

RISK REGULATION

FIRST SUBMISSION

TO THE

FINANCIAL SYSTEM INQUIRY

BY THE

INSURANCE COUNCIL OF AUSTRALIA LTD.

September, 1996.



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AIMS OF SUBMISSION

The Insurance Council of Australia Ltd. (ICA) represents 120 private and public general insurers and their associated companies whose combined annual premium is over 90 per cent of the total private and public sector premium income in Australia. ICA was formed in 1975 and operates as an independent, non-profit organisation wholly owned by its members (see Attachment 1).

This Submission by ICA:

- *Describes the role of general insurance.*
 - *Demonstrates the differences between general insurance and other sectors of financial services.*
 - *Explains why these differences matter, particularly in considering the nature of Australia's regulatory arrangements.*
 - *Illustrates the success and benefits of self-regulation by the general insurance industry.*
 - *Provides the general insurance industry's views on factors relevant to determining the most efficient regulatory arrangements from both an industry-specific and a national interest perspective, together with options for change in regulatory structures and arrangements in the financial system.*
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INTRODUCTION

In considering the role of the general insurance industry in the Australian community and approaches to regulation, it is important to recognise not only the national economic and social importance of the industry but also its uniqueness relative to other parts of the financial services sector. The following points are particularly relevant to the above:

1. The general insurance industry in Australia has essentially two primary functions of national importance. Firstly, of fundamental economic importance, the industry provides security and protection for a significant proportion of the nation's economic and social assets. Protection is provided for more than **\$1,600 billion** of commercial and domestic buildings and contents alone. Secondly, it manages assets in excess of \$50 billion.
2. While the general insurance industry is a significant funds manager, there is a fundamental difference between the industry and other sector of the financial services industry. General insurance provides a "risk transfer" product - quite different to other parts of the financial services sectors which principally provide payments system or savings and investment products. The primary function of general insurance is to transfer risk from policyholders to the insurance company. This vital difference between general insurance and the saving/investment sectors requires that the regulatory framework recognise and reflect these differences for such a framework to be efficient and effective.

On regulation, the general insurance industry supports the value of some degree of efficient prudential supervision but believes the burden of existing regulation could be reduced without compromising the objectives of regulation.

Industry self-regulation is considered preferable to statutorily-imposed regulation where inherent inflexibility can be inimical to efficiency and effectiveness. It is recognised that self regulation might not be considered a viable proposition in all circumstances but it should be considered a preferred option across the financial services industry.

This Submission elaborates on these views by:

1. Providing a brief profile of the Australian general insurance industry.
2. Highlighting the differences for consumers, both personal and commercial, in purchasing "risk transfer" products as compared to savings and investment products.
3. Describing the general insurance industry self-regulatory activities, i.e:
 - Insurance Enquiries and Complaints System
 - Industry Code of Practice.

The Submission will then address the specific Terms of Reference given to the Financial System Inquiry (FSI) both from an industry-specific as well as a national interest perspective.

EXECUTIVE SUMMARY

Nature of Submission

This submission describes the economic and social importance of the general insurance industry. It shows why it should be clearly differentiated from other parts of the financial services industry, and emphasises the importance of such differences being reflected in regulatory structures and arrangements.

General Insurance is Different

Savings and investment products provide income and/or capital appreciation.

General insurance provides risk products which transfer risk from a policyholder to the insurance company.

The skills and knowledge required for the efficient management of general insurance companies are quite different to those required for running a bank or a savings/investment product manufacturer.

Virtually all concerns about existing regulatory arrangements and industry structures have arisen in the areas of banking, savings and investment product providers, and the way those products are distributed.

There is therefore a serious danger that general insurance could find itself swept up in inappropriate changes, with adverse implications for the industry and its policyholders. General insurance is unique within the Financial Services Sector.

Protection and Competition

Maximising benefits to all:

The Federal Government must provide an appropriate level of protection while maximising the benefits of competition and market efficiencies. Therefore the general insurance industry:

- supports minimum standards of Government prudential supervision;
- considers it imperative that the general insurance industry supervisor has significant knowledge and understanding of the industry;
- regards it as vitally important that the costs of regulation, both prudential and consumer protection, should be clearly outweighed by the benefits;
- suggests there should be maximum harmonisation among different supervisors or regulatory requirements to avoid overlaps, inconsistencies and other inefficiencies;
- believes Government regulation should not seek to replace or duplicate the role of board and executive management;
- considers regulation should not be strict and prescriptive because it limits innovation and flexibility.

Where change is desirable:

There are specific areas of current or proposed regulatory arrangements where changes are desirable. These include:

- relaxation of the restrictions on related body assets contained in Section 30 of the Insurance Act;
- limitations on the ability to utilise overseas assets for solvency calculations;
- practical method of disclosure of insurers' solvency margins to allow the public to be properly informed;
- inappropriate accounting standards imposed by the Australian Accounting Standards Board;
- the requirement to complete 39 statutory forms;
- redundant, ineffective or inappropriate provisions in the Insurance Contracts Act;
- duplication and costs involved with State reporting mechanisms, particularly in workers' compensation and CTP motor vehicle insurance.

At a broader level, the industry is concerned about the barriers to entry to banking, particularly by Australian-owned institutions.

Self-Regulation is Better

Self-regulation has significant advantages over statutory regulation and should be pursued to the maximum extent possible.

The general insurance industry has a strong track record of successful self-regulation encompassing a widely lauded Enquiries and Complaints system and a Code of Practice relating to documentation, training and claims handling.

Benefits of Deregulation

The deregulation benefits flowing from the Campbell Report have generally led to more stringent prudential supervision and more consumer protection measures. Now that institutions and markets have become adjusted to the new environment, it is appropriate to assess the extent to which these measures could be removed or relaxed.

In the general insurance industry's case, quality and cost have been dictated more by strong competition than deregulation.

Australia could develop as a hub for general insurance business in the Asia Pacific area, even though off-shore barriers limit the Australian industry's ability to compete in some overseas markets.

Factors Driving Further Change

The industry is heavily involved in technological advances, which are opening up more direct marketing options. Insurance intermediaries play a valuable role that is quite different from financial planners/agents. This should be reflected in regulatory arrangements.

Future technological developments will depend on the willingness of customers to embrace new technologies, as well as such aspects as privacy. Flexible legislation will be necessary along with constant monitoring.

Complaints Handling

The general insurance industry has reacted positively to consumer demands, with the introduction of the Enquiries and Complaints scheme in 1991 and the Code of Practice in 1996.

The industry opposes the integration of existing complaints handling schemes into a single statutory scheme or “ombudsman” for the financial services sector. There is far too much diversity in the type of complaints, transaction sizes and remedies, as well as different expertise requirements, that would make a centralised system inefficient. Importantly, industry goodwill associated with “ownership” of complaints handling schemes have been critically important in their success.

Regulatory Structures and Arrangements

Regulation should promote efficiency, safeguard stability and protect consumers. There should be a clear recognition of the benefits of competition and a market-oriented approach to supervision. Where regulation is judged necessary, it should be efficient and cost-effective.

The industry supports minimum standards of prudential supervision. Most developed countries have such supervision and its absence in Australia could be an impediment to international competitiveness.

Deregulation, globalisation and technological advances have produced increased competition and innovation. Institutions have entered new areas of activity, traditional distinctions among institutional groups have become blurred, and financial conglomerates now dominate the Australian financial scene.

The overall risk characteristics of the system have also increased as it has adjusted to new competition and innovation. This has led to more stringent regulations; more equalisation in stringency across the system; unrealistic expectations about what regulation can achieve; and a diminution in the risk spectrum.

Options for change in Regulatory Structures and Arrangements

ICA has no major problems with the existing regulatory structure.

Lead Regulator and Holding Company Structures

The Council of Financial Supervisors (CFS) has chosen not to adopt a lead regulator approach to supervision of financial conglomerates, preferring a more informal liaison and co-ordination approach. This approach could be found wanting in the event of a crisis and the lead regulator is to be preferred.

Financial holding company structures are an important issue in the current financial system. Current policy, which opposes such holding companies where a bank is involved, has become anachronistic and should be changed.

CFS Consultative Processes

Some aspects of CFS activities could be improved.

Under existing arrangements the CFS does not undertake consultations directly with industry organisations, or other government agencies and interested parties. Such consultations would heighten the profile and accountability of the CFS as well as providing greater harmonisation and understanding.

Policy Board

A more substantial and formal option which would increase CFS accountability and improve supervisory co-ordination would be the establishment of a Policy Board along the lines of the Policy Board for Financial Services, a statutory body established in South Africa in 1993 in preference to a mega-regulator.

Appointed members of the Policy Board represent the regulatory authorities and the regulated financial institutions and markets. The majority of members are from the private sector. The Board is responsible for formulating and co-ordinating policy and advising the responsible Minister.

Mega-Regulator

A more fundamental change in the supervisory structure would be a single supervisor for the financial services industry. The general insurance industry does not support a mega-regulator.

Suggested Structural Changes

There is scope to change the structural arrangements which could improve efficiency, harmonisation and supervisor accountability.

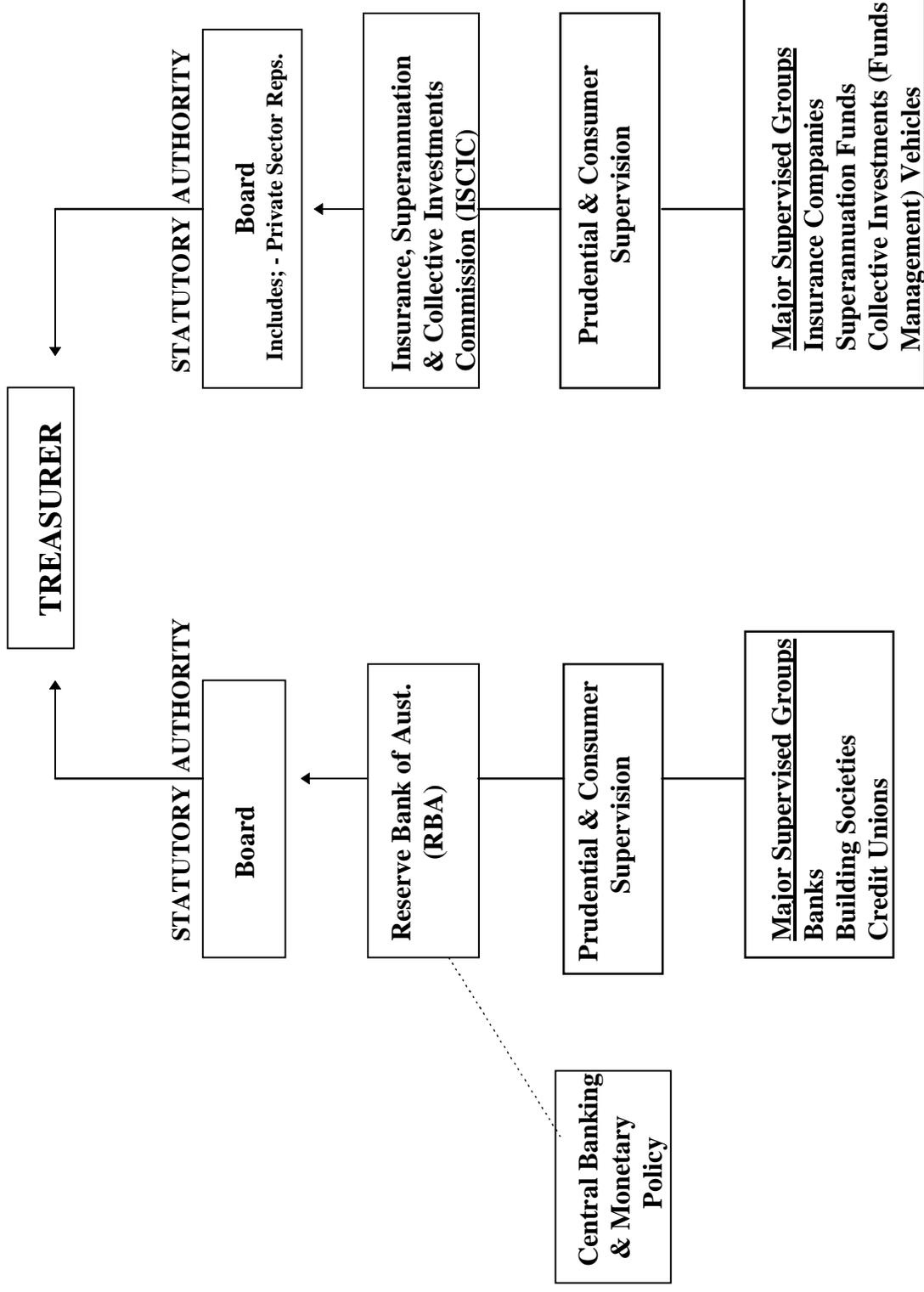
The general insurance industry is unique within the financial services sector, and there is a strong case to support a separate regulator for supervising general insurance companies and intermediaries.

Recognising the range of other supervisory structure options likely to be placed before the Inquiry, ICA suggests the following elements should be considered:

1. The Reserve Bank to be responsible for prudential supervision of banks, building societies and credit unions. There are significant benefits in the prudential supervisor also being responsible for consumer protection.
2. One other supervisor should be responsible for both prudential and consumer protection supervision in insurance, superannuation and collective investments. This should take the form of a statutory authority with an independent Board of Directors including private sector people with experience in the relevant areas.

Separating consumer protection from prudential supervision has some advantages, but the Council believes these are outweighed by the disadvantages.

ALTERNATIVE REGULATORY STRUCTURE



PROFILE OF GENERAL INSURANCE INDUSTRY

Financial Services Sector

The Council of Financial Supervisors (CFS) 1995 Annual Report notes that the financial services sector has total assets of approximately \$920 billion of which banks account for just less than half. The second major area of the financial services sector, that of funds managers and insurers, represents about one-third of the total sector's assets. General insurance companies, which are included in this sector, manage assets of \$51 billion.

General Insurance Companies

Some basic facts about general insurance:

BASIC FACTS ABOUT GENERAL INSURANCE

1. *The Insurance and Superannuation Commission supervises 162 insurance companies.*
2. *Annual premium revenue of general insurers is \$17.8 billion.*
3. *According to Australian Bureau of Statistics figures, the insurance industry in total employs approximately 55,000 people. It is estimated that approximately 26,000 of these are employed by the general insurance industry. This does not include the many thousands of agents, both full and part-time, who work within the industry.*
4. *In terms of premium income, Australia is the 11th biggest market in the world and second largest, after Japan, in the region.*

Another measure of the importance of the general insurance industry in the context of the overall financial services sector is indicated by the total assets under management. On this basis general insurance companies are the fourth most significant type of institution, behind banks, life insurance companies and superannuation funds.

The \$51 billion of assets (30/6/95) managed by general insurance companies are split on approximately a 60/40 basis between private and public general insurers.

Thus the significance of the general insurance industry as substantial investors in the economy should not be overlooked.

Protection of Nation's Assets

Asset size is, however, only one of the factors relevant to the critical importance of the general insurance industry to the Australian economy and the financial system.

The industry's own assets under management are obviously important, but the greater importance of the general insurance industry to the Australian economy lies in the protection which the industry provides to the nation's assets. This is crucial to both business activities and individual consumers' assets.

ICA estimates that general insurance companies in this country provide protection for building and contents property assets alone totalling approximately \$1,600 billion. This figure is divided roughly equally between Commercial and Industrial property assets and Household Building and Contents.

- **Commercial Business**

The protection of assets is essential to the operations of a modern business. The purchase of many general insurance products is prudently regarded by business as a necessity and not a “luxury” item.

Insurance protection means businesses have the security needed to allow them to expand and innovate with greater confidence and financial capability.

The importance of general insurance cover can be assessed by considering the implications for Australian commercial life if such cover were not available. From an economic viewpoint, most businesses would be forced to reserve capital for the type of unforeseen contingencies which general insurance covers. This would result in the inefficient use of capital.

It is estimated that approximately \$810 billion worth of commercial and business property assets are protected by material damage property insurance policies alone.

This does not include the protection of assets provided by various other classes of insurance such as Business Interruption, Marine Risks, Motor Vehicles and Construction Works insurance.

Nor does it include the invaluable protection offered to businesses through Public Liability, Product Liability and Professional Indemnity insurance policies.

A broad list of the classes of insurance on which statistics are collected by the Insurance and Superannuation Commission is shown at Attachment “2”.

- **Domestic Business**

In regard to Australian homes, it is estimated that approximately \$780 billion worth of assets are protected through Household Building and Contents insurance policies. Again, these figures do not include other areas of personal lines of insurance, such as Motor Vehicle which is estimated to afford protection approaching a further \$100 billion worth of assets.

The importance of insurance protection is further illustrated by looking at the consequences of non-insurance and under-insurance. Failure by businesses and individual consumers to properly insure assets can be regarded as a market failure. Such under-insurance and non-insurance can and often does result in businesses and individuals placing a strain on the broader community, i.e. through utilising resources provided by governments perhaps in the nature of disaster assistance, compensation, or Social Security benefits, etc.

Such avoidable and inefficient use of government resources, through the failure by commercial and domestic consumers to purchase adequate insurance, may also have an adverse impact on national saving as well as involving less efficient deployment of capital and resources.

At the same time, the consequences of a failure to insure or of a failure of the insurance system to meet its commitments can be economically and socially disastrous for many individuals and businesses.

“RISK TRANSFER” AND “SAVING AND INVESTMENT” PRODUCTS

Why is general insurance different?

General insurance products are “risk” products and, as such, are quite different by nature to the saving/investment products which characterise other industries in the financial services sector, although the life insurance industry also has some risk products.

This is not intended to suggest that saving and investment products do not have a degree of risk associated with their purchase. Clearly they do, and quite rightly, it is the spectrum of risk to which investors expose their funds which generally reflects the rates of investment returns which they might expect.

The fundamental difference with general insurance lies in the fact that “risk” products are provided to **transfer** a risk from a policyholder to the insurance company. For example, an individual or a business will purchase protection for a house or factory against the risk that the property burns down. By purchasing insurance the policyholder has effectively transferred the risk to the insurance company.

Unlike those who purchase investment products, the purchaser of general insurance does not expect to recoup the purchase price and/or any profit. In fact, policyholders genuinely hope that they will not have cause to recover their funds because to do so would mean some form of catastrophe has befallen them.

Investment products on the other hand, are purchased in the hope that the purchase price will be returned in full at a later time together with an additional capital appreciation and/or earnings component.

General insurance is unique in the Financial Services sector in that it is the only industry that does not offer savings/investment products.

Why does this difference matter?

This difference between “risk” and “saving and investment” products is of fundamental importance to the nature of Australia’s regulatory arrangements.

The public debate generated by the establishment of the Financial System Inquiry has focussed entirely on banking, deposit taking institutions, and saving/investment product providers, principally life insurance companies, superannuation and managed funds. There has been no differentiation or particular consideration in the public arena of the general insurance industry and the special considerations relevant to regulatory and other issues affecting this industry.

The reason for this, as indeed the *raison d’être* for the Inquiry, is simply because virtually all the concerns about the existing regulatory arrangements and industry structures have centred on issues which have arisen in the areas of banking, saving and investment product providers and the distribution of those saving and investment products.

Unfortunately, however, the general insurance industry has been adversely impacted in the past where assumptions have been made that what is appropriate for investment products is equally applicable to general insurance. Such an approach has, not unsurprisingly, been proven to be inaccurate in various instances. The development of the general insurance industry's own Code of Practice is an excellent example of this.

The products, operations and management of general insurance call for particular knowledge and skills which often differ from the broader range of financial service institutions. This highlights the need for regulatory arrangements to reflect the distinctive specialisation of general insurance business.

Risk transfer requires expert understanding of hazard assessment, risk management and protection. Australia, with a propensity for natural disasters, calls for a particular understanding of catastrophe impact and recovery.

Analysis of capacity and the need for, and arrangement of, reinsurance support, in many forms and frequently international, requires a particular range of knowledge and understanding.

The prudential direction of general insurance business demands an expert management of specific assets and liabilities. The former calls for skills in managing funds and investments. The latter demands specific expertise in assessing and maintaining a wide range of technical reserves including adequate provisions for outstanding claims, reserves for unexpired risk, deferred acquisition costs and reinsurance costs. Much of this calls for mature actuarial and statistical skill.

A regulator, perhaps expert in supervising institutions which provide investment products, will not necessarily have the expertise needed to supervise general insurance.

The need for specialist knowledge and arrangements are vital and should be reflected in the regulatory arrangements which are determined as a result of this Inquiry or other deliberations.

REGULATION

This section of the Submission sets out the basic current arrangements for regulation of general insurance, both government and self-regulation. It also describes some aspects of government regulation and the benefits of self-regulation.

Government Regulatory Structure & Arrangements

General insurers are supervised by the Insurance and Superannuation Commission. The Commissioner administers a number of statutes governing general insurance. The three most significant are:

GENERAL INSURANCE LEGISLATION

1. *Insurance Act 1973 - Prudential supervision of insurance companies.*
2. *Insurance Contracts Act 1984 - Consumer protection through provisions aimed at striking a fair balance in both insurance contracts and the practices of insurers in relation to such contracts.*
3. *Insurance (Agents & Brokers) Act 1984 - Provisions governing the distribution network for both agents and brokers.*

Structure

The economic and social importance of the general insurance industry, the complexities associated with ensuring that insurers can meet their commitments, and the consequences of significant failures provide a basis for Government to establish certain standards of financial prudence and market behaviour.

At the same time, the most efficient way of organising economic and commercial activity, and thereby providing the greatest net benefits to the community, is through a competitive market system which is subject to the minimum of Government regulation and intervention. Therefore, in considering whether official regulation is justified, the costs of the proposed intervention should be carefully weighed against the benefits.

In examining costs it is not only the direct costs that are relevant but also the effects regulations might have in inhibiting competition or reducing efficiency, thereby adding indirectly to the costs of the product or service.

The challenge is to maximise the benefits of competition and market efficiencies while providing what the community considers to be an acceptable level of protection against the possible economic and social consequences of an insurer failing or unacceptable market practices.

Against this background, the following specific views are expressed on Australia's regulatory framework for the general insurance industry, many of which are also relevant for other areas of the financial sector:

VIEWS ON REGULATORY STRUCTURE

1. *While recognising that primary responsibility for ensuring prudent management rests with the management and Boards of individual companies, the insurance industry supports some minimum standards of government prudential supervision subject to it being efficient, cost- effective and with adequate accountability by the supervisor.*
2. *It is imperative the general insurance industry supervisor has sufficient knowledge and understanding of the industry. Such knowledge is essential and, at this stage, exists within the current regulatory structure.*
3. *It is vitally important that any regulatory structure and arrangements are subject to reasonable efficiency tests. The costs of the regulatory framework and arrangements must clearly be outweighed by the benefits. This is obviously important not only to the wider Australian community in terms of efficiency of Australian industry generally, but also to consumers and to the shareholders of the institutions being regulated.*
4. *This benefit-cost assessment should be equally applied to consumer protection measures as well as prudential regulation. Unless consumer protection legislation is subject to an efficiency test, then consumers can be forced to pay more through their premiums for inefficient and unwieldy regulation.*
5. *In considering the costs of compliance regard should also be paid to the benefits of harmonising regulation among different supervisors or supervisory requirements, thereby avoiding overlaps, inconsistencies and other implications inimical to the efficiency of the institutions being regulated. This is a particular problem where institutions forming a financial conglomerate are straddled by different regulators, a situation which has become increasingly common.*
6. *Government regulation should not aim to replace or duplicate the role of executive management in an institution. General insurers, like other institutions within the financial services sector, need to be able to move quickly in an environment which encourages innovation and flexibility so as to maintain a competitive edge. This is increasingly important as financial services markets become more globalised rather than contained within national boundaries.*
7. *Regulation must not be strict and prescriptive. General insurers should not have to operate in a prescriptive environment which limits innovation and flexibility - such limitations are more likely to emanate from "black letter law regulation", although they can also be associated with administrative requirements of regulators.*

Arrangements

While the industry has benefited over the years from the consultative processes associated with the introduction of insurance industry regulation, there are nevertheless a number of changes to the current or proposed regulatory arrangements which the industry believes would produce a better balance of benefits and costs. Some examples of these are:

EXAMPLES OF POTENTIAL CHANGES TO EXISTING INSURANCE REGULATION

1. *Section 30 of the Insurance Act, which imposes unnecessarily restrictive limitations on an institution's ability to fully utilise Related Body Assets in calculating its solvency margins.*
2. *The current regulatory regime limits the ability of Australian authorised insurers to include many overseas investments in their financial solvency calculations.*
3. *An Insurance and Superannuation Commission proposal has raised real concerns in the industry about the method of releasing potentially misleading information through public disclosure of insurers' solvency margins.*
4. *Australian Accounting Standards Board (AASB) has effectively imposed inappropriate and significant regulations on insurance companies which reduce the international competitiveness of Australian companies, at the same time misleading the Australian public as well as overseas investors and reinsurers.*
5. *The prudential supervision of general insurers involves 39 Statutory Forms to be completed for the Insurance and Superannuation Commission. This results in up to 6,674 questions. As four forms have to be completed quarterly, the total increases, for some insurers, to 9,245 questions. In addition, some of the questions involve many answers, e.g. Forms 12B and 12C could involve 200 to 300 answers each. A list of the forms, together with the number of questions relevant to each is shown at Attachment "3".*
6. *In relation to the Insurance Contracts Act, there are clearly provisions which are redundant or for various reasons ineffective or inappropriate. For example, the 'Standard Cover' provisions serve little useful purpose, particularly given recent developments in self-regulation.*

POTENTIAL ISSUES FOR REFORM

1. *Concerns about the limits put on the involvement of Australian corporations (including general insurance companies) in banking. These limitations mean they are unable to control more than 10% of the voting shares of a bank. While, with the approval of the Treasurer, this can be lifted to 15% and beyond with the approval of the Governor-General, these limits raise important issues relating to banking competition and unfair barriers to entry, particularly by Australian-owned institutions.*
2. *General insurers also have concerns about some of the costs involved with State reporting mechanisms, particularly in the areas of Workers' Compensation and Compulsory Third Party Motor Vehicle Insurance.*

Efficient markets in Australia require efficient regulation. It would be quite inappropriate to follow the example of the USA where over-regulation has resulted in market inefficiencies which have driven up costs and contributed to some insurance being unavailable or unaffordable for many in the community.

Self-Regulation

Self-regulation is an alternative to statutory rules and supervision. It generally involves a particular industry establishing arrangements under which participants in the industry effectively supervise adherence to certain agreed standards. Such an approach is rarer and generally likely to be less effective in the area of prudential requirements but can be well suited to such matters as business practices, market behaviour, and the handling of disputes.

Based on the general insurance industry's experience in this area, self-regulation can, in many cases, be a more efficient form of regulation than that which is imposed by government. When an efficiency test is applied to self-regulation, it is easy to appreciate the benefits which industry self-regulation provides. The insurance industry does not advocate total deletion of all regulation, but rather a blend of statutory regulation and self-regulation which recognises the need for flexibility and efficiency.

ADVANTAGES OF SELF-REGULATION

The important advantages which self-regulation has over statutory regulation include:

1. *Self-regulation has the advantage of flexibility in that arrangements can be adjusted to market developments more speedily than statutory rules;*
2. *Primary responsibility for supervision rests with practitioners who are expert in the relevant industry practices;*
3. *"Ownership" by an industry of a self-regulatory scheme is a major force for ensuring its effectiveness;*
4. *Principles and practices agreed to voluntarily by business are more likely to be adhered to in spirit than black letter law;*
5. *Self-regulation usually involves lower costs for industry and consumers.*

The general insurance industry has a strong track record of self-regulation. Two of the most important initiatives introduced by the general insurance industry are:

1. Insurance Enquiries and Complaints System (IEC Limited).
2. General Insurance Industry Code of Practice.

Both are very well regarded by governments, consumers and the industry itself.

Insurance Enquiries & Complaints Limited

The general insurance industry, through ICA, has operated a consumer enquiry service since the 1970s. However in 1991 the informal system which had operated for some years was replaced when ICA launched the Insurance Enquiries & Complaints scheme after consultation with the then Minister for Consumer Affairs, the Insurance and Superannuation Commission and other interested parties.

The establishment of the system followed consideration of various forms of alternative dispute resolution mechanisms in operation throughout the world. Since that time the scheme has been further enhanced and developed and today is a separate company with its own Board of Directors. The Board includes representatives from the insurance industry, the Government and consumer representation.

Some of the key features of the scheme's operations are:

GENERAL INSURANCE ENQUIRIES & COMPLAINTS SCHEME

The General Insurance Industry Enquiries and Complaints Scheme (Scheme) is a national scheme developed by the Insurance Council of Australia to handle enquiries and complaints and to resolve claims complaints which come within the Terms of Reference of the Claims Review Panel(s). The Panel(s) and the Referee operate as the Determination arm of the Scheme. Insurance Enquiries and Complaints Ltd. (IEC Ltd.) is a company whose members are the participating general insurers and which acts as the secretariat to the Scheme.

In the year to 30/6/95 the scheme handled 31,179 enquiries, together with 5,171 complaints.

Of these complaints the vast majority were satisfactorily resolved informally and through conciliation. A small percentage went forward for more formal determination which resulted in 465 determinations.

Problems and disputes are minimal in the context of the large volumes of general insurance transactions (e.g. 3.1 million claims each year), but it is indicative of the general insurance industry's commitment to improve customer service and relations that such a scheme has been successfully working for five years. In ICA's view this is preferable to any government controlled scheme.

A copy of IEC Ltd's 1995 Annual Report describes the scheme in more detail. Attachment "5".

As the enquiries and complaints system has developed, it has received enthusiastic acclaim from a broad section of the community. See commentary made by parties with an interest in both the Disputes Resolution scheme and the Code of Practice.

**Chairperson Insurance Industry Complaints
Council, Lionel Bowen, AC**

This Annual Report illustrates the continual development of the General Insurance Enquiries and Complaints Scheme.

The Scheme is a world first and at the outset there were some misgivings as to whether it would be accepted by policyholders as an effective and equitable method of alternative dispute resolution. The information in this document refutes such doubts.

Reference is made to the Review of the Scheme by the Council and the recommendations made following that Review. It is pleasing to note the ready acceptance by the industry of the many changes resulting.

The Hon. Judith Cohen, AO and the Hon. Professor Joe Isaac, AO as Chairpersons of the two Panels refer to the extension of jurisdiction and the necessary emphasis by the Panels in determining what is fair and reasonable in all circumstances. They also draw attention to the fact that the claims which come before the Panels constitute a very small proportion of complaints received by the Scheme. That in itself means that the industry has been responsive to the needs of the consumer by developing internal processes to resolve complaints without delay.

New procedures for dealing with fraud have now been put in place and you will note the excellent results being achieved by Peter Hardham as Referee. Fraud remains a difficult issue to resolve, requiring the taking of oral evidence from the parties. It is interesting to read that both insurers and insured have been equally successful and supportive of this innovation.

The General Manager's Report refers to the implementation of the new Terms of Reference, the incorporation of the IEC and the new Code of Practice and the willingness of the industry to co-operate in all these changes.

I congratulate all the abovenamed, their colleagues and staff for the splendid progress that has been made and I thank them for their assistance and co-operation making it so much easier for the Council to carry out its responsibilities.

**Extract from 1995 Annual Report of
Insurance Enquiries & Complaints Ltd.**

Parliamentary Secretary to the Treasurer,
Hon. Paul Elliott, MP

The Parliamentary Secretary to the Treasurer, the Hon. Paul Elliott, MP, today welcomed the release of the Insurance Council of Australia's Code of Practice for the general insurance industry.

Mr. Elliott said implementation of the ICA's Code of Practice will be a significant step towards improving industry standards and enhancing service to consumers.

"The ICA's Code builds on its success in establishing the widely respected Claims Review Panel which has helped thousands of consumers since it began in 1991," Mr. Elliott said.

The ICA's Code represents an important step in reaching this objective.

Mr. Elliott congratulated the ICA on the considerable effort and commitment it displayed in working hand-in-hand with Government and others to develop the Code. I'm confident that the ICA will continue to show great resolve in ensuring that the Code is implemented with vigour by the industry.

The ICA has consulted widely with industry, professional and consumer groups. It has also worked closely with a Government taskforce comprising the Insurance and Superannuation Commission, the Trade Practices Commission and the Federal Bureau of Consumer Affairs.

The Code being launched today has been endorsed by the ISC and is likely to be widely adopted by the industry.

Extract of Media Release
Welcoming Release of Code of Practice

Code of Practice

The General Insurance Code of Practice (Code) was fully implemented on 1st July, 1996 and is supported by almost all authorised insurers writing domestic classes of business.

The Code describes best practices in a number of important areas including:

1. Plain language documentation which is now the "norm" in the industry.
2. Training of staff and agents. The Australian Insurance Institute has issued certificates to more than 16,000 staff and agents who have attended Code of Practice training sessions. In addition, many more staff and agents have attended course run "in-house" by major insurers.
3. Dispute resolution, both external and internal. Insurance companies have all established Internal Dispute Resolution procedures which are working well.
4. Claims handling. Under the Code insurers are encouraged to set benchmarks for responses to claims - with the aim to achieve "best practice". Insurers set standards which are then disseminated throughout the company.

A copy of the Code is attached. Attachment "6".

FINANCIAL SYSTEM INQUIRY - TERMS OF REFERENCE

1. ***The Inquiry will report on the results arising from the financial deregulation flowing from the Inquiry into the Australian Financial System (“Campbell Report”) published in 1981. This will involve examining and reporting the consequences for:***
 - (a) ***the choice, quality and cost of financial services available to consumers and other users;***
 - (b) ***the efficiency of the financial system including its international and domestic competitiveness;***
 - (c) ***the economic effects of deregulation on growth, employment and savings;***
 - (d) ***the evolution of financial institutions and products offered by them and the impact on the regulatory structure of the industry.***

The Australian financial system experienced substantial and rapid structural and market changes as deregulation combined with globalisation and technological advances introduced new competitive forces and spurred innovation. This markedly changed environment and some market developments produced a much greater official focus on prudential supervision of institutions and on consumer/investor protection. The result is that while deregulation generally increased the efficiency of financial markets and produced many benefits for consumers of financial services the general trend to more stringent prudential supervision and the introduction of increasingly demanding requirements ostensibly directed at protecting consumers operated to partly offset those benefits.

It is difficult to specify precisely the extent to which the benefits of deregulation benefited general insurance companies since there was virtually no deregulation in this industry post Campbell and consequently no direct benefits. The general insurance industry had been substantially affected in the early 1970s by the Trade Practices Act and the Insurance Act 1973 which imposed stringent new prudential standards on general insurers. The direct benefits of post-Campbell deregulation flowed mainly to institutions and markets involved in financial intermediation and the saving and investment process, again an indication of the differences between general insurance and other financial sectors. The general insurance industry, however, has benefited, along with other parts of the community, from the increased competition and market innovations which have been a concomitant of deregulation.

That having been said, the general insurance industry was caught up in the increased attention on prudential supervision and what appeared to be greater official concerns to avoid failures in the financial system. Similarly, as consumer groups increasingly focussed their attention on the banking and life insurance industries which experienced more dramatic change in the aftermath of deregulation, the general insurance industry was assumed to be in need of similar consumer protection measures. While the industry indicated by its initiatives that there was scope for improvement in the area of assisting customers, it was also required to devote significant time and effort towards ensuring that consumer protection measures were more balanced than many were seeking.

The impact of deregulation following the Campbell Inquiry can, arguably, be described as follows:

The Campbell Report recommended deregulation which led to greater competition/innovation in the financial services market. This greater competition led to some institutional instability and market imperfections which heightened official attention to prudential supervision and consumer protection. The result has been more stringent supervision and more consumer protection measures which can reduce the benefits of pro-competition deregulation.

It is an appropriate time for an assessment to be made of whether the responses to market developments associated with deregulation have been sufficiently balanced so as not to lose many of the potential benefits which can flow from market forces in a freer and more competitive environment. It is important in considering regulatory regimes not to lose sight of these benefits and the potential for market forces to eventually provide their own solutions to the problems which inevitably arise when substantial adjustments have to be made to new operating environments, such as with financial markets in the post deregulation era. This could mean that some of the measures introduced in recent years could be removed or relaxed now that institutions and market have largely adjusted to the deregulated environment.

Term of Reference 1(a)

“the choice, quality and cost of financial services available to consumers and other users”

The choice, quality and cost of general insurance services can genuinely be described as very good for a number of reasons, although for the most part not directly linked to deregulation. These include:

1. A very large number of authorised companies operate in a relatively small market in Australia.
2. This results in a highly competitive market.
3. Such competition is intensified by the fact that Australia has a number of very strong indigenous companies who compete against strong internationally-owned companies.
4. Australia has a tradition and history of good quality general insurance companies operating in this country.
5. The industry comprises skilled people.
6. Consistently better returns to the consumer in terms of the premium dollar being returned in claims payments than other comparable countries.
7. The industry has embraced self-regulation which has helped further develop the quality of products and services to the consumer.

While deregulation has not been a significant force behind developments in the general insurance industry, it is clear that deregulation has substantially improved the choice and, to varying degrees, the quality and cost of financial services available in the community. There are many examples across the financial services industry to support this view. One of the most obvious of these is that prior to deregulation ordinary bank customers had little opportunity to secure better treatment from another bank. Now such borrowers are pursued with a variety of incentives and a wide menu of loan options.

Term of Reference 1(b)

“the efficiency of the financial system including its international and domestic competitiveness”

Australia has an open market which is quite transparent in terms of its rules of entry for any overseas players wishing to enter. As supporters of the free enterprise open competition system, Australia’s general insurers have learnt to compete in a tough market. Unfortunately, Australia’s open and transparent approach is not always reflected in other nations.

There are particular barriers to our international competitiveness such as: ownership restrictions in some other countries (joint ownership requirements, minimum shareholder requirements), indigenous staffing requirements and marine insurance restrictions.

The general insurance industry has the opportunity to develop Australia as a hub for the Asia-Pacific area. This would enhance the capacity of the Australian market while also increasing revenue in Australia through the introduction of new general insurance businesses, including through reinsurers.

It is important that in pursuing this objective the industry is able to take advantage of an Australian financial system that operates on the most cost-efficient basis possible and the industry itself is not unnecessarily handicapped by overly-restrictive regulation.

Some of the significant advantages which the general insurance industry can offer to Pacific Rim countries are:

1. Potential as a base for regional headquarters.
2. The geographic location of Australia makes it quite central to the Pacific Rim.
3. Australia’s time zone gives it a central position in the Pacific Rim.
4. Active support given by Government to strategically place Australia in the forefront of Asian services trade.
5. Stable political system.
6. An open market with no barriers or discrimination imposed on foreign insurers with all companies subject to prudential controls by the Insurance and Superannuation Commission.
7. This country has a very competitive market which has honed the skills and capabilities of Australian insurers such that to successfully operate in Australia, means a capability to operate virtually anywhere.

8. Computer programmes have been developed for the insurance industry in Australia which have been well received in other parts of the world including Asian markets.
9. There is a high level of technology generally.
10. Australia has a diverse range of flexible sophisticated products.
11. Australia has excellent telecommunications facilities.
12. A skilled workforce exists:
 - Generally Australians are well educated
 - Specific insurance skills including Australian Insurance Institute exams
 - Specialised skills such as actuaries, lawyers, accountants, etc.
13. One of the key attributes of the Australian insurance industry is its human resources. Human resources are not only a large cost component of the insurance industry, but they also represent a substantial resource and a saleable skills base. Apart from the specialist skill levels mentioned earlier, we could add auditors, economists, information system analysts, and customer service employees.
14. Australia has a heightened awareness of consumer issues which have improved both the products and the service standards Australian insurers offer. This is something which could provide an advantage in markets overseas which may not have had the same realisation that good customer service is vital for commercial success.

Term of Reference 1(c)

“the economic effects of deregulation on growth, employment and savings”

The last decade particularly has seen some effects on the Australian/State economies caused by the movement both to and from government monopolies in two of the largest classes of general insurance. These classes are Workers’ compensation and Compulsory Third Party Bodily Injury insurances.

The degree to which this may or may not be related to deregulation is a moot point. It is difficult to quantify the effect of deregulation on the level of confidence in the system. ICA fully supports the National Competition Policy endorsed by the Council of Australian Governments in April, 1995 that privatisation leads to the more efficient allocation of resources, lower costs, increased productivity, greater variety of products and better levels of service.

In 1985 the Victorian Workers’ Compensation system was removed from private insurers and put in the hands of a government monopoly. The economic effects on Victoria were significant and detrimental and at one stage added over \$2 billion to the State’s deficit. While ICA does not suggest the Victorian Government move was a direct result of deregulation following the Campbell Inquiry, it is worth making the point that the impact on Australia’s financial services sector of poor government decisions can be quite profound. Both the public and private sector have a role to play and each must clearly understand such a role if the Australian economy is to benefit.

It is pleasing to note that State Governments are reversing the trend of the 1980s and heading back towards private sector open competition systems.

By providing opportunities for private enterprise insurance companies in this way, Governments are able to obtain the benefits flowing from increased competition and free themselves from administrative tasks in order to direct their focus to ensuring that the right regulatory framework is in place. The delegation of such services to the private sector market brings the benefits of competition, namely:

- (a) Lower prices
- (b) More variety and better products
- (c) Increased quality of service
- (d) Increased productivity.

Term of Reference 1(d)

“the evolution of financial institutions and products offered by them and the impact on the regulatory structure of the industry”

General insurance products and services have developed significantly through the 1980s and 1990s, although due largely to competitive forces inherent in the structure and operations of the industry rather than anything directly facilitated by deregulation. The increased sophistication of certain of these products and the longer term liabilities associated with some products have led to some greater stringency in prudential supervisory requirements. The major impact on the industry, however, has been in the area of more onerous consumer protection measures which parallels developments in other areas of the financial services industry.

Some general insurers are part of the large financial conglomerates which now dominate the Australian financial scene. In that context they have a significant interest in the potential implications of the blurring of institutional and product distinctions for regulatory structures and arrangements. They are particularly concerned to maximise harmonisation among regulators and to avoid unnecessary overlaps and inefficiencies in regulatory regimes. It is expected that detailed views on these matters will be directly expressed to the Inquiry either by the financial conglomerates or by the industry associations representing the major areas of activity of the institution.

2. *The Inquiry will identify the factors likely to drive further change including:*
- (a) *technological and marketing advances;*
 - (b) *international competition and integration of financial markets;*
 - (c) *domestic competition in all its forms;*
 - (d) *consumer needs and demand.*

Term of Reference 2(a)

“technological and marketing advances”

In line with the entire financial services sector, the general insurance industry has been and is expected to continue to be heavily involved in technological advances.

Australia is renowned for embracing new technology. This attitude can be ascribed to a number of factors such as:

1. Geographic spread and size and therefore the need for fast communications.
2. Distance from other countries.
3. Relatively high education levels.
4. Relatively high wealth/spending power.
5. Young population and a youthful culture in terms of its history.
6. Less rigid entrenched infrastructure or culture because of its youth.

At the same time as technology has been rapidly developing, there have been increasing pressures on the general insurance distribution system:

PRESSURES ON DISTRIBUTION SYSTEM

1. *Expenses make up an important cost element of general insurance.*
2. *Consumers want easy, simple, quick ways to arrange their insurance.*
3. *Developing technology offers easier, quicker, cheaper distribution.*
4. *There is no longer the same need to have branch offices since much can be done by ‘phone or computer.*
5. *Centralised ‘phone systems to provide specialist advice may be set up virtually anywhere.*
6. *Banks and home loan specialists and others are all introducing programmes such as buyer loyalty programmes and other ways to make the customer “theirs”.*

An interesting example exists in the UK where a “phone-based” company has become the largest motor vehicle insurer in the UK. The company was virtually an unknown in the mid-1980s. Since then it has gained significant home market share and is now moving into life insurance and banking.

Recent research indicates that Australia has a high penetration of direct marketing in the domestic insurance area with 80% of Motor Vehicle insurance and 65% of Home insurance written by direct underwriters.

The direct marketing options for the future are likely to include:

1. Broker/agent networks
2. Direct underwriter with their existing networks.
3. Non-direct insurers, with or without branches/networks.
4. Retailers.
5. Banks and other financial institutions.
6. Strategic alliances.
7. Technology through telephony, computers, internet.

It is important to recognise, however, that even with the development of information technology, direct marketing is not the only form of distribution available or in fact preferable for all circumstances. There is still a demand from many consumers for an independent distribution network. So far as general insurance is concerned, this comprises insurance brokers and independent agents who have an important role to play.

The role is quite distinct from that which is provided by investment advisers. Again the distinction between risk and saving/investment products needs to be made so as to fully appreciate the need for different regulatory mechanisms to deal with investment advisers and general insurance intermediaries.

The mere existence of professional insurance intermediaries adds choice to the market, may offer efficiencies as far as both providers and purchasers of insurance products are concerned, and adds flexibility to the distribution system.

Technology provides the opportunity for insurers to operate without the current distribution network such as branch operations. However, the essential question for general insurers, as it is for other financial institutions, is what degree of penetration of markets is likely to be achieved by technology. Technology provides opportunities but it also raises potentially important issues for regulatory arrangements and indeed for the competitiveness of industry. For example, the provision of products and services on the internet from offshore sources (possibly unsupervised institutions) could require fundamental changes in approaches to supervision. Such offerings could also significantly impact on domestic industries if the latter are unduly handicapped by regulatory requirements.

Predictions about the impact of technology on future developments in general insurance and the financial services industry generally are obviously difficult to make. A great deal will depend on the ability and, more importantly, the willingness of customers to conduct their financial affairs on an electronic basis. Privacy considerations will also be one of the major factors determining developments. At the general level, however, there are good reasons for believing that:

1. Information Technology specialists will become a major driving force behind marketing strategies rather than the tools of the marketing staff.
2. As consumers become more financially sophisticated and information becomes more readily available in electronic form, they will increasingly “buy” rather than be “sold to”.

These points made, it would not seem wise to presume what developments might occur and on that basis establish a regulatory structure and arrangements for the future. It makes far more sense to acknowledge that technology could have a major impact, albeit the nature and extent remains uncertain, and for that reason the regulatory structure and arrangements should be under constant watch, and adjusted as necessary, to ensure that they remain appropriate as well as efficient and cost-effective.

Privacy Issues and the General Insurance Industry

The Federal Government is currently reviewing Australia’s existing privacy laws. ICA understands that the Federal Attorney-General will make a statement soon on the direction of the Government’s intentions towards a privacy regime in the private sector.

The general insurance industry appreciates that technological developments such as smart cards and interactive TV have the potential to raise new and difficult privacy questions. Insurers also know that Australians will respond to new technologies, with enthusiasm, only if they feel confident that their privacy is protected.

The insurance industry comes from a culture of privacy and has been dealing with sensitive personal and commercial information for literally hundreds of years. There is no public perception or suggestion that the insurance industry abuses this trust.

Many ICA member companies are examining already the information privacy principles; and are considering whether any additional consumer protection is required as we move increasingly into the information age.

Insurers are examining the issue from the consumer viewpoint. This includes not just the customers’ concerns about the privacy of their personal information but:

- The additional cost of complying with a privacy regime affecting the ultimate price of insurance products
- Protecting the community against fraud and other irregularities
- The need for cost-efficient, speedy and accurate flow of data; in particular the information needed to settle customers’ claims.

General insurance companies are major users of information technology. The industry is among the most advanced in its systems for maintaining the security of personal and commercial information. The use of electronic information and communication technology provides the opportunity for highly developed security arrangements for access to personal files and protection of computer records.

Term of Reference 2(b)***“international competition and integration of financial markets”***

The Australian general insurance industry has a significant number of overseas companies and international competition will continue to drive changes in the industry. Such competition is likely to be accentuated as financial conglomerates, involving general insurance operations, continue their path of globalisation. At the same time, some Australian based insurers will seek to expand their offshore activities both to secure new business opportunities as well as to fully service the insurance needs of Australian companies from many sectors of the economy which are moving into off-shore markets.

The Australian general insurance market writes approximately \$1.6 billion in premium income from off-shore sources. Further aspects of this issue are covered earlier in the submission under Term of Reference 1(b).

Term of Reference 2(d)***“consumer needs and demand”***

The general insurance industry has, over recent years, implemented important changes in response to consumer needs and demands and can be expected to continue to respond positively to reasonable demands. It is vitally important, however, that the costs and benefits of all existing and proposed consumer protection measures should be carefully assessed to ensure their appropriateness.

This Submission earlier described two particular industry initiatives:

1. Insurance Enquiries and Complaints system (IEC Limited).
2. General Insurance Industry Code of Practice.

These important changes reflect the increasing interest and awareness of consumers about the services and products they purchase.

In the general insurance industry, experience indicates consumers are looking for products with the following characteristics:

CONSUMER DEMANDS

1. *Easy to understand*
2. *Quick service*
3. *Simple to obtain*
4. *Quality*
5. *Problem solving mechanisms*
6. *Assistance programmes*
7. *Inexpensive.*

These demands often lead to less face to face contact and more “technological” contacts, i.e. through computers or various forms of telemarketing. Australian legislation needs to be flexible to cope with this trend. A balance is required such that Australian companies are not constrained by unnecessary or unworkable domestic regulations.

At the same time, to meet these demands, an industry must tailor its approach to consumers. The distinction between general insurance risk products and saving/investment products mentioned earlier highlights the need for consumers to have specifically designed mechanisms in place such as Insurance Enquiries and Complaints Ltd. and a specific Code of Practice for general insurance.

There are, of course, complaints/disputes handling schemes in other areas of the financial services industry. There would, however, be major disadvantages in seeking to integrate existing schemes into a single statutory scheme or ombudsman for the financial services industry:

- there is substantial diversity in types of complaints, transaction sizes, and appropriate remedies for the various products provided in different areas of the financial services sector and this diversity requires different expertise to assess complaints, make appropriate decisions, and determine reasonable solutions;
- this diversity and need for specialist expertise would mean that a single scheme would effectively have to operate with discrete and autonomous units;
- there is little evidence of customer confusion or overlaps, with co-ordination and liaison among the various schemes operating to ensure customer satisfaction;
- statutory arrangements are not as flexible as industry-based schemes;
- industry goodwill and co-operation associated with industry “ownership” of specific schemes have been critically important to their success.

3. *The Inquiry will make recommendations on the regulatory arrangements and other matters affecting the operation of the financial system (including prudential and other regulations made by the Reserve Bank and other bodies) as will:*
- (a) *best promote the most efficient and cost-effective service for users, consistent with financial market stability, prudence, integrity and fairness;*
 - (b) *ensure that financial system providers are well placed to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovation;*
 - (c) *provide the best means for funding the direct costs of regulation;*
 - (d) *establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions.*

There are two principal areas of government supervision relating to general insurance companies; namely:

1. Prudential supervision.
2. Consumer protection.

Before discussing how best these types of supervision might be undertaken, it is appropriate to consider the broad objectives of government supervision in the financial services sector which are to:

OBJECTIVES OF GOVERNMENT SUPERVISION

1. *Safeguard the stability of the financial system, especially the safety and soundness of the payments system.*
2. *Provide an appropriate level of protection to consumers of financial services.*
3. *Promote efficiency in the operation of financial markets, including in the provision of financial products and services.*

There are various principles which desirably should underlie any regulatory arrangements. There should be a clear recognition of the benefits of competition and a market-oriented approach to supervision, ensuring that where official intervention is judged necessary because of market failures or imperfections it is done in an efficient and effective manner. Regulation should also be cost-effective; flexible to changes in business activities and market conditions; and involve consultations with affected parties to ensure that the full implications of particular measures are understood.

The extent and nature of government intervention judged appropriate would and should vary among various sectors of the financial system and statutory requirements may be combined with industry self-regulation.

Prudential Supervision of General Insurance Companies

A fundamental question for consideration is whether or not there is in fact any need for prudential supervision of general insurance companies.

The absence of statutory supervision is clearly a possibility with New Zealand providing such a model. The New Zealand general insurance industry is subject to a non-government ratings system delivered through private ratings agencies such as Standard and Poors and A.M. Best.

This approach is, however, more appropriate for New Zealand than Australia because New Zealand can, to a great extent, also rely on the knowledge that almost all general insurance companies operating in New Zealand are subject to prudential supervision in Australia, UK, USA, etc. Australia has a significant indigenous market and would not be able to rely on this method to the same extent as New Zealand.

Since most developed countries also have statutory supervision of their general insurance industry, the absence of such supervision in Australia could be a significant impediment to the industry operating in off-shore markets or to Australia developing as a 'hub' for the Pacific Rim region.

As stated earlier in this Submission, the general insurance industry sees substantial benefits in self-regulation but also supports some minimum standards of Government prudential supervision subject to it being made more efficient and cost-effective. This relates to the national economic and social importance of the industry, its complexities, and the consequences of significant failures.

Other Regulatory Issues from a National Interest Perspective

The extent of change in the financial system over recent years, combined with the national importance of ensuring that regulatory structures and arrangements meet their objectives as optimally as possible, make it appropriate to undertake a general assessment of the efficiency and cost-effectiveness of major aspects of existing regulatory structures and arrangements applying to the financial services industry.

Deregulation, combined with globalisation and technological advances, has seen a substantial increase in competition and product/service innovation in Australian financial markets. This is evidenced in most areas of activity whether in traditional fields such as mortgages or in the newer and more complex areas of funds management. Markets have become significantly more internationalised with greater movements of institutions and capital across national boundaries.

One of the more notable areas of recent developments has been the entry by institutions into new and wider areas of activity, often involving greater complexity and risk. This included moving into activities, often through subsidiaries, which traditionally had been the preserve of other institutional groups.

The result is more one-stop financial services shopping with traditional distinctions among institutional groups - banking, deposit-taking activities, insurance, securities business- becoming increasingly blurred. The desire to offer multi-functional products and services within the same group has led to the creation of the financial conglomerates which now dominate the Australian financial scene: currently about two-thirds of total assets in the financial system are controlled by the 30 largest groups.

A further concomitant of deregulation and associated market developments was an increase in the overall risk characteristics of the financial system as it adjusted to new competitive forces and innovated. This saw some instability in the system which generally operated to produce more stringent regulations and more interventionist attitudes by governments and regulators. The result is that a large part of the financial system is now subject to prudential supervisory regimes which are roughly equivalent in stringency. It also appears to have had the effect of engendering unrealistic expectations about what regulation can achieve and significantly diminishing the perceived risk spectrum in the financial system.

The effects can be similar to where guarantee or protection schemes are in place to protect customers against loss in the event of a failure. Such schemes remove the incentive for customers to consider risk when making financial decisions; encourage organisations to undertake higher risk business generally involving cross-subsidisation of imprudent by the prudent; and can draw governments into ever-increasing commitments to protect retail customers from ever losing money even if it involves injurious levies on other organisations and their customers or means heavy calls on the public purse. ICA does not support the explicit or implicit introduction of such guarantee arrangements.

It is the blurring of institutional distinctions and the concerns about the inefficiencies of regulatory overlaps and disharmony, combined with more equalisation in prudential stringency, which appear to have been the major driving forces by the suggestions that there would be advantages in moving towards some form of mega-regulator and a functional rather than institutional approach to supervision of the financial services industry.

Options for Change in Regulatory Structures and Arrangements

As stated earlier, ICA has no major problems with the existing regulatory structure from its own industry perspective but acknowledges that it needs to be reviewed against the background of the major developments impacting on the financial system generally. The comments below are principally made by ICA from a national interest perspective.

In setting out the considerations relevant to the various options, particular regard has been paid to the principles which should guide supervisory arrangements. In summary, these principles are that supervisory arrangements directed at efficiency, stability, and consumer protection objectives should:

1. Allow optimisation of the benefits of competition.
2. Be cost-effective, efficient, flexible, and involve consultation.
3. Carefully balance the costs and benefits of any supervisory measures.
4. Recognise that the implications of market imperfections vary across the system and maintenance of a risk spectrum is important.
5. Allow for changes in the supervisory framework if changing circumstances so dictate.

In general terms, the supervisory structure and arrangements have changed, but the important issues are whether the current structures or arrangements have sufficiently adjusted to the new environment and whether there can be greater harmonisation in approaches which provide benefits from the perspective of the supervised and the general efficiency of the system, but not at the expense of undermining achievement of particular and desirable objectives.

Regulatory Structure and Co-ordination

A significant response to financial market developments has been the establishment of the Council of Financial Supervisors (CFS) which has the basic aim of enhancing the quality of financial supervision by improving co-ordination of the activities of the four independent primary supervisors of the financial system, including harmonisation of supervisory requirements to avoid unintended gaps, duplication, or inconsistencies. The importance of such a role has significantly increased with the increasing dominance of the financial system by financial conglomerates offering multi-functional products and services and the blurring of institutional and product distinctions. An assessment of the CFS's activities indicates that it had made, through various means, a valuable contribution to improved regulatory co-ordination and the development of supervisory arrangements in a rapidly changing environment.

Status Quo

Against this background, continued reliance on the CFS to determine how best to achieve all the necessary co-ordination required for effective supervision of the financial system, and for it to facilitate necessary changes, could therefore be considered as a first option. The major arguments supporting this are:

1. The CFS was only established in 1992 in response to the major developments which have impacted on the financial system; it has a good track record in achieving the objectives set for it; and it would be premature to change these arrangements.
2. The non-statutory nature of the CFS gives it the flexibility to quickly adjust its priorities and arrangements to changing circumstances and this could be lost with a statutory body.
3. The CFS comprises the four supervisors totally responsible for prudential supervision of the system and for a substantial part of supervision directed at consumer protection and to change or extend its membership could be inimical to securing the cooperation necessary to effect changes speedily and effectively.
4. Reserve Bank chairmanship is consistent with the general responsibility of central banks for maintaining stability in the financial system.
5. The current members are closely involved with the international organisations - the Basle Committee (Banking); IOSCO (Securities Markets); and the IAIS (Insurance) - concerned with financial markets supervision and are therefore able to closely monitor supervisory developments overseas; work in these forums to identify and propose ways to solve emerging problems (eg conglomerate supervision); and generally assist in harmonisation of international supervisory arrangements which is becoming of increasing importance with the development of internationally operating financial conglomerates.

At the same time, there are aspects of the CFS's activities which could possibly be improved. These are addressed below.

Lead Regulator and Holding Company Structure

The lead regulator concept has attracted a substantial amount of attention around the world as a possible response to the growth of financial conglomerates and has operated in the United Kingdom since the late 1980s. Under such an arrangement, one of the primary supervisors is designated as a lead regulator for each financial conglomerate who would have overall responsibility for the conglomerate but supervision of the conglomerate's individual parts would remain with individual supervisors. After careful consideration, the CFS indicated in 1993 its belief that, on balance, the introduction of a single lead regulator at that time was neither necessary nor desirable, preferring instead to adopt the formal guidelines for supervision of financial conglomerates.

There is a significant risk, however, that the current informal liaison and co-ordination approach could be found wanting in the event of a crisis where individual supervisors with their own statutory responsibilities could pursue courses of action dictated by their specific and narrower interests which are not conducive to the group's overall stability. This risk should be given a heavy weighting in considering the option of a lead regulator approach which is favoured by ICA.

In its examination of supervisory issues relating to financial conglomerates, the CFS in its 1995 Annual Report paid significant attention to the issue of financial holding company structures in the Australian financial system. ICA considers that current policy which opposes such holding companies where a bank is involved is anachronistic in the current financial system and that arrangements should be developed as a matter of priority to permit such structures. The major issues relevant to this matter are referred to in the CFS Annual Report and their reading indicates a balance of argument in favour of allowing such structures.

Consultative Processes

Members of the CFS consult with industry organisations, other government agencies and interested parties (eg consumer groups), in developing supervisory arrangements. The results of such processes are factored into CFS deliberations through each of its members.

If the CFS were to undertake such consultations:

1. It would heighten the visibility of the CFS in the community and be seen as increasing its accountability;
2. It would allow harmonisation and other matters relating to the efficiency of supervisory arrangements to be discussed openly with both the views of the various industry supervisors and industry participants being tabled; and
3. Such consultations could facilitate achievement of greater harmonisation and avoidance of unnecessary duplicative supervision, or at least increase understanding of why different approaches/arrangements are judged necessary.

It is important, however, that arrangements for consultative processes be subject to guidelines which avoid wasteful or divisive use of this forum.

Policy Board

A more substantial and formal option in the direction of increasing CFS accountability and improving supervisory co-ordination would be the establishment of a Policy Board along the lines of the Policy Board for Financial Services and Regulation established in South Africa in 1993. This Policy Board, which is a statutory body, followed the Report of the Jacobs Committee which was appointed to investigate “the promotion of equal competition for funds in financial markets in South Africa”. This Committee recommended that a “holistic” approach to the regulation of financial services be adopted and recommended the establishment of a Policy Board to give effect to this objective. The South African Government adopted this approach in preference to the establishment of a mega-regulator.

Appointed members of the Policy Board represent the regulatory authorities and the regulated financial institutions and markets. In order to promote practitioner-based regulation, the majority of members are from the private sector. It was not assigned executive powers but was given the responsibility of formulating and co-ordinating policy relating to the further development of the financial services sector and the financial markets as well as to financial regulation.

The Policy Board acts as adviser to the Minister for Finance and the areas of advice include developments in the financial services sector and the financial markets, changes in the regulatory structure, amendments to existing financial legislation, the introduction of new financial legislation, and improvements in financial supervision. The Board may appoint committees to assist it in fulfilling its responsibilities and members of such committees need not be members of the Board.

The advantages of establishing such a Board in Australia responsible to the Federal Treasurer are that:

1. It would secure all the advantages associated with extended consultative processes discussed above but be seen as a more decisive move in the direction of seeking to deal with the changes in the financial services industry and increasing the accountability of supervisors.
2. It would better ensure a “holistic” approach to supervision and would promote practitioner-based supervision.
3. It could consider, but with a broader perspective, matters currently of concern to the CFS, industry participants and consumers, such as the elimination of gaps in supervisory structures; reducing systemic risks from financial market transactions (eg derivatives); enhancing competitive neutrality; harmonising financial supervision domestically and with international standards and practices; and seek to assess future financial market developments and take a pro-active approach to handling potential problems.

Mega-Regulator

A more fundamental change in the supervisory structure in response to financial market developments, particularly the growth of financial conglomerates, would be a single supervisor for the financial services industry or a so-called mega-regulator. The favourable aspects which some argue could derive from such an option include:

ADVANTAGES OF “MEGA-REGULATOR”

1. *There would be more commonality in approach to supervision and less jurisdictional conflict.*
2. *Competitive inequalities and gaps, overlaps, and inconsistencies in supervisory arrangements would be less likely.*
3. *It would facilitate intermingling of an institutional and a functional approach to supervision (it is desirable to seek a functional approach to consumer protection supervision whereas an institutional approach is necessary for prudential objectives given that it is institutions which become insolvent not functions).*
4. *It could be more cost-efficient.*
5. *There could be greater public transparency in supervisory arrangements and possibly increased credibility of supervisory process.*

There would, however, be significant disadvantages:

DISADVANTAGES OF “MEGA-REGULATOR”

1. *The community is likely to perceive all financial institutions and markets subject to single supervisor as being at the same position on the risk spectrum.*
2. *It could result in an unwieldy organisation with an undue degree of power and less accountability.*
3. *The specialist skills required for prudential supervision among institutional groups would limit scope for economies of scale with, in practice, supervision carried out in discrete units with a high degree of autonomy.*
4. *There would be a greater risk that a single authority could adopt an undesirable approach to supervision than where different approaches of various supervisory authorities focussed attention on basic supervisory issues and stimulated public debate to produce best results.*
5. *There is no strong international support for single regulator and where such arrangements do exist (Canada and Scandinavia), co-ordination issues still arise and are not necessarily better handled in a single organisation, where there are discrete units for different parts of financial sector, than through CFS.*
6. *States could see a super regulator as an infringement of their rights.*

The balance of the above arguments does not support a single regulator.

More generally, and as has been pointed out by regulatory bodies, the cases of instability which have arisen in the financial system have not arisen from a lack of co-ordination among supervisors of a financial conglomerate.

Suggested Structural Arrangements

This submission has emphasised the uniqueness of the general insurance industry, particularly the importance of differentiating it from other areas of the financial services industry, and the need for specialist knowledge and arrangements with regard to its supervision. These factors strongly argue for a regulator with the sole responsibility of supervising general insurance companies and intermediaries for prudential, consumer protection, and efficiency objectives. This is the preferred position of ICA.

It is recognised that in its deliberations the Inquiry will receive and consider a range of options with regard to supervisory structures. Such options are unlikely to have any special regard for the general insurance industry, but will be driven by developments, inefficiencies or weaknesses in existing regulatory structures from the perspective of other areas of the financial services sector. In such circumstances, ICA considers it should indicate its views on other structural arrangements which could be seen as meeting market developments, particularly the growth of conglomerates and blurring of market distinctions, and thereby improve the efficiency and harmonisation of regulatory arrangements.

On the basis that a super-regulator encompassing both prudential and consumer investor protection is inappropriate, an alternative regulatory structure which ICA considers appropriate would involve the following elements:

1. The Reserve Bank (RBA) should retain its responsibility for prudential supervision of banks (which are central to the payments system) but also take on responsibility for supervision of building societies and credit unions currently subject to the Financial Institutions Scheme. This should secure greater efficiency and cost-effectiveness in prudential supervision of the financial system.

ICA believes there are significant benefits in the prudential supervisor also being responsible for consumer protection. It would reduce conflicts between differing objectives, make best use of skilled regulatory resources, and avoid the danger that an agency concerned solely with consumer protection could have a propensity to overkill. It would be vitally important, however, that supervisory authorities should work closely to ensure, where appropriate, maximum harmonisation in regulatory requirements and the avoidance of overlaps, gaps and conflicts.

In view of the tensions which can arise between securing an appropriate degree of independence for the RBA in its monetary policy responsibilities yet ensuring appropriate accountability for its prudential supervision and consumer protection supervision activities, there could be a need for separate and special provisions in banking legislation relating to these dual functions.

2. There should be one other supervisor responsible for both prudential and consumer protection supervision in the insurance, superannuation and collective investments areas. This should take the form of a statutory authority similar to the RBA which would have an independent Board of Directors comprising some private sector persons with experience in areas supervised by this authority. Such an authority would assist in the avoidance of competitive inequalities and in achieving greater harmonisation in supervisory requirements. Statutory authority status would assist in the recruitment of skilled staff while the authority would benefit from the input of the private sector board members.

See Attachment “4”.

ICA recognises that pressures are likely to exist for a functional approach to investor and consumer protection with a separation of prudential and consumer protection supervisors. Such pressures could be for a single consumer protection supervisor or two supervisors divided in line with the division of responsibilities suggested above for the RBA and the other supervisor.

The responsibilities of such a supervisor(s) could encompass overseeing the marketing of retail products and services, including disclosure requirements, as well as codes of conduct and complaints handling.

While such an initiative could assist with harmonisation and competitive equality objectives, there is a serious danger that the establishment of separate consumer protection authorities would also be a recipe for more such protection whether genuinely needed or not. In the Council’s view, if this option is pursued (and two authorities would be preferred to one) it is vitally important that the mandates of these authorities, their structure and other arrangements are directed at ensuring that only regulation where the benefits clearly outweigh the costs are retained or introduced. This could involve the use of sunset provisions on existing and new measures.

LIST OF ICA MEMBERS**AAMI Ltd.****American Home Assurance Co.**

AIG Workers' Compensation (Vic) Pty. Ltd.

American Re-Insurance Company**AMP General Insurance Ltd.**

AMP Workers' Compensation Services (Vic) Ltd.

MGICA Ltd.

TGI Aust. Ltd.

Ansvar Australia Insurance Ltd.**Australian Unity General Insurance Ltd.**

Australian Natives Association Ins. Co. Ltd.

Manchester Unity Insurance Ltd.

BHP Marine & General Insurances Ltd.

World Marine & General Insurances Ltd.

Boral Insurance Ltd.**Catholic Church Insurances Ltd.****Chiyoda Fire & Marine Insurance Co. Ltd. (The)****Chubb Insurance Company of Australia Ltd.****CIGNA Insurance Asia Pacific Ltd.**

Crusader Insurance Co. of Aust. Ltd.

Colonial Mutual General Insurance Co. Ltd.**Combined Insurance Company of Australia****Commercial Union Assurance Co. of Aust. Ltd.**

Commercial Union Australian Mortgage Ins. Corp. Ltd. (CUAMIC)

CU Travel & General Insurance Ltd.

Com. Union Workers Ins. (Vic) Pty. Ltd.

Mutual Community General Insurance Pty. Ltd.

Swann Insurance (Aust) Pty. Ltd.

Union Insurance Company Ltd.

Commonwealth Connect Insurance Ltd.**Copenhagen Reinsurance Co. Ltd.****Cumis Insurance Society Inc.****Employers' Mutual Indemnity Association Ltd.****Employers' Reinsurance Corporation****FAI Insurance Ltd.**

FAI Car Owners Mutual Insurance Co. Ltd.

FAI General Insurance Co. Ltd.

FAI Reinsurances Ltd.

FAI Traders Insurance Co. Ltd.

FAI Workers' Compensation (Vic) Pty. Ltd.

GE Capital Insurance (Aust) Pty. Ltd.**General and Cologne Reinsurance Australasia Ltd.****Gerling Aust. Insurance Co. Pty. Ltd.**

Gerling Global Reinsurance Co. of Aust. Pty. Ltd.

Guild Insurance Ltd.

Hallmark General Insurance Co. Ltd.

HBF Insurance Pty. Ltd.

HIH Casualty and General Insurance Limited

CIC Insurance Ltd.

CIC General Insurance Ltd.

CIC General Insurance Holdings Ltd.

Heath CE (Marine & Aviation) Insurance Ltd.

Heath CE Underwriting & Insurance (Aust) Pty. Ltd.

HIH Winterthur Workers' Compensation (Vic) Ltd.

Lion Insurance Co. Ltd.

Norwich Winterthur (Aust) Ltd.

Kemper Reinsurance Co.

La Mutuelle Du Mans Assurance IARD

Lloyd's of London

Lumley General Insurance Ltd.

MMI Ltd.

MMI General Insurance Ltd.

Switzerland Insurance Aust. Ltd.

MMI - Switzerland Workers' Compensation (Vic) Ltd.

Mercantile & General Reinsurance Co. of Aust. Ltd. (The)

Mercantile Mutual Insurance (Aust) Ltd.

Mercantile Mutual Insurance (Workers' Compensation) Ltd.

Mercantile Mutual Worksure Ltd.

Mitsui Marine & Fire Insurance Co. Ltd.

MLC Insurance Ltd.

Munich Reinsurance Co. of Aust. Ltd.

Munich Reinsurance Co.

National Transport Insurance Limited

New India Assurance Co. Ltd. (The)

Nippon Fire & Marine Insurance Co. Ltd. (The)

NRMA Insurance Ltd.

RACT Insurance Pty. Ltd.

NZI Insurance Australia Ltd.

NZI Workers' Compensation (Vic) Ltd.

OAMPS International Insurances Ltd.

Oceanic General Ltd.

QBE Insurance Ltd.

Australian Eagle Ins. Co. Ltd.

QBE Workers' Compensation (Vic) Ltd.

Western Underwriters Insurance Ltd.

Kemper Insurance Company Ltd.

RAA-GIO Insurance Ltd.

RAC Insurance Pty. Ltd.

RACQ-GIO Insurance Pty. Ltd.

RACV Insurance Pty. Ltd.

Scor Reinsurance Asia - Pacific Pte. Ltd.

SGIO Insurance Ltd.

SGIC

Sumitomo Marine & Fire Insurance Co. Ltd.

Sun Alliance & Royal Insurance Australia Ltd.

Australian Alliance Insurance Co. Ltd.
Sun Alliance Secure Insurances Ltd.
Sun Alliance Insurance Ltd.
Sun Alliance & Royal Mortgage Insurance Ltd.
Sun Alliance & Royal Ins. Compn. Services Ltd.

Suncorp Insurance & Finance**Sydney Reinsurance Co. Ltd.****Swiss Re Australia Ltd.**

Swiss Reinsurance Co.

Territory Insurance Office**Tokio Marine & Fire Insurance Co. Ltd. (The)****Transport Industries Insurance Co. Ltd.****Union des Assurances de Paris IARD**

UAP (Aust) Ltd.

Union Reinsurance Co.**VACC Insurance Co. Ltd.**

Accident Insurance Mutual Holdings Ltd.
AMEV Family Insurance Co. Ltd.
TGIO Ltd.
VACC Ins. Worksafe Pty. Ltd.

Wesfarmers Federation Insurance Ltd.**Westpac General Insurance Ltd.****Yasuda Fire & Marine Insurance Co. Ltd. (The)****Zurich Australian Insurance Ltd.**

Zurich Workers' Compensation (Vic) Pty. Ltd.

INSURANCE AND SUPERANNUATION COMMISSION**Classes of Business**

Industrial Special Risks
Fire
Houseowners/Householders
CTP Motor Vehicle
Commercial Motor Vehicle
Domestic Motor Vehicle
Construction
Marine Hull
Marine Cargo
Aviation
Professional Indemnity
Product Liability
Public Liability
Employers' Liability
Loan, Mortgage & Lease
Trade Credit
Consumer Credit
Extended Warranty
Sickness and Accident
Travel
Other
Inward Reinsurance

Attachment "3"ISC STATUTORY FORMS

<u>FORM</u>	<u>QUESTIONS</u>
1	16
2	37
3	82
4 A	744
4 B	39
5 A	414
5 B	232
5 C	207
5 D	14
5 E	122
5 F	100
6 A	408
6 B	322
6 C	120
6 D	140
7 A	364
7 B	276
7 C	207
7 D	120
7 E	120
8 A	644
8 B	268
9	38
10	12
11	244
12 A	194
12 B	15 *
12 C	14 *
12 D	10 *
12 E	82 *
13	50
14	--
15	6 *
16 A	744 **
16 B	38 **
16 C	36 **
16 D	39 ***
17	--
<u>18</u>	<u>156</u>
TOTAL <u>39</u>	<u>6,674</u>

* Will usually require more than one answer

** Quarterly forms

ALTERNATIVE REGULATORY STRUCTURE

