Financial System Guarantees

NIBA Submission

August 2004

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NIBA Response to the Government Discussion Paper on Financial System Guarantees

Introduction

The National Insurance Brokers Association of Australia (NIBA) is the voice of the insurance broking industry in Australia. It represents 500 member firms and 2000 individual qualified Practising Insurance Brokers throughout Australia.

Insurance brokers represent the interests of the insuring public. The views put forward in this submission are made on behalf of the insuring public and not on behalf of insurance companies.

NIBA members handle approximately 90% of premiums for commercial insurance in Australia and the focus of this submission is on commercial insurance.

NIBA questions the idea of the Commonwealth Government guaranteeing financial contractual obligations. The Financial System Inquiry opposed guarantees because they introduced moral hazards and distort market signals. They invariably involve some form of cross subsidisation with the prudent and the purchasers of commercial insurance bearing an unreasonable cost burden.

In considering the question of financial guarantees for the general insurance industry, regard needs to be had to the existing guarantees that are provided by the state and territory governments for statutory insurance such as workers compensation, compulsory third party motor vehicle insurance and builders warranty insurance.

If there is to be any form of Commonwealth guarantee in the risk insurance area in addition to that already provided by the states and territories, NIBA strongly believes that it should be limited to domestic insurance products and ‘special cases’ and paid for by only those who might benefit from the arrangements.

As a general rule those taking out commercial insurance do not benefit from such guarantees and consequently they should not be called upon to bear the cost of such arrangements.

NIBA answers to the questions asked in the discussion papers follows.

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

NIBA’s Answer: A guarantee scheme could add a layer of cost to business in Australia making it less efficient and competitive to conduct business in Australia. While some policyholders may benefit from such an arrangement, the benefits would have to be paid for by the more prudent and by the purchasers of commercial insurance through increased insurance premiums.

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

A *caveat emptor* — a response that insists that customers and other stakeholders should bear the consequences of a financial institution failure;

B case-by-case, discretionary responses — that any assistance should be tailored to the circumstances of each instance of failure;

C limited explicit guarantees — that the extent of some limited assistance should be defined up-front; or

D alternative responses — for example, facilitating, but not underwriting an industry-based compensation arrangement?

NIBA's Answer: NIBA supports B above, the case-by-case approach. The HIH failure was a very unusual one not only because of its size but also because it represented the failure of many of the mechanisms in Australia for corporate regulation. The mechanisms that failed included management, directors, auditors, advisors, actuaries, the corporate regulator ASIC and the prudential regulator APRA.

NIBA fully supported the Government's action in establishing the HIH Claims Support Scheme. The fact that the Government stepped in to assist in this particular case should not, however, mean that automatic assistance should be provided whenever an Australian financial institution fails.

Not all general insurance company failures warrant Government intervention, nor would intervention of the same type always be appropriate.

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 scheme could be optimally designed?

Alternatively, you may wish to refer to relevant international experience in relation to some of the specific design issues discussed below.

NIBA's Answer: NIBA notes that only 9 of the 30 OECD countries have in place guarantees in the general insurance area that go further than the coverage of the guarantees already provided by the state and territory governments in Australia. Accordingly, any case for the Commonwealth to extend the existing guarantees in the general insurance industry is not strong when based on international comparisons.

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.

NIBA's Answer: NIBA generally supports the design principles articulated in the Davis Report. NIBA would add a further principal however, that only potential beneficiaries of such a scheme should be called upon to meet the cost of the arrangements. For example, an insurance company that was a captive insurer (i.e. only providing insurance to companies in its own group) should not be called upon to contribute to the scheme, if the group could not benefit from the arrangements. A similar situation could apply in relation to insurers that concentrate their activities in commercial areas.

NIBA believes that any guarantee scheme introduced by the Commonwealth Government should not involve an automatic cost shift from domestic insurance policyholders to those taking out commercial insurance. In other words the cost of any guarantee scheme should not be chiefly at the expense of those purchasing commercial insurance.

Q5. Comments are invited on the methods, underlying assumptions, and cost projections presented in the Davis Report.

NIBA's Answer: The cost of any scheme depends largely upon the specific design of the scheme and the assumptions employed in calculating the cost. The cost of the Commonwealth Government's support for those affected by the collapse of HIH has been considerable, of the order of $800 million. The recovery of such an amount over a relevantly short period of time could have a significant affect on insurance premiums. The effect on individual premiums would depend upon the proportion of policyholders that were called upon to contribute to the scheme and whether or not the costs flowed through to premiums for policies taken out by persons who were not eligible to any benefits under the scheme.

Q6. Do you have further information or suggestions that might improve the accuracy and reliability of the results?

NIBA's Answer: NIBA believes that because of the nature of general insurance products, accurate costing of a guarantee scheme for this industry is very difficult. Costing for a general insurance scheme is subject to greater error than the costing for a scheme for other industries e.g. the banking industry. General insurance is different in that the long tailed nature of some insurance policies means that the exact extent of the liabilities to be funded may not be known for many years after a collapse has occurred.

Q7. To what extent do concentrated markets present challenges to the viability of any scheme?

NIBA’s Answer: With a concentrated market such as the general insurance market at the present time, the results of an insurer collapse are likely to be severe.

In a post-funded scheme the pricing arrangements can be determined by the manager of the scheme having regard to the nature of the failure and the extent to which the guarantee will be called upon. The manager can take account of any concentration effects in setting the nature of the recovery levy in a post-funded scheme. Accordingly, the concentration issue is more significant in a pre-funded scheme.

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.

- If a pre-funded industry scheme should be preferred:
  - On what basis should the size of the target fund be set and over what period of time should the target balance be achieved?
  - What is the appropriate funding base and, in particular, should non-guaranteed products be included in funding base calculations?
  - Should restrictions be placed on the type of assets in which the scheme can invest?
  - Should the investment returns remain in the fund or be returned to participating institutions?
  - What arrangements should be put in place to allow the scheme to borrow in the event of under-funding?
  - In the event of a failure, how should supplementary levies be applied?

- If a post-funded industry scheme should be preferred, how should the following issues be dealt with?
  - Should the prudential framework require institutions to provision for their possible future contributions to a scheme?
  - Should the scheme’s governing body be able to borrow only from the market, only from the Government or a combination of both?
  - Should a cap be set on how much the scheme can recover from institutions in a year? How would this cap be determined? What is the appropriate funding base?

NIBA’s Answer: If there is to be a guarantee scheme, NIBA would prefer that it be post funded and that no liability flow through to insurance companies until after the failure occurred, an estimate of the potential liabilities from the failure calculated and an appropriate levy formula determined. Difficulties in estimating in advance of a failure the extent of the funds necessary, leads NIBA to believe that a post funded scheme is preferable to a pre-funded one.

The scheme should be able to borrow from both the market and the Government. NIBA would support a definite limit being placed on the amount that could be recovered from an insurer in any one year.

Q9. The Davis Report examined some general approaches to setting prices for industry funded explicit guarantees. Comments are invited on which approach should be preferred, and why.

- If risk-based pricing is preferred:
  - What is the best way to determine premiums?
  - How often should re-rating take place?
  - Who should be responsible for setting risk-based premiums?
- If flat-rate pricing is preferred:
  - How should the scheme deal with the moral hazard problems that may result from flat-rate pricing?
  - Is the prudential framework (in particular, capital adequacy requirements) sufficient to mitigate incentives for risk-taking?

NIBA's Answer: NIBA would prefer a risk based system but is conscious of the complexities involved with such a system. In NIBA's opinion the levy should not only have regard to the risk of a company failing but also to the likely cost of the company's failure to the guarantee scheme. The extent of the company's clients that are eligible to benefit from the arrangements should be important in determining the levy for the company. If the company has few clients that meet the criteria for benefits the company should only be called upon to make a modest contribution to the scheme.

If a post-funded scheme was established, the premiums could be calculated having regard to the extent of the failure and the nature and number of potential beneficiaries under the guarantee.

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.

NIBA's Answer: NIBA's preference for the administration of the scheme is based on its view that a post-funded model would be best for the general insurance industry. NIBA's preferred approach is that responsibility for the scheme resides with the Treasurer and with day-to-day functions being carried out under the supervision of the Treasury. NIBA dose not believe that administration of the scheme should be with APRA. The arrangements for the payment of claims could be based on the HIH model. Responsibility for levy calculation and collection is seen as a Treasurer /Treasury function rather than an APRA one.

Q11. What is the preferred allocation of functions among the relevant bodies?

NIBA's Answer: See NIBA's answer to Q.10.

Q12. The Davis Report examined a number of possible regulatory implications that may arise from introducing any guarantee scheme. The Government invites comments on the following issues:

- Under a pre-funded model, would it be feasible for the guarantee scheme funds to be available to achieve least-cost failure resolutions (for example, a transfer of business) if that might be less expensive than compensating eligible customers in a liquidation?
    - What regulatory and governance arrangements might be necessary to support least-cost failure resolution?
- Guarantee schemes and priority arrangements (for example, depositor preference and insurance ‘cut-through’ provisions) might be seen as alternative or complementary policy instruments to guarantees for protecting certain stakeholders in the event of financial institution failures.
    - What are your views on the existing arrangements for depositors and policyholders in Australia?
    - What changes should be made to priority arrangements if a guarantee scheme were to be introduced?
    - Should general insurance policyholders receive priority above other creditors?
- Could a guarantee scheme provide an opportunity for removing or reducing restrictions on branches of foreign ADIs accepting deposits from retail customers in Australia? Your views may differ depending on whether you think foreign ADIs would be within or outside of the scope of a guarantee scheme.
- The Davis Report notes that certain conditions may need to be met before a national scheme could apply to statutory insurance classes. What implications would a national guarantee scheme have for existing State-based arrangements for compensating policyholders under statutory insurance classes for insolvency-related losses?
- Would the introduction of a guarantee scheme allow or require changes to other financial sector regulations and arrangements?

NIBA’s Answer: If a guarantee scheme is introduced, NIBA supports the idea of as few as possible changes being made to the existing regulatory environment. NIBA would not favour changes being made to priority arrangements for general insurance policyholders.

In relation to compulsory insurance and state and territory guarantees, NIBA emphasises that it strongly supports a national approach being taken to all aspects of the regulation of insurance in Australia. While NIBA supports the concept of a national guarantee scheme for existing State-based arrangements for compensating policyholders under statutory classes for insolvency-related losses, it recognises that this matter is largely one for determination by state and territory governments.