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INSURANCE COUNCIL OF AUSTRALIA

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27 August 2004

Ms Veronique Ingram
General Manager
Financial System Division
Department of the Treasury
Langton Crescent
PARKES ACT 2600

Dear Veronique

ICA is pleased to provide you with a copy of its submission in response to the Government Discussion Paper on Financial System Guarantees on behalf of ICA members, all of whom are licensed insurers and subject to the *Insurance Act 1973.*

The submission makes the case for the establishment of a general insurance Limited Explicit Guarantee Scheme (LGS) in Australia and that a well designed LGS introduced as part of a package of reforms would enhance the competitiveness, efficiency and safety of the general insurance industry. By drawing upon international experience and utilising our own advantages, such as a strong prudential regulator, Australia can implement a worlds best practice LGS.

ICA supports the establishment of an LGS with the following features:

- Is general insurance specific with management by an independent industry body. Compulsory membership for all APRA licensed general insurers (excluding reinsurers) and funding on a PAYG basis (when called upon and based on market share).

- Is tied to the states and territories removing their nominal defendant schemes and getting out of the prudential regulation of insurers.

- Pre-determined eligibility requirements to assist the policyholders who need it most.

ICA, on behalf of its members, would be a willing participant in any moves to implement an LGS based on these core principles.

Yours sincerely

Dallas Booth
Deputy Chief Executive

INSURANCE COUNCIL OF AUSTRALIA

ICA submission in response to the Government Discussion Paper on Financial System Guarantees

August 2004

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The Insurance Council of Australia

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

ICA members, both insurance and reinsurance companies, also form a significant part of the overall financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates over $34.9 billion per annum in gross premium revenue and has assets of $61.0 billion[1]. The industry employs about 30,000 people.

In this submission where ICA talks about members of a Limited Explicit Guarantee Scheme it does not include reinsurers who are specifically excluded from ICA's LGS proposal.

1 Executive Summary

Few policyholders are in a position to assess the ability of an insurer to meet its financial promises. At least this is true for relatively unsophisticated purchasers of insurance, such as small businesses and individuals. Similarly third party claimants have no prior knowledge or influence over the choice of insurer against which they are seeking recourse – they are nevertheless exposed in the event of default on the part of an insurer.

A post-event funded general insurance Limited Explicit Guarantee Scheme (LGS) will provide an additional level of protection for the policyholders who need it most and who are least able to avoid or mitigate the risk of an insurer collapse, without any significant or unnecessary burden on either policyholders or the industry.

While there is a divergent view within the industry of the need for an LGS, there is unanimous support for the view that, if an LGS were to be introduced it should be post-event funded and be part of a package of reforms recommended by the HIH Royal Commission, which are:

- Extending the benefits of prudential regulation to all areas of insurance and insurance like products, with potential changes to the definition of insurance business in the *Insurance Act.*

  Should the LGS be required to respond to an insurer collapse, the presence of non-APRA licensed and regulated players in the market could further exacerbate the present uneven playing-field (differing regulatory requirements and tax treatments). Insurers not required to contribute to the LGS would gain a pricing advantage. This inequality would need to be addressed to prevent insurance business being transferred to the un-regulated sections of the market to avoid LGS contributions.

- A rationalisation of regulation with APRA being the sole prudential regulator and States and Territories removing overlapping or duplicative requirements in statutory and other classes of insurance.

[1] http://www.apra.gov.au/Insight/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=7098 , last accessed 10 June 2004.

The introduction of an LGS should be tied to States' and Territories' removing themselves from prudential regulation and shutting down their nominal defendant schemes. ICA also calls for the removal of the power of State and Territory governments to legislate in any way that affects the capital, profit or solvency of authorised insurers.

- Increased affordability of insurance products through the removal of insurance taxes and levies (stamp duty, fire services levy, etc). Without comprehensive reform of insurance taxes, the LGS would impose an unacceptable burden on policyholders.

ICA's basic model of an LGS comprises:

- Administration by an independent industry body, which would sit dormant until such time, if ever, as the scheme is required. The ongoing costs would be negligible and borne by participating insurers.

- It would be a condition of any authorisation to carry on insurance business in Australia under the *Insurance Act* that the insurer be a member of the LGS, and satisfy any funding requests from the scheme administrator.

- Eligibility to the following classes of policyholders:
  - individual policyholders who are Australian citizens or permanent residents;
  - business policyholders (including body corporates) with a turnover of up to $1 million;
  - family trusts which own property for private and residential purposes; and
  - policyholders under all eligible state statutory schemes[2].
- Assistance be provided to the eligible policyholders of APRA authorised and licensed insurers at the following levels:
  - for statutory personal injury motor accidents and workers compensation schemes, loss of income policies and personal injury claims (by third party claimants), 100% of amount properly payable under the policy (up to the maximum amount insured under the policy); and
  - for all other claims, the first $5,000 of the amount properly payable under the policy, then 90% of the remainder of that amount, to a maximum of $500,000 (subject to the maximum amount insured under the policy).

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

- Post-event funding by levying members, with the capacity to request funding from all authorised general insurers in Australia. Members of the LGS would have the ability to pass the levy onto consumers through the pricing mechanism.

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

2 Background information

Existing protection for general insurance policyholders

The Discussion Paper on Financial System Guarantees noted that the:

> "safety net supporting the prudential framework includes depositor preference arrangements for authorised deposit-taking institutions (ADIs), the requirement for life insurance statutory funds, **priority arrangements for insurance policyholders** and compensation arrangements under Part 23 of the *Superannuation Industry (Supervision) Act 1993*.[3]" [emphasis added]

The "priority arrangements" for insurance policyholders are the reinsurance cut-through provisions contained in the *Insurance Act* and the *Corporations Act*. The proper construction and application of these sections is unclear and currently before the courts for interpretation in the context of post-HIH litigation. This is discussed in some detail in Section 11 of this submission.

With the exception of ad hoc arrangements (such as the HIH Claims Support Scheme) that were introduced in the wake of the collapse of HIH, general insurance policyholders have an uncertain standing should their insurer collapse. This contrasts with the rights afforded to consumers of failed ADIs, life insurers and superannuation funds.

As such, there remains a gap in the protection mechanisms that exist for general insurance consumers in Australia and that could be filled by a well conceived general insurance LGS.

The objectives of an LGS are well established in legislation

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

Recent (and proposed) reforms to the Australian regulatory environment[4] should lessen the risk of general insurer insolvency. Indeed the prudential standards form a strong foundation for the industry and must be complemented with effective oversight by a strong prudential regulator. However, general insurance is a highly competitive global industry and even the most stringent regulatory framework cannot, *and, for sound economic and competitive reasons, should not*, provide a 100 percent guarantee for all policyholders against the failure of a general insurer. Further, regardless of how strong a prudential regulatory regime is there can be no guarantee against insurer failure.

ICA supports a limited explicit guarantee as a part of broader reform

ICA believes that the introduction of an appropriate LGS is a key part of the task of building a better regulatory framework for general insurance in Australia, and it strongly recommends that any such scheme be complemented with a comprehensive package of reforms. The scheme should be designed and agreed and if necessary legislated, but only operated AFTER the failure of an

[3] Australian Government Discussion Paper on Financial System Guarantees, p. 1.

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

authorised general insurance company. The funding mechanism should operate on a post-event basis only.

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

Policyholder protection and broader reform

AN LGS must be part of a comprehensive package of reforms designed to create a stronger regulatory framework for general insurance in Australia. ICA supports the package of reforms recommended by the HIH Royal Commission as they represent a solid platform for major regulatory reform. The Commission's key reforms are:

1) Extending the benefits of prudential regulation to all areas of insurance and insurance like products, with potential changes to the definition of insurance business in the *Insurance Act*.

2) A rationalisation of regulation with APRA being the sole prudential regulator and States and Territories removing overlapping or duplicate requirements in statutory and other classes of insurance.

   ICA's expectation is that once an LGS is established and in place, that the States and Territories should be required to remove themselves from prudential regulation and shut down their nominal defendant schemes in respect of insurer failure. If they did not do this, then the *Insurance Act* should be amended to remove their power to prudentially regulate general insurers.

3) The potential for greater affordability of insurance products through removal of insurance taxes and levies.

4) A safety net for policyholders in the unlikely event of a future collapse of an authorised general insurer.

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

3 Implications of a limited explicit guarantee (Question 1)

Question 1 – If a limited explicit guarantee were introduced, what implications might this have for the safety, efficiency, and competitiveness of the Australian financial system?

The implications of an LGS for the Australian financial system are dependant upon the design features and structure of the LGS. The discernible impacts of a well designed LGS, such as that proposed by ICA, are as follows:

- *Mitigated moral hazard issues for insurers* – Through the protection of APRA's independence from the LGS, ICA's proposed structure for the LGS mitigates the prospect of changed insurer behaviour (moral hazard). Effective regulation is essential to the ongoing health of the general insurance industry in Australia.

- *Mitigated moral hazard for APRA* – An LGS that is operated at arms length to the prudential regulator also protects APRA from its own moral hazard, so called "regulatory forbearance"[5].

- *Reinforced market discipline* – An LGS would reinforce the onus on Brokers to monitor the financial well being of insurers that they recommend their clients use. Under their Professional Indemnity insurance Brokers may find themselves liable for decisions they make.

- *Reduced costs* – The reform package proposed by ICA reduces costs to consumers and insurers through:

    i. either the reduction or removal of state and territory stamp duties on insurance contracts which is paid by consumers; and

    ii. the consolidation of prudential regulation as the states and territories excuse themselves from this function.

- *Enhanced market efficiency* – Through the combination of post-event funding and the removal or reduction of state and territory stamp duties on insurance, ICA's preferred LGS enhances the efficient operation of general insurance markets in Australia by removing taxes that distort efficiency. It is only in the event of an insurer collapse that consumers are required to contribute indirectly through levies on insurers which would be passed on in a competitive marketplace.

- *Enhanced safety* – An LGS provides all policyholders with the certainty they require to be able to make well-informed decisions concerning the insurance they choose to purchase.

- *Enhanced international standing* – ICA notes that Australia's lack of an LGS for general insurance places it in the minority of OECD nations. A cost effective LGS would rectify this anomaly while protecting the competitive position of APRA regulated insurers in global markets.

4 The form of the guarantee (Question 2)

Question 2 – Comments are invited on what general approach government should take to reduce the consequences for consumers of financial institution failure:

caveat emptor — a response that insists customers and other stakeholders should bear the consequences of a financial institution failure

ICA does not support this approach.

A laissez faire policy response is inappropriate in a market (general insurance) regulated by the Commonwealth Government and where few consumers have the capacity to assess the creditworthiness of the institutions they choose to deal with.

[5] Commonwealth of Australia, 2004, Report into the Study of Financial System Guarantees, p. 144-145.

In addition, ICA submits that there already exists an implied guarantee to assist policyholders in the event of another insurer failure by virtue of the Commonwealth Government's involvement in HCS.

This approach also provides the States and Territories with no incentive to remove themselves from prudential regulation. The duplicative regulatory requirements in Australia would remain.

case-by-case, discretionary responses — that any assistance should be tailored to the circumstances of each instance of failure

ICA does not support this approach.

At the time of the HIH collapse there was no generic Commonwealth policyholder protection arrangement for people, organisations or businesses. In response to the collapse of HIH, the Commonwealth Government initiated the HIH Claims Support Scheme and the general insurance industry, in consultation with the Commonwealth, established HIH Claims Support Limited (HCS), a not-for-profit company[6]. HCS was appointed by the Commonwealth to manage the $640 million[7] rescue package that the Commonwealth had pledged for eligible HIH policyholders.

The HIH experience also demonstrated State and Territory government's involvement in guaranteeing payment of claims under statutory schemes. Nominal insurer arrangements were activated to pay workers compensation and compulsory third party claims, and States and Territories applied levies on policies to fund those liabilities.

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

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

Were a "case by case" discretionary assistance approach to be adopted, policyholders would have no way of knowing whether they would be assisted in the event of an insurer collapsing and that this uncertainty bears costs. Further, a discretionary approach to policyholder assistance fails to capitalise on the market discipline that a limited guarantee could bring. Under an explicit limited guarantee, sophisticated (eg. corporate) consumers of insurance would most likely be excluded from assistance. Knowing this in advance would encourage such consumers to impose on their insurer an increased level of assessment and market discipline than would otherwise be the case in an uncertain and discretionary assistance regime.

[6] See generally, www.hihsupport.com.au.

[7] The current funding level.

There are also problems owing to the time it would take to establish a scheme, all the while as affected policyholders are suffering. The certainty of an LGS would provide much needed comfort to the policyholders of a failed insurer.

As with the "caveat emptor" approach, States and Territories would have no incentive to exclude themselves from prudential regulation. The duplicative regulatory requirements in Australia would remain.

limited explicit guarantees — that the extent of some limited assistance should be defined up-front

ICA supports this approach.

As noted by Justice Owen, '*in comparison a permanent, systematic scheme offers the benefit of administrative efficiency, transparency, certainty and consistency of approach*'[8] and a removal of any underlying doubt that support will be available following a collapse. This should lead to greater consumer confidence and stability in the general insurance industry.

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

While the primary layer of protection for policyholders and third party claimants is a strong system of prudential regulation as evidenced by most recent changes to the *Insurance Act*, the strengthening of prudential standards and the APRA Stage 2 Reforms, a limited explicit guarantee would provide an additional level of protection for the policyholders who need it most and who are least able to avoid or mitigate the risk of an insurer collapse. These are the relatively unsophisticated purchasers of insurance, such as individuals and small business policyholders who are not in a position to assess the financial strength and solvency of an insurer and its ability to meet the financial promises made. Similarly third party claimants (major beneficiaries under the industry's proposed LGS) have no capacity to choose the insurer of a person against whom they have a claim and it is important that the security provided by the general insurance sector flows through to these people as well.

alternative responses — for example, facilitating, but not underwriting an industry-based compensation arrangement?

ICA does not support this approach.

The success of any guarantee scheme relies upon explicit Commonwealth Government support by way of using its powers to mandate membership of all APRA licensed general insurers in Australia (this is discussed in Section 10). A lessor form of Government commitment, such as "in principle" support, would not protect Australian consumers.

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

5 International experience with guarantees (Question 3)

Question 3 – Are you aware of additional international experience that could add to the debate about whether explicit guarantees may be desirable in the Australian context, or how any scheme could be optimally designed?

Alternatively, you may wish to refer to relevant international experience in relation to some of the specific design issues discussed below.

Appendix B of ICA's Submission to the *Study of Financial System Guarantees* highlighted the experiences of a number of existing international guarantee mechanisms, such as in Canada, the United Kingdom and the US[9]. Of the schemes considered by ICA several commonalities with ICA's proposed model for an LGS were evident, such as:

- A scheme that is independent and specific to general insurance in its own right or, like the UK, gives the appearance of a coordinated response but is, in reality, a siloed general insurance scheme;

  ICA does not support the introduction of a cross sector scheme, however, were one to be established, then ICA would like to see a management similar to that used in the UK, whereby schemes for specific industries (eg. general insurance, ADIs) are siloed under some coordinating structure. ICA would not support a situation that would see general insurers and their policyholders being required to contribute to a collapse that outside of their industry.

- Membership of the fund being a condition of licensing;

- The exclusion of reinsurers;

- Caps on the amount of compensation payable; and

- Post-event funding (only Canada had part pre-event funding)[10].

While some international experience has found that moral hazard and system stability problems may arise under any guarantee scheme as a result of an ineffective regulator[11], ICA does not consider this to be a potential issue for Australia.

ICA views APRA as already being a world leader in prudential regulation, and notes that APRA is further strengthening its requirements through the Stage 2 reforms, yet Australia is one of only a few developed countries without a guarantee system for policyholders. It is also worth noting that ICA is currently having discussions with APRA concerning the mandatory provision of data across all general insurance classes (except statutory classes). This will only serve to help better inform both regulators and insurers as to the underlying trends in classes of insurance and further fortify Australia's strong regulatory regime.

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[9] ICA Submission to the Study of Financial System Guarantees, Appendix B – Comparison of Policyholder Protection Schemes. Submission available at: http://fsgstudy.treasury.gov.au/content/input_received.asp

[10] Ibid.

[11] Government Discussion Paper on Financial System Guarantees, p. 7.

ICA is of the view that Australia's prudential regime is capable of supporting a guarantee scheme.

Specific details of ICA's position on APRA's standing as a regulator may be found in Section 9, of this submission.

6 Design principles (Question 4)

Question 4 – Comments are invited on the design principles, the associated institutional, product and consumer coverage or the more specific design features outlined in the Davis Report.

ICA is generally supportive of the design principles discussed in Professor Davis' Report, which includes:

- Coverage for general insurance (risk) products that allow consumers to protect against the loss of an asset or the loss of an ability to earn income;
- Coverage limited to retail consumers, the important feature of which is that they have reduced capacity to assess the creditworthiness of insurers. Wholesale consumers would not be covered as they are assumed to have the resources to make an assessment of an insurers capacity to meet their financial promises or otherwise be able to off-load or diversify their risks[12];
- Regulation by APRA as a precondition of membership into any guarantee scheme(s); and
- Limits to the maximum amount of compensation paid and incorporation of a degree of coinsurance (eg. paying 90 cents in the dollar) for certain claims.

The exceptions to these are, as discussed below, that ICA supports payment of 100 percent of the amount properly payable under policies for salary continuance, personal injury including workers compensation and compulsory third party and 90 percent of the amount properly payable under the insurance policy for other types of claims (other lines of insurance) with the potential for an upper limit (a cap) on the amount paid.

Professor Davis also discussed whether to establish different schemes for different sectors or within each sector, rather than an umbrella guarantee scheme.

ICA supports a general insurance limited guarantee scheme funded from within the general insurance industry. ICA would not support a cross-sector guarantee where the consumers of insurance would be exposed to potential losses in other sectors of the industry.

[12] Appendix A of ICA's submission to the Study of Financial System Guarantees dealt with the issue of "retail" and "wholesale" consumers at some length. The submission is available at: http://fsgstudy.treasury.gov.au/content/input_received.asp

7 The costs of a guarantee (Questions 5 & 6)

Question 5 – Comments are invited on the methods, underlying assumptions, and cost projections presented in the Davis Report.

Question 6 – Do you have further information or suggestions that might improve the accuracy and reliability of the results?

ICA has no comments on the technical aspects of Professor Davis' Study.

However, ICA notes the following findings contained in the analysis:

- Scheme costs can be and are greatly influenced by scheme design and preference arrangements;
- Compensation payments under any general insurance guarantee would likely run for 15 years or more; and
- By spreading the funding of a guarantee across the entire general insurance industry, the marginal costs can be greatly reduced.

ICA notes that the Study acknowledges the difficulties associated with calculating an "expected loss" for any given year or a fair price for an option. ICA views this as an additional reason as to why a post-event funded guarantee is the only plausible option as it is only at that time that funding requirements can be accurately and appropriately calculated.

8 The effect of concentrated markets on a limited explicit guarantee (Question 7)

Question 7 – To what extent do concentrated markets present challenges to the viability of any scheme?

That a particular insurer may be the dominant player in a market only serves to reinforce the need for a national (across jurisdictions and insurance classes) post-event funded LGS.

Under ICA's preferred model, post-event funding with members of the guarantee levied according to their market share, market structure is a transient influence on the capacity of any scheme to raise funds.

Should a general insurer collapse there would, initially at least, be some disruption in the market share of remaining insurers, as there was when HIH collapsed. However, over the course of the premium renewal cycle, the remaining industry participants fill the void left by the collapse. Market shares of those remaining grow and the premium base also recovers to pre-collapse levels.

The capacity to fund a guarantee through market share based levies is largely unaffected by market concentration.

9 Funding and pricing a guarantee (Questions 8 & 9)

Question 8 – The Davis Report explored some of the alternative approaches for funding explicit guarantees. Comments are invited on which approach should be favoured, and why.

ICA proposes that the LGS be post-event funded and have the capacity to request funding from all authorised general insurers in Australia. Insurers would have the capacity to pass on any contribution to the LGS to policyholders through the pricing mechanism in a competitive market place.

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

a) Must be determined and agreed, in consultation with the insurance industry, at the time the LGS becomes active following a collapse;

b) Must not put at risk the solvency of a particular insurer or a particular class of insurers, nor should it result in or encourage market distortions in pricing;

c) Must not be subject to Stamp Duty and Fire Services Levy (where they still exist), or GST;

d) The risk of inadvertent signals to the market should not be borne by an LGS. For example, with a risk based approach to the application of a levy, the compensation scheme could send a message to the marketplace that a particular insurer is involved in 'riskier' lines of insurance and is therefore, for prudential or solvency purposes, at risk; and

e) Should be assessed by reference to the likely cost of claims and estimated recoveries from the liquidator.

In light of these principles, ICA considers that the post-event LGS should be funded by a levy imposed on all authorised general insurers to reflect their market share, which is the method applied in most jurisdictions. It would be a condition of an insurer's authorisation from APRA that it pays amounts for which it is levied by the LGS. Enforcement of this requirement could be undertaken by APRA and possibly include sanctions.

A premise of ICA's support for the introduction of an LGS is that all insurance business in Australia be APRA regulated. Should this not be the case, non-APRA authorised insurers who would not required to contribute to the LGS would gain a pricing advantage over those that are. This would need to be addressed to prevent insurance business being transferred to the un-regulated sections of the market to avoid LGS contributions.

To further facilitate the funding of an LGS, and as a part of the package of reforms to strengthen the general insurance industry in Australia, State and Territory taxes on general insurance premiums (Stamp Duty, Fire Services Levy) should be removed.

If a pre-funded industry scheme should be preferred:

ICA is opposed to pre-event funding in any form.

The reasons for this are articulated in our support for a post-event funded general insurance LGS, which appears under Question 8 (continued) below

On what basis should the size of the target fund be set and over what period of time should the target balance be achieved?

What is the appropriate funding base and, in particular, should non-guaranteed products be included in funding base calculations?

Should restrictions be placed on the type of assets in which the scheme can invest?

Should the investment returns remain in the fund or be returned to participating institutions?

What arrangements should be put in place to allow the scheme to borrow in the event of under-funding?

In the event of a failure, how should supplementary levies be applied?

Question 8 (continued) – If a post-funded industry scheme should be preferred, how should the following issues should be dealt with?

The guarantee should be post-event funded by levying members of the scheme. Members would have the ability to pass the levy onto consumers through the pricing mechanism. ICA opposes a funding regime that does not allow the costs of an LGS to be passed onto consumers – the ultimate beneficiaries.

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

a) The recent (and proposed) prudential standards for general insurance significantly reduce the likelihood of an insurer failure occurring.

b) Australia has a very limited history of insurer failures that have caused significant loss to policyholders (with the obvious exception of HIH Insurance).

c) Pre-funding would constitute another permanent levy or tax on general insurance, and would further exacerbate the already high tax burden carried by policyholders in Australia.

d) As insurer failure is unlikely, pre-funding would be likely to see a substantial fund accumulate. Post-event funding would avoid the negative consequences of a large, unallocated accumulation of funds that is a reality of pre-event funding. These consequences include:

- The question of what to do with a large investment that might not be called upon;
- Determining how large a fund would be sufficient when it is inherently difficult to predict the size of a failure and indeed whether such a failure would occur;
- Requiring policyholders to pay for a scheme that may not be used; and
- The potential for funds to be appropriated for other purposes.

e) It is not possible to predict the amount of any shortfall or the complexity of compensation arrangements in advance[13]. Post-event funding would enable a level of funding to be set which reflects the size and nature of the shortfall, and the cash flow needs resulting from that shortfall.

f) A pre-event funded scheme will pose a greater administrative burden to maintain until required. This will include undertaking funds management and collection management. Administration costs are an additional financial burden that can be avoided.

g) Although pre-event funding has the benefit of being readily available, funds for the proposed post-event funded LGS could be made equally available. The LGS should have the capacity to borrow or raise funds and be repaid from future funding contributions from member companies. This system is used in other major jurisdictions.

h) Reduces risk of 'moral hazard'. This position is supported by the Productivity Commission which has stated:

> *'A desirable feature of the HIH Royal Commission proposal is that it involves a post-event levy. This obviates the need to estimate the anticipated cost of an insurer insolvency that has yet to occur and is of unknown probability, to tie up capital for an indeterminate period as well as put in place administrative arrangements to manage the capital. An additional benefit is that it reduces the likelihood of moral hazard among insurers. Moral hazard arises where insurers adjust their commercial decisions in response to the existence of the fund and, in particular, take on financial risks that they would not otherwise have borne.'*[14]

In the event of the failure of an insurer, the funds required to provide a safety net to policyholders should be able to be kept to a minimum. ICA anticipates that recoverable assets, including reinsurance[15], will minimise the size of any unfunded losses that would need to be funded by an LGS in the future.

Should the prudential framework require institutions to provision for their possible future contributions to a scheme?

No. Any levy obligations should operate on a Pay-As-You-Go (PAYG) basis. That is, the market as it exists post-failure will fund them. ICA does not support any situation where insurers would have to carry a provision of an unspecified amount for any possible future insurer collapse. In addition to the problematic calculation of an undefined provision, the cost of that provision would invariably be passed onto policyholders through the pricing mechanism, perhaps for no benefit.

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

[14] Productivity Commission, 2003, National Workers Compensation and Occupational Health and Safety Frameworks, Interim Report, Canberra, October, p. 260.

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

Should the scheme's governing body be able to borrow only from the market, only from the Government or a combination of both?

The scheme should be able to raise funds in the most commercially prudent manner. The underlying asset which would secure loans would be the power of the Government to impose an obligation to fund on APRA licensed (LGS participating) insurers. Insurers would then raise these funds at their own discretion and within the discipline of the competitive market.

ICA recommends that any LGS incorporate a mechanism to allow for medium to long-term smoothing in cash flow requirements, perhaps through the use of commercial lines of credit, with contributions based upon market share and collected PAYG. ICA has explored this issue and determined that a legislative backed levying capacity would suffice for raising commercial loans.

Should a cap be set on how much the scheme can recover from institutions in a year? How would this cap be determined? What is the appropriate funding base?

ICA does not envisage a situation where a cap would be required. ICA research indicates that a significant cash flow requirement for any given year could easily be funded in that year if, as proposed by ICA, contributions are spread across the entire general insurance industry according to market share.

Question 9 – The Davis Report examined some general approaches to setting prices for industry funded explicit guarantees. Comments are invited on which approach should be preferred, and why.

If risk-based pricing is preferred:

What is the best way to determine premiums?

How often should re-rating take place?

Who should be responsible for setting risk-based premiums?

If the guarantee is, as recommended by ICA, post-event funded then risk-based pricing becomes superfluous.

The application of risk based pricing leads to the very real prospect of adverse selection. An insurer may be deemed to be a higher risk owing to the types or terms of the cover it offers. Under a risk-based guarantee regime this presumably would be reflected in some additional impost to the consumer – a "guarantee levy" if you will. Consumers, as they normally would, may compare cover from a number of potential insurers only to find that one insurer has a higher guarantee levy than its competitors and that the additional levy is representative of the additional risk that insurer is perceived to be. Consumers that are "good risks" will invariably insure elsewhere, leaving said insurer with the "not so good a risk" elements of its portfolio. This of course will only serve to exacerbate the problems of the insurer as the quality of its book of business declines.

Regardless of this, ICA opposes risk based contributions and instead proposes that general insurers become liable for a given proportion of the funds payable within any period based upon their share of overall premium within that period (or immediately proceeding period).

If flat-rate pricing is preferred:

ICA and its members support contributions to the LGS based upon market share and oppose risk-based contributions.

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

ICA research indicates that a significant unfunded deficit could be covered by an LGS scheme through a levy based on market share without undue impact on the remainder of the industry or its customers.

How should the scheme deal with the moral hazard problems that may result from flat-rate pricing?

The antidote to moral hazard is effective regulation.

The regulatory reforms that followed the HIH collapse delivered a prudential regime that is already as good as any other in the world. And it will soon be even better owing to the APRA Stage 2 reforms. Combined with the enforcement powers of other commercial regulators (the Australian Securities and Investments Commission and the Australian Competition and Consumer Commission) there is little opportunity for unscrupulous or imprudent corporate management in general insurance.

More specific details of recent regulatory reforms follow.

Is the prudential framework (in particular, capital adequacy requirements) sufficient to mitigate incentives for risk-taking?

As noted, Australian prudential standards for general insurers are world's best practice. ICA considers that any prospect for moral hazard arising from an LGS is effectively mitigated by the strength of Australian prudential oversight.

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

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

The standards covered the following:

- Minimum capital requirement (MCR);
- Valuation of liabilities (including mandatory risk margins and discount rates);
- Risk management;
- Reinsurance arrangements; and
- Transfer and amalgamation of insurance businesses.

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

The new regime took effect on 1 July 2002 and ensures that insurers are appropriately capitalised and that adequate provisions have been set aside for premium and claims liabilities. The new standards mandate sound management procedures, including reinsurance arrangements. The reforms make it much more difficult for an insurer to under price (premium liabilities) or under reserve (claims liabilities)[16], thereby substantially reducing the likelihood of another insurer failure in the future. Though these reforms have been successful, APRA is going further and its Stage 2 Reforms expand upon several of the areas mentioned above, as well as introducing new standards in areas such as corporate governance, disclosure, the role of the approved actuary, financial condition reports, and regulations governing conglomerates.

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

10 Governance arrangements (Questions 10 & 11)

Question 10 – The Davis Report outlined some possible governance arrangements to support an explicit guarantee scheme if one were to be introduced. Comments are invited on which approach should be favoured, and why.

Scheme Governance / pricing and levy setting / asset and debt management

Minister / Department – ICA supports the finding that this is not the preferred alternative.

New Statutory Authority – Given that there is no justification for a pre-event funded LGS (please refer to Section 9 of this Submission), there is similarly no need to establish a new statutory authority. ICA is also of the view that the establishment of a new statutory authority would be an inefficient manner through which to administer the scheme on a daily basis.

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

APRA / or new body within APRA – ICA agrees with the finding that this is not a preferred option. The risk of regulatory forbearance (moral hazard) is too great, even in a country with such strong prudential standards, for the prudential regulator to also be the LGS scheme administrator. ICA's preference is for APRA to remain a vigorous prudential regulator and the industry would not want this compromised in any way by a conflict of interest.

Combined public / private sector body – A hybrid management structure is likely to lead to tensions between the regulator (the Government) and the regulated (general insurers) and this could affect the efficient operation of the LGS.

Industry arrangements – ICA's preferred alternative is that management of the LGS be undertaken by an independent industry body. The potential for moral hazard is mitigated owing to the strong prudential regulation of APRA and this alternative takes best advantage of existing industry expertise in claims management.

Claims assessment and payment

New Statutory Authority – ICA does not support the establishment of a new statutory authority for reasons explained above.

Combined public / private sector body – As earlier mentioned, a hybrid management structure is likely to lead to tensions between public and private sector cultures.

Industry service provision – ICA is strongly supportive of the role of the remaining APRA regulated insurers in providing their expertise to the LGS and undertaking claims assessments and payments in a manner consistent to the commercial practices of an insurer.

Prudential regulation and supervision / failure management / insolvency

New Statutory Authority – In addition to there being no need for the establishment of a new statutory authority, ICA is fully supportive of APRA's ongoing capabilities and exclusive role in this area.

APRA – ICA supports APRA's continued role as a vigorous prudential regulator and, should the need arise again, in failure management and insolvency.

Industry bodies – Upon the collapse of an insurer the LGS will swing into action and, subject to the pre-determined eligibility criteria, act in a manner as close to that of the failed insurer in managing claims. As such, it is appropriate that it be regulated in the same manner by APRA.

Question 11 – What is the preferred allocation of functions among the relevant bodies?

ICA supports:

- Prudential regulation and supervision, enforcement and failure management remaining the responsibility of APRA;
- The role of the appointed Liquidator in managing the assets and liabilities of the failed insurer in the interest of all creditors, including non-insurance creditors; and
- Industry management of the scheme, including:

- Levy determination; and
- Claims assessments and management.

ICA's proposal

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

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

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

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

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

- The general insurance industry has benefited from the experience gained in the establishment of the HCS scheme. It was instrumental in developing and implementing the operational arrangements for that scheme. Accordingly, the industry has in place the existing model structures and necessary experience from which to leverage the establishment an LGS scheme for general insurance in the future.

- Experience derived from HCS scheme indicates that the skills, systems and resources of insurers are needed to deliver policyholder protection arrangements, particularly, in long tail insurance. The key skills that insurers provide are claims management and recoveries, and reinsurance management and recovery.

- The risk that if a regulator, such as APRA, administered the LGS, they could be inclined towards regulatory forbearance (moral hazard) – where there is the potential for the regulator to behave differently to how it would in the absence of such a scheme.

The proposed administrative responsibility largely reflects that of the Canadian[17] and UK[18] LGS scheme administrators.

Managing claims

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

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

The scheme administrator should, as a condition of making a payment under the LGS, take an assignment of a policyholder's rights against the defaulting insurer and, as appropriate, seek recovery (including recovery under reinsurance policies[19]) from that defaulting insurer or a dividend in any liquidation of the defaulting insurer. The scheme administrator should be entitled to those recoveries and hold them for the benefit of the LGS.

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

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

This proposal draws heavily on the industry's experience in managing HCS claims[20].

11 Regulatory implications (Question 12)

Question 12 – Under a pre-funded model, would it be feasible for the guarantee scheme funds to be available to achieve least-cost failure resolutions (for example, a transfer of business) if that might be less expensive than compensating eligible customers in a liquidation?

What regulatory and governance arrangements might be necessary to support least-cost failure resolution?

Least-cost failure resolutions (such as transferring business) can blur the roles of APRA, the liquidator and the LGS as set out in Section 10. In ICA's view, the core activity and purpose of an LGS should be to provide compensation to eligible persons.

APRA and the liquidator have important and distinct roles in assisting companies to resolve and, in some cases, survive financial hardship. ICA believes that the role of the LGS as providing a

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

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

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

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

source and mechanism for compensation in the event of hardship should not be blurred with the role of APRA and the liquidator in resolving the failure of a general insurer.

Guarantee schemes and priority arrangements (for example, depositor preference and insurance 'cut-through' provisions) might be seen as alternative or complementary policy instruments to guarantees for protecting certain stakeholders in the event of financial institution failures.

What are your views on the existing arrangements for depositors and policyholders in Australia?

ICA was instrumental in the establishment of the HCS Scheme and, within the context of the HIH collapse and the existing regulatory framework, continues to support that scheme.

However, for any future (possible) insurer collapse ICA does not support a case-by-case discretionary response. Instead ICA supports an LGS which would provide certainty to policyholders and remove the need for nominal defendant arrangements in the States and Territories.

Australian policyholders benefit from a number of existing arrangements that provide them some preference upon the winding-up of a general insurance company. The recent case of *New Cap Re v Faraday Underwriting* [2003] NSWSC 842, Supreme Court of NSW per Windeyer J determined the following order of priority for the liquidation assets of a reinsurance company:

1. The Australian assets of the general insurer must be used to satisfy Australian liabilities (s116, Insurance Act).

2. Any monies received under contracts of reinsurance that equal or exceeds the total amount payable by the company under the underlying contracts of insurance must be used to satisfy the amounts payable by the insolvent insurer pursuant to those underlying contracts of insurance (s562A of the Corporations Act). Similar provisions are found in state and territory statutory classes legislation (see below).

3. Finally, liquidation assets are to be distributed in accordance with sections 555 and 556 of the Corporations Act.

However, this decision has been appealed by Faraday Underwriting Limited on various grounds. It remains to be seen whether parts of this decision will be overturned on appeal.

The existing arrangements for policyholders are further complicated by the wording of s562A. Whilst s562A may appear to be simple, in practical terms it is not. There are competing views about the proper construction and application of these provisions. On one hand, it has been argued that s562A enables an insured whose underling contract with a general insurer to have direct access to reinsurance recoveries. On the other hand, it has also been argued that s562A provides for reinsurance recoveries to be pooled for the benefit of all creditors who are policyholders. A further variation of this argument is that the section provides for reinsurance recoveries to be pooled amongst those who are reinsured under a specific underlying policy.

ICA takes no particular view on these competing views. It is expected that the application of reinsurance recoveries between different creditors will receive some court direction during the course of the New Cap Re liquidation.

What changes should be made to priority arrangements if a guarantee scheme were to be introduced?

The Study of Financial Systems Guarantees sets out three broad options for revising priority arrangements:

(a) Leave existing priority arrangements unchanged;

(b) Narrow the scope of priority arrangements to apply them only to those liabilities covered by a guarantee scheme; or

(c) Remove priority arrangements altogether.[21]

Of these three broad options for revising priority arrangements, ICA supports option (a). If the existing priority arrangements are retained and an LGS is introduced, then any monies received under reinsurance contracts would be channelled, by operation of the "cut-through" provisions discussed above, to compensate policyholders to satisfy the amounts payable by the insolvent insurer pursuant to those underlying contracts of insurance. Liabilities that do not benefit from the "cut-through" provisions would join the ranks of unsecured creditors pursuant to s555 and would not receive any particular priority under s556(1) of the *Corporations Act*.

As such, persons who are eligible for LGS assistance would benefit from the cut-through arrangements to the same extent as policyholders to whom the guarantee fund does not apply. In practical terms, this means that upon a winding up, an LGS, having paid out claims to those individuals, small businesses, family trusts and statutory scheme policyholders who meet the LGS eligibility requirements, would have the same standing to recover monies received under contracts of reinsurance as would policyholders that do not meet the eligibility criteria.

ICA believes that option (a) delivers the fairest and most workable approach to priority arrangements. ICA holds this view for the following reasons:

- The "cut-through" provisions remain intact. ICA believes that it is of central importance to, so far as possible, respect the legal arrangements made between the parties. The cut-through provisions recognise these underlying arrangements, specifically reinsurance contracts. In some cases, particular policyholders take particular action to secure reinsurance cover. ICA is opposed to option (c) for the reasons same reasons that it supports the retention of "cut-through" provisions.

- Persons eligible for LGS assistance (being, after assignment of their rights, the LGS standing in their shoes) do not receive a priority ranking. ICA supports the LGS as a means by which to distribute the burden of policyholder losses that result from the failure of a general insurer more widely. It is the mechanism by which to spread the losses across a greater number of stakeholders over a longer period of time.

- If persons eligible for LGS assistance (being, ultimately, the LGS standing in their shoes) were to receive a priority ranking under, s556(1) of the *Corporations Act* (being option (b)), then unsecured creditors would shoulder the burden of their loss. ICA believes that this would not be an equitable solution because it would narrow the pool of people shouldering the burden of policyholder losses that result from the failure of a general insurer. There does

[21] Study of Financial Guarantee Schemes at p161

not appear to be a strong policy reason for unsecured creditors to sit behind persons who are eligible for LGS assistance, because those persons have the benefit of an LGS, whereas unsecured creditors do not.

Should general insurance policyholders receive priority above other creditors?

ICA believes that general insurance policyholders should receive priority above other creditors to the extent that they presently receive that priority by operation of the current law. We do not believe that there are sufficient arguments for insurance creditors to stand at an increased priority in relation to other (non-insurance) creditors in a liquidation and even if they did the deficiency of assets would mean that they would not be fully reimbursed, therefore hardship would occur and the need for an LGS remains.

Detailed reasons for ICA's support for the "cut-through" provisions are set out in relation to the above questions.

Could a guarantee scheme provide an opportunity for removing or reducing restrictions on branches of foreign ADIs accepting deposits from retail customers in Australia? Your views may differ depending on whether you think foreign ADIs would be within or outside of the scope of a guarantee scheme.

As this question relates to ADIs and not to general insurers, ICA makes no comment.

The Davis Report notes that certain conditions may need to be met before a national scheme could apply to statutory insurance classes. What implications would a national guarantee scheme have for existing State-based arrangements for compensating policyholders under statutory insurance classes for insolvency-related losses?

ICA supports the introduction of an LGS as part of a package of reforms. That package also includes:

- The extension of benefits of prudential regulation to all areas of insurance and insurance like products (DMFs and DOFIs);
- Removal of taxes and levies; and
- The rationalisation of regulation by making APRA the sole prudential regulator.

As such, ICA's support for an LGS is conditional upon the revocation of the various provisions at a State and Territory level with respect to statutory and other classes of insurance that overlap with Federal regulation.

State and Territory governments attempt to counter insolvency-related losses statutory insurance classes in two ways: directly and indirectly.

The direct method is by way of nominal defendant and nominal insurer schemes that seek to provide a form of guarantee in the event of a failure of a general insurer in statutory classes.

The indirect method is by way of prudential regulation. State and Territory Governments currently regulate the general insurance industry with respect to capital, profit or solvency. For example, under the *Motor Accident Insurance Act 1994* (Qld), the commission establishes prudential standards with which licensed insurers must comply (s10).

The HIH Royal Commission Report noted the link between the direct and indirect methods in its statement:

> "If, for example, a support scheme assumed responsibility for the states' and territories' nominal defendant schemes in respect of failed insurers – but not other aspects of nominal defendant schemes, such as where a defendant cannot be found – there should be a consequent reduction in the need for the states and territories to duplicate the Commonwealth's system of prudential regulation."[22]

ICA supports the view of the HIH Royal Commission. The role that State and Territory Governments have assumed as prudential regulators and nominal defendants should cease to the extent that those roles guarantee against insolvency-related losses.

Would the introduction of a guarantee scheme allow or require changes to other financial sector regulations and arrangements?

The introduction of an LGS would require the Government to carefully consider the following:

- *State and Territory cut-through provisions contained in: Section 235 of the Workers Compensation Act 1987 (NSW); Section 191 of the Motor Accidents Compensation Act 1999 (NSW); Section 103V of the Home Building Act (1989) (NSW); Section 98(3) of the Workers Compensation Act 1958 (VIC); Section 129 of the Workers Rehabilitation and Compensation Act 1988 (TAS); Section 61(3) of the Motor Accident Insurance Act 1994 (QLD); Section 137(3)(c) of the Work Health Act 1986 (NT); Section 40(1) of the Workers' Compensation Supplementation Fund Act 1980 (ACT); and Section 36 of the Employers' Indemnity Supplementation Fund Act 1980 (WA).*

- The manner in which membership of the LGS is to be disclosed to policyholders, perhaps a matter under the Corporations Act.

- The interaction of insolvency provisions in the Corporations Act and Insurance Act.

[22] HIH Royal Commission Report, p294

12 Conclusions

There is a compelling case for the establishment of a general insurance LGS in Australia and a well designed post-event funded LGS introduced as part of a package of reforms would enhance the competitiveness, efficiency and safety of the general insurance industry. Drawing upon the experience of international jurisdictions and utilising our own advantages, such as a strong prudential regulator, Australia can implement a worlds best practice LGS.

As such, ICA supports the establishment of a general insurance specific LGS, which has the following features:

- Compulsory membership and funding (when called upon) for all APRA licensed general insurers.

- Is general insurance specific. ICA does not see the need for, or support, an LGS across all financial services. If however, a cross sector scheme is established, then ICA would like to see a governance structure akin to that of the UK scheme used, whereby schemes for specific industries (eg. general insurance) are siloed under some wider management structure. General insurers and their policyholders should not be required to contribute to a collapse that outside of their industry.

- Is tied to the states and territories getting out of prudential regulation and removing their nominal defendant schemes;

- Post-event funding by way of a PAYG levy on general insurers based on market share.

- Management by an independent industry body.

- Pre-determined eligibility requirements designed the assist policyholders who need it the most.

ICA, on behalf of its members, would be a willing participant in any moves to implement an LGS based on these core principles.