

**ADDRESS TO THE INSURANCE COUNCIL OF
AUSTRALIA CONFERENCE**

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Today I want to talk to you about the importance of insurance to the Australian economy.

That will require me to say something about some of the stresses presently affecting the industry, and relevant developments in the regulatory environment.

Importance of the general insurance industry

The Australian general insurance industry is substantial. Australia represents some 2 per cent of the world insurance market — about twice its share of world gross domestic product. The Australian industry is ranked 11th in the world and second in our region after Japan.

There are around 150 private general insurers and reinsurers operating in the Australian market, employing around 35,000 people — and that figure excludes agents and brokers.

Total assets, both inside and outside Australia, of private sector insurance entities stood at some \$66.3 billion as at 31 March this year, an increase of 10.8% on last year. These assets were backing \$49.8 billion in liabilities, up \$5 billion on last year.

Net premium revenue for the year to March totalled \$15.4 billion, up \$1.5 billion (or 10.8%) on last year. Net claims expense totalled \$11.1 billion, down \$679 million (or 5.8%) on last year.

The underwriting result for the year to March was \$155 million, an improvement of \$1.6 billion (or 110.6%) on last year. Aggregate private

sector industry operating profit after income tax was \$669 million for the year to March, down something less than \$100 million on last year.

Those figures probably don't give a complete picture of just how tough the last twelve months have been for the Australian insurance industry — indeed, the last twelve months has been tough for the insurance industry worldwide. Many of the factors that have been affecting investment earnings, in particular, are not peculiar to Australia. Neither, obviously, are the implications of events like those of September 11 last year. I will have more to say about these events and their implications later. And it seems that we are not alone either when it comes to stresses in the area of corporate governance. I don't wish to say any more about these latter issues today. I understand that Senator Campbell had some remarks to make about corporate governance issues earlier. And, in the area of insurance, corporate governance issues, as you know, are receiving a good deal of attention in another place.

Notwithstanding recent financial difficulties and other stresses in parts of the industry, the general insurance industry is clearly a substantial contributor to Australia's national income.

But, of course, this financial measure of the direct contribution of the insurance sector to national income — impressive as it is — provides little indication of the real value to the Australian economy of general insurance activity. Moreover, instances of weakness in the general insurance industry are important not only — indeed, not primarily — for their implications for employment, net assets and profits in the insurance sector. The true significance of the insurance industry lies in the fact that if it didn't exist a large proportion of the rest of the economy wouldn't exist either. Without a reliable mechanism for pooling and transferring risk, much economic activity simply would not take place. Neither would a lot of social activity take place

— as is being demonstrated through the problems presently besetting public liability insurance.

Another way of saying this is that when the insurance industry is in difficulty so too, unavoidably, is much of the rest of the economy. Indeed, it is not overstatement to say that society is weakened. A safe, stable insurance industry is vital for underwriting stability and confidence in economic and social interaction — in underwriting the economy and society.

This is why the problems presently besetting the insurance industry are of such public policy significance.

And problems there are.

Some forms of insurance — aspects of terrorism insurance and public liability cover — once taken for granted, are simply not available today, or are available only at premiums that raise serious questions of affordability.

A major insurance company has folded.

Public liability and professional indemnity insurance premiums have been increasing substantially. And our largest provider of medical indemnity insurance is in provisional liquidation.

This is a significant catalogue of problems.

Clearly, it would be wrong to infer from this list that the entire industry is in crisis. Public liability and professional indemnity insurance represent less than 10 per cent of premium income, and the withdrawal of terrorism cover is not uniform. But the list is sufficiently interesting to have captured the attention of governments across Australia — and for good reason.

There is no single explanation for recent problems. In some cases premium increases are a correction of earlier under pricing. In other cases premium

increases reflect continuing — and in some areas accelerating — increases in the cost of claims. Reinsurance costs have suffered an adverse shock, partly related to the events of 11 September last year. And the structure of the industry is adjusting to the withdrawal of some industry players.

Not all of these developments raise public policy issues. Price increases — even large ones — are not necessarily evidence of the need for government intervention. Neither is the exit of even large market participants. Indeed, an industry in which no participant ever fails is unlikely to be competitive or efficient.

But some developments do raise significant public policy issues.

The prudential framework

Before saying more about recent problems, let me say a little about some developments in the principal piece of regulatory architecture in the general insurance industry — the prudential framework.

The prudential regulation of general insurers aims to provide policyholders with a degree of confidence that insurers will be in a position to honour their financial commitments.

All financial products involve exposure to a degree of risk. An efficient financial market will manage, allocate and price this risk, rewarding those willing to bear it. Government regulation of financial markets does not aim to remove this risk. Indeed, it doesn't aim even to prevent an insurer from going out of business. Rather, the prudential framework seeks to balance the objectives of maintaining efficient, dynamic and competitive financial markets and ensuring the continuing stability and integrity of the financial system.

This balancing act requires, on the one hand, that the government does not

guarantee the future of any particular player in the financial system; and, on the other, that the failure of one player does not threaten systemic stability.

The policy framework is based on the premise that ultimate responsibility for the prudent operation of general insurers rests with the management and board of each institution. Hence, if a general insurer fails the presumption has to be that the management and board of the institution have failed. And that has to be the presumption no matter how well the regulator has done its job, and no matter how well crafted the regulatory framework.

To be clear, while the design of the prudential framework seeks to reduce the likelihood of failure, there should be no pretence that it can prevent all such instances. Similarly, there must be no pretence that the authority charged with administering the prudential framework can, or even should, prevent all instances of failure.

As you would be aware, following the recommendations of the Wallis report, responsibility for the prudential supervision of the financial sector at the Commonwealth level was consolidated in one authority — APRA. This consolidation of responsibilities has facilitated a more consistent treatment of like products across the entire financial sector.

General insurers are regulated under the *Insurance Act 1973* (Insurance Act). The prudential regime had, until recently, remained virtually unchanged since its inception nearly thirty years ago and, while it had served policyholders well for many years, its continuing effectiveness was being challenged on a number of fronts. In particular, advances in risk modelling techniques, changes in market structure, as financial institutions had become more diversified and complex, and improvements in domestic and international regulatory best practice, had made the former regime increasingly blunt and unresponsive. Moreover, ‘one-size-fits-all’ approaches to supervision,

involving externally prescribed rules and standards, were becoming less relevant in an increasingly dynamic and complex marketplace.

The Government's response to the Wallis report favoured supervisory regimes that would better be able to respond quickly and flexibly to fluid market conditions. This response included a modernisation of the Insurance Act.

Turning to more recent developments, a revised prudential framework for general insurers was introduced on 1 July of this year. The most important aspect of this framework is a substantial increase in the level of regulatory capital that must be held by insurers. I am aware that these measures in particular are somewhat controversial. So I want to spend a little time explaining them.

Insurers are being required to hold capital commensurate with the risk profile of the insurance business being underwritten. Accordingly, the capital requirements for 'long-tail' insurance, such as public liability and professional indemnity insurance, have been increased. Entry-level capital requirements have been increased from \$2 million to \$5 million. The changes also impose compulsory risk management systems, which include pricing and underwriting control mechanisms.

It has been argued in some quarters that the new capital adequacy requirements for general insurance could exacerbate premium increases in public liability and professional indemnity insurance. The implication is that the consumer of general insurance products will be the loser.

This argument is not well based. Even if it is true that the new capital adequacy requirements will put some upward pressure on premiums, and that proposition should not be accepted without challenge, that does not imply that consumers will be disadvantaged. Increases in insurance premiums are

always hard for consumers to bear. That is a truism. But that hardship has to be weighed against the consequences that arise when — because of a lack of capital — an insurer fails or, worse, confidence in the industry is eroded. To put it bluntly, a policy framework that allows poorly capitalised entities to operate does not serve the interests of consumers.

The pricing of insurance products rests on assumptions about claims and investment returns. If these assumptions turn out to be overly optimistic, the provider's balance sheet will be weakened. Without capital reserves, policyholders would immediately be exposed to underwriting losses. Capital provides a buffer to absorb losses without an immediate impact on policyholders.

The longer the time lag between the pricing of a product and the likely payment of claims — that is, the longer the 'tail' — the bigger is the risk that an insurance provider will get its pricing assumptions wrong. Hence, longer tail products, such as public liability and professional indemnity, demand more capital.

The new, risk based, capital adequacy standard also takes into account the potential asset risks in insurance companies and the accumulation of risks that can arise through a single event having an impact on a wide range of policies in an insurer's portfolio.

Another important component of the new prudential requirements for general insurers is a requirement to value liabilities in accordance with a liability valuation standard. Accounting standards that rely on probable outcomes to value liabilities are not adequate in the insurance context. The variability in insurance liability estimates requires a higher level of probability of sufficiency. This is especially the case in 'long tail' classes.

The new requirements should also see an improvement in the risk management processes of insurers. Risk management is not a concept that should be foreign to insurers, of course, since that is the essence of their business.

In this new regulatory environment, the role of the regulator becomes one of quality assurance of control systems and risk management practices more generally. Other leading national regulators, including in Canada, the United Kingdom and the United States, are either undertaking similar reviews or have already implemented changes towards a more risk-oriented system of regulation.

Overall, the new regulatory framework should significantly reduce the likelihood of failure in the general insurance sector. But I repeat: it is not designed to guarantee that there will be no failure.

Recent problems

Terrorism insurance

September 11 2001 sent a shock wave through the insurance industry world-wide. Views have had to adjust on two things critical to the business of insurance: first, assessments of the probability of occurrence of a catastrophic terrorist event; and second, assessments of the probable scale of financial damage that might be inflicted by an act of terror.

Of course, this concentration on the financial dimensions of the events of September 11 should not, in any way, be allowed to obscure the truly horrific dimensions of the greater human tragedy involved. But, like the shadow of the human tragedy, the financial consequences of September 11, including the consequences for insurance activity, will be with us for a very long time.

We now know — even if we did not know previously — that some of the world's largest and most valuable buildings can be taken out by terrorists: we know that it is technically feasible, and we know that there are people in the world motivated, and with the capability, to do this sort of thing.

This is a large amount of new information that has to be absorbed by an industry overwhelmingly dependent upon the sober processing of information. The process of information absorption will take some time. It is too early yet to predict the longer-term impact on the coverage and pricing of terrorism insurance. In the meantime, however, we — like others all around the world — have a problem.

In essence, the problem is that the private market is failing to provide a product — terrorism insurance — even though the social benefits of its provision exceed the costs of supplying it. This is a familiar public policy issue for economists: the case of market failure.

Before moving on I should emphasise two things about market failure. First, its meaning is very strict: the market must actually be failing to deliver the 'socially optimal' amount of a product or a tolerable substitute. The amount being provided is less than socially optimal if the true social benefit of more of the product being provided exceeds the full economic cost of supplying that additional amount.

The point here is that there are many things that markets do not provide, and an extremely large number of products that could, as a technical matter, be provided in larger quantity, but where no instance of market failure arises. You don't need me to tell you that there are a lot of activities that are quite properly uninsurable. Moreover, the fact that your industry won't insure certain things does not, in most cases, provide an argument for the government stepping in to do so. Yet it is the failure to appreciate this simple

point that underlies most calls on the government to subsidise various forms of activity. For that reason, most such calls will be resisted.

The second thing that should be emphasised is that the best policy response to an instance of market failure depends on a range of circumstances. Rarely will the best response involve government provision, even government underwriting.

But in the case of terrorism insurance it seems likely that we do, indeed, have a case of genuine market failure. That is to say, we have prima facie grounds for government intervention. I say 'prima facie' because government intervention is also capable of failure. But it seems that we have prima facie grounds for government intervention in the aviation sector and in respect of commercial and industrial property. Moreover, it seems likely that the best form of intervention — at least at the present time — involves an element of underwriting, in the form of indemnities and/or 'remainder insurance'.

As you would be aware, the Australian Government is working — in consultation with this Council, major individual insurers, the Australian Banking Association, the Property Council of Australia, reinsurers and brokers — to develop arrangements that will provide adequate terrorism insurance cover. An announcement on the form of these arrangements, and implementation details, is expected within weeks.

The arrangements will not be open-ended. Any intervention by the Government will be consistent with the following principles. First, the need to maintain, to the greatest extent possible, private sector provision of insurance; second, the need to ensure that risk transferred to the Commonwealth is appropriately priced to minimise the impact on the Commonwealth's financial position, and to ensure that the Commonwealth is being compensated by those benefiting from the assistance; third, the need to

allow the commercial insurance and re-insurance markets to step back in when they are able (that is, ensuring an appropriate 'exit strategy' for government); and fourth, the need to be compatible with global solutions.

The government has no desire to participate in any part of the insurance market for any longer than is absolutely necessary. And in respect of terrorism insurance it is aware that its involvement, for even a limited period, could, if not handled carefully, compromise the chances of a revival of the private insurance market.

Public liability insurance

Over the past six months, insurance premiums for public liability insurance have risen dramatically. In some circumstances, businesses have been unable to secure insurance at affordable rates.

Not-for-profit organisations, such as charities and amateur sporting organisations, are having particular difficulties in accessing affordable insurance.

The Commonwealth, States and Territories and local government have been working together through the ministerial meetings on public liability insurance to identify the drivers behind the problems of rising premiums and reduced availability of public liability insurance and to tackle these with a package of socially responsible reforms.

Ministers have agreed measures in a number of areas, including tort law and legal system reforms, a review of the law of negligence, measures to protect volunteers from litigation, self assumption of risk, the development of better claims data, and price monitoring.

Medical indemnity insurance

Medical indemnity is not a conventional category of general insurance. It is worth asking why that should be so. Indeed, the answers to that question will probably go a long way to identifying what needs to happen to medical indemnity insurance in order to address present difficulties in that area.

Some of the measures being considered in respect of public liability insurance have clear 'cross-over' to medical indemnity. A medical indemnity forum on 23 April this year expressed support for the outcomes of an earlier ministerial meeting on public liability, noting as particularly relevant for medical indemnity: Commonwealth, State and Territory legislation to encourage use of structured settlements; and the development of practical measures in relation to broadly based tort law reform and legal system costs and practices.

The medical indemnity forum agreed: to the development of a workable model to provide an equitable and effective way of managing the long-term care needs and costs of the catastrophically injured; to the development by Health Ministers of nationally consistent legislative proposals to ensure that a doctor's expression of regret is not construed as an admission of liability; in-principle, to a national database for all medical negligence claims, with the AHMAC Medical Indemnity Group continuing its work and seeking to include information from medical defence organisations; that changes to prudential supervision arrangements for the medical defence industry be expedited; and to the Australian Council for Safety and Quality in Health Care continuing to develop a list of catastrophic adverse events for specific action.

At the end of May, the Prime Minister announced a set of principles that will guide the Commonwealth's response to the difficulties being experienced in the medical indemnity insurance market. The Prime Minister's

announcement addresses those features of the business that presently prevent its being a viable commercial product. The measures targeted by the Prime Minister include: seeking the removal of New South Wales legislation capping premiums of high risk specialties; developing arrangements, including consideration of direct financial assistance, to ensure premium affordability for doctors engaging in higher risk activity; improving transparency in the financial reporting of medical defence organisations and bringing all the insurance business of these organisations into the prudential framework for general insurers; and working with the States to develop a suite of mechanisms that will give insurers greater certainty in calculating the size of likely claims, assist in pricing risk and setting affordable premiums. The Prime Minister noted that this suite of mechanisms will have to include: substantial tort law reform; a range of measures to deal with the more serious, high cost claims; improved claims management; and better clinical assessment.

A comprehensive framework of measures is to be in place by the end of the year.

As I noted earlier, medical indemnity insurance is not a traditional product of the general insurance industry. It may or may not be at some future time; I'm not going to prejudge that. But one thing is clear: however medical indemnity insurance is provided in the future, it will be secure only if it 'looks a lot more like' the core business of general insurance.

What do I mean by 'looks a lot more like'? I mean that providers of medical indemnity insurance are able to assess, and charge premiums according to, actuarial fair values. I mean that providers of medical indemnity insurance are subject to rigorous transparency requirements in respect of financial reporting. And I mean that providers of medical indemnity insurance are subject to the full prudential framework for general insurance.

Indeed, it is worth asking whether UMP/AMIL would be in provisional liquidation today had it been subject always to the requirements of the revised prudential framework for general insurers introduced on 1 July of this year. Of course, it may. But I think it more likely that the industry would have had a very different structure. It would have been better capitalised. The medical indemnity insurance market would have been more efficient, more dynamic and more competitive. And it would today be contributing to, rather than detracting from, the stability and integrity of the economy.

That is why the new prudential framework is so important. It cannot guarantee that no future provider of medical indemnity insurance will ever go into provisional liquidation, nor that a sizeable general insurer will not fail. But it will make these things less likely. And in so doing it will contribute to economic stability and social improvement.