



ICA submission to the Study of Financial System Guarantees

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1 Introduction

ICA is the representative body of the general insurance industry in Australia and its members account for over 90 per cent of total premium income written by private sector general insurers.

ICA members, both insurance and reinsurance companies, also form a significant part of the overall financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates over \$20.5 billion per annum in gross premium revenue and has assets of \$59.2 billion¹. The industry employs about 25,000 people.

1.1 ICA's supports policyholder protection as part of broader reform

ICA believes that the introduction of an appropriate policyholder protection scheme (PPS) is a key part of the task of building a better regulatory framework for general insurance in Australia, and it strongly recommends that any such scheme be complemented with a comprehensive package of reforms (see part 2 of this submission). The scheme should be designed and agreed and if necessary legislated, but only established and operated AFTER the failure of an authorised general insurance company. The funding mechanism should operate on a post-event basis only.

Without comprehensive reform, any new safety net could impose an unacceptable burden on Australian policyholders and general insurers. Consequently, the industry is unable to support the introduction of a PPS in isolation from the other reforms.

1.2 ICA, the Commission and the Study

ICA worked closely with the HIH Royal Commission (Commission) by providing background and insights into the general insurance industry, as well as six submissions in relation to the future regulation of the industry².

The Commission accepted many of the recommendations in those submissions, including recommendation 61 which ICA understands prompted the Commonwealth Government to commission the Study of Financial System Guarantees (the Study). Recommendation 61 suggests that *'the Commonwealth Government introduce a systemic scheme to support the policyholders of insurance companies in the event of the failure of any such company'*.

ICA has publicly supported the recommendations of the Commissioner, Justice Owen. These recommendations, taken together, can create a solid platform for major regulatory reform. The recommended reforms present a real opportunity for a stronger and more streamlined regulatory structure and ultimately greater protection for consumers, thereby enhancing confidence in the industry.

¹ APRA, 2002, Selected Statistics on the General Insurance Industry – Year Ending 30 June 2002, p. 5, <http://www.apra.gov.au/Statistics/Selected-Statistics-on-the-General-Insurance-Industry.cfm>, accessed 18 September 2003.

² ICA submissions: 'Regulation and prudential supervision of the general insurance industry', August 2002; 'Alternative risk transfer products and accounting for reinsurance contracts', August 2002; 'Protection for general insurance policyholders in Australia', August 2002; 'Taxation issues for the general insurance industry', August 2002 and 'Prudential regulation and price supervision in State and Territory statutory insurance regimes', August 2002.

1.3 The purpose and contents of this submission

This submission is ICA's response to the Study's request for public input and it is made on behalf of ICA members that are licensed insurers and subject to the *Insurance Act 1973 (Cth)* (*Insurance Act*).

ICA understands that the Study will establish a conceptual framework for considering the merits of financial system guarantees, rather than make specific policy recommendations to the Commonwealth Government. Accordingly, ICA's submission includes substantial background on policyholder protection schemes, technical information on its implications and an analytical framework within which all interested parties can develop their views, as well as proposing a preferred form of a PPS framework for Australia.

This submission has four key sections:

- Part 2 explains the relationship between policyholder protection and broader reform
- Part 3 is a summary of ICA's position on the need for a protection scheme and existing mechanisms
- Part 4 addresses the general design issues and provides a summary of ICA's preferred scheme
- Part 5 discusses ICA's preferred scheme in more detail and demonstrates how that scheme could be funded.

To assist the Study team to quickly identify the relevance of each ICA submission to the terms of reference (ToR), we have referred to terms of reference by footnote.

2 Policyholder protection and broader reform

A policyholder protection scheme (PPS) will work best as part of a comprehensive package of reforms which are designed to create a stronger regulatory framework for general insurance in Australia. ICA strongly supported the package of reforms recommended by the Commission as creating a solid platform for major regulatory reform. The following key areas of reform would achieve this:

- 1) Extending the benefits of prudential regulation to all areas of insurance and insurance like products, with potential changes to the definition of insurance business in the *Insurance Act*.
- 2) A rationalisation of regulation with APRA being the sole prudential regulator and States and Territories removing overlapping or duplicate requirements in statutory and other classes of insurance.
- 3) The potential for greater affordability of insurance products through removal of insurance taxes and levies.
- 4) A safety net for policyholders in the unlikely event of a future collapse of an authorised general insurer.

The reforms are considered as a package as each builds on the other to strengthen the industry and enhance the confidence of consumers.

2.1 Extending the reach of regulation³

Currently, there are gaps in the regulation of insurance and insurance-like products. Expansion of the definition of insurance in the *Insurance Act* would ensure that all entities offering insurance or insurance-like products in Australia are regulated by APRA and are required to apply the APRA prudential standards to their business.

Where offshore (non APRA licensed and regulated) insurers are offering insurance into Australia they should be regulated to the same APRA standards, thus promoting a level playing field and mitigating the adverse competitive situation that currently exists. For example, foreign insurers are often able to offer lower premiums as they don't have the costs associated with the APRA prudential standards⁴.

Importantly, the Commonwealth Government is currently considering the appropriate regulation needed for discretionary mutual funds (DMFs) and direct offshore foreign insurers (DOFIs)⁵. The Review of DMFs and DOFIs⁶ is currently being undertaken by Mr Gary Potts and is due to report to Government in January 2004. Any proposals for regulation of DMFs and DOFIs that result from the Potts Review should be considered in conjunction with the outcomes of this Study, in particular the likelihood that participation in any policyholder protection scheme would be restricted to the policyholders and claimants of Australia's authorised general insurers.

2.2 Strong prudential regulation by APRA⁷

In the industry's view, the reform process that was begun after the collapse of HIH is not complete and these additional measures should be pursued in conjunction with the implementation of a policyholder protection scheme in Australia:

- State and Territory governments should remove nominal defendant and nominal insurer schemes relating to the failure of a general insurer in statutory classes of insurance⁸.
- The capacity for State and Territory governments to legislate in any way which impacts on the capital, profit or solvency of authorised insurers should be removed⁹
- APRA should be the strong, central and sole regulator of capital and solvency for general insurers in Australia. This would remove regulatory overlap and confusion, jurisdictional discrepancies and improve insurers' confidence as they price and write policies¹⁰.

These additional measures would supplement the following reforms which have been introduced since the collapse of HIH.

³ Refer to ToR (c).

⁴ The APRA prudential standards are arguably the most stringent in the world.

⁵ Refer to ICA's submission to the Review 'Submission to the Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers', December 2003.

⁶ <http://dmfreview.treasury.gov.au/content/default.asp>.

⁷ Refer to ToR (b).

⁸ Refer to page 294 of The HIH Royal Commission, April 2003, The failure of HIH Insurance, Volume 1 A corporate collapse and its lessons.

⁹ Refer to recommendations 49 and 58 of The HIH Royal Commission, April 2003, The failure of HIH Insurance, Volume 1 A corporate collapse and its lessons., and ICA's third Submission to the Productivity Commission Inquiry into National Workers' Compensation and Occupational Health and Safety Frameworks, in which the anomalous regulatory situation facing two specialised workers' compensation insurers in NSW (CCI and Guild) was discussed. The Submission was No. 174 to the Inquiry and can be found at: <http://www.pc.gov.au/inquiry/workerscomp/subs/sublist.html>

¹⁰ Refer to recommendation 49 of The HIH Royal Commission, April 2003, The failure of HIH Insurance, Volume 1 A corporate collapse and its lessons.

The *General Insurance Reform Act 2001(Cth)* (*GI Reform Act*) empowered APRA to issue new regulatory standards and guidance notes. Other specific legislative changes included:

- requirement for insurers to appoint an auditor and actuary, as approved by APRA
- review of insurance company Board composition to ensure that membership provided adequate independence and oversight
- new standards of fitness and propriety for directors and senior management and
- board audit committee requirements.

The new standards covered the following:

- minimum capital requirement (MCR)
- valuation of liabilities (including mandatory risk margins and discount rates)
- risk management
- reinsurance arrangements and
- transfer and amalgamation of insurance businesses.

Other standards covered the appointment of approved auditors and actuaries, and licensing requirements.

The new regime took effect on 1 July 2002, and ensures that insurers are appropriately capitalised and that adequate provisions have been set aside for premium and claims liabilities. The new standards mandate sound management procedures, including reinsurance arrangements. The reforms make it much more difficult for an insurer to under price (premium liabilities) or under reserve (claims liabilities)¹¹, thereby substantially reducing the likelihood of another insurer failure in the future.

Importantly, the requirements are risk-based and therefore an insurer carrying greater risk requires more capital. Each item on an insurer's balance sheet is weighted with a 'capital charge' and the greater the risk, the greater the charge. The MCR is the aggregation of these charges.

APRA has released a further Discussion Paper "Prudential Supervision of General Insurance Stage 2 Reforms", outlining a range of further initiatives to strengthen the prudential regulatory framework in Australia¹². Comments on the issues raised in the Discussion Paper have been requested by 27 February 2004.

¹¹ This point is relevant to the introduction of a guarantee. There is an argument that the existence of a guarantee would lead insurers to make different commercial decisions and take on financial risks that they would not otherwise have borne, that is that there would be a moral hazard for insurers. Specifically, the concern is that insurers would under reserve and under price insurance in order to maximize their market share. ICA rejects the suggestion that the existence of a guarantee would, in any way, increase the incentive of insurers to engage in such practices. As discussed above, the reforms make it much more difficult for an insurer to under reserve.

¹² Available at: <http://www.apra.gov.au/general/register/Discussion%20paper.PDF>

2.3 Creating a safety net for policyholders

The primary layer of protection for policyholders and third party claimants is a strong system of prudential regulation as evidenced by most recent changes to the Insurance Act, the strengthening of prudential standards for authorised general insurers and the recently announced Stage 2 Reforms.

A policyholder protection scheme will provide an additional level of protection for the policyholders who need it most and who are least able to avoid or mitigate the risk of an insurer collapse. These are the relatively unsophisticated purchasers of insurance, such as individuals and small business policyholders who are not in a position to assess the financial strength and solvency of an insurer and its ability to meet the financial promises made. Similarly third party claimants (major beneficiaries under the industry's proposed PPS) have no capacity to choose the insurer of a person against whom they have a claim and it is important that the security provided by the general insurance sector flows through to these people as well.

3 Need for protection and existing mechanisms

3.1 Consequences of a collapse

The consequences of a collapse depend on the type of financial institution that fails. Justice Owen considered both the report of the Financial System Inquiry (1997)¹³ regarding depositor protection and APRA's submission to the Commission that any scheme should be considered for the entire financial services sector. Justice Owen found sufficient justification for proceeding with a compensation scheme limited to the general insurance industry because:

- policyholders potentially face relatively high losses from the failure of an insurer compared to depositors, who face the prospect of a known fixed loss
- depositors have protection through other mechanisms such as preferred creditor status¹⁴.

ICA strongly supports this position. In brief, the business of the assumption and pooling of risk that comprises general insurance is quite different to banking or other financial services and the failure of a bank (for example) and a general insurer give rise to very different problems for consumers and the financial system.

ICA also strongly believes that the general insurance industry and its customers should not be required to pay for banking or superannuation insolvencies. Equally, other financial service sectors should not be required to pay for a general insurer failure. The current prudential regulatory regime supports the separation of compensation arrangements by requiring a separate authorisation for the insurer whether that insurer is the primary entity or a subsidiary of a larger financial services conglomerate.

¹³ Also known as the Wallis Inquiry.

¹⁴ Refer to page 300 of The HIH Royal Commission, April 2003, The failure of HIH Insurance, Volume 1 A corporate collapse and its lessons.

3.2 Reasons for protection

3.2.1 Existing legislation

ICA considers that the objective of policyholder protection is well-established in existing legislation. The primary object of the Insurance Act (section 2A) reflects the intention of the Commonwealth Government to protect the interests of policyholders. *ICA considers that a policyholder protection scheme is a logical extension of the framework established by the Insurance Act, as it provides support and protection to general insurance consumers most likely to suffer severe hardship in the case of an insurer failure.*

Recent (and proposed) reforms to the Australian regulatory environment¹⁵ greatly lessen the risk of general insurer insolvency. Indeed the prudential standards form a strong foundation for the industry and must be complemented with effective oversight by a strong prudential regulator. However, general insurance is a highly competitive global industry and even the most stringent regulatory framework cannot, *and, for sound economic and competitive reasons, should not*, provide a 100 percent guarantee against the failure of a general insurer. APRA has made it very clear that even under the new prudential regulatory regime, there is no guarantee against another insurer failure.

3.2.2 Market Failure¹⁶

Market failure creates a prima-facie case for some form of government intervention. ICA suggests that the consequences of market failure which arise when a general insurer fails would be alleviated by a safety net mechanism in the form of a PPS.

Externalities

Externalities are the unaccounted for costs and benefits arising out of the market activities of economic agents. The costs which arise as a result of a general insurer failing fall into two types. The direct financial costs, in the form of the value of claims which cannot be paid because of the failure, can be quantified, and policyholders usually stand as unsecured creditors in the liquidation for this amount. The second type of cost, and one which is far more difficult to quantify, are the personal and business losses which arise because the insurance mechanism is not available to respond to the loss that has occurred. A family unable to rebuild a damaged home could be left without its major asset. A business that cannot claim under an insurance policy may have no alternative option but to fail and liquidate its assets. A person relying on personal accident or salary continuance benefits would have no option but to seek support from social security mechanisms.

As evidenced by the HIH Insurance experience, the costs of a failure to policyholders can be significant and may fall hardest on those who are least able to determine the financial health of the insurer from which they purchase their insurance. The costs of insurer collapse also extend beyond those who were simply unfortunate enough to have been insured with an insurer that fails. For example, a third-party seeking compensation or damages from a policyholder covered by a public liability or professional indemnity policy may be denied just compensation for an injury or event, should an insurer collapse and the policyholder does not have the capacity to fund the compensation or damages (which could be substantial). Similarly, in the commercial lines of business, an insurer collapse may be a catalyst for small business failure where the latter relies upon the cover provided by the insurer.

¹⁵ Refer to Appendix A of ICA submission, 'Regulation and prudential supervision of the general insurance industry', August 2002.

¹⁶ Refer to ToR (a).

A PPS for the general insurance industry would provide a mechanism through which the direct financial costs associated with the collapse of an insurer can be accounted for in a systematic fashion, and the indirect costs and hardship can be avoided, with the burden of the protection scheme being spread across the general insurance industry. Such a scheme minimises the direct adverse effects on policyholders, third-party claimants and consumers.

Incomplete information

Incomplete information (or information asymmetry) occurs where one (or both) side(s) to a transaction possesses less than complete information. Inadequate information and the complex nature of insurance make it very difficult for many policyholders to ascertain or understand the prudential standing and strength of an insurer. A primary reason for establishing a prudential regulator is the need to address 'information asymmetry'¹⁷, and the recognition that consumers of financial products may have neither the time, nor expertise to assess the financial strength of a financial services provider. Such consumers rely on the proper and full exercise of the powers and duties of the prudential regulator which thereby provides a level of confidence in the community concerning the viability of the financial service provider.

The new prudential regime requires a substantial increase in the level of disclosure and reporting to APRA to enable its assessment of the prudential strength of a regulated insurer. But as noted above, APRA does not guarantee that there will be no further insurer failures, and the possibility remains that the community's confidence in the regulatory process may again be challenged if there is in fact another insurer failure.

ICA submits that the primary goal of a PPS is to protect those who are not able (due to lack of information, expertise or awareness) to make informed choices between insurance providers. The benefits of PPS protection will also extend to those indirectly affected such as third party claimants (particularly those who have suffered personal injury). For this reason the PPS is limited to providing assistance to individuals and small businesses. Purchasers of insurance with knowledge and capacity to make informed decisions (such as medium to large enterprises) and those utilising the services of professional intermediaries such as insurance brokers should be capable of assessing the security of the chosen underwriter, and must continue to do so.

Business cycles

Business cycles are a form of macroeconomic instability. Such cycles can be extreme in terms of both their intensity and length and even the most financially sound insurer may experience financial difficulties as a result. Recent problems with the international equity markets forced many insurance companies to raise additional capital and strengthen their asset base.

In Australia, the medical indemnity insurer UMP has indicated that its major difficulties resulted from extreme external events that occurred in 2001: the collapse of HIH Insurance (which provided insurance and reinsurance support to the group), the passage of the NSW *Health Care Liability Act*

¹⁷ See the Commonwealth Government submission to the HIH Royal Commission, 2002. At pp 10-11, it is noted that 'The second source of market failure in the financial sector is information asymmetry. Reflecting the complexity of financial products, consumers may not have, or be able to obtain, adequate information to assess the risk associated with either financial products or the creditworthiness of financial institutions. ... Financially unsophisticated consumers therefore may need protection and a degree of assurance that financial promises will be met. The aim of financial sector regulation is to reduce the impact of systemic risk and information asymmetry on the stability and efficiency of the financial system by promoting its safety and protecting the interests of consumers.'

On the issue of information asymmetry, see also APRA (B Goldsworthy, D Lewis, G Shuetrim), 'APRA and the Financial System Inquiry', Working Paper No 3, January 2000, pp 12, 19-20.

(which resulted in an abnormal increase in the number of claims for support) and the impact of the events of September 11 on the world wide reinsurance markets¹⁸.

ICA suggests that the most appropriate manner through which the policyholders of insurance companies can be protected from the impact of these externalities is through a PPS arrangement.

3.3 Existing protection mechanisms¹⁹

When a general insurer, such as HIH, fails, governments currently respond on an ad hoc basis²⁰. Governments can come under intense pressure to respond in the event of a company failure, especially when significant sectors of the community suffer an adverse impact as a result of the failure. This not only relates to the collapse of an insurer but also other entities whose failure can have significant repercussions on the community or employees²¹.

3.3.1 An implicit guarantee

At the time of the HIH collapse there was no generic Commonwealth policyholder protection arrangement for people, organisations or businesses. In response to the collapse of HIH, the Commonwealth Government initiated the HIH Claims Support Scheme and the general insurance industry, in consultation with the Commonwealth, established HIH Claims Support Limited (HCS), a not-for-profit company²². HCS was appointed by the Commonwealth to manage the \$640 million²³ rescue package that the Commonwealth had pledged for eligible HIH policyholders. HCS undertook this management role with assistance from insurers acting as claims managers (whose involvement was also on a not-for-profit basis).

HCS assesses the eligibility of applicants seeking assistance from the HCS Scheme and the managing insurers manage those applicants' insurance claims.

By virtue of the Commonwealth's involvement in HCS, *ICA submits that there already exists an implied guarantee to assist policyholders in the event of another insurer failure at the Commonwealth level.*

The HIH experience also demonstrated State and Territory governments involvement in guaranteeing payment of claims under statutory schemes. Nominal insurer arrangements were activated to pay workers compensation and compulsory third party claims, and States and Territories applied levies on policies to fund those liabilities. NSW Government also introduced a new tax on insurers' capital²⁴ (the insurance protection tax) to fund CTP and builders warranty liabilities in NSW.

3.3.2 Implicit and limited explicit guarantees are no substitute for a PPS

The ad hoc measures put in place by Commonwealth, State and Territory Governments after the failure of HIH have responded in various ways to the particular needs of policyholders. Ad hoc

¹⁸ UMP Annual Review for 2002-2003, page 1, available at: <http://www.unitedmp.com.au/0/0.10/0.10.4/0.10.4.30.pdf>.

¹⁹ Refer to ToR (b).

²⁰ A detailed summary of the responses of governments in various Australian jurisdictions is set out in 'Protection for general insurance policyholders in Australia', August 2002 pp4-8.

²¹ For example Government responses to the Ansett Airlines collapse, United Medical Protection's provisional liquidation as well as the response to the failure of HIH Insurance.

²² See generally, www.hihsupport.com.au.

²³ The current funding level.

²⁴ The *Insurance Protection Tax Act 2001* (NSW) creates a tax on shareholder capital which cannot be passed through to policyholders.

responses provide greater flexibility to governments in responding to a collapse as it arises. However ICA considers that the uncertainty created by this situation is unsatisfactory particularly as these ad hoc measures are likely to have led to an expectation in the minds of policyholders that the government will provide a form of guarantee or support if another insurer fails.

The ad hoc nature of the responses to the failure of HIH also meant that there were ad hoc measures to fund the support schemes. The Commonwealth Government decided to fund the HIH Claims Support Scheme from general government revenues, and the NSW Government created the Insurance Protection Tax but prevented insurers from passing on the tax in their premiums, thereby taxing the capital of insurers at a time when capital reserves were being rebuilt after significant losses in many areas of business.

As noted by Justice Owen, *'in comparison a permanent, systematic scheme offers the benefit of administrative efficiency, transparency, certainty and consistency of approach'*²⁵ and a removal of any underlying doubt that support will be available following a collapse. This should lead to greater consumer confidence and stability in the general insurance industry.

A policyholder support scheme would also provide the capacity for the removal of overlap in prudential regulation between the Commonwealth and the States and Territories and allow for a reduction in regulatory duplication. This is because the States and Territories would not need to maintain their nominal defendant and nominal insurer arrangements for insurer failure, as under the ICA proposal claims falling within those arrangements would be fully covered by the proposed PPS scheme. Once the States and Territories cease to guarantee the payment of claims following insurer failure, their residual interest in the prudential regulation of insurers can be undertaken by the Commonwealth regulator, APRA.

4 The design of a guarantee scheme²⁶

4.1 ICA's preferred design

ICA has considered many possible models that could be introduced in Australia.

The industry refers to its preferred model as the Policyholder Protection Scheme (PPS). Its key features are consistent with the model favoured by the Commission²⁷.

The key features of the PPS supported by the industry are as follows:

- 1) Coverage to extend in principle to all policies issued by authorised general insurers and with the agreement of the states and territories, statutory policies issued by general insurers
- 2) The PPS would be substituted for nominal defendant and nominal insurer roles of the States and Territories for insurer insolvency
- 3) Protection would be afforded to individual and small business policyholders eligible for compensation from the PPS (subject to certain eligibility criteria).

²⁵ The HIH Royal Commission, April 2003, The failure of HIH Insurance, Volume 1 A corporate collapse and its lessons, page 293.

²⁶ under ToR (d).

²⁷ The HIH Royal Commission, April 2003, The failure of HIH Insurance, Volume 1 A corporate collapse and its lessons, page 301.

- 4) The compensation paid under the PPS (for eligible applicants) would be:
 - 100 percent of the amount properly payable under the insurance policy for salary continuance, personal injury including workers compensation and compulsory third party and
 - 90 percent of the amount properly payable under the insurance policy for other types of claims (other lines of insurance) with the potential for an upper limit (a cap) on the amount paid.
- 5) The administration would be similar to the successful HCS model.²⁸
- 6) The PPS must be post-event funded by all authorised general insurers in Australia.

ICA has researched various options for the post event funding of an insurer failure, and believes the insurance market in Australia has the capacity to support a significant failure if required.

4.2 Guiding principles

ICA believes that the design of any protection scheme should be guided by the following principles. These principles are reflected by the Commission in support of a policyholder support scheme²⁹.

Administrative efficiency

Efficiency objectives require levels and types of regulation which minimise the impact on the commercial behaviour of the industry and the consumers it supplies with goods and services.

Because a PPS would only be brought into operation following an insurer failure, there is minimal impact on the insurance market until that point in time. Further, careful design of eligibility criteria and the nature and level of support provided by PPS will reduce the potential for undesirable commercial behaviour within the industry and by consumers of its products. It can safely be expected that the industry would remain dedicated to efficiently delivering its products and services³⁰.

Affordability

It is difficult to predict the financial impact of another insurer failure. The ultimate impact depends on the extent of the deficiency in funding available for the payment of outstanding claims. Nevertheless, a significant shortfall may occur, and it is therefore important that the PPS funding mechanism does not have an unduly adverse impact on the insurance industry or its customers. Spreading the cost of PPS funding across all policies in Australia operates to minimise the impact of the scheme on consumers.

Post event funding of a PPS arrangement will also ensure that no funds are actually required unless and until there is another insurer failure. Primary emphasis must continue to be placed on effective prudential regulation of insurers, in order to reduce the likelihood and cost of another insurer failure.

²⁸ HIH Claims Support Limited a not for profit company established and administered by the ICA to manage the Commonwealth HIH rescue arrangements.

²⁹ The HIH Royal Commission, April 2003, The failure of HIH Insurance, Volume 1 A corporate collapse and its lessons, page 293.

³⁰ G Banks, Chairman, Productivity Commission, 'Challenges for Australia in Regulatory Reform', Address to the Conference, *Regulation Reform Management and Scrutiny of Legislation*, hosted by the NSW State Parliament, Sydney, 10 July 2001. This address can be found on the Productivity Commission's website at <http://www.pc.gov.au>.

Transparency

Transparency is a key pillar of a well-regulated industry. Any response mechanisms should provide systemic coverage and allow for greater certainty and consistency of approach. A transparent scheme would be established in advance so that eligible policyholders would know in advance the nature and level of support that would be available and insurers would have confidence in the effective operation of the funding mechanism, thus removing any doubt about whether support will be provided or the funding of that support following a failure.

Certainty and consistency of approach

Any support mechanism should recognise the protections already in place through prudential regulation and should serve to support and enhance those existing protections. Policyholders should be treated within the regulatory protections afforded to them by a protection scheme that operates with certainty and consistency. Systematic and permanent arrangements offer both certainty for policyholders in regard to whether support will be available and how claimants may access the scheme. Australia currently has no mechanisms in place to provide support to those suffering hardship if another insurer fails (other than the existing nominal defendant and nominal insurer arrangements for the statutory classes).

4.3 Identification of variables

The Study is required to consider the merits of various design variables. ICA has identified the key design variables as:

- who should be a participant in any PPS
- which policyholders should be entitled to benefit from the PPS
- which claims should be covered and to what amounts would they be covered
- what would trigger the operation of the PPS
- how would the PPS be funded and
- who would administer the payment of compensation to policyholders.

In considering the merits of different design variables, the industry has drawn on its experience in administering HCS and knowledge of policyholder protection schemes abroad.

The industry remains involved in the operation of HCS³¹, although it should be noted that the Commonwealth Government is in the process of implementing alternative arrangements for the long term run-off of claims supported by the HIH Claims Support Scheme³².

The industry also has an understanding of the operation of general insurance support systems overseas. The 2000/2001 APRA Annual Report³³ states that Australia is one of the few developed

³¹ For more detailed information refer to <http://www.hihsupport.com.au/>.

³² See Press Release C082/03 from Senator the Hon Helen Coonan, Minister for Revenue and Assistant Treasurer, available at: <http://assistant.treasurer.gov.au/atr/content/pressreleases/2003/082.asp>.

³³ APRA Annual Report, 2001.

countries that does not have a formal structure of policyholder support in the event of general insurer insolvency.

At the end of 2000 there were 21 OECD countries that had one or more protection schemes covering insurance companies. Guarantees have been in place in the United Kingdom,³⁴ most States in the United States,³⁵ and Canada³⁶ for many years. At the time of writing, the European Union and Hong Kong are evaluating the costs and benefits of guarantees and consulting with stakeholders on the relative worth of design variables. It should be noted that while the United Kingdom Financial Services Compensation Scheme (FSCS) has the appearance of an integrated financial sector protection mechanism, in fact the FSCS operates three distinctly separate schemes, for deposits, investments and insurance. ICA believes there is no reason why a PPS could not be established in Australia in its own right, without the need for protection mechanisms for deposits and investments.

5 Detailed consideration of ICA's proposed scheme

5.1 Participants in a PPS

ICA proposes that it would be a condition of any authorisation to carry on insurance business in Australia³⁷ under the Insurance Act that the insurer be a member of the PPS, and satisfy any funding requests from the scheme administrator.

This is consistent with ICA's proposal to widen the definition and/or interpretation of 'insurance business' in the Insurance Act to ensure that all entities that offer insurance or insurance like products³⁸ are regulated³⁹.

The proposed membership arrangement would ensure that a consistent definition of member would apply to general insurers across all jurisdictions and reflects the current position in most countries that have a protection scheme for policyholders.

ICA proposes that an entity which is not regulated by APRA (and therefore not a member of the PPS) and which offers insurance or insurance like products should be required to disclose these matters to its customers before any contract is entered into. This should provide a further incentive for policyholders to seek insurance from strong and reputable insurance companies.

Reinsurers would be specifically excluded from the PPS. This is consistent with other major jurisdictions⁴⁰.

³⁴ In December 2001, the Financial Services Compensation Scheme took effect in the United Kingdom. Information about the Scheme can be found at www.fcs.org.uk.

³⁵ In the United States policyholder protection is dealt with on a State-by-State basis through a controlling national body, the Nation Conference of Insurance Guarantee Funds. Further information can be found at www.ncigf.org.

³⁶ Policyholders in Canada receive protection through the industry funded, non-profit Property and Casualty Insurance Compensation Corporation. For more information see www.pacicc.com.

³⁷ APRA has the power to impose conditions on the insurer's authorisation to conduct business under section 13 of the *Insurance Act*. This may require some amendment of the *Insurance Act* because at present, section 13 provides that such conditions 'must relate to prudential matters.' The condition should include an obligation to contribute to the fund at the required level. A breach of this condition should enable APRA to exercise its existing powers under section 15 of the *Insurance Act*, that is, the power to revoke an authorisation if it is satisfied the insurer has no liabilities in respect of insurance business carried on in Australia and the insurer has failed to comply with a condition of the insurer's authorisation.

³⁸ Section 2, proposal 1, ICA submission 'Regulation and prudential supervision of the general insurance industry', August 2002.

³⁹ See also 'ICA Submission to the Review of Discretionary Mutuals Funds and Direct Offshore Foreign Insurers', December 2003.

⁴⁰ Refer to Appendix B.

5.2 Beneficiaries of the PPS

ICA proposes that the following policyholders would be eligible for protection under the PPS:

- *individual policyholders who are Australian citizens or permanent residents*
- *small business policyholders. ICA proposes that small business be defined as a business with a turnover of up to \$1 million⁴¹. This definition would include a body corporate (owners corporation) and*
- *family trusts which own property for private and residential purposes*
- *policyholders under all eligible state statutory schemes⁴².*

The proposed eligibility criteria have been developed from the industry's experience in handling the more complicated eligibility criteria applied to HCS applicants. It represents a relatively simple and effective means of identifying those policyholders who are most in need of protection. The PPS is intended to provide protection to purchasers who are unable to assess the financial health and technical solvency of a potential insurance provider due to lack of information or understanding or both.

There is an argument that if a PPS were to be introduced, policyholders would decide which insurer to take out a contract of insurance purely on the basis of the premium, with no regard for the financial viability of the insurer they choose. This is a form of moral hazard and could result in 'adverse selection'.

This argument assumes that all policyholders consider the financial merits of a potential insurer before entering into a contract of insurance. ICA is of the view that individuals and small businesses have a limited capacity to assess the financial viability of potential insurers. Larger entities that are capable of assessing the financial viability of potential insurers would not be covered by the proposed PPS and therefore, the existence of a guarantee for individuals and small businesses is unlikely to give rise to morally hazardous behaviour.

Internationally, protection schemes generally only provide protection for individuals and small businesses.

Alternatives to the PPS design include:

- All policyholders are eligible. This alternative would provide protection to medium to large enterprises that should be capable of assessing the security of their chosen insurer, and would significantly add to the cost of a protection scheme.
- All policyholders are initially eligible however if a large policyholder receives payment from the guarantee, it must repay the guarantee. This alternative operates in the US where many

⁴¹ There are various ways of defining a small business, eg the number of employees, annual turnover, level of profitability. However, there are difficulties in using a definition of small business based on number of employees as this may be a poor reflection of the value and worth of the business, eg most holding companies do not have employees. ICA proposes that the annual turnover definition, consistent with the United Kingdom where a small business is a business with turnover of up to £1 million, is the most appropriate definition for the purposes of policyholder protection.

⁴² Eligible state statutory schemes are those underwritten by private general insurers. For the purposes of the proposed model State underwritten insurance schemes are not eligible state statutory schemes.

states require any corporation with a net worth of more than \$50 million to reimburse state guarantees for liability claim payments made on its behalf. In ICA's view this system would add to administrative costs (of first compensating and then seeking reimbursement), without improving the safety net.

- Exclusion of 'wholesale' contracts⁴³. The terms 'retail' and 'wholesale' are defined in Chapter 7 (Financial Services and Markets) of the *Corporations Act 2001* (*Corporations Act*). Under the meaning of 'retail' and 'wholesale' in the *Corporations Act*, not all products purchased by a small business or an individual are retail products. Retail products do not include liability policies. ICA suggests that the use of the *Corporations Act* concept of 'retail' products is not appropriate because it would not capture all people or entities that suffer hardship following an insurer collapse⁴⁴.

5.3 Compensation levels

ICA proposes that assistance be provided to eligible policyholders at the following levels:

- *for statutory personal injury motor accidents and workers compensation schemes, loss of income policies and personal injury claims (by third party claimants), 100% of amount properly payable under the policy (up to the maximum amount insured under the policy) and*
- *for all other claims, the first \$5,000 of the amount properly payable under the policy, then 90% of the remainder of that amount, to a maximum of \$500,000 (again up to the maximum amount insured under the policy).*

This level of benefit takes into account the experience gained by HCS and the international examples⁴⁵. It reflects the UK model particularly closely. Under the HCS model, the amount of compensation an eligible individual will receive depends on the type of insurance, on their income and on the amount of the claim as a percentage of their income. This is a more complicated design than the proposed PPS. ICA suggests that a simple capping model is preferable because consumers are better able to understand their prospects of obtaining assistance and administrators are able to distribute compensation more efficiently. The capping of benefits also helps to reduce any moral hazard associated with the scheme's existence, in that it forces the owners of valuable property to have specific regard to the security of the insurance provider.

5.4 Administration of the PPS

5.4.1 Responsibility for administering the guarantee

ICA proposes that the PPS would be industry owned and operated.

Insurers would establish a not-for-profit company to operate the scheme (the scheme administrator). The proposed PPS would operate prospectively, that is, for failures of authorised insurers that are members of the scheme following its establishment. The PPS would be available after a general insurer was placed into liquidation by way of court order. The PPS would also respond in cases where an insurer was placed in provisional liquidation and was unable to meet claims commitments.

⁴³ We have inferred this design variable from the reference to 'retail financial products' in ToR (a).

⁴⁴ Further details on the meaning of 'wholesale' and 'retail' under the *Corporations Act* are set out in Appendix A.

⁴⁵ Refer to Appendix B for a comparison of the HCS Scheme, schemes in other countries and the proposed PPS.

The scheme administrator would be a company limited by guarantee, with the members of the scheme being insurance companies authorised and licensed to operate in Australia. The company would comply with the usual *Corporations Act* requirements.

The scheme administrator would lie dormant until it is needed to become fully operational. It would have the capacity to contract for the provision of claims handling and other services as and when they are required. It would report progress in the handling of the assessment of eligibility and the payment of claims to APRA.

An industry owned and operated company would have the advantage of direct access to insurance skills and expertise necessary to determine policy coverage and the assessment of liabilities under the policy. Such expertise would be difficult for a Commonwealth or State agency to otherwise access quickly and effectively in the event of a failure. A further problem would arise if, for example APRA were selected to administer the fund. There may be a conflict for APRA in managing the delivery of compensation arrangements for a failed insurer. APRA must carry out its regulatory responsibilities as if no guarantee exists. The model of a scheme operated by the Commonwealth or its agency is thus opposed.

The PPS should be industry owned and operated and specific to general insurance, based on the following considerations:

- the general insurance industry has benefited from the experience gained in the establishment of the HCS scheme. It was instrumental in developing and implementing the operational arrangements for that scheme. Accordingly, the industry has in place the existing model structures and necessary experience from which to leverage the establishment a PPS scheme for general insurance in the future
- experience derived from HCS scheme indicates that the skills, systems and resources of insurers are needed to deliver policyholder protection arrangements, particularly, in long tail insurance. The key skills that insurers provide are claims management and recoveries, and reinsurance management and recovery and
- risk that if a regulator, such as APRA, administered the PPS, they could be inclined towards moral hazard – where there is the potential for the regulator to behave differently to how it would in the absence of such a scheme.

The proposed administrative responsibility largely reflects that of the Canadian⁴⁶ and UK⁴⁷ PPS scheme administrators.

5.4.2 Managing claims

In the event of insurer failure, claims by or against eligible policyholders should be handled in accordance with sound industry practice and the terms and conditions of the defaulting insurer's policy (up to maximum benefit levels).

The PPS administrator should establish procedures for the handling of claims and in the event of a failure, managers engaged to handle the claims would use these procedures.

⁴⁶ The Canadian guarantee administrator is a corporation without share capital. Its board comprises 15 directors 7 of whom are presently senior officeholders of members and the balance of whom are independent (mostly former industry members).

⁴⁷ The UK guarantee is administered by a company limited by guarantee without share capital. Directors are appointed by the Financial Services Authority, but the UK guarantee is independent from the Financial Services Authority.

The scheme administrator should, as a condition of making a payment under the PPS, take an assignment of a policyholder's rights against the defaulting insurer and, as appropriate, seek recovery (including recovery under reinsurance policies⁴⁸) from that defaulting insurer or a dividend in any liquidation of the defaulting insurer. The scheme administrator should be entitled to those recoveries and hold them for the benefit of the PPS.

The PPS claims manager should pursue any rights under subrogation against third parties, if available, and account to the scheme administrator for any such recoveries.

People who are not satisfied with a determination of their claim would have access to the normal insurance industry dispute resolution procedures, including the General Insurance Enquiries and Complaints Scheme.

This proposal is largely based on the industry's experience in managing HCS claims⁴⁹.

5.5 Funding arrangements⁵⁰

The PPS must be post-event funded by levying members of the PPS. Members would have the ability to pass the levy onto consumers through the pricing mechanism.

5.5.1 Pre and post event funding

ICA has considered the merits of pre-event funding a PPS. ICA and insurers are strongly opposed to any form of pre-event funding, and consider that a post-event funded arrangement is more appropriate for the following reasons:

- a) the new (and proposed) prudential standards for general insurance significantly reduce the likelihood of an insurer failure occurring
- b) Australia has a very limited history of insurer failures that have caused significant loss to policyholders (with the obvious exception of HIH Insurance)
- c) Pre-funding would constitute another permanent levy or tax on general insurance, and would further exacerbate the already high tax burden carried by policyholders in Australia
- d) As insurer failure is unlikely, pre-funding would be likely to see a substantial fund accumulate. Post event funding would avoid the negative consequences of a large, unallocated accumulation of funds that is a reality of pre-event funding. These consequences include:
 - the question of what to do with a large investment that might not be called upon
 - determining how large a fund would be sufficient when it is inherently difficult to predict the size of a failure and indeed whether such a failure would occur
 - requiring policyholders to pay for a scheme that may not be used and

⁴⁸ The entitlement to proceeds of reinsurance is governed by section 562A of the *Corporations Act*.

⁴⁹ Under the HCS model, a claimant must first for eligibility for the assistance scheme. When HCS has the application for eligibility, HCS determines whether a policyholder is eligible for assistance under the Scheme. Once HCS has confirmed that the policyholder is eligible, HCS forwards the claim to one of the participating insurance companies, where the claim is assessed according to the terms and conditions of the policy.

⁵⁰ Refer to ToR (f).

- the potential for funds to be appropriated for other purposes.
- e) It is not possible to predict the amount of any shortfall or the complexity of compensation arrangements in advance⁵¹. Post-event funding would enable a level of funding to be set which reflects the size and nature of the shortfall, and the cash flow needs resulting from that shortfall.
- f) A pre-event funded scheme will pose a greater administrative burden to maintain until required. This will include undertaking funds management and collection management. Administration costs are an additional financial burden that can be avoided.
- g) Although pre-event funding has the benefit of being readily available, funds for the proposed post-event funded PPS could be made equally available. The PPS should have the capacity to borrow or raise funds and be repaid from future funding contributions from member companies. This system is used in other major jurisdictions.
- h) Reduces risk of 'moral hazard'. This position is supported by the Productivity Commission which has stated:

*'A desirable feature of the HIH Royal Commission proposal is that it involves a post-event levy. This obviates the need to estimate the anticipated cost of an insurer insolvency that has yet to occur and is of unknown probability, to tie up capital for an indeterminate period as well as put in place administrative arrangements to manage the capital. An additional benefit is that it reduces the likelihood of moral hazard among insurers. Moral hazard arises where insurers adjust their commercial decisions in response to the existence of the fund and, in particular, take on financial risks that they would not otherwise have borne.'*⁵²

In the event of the failure of an insurer, the funds required to provide a safety net to policyholders should be able to be kept to a minimum. ICA anticipates that recoverable assets, including reinsurance⁵³, will minimise the size of any unfunded losses that would need to be funded by a PPS in the future.

5.5.2 Levy

ICA proposes that the PPS would have the capacity to request funding from all authorised general insurers in Australia. Insurers would have the capacity to pass on any contribution to the PPS to policyholders through the pricing mechanism.

Detailed actuarial and accounting analysis will need to be undertaken in order to determine the appropriate basis upon which the calculation of contributions will be based for a post event funded PPS. However, ICA suggests that the calculation and collection of levies should be guided by the following principles:

⁵¹ The HIH failure is characterised by a potentially large unfunded deficit. Under the *HCS Appropriation (HIH Assistance) Act 2001 (Cth)*, the Commonwealth has set aside \$640 million for the payment of HIH claims. Claims paid out to 30 November 2003 are \$300m. Liabilities towards nominal defendant and nominal insurer schemes exceeds \$700 million with relatively few recoverable assets (other than reinsurance) likely to be identified. The liquidator has predicted a total group shortfall of between \$3 billion and \$5 billion. Liquidators' Report to meeting of creditors, 3 April 2002 available at www.hih.com.au/creditors/sld001.htm.

⁵² Productivity Commission, 2003, *National Workers Compensation and Occupational Health and Safety Frameworks*, Interim Report, Canberra, October, p. 260.

⁵³ Refer to Appendix C for further information on the reinsurance 'cut through' arrangements provided by the *Corporations Act*.

- a) must be determined and agreed, in consultation with the insurance industry, at the inception of the PPS
- b) must not put at risk the solvency of a particular insurer or a particular class of insurers, nor should it result in or encourage market distortions in pricing
- c) the risk of inadvertent signals to the market should not be borne by a policyholder protection scheme. For example, with a risk based approach to the application of a levy the compensation scheme could send a message to the marketplace that a particular insurer is involved in 'riskier' lines of insurance, and is therefore, for prudential or solvency purposes, at risk and
- d) should, be assessed by reference to the likely cost of claims and estimated recoveries from the liquidator. To the extent possible, later generations of insurers should not be levied for the failure of earlier insurers.

In light of these principles, ICA considers that the PPS should be funded by a levy imposed on all authorised general insurers to reflect their market share. Market share is the method applied in most jurisdictions.

It would be a condition of an insurer's authorisation from APRA that it pays amounts for which it is levied by the PPS. A breach of this condition would invoke provisions of the *Insurance Act*.

5.5.3 How the PPS could be funded

ICA's preferred funding mechanism is one in which all general insurers would become liable for a given proportion of the funds payable within any period based upon their share of overall premium within that period (or immediately preceding period). It would then be the responsibility of the insurer as to how they would raise these monies. To protect the competitive dynamic of premium pricing within the industry, ICA believes that it is important that no specified ad-valorem or flat rates be imposed on insurers.

ICA has researched a range of funding models based on the principles set out in this submission, and is confident that a significant unfunded deficit could be covered by a PPS scheme without undue impact on the remainder of the industry or its customers.

5.6 Summary of costs and benefits of the proposed PPS⁵⁴

The following table provides a summary of the qualitative costs and benefits of simply relying on the existing form of regulation compared to introducing the package of reforms including the ICA's proposed PPS.

⁵⁴ Refer to ToR (a) and (c).

Summary of costs and benefits of the proposed PPS

Benefits	Costs
Existing arrangements	
<ul style="list-style-type: none"> • Limited guarantee for third party motor vehicle and some workers compensation policies or arrangement guarantee to fund the cost of insurer failure • Insurer defaults are relatively rare, and any other policyholder protection responses are customised to the needs of policyholders arising following each failure • Little or no 'moral hazard' - insurance purchasers in the voluntary market have an incentive to take account of security of the underwriter when buying insurance 	<ul style="list-style-type: none"> • Real possibility that governments will fund guaranteed or ad hoc protection by inequitable funding mechanisms, as seen in the introduction of the NSW IPT which passed the costs of the protection arrangements onto the shareholders of authorised insurers. This amounts to an implicit guarantee. • Compliance costs associated with separate State and Territory capital requirements and solvency regulation, as seen in NSW and Qld CTP regulation. Compliance costs associated with duplication and overlap of regulation. • Length of time, expense and shortfall issues for policyholders under normal insolvency provisions.
PPS as one of a package of reforms	
<ul style="list-style-type: none"> • Provides the certainty of pre-determined system for responding to insurer failure that should allow policyholders access to compensation quickly and with maximum efficiency • Provides at least the same level of protection available under current State and Territory policyholder protection regimes • Reduced impost upon the community as a result of a systematic and well-conceived PPS. • Transfer of the implicit guarantee provided by governments for assistance in the event of an insurer failure. This would allow States and Territories to absent themselves from any role in policyholder or claimant protection • Will alleviate the need for full government assistance in the event of insurer failure, as occurred in the establishment of HCS after HIH collapsed • Provides industry and consumer confidence that governments will not utilise existing nominal insurer funding mechanisms or introduce a new tax, as seen in the introduction of the NSW IPT • Reduces overlap and confusion of regulatory function • Safety net for eligible policyholders and third party claimants in the event that there are not enough assets in the insurer to pay claims upon the liquidation of the failed insurer • Lessening of political risks associated with government responses to a collapse 	<ul style="list-style-type: none"> • Minimal initial of costs of establishing a funding system / entity. Once established the facility will lie dormant until called upon. • Moral hazard: <ul style="list-style-type: none"> • policyholders may stop caring about the quality of the insurer and simply chose an insurer covered by the guarantee scheme. This risk is considered immaterial because of the design features of the proposed scheme. • insurers may take on risks and behave contrary to how they would if no PPS existed. This risk is mitigated by the new prudential and reporting standards. • APRA may behave contrary to how they would if no PPS existed. This risk is considered immaterial and mitigated by the accountability of the regulator.

5.7 Other technical matters

ICA recognises that the introduction of the PPS will involve significant consultation between the stakeholders and further development and implementation of a model for the PPS. This submission includes some detail of ICA's proposed model but ICA recognises the need for, and will participate in further consultation or provide further detail on particular issues as required.

ICA suggests that the following technical issues on the design of the PPS are matters that require further consideration:

- Transitional arrangements - Whether the PPS should cover any events which occur after the date the insurer fails for the purpose of the PPS. In some jurisdictions, policyholders may also claim with respect to events occurring up to many days afterwards - for example, 45 days under the Canadian guarantee. The HIH Claims Support Scheme provides assistance for insured losses that occurred up to 10 June 2001, even though HIH failed on 15 March 2001. This extension covers policyholders whilst they shop for a new policy.
- Whether the PPS provides compensation for unearned premium coverage. Policyholders are entitled to recover premiums in respect of that part of the policy that is no longer effective because of the failure of the insurer under the Canadian and US guarantees. However, the loss of the actual premium may be something that is normally an affordable cost for the policyholder. Adding this avenue for compensation may also add to the costs of administering the PPS. If unearned premiums are to be compensated under by the PPS, then they should be capped. The Canadian guarantee refunds 70% of the unused portion of each policyholder's premium to a maximum payout of \$700 per policy.
- Whether the PPS administrator is required to assist policyholders transfer their policies before paying compensation. The UK administrator, for example, is required to seek to transfer the policy to another insurer, and this also occurs for some long-term policies such as life insurance.
- Whether the PPS administrator would assist companies in short term financial difficulties. For example, in the UK the administrator has broader powers and obligations than in most other jurisdictions. The UK administrator's assistance may involve allowing a member who is the subject of a winding up application or who is in financial difficulties and has entered into a deed of company arrangement with creditors to defer payment of liabilities or benefits under the policy.
- Distribution and priority issues – In the insolvency of an insurer, the policyholders are unsecured creditors and have no priority in a winding up under the *Corporations Act*⁵⁵. There is some priority given to:
 - policyholders whose policies were the subject of reinsurance⁵⁶ and
 - for Australian policyholders in relation to distribution of the assets of the insurer in Australia⁵⁷.

⁵⁵ Sections 555 and 556 of the *Corporations Act*.

⁵⁶ Refer to Appendix C for further information on the priority of access to reinsurance under Australian law.

It will be necessary for a mechanism to be established in order to allow the PPS administrator (or another appropriate entity) to obtain any distribution in the winding up of an insolvent insurer, instead of the policyholder. This may be achieved by a contractual or statutory assignment to the PPS administrator. In any event, consideration will need to be given to whether the PPS administrator should have any priority, over and above that of an unsecured policyholder creditor, in the winding up of the insolvent insurer. It is noted that the HIH Claims Support Scheme is an unsecured creditor of HIH, and receives no favourable treatment, compared to other creditors, in the liquidation of the group.

⁵⁷ Section 116(3) of the *Insurance Act*.

Appendix A - 'Retail' and 'wholesale' clients

Chapter 7 of the *Corporations Act* deals with the licensing of entities that carry on a financial services business in Australia and puts in a place a disclosure regime for those licensed entities.

The key distinction in Chapter 7 for the purposes of the disclosure regime is that between retail and wholesale clients. The *Corporations Act* treats the recipient of financial products and services attached to financial products as a wholesale client, unless they are specified as a retail client⁵⁸.

The *Corporations Act* sets out special rules for general insurance products in determining who will be a retail client in connection with those products⁵⁹. The rules establish a two-tiered test:

- Firstly, who is buying the financial product? and
- Secondly, what are they buying?

Based on the first tier of the test, only individuals and small businesses can be retail clients⁶⁰. A business will be a small business if it has less than 100 employees (manufacturing) or 20 employees otherwise⁶¹. However, they will only be retail clients for general insurance products that are in the specified consumer classes. These specified consumer classes are motor vehicle, home building, home contents, sickness and accident, consumer credit, travel and personal and domestic property insurance⁶².

Businesses that do not meet the small business test can never be retail clients for any type of general insurance product. Individuals and those businesses that do meet the small business test can never be retail clients for general insurance policies that are not in the specified consumer classes. A person or entity is a wholesale client if they fall outside of these special rules.

The premise of the distinction between retail and wholesale clients in Chapter 7 of the *Corporations Act* is that wholesale clients do not require the same protection as retail clients, as they either have adequate knowledge of the insurance product or service or the means to acquire appropriate advice.

ICA reads Term of Reference a. to imply that the classification of retail and wholesale clients in Chapter 7 of the *Corporations Act* could function as an eligibility threshold for the PPS.

ICA suggests that this is not an appropriate eligibility mechanism for the PPS. Because the distinction between retail and wholesale clients in Chapter 7 of the *Corporations Act* has two tiers it may not capture all people or entities that ICA proposes should be protected by a PPS. The following examples assist to demonstrate the deficiencies:

- Not all products purchased by a small business or an individual are retail products. In particular, policies that would be purchased to protect business assets are not retail products. This means that a small business would not be protected by a PPS in relation to a

⁵⁸ Section 761G(1) of the *Corporations Act*.

⁵⁹ Section 761G(5) of the *Corporations Act*.

⁶⁰ Section 761G(5)(a) of the *Corporations Act*.

⁶¹ Section 761G(12) of the *Corporations Act*.

⁶² Section 761G(5)(b) of the *Corporations Act*.

fire policy covering business assets. This is inconsistent with the premise of a PPS which is to protect policyholders without the means to assess the financial viability of their insurer. Product type should, accordingly, be irrelevant.

- The specified classes of retail products do not include liability policies. Accordingly, if a person cannot pay compensation to a third party because of the insolvency of an insurer, a PPS based on the retail client definition would not assist the affected third party. This in circumstances where the third party had no input into the selection of the insurer.
- All policyholders are eligible if they hold compulsory insurance but only smaller policyholders are eligible beneficiaries for compensation paid under non-compulsory insurance⁶³. In the UK all policyholders (including overseas financial institutions and large companies, being companies which have a turnover of not more than £2.8 million, and balance sheet total of not more than £1.4 million and not more than 50 employees) are eligible for compensation with respect to compulsory insurance (such as third party motor insurance and employers liability).

⁶³ Under the Financial Services Compensation Scheme in the UK, individuals, small businesses (being business with a turnover of less than 1 million pounds a year) and large partnerships (being a partnership or unincorporated association with net assets if more than £1.4 million) are eligible for compensation with respect to non-compulsory insurance (such as home insurance). Individuals, small businesses and some large corporations are eligible for compensation with respect to long term insurance (such as pension plans and life insurance).

Appendix B - Comparison of Policyholder Protection Schemes⁶⁴

Issue	Proposed PPS	HCS scheme	Canada	UK	US
Members of guarantee fund	It would be a condition of any authorisation to carry on insurance business in Australia under the Insurance Act that the insurer be a member of the PPS, and satisfy funding requests from the scheme administrator.	Not applicable.	<p>Members are 'all General Insurers'. General Insurers are those bodies that issue general insurance policies.</p> <p>Members of the Canadian guarantee can terminate their membership only if they cease to be licensed everywhere in Canada for the types of insurance covered by the Canadian guarantee.</p> <p>Reinsurers are excluded: 'a reciprocal or inter-insurance exchange or an insurer whose business is limited to that of reinsurance.'(By-law: cl 1(f)).</p>	<p>Membership is compulsory for insurers who are licensed to provide insurance in the UK</p> <p>Reinsurers are excluded</p>	<p>Insurers are required to be licensed under each state accredited by the National Association of Insurance Commissioners. Usually, it is a condition of an insurance license, that the licensee becomes a member of the guarantee.</p> <p>Reinsurers are excluded</p>

⁶⁴ Information on the HCS is drawn from <http://www.hihsupport.com.au/>. Information on the Canadian guarantee is drawn from the Property and Casualty Insurance Compensation Corporation (PACICC) website at www.pacicc.com.au. Supplementary information has been drawn from The PACICC By-law, PACICC Memorandum of Operation, PACICC *Options to ensure another fifteen successful years of service* (4 March 2003) ('PACICC (March 2003)') and PACICC *A proactive vision for PACICC in a challenging business environment* (29 April 2003) ('PACICC (April 2003)'). The instruments referred to is the PACICC Consolidated By-Law No 1 March 25 2003 (By-law) and PACICC Consolidated Memorandum of Operation March 25 2003 (Memorandum). Information on the UK guarantee drawn from the Financial Services Compensation Scheme Limited website at <http://www.fscs.org.uk/>. Note that the UK system incorporates entities from across the sector: members belong of one of the three sub-schemes (insurance, investments and deposits), but each scheme appears to operate relatively independently. Information on the US state guarantee funds has been primarily drawn from the National Conference of Insurance Guarantee Funds website at www.ncigf.org and <http://www.iii.org/media/hottopics/insurance/insolvencies/>. There is an independent guarantee fund in each state of the US. Although there is significant variation between the states, the industry body, the National Association of Insurance Commissioners (NAIC) is the body that exerts most federal and unifying influence on the guarantee funds. The NAIC appears to have the dual (and perhaps contradictory) goals of preserving state autonomy and promoting uniform nationalised regulation. The NAIC developed the NAIC Post-Assessment Property and Liability Insurance Guaranty Association Model Act (Model Act), to further the second of these goals. Entries in this column set out the Model Act provisions adopted by most states, unless stated otherwise.

Issue	Proposed PPS	HCS scheme	Canada	UK	US
Eligible policyholders (beneficiaries)	<p>Individual policyholders (Australian citizens and permanent residents)</p> <p>Small business policyholders where small business is defined as a business with a turnover of up to \$1 million (includes a body corporate (owners corporation).</p> <p>Family trusts which own property for private, and residential purposes</p> <p>Third party personal injury claimants under all eligible state statutory schemes</p>	<p>Private individuals (Australian and NZ citizens and permanent residents)</p> <p>Small businesses (50 or fewer employees)</p> <p>Non profit organisations</p> <p>Third parties with statutory cut through rights (provided the insured would have been eligible)</p>	<p>All persons (whether individuals or corporations) who have a property or casualty policy with a member of the scheme</p>	<p>All policyholders (including overseas financial institutions and large companies: turnover of not more than £2.8m, and balance sheet total of not more than £1.4m and not more than 50 employees) for compulsory insurance (CTP, employers liability);</p> <p>Individuals, small businesses (turnover less than £1m p/a) and large partnerships for non-compulsory insurance (eg. home insurance);</p> <p>Individuals, small businesses and some large corporations for long term insurance (eg. pension plans, life insurance)</p>	<p>In many states, any corporation with a net worth of more than \$50 million to reimburse state guarantees for liability claim payments made on its behalf.</p>
Claims covered	<p>Valid claim under a valid policy. Payment should operate as full and final payment of claim, with the scheme taking an assignment of rights and seek recoveries as a creditor.</p> <p>All types of insurance included.</p>	<p>Excludes many types of insurance mandated by State and Territory Governments including compulsory third party motor vehicle insurance (CTP), workers' compensation, builders' warranty and professional indemnity for legal practitioners (to the extent that it is compulsory).</p>	<p>All unpaid claims made under property and casualty insurance policies for losses arising from a single occurrence. 'Property and casualty' insurance policies include directors' and officers insurance, employer's liability insurance, errors and omissions insurance and personal accident insurance.</p>	<p>Most covers, including statutory classes.</p>	<p>Must be covered by a policy issued by a licensed insurer and, if a first party claim for damage to property with a permanent location in the state, or, if for workers compensation claim, the policyholder is a resident of the state at the time of the insured at the time of the event</p>

Issue	Proposed PPS	HCS scheme	Canada	UK	US
<p>Caps on compensation</p>	<p>Compulsory schemes where nominal insurer requirements for insurer insolvency is removed.</p> <p>Statutory schemes, loss of income policies and personal injury claims: 100% of loss</p> <p>All other claims: First \$5,000, then 90% of the remainder, to a maximum of \$500,000.</p>	<p>HCS pays 90 cents in the dollar for claims other than those set out in paragraph (a) above where the policyholder is subject to an income test as follows:</p> <p>Where family taxable income is less than \$77,234 (increased by \$3139 for each additional child); a policyholder qualifies regardless of the size of the claim.</p> <p>Where family taxable income is more than \$77,234 (increased by \$3139 for each additional child); a policyholder qualifies for assistance if the claim is more than 10 per cent of family taxable income.</p>	<p>Level of assistance limited to \$C250,000 per event. The maximum recovery from the Canadian guarantee is \$250,000 with respect to all unpaid claims for losses arising from a single occurrence. The figure of \$250,000 is said to reflect current claims trends. If a claim exceeds the limit of \$250,000 a policyholder may eventually be reimbursed for all or part of the shortfall from funds released by the liquidator. The Canadian guarantee is reimbursed for the moneys it has paid to the policyholder before the policyholder receives more.</p> <p>If PACICC pays a policyholder \$250,000 on an agreed-upon claim of \$400,000 and eventually recovers \$300,000 from the liquidator, PACICC will pay the policyholder a further \$50,000, bringing the policy-holder's total recovery to \$300,000. However, if the recovery were to be \$400,000 from the liquidator, the policyholder would receive full payment of their claim.</p>	<p>Compulsory classes are met in full. Others: first £2,000 then 90% of remainder.</p> <p>The Financial Services Compensation Scheme in the United Kingdom provides benefits of £ 2,000 and then 90% of the remainder for policies other than compulsory insurance (workers compensation and CTP, which are paid at 100%). The maximum level of compensation policyholders may obtain depends on the type of insurance policy. Those maximums are as follows: (a) compulsory insurance (such as third party motor insurance and employers liability) is covered in full; (b) non-compulsory insurance (such as home insurance): (i) the first £2000 of a claim or policy is covered in full; then (ii) for amounts above the first £2000, 90% of the remainder of the claim or value of unused premium; (b) long term insurance (such as pension plans and life insurance): (i) the first £2000 of a claim is covered in full; then (ii) for amounts above the first £2000, 90% of the value of a policy. If a policy is due to be paid after the date of liquidation, FSCS must try to arrange to transfer the long term policy to</p>	<p>Workers' compensation claims are paid in full and the balance of claims are paid up to the limit of \$300,000. However, this differs across states. In Georgia, the maximum covered claim or the largest payment that state's guarantee will make is \$100,000. In Arkansas, it is \$300,000 and in California, the maximum figure is \$500,000.</p>

				another insurer or obtain a substitute policy at 90% of the value. If this is not possible, the policyholder will receive compensation. The liquidator determines the value of the policy.	
Administrator of guarantee	Industry owned and operated. ICA would establish a not-for-profit company limited by guarantee, with the members of the company being insurance companies authorised and licensed to operate in Australia. The company would comply with the usual Corporations Act requirements. The scheme administrator would operate within the ICA on a relatively dormant basis until it needed to become fully operational.	Not-for-profit company, with small administration and some outsourcing	Corporation without share capital. It is staffed by 4 part-time contract personnel. The board comprises 15 directors, 7 of whom are presently senior officeholders of members and the balance of whom are independent.	Corporation limited by guarantee without share capital. Directors are appointed by the Financial Services Authority. It does not have a regulatory role.	Nonprofit, unincorporated legal entity. Most of the guaranteees are overseen by a board comprised of representatives elected by member insurers
Funding arrangements	Post-event funding by levies on members. Member companies would have the capacity to pass on any contribution to the PPS to policyholders through the pricing mechanism.	Fully post-event funded by the Commonwealth	Part pre-funded. All members pay a small levy to cover administration (capped at \$1m). Also retains a pre-fund (\$30m) so that payments could be made quickly. Part post-funded. Members are levied. Maintains a line of credit from a Canadian chartered bank in the amount of not less than \$10m. May also enter into an arrangement with the liquidator whereby the liquidator will distribute assets to PACICC prior to other creditors.	Post-funded by levies on members. Members belong of one of the three sub-schemes (insurance, investments and deposits). Quarantines funds provided by, for example, insurers for the benefit of policyholders, rather than, for example, persons who have placed a deposit with a failed bank.	Post-funding in all states except for New York.

Issue	Proposed PPS	HCS scheme	Canada	UK	US
Levy structure	While a variety of options exist, that which is favoured by ICA is one where participating general insurers would be levied by the PPS according to their (market) share of premium. The manner in which insurers then fund this liability remains a commercial decision for them, thus retaining the competitive dynamic of the industry.	Not applicable	<p>Capped levy on members.</p> <p>In any one year, no member of the Canadian guarantee may be called upon to pay assessments levied by the Canadian guarantee with respect to any particular jurisdiction more than the greater of:</p> <p>0.75% of its direct written premiums in that jurisdiction; and</p> <p>Its proportionate share in that jurisdiction of the lesser of \$10,000,000 and 1% of all direct written premiums in that jurisdiction.</p>	<p>Levy on members calculated according to purpose of levy:</p> <p>Establishment costs. All members levied annually for costs of setting up the guarantee for the whole sector.</p> <p>Management expenses. All members levied for the costs of assessing and making payments to policyholders. Maximum levy for management set by Financial Services Authority.</p> <p>Compensation payments. Levy on insurers is capped at 0.8% of a member's net premium income on protected policies.</p>	<p>Methods used by states to levy members include:</p> <p>Premiums. The majority of states allow members to recover the cost of assessments by permitting them to include the cost of assessments as a factor in determining rates and premiums that the insurer is allowed to charge for its policies.</p> <p>Premium tax offset. Sixteen states offset assessments through a reduction in premium taxes — a state tax levied on the amount of insurance premiums paid by the policyholders in the state.</p> <p>Surcharge. California, Hawaii and New Jersey raise assessments through an insurance policy surcharge.</p>

Appendix C - Cut-through provisions

Under Australian law there are two mechanisms by which priority is achieved in relation to the reinsurance recoveries of an insolvent insurer. These are:

- under section 562A of the *Corporations Act*; and
- by virtue of specific 'cut-through' provisions in State and Territory legislation.

Section 562A of the *Corporations Act* operates to give priority to some unsecured creditors over others. Section 562A provides any amount received under contracts of reinsurance (after deducting expenses of or incidental to getting in reinsurance) that equals or exceeds the total amount payable by the company under the underlying contracts of insurance, the liquidator must, out of the amount received and in priority to all payments in respect of other debts of the company, pay the amount that is payable under those underlying contracts of insurance.

This means that some policyholders will have priority in relation to reinsurance recoveries of an insolvent insurer. This priority exists together with a priority given to for Australian policyholders in relation to distribution of the assets of the insolvent insurer in Australia⁶⁵.

The application of sections 562A, section 116(3) and the *Corporations Act*. In the recent decision of the Supreme Court of NSW in *New Cap Reinsurance Corporation Limited (in liquidation) v Faraday Underwriting Limited and Gerling Global Reinsurance Company of Australia Pty Ltd*⁶⁶, the court held that the order of priority is:

- liabilities in Australia are to be satisfied out of assets in Australia, if necessary pro rata, in accordance with section 116(3) of the *Insurance Act*
- Section 562A priorities are to be satisfied insofar as they have not been satisfied under the 116(3) distribution, out of the balance of assets in Australia and any other assets.

After that, the priority in sections 555 and 556 of the *Corporations Act* is applied.

In addition, cut through provisions in Australia are found in the following State Acts:

- Section 235 of the *Workers Compensation Act 1987* (NSW)
- Section 191 of the *Motor Accidents Compensation Act 1999* (NSW)
- Section 103V of the *Home Building Act (1989)* (NSW)
- Section 98(3) of the *Workers Compensation Act 1958* (VIC)
- Section 129 of the *Workers Rehabilitation and Compensation Act 1988* (TAS)
- Section 61(3) of the *Motor Accident Insurance Act 1994* (QLD)

⁶⁵ Section 116(3) of the *Insurance Act*.

⁶⁶ unreported decision of the Supreme Court of New South Wales, September 2003.

- Section 137(3)(c) of the *Work Health Act 1986* (NT)
- Section 40(1) of the *Workers' Compensation Supplementation Fund Act 1980* (ACT).
- Section 36 of the *Employers' Indemnity Supplementation Fund Act 1980* (WA)

These Acts establish licensed insurance schemes and/or nominal defendant, nominal insurer or other policyholder protection regimes that deal with insurer insolvency. The cut-through provisions operate, if a licensed insurer becomes insolvent, to give the nominal defendant, nominal insurer or protection entity the benefit of, and the right to exercise the rights and powers of the licensed insurer under, contracts of reinsurance, so to enable the nominal defendant, nominal insurer or protection entity to recover the reinsurance directly from the reinsurer.

These cut-through provisions are intended to avoid the priority rules in the Insurance Act and the Corporations Act by operating in a way that allows direct access to the reinsurance proceeds, rather than by distribution from the estate of the insolvent insurer.