

# **Post-Implementation Review — Financial Claims Scheme for General Insurance Policyholders**

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## 1. INTRODUCTION

- 1 The *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* introduced measures to implement a Financial Claims Scheme (FCS). The FCS is designed to protect depositors in authorised deposit-taking institutions (ADIs) and general insurance policyholders in the event of a failure of an ADI or a general insurer.
- 2 A Regulation Impact Statement was not produced when the FCS was first introduced in October 2008, as the Global Financial Crisis (GFC) necessitated immediate action by the Government to maintain confidence in Australia's financial system. At that time, the Government committed to review the settings of the FCS after three years. This document is a post-implementation review (PIR) of the FCS, although it will cover only the FCS for general insurance policyholders (hereby referred to as FCS GI). It does not consider the FCS for ADIs, which was the subject of a separate PIR in 2011.<sup>1</sup>
- 3 The PIR commences by characterising the problem which the FCS GI was designed to address. It then describes the key features of the FCS GI, provides more detail on the problems it was intended to address, and assesses the effectiveness of the FCS GI against the Government's objectives in implementing the scheme. The report then undertakes an impact analysis to investigate any unintended consequences caused by the introduction of the scheme. In so doing, it draws from consultations undertaken with key stakeholders, including general insurers and consumers of general insurance products, and ultimately draws a conclusion on the in-principle appropriateness of having an FCS GI scheme, including whether it should continue in its current form.

## 2. POLICYHOLDER PROTECTION AND THE FCS GI

- 4 The FCS GI was introduced in order to provide policyholders with timely access to funds arising from valid insurance claims from an insurer that has become insolvent. Prior to the FCS GI's introduction, in the event of a failure of an Australian Prudential Regulation Authority (APRA) authorised general insurer, policyholders were pooled with other unsecured creditors in a wind-up process that in most cases was complex and lengthy. The result was that policyholders with valid insurance claims had to wait months, or even years before funds were available. Given policyholders may have suffered substantial losses, relative to both the premiums paid to the insurer<sup>2</sup> and their wealth and assets<sup>3</sup>, a lengthy process for settling claims can cause serious financial hardship. It may also impact on overall confidence in the general insurance market.
- 5 The lack of a mechanism for providing eligible general insurance policyholders with timely access to funds owing as the result of a valid insurance claim in the event of a failure of a general insurer was highlighted with the failure of HIH Insurance Group (HIH). In that case, the Commonwealth set up an ad hoc scheme for claims arising from the collapse of HIH, HIH Claims Support Limited, to deal with the many cases of financial hardship which emerged as a result of the collapse of the company. Since the Scheme's commencement on 1 July 2001 it has received about 16,000 applications for assistance and has managed 10,950 claims. To date the

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<sup>1</sup> <http://ris.finance.gov.au/files/2011/10/03-Financial-Claims-PIR-and-RIS.pdf>.

<sup>2</sup> While in the collapse of an ADI the losses borne by depositors are roughly equal to the amounts deposited, in insurance outstanding claims against the insurer are likely to be far in excess of the premiums paid.

<sup>3</sup> A policyholder who has suffered damage to their home or motor vehicle, for example.

Scheme has paid approximately \$664 million in assistance to eligible policyholders. However, the scheme's effectiveness in providing HIIH policyholders with timely access to funds was inhibited, in part, because it had to be established in a short period of time, with consideration given to factors such as eligibility, funds disbursement, reporting. The subsequent HIIH Royal Commission in 2003 recommended that a permanent scheme similar to HIIH Claims Support Limited be established.

## 2.1 The HIIH Collapse: HIIH Royal Commission and the Davis Report

### *The collapse of HIIH*

- 6 The collapse of HIIH in March 2001 was the biggest corporate collapse in Australian history, with losses of \$5.3 billion. The failure had wider economic consequences because it impacted specific (niche) classes of insurance business where HIIH held a dominant share in Australia, in particular professional indemnity as well as public and product liability insurance markets. Furthermore, the wind-up process, including the establishment of HIIH Claims Support Limited, highlighted the need for a permanent policyholder protection mechanism.
- 7 Given HIIH's dominant market share, it became clear that a large number of policyholders with outstanding claims would be affected by its collapse. In response, the Government established a specific mechanism by which policyholders with valid claims could seek access to funds, HIIH Claims Support Limited. As mentioned in the previous section, the scheme's ability to quickly pay legitimate claims to policyholders was inhibited in part by the fact that it had to be established from scratch, with complicated aspects such as eligibility, governance and legal requirements to be considered prior to claims being paid out.
- 8 The failure of HIIH and its subsequent wind-up highlighted the need for a permanent policyholder protection scheme that could be quickly activated following the collapse of a general insurer.

### *HIIH Royal Commission*

- 9 The Commonwealth Government announced the establishment of a Royal Commission to investigate and report on the causes and the circumstances of the collapse of HIIH. In April 2003, the HIIH Royal Commission delivered its report. Noting the effects the failure of a general insurer such as HIIH can have on policyholders with eligible claims, the Commission's final report recommended 'the Commonwealth Government introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company'.<sup>4</sup>
- 10 In September 2003, the then federal Treasurer announced the Government's response to the HIIH Royal Commission report. On the recommendation that 'the Commonwealth Government introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company', the Government stated that the precise design of any guarantee, its incentive properties and its associated financial costs warranted closer consideration.

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<sup>4</sup> HIIH Royal Commission (2003), *The Failure of HIIH Volume 1: A Corporate Collapse and its Lessons*, Recommendation 61, available at <http://www.hiihroyalcom.gov.au/finalreport/index.htm>.

## **Davis Report**

- 11 In response to the HIH Royal Commission, the Government commissioned a technical study to consider the merits of introducing an explicit guarantee of part or parts of the Australian financial system, as well as possible coverage and design options. The Government engaged Professor Kevin Davis to lead the study. Professor Davis provided his report – the Study of Financial System Guarantees (the Davis Report) – to the Government in March 2004.<sup>5</sup>
- 12 The Davis Report argued that the community expected government support in relation to failed prudentially regulated financial institutions and ‘critical’ financial products. The report also echoed the HIH Royal Commission’s observation that the time between the failure of an institution and its resolution could be significant, which could create significant costs for stakeholders.
- 13 The Davis Report found that correctly-designed explicit guarantees could contribute to the stability of the Australian financial system, improve risk allocation and pricing, provide greater financial security to individuals and support more timely access to funds.
- 14 As foreshadowed at the time of commissioning the Davis Report, the Government proposed conducting a broader consultation process before making a final decision on this matter. The Council of Financial Regulators (CFR)<sup>6</sup> was charged with undertaking this consultation.
- 15 After receiving the Davis Report, the CFR published an outline of a proposed FCS (covering depositors and general insurance policyholders) for industry consultation.<sup>7</sup> With a view to minimising unnecessary efficiency costs associated with financial sector regulation, the CFR recommended that an FCS be designed as a minimalist scheme intended to cover the more vulnerable consumers such as individuals, small businesses and community organisations.
- 16 In considering the design principles for an FCS, consideration was given to community expectations about government assistance in the event of failure of an APRA regulated ADI or general insurer. At that time (and to this day), consumer expectations of government assistance in the event of the failure of a general insurer does not correlate with the protections set out by the regulatory framework. For example, in 2006, the RBA commissioned a survey on public attitudes regarding what would happen if a general insurer were to fail. Around 50 per cent of respondents believed either that their policies were guaranteed by the government, or that the government would step in to protect them in the event of a failure, despite the fact that no explicit guarantee existed.

## **2.2 The Global Financial Crisis**

- 17 Throughout 2008, in the midst of the worst financial crisis since the Great Depression, market confidence and global financial stability were severely disrupted and there were significant concerns about the ongoing viability of many global financial institutions. The crisis resulted in a number of corporate failures with, for example, Bear Sterns, Lehman Brothers, American Insurance Group, Royal Bank of Scotland, Northern Rock, Dexia and Fortis, either being liquidated, hastily sold to rivals or bailed out by Governments.

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<sup>5</sup> K. Davis (2004), *Study of Financial System Guarantees*, available at <http://fsgstudy.treasury.gov.au/content/default.asp?NavID=1>.

<sup>6</sup> The CFR comprises the Reserve Bank of Australia, the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Treasury.

<sup>7</sup> Council of Financial Regulators (2005), *Failure and Crisis Management in the Australian Financial System*, available at <http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1040>.

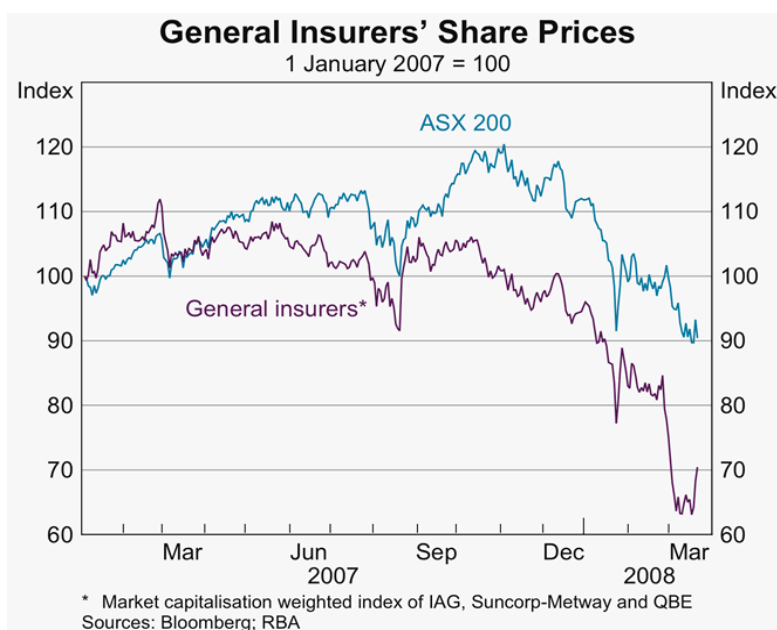
18 Following the collapse of Lehman Brothers, the near freezing of credit markets around the world, combined with significant equity market volatility as investors shunned equities, particularly financial sector stocks, and a global economic slowdown, including in Australia, placed considerable strain on Australia’s financial institutions.

19 The Reserve Bank stated at the time that:

‘spreads have widened on a broad range of debt securities, volatility in financial markets has increased and funding conditions for financial institutions have tightened considerably ... A distinguishing feature of recent developments has been a sharp increase in uncertainty. In part, this reflects considerable opacity about where, and when, the full scale of credit losses on US sub-prime housing loans will show up. Adding to the uncertainty is the fact that many of the newer structured products are difficult to understand and have never really been tested in an adverse environment. The complexity of these products has also meant that transactional liquidity is often extremely limited, complicating the task of accurately valuing these products and adding to volatility.’<sup>8</sup>

20 At that time, concerns were held about the exposures of Australia’s general insurers given their investment holdings and use of reinsurers both domestically and internationally.

21 Overall, the volatility of domestic and international markets created considerable uncertainty as to the effect of the crisis on Australian insurers. The risk of financial sector contagion spreading from the US and Europe to Australia was real and a significant concern, which was reflected in the share prices of Australia’s insurers.



This meant that the financial regulators during this period were actively monitoring all prudentially regulated institutions. The uncertainty around upcoming results announcements of major insurance companies contributed to the continued negative press and tight conditions in markets, and focused monitoring of all prudentially regulated domestic insurers.

<sup>8</sup> Reserve Bank of Australia 'Financial Stability Review: September 2007'. Accessible at <http://www.rba.gov.au/publications/fsr/2007/sep/pdf/0907.pdf>.



- 22 Given this was a time of fragile market confidence and it was accepted that Australia was not immune from developments in international financial markets the Government, in concert with Australian regulators, took steps to strengthen the resilience of Australia's financial sector, including improving Australia's crisis management arrangements via the introduction of the FCS to ensure that depositors and insurance policyholders have access to at least some of their funds in a timely manner should their financial institution fail.<sup>9</sup>
- 23 The Government introduced the FCS in October 2008, shortly after the collapse of Lehman Brothers, at the same time as other G20 nations responded to the financial crisis with similar (and extraordinary) policy measures, including enhanced protections for depositors, guarantees of financial institutions' wholesale fundraising, recapitalisations of major financial institutions and injections of liquidity into financial markets.
- 24 It should be noted, however, that the FCS GI was not predominantly established to respond to the GFC. It had already been proposed as a permanent structure to protect depositors and policyholders with valid claims in a number of financial system reviews (see previous section) and was being actively considered and indeed developed by Treasury at the time. Nevertheless, its introduction during the GFC was intended to provide confidence at that time to both consumers and the markets that the Government had robust arrangements in place to deal with a failure of any key financial institution.

### **2.3 Australia's robust prudential framework**

- 25 Since the collapse of HIH, APRA has strengthened, and continues to strengthen, its framework of prudential regulation and now has a range of mechanisms in place including: a systemic approach to financial system regulation; a tough prudential regulation regime involving strong oversight of general insurer compliance with prudential standards; and an enhanced range of crisis management powers and tools.
- 26 Australia also continues to participate internationally in forums such as the G20, the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) which are focused on the development of stronger global standards for financial sector oversight and regulation.
- 27 However, while it is logical to minimise the risk of failure of financial institutions through sound prudential regulation in the first instance, it is not possible to completely eliminate this risk. Hence, it is desirable to have in place mechanisms such as the FCS GI which can be quickly activated in the event of the collapse of an APRA-authorized general insurer in order to facilitate the orderly wind-up of that institution for its many individual policyholders.

## **3. KEY FEATURES OF THE FCS GI**

- 28 The design principles for the FCS GI were developed over a number of years and drew heavily from lessons learnt through the collapse of HIH Insurance. This section will cover the key features of the FCS GI: its main objectives, eligibility criteria and activation mechanism. It will also look at the scheme in the international context.

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<sup>9</sup> *New Protections for Depositors and Policyholders*, Treasurer Media Release 061/2008, available at <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/061.htm&pageID=003&min=wms&Year=2008&DocType=0>.

### 3.1 Primary objective of the FCS GI — policyholder protection

29 The primary objective of the FCS GI is to ensure there is a robust mechanism in place that can be quickly activated following the collapse of a general insurer to provide assurance that policyholders with valid claims against the failed general insurer have timely access to funds. This means that key design features and technical issues such as the appropriation of funds are settled and a response can be quickly put in place.

30 The alternative is that policyholders' claims are settled as part of a liquidation process of a general insurer, where policyholders line up with other unsecured creditors. This is costly, lengthy, uncertain in outcome (that is there may be insufficient assets to cover the claim), and could take many years to settle, leaving many policyholders facing potential hardship where a valid claim cannot be pursued due to failure. The failure of HIH highlighted the uncertain nature of the wind-up process.

31 At the time of the FCS' introduction, the Treasurer stated that:

'Depositors in authorised deposit-taking institutions (ADIs) already receive preference in any liquidation, which means they will almost certainly recover all of their funds eventually. However, there is currently no mechanism to provide depositors or general insurance policyholders with timely access to at least some of their funds in the event of a failure. Early access to funding is important to ensure that Australian families can continue to meet day-to-day costs while the liquidation of an institution is carried out.'<sup>10</sup>

32 The scheme is post-funded and is intended to have few other compliance costs for insurers in normal circumstances.

### 3.2 International Best Practice

33 Policyholder protection schemes are now considered international best practice. The International Association of Insurance Supervisors' (IAIS) (the insurance equivalent of Basel) Insurance Core Principle 12, Winding-up and Exit from the Market, emphasizes that a country's legal framework should give priority to the protection of policyholders and aim at minimising provision of benefits to policyholders.<sup>11</sup>

34 Similarly, a 2011 OECD report '*The Impact of the Financial Crisis on the Insurance Sector and Policy Responses*' concludes that:

'Well-designed systems of deposit insurance, with adequate levels of protection, are believed to have played an important role in maintaining consumer confidence in the banking system. While the insurance sector may not have the same liquidity challenges as banks, considerations of consumer confidence and protection may still arise and provide grounds for the establishment of a policyholder protection scheme.'<sup>12</sup>

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<sup>10</sup> 'New Protections for Depositors and Policyholders' Press Release. 2 June 2008. Accessible at: <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/061.htm&pageID=003&min=wms&Year=&DocType>.

<sup>11</sup> International Association of Insurance Supervisors *Insurance Core Principles, Standards, Guidance and Methodology*. 1 October, 2011. pp.102 available at <http://www.iaisweb.org/Insurance-Core-Principles-material-adopted-in-2011-795>.

<sup>12</sup> OECD (2011), *The Impact of the Financial Crisis on the Insurance Sector and Policy Responses No. 13*, OECD Publishing <http://www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/theimpactofthefinancialcrisisontheinsurancesectorandpolicyresponses.htm>.

35 Several other jurisdictions have forms of policyholder protections for non-life insurance – Belgium, Canada, Finland, Greece, Ireland, Japan, Korea, Spain, Turkey, United States, United Kingdom and Russia.<sup>13</sup> The EU carried out a review of the adequacy of existing insurance guarantee schemes in 2009 and in 2010 produced a white paper calling for the creation of a coherent and legally binding framework to establish an insurance guarantee scheme in each member state.<sup>14</sup>

### 3.3 Eligibility for the FCS

36 When deciding to introduce the scheme, the Government was mindful of the need to minimise market distortions and protect against moral hazard. Consequently, the FCS GI relied on focused eligibility criteria.

37 Access to the FCS GI is limited to specific classes of policyholders ('eligible policyholders') which include:

- individuals who are Australian citizens or permanent residents or non-resident individuals who have insured against risks in Australia with an APRA-regulated general insurer;
- small businesses as defined in sub-division 328-C of the *Income Tax Assessment Act 1997* (in broad terms a 'small business' for the purposes of this legislation is a business with annual aggregated turnover of less than \$2 million);
- family trusts which own property for private and residential purposes as defined in sub-division 272 of the *Income Tax Assessment Act 1997*;
- Australian-based non-profit organisations; and
- any policyholder who has made a claim for less than \$5,000.

38 The FCS GI provides continued policy coverage for extant eligible policyholders for a month after the declaration of the FCS GI, to give them time to find alternative insurance cover.

39 The FCS GI is not intended to provide compensation where an Australian general insurer provides cover on a cross-border basis to foreign persons or entities.

40 Because of the operation of these eligibility requirements, a number of policyholders, including the largest policyholders such as large corporations, are not covered by the FCS GI. Those policyholders that do not meet the eligibility requirements remain eligible to recover any funds owing to them in the normal course of the liquidation of the general insurer.

41 As a result of their exclusion from the FCS GI, these non-eligible policyholders have strong incentives to monitor the health and stability of their general insurance company and assess the counterparty risk that might impact on the value of their insurance coverage. The imperative of winning and keeping these clients imposes market discipline on general insurers and mitigates any moral hazard created by the FCS GI.

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<sup>13</sup> Ibid.

<sup>14</sup> European Commission (2010), *White Paper on Insurance Guarantee Schemes*. Available at: [http://ec.europa.eu/internal\\_market/consultations/docs/2010/whitepaper-on-igs/whitepaper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/whitepaper-on-igs/whitepaper_en.pdf).

### 3.4 Activation of the FCS GI

42 The FCS GI is invoked at the discretion of the Minister. Before the Minister can activate the FCS GI, the general insurer must be in judicial management or external administration, and APRA must have advised the Minister that it believes that the general insurer is insolvent (within the meaning of insolvent in the *Corporations Act 2001*) or the general insurer is a foreign general insurer with insufficient assets in Australia to pay its Australian debts as and when they fall due.

### 3.5 Funding of the FCS GI

43 The FCS GI is a post-funded scheme. In the event the FCS GI is invoked, APRA makes an assessment of claimant eligibility and determines the validity of claims. APRA will pay all valid claims under \$5,000. However, for claims of \$5,000 or more, valid claims will only be paid to claimants who meet the eligibility criteria outlined in paragraph 34.

44 After APRA assesses and pays valid claims to eligible policyholders, it takes the place of those policyholders as creditors in the liquidation of the general insurer. Should APRA not receive the full amount it has paid policyholders in the liquidation process, a provision in the *Financial Claims Scheme (General Insurance) Levy Act 2008* enables the Government to recover any shortfall through a levy applied by the Government on the authorised general insurance industry. This provision is only able to be used if APRA is not able to recoup the full amount paid out to policyholders in the liquidation process.

45 There is no set formula for the setting of levies on the industry in order to recover APRA's shortfall. However, as a general principle levies would be imposed in such a way as to have as little regulatory burden as possible. This may involve spreading levies over a number of years or across many insurers, depending on the state of the market and nature of the liquidated insurer. Insurers may recoup the levies through higher premiums or lower returns to shareholders, so long as any changes comply with existing capital requirements and laws.

46 The FCS GI does not apply to the unexpired insurance premium paid to the insurer before its failure. However, policyholders may receive a return of some or all of their unexpired premiums from the liquidator of the general insurer, depending on the amount of an insurer's assets upon winding up. The FCS GI has been activated only once since its introduction (see text box below).

#### **The Failure of Australian Family Assurance Limited (AustFam)**

AustFam was a small general insurer that specialised in personal accident and sickness, travel, mobile phone cover, legal fees, prestige motor, salary continuance and heavy motor risks. It was also a co-insurer of policies issued to the amusement and leisure, childcare and community care industries. Since 2002, it was only authorised to conduct run off business. On 3 July 2009, APRA applied to the Federal Court of Australia to appoint a Judicial Manager for AustFam. The Court agreed to the appointment. At that time the company had an estimated \$2.5 million in liabilities, while its tangible assets were reported to be \$603,000. On 15 October 2009, the former Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP activated the FCS GI for AustFam.

## 4. IMPACT ANALYSIS OF THE FCS GI

47 This section begins with an assessment of the FCS GI against its original objective. It then provides a short summary of Australia’s general insurance industry and looks at the regulatory impact of the FCS GI on various stakeholders, including the general public, consumers and policyholders and the general insurance industry. It has assessed, as a result of the consultations with relevant stakeholders, whether the original objectives of the FCS GI have been met.

### 4.1 Assessment against the original objective

48 The original intent of the FCS GI as stated at the time of its introduction was to provide policyholders of a failed insurer with timely access to funds arising out of valid insurance claims against that failed insurer. It is difficult to assess the policy on the basis of its actual performance, given that since its introduction no medium or large-sized insurer has failed. Its only activation was for Austfam Limited, a small insurer with only \$2.5 million in liabilities.

49 However, assessment of the design of the FCS GI can be undertaken on the basis of whether its design meets the original objective, taking into account the views of stakeholders.

50 The original intent of the scheme was to have a framework in place, which could be quickly activated, to provide policyholders with valid claims against a failed insurer. On this basis, the FCS GI has been successful as it clearly outlines eligibility criteria, the circumstances under which it is to be activated, and how it will be funded and administered.

51 Furthermore, the scheme is designed to have minimal impact during normal circumstances (that is when no insurer has failed). This is achieved through its post-funding approach and activation only in the event of an insurer’s failure.

### 4.1 Australia’s general insurance industry

52 The Australian general insurance industry today comprises 124 direct insurers, and covers such classes of insurance as aviation, commercial and domestic motor vehicle, consumer credit, compulsory third party motor vehicle, employers liability, fire and industrial special risks, house-owners, marine, mortgage, professional indemnity, public and product liability and travel. Domestic motor vehicle and house-owners insurance make up over 40 per cent of gross earned premium.<sup>15</sup>

53 The industry generated net premium revenue of \$27.8 billion in 2011-12.<sup>16</sup> In that year it had around \$16.6 billion in net incurred claims, mostly relating to motor vehicle, and home and contents policies.<sup>17</sup> Around 80 per cent of the industry’s total revenue is attributable to the Eastern States (New South Wales, Victoria, Queensland and the Australian Capital Territory).<sup>18</sup>

54 APRA is responsible for prudential oversight of the general and life insurance industry. Regulated insurers are subject to ongoing supervision to ensure they are managing risks

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<sup>15</sup> APRA Quarterly General Insurance Performance Statistics, June 2012. available at:

<http://www.apra.gov.au/GI/Publications/Pages/quarterly-general-insurance-statistics.aspx>.

<sup>16</sup> APRA Quarterly General Insurance Performance (June 2012; issued 30 August 2012) available at:

<http://www.apra.gov.au/GI/Publications/Documents/GI%20Quarterly%20Performance%2020120630.pdf>.

<sup>17</sup> Ibid.

<sup>18</sup> APRA Half-Yearly General Insurance Bulletin (June 2010; updated 27 May 2011) available at:

<http://www.apra.gov.au/GI/Pages/gi-half-yearly-statistics.aspx>.

prudently and meeting prudential requirements so as to minimise the likelihood of financial losses to policy holders. APRA follows a risk-based approach under which institutions facing greater risks receive closer attention. The other specific industries prudentially regulated by APRA are the deposit taking institutions, and the superannuation industry, with the remaining segments of the financial services industry subject to non-prudential regulation by ASIC. APRA also administers the FCS GI.

## 4.2 Regulatory Impact of the FCS GI

55 In seeking to determine the regulatory impact of the FCS GI, Treasury undertook a consultation process with a number of targeted stakeholders representing industry, consumers and relevant intermediaries. Treasury also received two written submissions in response to its consultation paper seeking submissions on the FCS GI (see attachment). Fourteen face-to-face meetings with interested parties were held, as were three teleconferences. The consolidated views of each different class of stakeholders are considered in this section of the report.

56 In considering the views of each stakeholder, it is important to note that the FCS GI remains largely untested against its primary objective, to provide policyholders timely protection in the wind-up of a failed insurer. It has been activated only once following the runoff of AustFam (see box on page 12), a small insurer with only \$2.5 million in liabilities at the time of runoff. Nevertheless, the overall design and operating frameworks of the FCS GI have been settled. In the event of a wind-up of a failed insurer, APRA's responsibilities are well defined through legislation. There is no indication that APRA would be unable to exercise its responsibilities fully in meeting the primary objective of timely payouts to targeted eligible policyholders.

### 4.2.1 The General Public, Consumers/Policyholders of general insurance products

57 While awareness of the scheme was high immediately following its introduction and in the aftermath of the GFC, as the scheme is not advertised by the Government or the insurance industry, awareness is now quite low. Consultations with stakeholders confirmed this view, some select comments received were that:

- 'while insurers are required to include information regarding the FCS in their product disclosure statements, consumers are unlikely to read this information';
- 'policyholders are unlikely to be aware of the FCS GI, indeed awareness is very low'; and
- 'low awareness of the scheme by consumers is probably an advantage, as it limits any potential moral hazard' (paragraphs 57-60 consider moral hazard issues).

58 While awareness of the scheme is low, this is not surprising since only in the event that an insurer was to collapse would the Government activate the scheme. Arguably, there is little need for consumers to be aware of the existence of the FCS GI until it is required.

59 Furthermore, there is less need for general insurance consumers to be informed about the existence of the FCS GI than for the FCS for ADIs, for example. The purpose of the FCS for depositors is to prevent or avert a run on ADI deposits. This risk is not generally associated with the general insurance industry.

#### **Moral Hazard**

60 Despite the low awareness, in any guarantee scheme there is a risk, however, small, of moral hazard. In the case of the FCS GI for general insurance policyholders, the risk is that policyholders, or at least those that are aware that the Government stands ready to cover valid

claims through the FCS GI scheme, will sign up with general insurers regardless of the riskiness of the insurer. In this way, the market fails to exert discipline on general insurance providers.

- 61 However, this argument relies on policyholders being aware of the FCS GI and also being well-placed to assess the riskiness of an insurer prior to entering into an insurance contract. Policyholders, though, are typically individuals and households who would (more than likely) be unable to make a sound judgement as to the current or future financial position of an insurer and the likelihood of that insurer becoming insolvent. The HIH Royal Commission considered this point and reasoned that:

‘...few policyholders would be in a position to assess the ability of an insurer to meet its financial promises. At least for relatively unsophisticated purchasers of insurance, their ability to make an informed choice when seeking a secure insurer with which to place their risk is limited. Similarly, most third party claimants will have had no prior knowledge of or ability to influence the choice of the insurer against which they are seeking recourse. They will nevertheless be exposed in the event of default on the part of the insurer.’<sup>19</sup>

- 62 The inability of individual consumers to determine the financial status of a general insurer was one of a number of considerations in the design of the FCS GI, and in particular the eligibility criteria for the scheme. The eligibility criteria mitigate moral hazard<sup>20</sup> by ensuring that those policyholders which are, or should be in a position to assess the financial status of their insurer, such as large corporations, are not covered by the scheme. As a result of their exclusion, these policyholders have stronger incentives to monitor the health and stability of their general insurance company and assess the counterparty risk that might impact on the value of their insurance coverage. The imperative of winning and keeping these clients imposes market discipline on general insurers and the industry as a whole.

- 63 The question of policyholder support involves the balancing of concerns about moral hazard against the broader benefit of reducing the social costs incurred as a result of the collapse of a general insurer. In his consideration of this balance, Justice Owen (HIH Royal Commission) noted that ‘a sensibly designed scheme could avoid most of the moral hazard problems, and could play a valuable role in increasing consumer confidence and addressing social costs in the wake of any collapse’.<sup>21</sup>

### ***Policyholder expectations of support***

- 64 While the general public and consumer’s knowledge of the scheme is limited, there is nonetheless a general expectation among these stakeholders that the Government would operate some kind of support scheme in the event that an insurer was declared insolvent, as evidenced by the response of one stakeholder below:

‘while consumers may not have heard of the FCS GI, it is likely that in the event that an insurer did become insolvent they would expect that the Government would act in a manner consistent with the FCS GI’.

- 65 Recent experience shows that consumers and the broader community will not readily accept the huge losses that flow from the failure of a regulated financial institution. The consequence is that governments at all levels come under pressure to respond to such failures, as evidenced following the collapse of HIH Insurance, during which time the Commonwealth and State

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<sup>19</sup> The HIH Royal Commission Report, Volume 1.

<sup>20</sup> A moral hazard occurs when a party will have a tendency to take risks because that same party will not incur the costs through taking the risk.

<sup>21</sup> The HIH Royal Commission Report, Volume 1

Governments set up several schemes to support policyholders losses.<sup>22</sup> As such, the operation of an FCS GI scheme is consistent with community expectations of government support in the event of a failure of a general insurer. The scheme meets this community expectation and provides eligible general insurance policyholders with timely access to funds owing as a result of an insurance claim in the event of a failure of a general insurer.

66 Overall, it can be conclusively assumed that the very low level of awareness of the FCS GI has not had a significant, if any impact, on the purchase decision by consumers of general insurance products covered by the FCS GI.

#### **Findings:**

- Awareness of the FCS GI scheme amongst the general public and policyholders is low.
- The scheme has not had a significant, if any impact, on the purchase decision by consumers and policyholders of general insurance products covered by the FCS GI.
- The scheme, as one of a wider suite of financial sector stability measures, benefits the general public and consumers by contributing to the overall stability of the financial sector.
- The operation of the scheme is consistent with community expectations of government support in the event of a failure of a general insurer.

#### **4.2.2 The Insurance Industry**

67 Consultations with insurance industry stakeholders indicated that awareness of the FCS GI in the general insurance industry was understandably high. In addition, virtually all insurer industry stakeholders were of the view that the FCS GI was well designed and desirable, particularly given the likely public pressure on the Government to act following the failure of an insurer, as was the case following the collapse of HIH Insurance.

68 As the comments below from one industry stakeholder indicate (and this view was shared by other industry stakeholders), the introduction of the FCS GI has not impacted on the operational decision of insurers, including for example, on underwriting or marketing, or on the competitive structure of the industry:

- 'existence of the FCS is unlikely to factor into insurance companies' operating decisions';
- 'APRA's minimum capital requirements and requirements placed on insurers by shareholders are far more important in determining underwriting and capital decisions by insurers. The performance of Australian insurers during the GFC showed that they are well capitalised';
- 'the introduction of the FCS GI has not had an impact on competition in the sector. Companies are more focused on their regulatory capital requirements, prudent capital management strategies and other regulatory requirements, as opposed to the FCS GI, as part of their business decision processes – the FCS GI simply does not feature in this regard'; and
- 'the scheme had enhanced confidence in the general insurance industry'.

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<sup>22</sup> For example, the HIH claims support scheme and builders warranty insurance schemes in NSW and Victoria.



- 69 As indicated in the paragraphs above, the insurance industry is subject to prudential oversight by APRA which imposes more stringent capital requirements on insurers than in many other countries. Any changes to insurers' behaviour since the introduction of the FCS GI are likely to have been attributable to changes in prudential requirements by APRA, as well as to market discipline following the GFC. Furthermore, Australia's prudential regulations and oversight ensure that any risks to the insurance industry or to individual companies within the industry which may arise, whether through natural competitive pressures or new policies being implemented or existing policies being changed, are proactively managed to minimise those risks. In addition, other regulations such as ASIC disclosure rules and Australian Securities Exchange listing requirements apply to general insurers.
- 70 Given the views of industry stakeholders, it is fair to conclude that the FCS GI is unlikely to be a consideration in business decisions made by general insurers in Australia. Consequently, insurers were unanimously of the view that the scheme has not distorted the competitiveness of segments of the general insurance industry, for example small insurers vis-à-vis large insurers.
- 71 Insurance industry stakeholders agreed that the design of the FCS GI is such that there is minimal regulatory burden for the industry. This is because the scheme is only activated in the event of a failure of a general insurer (that is post event). Following failure, the industry may be impacted as the costs to the government for compensating policyholders will be recovered from industry if assets in liquidation are insufficient to cover the payouts. However, on a day-to-day basis, there is little to no compliance costs associated with the scheme.
- 72 In response to the appropriateness of the FCS GI, including for example, the eligibility criteria and disclosure requirements for the scheme, insurers agreed that the scheme as it stands is appropriate. Nevertheless, a number of minor technical issues with respect to the scheme were raised during the consultation period.
- 73 Overall, consultations with industry stakeholders confirmed that the FCS GI has not altered the behaviour of, or imposed any tangible regulatory burden on the insurance industry. The scheme is well designed and while some minor technical design issues have been identified, these can be considered as part of the consultation for *Strengthening APRA's Crisis Management Powers*.

**Findings:**

- The design of the FCS GI is such that there is little regulatory burden on the day-to-day operations of industry.
- The FCS GI has not distorted the behaviour of the insurance industry.
- The policy and design parameters of the FCS GI are broadly appropriate.
- Further consideration of some minor issues raised by industry stakeholders is best addressed as part of the recently released '*Strengthening APRA's Crisis Management Powers*' consultation paper.

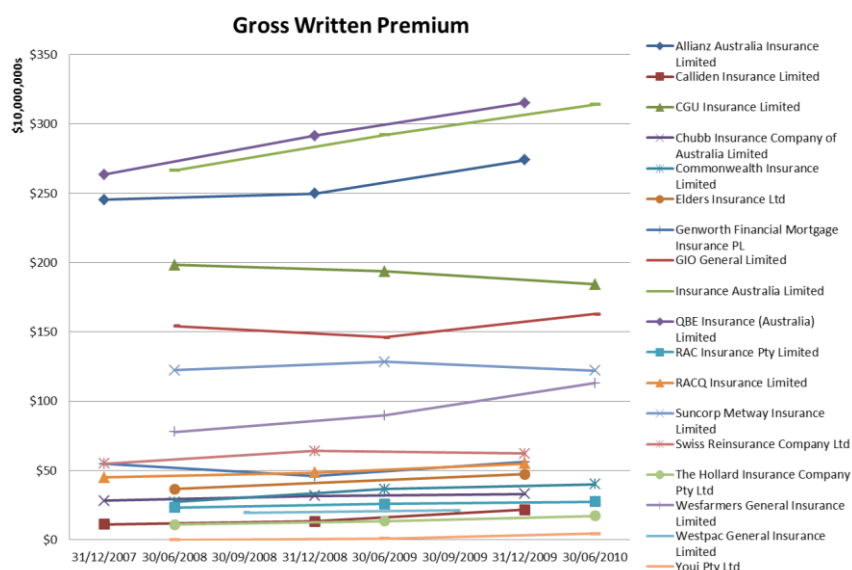
### 4.3 Quantitative Analysis

- 74 A number of hypotheses were tested using APRA data on how the FCS GI may have altered market behaviour. This quantitative assessment would complement the qualitative assessment undertaken through the consultation process for this PIR.

75 Firstly, the introduction of the FCS GI may have given some consumers greater incentive to purchase insurance, although the purchase decision of a consumer is ordinarily driven by their insurance needs and the cost of that insurance cover, rather than whether or not an FCS GI scheme is in place. In addition, the low awareness of consumers indicates that consumers would not have taken the FCS GI into consideration in their purchase decision.

76 An analysis of a sample of insurers most likely to be affected by the introduction of the FCS GI, given their focus on retail household type insurance products, was conducted using gross written premium (GWP)<sup>23</sup> data available from APRA<sup>24</sup>. As can be seen from the following graph, there is an overall trend upwards, consistent with inflation and increasing sums insured, but there does not appear to be any significant increase for the majority of insurers across the period, leading one to conclude that the introduction of the FCS GI did not result in an increase in the take-up of insurance by consumers.

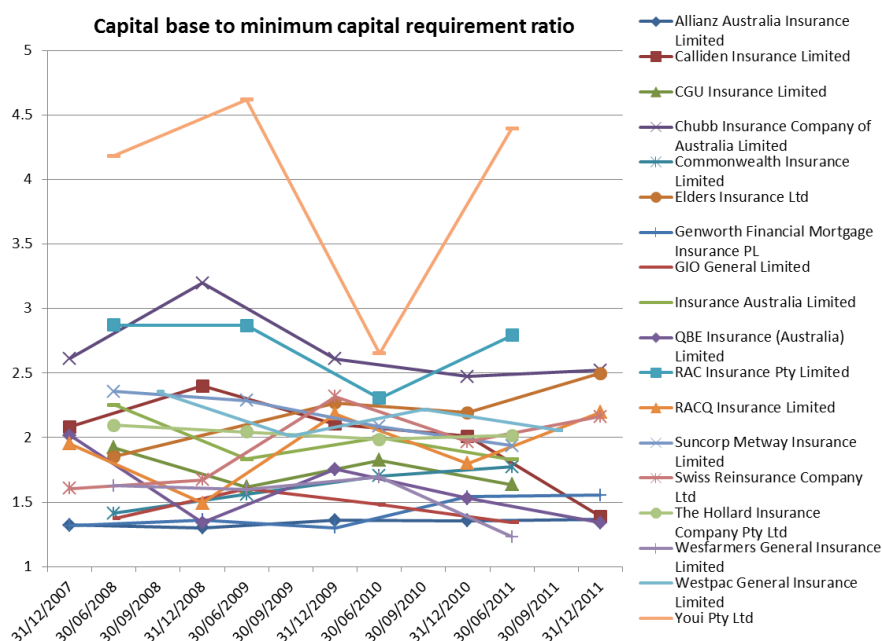
77 Secondly, further analysis of the GWP data shows that smaller insurers, who logically would benefit most from the introduction of an FCS, do not appear to have been significantly advantaged following the introduction of the FCS in 2008, relative to the larger insurers (such as Suncorp and Insurance Australia Group). The converse does not appear to be the case either.



78 An analysis of insurer’s capital base over their minimum capital requirement (MCR) as prescribed by APRA (see graph below) shows no obvious overall trend in the ratio of the capital base to MCR. While there are differences between insurers, there are a wide range of factors which are likely to cause these changes. The key point is that there is no overall decline in the capital position of insurers due to the introduction of the FCS GI. This is unsurprising, given MCR must be met, thereby mitigating against any risky business behaviour an insurer may follow in response to changes in Government policy, or other competitive pressures.

<sup>23</sup> CWP: the total premiums written before taking into account commissions and reinsurance expenses.

<sup>24</sup> APRA General Insurance Company Level Statistics, December 2011. Available at <http://www.apra.gov.au/GI/Publications/Pages/General-Insurance-Company-Level-Statistics.aspx>.



79 It is also important to note that there has not been any significant exit or entries into the Australian insurance market since the introduction of the FCS GI scheme. As at 30 June 2008, there were 130 APRA regulated general insurers; as at 30 June 2011, the number was 127 and today 124. There has not been any significant consolidation in the Australian market over this time period, thereby not affecting the ordinary competitive pressures which exist among existing insurers. This suggests that the FCS GI has not had a significant impact on competition in the general insurance sector since its introduction.

## 5. CONCLUSION

80 The introduction and continuing operation of the FCS GI ensures that a policyholder protection scheme is available to deal with the failure of an APRA-regulated general insurer, thereby minimising the economic and social disruption the failure of such an institution could cause.

81 The FCS GI is consistent with international best practice, with more countries tending towards introducing similar schemes, in accordance with the International Association of Insurance Supervisors Core Principles.

82 At the time of its introduction, the FCS GI formed just one part of a broad range of financial system stability tools which responded to the GFC. Stringent prudential regulation by Australia's prudential supervisor, APRA, helps ensure the need for the scheme is minimised, however, this does not completely eliminate the risk of a failure of a general insurer, thereby requiring a FCS GI scheme to remain in place.

83 A key feature of the design of the FCG GI is that it is post-funded. There is no evidence to suggest that following its introduction the FCS GI has altered consumer or insurer behaviour, or altered competition in the general insurance market. Furthermore, given the scheme is only operationalized following an insurer's insolvency, it has not resulted in any meaningful compliance costs for insurers.

- 84 Both consumers and the insurance industry are comfortable with the design and intent of the FCS GI. Insurers have raised some minor technical aspects of the scheme, largely around clarification of eligibility and process in the event an insurer becomes insolvent. These issues will be considered in the context of the recently released *'Strengthening APRA's Crisis Management Powers'* consultation paper, in which the technical details of APRA's crisis resolution powers are being considered.

## ACRONYM LIST

Term	Definition
APRA	Australian Prudential Regulation Authority
ADI	Authorised Deposit-taking Institution
ASIC	Australian Securities and Investments Commission
CFR	Council of Financial Regulators
FCS	Financial Claims Scheme
FCS GI	Financial Claims Scheme for General Insurance
FSB	Financial Stability Board
GFC	Global Financial Crisis
GI	General Insurance
GWP	Gross Written Premium
HIH	HIH Insurance
IAIS	International Association of Insurance Supervisors
MCR	Minimum Capital Requirement
OECD	Organisation for Economic Co-operation and Development
PIR	Post-implementation Review
RBA	Reserve Bank of Australia



**ATTACHMENT: FINANCIAL CLAIMS SCHEME FOR GENERAL  
INSURANCE CONSULTATION PAPER**

