

We note that the HIH Royal Commission Report relating to a policyholder support scheme recommended that such a scheme funding model should be funded post-event. Indeed, the HIH Royal Commission Report commented on the practical difficulties associated with a pre-event funded scheme:

".... Because the funding for a pre-event scheme is necessarily calculated without reference to the known dimensions of a future event, the amount held in the fund will almost certainly be either too much or too little to cope with a specific failure. Further, if the added protection offered by a new prudential regime results in less-frequent need for recourse to a support fund, a pre-event fund could accumulate over a lengthy period to unnecessary levels".

IAG argues that insurance companies calculate the risks of events occurring and price cover accordingly. The premiums paid by large groups of people cover the losses incurred by small groups. This is the fundamental nature of insurance. However, the probability and severity of loses from an insurance company failure are not calculable in advance and therefore unsuitable for a pre-funded financial systems guarantee scheme. In the light of these statements, along with a range of equity and administrative issues, we believe any financial systems guarantee (if introduced) should operate on a post-event funding basis.

IAG would be happy to discuss this submission and to assist the Review in any way we can. If you wish to discuss this matter or make further inquiries please contact Barbara Hayes, Head of Government Relations and Policy, on (02) 9292 9744.

Thank you again for the opportunity to make a submission to the Review.

Yours sincerely,

Michael Hawker
Chief Executive Officer
Insurance Australia Group