INSURANCE COUNCIL OF AUSTRALIA

Submission to the Financial System Inquiry

March 2014

Executive summary

Well functioning insurance markets and institutions are one of the hallmarks of advanced economies. Effective and efficient insurance markets facilitate the pricing of risk, thereby ensuring that resources are deployed for their best purpose and that behaviours and practices that generate high social costs are mitigated. In short, in the advanced world, insurance markets are fundamental – they are the enablers of economic activity.

Notwithstanding this, attention to the fundamental importance of insurance markets in the broader financial system (let alone the economy more widely) has been muted. Regrettably, the Wallis review in the financial system paid limited attention to insurance markets apart from the institutional impacts of the broader "twin peaks" prudential and conduct framework recommended. Later on from Wallis, the collapse of Australia's second largest insurer of the time, HIH, brought fundamental awareness of the significance of insurance to the wider economy and with that, where on occasions insurance markets "fail" (such as with information asymmetry) and what regulatory interventions are needed to improve the functioning of insurance markets (such as prudential supervision).

The current review of Australia's financial system has the unique opportunity to embed into Australia's future policy making the key role that insurance plays in the system and the wider economy. Importantly, the review has the opportunity to articulate a lasting and durable framework from which future policy makers will draw. Simply, the Financial System Inquiry has the potential to settle ad hoc policy debates in the sector and to establish the conditions under which insurance markets operate effectively and efficiently in the future and risk is allocated in the economy to those with the least cost capacity to bear such risk.

To assist the FSI with this challenge, the Insurance Council of Australia has sought to advance a general framework of understanding insurance markets and how risk is allocated and apportioned in the greater economy. The ICA contends that the articulation of a framework understanding of the financial system was a key strength of the Wallis review and efforts should be made to continue this approach. In this regard, a fundamental distinction observed in the ICA submission is that unlike other financial institutions, insurable risk can never be eradicated at least in the short term. In the financial system, the task of intermediation is to align investment intentions with savers preferences. In the absence of such intermediation, projects are abandoned. However, when insurable risk is not borne by an insurance intermediary, the risk is not extinguished, it is ultimately transferred to either the individual (whether consciously or unconsciously) or to the state/government. This together with the fact that insurers do not engage in maturity transformation emphasises the key distinctions of insurance markets within the financial system that the ICA submission will draw attention to.

Nevertheless, beyond espousing a general framework of understanding insurance in the financial system, the ICA submission will outline some of the contemporary challenges in insurance markets and importantly, how the general framework articulated can inform the FSI in interpreting these challenges. For example, on the issue of insurance affordability, the ICA submission examines the risk to prudential stability from the mispricing of risk and the tensions that develop in the system when policy makers seek to disturb financial market regulatory arrangements for social policy goals. The ICA submission also remarks on the case for prudential supervision given the presence of information asymmetry in insurance markets however, the balance needed to ensure that stability does not come at the expense of ensuring greater competition and innovation in the sector.

Lastly, the ICA submission offers a policy pathway to the FSI to improve the insurance market settings and its institutional approach. A key to these recommendations is the affirmation of the framework espoused in the submission as the best path forward for the future regulation of insurance markets.

1 Introduction

The Insurance Council of Australia (ICA) has prepared this submission with the advice and assistance of Deloitte Access Economics (DAE). However, the views expressed are exclusively those of the ICA.

For the purposes of this submission, general insurance (GI) includes such products as home and contents insurance; travel insurance; motor vehicle insurance; personal injury insurance (such as third-party and workers' compensation); public liability insurance; commercial property insurance; and directors' and officers' liability insurance. Importantly, general insurance does not include life or health insurance.

This submission aims to assist the Financial System Inquiry (FSI) by presenting an overall framework for understanding the role of general insurance in mitigating insurable risk for individuals and businesses in Australia. The framework provides the conceptual base for a series of specific recommendations presented for consideration by the Inquiry.

The ICA is the representative body of the GI industry in Australia, including both insurers and reinsurers. ICA members represent more than 90% of the total premium income written in Australia by private sector general insurers. Further detail of the structure of the GI sector is presented later in the submission.

The ICA submission responds to the FSI terms of reference by seeking to establish clear principles to guide the future direction of government policies affecting general insurance in Australia. The industry contends that the success of the Wallis review was its ability to lay out a broad and appropriate conceptual framework within which to think about government regulation of the financial system and, to develop specific proposals for regulatory reform that accord with such a framework.

Fundamentally, the ICA submits that formulating a durable conceptual framework for GI helps to avoid *ad hoc* policy development, which in turn ensures that the sector optimises its role in managing insurable risk in the financial system.

The ICA acknowledges that the Australian financial system has evolved markedly since the Wallis Inquiry completed its report in 1997. Further, the ICA notes that other significant events, most especially the collapse of HIH insurance in March 2001, have profoundly shaped the structure of the GI sector since Wallis.

Nevertheless, the ICA submits that a fundamental strength of the Wallis Report was its inclusion of a conceptual framework to guide the consistent formulation of its recommendations for regulatory reform. The ICA contends that the FSI should aim to do likewise, acknowledging that such frameworks are often challenged by subsequent events, as was the Wallis framework by the Global Financial Crisis (GFC) of 2008-09.

The fundamental role general insurance plays in the broader financial system

A fundamental role of financial institutions and markets is to assist individuals and corporations to manage risk. Financial entities also mobilise savings and allocate them across the spectrum of investment opportunities. The general insurance industry plays a role in this regard but its role is not unique. The key and distinctive role of general insurance is the mitigation of insurable risk.

General insurers facilitate the transfer of risk among households, businesses (small and large) and, where applicable, the public sector (including government trading enterprises). Insurance policies represent a contractual promissory (that is, the premium payable) paid in advance by the insured to have the insurer "make good" losses generally arising from specified, pre-defined perils or risks.

Sharing a more certain aggregate outcome allows individuals and companies to convert an uncertain loss into a certain outlay, namely, the premium paid to the insurer. Through the acceptance and pooling of such risks, GI improves economic welfare by reducing the costs of self-insurance and liberating resources for more productive uses. Risks are more efficiently allocated and, at a practical level, individuals and businesses can pursue economic activities secure in the knowledge that risk has been transferred to a third party.

Insurable risk is mitigated through pooling. Pooling aggregates and shares individual risks among a group of similarly exposed individuals and companies. Importantly, where individual risks obey the "law of large numbers", pooling has the advantage of making more certain at the aggregate level what is uncertain at the level of the individual. It should also be emphasised that, unlike the banking sector, the insurance sector does not engage in maturity transformation and, as such, is not subject to the same liquidity risks evident in the banking system.

However, insurance is not the only mechanism for managing risk. Risk can be mitigated by preventive action, sold into capital markets, absorbed by government or simply borne by individuals themselves. Risks are efficiently allocated in an economy when the parties best placed to bear those risks actually do so. In other words, when the parties to whom risks are allocated bear and manage those risks at the lowest possible social cost, the allocation of risk-bearing can be said to be efficient.

In general, risks will be spread among various parties, including financial institutions like general insurers, but also financial markets, governments and individuals. General insurers specialise in bearing insurable risks. Although some risks may be more efficiently borne through other mechanisms (including being underwritten by governments through the tax and transfer system), insurers are well placed to provide insurance tailored to individual circumstances and to encourage appropriate management of the risks by individuals.

Everyone is risk-averse to some extent – even governments. But some parties are better placed to mitigate, manage or absorb particular risks. An efficient allocation of risk-bearing requires that the parties bearing the risks – in part or in whole –are those best placed to bear such risks. Distortions to this efficient pattern of risk-bearing will impose unnecessary social cost, and hence reduce economic welfare and living standards.

For example, if households or businesses are forced to bear too much risk, they modify their plans for economic expansion or curtail other activities. This might mean they choose not to move house to take a new job, not to build a new house or factory, or not to expand a business that might employ more people. If individuals are left bearing too much residual risk because suitable insurance products are not available, changes to regulation which encourage a wider range of insurance products onto the market can deliver a more efficient allocation of risk-bearing in the economy.

How insurers manage risk

Risk pricing: insurers maintain complex risk pricing models which combine potential-for-loss information with the specific characteristics of policyholders. Developments in technology are adding to the sophistication of risk pricing.

Risk transfer: insurers transfer risk from risk-averse individuals to those more willing to bear risk

Risk pooling and risk reduction: by pooling insurable risks faced by many similar individuals, the impact of one unexpected loss for an individual is spread across a larger pool of people

Managing risk through risk transfer from individuals or businesses to a larger diversifiable pool encourages individuals to participate in more risky activities than they would otherwise. Activities such as starting a business, purchasing a large asset or driving a car are fundamental to a well-functioning economy. Thus, through this pass-through mechanism the insurance industry promotes activity in the economy.

Source: CIE 2005

The importance of good regulation to efficient risk-bearing

The allocation of risk-bearing matters for economic efficiency, living standards and growth. If market failures distort risk-bearing so that too much risk is borne by individuals and governments and too little by the general insurance sector, there are prima facie grounds for regulatory intervention to improve market outcomes. On the other hand, if regulation itself distorts the optimal pattern of risk-bearing – leading to underinsurance by individuals and excessive reliance on government, for example – there is again a case for regulatory reform.

The ICA submits that at the heart of the FSI work is an examination of the settings pertinent to the pattern of risk-bearing in the Australian financial system, including how such settings accord with what efficiency would require. Further, the ICA contends that the key to this assessment is examining whether there are systematic factors leading households and companies to accept risks they ought not to be bearing or to lay off risks they ought to be bearing.

From the perspective of general insurance, such a review involves assessing whether there are constraints that inhibit the ability or incentive for general insurers to accept risks they are otherwise optimally placed to bear. In short, the fundamental question posited is whether some form of market failure or regulatory intervention is making the acceptance of insurable risks unattractive to general insurers or, to put it in another way, the scope for laying off of insurable risks unattractive to those exposed to perils.

This submission identifies a number of issues where further examination by the Inquiry is warranted and offers recommendations for reform where these are clear. The submission looks to assist the FSI by advancing a conceptual framework based on the optimal allocation of risk among three key parties to the risk transfer process.

- Individuals and businesses
- Insurers and capital markets; and
- Government

Further, the submission employs the conceptual framework to analyse specific issues that arise in the context of general insurance. These are potential sources of inefficiency in the allocation of risk-bearing that warrant consideration by the Inquiry. They include such matters as:

- The impact of tighter regulation of general insurance in the wake of the GFC
- The affordability of general insurance, especially as it relates to catastrophic risks
- The role of new technology, especially in facilitating the measurement and identification of risk and in the emergence of price discovery instruments
- The impact of demographic change, including ageing

The key functions of the financial system

The World Economic Forum (WEF) recently identified the following functions that a well-regulated financial system should perform:

Promote financial and economic resilience: mechanisms should exist to minimise the impact of shocks originating in the financial system by limiting financial contagion as well as limiting the impact of shocks originating outside the financial system.

Safeguard savings and the integrity of financial contracts: access to savings should be secured with legal and operational reliability.

Facilitate efficient allocation of capital to support economic growth: the means for raising both debt and equity should be available to fund new productive investments, with positive implications for economic growth.

Provide broad access to financial services products and services: access to financial services both domestically and abroad should be available to a wide range of participants.

Enable smoothing of cash flows and consumption over time: mechanisms should be in place to encourage consumption smoothing, investment and saving across lifecycle phases, including the capacity to shift savings and investments across time and risk profiles to promote economic growth.

Enable payments: payment for goods and services should be possible in a safe, low-cost and reliable manner.

Provide financial protection, risk transfer and diversification: the burden of risk should be shared among groups willing, and able to bear it, limiting individual loses and managing risk and vulnerability in the economy.

Collect, analyse and distribute information for better economic decision-making: intermediaries should provide financial information needed to meet individual objectives.

Provide effective markets: a broad range of investment opportunities should be accessible, market prices should be transparent and the provision of liquidity should be reliable.

Source: WEF 2013

2 Overview of the General Insurance sector

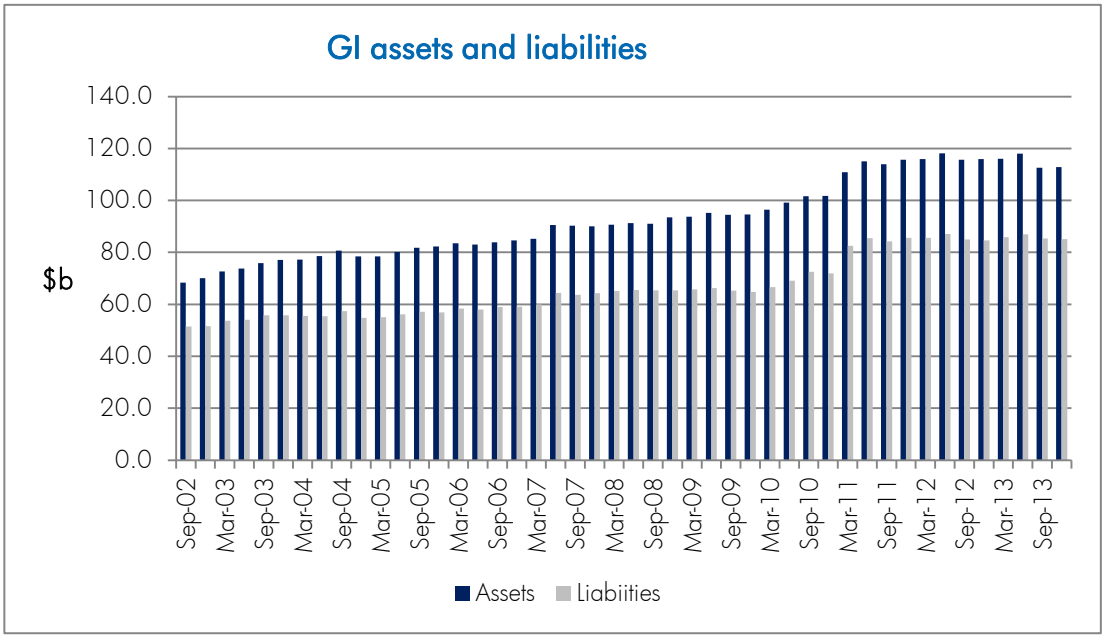
The general insurance industry supplies products and services which protect households and businesses from specific types of risks, including:

- Motor vehicle insurance, including compulsory third party
- Household building and contents insurance
- Fire and Industrial Special Risks (ISR) insurance
- Public and product liability insurance
- Professional indemnity insurance
- Employers' liability (or worker's compensation) insurance
- Mortgage and consumer credit insurance; and
- Travel insurance

The size of the GI sector

At present, there are 116 insurers licensed to conduct general insurance in Australia, of which 104 are direct insurers and the balance reinsurers. In the 2013 year, the GI sector collected some $41 billion in gross premium. Direct insurers accounted for $39 billion of gross premium with the remainder accounted for by reinsurers. The total assets of the GI sector amounted to $113 billion with total liabilities, including outstanding claims liabilities amounting to $85 billion. Direct insurers enjoyed assets of $101 billion with total liabilities of $77 billion.

Over the last ten years, the sector has enjoyed considerable growth in assets as demonstrated in the chart below.

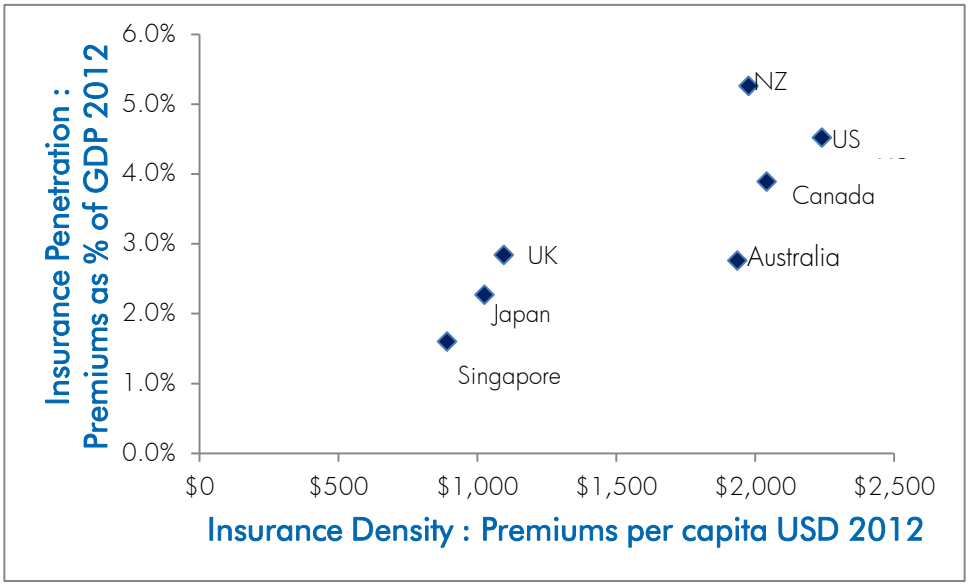


Source: APRA

The Australian GI sector and international comparisons

International comparisons indicate that Australia sits in the middle of the pack in regard to insurance penetration (i.e. premiums as a percentage of GDP) and insurance density (i.e. premiums per capita).

Australian non-life insurance premiums represent some 2.76% of GDP, compared to 4.52% in the USA, 3.89% in Canada, 5.26% in New Zealand and 2.84% in the UK. In terms of insurance density, Australians insured for non-life risks to an outlay of US$1,935 per capita, compared to US$2,239 in the United States, US$2,040 in Canada, US$1,975 in New Zealand and US$1,094 in the UK.



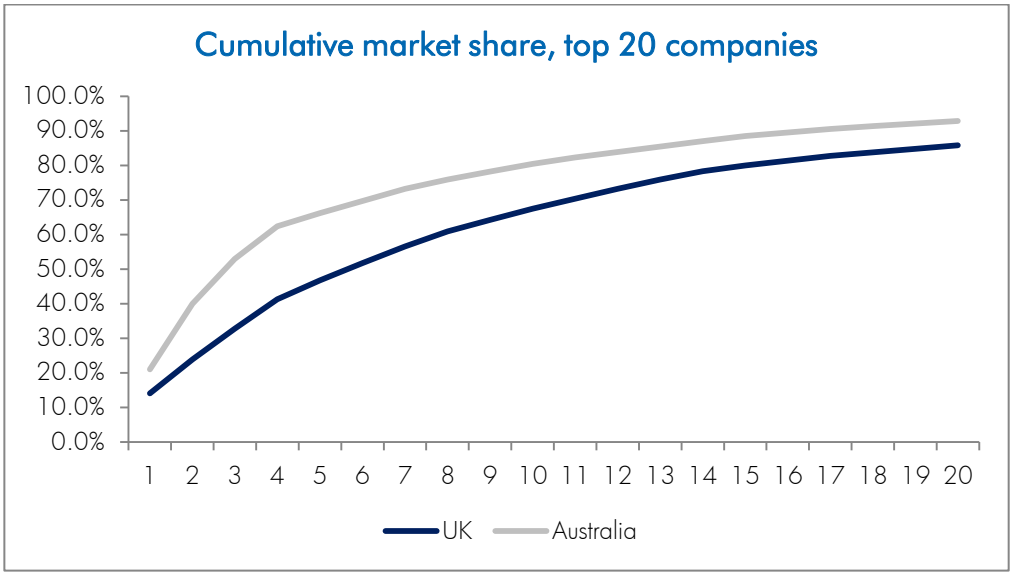
Source: Swiss Re & Sigma Consulting

The GI sector post the Wallis Inquiry and HIH Royal Commission

The general insurance sector has changed fundamentally since the release of the Wallis Report in 1997 and the subsequent Royal Commission into the failure of HIH. In particular, general insurance has enjoyed a period of strong growth and prudential strength despite the stresses imposed by a series of significant natural catastrophes in recent years.

Industry structure

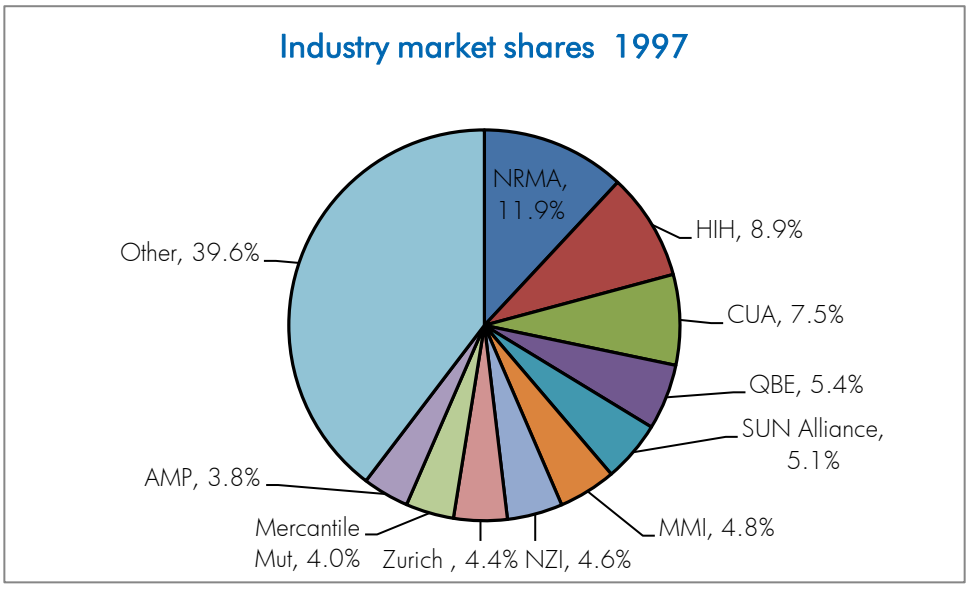
At present, the GI sector has 104 direct insurance licences, with four major insurer groups – IAG, Suncorp, QBE & Allianz– accounting for just over 62% of all premiums. In the case of Australia, the top five insurance groups account for two thirds of the insurance market compared to 47% in the case of the United Kingdom.



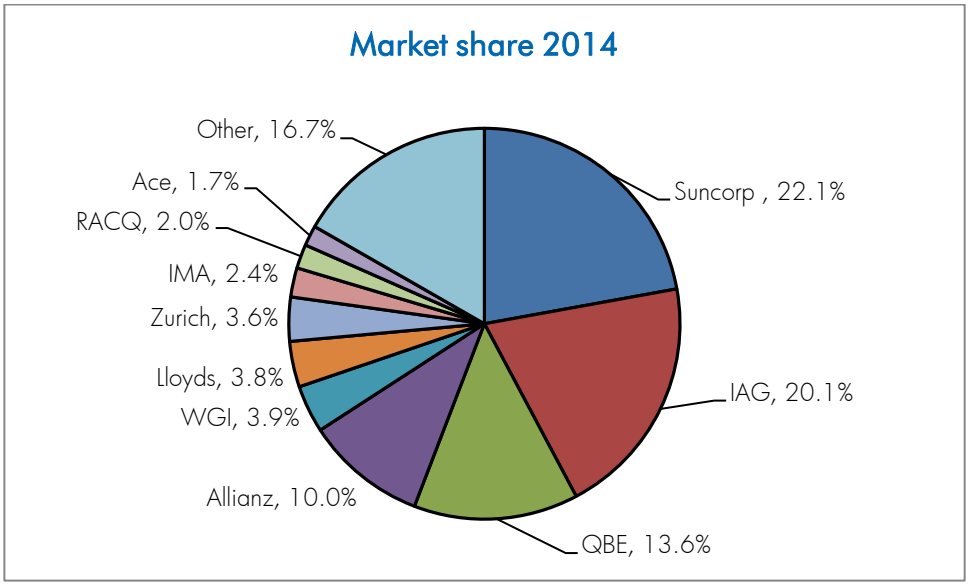
Source: Insurance Council of Australia & Association of British Insurers

Pre and post Wallis industry structure

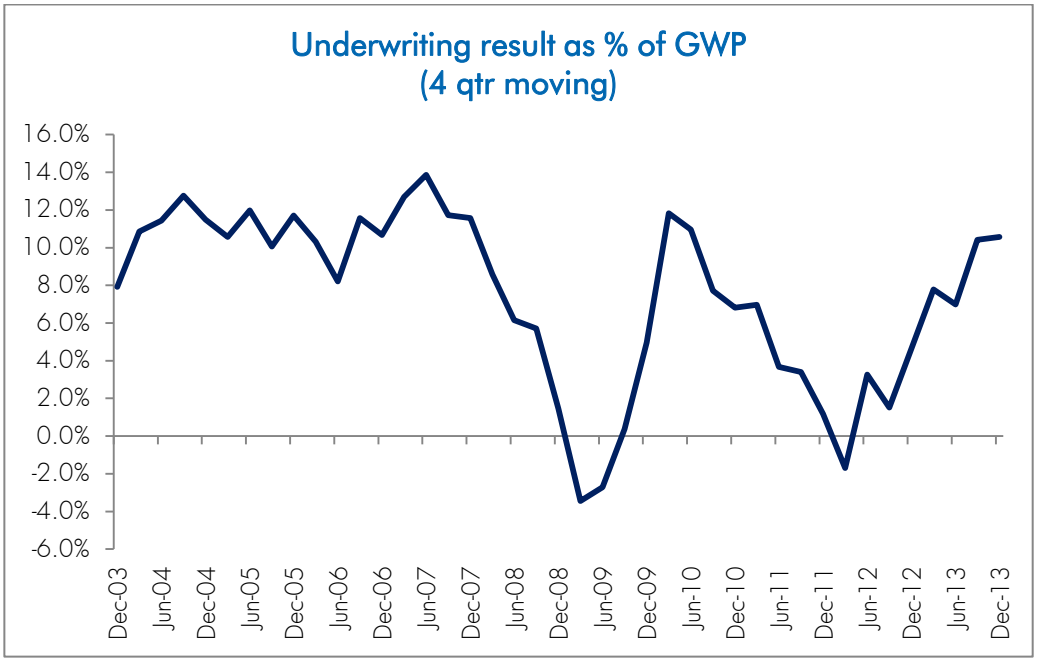
The general insurance industry has undergone significant change in the period following the Wallis Review. For example, at the time of Wallis, the single largest provider was NRMA Insurance with a market share of 12%, followed by HIH Insurance with a market share of 9% and the Commercial Union Assurance Company with a market share of 7.5%. At present, the latter two firms are no longer present in the Australian market and the NRMA has subsequently been demutualised and is now incorporated in the IAG group. A demonstration of the industry structure pre and post the Wallis review is outlined below.



Source: Insurance Council of Australia



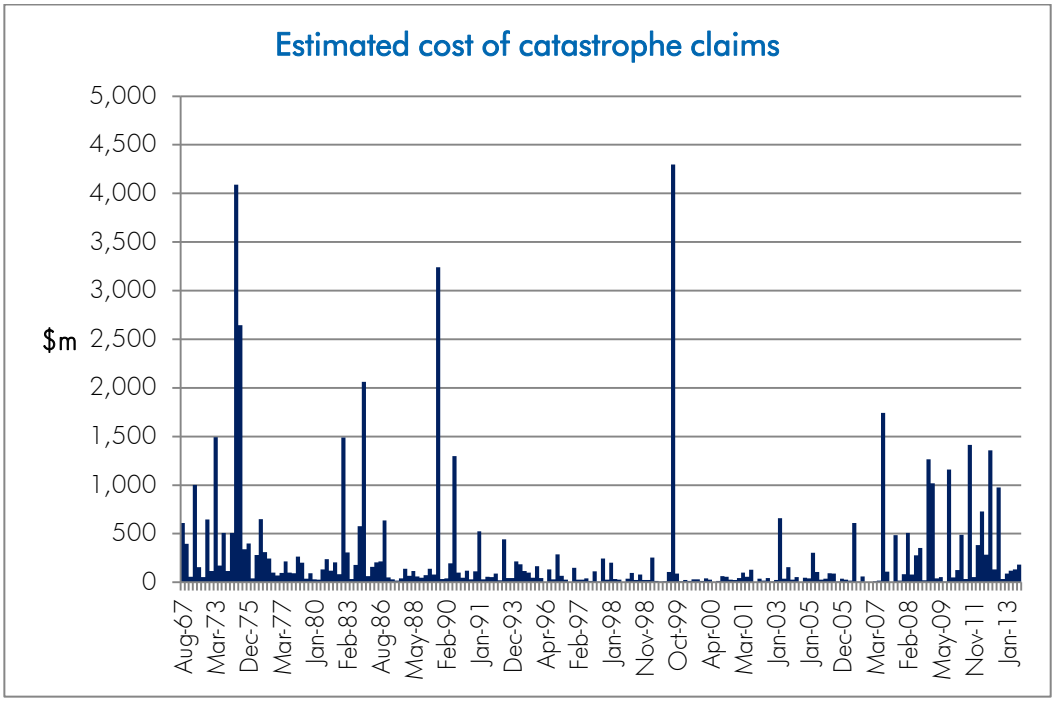
Source: Insurance Council of Australia



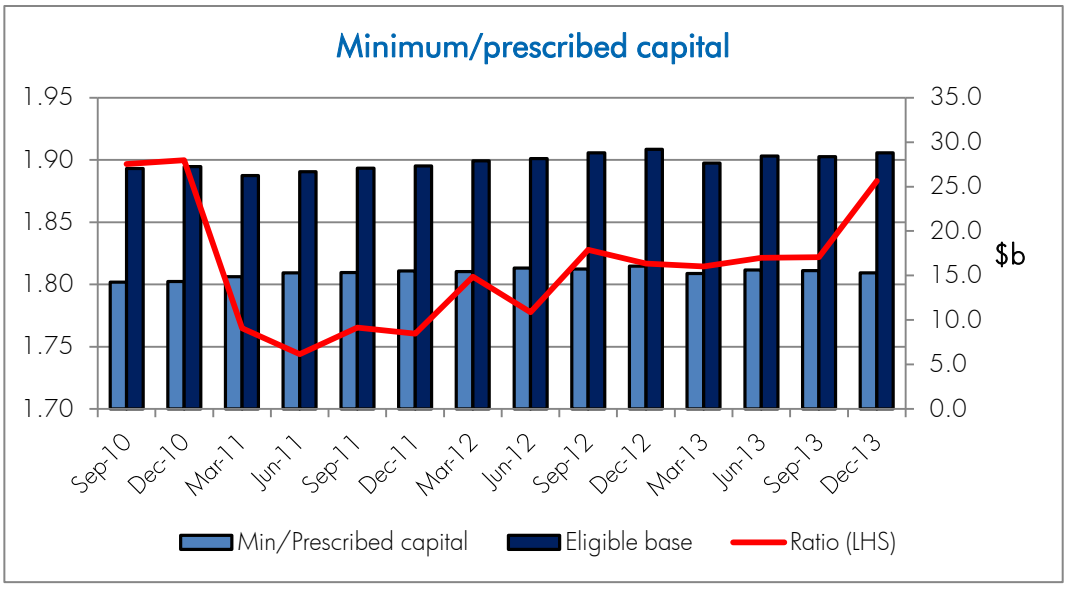
Source: APRA

Prudential supervision & oversight

The GI sector has transformed fundamentally post the Wallis Review and in response to the collapse of HIH. The sector is stable and well capitalised after having responded to a major review of its prudential settings initiated by the Australian Prudential Regulation Authority under the Life and General Insurance Capital Project (LAGIC), which has seen a readjustment of prudential capital requirements. As an industry, the GI sector holds some $29 billion in available capital, which represents a ratio of 1.88 times the prudential capital requirement.



Source: Insurance Council of Australia



Source: APRA

Moreover, over and above efforts to ensure system stability through the imposition of prudential capital standards, stability has also been enhanced with an overlay of additional non capital regulatory standards such as governance standards, risk management guidelines and guidance, financial condition reporting and the introduction of policyholder protection arrangements, including management powers for the regulator in cases of insurer stress. Together, these regulatory settings have resulted in the GI sector enjoying a sustained period of stability, notwithstanding the shocks to the system from the recent spate of natural catastrophes and the Global Financial Crisis.

APRA GI supervisory arrangements over the past 5 years

2008: Level 2 insurance group supervision, including power to supervise group holding companies and capital requirements for the insurance group. Further refinements in October 2011.

April 2010: Requirements for remuneration arrangements that supported prudential risk management.

July 2010: Changes to align prudential reporting more closely with statutory reporting for general insurers.

July 2010: Changes to Maximum Event Retention (MER) for Lenders Mortgage Insurers (LMI's).

July 2012: Consolidated (multi-industry) prudential standards on governance, fit and proper, outsourcing and business continuity.

January 2013: The introduction of new capital standards under the Life and General Insurance Capital Project (LAGIC).

September 2013: Guidance on data risk management

January 2014: Reinsurance counterparty data collection

From January 2015: Consolidated (multi industry) risk management standards

Source: APRA (2014)

3 Developing a GI Framework for policy makers

Why the need for a conceptual framework

A far-sighted approach to the regulation of general insurance requires a conceptual framework to assist in determining where market failure might arise and where government intervention might be needed to promote the public interest.

A strength of the GI sector is its longevity and its ubiquitousness. Insurance has been on offer to the public for many years – it is by no means a recent arrival on the finance scene nor is it an "exotic" product. Furthermore, insurers have developed well-settled instruments to mitigate some of the traditional and orthodox "failures" in insurance markets, such as adverse selection and moral hazard. Co-insurance, excesses and deductibles, for example, are devices introduced by insurers to manage the misallocation of risk between themselves and their policyholders. Acknowledging such arrangements are established practices and strengthen insurance markets, the challenge for policy makers is to develop a contemporary framework of insurance regulation that allows for evolution in insurance markets but does not fundamentally disturb these market arrangements.

The ICA submits that a key consideration for the FSI is the development of a conceptual framework that encapsulates a long-term understanding about how insurance risk is allocated. The ICA recognises that the insurance industry exists to mitigate insurable risk but, even in liberal markets, insurable risk may not be borne entirely by insurers and their reinsurers.

In this regard, it is efficient for some insurable risk to remain with individuals and companies exposed to perils to ensure they play their part in keeping risk as low as possible. (This addresses the classical problem in insurance markets of moral hazard.) Simply put, a free market is not necessarily absent of incentive problems given insufficient or asymmetric information.

There also remains the risk that the insurer will be "ruined" by an adverse turn of events or inappropriate behaviour/conduct with policyholder premiums, consequences of which are ultimately borne both by policyholders and governments (i.e. taxpayers). Again, this is the result of asymmetric information – in this case, access to information on the prudential health of an insurer to "make good" losses despite receipt of payments in advance for such a purpose. Accordingly, it remains sound that regulatory measures are in place to ensure that governments do not bear excess "tail risk" of any such losses and that the public interest is served by ensuring that policyholder claims are paid as and when they fall due.

Is the free-market allocation of insurable risk the most efficient?

A fundamental question to consider as part of the FSI terms of reference is whether the sharing of insurable risk among policyholders (individuals and businesses), insurers and government in a free market is efficient or, alternatively, whether a superior allocation might not be achieved through some form of market intervention.

If there is good reason to believe that, left to themselves, general insurance markets would not operate efficiently, then the further question arises as to what type of intervention might be most effective in improving the allocation of risk-bearing in the financial system. This leads directly to policy recommendations for regulation of insurance markets.

What is the role for government

The ICA contends that governments have an interest in ensuring that insurance markets operate efficiently and equitably. Governments are responsible for ensuring fair and open dealing between insurers and the insured when imbalances of market power and asymmetry of information threaten to deliver biased outcomes.

Governments must also seek to protect the wider financial system from instability arising from the failure of an insurer to meet its obligations to the insured. Australia's experience of the failure of the HIH insurance group in 2001 is a timely reminder that failure of an insurance company can inflict significant harm on policyholders and the wider economy, through second-round impacts on access to insurance and disruption of real activity.

When to intervene— evaluation of insurance and uninsurable risk

Some risks are uninsurable (for example, terrorism risk). It may be possible to detach uninsurable risks from their owners and sell them using specialised instruments on capital markets, however these carry their own regulatory burden. Alternatively, such risks may be 'socialised' by having government assume responsibility for making good any losses and recovering them through the tax system. As a final option, there may be no feasible or more efficient alterative than to leave some or all of such uninsurable risks attached to their owners.

For insurable risks, on the other hand, the ICA notes that there is a well-developed and advanced market for general insurance. Figure 3.1 explains the conditions that must be satisfied for a risk to be classed as 'insurable' and become the subject of an insurance policy drawn up between an insurer and a risk-owner.

In a liberal market, insurable risk will be traded between individuals, businesses and possibly even governments (in their role as asset owners, for example) and the insurance industry. The terms of such arrangements will reflect the nature of the underlying risk, the extent of competition among insurers and their ability to manage information problems like adverse selection and moral hazard.

Even in a liberal market for general insurance, government will still be exposed to "tail risk" either because policyholders of a ruined or inappropriately behaved insurer will look to government for relief or because failure occurs on a scale sufficient to affect general economic conditions and hence the government's own revenues and outlays.

Insurance and Insurable Risk

Not all risks can be mitigated through insurance. Insurance is one of a number of risk mitigation and allocation mechanisms available to individuals, companies and governments.

The general insurance industry offers protection against insurable risk.

The characteristics of insurable risk include:

- The exposure to loss must be random (in particular, not subject to adverse selection), i.e. the loss must be accidental or the result of pure chance
- The loss must be definable and measureable
- There should be a large number of similar risk exposures so that individual losses can be aggregated and shared
- The premium paid for insurance must be affordable relative to the gain from risk mitigation; and
- The risk of catastrophically large losses must be low

Risk mitigation through insurance is unlikely to be effective in the following circumstances:

- Where the loss is inevitable
- Where there is insufficient past experience to assess risk
- Where the proposer does not have an insurable interest (giving rise to moral hazard)
- Where the loss arises from 'fair wear and tear' such as rust or corrosion; or
- Where too many factors influence the outcome making it difficult or impossible to predict, e.g. the risk that a newly established business will fail

Source: (Roeser, Hillerbrand and Sandin 2012)

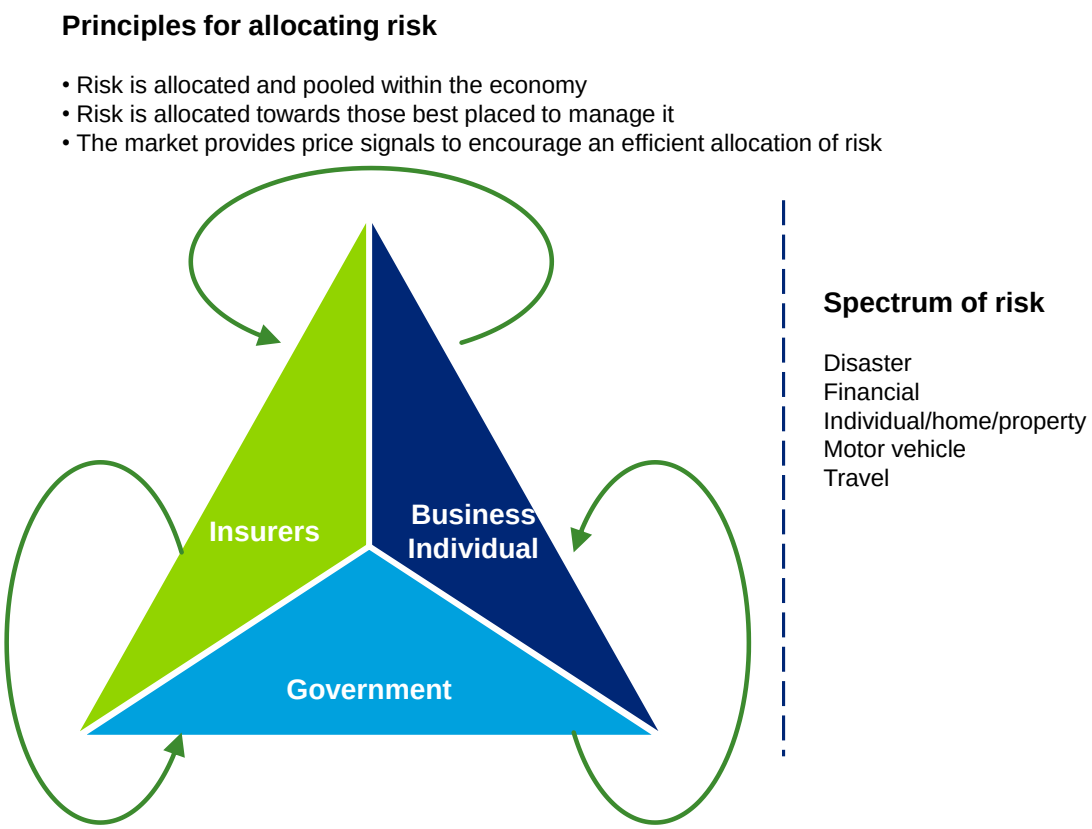
Allocating insurable risk

Insurable risks are typically shared among individuals/businesses, insurance providers and governments. In the financial system, where investors' intentions are not matched with a saver's preference via intermediation, a project is abandoned with the consequent impact on efficiency. However, in the case of insurance, insurable perils that are not entirely mitigated can never be eliminated. Such risks can only ever be transferred from one party to another or apportioned among parties (e.g. across individuals, insurers or governments).

In this regard, the challenge facing policy makers in general insurance is to promote least-cost arrangements for allocating insurable risk in the financial system. This contrasts with the challenge for policy makers in deposit-taking, for example, where the ideal framework must allow investor intentions to be efficiently matched with saver preferences.

Figure 3.1 provides an illustrated summary of how insurable risk is allocated among three broad groups in the financial system:

- Individuals and businesses
- Insurers; and
- Government



The ICA advances the above framework as a conceptual device to allow the FSI to assess policy options in general insurance. For example, individuals and businesses who "own" insurable risks may choose to self-insure. Even if they seek to lay off their risks to insurers, they are likely to be required to retain some exposure to help the insurer manage the moral hazard involved in fully insuring against known perils.

Insurers will accept as much of an insurable risk as is commercially viable, i.e. where the premium paid covers the insurers' costs, including the cost of moral hazard.

Governments will bear as much of the insurable risk as their obligations to ensure equity and fairness, including of social outcomes, require. They will also be exposed to the wider economic costs of the failure of an insurer to fulfil its promise to make good losses when they occur, such as at the time of an insurer "failure".

At the conceptual level, the allocation of insurable risk among these three parties will be efficient if the share of risk borne by each party gives rise to the lowest possible social cost. In other words, if no alternative rearrangement of risk-bearing among the three parties secures a reduction in social cost, then the allocative outcome is efficient or optimal.

By contrast, if the outcome arising from free exchange between insurers and policyholders in the presence of a government with responsibilities to ensure equity and stability is not optimal, there must exist a feasible re-assignment of risk-bearing between or within these broad groups that would demonstrably lower social cost. In such circumstances, if a superior allocation exists, then the question for policy makers is how such a re-arrangement may take place and what type of regulatory or policy intervention is required to deliver the preferred allocation of insurable risk.

Conceptualising a liberal market in the allocation of insurable risk

What it means for individuals, businesses and insurers

For individuals and businesses exposed to insurable risk, there is the trade-off between laying much of the risk as the insurer will bear or self-insuring. Ehrlich and Becker (1972) define a model in which market insurance and self-insurance are substitutes, and the demand for either depends upon prices, income and a range of other variables.

Rational individuals (including business owners) can be expected to weigh the costs and benefits of purchasing insurance against the alternative of self-insuring. Everyone is risk-averse to some extent and so (by definition) will pay something to avoid a fair gamble. Subject to the insurance premium not exceeding this margin, the individual exposed to risk will purchase insurance.

For their part, insurers are assumed to maximise expected profit. They will be willing to supply insurance so long as the premium at least covers their expected costs, including administration costs and a return on invested capital (Kunreuther and Pauly 2006).

Given that insurers cannot observe all outcomes with precision or monitor the behaviour of policyholders, (that is, information is imperfect and asymmetrically distributed between insurers and policyholders), it is unlikely that the insurer will accept full exposure to the risk the individual seeks to lay off.

Accordingly, in these circumstances there will very likely be some measure of coinsurance, deductible or exclusion incorporated into the policy document. In other words, even in a free market, an efficient allocation of insurable risk is unlikely to involve full transfer of risk from the insured party to the insurer. The box belows describes the familiar case of motor vehicle insurance.

The framework in practice – the example of car insurance

Insurance generally involves the sharing of responsibility for managing risk between the insurer and the insured. A typical car insurance policy, for example, will require the insured to make a specified contribution (the 'deductible') to the cost of any claim. Varying the deductible changes the allocation of insurable risk between the insured and the insurer, and hence also changes the premium charged on the policy.

What it means for insurers and government

Governments sometimes choose to socialise insurable risk through the tax system or through ownership of statutory enterprises that underwrite such risk. For example, Medicare is an example of publicly-underwritten health cover funded via taxation revenue while various state owned personal injury schemes (such as State owned CTP motor schemes, catastrophic injury schemes and workers compensation schemes) are examples of publicly-underwritten liability insurance.

The case for government intervention often rests with the view by policy makers that only through transferring risk to the state can government's equity objectives be achieved. Under such a policy

premise, market insurance may be judged as unaffordable, and rather than seek to subsidise private insurance purchase (as happens with private health insurance in Australia), the government looks to underwrite losses directly.

The box below describes the example of catastrophe risk which is testing the boundaries of private insurance and precipitating policy maker interest in establishing various schemes of public insurance to avoid the equity implications of unaffordable premiums. Even where the government opts for a scheme of public insurance, private insurers generally offer supplementary cover for an additional premium paid by those who choose to afford it. In such cases insurable risk is shared between government and insurers, and also taxpayers/policyholders if some form of co-payment is mandatory.

The framework in practice – catastrophic risk

Catastrophic events with their extremely high insured losses have been a feature of the Australian insurance market in recent times. To the extent that such events are predictable, they may even be uninsurable; but at the very least they may give rise to unaffordable premiums. A number of advanced economies have established state guarantees or private-state insurance solutions that seek to manage such catastrophe risk. The UK and US flood schemes are examples of public/private partnerships where flood risk is pooled across the community and funded by government imposts.

There are a number of other ways in which government seeks to shares insurable risk, including as "insurer of last resort". Since citizens look to government to ensure fair and transparent dealing in commercial transactions and to protect consumers from the consequences of commercial failure, governments are inevitably exposed to hazard arising from market transactions between insurers and their policyholders. In other cases, State governments have sought to both own and manage compensable risks, such as for personal injury or workers compensation.

Where could liberal markets in insurance go wrong

As the aforementioned framework outlines, in a liberal market, insurable risk will be shared among individuals, including businesses, insurers and government. However, the key question is whether, left undisturbed, free markets in insurance result in an efficient allocation. The corollary question is whether, *ex ante*, there is a more efficient allocation of risk-bearing that could be achieved if certain features of the free market were adjusted.

Behavioural issues affecting the insured

Market efficiency requires that consumers act rationally. In the context of insurance, biases in the perception of risk and difficulties in accessing or processing relevant information can undermine the rationality of consumer choice.

Misperception of risks is a common reason for people not to select the optimal level of insurance cover. Consumers may have neither the information nor the requisite skill to assess the financial risks they face. The cost of obtaining information to make better decisions may be excessive. Moreover, people tend not to purchase insurance against risks they perceive as having a low probability of occurrence irrespective of the magnitude of the potential loss.

It is also a possibility that in some circumstances consumers view insurance, even general insurance, as a form of investment rather than a risk management tool. In these circumstances they seek to earn a return on their investment, typically leading them to prefer low deductibles and thereby unnecessarily paying too much for their insurance.

The ICA is aware that recent developments in behavioural economics offer insights into the behavioural heuristics or biases that may affect the optimal level of risk transfer from individuals. For example, present term bias impacts how risk is understood across time. Status quo basis can impact on choice behaviour and lend support to nominated default settings. Nevertheless, , the regulatory measures developed in response to such behavioural issues remain a work in progress and where applicable, have taken the form of mandating particular types of insurance for a given activity (such as compulsory third party insurance for motor vehicle registrations).

Information asymmetry and incentive problems affecting insurers

Insurance has traditionally struggled with incentive problems arising from the asymmetry of information between the insurer and its policyholder.

The problem of adverse selection arises when the insurer cannot distinguish between good and bad risks. Charging the same premium to both classes of risk attracts the bad risks and discourages the good risks, leading the insurer to chronically misprice insurance and increase the risk of ruin. Fear of adverse selection may drive insurers out of a market for insurable risk altogether.

The problem of moral hazard refers to the ability of insured parties to increase their risk once the insurance contract has been signed. Efforts to manage this problem may again discourage people from taking out insurance (the insurer is regarded as intrusive) or discourage the insurer from offering cover ("red lining" certain suburbs in a city in the belief that insurance fraud is rife among residents).

It is important to emphasise that such information inefficiencies should be distinguished from improved measurement and observation leading to events ceasing to be insurable risks. If information about certain events becomes so accurate that the event becomes virtually certain, (for example, inundation of land due to sea-level rise), and hence no longer a peril, insurance no longer becomes a viable option. In these circumstances, there is no insurable risk but rather a certain event that must be planned for and managed in other ways. The development of new technologies is impacting on this dilemma and focussing more acutely on risks that require management beyond insurance markets, such as through mitigation.

'Charity hazard' affecting governments

When arrangements between insurers and policyholders go wrong, governments inevitably find themselves assuming the losses. Misunderstandings, miscalculations, inappropriate conduct, and catastrophic events can leave policyholders short, in which case they will look to government to make their losses whole.

Nevertheless, governments compromise longer term, sustainable policy in GI by offering to socialise insurable risk when the private market has the capacity to handle such losses efficiently. When governments are too generous in compensating natural disaster losses, for example, they may inadvertently undermine or "crowd out" private insurance and increase their exposure to future losses.

"Charity hazard" refers to the circumstance where, households and businesses express a diminished incentive to purchase private insurance when it becomes evident that government assistance is available in the event of disaster. This effect is further exacerbated when insurers have little incentive to offer insurance if the best risks opt to rely on such government assistance leaving only the worst risks in the market for supplementary private cover.

What are the solid grounds for regulatory and policy intervention

Prudential supervision and conduct oversight

A liberal market for general insurance may well see people and businesses buying too little insurance (and hence bearing too much insurable risk) because of irrational miscalculations about their exposure to risk ("underinsurance"); and insurers bearing too little insurable risk because of mutual mistrust between insurers and the insured (reflecting information asymmetries).

In such an environment governments can find themselves bearing too much insurable risk as citizens call on them to make good losses that private insurers would otherwise have covered and/or encouraged insured policyholders to mitigate.

In this regard, policy makers can assist the proper functioning of insurance markets by enhancing trust and reducing information asymmetry between private insurers and the insured through prudential oversight of insurers and through open disclosure arrangements. This is the basis of existing regulation post-Wallis and is aimed at ensuring the financial soundness of insurers and adequate disclosure of policy conditions so as to minimise misunderstanding and misinformation.

Prudential regulation of insurers establishes confidence that the promises they make to insured parties will be kept and that premiums paid in advance in expectation of a loss are available when losses accrue. This not only encourages greater use of insurance but also helps to mitigate the risk to government of systemic failure in insurance markets. Governments reduce their own exposure to insurable risk by upholding soundness and safety in the operations of private insurers.

On the other hand, disclosure arrangements assist in reducing agency and information problems between insured parties and insurers. In this regard, efforts to improve financial literacy are to be encouraged and may assist in dealing with misperceptions or misunderstandings among the owners of insurable risks.

Getting the settings right - balancing the benefits and costs of intervention

Choosing the right level and means of intervening to improve the efficiency of insurance markets is an exercise in balance. Intervention may be justified when a liberal market in insurable risk produces too much self-insurance, or too little market insurance and as a consequence leaves government too exposed to the risk of compensating needy citizens. On the other hand, intervention that is too heavy-handed may risk creating the same set of circumstances, this time as a result of insurance, becoming unaffordable, inducing parties once again to self-insure and fall back too quickly on government.

Notwithstanding this, government intervention and regulatory measures are not costless. Regulatory costs imposed on insurers are ultimately passed through to policyholders who, beyond some point, find themselves preferring to self-insure. This induces individuals and businesses to carry more risk than is efficient, and exposes governments once more to calls from citizens to make good their losses. Well-designed regulation supports the efficient allocation of risk-bearing. However, regulation raises the operating costs of insurers by imposing costs of compliance as well as obliging insurers to hold more capital or liquid assets than they otherwise prudently would in the course of their business/commercial operations.

At the margin, the costs of such regulation must be recovered from insured parties through higher premiums. Recovering costs from the owners of insurance companies or their employees rather than their customers is not feasible as capital is mobile and shareholders can easily disinvest in insurance companies while labour is able to seek more highly remunerated employment outside the industry.

Raising premiums to recover higher operating costs imposed by regulation encourages people to buy less insurance, i.e. to self-insure more than they otherwise would. It also exposes governments to a different risk, namely, the call for assistance from citizens whose losses are no longer covered by insurance. In other words, excessive regulation of insurers can be counterproductive, distorting the allocation of risk-bearing away from its optimal or efficient configuration.

The challenge for policy makers is to secure the right balance in regulation. Achieving the right balance ensures the promotion of a healthy general insurance sector, carrying its share of insurable risk with integrity and soundness, and meeting the changing needs of customers with innovative products at affordable premiums

4 Current policy issues in General Insurance

Regulatory developments in the wake of the Global Financial Crisis

The Global Financial Crisis marked a watershed in the regulation of financial markets overseas and in Australia. Restoring stability to financial systems assumed paramount importance and concerns about the attendant costs to efficiency and competition took second place. In other words, the balance between stability and efficiency took a decided swing in the direction of stability.

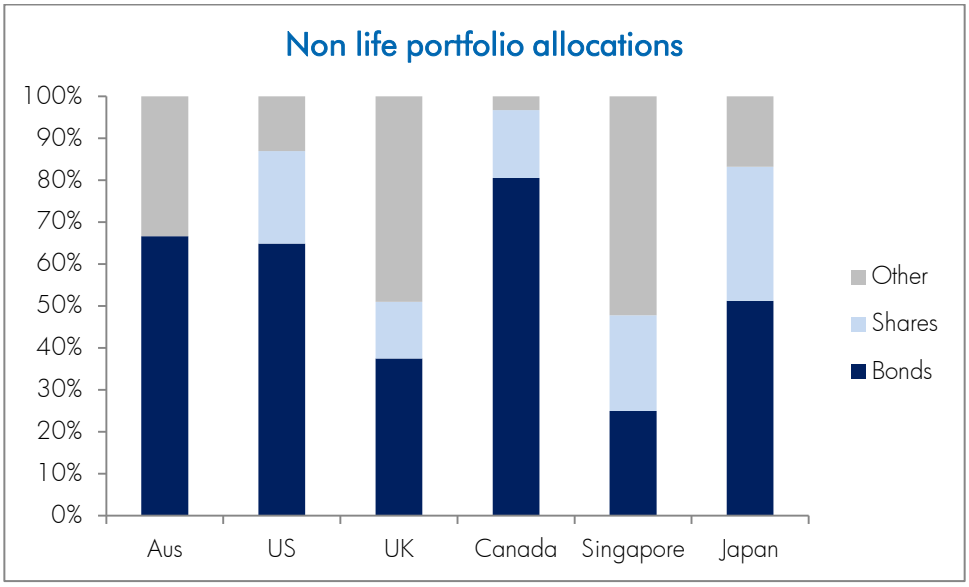
Shoring up stability continues to be a theme of regulatory developments around the world. Australia has followed international regulatory trends quite closely as Australian financial regulators seek to ensure that domestic arrangements do not fall out of step with global requirements, potentially exposing Australia to accusations of non-compliance.

Developments in the general insurance industry are no exception. The burden of regulation has steadily risen since the GFC. A challenge for the FSI arises from the question of whether tighter regulation of general insurance delivers benefits to the Australian community that outweigh its costs. Beyond a certain point, tighter regulation makes little difference to the probability that an insurer fails but induces risk-owners (individuals and businesses) to increase their levels of self-insurance.

Regulation reduces the productivity of insurers since it raises cost with no offsetting value created for the insurer. Regulation may also be compromising the industry's capacity to innovate and compete effectively. Ideally, Australian insurers should be well positioned to export their services to foreign markets. Australia should also remain an attractive place for foreign insurers to do business, adding to the competitive pressure in local insurance markets and widening consumer choice. Both of these desirable outcomes are compromised if Australia's regulatory regime is more onerous than those found elsewhere in the world.

There is no doubt that well-balanced regulation creates social benefits that match its social costs. But a reassessment of the benefit-cost ratio of current and prospective regulation of general insurers would be timely given the pronounced swing towards tighter regulation experienced in recent years.

Combining the regulation of insurance and banking was one of the aims of the Wallis Committee in recommending the creation of a dedicated "integrated" regulator in APRA. There is a danger implicit in the integrated model, however, that bank regulation becomes a template for the regulation of insurance. The risks faced by banks, namely credit and liquidity risks, are wholly different from those faced by insurers. Regulatory treatment of insurers should reflect the unique circumstances and risks that characterise the insurance industry, not the banking industry. Moreover, the regulator should be obliged to weigh the cost of regulation – especially where it has the potential to run counter to the very objectives of the regulation itself – against the social benefits



Notes: Australia "other" includes shares as reporting is confidential
Source: OECD Global Insurance Statistics

The ICA understands that regulation of general insurance remains a work in progress. One anomaly is that not all insurance arrangements are governed by the prudential settings of APRA. For example, private health insurance funds are currently regulated by a different agency—the Private Health Insurance Administration Council (PHIAC)—and where applicable, State-based motor accident injury schemes have State-based regulators managing "fully funded" tests (i.e. prudential strength tests.

Excess regulatory burden and principle based regulation

In the years since their creation, ASIC and APRA have developed strong cultures of independence. While this is to be expected and welcomed, it has given rise to instances of overlap where insurers are obliged to comply with separate regulations administered by the two agencies that are aimed at dealing with essentially the same issue. (For example, with governance issues such as fit and proper tests).

When the Australian Taxation Office (ATO) is added to the mix, high and rising compliance costs become an issue. There should be scope for coordination among the different regulators to ensure that duplication and overlap in regulatory compliance are minimised.

Adopting a principles-based rather than a prescriptive approach to regulation can help regulators adapt to rapid change within regulated industries. Regulators in the United Kingdom have begun to move in this direction, with an increasing emphasis on principles and outcomes rather than prescriptive rules. The Australian insurance sector has also demonstrated how consumer protection arrangements can be strengthened in a self regulatory regime following its recent enhancement of the GI Code of Practice.

A level playing field in regulation – the international experience

The challenge for Australian regulators of the financial system is to not impose regulatory settings that add to the burden and cost of Australian providers such that their international competitiveness is constrained. As part of APRA's consultation in relation to the Review of Capital Standards for General Insurers and Life Insurers (LAGIC), assessments were made of a number of insurance company's Asian strategy with these assessments placing greater weight on the associated risk of the ventures and a lower weight on the economic value of joint venture investments. The consequence of this approach was that APRA excluded almost all the economic value of the joint ventures. Given the current regulatory requirements in the Asia Pacific region generally only allow minority investments as a first step towards ultimate control and ownership, it is likely any expansion will be more financially difficult for Australian insurance companies compared with their European or US counterparts as a result of this assessment by the Australian regulator. This is an example of how the decisions of a domestic financial system regulator work across Australian policy makers goals for exporting the Australian financial services sector including positioning Australia as a leading financial services centre in the Asia Pacific region.

Getting the regulatory balance right in the financial system – the experience of Lenders Mortgage Insurance

In Australia ADIs determine capital held for regulatory purposes according to one of two models; a standardised default method; or a model based approach. Currently there is a lack of explicit recognition of LMI for capital relief for the model based approach.

As the Reserve Bank stated in 2013, the explicit regulatory incentive for Australian banks to use LMI has, to a significant extent, been reduced for banks approved to use internal models because APRA requires a minimum 20 per cent loss given default assumption in these models irrespective of LMI

Further, LMI performs a second set of eyes function, assessing banks mortgage policy, underwriting processes and data at a disaggregated level. As such, LMI encourages a better quality of risk assessment throughout the economy and provides extra risk diversification.

In consideration of all capital held for regulatory purposes, (through ADIs and LMIs) it appears that Australian institutions are relatively over capitalised compared to their international counterparts (the BCBS recommends a 10% LGD floor).

The cost of holding additional capital is passed onto borrowers through higher interest rates. The inefficient allocation of capital resulting from this has implications for the broader economy, by tying up funds available for productive investments. In this instance, a full assessment of the costs and benefits of the prudential regulatory settings seems to be warranted.

For more information on this matter, please see the ICA's recent submission to the Senate Inquiry into Affordable Housing at http://www.insurancecouncil.com.au/assets/submission/2014/2014_March_25_ICA_Committee%20Secretary_Senateinquiry_%20Housing%20affordbilit.pdf. The ICA would be pleased to discuss in detail with the FSI the arguments for greater recognition of the role of LMI in managing mortgage risk and its contribution to financial stability.

Affordability and accessibility

Within the policy making community there is growing concern that insurance against certain types of risks, in particular, flood risk and other natural perils like cyclones, is becoming unaffordable or even unavailable to many. In recent periods, decision makers have emphasised this concern with the sector and have raised the possibility of regulatory action in response. Public pressure has been placed on the sector to make insurance for these risks more widely available and, moreover, to keep premiums 'affordable'.

While prepared to engage with policy makers on affordability concerns, the ICA respectfully contends that ad hoc policy efforts that result in a mispricing of insurance for the (albeit commendable) purpose of helping governments achieve social objectives (as opposed to managing risk towards its lowest cost) serve to distort efficient insurance markets.

As a principle, policy efforts that serve to misprice risk run counter to the prudential goal of adequacy of capital held against all risks. As information becomes more readily available on the incidence and potential scale of losses, prudential supervisors look to insurers to ensure their premiums and actuarial reserves take into account this revised profile. Contrary to their well-intentioned policy interest, policy makers urging insurers to keep premiums low when the cost of insuring the underlying risk is rising contributes to prudential stress and with that, the concomitant "fail" risk to government.

The contemporary challenge in the wider community is that governments face strong pressure from their constituents concerned about being priced or "locked" out of adequate insurance. Patterns of premium variation can also often reflect differences in socio-economic status which governments are keen to smooth wherever possible. When insurers price risks appropriately (generally in line with prudential soundness), the often regrettable result is that in certain circumstances, cover is either declined by the insured or alternatively, some are declined cover altogether.

It is not surprising then, that communities look to governments to remedy their situation or to cover the risks on their behalf. Budgetary constraints faced by governments often challenge risk-eliminating alternatives such as the funding of mitigation infrastructure, leaving decision makers with the political preference to adopt interventions that disturb general insurance markets or seek to socialise the risks through the establishment of a national insurance scheme of some type. Further, given governments find themselves in any case exposed to risks declined by private insurers, the incentive to establish a social scheme can often become quite strong. However, while this solution seemingly resolves the dilemma of affordability and accessibility, depending on the generosity of the scheme, it can undermine private insurance markets and the instrument of funding for such schemes can impose their own distortions.

Dealing with the social dimension of rational pricing and availability of insurance is a complex issue. As a rule, it is not unexpected that governments seek to address the inability of citizens to afford or access insurance against risks that can materially affect their living standards (and that government's may end up funding). Yet compromising insurers' ability to price risks accurately undermines the incentives for individuals and businesses to make sensible decisions in the light of the risks they actually face. For example, if land in a particular location faces a rising risk of inundation or bushfire, raising premiums helps to encourage risk mitigation by other means, such as relocation to a safer locality. Failure to allow these signals to be issued merely exposes the whole system – individuals, insurers and governments – to higher levels of risk and social cost.

However, the ICA recognises that legacy issues can and do affect the sector and that the most difficult cases generally involve decisions made in the past where it is simply unreasonable to expect individuals, households and businesses to have foreseen changes in their risk many years in advance. Such cases may warrant compensation at public expense of the costs of relocation or mitigation.

Yet even in these circumstances such schemes must be designed with care if adverse incentives are not to be triggered. In short, the ICA contends that, at the fundamental level, policy makers should not look to distort the financial system (and hence general insurance markets) to achieve specific social policy goals that seek to make insurance more affordable. Policy makers should look at alternative policy options that exist outside the financial system (such as mitigation investment) to address such issues.

The ICA notes that insurance affordability is not only a matter of the rising cost of risk. As noted above, tighter regulation is also a source of rising premiums, arising from both higher capital requirements but also the cost of administering more elaborate regulatory imposts. This exacerbates the tensions evident in the insurance market. The challenge for the FSI is to avoid contradictory policy principles by having insurers in a position of "double jeopardy" – that is, required to absorb higher costs of regulation by one arm of government only to be criticised for adjusting premiums to unaffordable levels by another.

The ICA strongly submits that, in the end, private insurance is not a substitute for social policy. Efficient risk-bearing requires that the true cost of insurance be signalled to those who own insurable risks. The efficiency of the overall system is enhanced when a rational decision is made as to how much risk is self-insured and how much risk is ultimately laid off. Furthermore, the efficiency of the system is not improved if policy makers inadvertently "crowd out" private market insurance markers with social insurance schemes especially if inadequate consideration is given to the implications for risk mitigation across the entire system. Nevertheless, in circumstances where self-insurance becomes the only option for selected groups in society, policy makers may need to turn to measures through the social safety/transfer system to provide assistance in response to such risks.

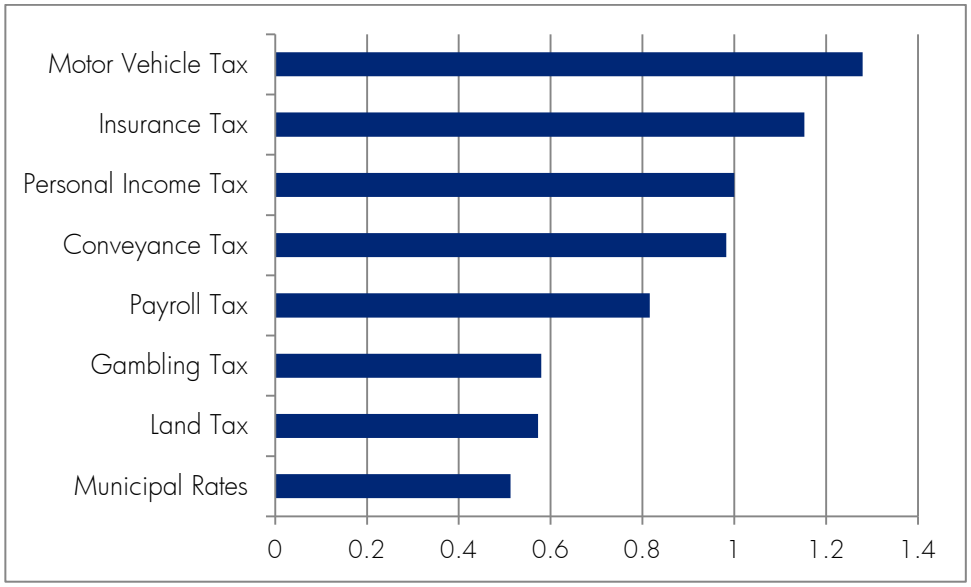
The drag to the system from transaction taxes on financial services

Given its terms of reference, the ICA submits that a key consideration for the FSI is the drag to the financial system imposed by the impact of transaction taxes on financial transactions, such as stamp duties (and in the case of insurance, and where applicable, fire service levies). In the case of insurance, stamp duties and fire service levies drive a wedge between the technical price of insurance and the retail price paid by consumers, resulting in non-prudent levels of private insurance (and under the framework described above), the final costs being borne by government).

Tooth and Barker (2007) identify State taxes as a significant contributor to the unaffordability of insurance. In the case of property transfers, stamp duties on property transfers adversely affect stock turnover and result in additional private debt to finance the asset trade. Stamp duties on property transfers have also been identified as a drag to the mitigation of risk to the extent that they circumscribe relocation of assets away from risk zones. The chart below outlines the marginal excess burden of selected taxes, with the greater the burden, the larger the drag to economic efficiency.

The Review of Australia's Tax System (the Henry Review) recommended the reform of transaction taxes as a matter of priority. The Henry Review identified transaction taxes as amongst the most inefficient of all taxation alternatives, largely for the reasons described above. The FSI would be well placed to reaffirm the recommendations of the Henry Review as they relate to transaction taxes, especially stamp duties. The ICA contends that tackling affordability (whether in insurance or property markets) should begin with an examination of inefficient and unnecessary cost burdens imposed by governments. In the case of transaction taxes, the ICA contends that reform of these taxes represents a lower cost solution to improving affordability and access to insurance than alternative schemes. The Chart below provides an outline of the efficiency rankings of selected taxes in terms of their marginal excess burden – that is, the loss to economic efficiency of raising revenue through the respective taxation measure. The greater the excess burden the more inefficient the tax. The chart makes clear that insurance taxes are highly inefficient (as are other stamp duties such as on property transfers and on motor vehicles) vis a vis other taxation measures and accordingly economic welfare would be improved through a "tax mix switch" from transaction taxes to other taxes, including State payroll taxes.

Tax efficiency rankings - selected taxes



Source: Finance Industry Council of Australia (2011)

Other emerging issues in GI markets

This section addresses issues which are beginning to emerge and whose impact on the general insurance industry is likely to grow over the medium to longer term.

The impact of technology

New waves of technology are continuing to shape the modern economy. Consumers increasingly demand and expect convenience, new features and the ability to interact with businesses socially, rather than on a transactional basis. It is enabling business to develop new products, increase efficiency and productivity, and deliver more value to customers.

These changes are still working their way through the financial services industry in Australia. Different industries have taken up new technologies to differing extents. For example, retail banking has been a leader in adopting digital technology. Innovative products have been introduced, ranging from mobile banking to near-field-communication-based payments and no-frills online banking. This has contributed to increased convenience and satisfaction for customers. In the case of insurance, digital elevation mapping, sophisticated hazard mapping, in car testing and telematics have all fundamentally changed the understanding of risk and the symmetry between insured and insurer.

Data analysis capabilities have always been important to insurers. The business of insurance revolves around managing and pricing insurable risk and data is vital to this endeavour.

The lowering costs and availability of data have bolstered the capacity of insurers to provide accessible insurance. Collecting extensive data on the characteristics of policyholders, their surroundings as well as other general trends (such the economy and environment) is now possible, since large data sets can be stored in a more cost-effective manner. Analytical tools mean that these data can be analysed with more nuance and in a timely manner. This enables improved forecasting and thus pricing. The availability of data also has the scope to improve access to insurance through pricing adjustments resulting from changes in behaviour.

For example, motor vehicle insurers offering telematic products are now able to price risk according to actual driver behaviour as opposed to broader measures of risk associated with age profile alone. Through the use of in-car technologies, driving habits are identified allowing for pricing on an individual basis. This improves welfare by allowing for more technical pricing and through the avoidance of adverse selection by making insurance more attractive to better risks. Social costs are also reduced with safer driver behaviour reducing the road toll. However, developments in such technologies needs accommodation with flexible regulatory arrangements that allow for their adaptation.

Further, the development of the internet and other such tools have altered distribution arrangements and the opportunity costs of price and product discovery. Aggregators, or price comparison platforms, are a recent development in the Australian insurance market (APRA 2011). Aggregators serve to lower search and switching costs, changing the cost benefit of price discovery. However, concerns exist that disclosures on key aspects of the insurance agreement other than price (such as terms and cover arrangements) which are intrinsic to the insurance offer may not be adequately presented.

As a principle, increasing competition in any market is positive for consumers as suppliers compete more aggressively on price and product offerings. However, in the case of insurance (and indeed other financial products) concerns arise where price discovery websites/instruments favour or direct towards specific products without informing consumers of their financial links to particular product providers. The potential to use the internet as a primary distribution channel has strengthened competition in the insurance market. Traditionally, insurers needed extensive distribution networks in order to attract and serve their customers. This has led to the development of new business models and enriched competition by making it easier for new players to enter the market. The success of new online insurance providers provides evidence to the success of these new business models.

Faced with the presence of such technology, financial market regulators need to be cognisant of information agency and asymmetry concerns. In that regard, the ICA urges that a "level playing field" in regulation including mandatory disclosure should apply equally to aggregators as to directly licensed financial entities such as insurers. In 2012 ASIC examined the possibility of proceeding with actions against aggregators who do not comply with consumer laws, and in particular those who provide inaccurate or misleading information. The FSI would be well placed to insist upon requirements to disclose commissions and payments payable when products are featured on comparison platforms.

An ageing population

Demographic change is one of the key issues shaping the future of the Australian economy. Like many developed nations, Australian life expectancies are increasing and fertility rates are low. The ABS estimates that, by 2061, the proportion of the population aged 65 years and over will increase from 14% to 22%. The proportion of the population over the age of 85 is expected to more than double over the same period from 2% to 5% (ABS, 2013).

Demographic ageing introduces new risks for the financial system, including:

- Longevity risk: living longer than expected, and as a result having insufficient savings to cover the entire period of retirement;
- Inflation/investment risk: fluctuations in the market or the macro-economy meaning that retirement savings are no longer sufficient; and
- Aged care and debility risk: diseases of advanced old age that debilitate people for much longer than was the case in the past and require full-time care (e.g. dementia among older people who are otherwise physically healthy).

Like other risks, some aspects of these risks will be insurable and some not. Those that are not insurable will be borne in part by the risk-owners and in part by governments. The whole question of how best to share the burden of these risks among individuals (and their families), insurers and governments has yet to be tackled in any systematic way. The ICA looks to the FSI to provide the overarching policy framework for how ageing-related risk is managed within the financial system.

Mitigating demographic risks is perhaps the most under-served segment of the insurance market in Australia. The ICA contends that insurance markets will play a fundamental role in the management of risks associated with ageing and demography. Further, the ICA contends that the framework outlined in this submission forms the basis under which the FSI and policy makers broadly should consider the efficient allocation of ageing risk across the community.

5 Where to next? A policy pathway post Wallis.

Affirmation of the framework

The ICA contends that the framework outlined in this submission should be affirmed by policy makers when considering or evaluating reforms to insurance markets. Insurable risk is unable to be extinguished in the short run and efforts to transfer such risk from one sector to the next can lead to higher social costs or at the very least, the absorption of risk by a sector of society least equipped to bear such a cost.

The affirmation of the framework outlined in this submission allows the FSI to reconcile many of the contemporary issues affecting insurance markets. For example, the ICA contends that in the affordability debate the challenge must be to avoid policy options that distort insurance markets and impose high-cost solutions to the absorption of insurable risk. Moreover, the ICA contends that the framework, if affirmed, is sustainable enough to ensure that the great strength of insurance markets – the pricing of risk with the consequent benefits to behaviour and activity – is assured thereby improving welfare through the efficient allocation of resources.

Review stability for competition/innovation

The ICA submits that, in the broad (see further below), the regulatory architecture established under the Wallis Committee remains appropriate and apposite. In particular, the so called "twin peaks" model has proven to be resilient in the face of significant stresses (such as the GFC and post the HIH collapse). In the case of general insurance supervision, the ICA re-affirms its preference that prudential supervision for GI is best managed under a separate statutory commission and not, as is the case in the UK and New Zealand, by the central bank.

Nevertheless, the ICA contends that the FSI would be well placed to recommend a detailed examination of the extent to which regulatory imposts and prudential stability have constrained insurance markets, and in the context of the framework hitherto mentioned, resulted in a misallocation of insurable risks (and added costs). The ICA notes that, in the course of such a review, consideration should be given to how, in practical and administrative terms, the prudential supervisor can exercise its functions beyond prudential stability alone such that equivalent regard is given to promoting and supporting competition and innovation in the sector.

The ICA also contends that in the course of such a review, a reference may be included to assess the extent of regulatory creep (of all forms) and the impact such additional (and costly) regulatory burden is having upon the efficient delivery of innovative financial products. Although the ICA understands that international regulatory developments are arguably the basis of many of proposed regulatory interventions, the ICA urges considerable caution with their application in an Australian setting and consideration be given to the cumulative impact of additional regulatory burden.

Furthermore, in the case of prudential supervision, the ICA respectfully submits that the sector is too often faced with policy 'double jeopardy' – on the one hand a desire by decision makers for insurers to offer affordable products and insurance relief (and thereby lift the burden away from individuals and governments under the framework) and on the other, requirements from the prudential supervisors to retain more resources in the interests of stability (or driven by international developments).

Remove the drags on efficiency by eliminating transaction taxes and abolishing specific taxes on insurance products by 2015

A key drag on the efficient allocation of resources in the financial system is the imposition of transaction taxes, largely levied by the States. For example, the Henry Tax Review found that insurance taxes rank as one of the least efficient taxes and act as drag on prudent levels of insurance purchase. Stamp duties on insurance and property conveyances act as a disincentive to the purchase of prudent insurance and limit the adaptation to risk by circumscribing stock turnover and relocation. Stamp duties on property also contribute to personal debt by effectively capitalising the tax on individual household balance sheets.

The ICA concurs with the recommendations of the Henry tax review and urges the FSI to affirm the inefficiencies of State transaction taxes and urge their abolition as a clear matter of taxation priority. In recognition that all transaction tax reform (including conveyances on property) requires a substantial revenue replacement program, the ICA urges that at the very minimum, the FSI recommend that all specific taxes on insurance premiums be removed by 2015 and that transaction taxes in general be removed within five years of that.

Consideration of equivalent prudential treatment for all insurable risk products

As mentioned above, the ICA believes that, broadly, the regulatory architecture underpinning the financial sector is appropriate. However, the ICA contends that one reform that has the potential to improve the regulatory setting in insurance markets would be to consider establishing a regulatory "level playing field" for all insurance products, irrespective of type or class.

The present arrangements require life and general insurers to be supervised by APRA for their prudential requirements. Regrettably, products classified as being health-related are subject to alternative prudential supervisory arrangements. With an ageing population and an increasing blurring of insurance-related products, consideration should be given to whether the existing regulatory arrangements act as a brake on innovation.

Moreover, as the population ages, it is expected that governments will look to improve their budgetary capacity by seeking to off-load ageing risk to individuals themselves (through means testing for example). Reform of the regulatory arrangements offers scope for a greater ability of the insurance sector (defined broadly) to assume the risk of ageing through the development of composite products designed to manage the broader risks of ageing (for example, ,medical, travel, accommodation, aged care support etc).

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