

Australian Consumers' Association

Submission to the Study of Financial System Guarantees

December 2004

The Australian Consumers' Association (ACA) supports the introduction of limited explicit guarantee arrangements into the Australian financial regulatory system. ACA also supports the development of particular arrangements covering general insurance as a high priority, consistent with the recommendations in the HIH Royal Commission report.

ACA commends the FSG reports outline of the rationale for guarantee arrangements and the issues that would need to be taken into account in the design of such arrangements.

Background

The last 10-20 years have seen substantial growth in the participation by consumers in the financial system. This has occurred for a variety of well-recognised reasons, some policy driven, some supply driven, some demand driven. These include:

- The growth of compulsory superannuation
- Demographic changes with an ageing population
- The need for consumers to have certain financial arrangements in place as a "prerequisite" for participation in the economy (eg a transaction account)
- Changes in workforce participation and safety net arrangements that mean many people have to more actively manage risks associated with loss of employment, sickness etc
- The need to purchase some "compulsory" insurance in certain professions or in association with certain products
- Changes in technology affecting both the design and supply of financial products on the one hand and the demand for and access to financial products

Many of these developments are positive, and have given consumers greater flexibility in the way they manage their financial lives. However, they also expose consumers more fully to the overall health of a greater range of financial entities, both directly and as third parties.

It is also well recognized that consumers experience a greater range of challenges and informational problems in dealing with financial products and contracts than occurs in other markets. This is due to the nature of the products in question (eg the value of the product depends on the behaviour of the supplier after purchase, sometimes many years into the future). Given these features of the financial system, many countries have introduced guarantee schemes as a basic consumer protection device.

In the Australian context the failure of HIH clearly demonstrates the impact of institutional collapse of major financial entities. Prudential regulation is a critical protective measure against institutional and systemic instability in such an environment. However, prudential regulation is not designed to prevent all firms failing. Prudential regulation cannot always ensure that even those financial firms that consumers believe are ‘safe in a storm’ will remain ‘afloat’. Importantly, prudential regulation, especially in the absence of guarantee arrangements, is typically difficult to communicate clearly to retail consumers in such a way that they understand the relative risk of different firms and different products. Thus while rigorous prudential regulation is the major mechanism for ensuring institutional and systemic stability, it is not intended to always and everywhere prevent collapse, even of those institutions that consumers trust.

Limited explicit guarantee

In ACA’s experience consumers consistently rank safety as a key issue in all their dealings with financial sector entities. ACA supports a limited but clear and unambiguous set of arrangements that give consumers certainty about those parts of the financial system where “guarantees” apply.

- ACA prefers the establishment of system-wide explicit arrangements to ensure that consumers had a clear and consistent understanding of support provisions across the relevant products they purchase in the finance sector.
- ACA strongly supports the immediate development of a policyholder holder protection scheme for consumers in the general insurance sector without any delay while wider arrangements are contemplated, as clearly recommended by Justice Owen in the HIH Royal Commission report (recommendation 61).

A *caveat emptor* approach is neither a credible or realistic alternative in this area. Consumers and businesses know that customers of financial institutions will be compensated or “rescued” from time to time in the face of failure, despite the absence of a coherent scheme. The Australian experience clearly demonstrates this point. However, a case-by-case approach is inconsistent and less efficient compared to an explicit and well designed approach that reduces uncertainty.

An ambiguous “case-by-case” approach does not encourage sensible consumer decision making and contributes to consumer confusion. The notion of ‘productive ambiguity’, a phrase with currency around the time of the Financial System (Wallis) Inquiry that was used to characterize the vague and poorly understood rescue arrangements that apply to much of the Australian financial system, is no longer helpful (if indeed it ever was). It is difficult to see how the HIH experience would support the notion that ambiguity about guarantee arrangements is productive or somehow reduces moral hazard.

A case-by-case approach facilitates “gaming” by businesses in certain parts of the market. This leads to possibly sub-optimal consumer decision making, which we would argue is one of the features of a system without *clear* guarantee arrangements that can be easily communicated to consumers. A simple example is the widespread marketing of higher risk fixed interest investments in a way that leads many consumers to believe the investment is less risky and more akin to offerings from ADIs than is actually the case. The use of language in this marketing often suggests “safety” (eg use of the word “deposit”) and makes inappropriate comparisons with banking products that typically offer lower rates. However, there are significant differences between prudentially regulated ADIs and the lightly regulated firms offering higher risk fixed-interest investments that are essentially used for commercial property loans that banks regard as unacceptably speculative. The absence of clear and straightforward guarantee arrangements does not help consumers make a choice that clearly weighs up the relative benefits of risk and return in this market environment.

In summary ACA supports an explicit depositor/policyholder protection system for Australia as occurs in many other OECD countries. Australia has the benefit of learning from the experience of other regulatory approaches in the design of such schemes.

General Insurance Scheme

While ACA supports a broad-based scheme, we also strongly support the immediate development of a scheme for general insurance. The current study was generated by events in the general insurance sector - the collapse of HIH. The prolonged market chaos and consumer and business uncertainty that followed that event highlighted the impact of the collapse of an insurer, both on those directly insured and third parties. In effect, it highlighted the importance of insurance for our economy and community.

The HIH Royal Commission looked at this issue in some depth (Chapter 11), and ACA supports the arguments set out by Justice Owen in the Royal Commission final report.

As Justice Owen noted:

The question of policyholder support involves the balancing of concerns about so-called moral hazard against the broader benefit of reducing the social costs incurred as a result of the collapse of a general insurer.¹

In his consideration of this balance, Justice Owen was clear - a sensibly designed scheme could avoid most of the moral hazard problems, and could play a valuable role in increasing consumer confidence and addressing social costs in the wake of any collapse. Recommendation 61 states that:

The Commonwealth Government [should] introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company.²

ACA also strongly supports Justice Owen's comments about the desirability of introducing a general insurance scheme without waiting for any broader scheme to be developed:

Implementation of this recommendation should *not* await a decision whether to establish a scheme that covers other parts of the financial services sector. A support scheme for general insurance would *necessarily* differ in some respects from any scheme that might be introduced for other prudentially regulated institutions - such as banks and other approved deposit taking institutions. I cannot see why the introduction of a scheme

¹ The HIH Royal Commission Report, Volume 1, p289

² Ibid, p 301

for general insurance should await any move towards a more comprehensive scheme for the financial services sector.³

ACA is concerned that a discussion of a “single” scheme for all sectors within the finance industry should not distract from the proper advancement of a general insurance scheme. The potential confusion created by this approach could have the effect that opposition to a scheme covering *banking* will be used to reject a scheme covering *general insurance*. This would be highly unfortunate.

This issue is not hypothetical. Appendix 2.2 of the FSG report discusses submissions to the study. It states that “the *vast majority* of formal submissions did not support the introduction of an explicit guarantee to the Australian financial system on the grounds that a case for change is yet to be made”⁴ [our emphasis]. However, there were only eight submissions. Only four were from organisations directly involved in insurance, and it is unclear as to whether these four were supportive or not. It is of concern to ACA that this very limited sample, which includes entities without a strong direct interest in general insurance, is being presented in the report in such a way as to possibly undermine support for Recommendation 61 from the Royal Commission.

On this point, while “a case for change” has not have been a major focus of public debate in the last few years in the banking sector (although it clearly can be made) it is arguable that the HIH Royal Commission report would represent a rigorous and public case for change in the general insurance sector.

ACA would like to see a sensibly designed general insurance scheme decided upon quickly and advanced without the distraction of developing a depositor protection scheme for the banks and other ADIs at the same time. As the FSG Study notes (p77):

It is generally the case internationally that different schemes are established for the key sectors of deposit-taking, life insurance and general insurance, and where they exist, pension schemes. Schemes vary in the types of risks or outcomes that they cover.

In other words, while a cross-sectoral scheme is preferable, any scheme across the finance sector will inevitably have different sub-sectoral elements.

³ Ibid, p302

⁴ Study of Financial System Guarantees, p199

Scheme design

ACA commends the FSG Report for its exploration of the issues around the design of schemes. In particular, there is extensive discussion of the issues around moral hazard and how best to minimize its impact. ACA believes that a sensibly designed scheme can deal with moral hazard. We would, for example, support a risk-based approach to pricing as one mechanism to help address this issue.

In any case, the starting point for assessing a scheme should not be a comparison (along traditional economic lines) with a situation in which there is no scheme and hence no moral hazard. This is not consistent with real world experience. As we saw with HIH, the absence of such arrangements does not remove moral hazard and risky (or irresponsible) behaviour. Rather, the absence of such arrangements simply ensures that moral hazard will be more uncertain in its impact on governments, markets and the community.

ACA does not support “means testing” any such arrangements. This would add to complexity and delays. Rather, an appropriate cap is the best mechanism to deal with issues around equity and eligibility. Obviously any such scheme should have limits on types and amounts of claims.

ACA would support a post-funded scheme through a levy on industry (as discussed in the FSG report in Chapter 8). We would like some consideration given to some a minimal pre-funding level in scheme design to make sure that there was money on hand to deliver the capacity to immediately embark on a policyholder/depositor support and communication process following any event. But a scheme could be primarily post-funded.

Such a scheme should be limited to entities regulated by APRA. This is significant in the light of the recent decision made about the access of unauthorised foreign insurers to the Australian market. At present, UFI's do not service the consumer market to any great degree, but this could change over time. It is difficult to envisage that disclosure could be simple enough to protect retail consumers in this area in the absence of an explicit guarantee. The introduction of such a guarantee would be the single straightforward piece of information that would most obviously help consumers distinguish UFI's from firms prudentially regulated in Australia. The consumer may still decide to deal with UFI's, perhaps based on price, but they would have a much clearer indication of the risk differential in making this choice than if a policyholder protection scheme did not exist.

Communication

It would be vital to have an ongoing communication program in place to inform consumers about explicit guarantee arrangements. This is another area where experience from other jurisdictions is potentially very helpful. For example, the Canadian deposit insurance scheme regularly advertises to consumers, and there is a high level of understanding in Canada about what is inside and what is outside of the guarantee arrangements – which ultimately is the objective of such a scheme.