

REPRESENTING PROFESSIONAL INSURANCE BROKERS



NIBA Submission

Financial Systems Guaranteed

November 2003

Submission to the Study of Financial Systems Guarantees

Introduction

NIBA, the National Insurance Brokers Association of Australia, is the voice of the insurance broking industry in Australia. It represents 500 member firms and 2000 individual Qualified Practising Insurance Brokers throughout Australia. NIBA members handle approximately 90% of premiums for commercial insurance in Australia and the focus of this submission is on that type of insurance.

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

While fully supportive of the HIH Claims Support Scheme, NIBA questions the idea of the Commonwealth Government guaranteeing financial contractual obligations. The Financial System Inquiry opposed guarantees because they introduce moral hazards and distort market signals. They inevitably involve some form of cross subsidization with the prudent often having to bear an unrealistic burden.

NIBA believes that the Commonwealth Government's obligations in relation to financial contracts generally should be limited to:

1. Having in place an effective system of prudential supervision of financial institutions, and
2. Providing the public with access to sufficient information for analysts, rating agencies, insurance brokers and others to make a reasonable assessment of the likelihood of a financial institution honouring contracts with policyholders or consumers.

Once these two requirements have been satisfied, the ultimate risk for the failure of a financial institution should lie with those that deal with the institution.

At the present time Australia does have a reasonably effective system of prudential regulation. The public is, however, poorly informed about the risk of an insurance company being able to satisfy policyholder claims. Recommendations to rectify this situation have been made by the Financial System Inquiry and by the HIH Royal Commission. We still, however, await implementation.

Rather than introducing some new form of policyholder protection scheme NIBA would like to see APRA being made responsible for ensuring that the public has access to sufficient information for people to be aware of the risk of failure of the financial institutions that they deal with.

The Financial System Inquiry

The Financial System Inquiry that was responsible for laying the foundations of Australia's financial regulatory system, specifically recommended against the introduction of any guarantee for financial products.

The Financial System Inquiry stated;

“If regulation is pursued to the point of ensuring that promises are kept under all circumstances, the burden of honor is effectively shifted from the promisor to the regulator. All promisors would become equally risky (or risk free) in the eyes of the public. Regulation at this intensity removes the natural spectrum of risk that is fundamental to financial markets. If it were extended widely, the community would be collectively underwriting all financial risks through the tax system, and markets would cease to work effectively.

Thus, regulation cannot and should not ensure that all financial promises are kept. Indeed, the Inquiry considers that the government should not provide an absolute guarantee in any area of the financial system (just as it does not do so in other areas). Primary responsibility should remain with those who make financial promises.”

Given the holistic approach to regulation in Australia following on from the Financial System Inquiry, NIBA does not think it appropriate for the Commonwealth Government to introduce any form of guarantee for financial contracts generally or for the general insurance sector to go it alone with a new policyholder scheme.

The Failure of HIH

The HIH failure was a very unusual one not only because of its size (the largest corporate failure in Australia's history) but also because it represented the failure of many of the mechanisms in Australia for corporate regulation. The mechanisms that failed included management, directors, auditors, advisors, actuaries, the corporate regulator (ASIC) and the prudential regulator (APRA).

NIBA fully supported the Commonwealth Government's initiative in establishing the HIH Claims Support Scheme that was able to assist the thousands of cases of personal hardship, which emerged as a result of the failure of HIH.

The fact that the Commonwealth Government stepped in to assist in this particular case should not mean that automatic assistance should be provided whenever an Australian financial institution fails. The HIH situation should be taken for what it was, a once-off assistance measure to certain citizens in special need.

Guarantee Schemes

Invariably there are difficulties in administering guarantee schemes. These schemes, by their very nature, involve inequities and have some form of cross subsidization with the prudent having to bear an unreasonable burden.

The **compulsory** nature of such schemes means that membership is made up of a number of people who simply do not want to be included.

Difficult decisions need to be made as to who the beneficiaries will be, the level of the benefits and who will fund the benefits. No matter what the decisions, there will be inequity and considerable administrative complexities.

For example, it is noted that the HIH Royal Commission indicated that there were practical difficulties in administering a pre-event funded scheme and suggested that funding should be by a post-event levy on all insurers. Calculating the amount necessary to fund the arrangement and when the funds would be required could also involve considerable complexities. The actual amount required and when the funds would actually be needed is unlikely to be known for many years. Imagine attempting to estimate at the time HIH went into provisional liquidation what and when funds would be required.

If deciding the amount of funds necessary is difficult, deciding who should pay is not much easier. For example, should it be other insurance companies at the time the company went into provisional liquidation or at the time the funds are required? Shareholders and policyholders could change significantly over the period. There would be a significant difference in the HIH case. Should an insurer whose policyholders could never receive any benefit under the scheme have to contribute, e.g. a captive insurance company?

To NIBA a significant feature of the various State and Territory schemes that are activated in the event of the failure of an insurer writing compulsory workers compensation insurance is that it is only workers compensation policyholders in the same State or Territory that are required to fund the arrangement. By relating funding to beneficiaries by type of policy and State or Territory in this way, reduces, but does not eliminate, the cross subsidization and inequities involved.

Whatever the detailed arrangements chosen there is likely to be inequity and criticism of the arrangements.

An Alternative Solution

At the present time policyholders of general insurance products in Australia are in a very poor position to make an assessment of the ability of their insurer to meet its claims liabilities.

Despite Recommendation 44 of the Financial System Inquiry that APRA should promote transparent disclosure; the public was not in a position to adequately assess the risk of insuring with HIH immediately prior to its collapse. There was simply insufficient information available to make any reasonable assessment of the situation. The HIH Royal Commission recognized the value of a well-informed market when it stated:

“Part of the difficulty that consumers have encountered in making a reasonable judgment of the likely future financial viability of a general insurer is in gaining access to relevant information. Greater disclosure would help to overcome this problem. In particular it would provide better information for analysts, rating agencies, the media and others whose reports help to inform investors, consumers and others.

Another advantage of requiring the general insurers to disclose more information is that it would make the work of the prudential regulator more visible and contestable. Informed market commentators and analysts could provide an alternative view to that of the regulator.

Greater visibility and contestability of information in this area may also act to encourage the regulator to reconsider relevant issues that it might otherwise have dismissed as unimportant,”

The HIH Royal Commission went on to recommend that insurance companies and APRA disclose far more information than they presently do (Recommendations 34 to 37). NIBA strongly supports these recommendations and would like to see them implemented without delay.

NIBA believes that APRA should be charged with the specific responsibility of ensuring that the public has access to sufficient information so that certain members of the public (analysts, rating agencies and insurance brokers etc) would be able to make a reasonable assessment of the likelihood of a financial institution honoring its commitments to consumers and policyholders.

If the Australian public with the assistance of analysts, rating agencies and insurance brokers etc. is able to make a reasonable assessment of its financial institutions it should not need new financial system guarantees.

Yours sincerely



Noel Pettersen
Chief Executive Officer