



SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY



March 2014

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EXECUTIVE SUMMARY

- Since the Wallis Financial System Inquiry, the Australian regulatory and supervisory systems have generally preformed well, and insurers' management and business models in particular have ensured that Australian insurance companies are well capitalised, profitable and performed well during and since the global financial crisis.
- While there is no need for an overhaul of the financial sector regulatory architecture in Australia, there are opportunities for targeted improvements to be made in order to increase the efficiency and effectiveness of the financial system.
- Australian governments have recognised that efficient and effective regulation is necessary and desirable to facilitate the smooth functioning of the economy and to ensure that social, economic and environmental aims are achieved. However, excessive, poorly designed and overlapping regulation places a significant cost burden on Australian businesses and consumers.
- Key principles for an efficient and effective financial services system need to ensure there is appropriate balance in the discharge of key regulatory missions of stability, efficiency and competition. As such:
 - It is important that Australian **prudential regulations don't prejudice** the relative ability of Australian general insurers to achieve a commercial presence offshore compared with competitors based in other jurisdictions. e.g. APRA's capital treatment of joint ventures in Asia puts Australian insurers at a disadvantage to international competitors.
 - Regulation must take into account the **difference between the banking, insurance** and other financial sectors. The core insurance business has proven its ability to protect policyholders and absorb shocks from natural and man-made events without posing or extending systemic risk. Insurers do not operate critical financial market utilities that are necessary to payments and clearing systems. In relation to the global financial crisis core insurance activities were not the source of instability in global markets but rather a stabilising force. As such, the systemic risk developments in the banking sector would be a poor guide to what changes are necessary in the regulation and supervision of insurance, given the differences in business models and types of institutions.
 - There is a need for a **rationalisation of prudential regulation** removing overlapping or duplicate requirements in statutory and other classes of insurance currently governed by the States and Territories.
 - The Australian Government needs to ensure that **regulators do not overstep their mandate** and start to develop policy – this clearly is the realm of Executive Government. In recent years we have witnessed a 'creep' in this direction. It is important to reinforce that responsibility for the legislative framework rests not with regulators, but with the Government. **Unwarranted and unjustified intrusion** into business management and significant regulatory overreach with no public benefit need to be avoided.
 - Legislative or regulatory initiatives should protect the **competitive process** rather than a specific market structure or individual competitors.
 - There is a clear economic case for **reducing state insurance taxes and charges** ahead of many other taxes in order to reduce the taxation impost on insurance premiums to businesses and households.

EXECUTIVE SUMMARY (CONTINUED)

- The existence of a sound insurance market that is both **affordable and accessible** is a shared responsibility between the government, consumers and insurers. Affordability must be understood not just as an insurance issue but as an environmental and economic adaptation issue. Driven by **technological advances** the industry trend toward **granular insurance pricing** has many consumer and economic benefits. Artificial premium reductions – either through regulatory intervention or industry led – without a long-term plan to address legacy issues and invest in future risk reduction will only aggravate existing issues.
- The Australian financial system needs to have a regulatory framework that enables insurers, and other financial service providers, to meet the needs of a **digital, empowered customer-centric market**. As regulatory reform can only ever be part of the answer, a multi-faceted financial literacy and insurance education strategy is also necessary.
- **Consumer protection, disclosure and financial advice** are an important part of the framework. However, as has been recognised to some degree since the implementation of the financial systems reforms, a one size fits all approach to disclosure and advice for all financial product classes is not best practice.

INTRODUCTION

The Financial System Inquiry notes the financial sector has served Australia well, it has been transformed by forces such as domestic and international economic and financial crises, a substantial regulatory reform agenda, the growth in superannuation, changes in industry structure, new competitive dynamics, technology, innovation and broader macroeconomic trends.

The Financial System Inquiry presents a timely opportunity to take stock of the regulatory environment impacting the Australian financial services sector since the Wallis Financial System Inquiry.

INSURANCE AUSTRALIA GROUP

Insurance Australia Group (IAG) is the parent company of a general insurance group with controlled operations in Australia, New Zealand, Thailand and Vietnam, employing over 13,500 people (8,759 are in Australia). IAG has more than 762,000 shareholders. IAG's share register is the fourth largest in Australia. IAG is a top 30 ASX-listed company.

IAG's current businesses underwrite approaching \$10 billion of gross written premium (GWP) per annum, selling insurance under many leading brands including NRMA Insurance, CGU, SGIO, SGIC and Swann (Australia); NZI, State and AMI (New Zealand); Safety and NZI (Thailand); and AAA Assurance (Vietnam). IAG also has interests in general insurance joint ventures in Malaysia, India and China. Standard & Poor's has assigned a 'Very Strong' Insurer Financial Strength Rating of 'AA-' to the Group's core operating subsidiaries.

Across IAG's portfolio of brands IAG insurers 8.4 million cars, 2.9 million homes, 103,000 farms, 123,000 employers and 408,900 businesses. IAG had more than 16.1 million policies in force in financial year 2013.

At 30 June 2013 the Group's overall investment allocation remained conservatively positioned, with 86% of total investments in fixed interest and cash (rates of 'AA' or higher). At that date, the Group had:

- total investments of \$13.6 billion;
- technical reserves of \$9.4 billion backing insurance liabilities, invested in fixed interest and cash; and
- shareholders' funds of \$4.2 billion

PREVIOUS REVIEWS OF AUSTRALIA'S FINANCIAL SYSTEM

As the Financial System Inquiry notes previous financial system inquiries, including the Campbell Report (1981) and Wallis Report (1997), were the catalysts for major economic reforms in Australia.

The Wallis Financial System Inquiry (1997) in particular provided a comprehensive investigation into the regulation of the Australian financial services sector. Most notably, it advocated a “principles-based” approach to regulation emphasising competitive neutrality, cost effectiveness, transparency, flexibility and accountability.

The Financial Sector Advisory Council (FSAC) undertook a Review of the outcomes of the Financial System Inquiry (Wallis) in 2003. FSAC noted that the Australian regulatory system is fundamentally well placed to meet the challenges of the future. In its report, FSAC recommended however, that there was scope for the regulatory agencies to improve their exchange of information.

In 2006 the then Australian Government released a report *Rethinking Regulation*. The aim of the Report was to revisit and consider the effectiveness of Australia's regulatory structures and, in particular, any unnecessary burden imposed on business. The Report did not recommend any changes to the ‘twin peaks’ model of financial regulation saying that:

“Australia’s financial and corporate sectors, and the associated regulatory structures, are highly regarded internationally. Moreover, the broad policy framework has widespread support within business and the wider community in Australia.”

While wholesale change was not recommended, the issue of regulatory overlap between Australian Prudential Regulation Authority (APRA) and Australian Securities and Investment Commission (ASIC) was highlighted and subsequently addressed by the passage of the *Simpler Regulatory System Act* in June 2007.

The International Monetary Fund's (IMF) (2012) Article IV *Staff Report and Financial Sector Assessment Program* reports released on 16 November 2012 noted Australia's financial system is sound, resilient, and well managed. Australia is one of the few advanced economies to avoid a recession during the global financial crisis, supported by strong economic fundamentals at the onset of the crisis, a well coordinated response as the crisis unfolded, and a mining investment boom fuelled by a surge in China's demand for commodities.

The IMF stated that the Australian financial regulatory and supervisory framework exhibits a high degree of compliance with international standards and that both ASIC and APRA are extremely effective and well-regarded financial regulators.

THE AUSTRALIAN GENERAL INSURANCE INDUSTRY

According to APRA as at 30 June 2013, there were 121 general insurers authorised to conduct business in Australia. Of these, 98 were authorised to conduct new or renewal business while 23 were authorised only to conduct run-off business. For financial years ended in the 12 months to June 2013, direct insurers earned \$32.6 billion of gross premium inside Australia. The total claims incurred were \$20.8 billion for the financial years ended in the 12 months to June 2013 (APRA). In general, over 97% of Australian insurance claims are paid without dispute.

APRA also noted there has been consolidation in the number of licensed insurers and reinsurers in the market over the past four years (see Table 1). The decrease in the number of licensed general insurers in 2012-13 was due to some insurance groups rationalising licenses acquired through their previous acquisition activities.

Table 1: Industry Structure

CATEGORY	30 JUNE 2010	30 JUNE 2011	30 JUNE 2012	30 JUNE 2013
Number of licensed insurers	118	115	112	109
Number of licensed reinsurers	12	12	12	12
Total licensed insurers/reinsurers	130	127	124	121

Source: APRA.

The Australian general insurance industry is well capitalised and highly competitive, in spite of a low interest rate environment and unprecedented natural disasters over recent years. APRA notes the industry maintained a sound financial position throughout 2012-13. This was driven by strong profitability, particularly in the property classes of business (*APRA Insight, Issue 3, 2013*).

The industry is viewed as having low barriers to entry in short-tail classes of insurance - limited to the national regulatory requirements, including APRA's minimum capital and solvency requirements and ASIC's licensing requirements.

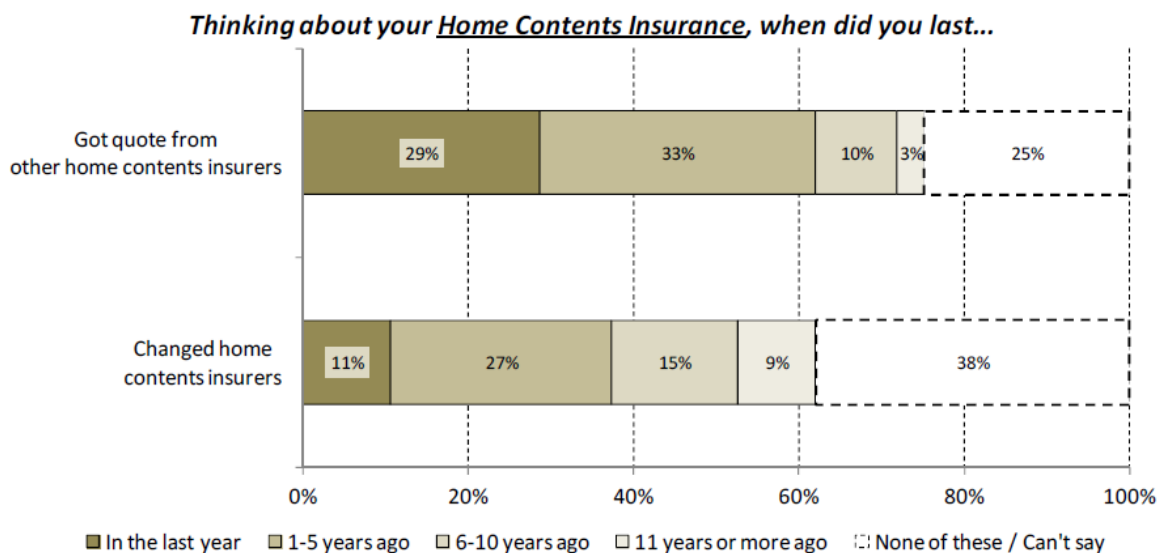
The general insurance market in Australia is relatively mature and sophisticated in terms of product offering and risk assessment and management. The sector is competitive and dynamic with ever increasing transparency of pricing and policy features. It is serviced by a large number of insurers, providing a wide range of offerings to customers. There is intensive price, service and product competition. Customers have access to a healthy range of products from which to choose and they are able to take advantage of special features such as loyalty and multi-policy discounts. The general insurance market is considered to be stable, being a consolidated market that is quite disciplined in risk-based pricing of its products.

APRA notes strong levels of competition are evident in most classes of business. In the personal lines market, the presence of various foreign insurers as well as large retail groups is having an impact as they seek to build market share, particularly in the domestic motor class of business (*APRA Insight, Issue 3, 2013*).

Research showing a significant amount of shopping around and switching by consumers, with around 29 percent shopping around for a quote in the last year and 11 percent choosing to switch insurers (Sapere Research Group and Roy Morgan Research - *Australian Household Insurance: Understanding and Affordability - February 2012*) indicates a healthy and competitive insurance market where consumers genuinely appreciate variety.

THE AUSTRALIAN GENERAL INSURANCE INDUSTRY (CONTINUED)

Figure 1: Insurance Policy Review



Source: IAG commissioned research - Sapere Research Group – Australian Household Insurance: Understanding and Affordability (2012).

New competitors are also emerging from other financial services sectors, notably banks, and also from outside the industry, such as motor vehicle retailers. Price comparison platforms or aggregators are also emerging in Australia. Importantly, APRA note “It is important that aggregators make clear the differences in terms and conditions between policies and consumers do not make a decision based solely on price.” (APRA *Insight 3*, 2013). This issue is outlined further in the consumers and insurance section of this submission.

APRA data indicate the number of insurers writing each class of business varies significantly. For example, the market for comprehensive motor vehicle insurance is serviced by a large number of insurers, providing a wide range of offerings to customers. In this market there is intensive price, service and product competition. Details of the size of the Australian general insurance market are detailed in Table 2.

THE AUSTRALIAN GENERAL INSURANCE INDUSTRY (CONTINUED)

Table 2: Gross Earned Premium by State of Australia (direct insurers) Financial year in the 12 months to June 2013 (\$ millions)

Class of business	NSW/ACT	VIC	QLD	SA	WA	TAS	NT	Total Australia
Houseowners/householders	2,661	1,463	1,683	481	651	137	20	7,095
Commercial motor vehicle	588	425	322	179	250	32	12	1,807
Domestic motor vehicle	2,807	1,829	1,334	502	738	120	25	7,354
Travel	383	156	76	47	59	6	2	730
Fire and ISR	1,492	973	704	224	468	67	21	3,948
Marine and aviation	224	150	107	37	64	12	7	602
Mortgage	257	183	214	49	125	14	11	853
Consumer credit	108	66	82	18	45	8	3	330
Other accident	348	248	194	100	127	17	7	1,042
Other	278	216	179	49	89	9	7	826
CTP motor vehicle	1,997	0	1,061	0	0	0	0	3,058
Public and product liability	746	461	356	172	226	28	9	1,998
Professional indemnity	600	307	230	77	140	15	7	1,375
Employers' liability	338	21	5	13	960	137	94	1,568
Total direct business	12,829	6,496	6,546	1,946	3,943	601	225	32,586

Notes:

Gross earned premium in this table is reported according to the location of risk.

Source: APRA.

REGULATION OF THE AUSTRALIAN GENERAL INSURANCE INDUSTRY

In addition to the competitive market place in which insurers operate, general insurers are subject to the corporate regulatory regime that applies to Australian incorporated businesses generally. This includes the legislative regimes of the *Corporations Act 2001 (the Corporations Act)*, the *Australian Securities and Investments Commission Act 2001 (the ASIC Act)*, the *Competition and Consumer Act 2010* and, for public listed companies, the requirements of the Listing Rules of the Australian Securities Exchange.

General insurers are also subject to a range of industry specific regulations at Federal (e.g. *Insurance Act 1973*, *Insurance Contracts Act 1984* (the Insurance Contracts Act)), State and Territory levels. These regulations subject insurers to prudential supervision. They also deal with aspects of market conduct and consumer protection and the various statutory insurance schemes, which operate in each State and Territory. A detailed analysis of the regulatory arrangements associated with providing insurance in Australia was outlined by the HIH Royal Commission - <http://www.hihroyalcom.gov.au/finalreport/index.htm>.

The main regulatory changes introduced over the last few years for the general insurance sector in Australia were recently outlined by APRA and include:

- “2008: level 2 insurance group supervision, including power to supervise group holding companies and capital requirements for the insurance group. There were refinements in Oct 2011;
- April 2010: requirements for remuneration arrangements that supported prudential risk management;
- July 2010: changes to align prudential reporting more closely with statutory reporting for general insurers;
- July 2010: changes to Maximum Event Retention (MER) for Lenders Mortgage Insurers (LMIs);
- July 2012: consolidated (multi-industry) prudential standards on governance, fit and proper, outsourcing and business continuity;
- January 2013: the introduction of new capital standards under LAGIC;
- 2013: consultation on data confidentiality (ongoing);
- Sept 2013: guidance on data risk management; and
- January 2014: reinsurance counterparty data collection; presently consulting on guidance and reinsurer identifiers” (*Ian Laughlin, APRA to the Insurance Council of Australia 2014 Regulatory Update Seminar*).

The general insurance industry also adopts the Insurance Council's *General Insurance Code of Practice*. Industry self regulation provides a benchmark standard. Once this standard is set, there is a strong incentive for individual companies to exceed the benchmark in order to attract customers and expand market share.

THE IMPORTANCE OF INSURANCE

The ways in which insurance contributes to society and economic growth is summed up by the Geneva Association (2012) as follows:

- “it allows different risks to be managed more efficiently;
- it encourages loss mitigation;
- it enhances peace of mind and promotes financial stability;
- it helps relieve the burden on governments for providing all services of social protection to citizens via social security systems;
- it facilitates trade and commerce, supporting business and economic growth;
- it mobilises domestic savings; and
- it fosters a more efficient allocation of capital, advancing the development of financial services”
(*Geneva Association, The Social and Economic Value of Insurance, September 2012*).

The most significant contribution of insurance to society is the provision of risk sharing, risk transfer abilities and loss prevention measures. General insurance products allow individuals to avoid the financial burden of incurring damage resulting from a specified event. Insurance supports the individual by keeping his/her financial situation stable by decreasing the level of unnecessary (individual) precautionary savings which enables capital to be allocated to higher-return projects. Thus, insurance stimulates investment and consumption by reducing the amount of capital tied up in relatively unproductive areas such as a traditional banking product. Additionally, unlike insurance, savings may not be sufficient to cover losses following an insurable event in which case governments may be called upon to cover the costs.

The private insurance market remains the most effective and economically sustainable solution to ensuring the maximum number of Australians choose to cover themselves for their risks.

THE PHILOSOPHY, PRINCIPLES & OBJECTIVES UNDERPINNING THE DEVELOPMENT OF A WELL FUNCTIONING FINANCIAL SYSTEM

Regulation and Regulatory Frameworks

Regulation and regulatory frameworks play a critical role in shaping the business environment in which economic activity takes place. As the Chairman of Australia's Productivity Commission, Gary Banks (2003) noted:

"Regulation serves a vital role in improving social, environmental and economic standards for Australians. At their most fundamental level, laws — merely a form of regulation — define and enforce property rights, which are the basis for economic exchange. There are also other persuasive rationales for regulation based on the failings of the market. Uninhibited markets can produce undesirable outcomes, such as environmental degradation, unnecessary health hazards, excessive prices and 'unfairness'. By shaping incentives and influencing how people behave and interact, regulation can help societies deal with otherwise intractable problems. At their best, regulations create order, preserve norms and provide a basis for stable progress." (page 2)

The importance of regulation is increasing, as the effects of globalisation and technological development increase, and national economies become more inter-connected and inter-dependent.

As globalisation increases, it is reasonable to expect general movement towards global frameworks to align and improve standards. A consistent regulatory framework becomes even more important. This leads to greater cooperation between global regulators.

The Financial Sector Advisory Council (FSAC) noted in its *Review of the Outcomes of the Financial System Inquiry 1997* (2003):

"Globalisation, convergence and technological change are three important forces that will continue to drive the evolution of the financial system. There is a need for policy development and regulatory structures to keep pace with the inevitable interplay of these forces." (p.1)

"Adherence to a principles-based rather than a rules-based framework is seen as one means of limiting the potential for regulation to impact adversely on investment decisions and market entry"(p.2)

The question is one of **balance**. The difficult task is to strike an appropriate regulatory balance.

IAG appreciates that the Australian Government is mindful of a general policy that has been adopted by successive Australian Governments in recent times, to the effect that where commercial markets, including insurance markets, operate efficiently and effectively on their own, the government should be reluctant to intervene.

In considering the impact - or likely impact - of any government intervention in the general insurance market in Australia, the views of Ken Henry, former Secretary of the Australian Treasury are of note:

"...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

THE PHILOSOPHY, PRINCIPLES & OBJECTIVES UNDERPINNING THE DEVELOPMENT OF A WELL FUNCTIONING FINANCIAL SYSTEM (CONTINUED)

government provision, even government underwriting.” (Ken Henry, Address to the Insurance Council of Australia Conference, 22 August 2002).

As the Finance Industry Council of Australia (FICA) highlighted to the Australian Government's Regulation Taskforce (2005):

“...it needs to be recognised that the success of market economies is built on their ability to respond flexibly and in innovative ways to changing circumstances. Rigid regulations can harm this flexibility. Thus, the presumption should be to intervene only where there is a clear need and to do so in ways that minimise costs and distortions. Wherever feasible, policy-makers and regulators should aim to establish the objectives that the policy or regulations aim to achieve and then design regimes that allow these to be carried out in a flexible rather than prescriptive manner.” (FICA submission to Australian Government Taskforce on Reducing the Regulatory Burden on Business, November 2005, p. 1).

Importantly, the Commonwealth noted in its submission to the HIH Royal Commission:

“...Government regulation is not intended to, and cannot effectively, remove risk for either financial institutions or consumers. There needs to be an appropriate balance between regulation designed to promote financial safety and transparency, whilst still allowing for innovation and the development of new products....” (Commonwealth Submission to the HIH Royal Commission, October 2002).

The Commonwealth highlighted that *“...Risk is an important element of market development, and risk also means that institutions may fail”. The failure of a financial institution may reflect a range of factors, including poor or inappropriate management, exogenous shocks, strong competition or adverse economic conditions.*

The Commonwealth stated that *“...as sound management is encouraged through an appropriate regulatory framework and cannot be legislated, it follows that regulation cannot guarantee absolutely against institutional failure. Ultimate responsibility for the management of a business rests with the board of directors and senior management, not with the regulator or the Government. This is consistent with the Wallis Inquiry view on the extent of regulatory assurances...”*

IAG is committed to the highest standard of corporate governance. Our approach to governance is based on the view that it must be more than just compliance. Whilst we already have the systems to help comply with a multitude of regulations, codes, rules and practices which govern how we operate, we believe the best protection for a company is a healthy risk management culture led by the Board and based on strong values in achieving the company's goals.

Government Assistance

IAG does not support measures that distort the private sector insurance market and results in households who have zero or extremely low levels of risk paying higher premiums to support those living in high risk areas. The price of insurance premiums provides an important signal that can help individuals and communities make decisions about development and risk management. This issue is outlined further in the consumers and insurance section of this submission.

As IAG highlighted in its submission to the Productivity Commission's *Inquiry into Barriers to Effective Climate Change Adaptation*, IAG believes individuals electing not to insure their assets place a burden on the community when governments, in the absence of private insurance, are faced with the position of taking on the responsibility of insurer of “last resort”. While there may be an

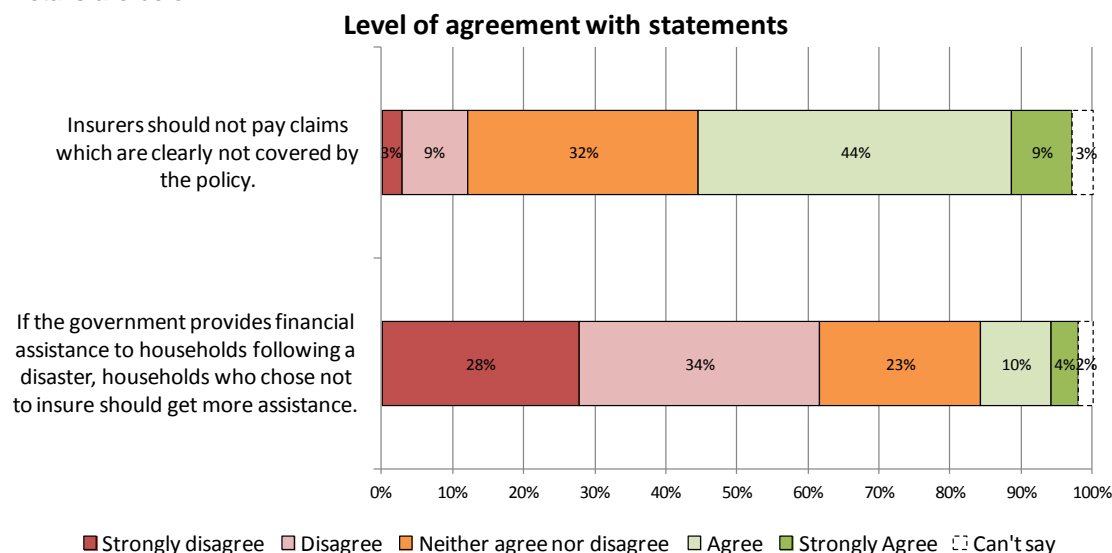
THE PHILOSOPHY, PRINCIPLES & OBJECTIVES UNDERPINNING THE DEVELOPMENT OF A WELL FUNCTIONING FINANCIAL SYSTEM (CONTINUED)

equity argument for individuals who are financially disadvantaged to access government assistance, open-ended assistance is inequitable when it is provided to individuals who are able to responsibly insure, but choose not to do so.

Survey results indicate:

- About 53% supported (agreed or strongly agreed that) insurers should not pay claims which are clearly not covered by the policy while only about 12% disagreed or strongly disagreed with this statement; and
- About 62% were against (disagreed or strongly disagreed with) additional financial assistance to those who chose not to insure while only 14% agreed or strongly agreed.

Details are below.



Source: Full Sample. Population weights used.

Source: IAG commissioned research - Sapere Research Group – Australian Household Insurance: Understanding and Affordability (2012).

Governments need to avoid interventions that promote dependence on government assistance and reduce incentives for self-reliance and personal responsibility. If governments see a need to provide financial support to non-insured, IAG considers that a counter-balancing policy setting, possibly using an income tax measure, is required to ensure there remains continued incentive for individuals to exercise prudent risk management by taking out private insurance.

Competition Regulatory Balance

IAG believes it is essential to ensure that the application of Australia's competition laws remain in step with the competitive pressures faced by the Australian economy and businesses. The fundamental premise that underpins competition policy is that all sectors of the economy should be subject to competition unless it can be shown that there is a net public benefit not to do so. IAG continues to oppose any legislative or regulatory reform that results in legitimate competitive behaviour being prohibited or stymied to protect some businesses from facing fair competition.

IAG cautions against legislative or regulatory intervention, no matter how apparently well intentioned that has the potential to unduly inhibit market influences. Legislative or regulatory initiatives should

THE PHILOSOPHY, PRINCIPLES & OBJECTIVES UNDERPINNING THE DEVELOPMENT OF A WELL FUNCTIONING FINANCIAL SYSTEM (CONTINUED)

protect the competitive process rather than a specific market structure or individual competitors. As the OECD (2011) notes “There is broad agreement among competition agencies from OECD countries that the purpose of competition policy is to protect competition, not competitors” (*OECD, Bank Competition and Financial Stability 2011*).

The consumer regulatory regime has grown substantially since the introduction of the *Financial Services Reform Act in 2001*, and in an ad hoc manner that has added substantially to the cost of the general insurance products without a commensurate increase in protection for customers. This issue is outlined further in the consumers and insurance section of this submission.

While the *Terms of Reference* makes reference to the examination of taxation of financial arrangements that could inform the Tax Policy White Paper no reference is made to the Government’s Inquiry into Competition Policy. It will be important that the Inquiry into the Financial System and the Inquiry into Competition Policy interact as both provide the opportunity to consider the effective timetabling of related or complementary legislative changes to avoid the duplication of effort and facilitate a smoother transition in terms of documentation and related requirements.

INSURANCE AS A SYSTEMIC RISK

Addressing the risks posed by systemically important financial institutions (SIFIs) has continued to be a priority of the international regulatory reform agenda. The Financial Stability Board and the Basel Committee on Banking Supervision (BCBS) were tasked by the G20 with developing a policy framework to address the risks posed by global systemically important banks. The Financial Stability Board and BCBS were tasked with extending the G-SIFI framework to banks that are systemically important in a domestic context (D-SIBs). The G-SIFI framework is also being extended to global systemically important insurers (G-SIIs) and will be extended to insurers in a domestic context as well.

The Geneva Association notes that:

- the core insurance business has proven its ability to protect policyholders and absorb shocks from natural and man-made events without posing or extending systemic risk;
- insurers do not operate critical financial market utilities that are necessary to payments and clearing systems and
- in relation to the global financial crisis core insurance activities were not the source of instability in global markets but rather a stabilising force.

As such, the systemic risk developments in the banking sector or other sectors such as managed funds and investments would be a poor guide to what changes are necessary in the regulation and supervision of insurance, given the differences in business models and types of institutions.

Daniel Tarullo, Member, Board of Governors of the Federal Reserve System noted in a speech on 22 February 2013: *"It is important to take the time to evaluate carefully the actual systemic risk associated with these (insurance) companies, and to understand the amount of such risk relative to other financial firms, before fixing on a list of firms and surcharges. (...) This seems to me a realistic goal over the next six months."*

Moreover, Ben Bernanke, Chairman, Board of Governors of the Federal Reserve in hearings before the House Financial Services Committee in February 2013 noted "...we recognise that there are important differences between banks and insurance companies" He also added, "we have also heard from Congress about this insurance/banking distinction and we're looking at it very seriously."

IAG does not believe there is market failure in the provision of insurance in Australia.

HIH and systemic risk

From an Australian general insurance sector and corporate governance point of view there is a common misconception that the HIH Insurance Group collapse in March 2001 and its aftershocks prompted a reshaping of the Australian general insurance prudential and regulatory framework. In fact, significant legislative change to modify the legislative framework was already underway before the HIH collapse.

However the collapse accelerated reform and change, escalated its perceived importance and public profile, and caused an expansion of the focus on the various aspects of the legal and regulatory framework which were considered to be in need of attention.

In April 2003 Commissioner Justice Neville Owen delivered a total of 61 policy recommendations in the report on the findings of the Royal Commission into the collapse of HIH. The recommendations were broad ranging and addressed issues impacting every level of the prudential, legal, and regulatory regime governing the general insurance industry in Australia. They focussed on:

INSURANCE AS A SYSTEMIC RISK (CONTINUED)

- corporate governance;
- financial reporting;
- the approach of the insurance regulator, the Australian Prudential Regulation Authority (APRA);
- the scope of the principal piece of insurance prudential legislation, the Insurance Act 1973 (Cth) (*the Insurance Act*);
- state and territory regulation of insurance; and
- taxation of general insurance products.

The major policy reform measures reflected many recommendations of the Royal Commission and, in particular, other general insurance reforms that had already commenced prior to the release of the HIH Royal Commission report including:

- increased entry level capital requirement from \$2 million to \$5 million;
- minimum capital requirements more closely linked to the risk profile of individual insurers;
- improved consistency and reliability in measuring and reporting liabilities; and
- the introduction of a Risk Management Standard designed to ensure that an insurer is well managed, has access to appropriate independent expertise and has systems for identifying, managing and monitoring risks.

A noticeable trend has been the drive to harmonise more and more regulatory requirements across the various sectors within financial services. There are some aspects, such as business continuity and fit and proper where harmonisation makes absolute sense. However, in other areas there are fundamental differences in the types of risks faced by life insurers, general insurers, managed investments, superannuation and banks.

IAG remains concerned about the tendency to transfer regulatory concepts from one sector of the financial services industry to another without differentiating between them. While endorsing harmonisation of prudential regulation across financial sectors, the Australian general insurance industry believes that regulators should take account of sectoral differences:

- General insurance has different risk profile to banking and other sectors such as managed funds and superannuation;
- General insurance failures can generally be managed over time. Bank failures occur much faster and have the scope to be more disorderly than insurance failures (there can't be a "run" on an insurance company);
- The failure of a general insurer has less contagion impact; and
- More delayed consequences for the wider economy than of a bank.

PRUDENTIAL REGULATION AND INSURANCE

Need for level playing field – international

The worldwide liberalisation of trade and capital markets has resulted in Australian businesses being increasingly exposed to international opportunities and competition in our home markets. As such, it is vital that Australia has a regulatory framework which allows business to respond to challenges and developments in the international marketplace.

For international companies to continue to operate globally it will be important to ensure that any changes to international regulation of groups lead to reduction or elimination of regulatory overlaps and more efficient and fair operation of global marketplace. More consistent application of regulatory regimes will also mitigate against regulatory arbitrage by larger groups.

It is increasingly important that Australian prudential regulations not prejudice the relative ability of Australian general insurers to achieve commercial presence offshore, compared with competitors based in other jurisdictions such as Europe. A competitive disadvantage is created, for example, when the minimum capital requirements in Australia are significantly higher than those of our competitors.

Regulators should be encouraged to take a global view in their deliberations. It is necessary to ensure that Australian regulators do not impose significant regulatory burden and cost on Australian insurers that undermines international competitiveness. What is needed is an approach to regulation that balances the objective of promoting financial safety with the need to minimise the adverse effects on efficiency, and competition. APRA's consultation in relation to the Review of Capital Standards for General Insurers and Life Insurers (LAGIC) indicated APRA's assessment of IAG's Asian strategy places greater weighting on the associated risk and lower weighting on the economic value of joint venture investments. APRA excludes almost all the economic value of the joint ventures.

APRA's view of joint venture investments is at odds with Australian Government's vision for the growth in the Australian financial services sector and positioning Australia as a leading financial services centre in the Asia Pacific region. Given the current regulatory requirements in the Asia Pacific region generally only allow minority investments as a first step towards ultimate control and ownership, it is likely any expansion will be more financially difficult for Australian insurance companies compared with European or US Counterparts.

Need for level playing field – domestic

The main rationale for prudential regulation of general insurance is one of consumer protection. It also has a role in ensuring that an even playing field is maintained with respect to competition when implementing prudential regulation. Within the general insurance sector, IAG considers that a substantial information "asymmetry" exists, in that policyholders may not be equipped with sufficient information on which to base a decision to insure. The consequences of this are adverse for policyholders if it results in insurance claims not being met. It is unreasonable to expect retail consumers to conduct a detailed review of the financial security of their insurance contract or its provider. They should be entitled to assume a base level of security from all providers of retail insurance operating in the local market.

IAG believes all providers of insurance-like products (e.g discretionary mutual funds) should be required to meet the APRA prudential and reporting standards. IAG submits that this will help develop a level prudential playing field. In this environment, the performance of different entities providing those products is measured on the same basis.

PRUDENTIAL REGULATION AND INSURANCE (CONTINUED)

Regulatory overreach and intrusion

The Australian Government needs to ensure that regulators do not overstep their mandate and start to develop policy – this clearly is the realm of Executive Government. In recent years we have witnessed a ‘creep’ in this direction. It is important to reinforce that responsibility for the legislative framework rests not with regulators, but with the Government.

Similarly, there should be scope for increased co-ordination amongst regulators to ensure that duplication and overlap in regulatory compliance and minimised. For example, differences in definitions, documentation and overly prescriptive compliance and governance requirements which limit the sensible discretions which should be available to responsible Boards and managements should be avoided.

Unwarranted and unjustified intrusion into business management and significant regulatory overreach with no public benefit should be avoided. APRA’s recent consultation process in relation to the issue of confidentiality of general insurance data and changes to general insurance statistical publications is an example of an overly bureaucratic response which has resulted in an unwarranted intrusion into business operations. IAG submits that APRA’s proposal in relation to the release of confidential data go substantially beyond APRA’s legislative remit. IAG believes the release of confidential data will not benefit the public and it will cause detriment to the commercial interests of industry participants.

APRA’s proposals are inconsistent with the approach taken by ASX and ASIC with respect to balancing confidentiality with disclosure obligations. The disclosure and continuous disclosure obligations imposed by ASX and ASIC are designed to protect market integrity and to ensure timely information is provided to keep the market informed. In this process, confidentiality of protected information is strictly enforced.

Regulatory cost

Any regulatory or legislative proposal which will have the effect of increasing the regulatory or administrative burden on business should only be implemented where material or prudential benefits are expected to outweigh the costs. There has been a significant increase in continuing compliance costs over recent years. The costs of regulatory change include:

- Increase in compliance officers required to ensure companies meet regulatory requirements – monitoring is a key component of the work;
- Development and implementation of training resources and materials – may include on line training modules, purchase of software licences;
- Training of staff and authorised representatives – conduct of training sessions;
- Development of incident reporting tools and the monitoring, reporting and rectification of incidents;
- Preparation of manuals particularly for authorised representatives;
- Preparation of documentation specific to regulatory requirements and printing- excluding existing requirements such as the *Insurance Contracts Act 1984*;
- Marketing materials – inclusion of disclaimers, consideration of the nature of the proposed marketing campaign and relevant regulatory requirements;
- Preparation of scripts for telephone sales and inquiries; and
- Audit reporting including retention of auditors, development of processes to support audits, staff and management time.

PRUDENTIAL REGULATION AND INSURANCE (CONTINUED)

For example the costs of the implementation of Financial Services Reform over a period of approximately two years were between \$17 million to \$20 million for IAG.

The aim of financial sector regulation is to reduce the impact of systemic risk and information asymmetry on the stability and efficiency of the financial system. However, an appropriate balance needs to be maintained between the efficiency costs and the benefits to financial safety.

National framework – insurance regulation

While a significant amount of regulatory reform has already taken place in the general insurance sector over the last few years, there is the need for a national regulatory framework. In particular, there is a need for the rationalisation of prudential regulation with APRA being the sole prudential regulator and the States and Territories removing overlapping or duplicate requirements in statutory and other classes of insurance.

Under such a national model, APRA could assume responsibility as the sole prudential regulator. This would obviate the need for State or Territory involvement in setting overlapping or duplicate requirements in statutory or other classes of insurance. This would address the current problem of State based insurance monopolies which are antithetical to the notion of open and competitive marketplace in insurance.

Industry self regulation

IAG believe industry self regulation provides Governments with an alternative flexible approach to regulation. Industry self regulation provides a benchmark standard. Once this standard is set, there is a strong incentive for individuals companies to exceed the benchmark in order to attract customers and expand market share.

Moreover, IAG considers that market forces serve as a powerful and healthy driver of corporate behaviour. Investor demands can influence a company to consider and integrate corporate responsibility; while at the same time those demands can be flexible enough to enable a company to tailor its approach in a way that meets the demand yet suits the company's operation and culture.

IAG contends that effective and robust corporate governance is dependent on corporate culture which values and rewards accountability and transparency and has in place strong and well understood checks and balances. It does not believe that externally imposed rules which are not "owned" by companies and their staff achieve effective governance. Ultimately, boards and management should be responsible for their own cultures and behaviour, and for openness in company governance.

INSURANCE TAXATION

IAG has been a strong advocate for improved taxation bases and taxation reform that see revenue dependency shift from transaction style taxes (for example insurance) towards those taxes that are more efficient.

A number of Federal and State Government reviews and inquiries have argued for insurance tax reform - the IPART Review of State Taxes (2008), the Henry Tax Review (2009), the Victorian Bushfire Royal Commission (2009), the Johnson Report into Australia as a Financial Centre Forum (2009), Tax Forum (2011), Lambert Report (2011), ACT Taxation Review (2012) and the Productivity Commission Report on Barriers to Effective Climate Change Adaptation (2012).

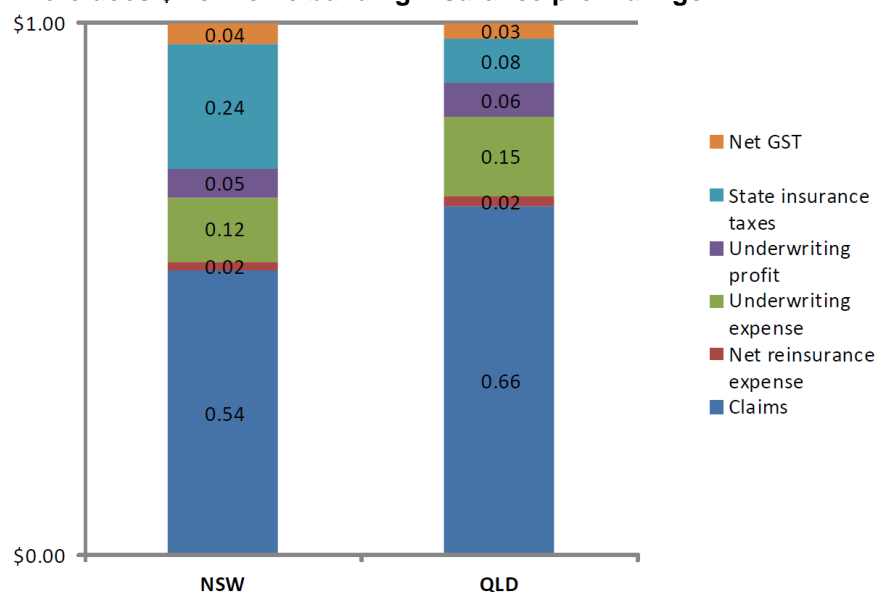
IAG believes the current regimes for the taxation of insurance are inconsistent upon the generally accepted taxation principles of simplicity, efficiency and equity. These tax regimes are inappropriate, regressive and based on historical circumstances rather than equity. These regimes contribute to under-insurance and non-insurance, with consequential negative fiscal impacts when the public purse is inevitably called upon in times of climate related disasters.

IAG argues that there is a clear social and economic case for eliminating or at least reducing State insurance taxes. This case is based on recognition of the essential benefits of insurance to the economy and community generally and of the role of the tax system in encouraging insurance coverage.

State taxes represent a significant proportion of the cost of insurance. A Paper (Justin Douglas, Matt Bowditch, Adam Ni, 2013, *Affordability of Natural Disaster Insurance*) indicates that taxes “represent just over 10 per cent of the cost of household insurance premiums in Queensland and more than one quarter of premiums in NSW. All states currently apply insurance stamp duties. The main reason for the different proportions for taxes between NSW and Queensland is that a large proportion of NSW’s emergency services are funded by emergency services levies on insurers”

Details of the impact of taxes on home building insurance premiums are detailed in the figure below.

Figure 2: Where does \$1 of home building insurance premium go?



Source: J. Douglas, M. Bowditch, A. Ni, *Affordability of Natural Disaster Insurance* (2013).

INSURANCE TAXATION (CONTINUED)

Taxation reform – a case for insurance duty reform

The Financial Industry Council of Australia (FICA) commissioned Access Economics in 2008 to review State taxes and, especially their impact on economic efficiency. The 2008 FICA report detailed a quantitative analysis of the efficiency of individual taxes and a number of revenue neutral tax reform scenarios. The efficiency rankings reported that state stamp duty on motor vehicles and insurance are amongst the least efficient of taxes, generating significant deadweight losses. The Report is available at: <http://www.niba.com.au/tax/resource/Article13.pdf>

FICA commissioned Deloitte Access Economics in 2011 to report on the efficiency of existing State and Federal taxation arrangements. The 2011 study found that State Governments remain heavily reliant on inefficient tax bases. Again, the 2011 study found motor vehicle taxes (specifically, stamp duty on motor vehicles) and taxes on insurance are least efficient while municipal rates, land tax and gaming taxes are most efficient. The 2011 Report suggest that the potential gains from the reform of state taxation are large and rival the gains derived from past microeconomic reforms.

Additional research by Dr Richard Tooth (2011), *Flood insurance: economics and issues* commissioned by Insurance Australia Group highlighted the effect of insurance taxes:

“...is to increase the price of the insurance service for consumers and reduce consumer demand for taking out insurance. This lower demand could be seen in households either choosing not to insure; or choosing to under-insure i.e. reduce their premiums by partly self-insuring”.

The effect of taxes on demand has been estimated by analysing how demand has changed in responses to variations in taxes across jurisdictions and time. The estimated impact (summarised in Sullivan, 2010) of removing the non-GST taxes from insurance premiums is an increase in the number of households without contents insurance by around 300 thousand and an increase in the number of owner-occupiers without home insurance by around 69 thousand” (p.9)

The Henry Tax Review (2009) recommended the following in relation to taxation on insurance:

“All specific taxes on insurance products, including the fire services levy, should be abolished. Insurance products should be treated like most other services consumed within Australia and be subject to only one broad-based tax on consumption.”

The NSW IPART's *State Taxation Review (2007)* noted in relation to insurance duty:

“Insurance duty is a highly inefficient tax that creates disincentives for appropriate insurance. This suggests that the State should seek to reduce its reliance on this duty over the long term.”(p.61)

“Insurance duty is a highly inefficient tax. By adding to the price of insurance, it encourages underinsurance and non-insurance in a market that already exhibits significant market failures. The effect on consumer and business behaviour is amplified because the duty is applied on top of the embedded fire services funding contributions and the GST. The Royal Commission into the collapse of HIH recommended governments throughout Australia review their taxes on insurance.”(p.61)

“The ad valorem nature of insurance duty means that individuals with more assets to protect pay higher premiums, to the extent that the risk related to those assets is the same. However,

INSURANCE TAXATION (CONTINUED)

risk plays a significant role in determining insurance premiums so the link is very weak. Furthermore the equity impacts are confused by the incentive to underinsure.”(p.61)

“In principle the insurance duty should be a reasonably stable source of revenue – the changes in the revenue collected would largely reflect changes in the condition of insurance markets. However, in practice, it may be less robust due to the incentive to underinsure. Furthermore, tax rates have been subject to significant changes.”(p.62)

Similarly, the 2012-13 ACT Budget noted:

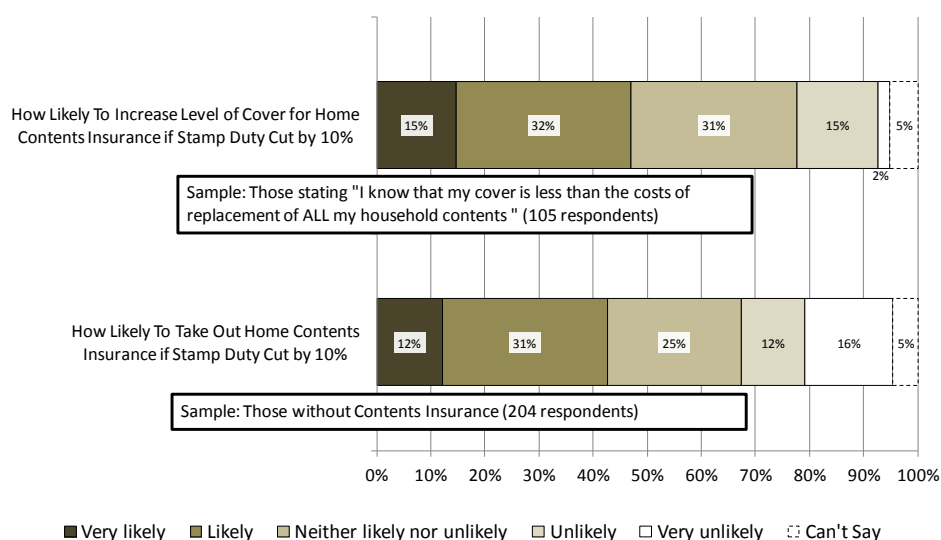
“Inefficient taxes distort behaviour. For example, households and businesses pay a tax on insurance premiums this may – increase insurance costs – result in under insurance – create a disincentive to insure.”

IAG commissioned research (Sapere Research Group and Roy Morgan Research - *Australian Household Insurance: Understanding and Affordability - February 2012*) looking at the level of understanding of insurance and affordability also highlights the case for reform. The survey (1,200 households) seeks to understand household attitudes to insurance, their likely decisions around how they insure in response to affordability pressures and associated outcomes for under and non-insurance. Results indicate:

- 12% of those without contents insurance thought it ‘very likely’ they would take out Home Contents insurance if stamp duty was cut;
- Another 32% thought it ‘likely’; and
- Of those who knew their cover was insufficient, around 15% thought it ‘very likely’ they would increase their cover.

See details below.

Figure 3: Response to cut in stamp duty
Impact of price cut stamp duty



Base: Those with home contents insurance (975 respondents). Household weights used.

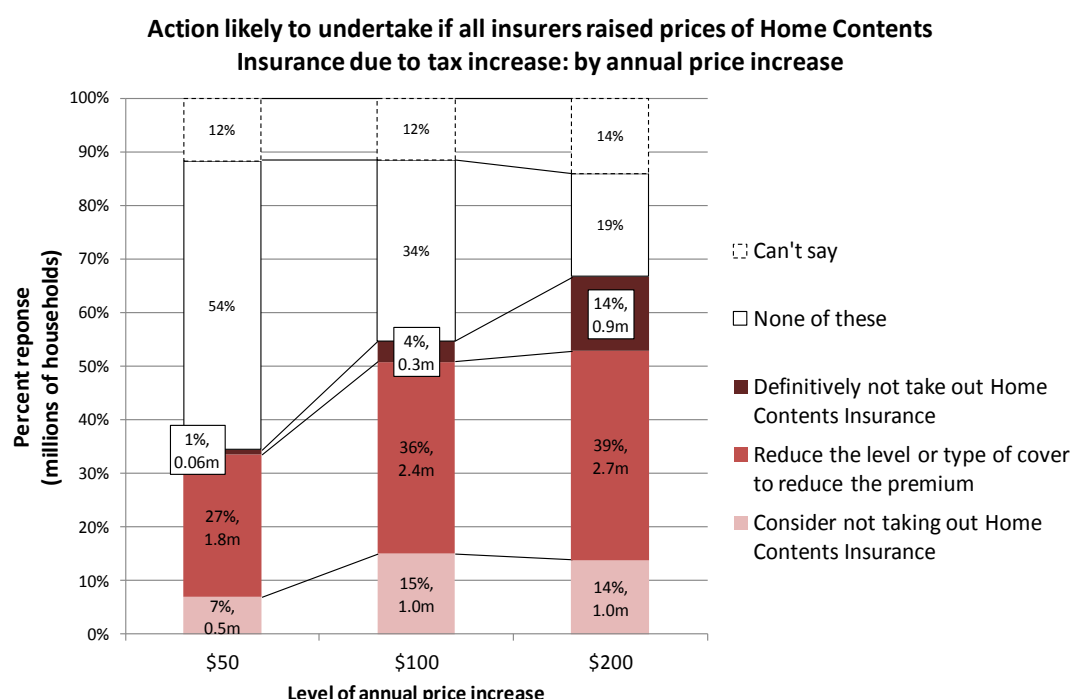
Source: IAG commissioned research - Sapere Research Group – *Australian Household Insurance: Understanding and Affordability (2012)*.

INSURANCE TAXATION (CONTINUED)

To assess the impact of increased taxes on premiums, respondents with contents insurance were asked what their likely actions would be to different price rises.

Results indicate a small price increase would lead to a significant response. For an increase of \$50 per year — in the order of 10% of the average home contents insurance premium¹ — the results suggest an estimated 27% of insured households would choose to underinsure and between 1 and 8% would choose to not insure. Predictably a larger yearly price increase yielded a more extreme response. See results below.

Figure 4: Response to tax increase



Base: Respondents with contents insurance from Full Sample. Household weights are used

1. Respondents could only choose one action.

2. Results are largely insensitive to sample used.

Source: IAG commissioned research - Sapere Research Group – Australian Household Insurance: Understanding and Affordability (2012).

Although 2013 saw the removal of the Victorian fire services levy from insurance from 1 July, the Queensland Government announced an increase in insurance stamp duty rate to 9%. The NSW Government, following a 12 month consultation period, announced a deferral of reform of NSW emergency services funding. The ACT Government, meanwhile, continues its reform with a phase out of stamp duties on insurance leading to complete abolition from 1 July 2016.

¹ No exact percentage can be calculated as home contents and home building insurance premiums are typically combined. Information from the ABS SIH 2009/10 indicates the average household premium was around \$885 per annum. With some premium inflation and assuming the home contents insurance component is of similar magnitude to home building, the home contents insurance premium component is in the order of \$450 to \$500.

INSURANCE TAXATION (CONTINUED)

Federal – State Government financial relations

When the Federal Government announced that it would fundamentally reform the Australian taxation system by introducing a Goods and Services Tax (GST) it also announced that the revenue would go to the States and Territories. The stated intention was that the GST, as a growth tax, would build revenue for State Governments and as a result an opportunity should be created to reduce certain State Government taxes. Under the *Intergovernmental Agreement*, all GST revenue collected by the Australian Taxation Office is provided to the States.

The Henry Tax Review (2009) highlighted:

“...Changes are required to taxes, transfers and other types of expenditures across levels of government. Reforms would also need to be sequenced in a way that allows people to understand the reason for change and how they will be affected. One way to coordinate and implement reforms over time would be through an intergovernmental agreement between the Australian government and the States. A well-managed process would not only allow for poorly performing taxes to be replaced by more sustainable ones, it could also be a mechanism to deliver better policy outcomes across the federation on an enduring basis.”
(p.70)

In relation to **stamp duty on insurance** IAG believes it is appropriate for the Federal and State Governments to examine a new set of undertakings beyond the current *Intergovernmental Agreement* to assist further reform of State taxation. As outlined above, a strong case can be made that reform of insurance taxes should have a high priority.

CONSUMERS AND INSURANCE

Several global and domestic economic, environmental, technological and social developments have had a profound impact on the Australian general insurance industry since the Wallis Inquiry.

Without underplaying the importance of other developments we would like to draw the Inquiry's attention to those that have particular significance for consumers of general insurance and our relationship with our customers.

These include rapid advances in digital technology and communications, the massive growth in data generation, collection and analysis, the increasing cost and impact of extreme weather events, and demographic changes in both age and cultural background.

We have seen substantial benefits for both the industry and consumers including in product innovation, pricing that reflects individual customer risk profiles and rewards risk reduction, and a richer interaction with and understanding of our customers' needs which in turn leads to better customer service.

These developments have also created very real challenges for the general insurance sector from a retail consumer perspective – consumers living in areas of high natural hazard risk are facing higher premiums than they have historically experienced. Further, the high-speed, self-service model encouraged by digital and web-based services arguably undermines the effectiveness of existing disclosure and advice regimes and exposes their limitations.

The consumer impact of these developments and their interaction with the existing regulatory framework/regime will be explored under two key themes:

- (1) Insurance pricing, availability and affordability; and
- (2) Consumer protection and consumer confidence

These themes illustrate the intersecting and overlapping nature of the issues and how they are playing out in the general insurance sector.

Insurance pricing, availability and affordability

The ability of Australian general insurers to understand the likelihood and cost of a large variety of different types of risk at an individual customer level has improved dramatically over the past 10 to 15 years. This has largely been driven by technological advances and will continue as insurers harness the potential of existing and future technologies.

There are significant consumer and commercial benefits as well as broader social and economic policy reasons reinforcing this industry trend. These developments have also contributed to the challenge of ensuring consumers living in areas vulnerable to natural hazards can access affordable home insurance.

Pricing insurance – risk rating

At its simplest, insurance is about transferring risk. General insurers take on their customers risk allowing them to avoid the financial burden of damage resulting from a specified event. Insurers identify, and then manage the costs of these risks to make sure there is enough money coming in through premium payments to meet the cost of future claims as they arise.

Broadly speaking general insurance in Australia is risk rated. In a risk rated insurance market, an insurer calculates the premium payable by a potential policy on the basis of various factors particular

CONSUMERS AND INSURANCE (CONTINUED)

to that individual, such as the risk of a claim occurring, and the value of any such claims during the term of an insurance policy.

The ability to understand the risk of each customer – and to employ that understanding as part of pricing - depends on a variety of factors including the type of product (motor, home, travel), the event covered (theft, type of natural disaster or weather event, injury), the quality of risk information available and the commercial incentive to invest in that capacity.

This is in contrast to community rating where an insurer may not calculate premium on the basis of the risk factors attaching to the particular person wishing to purchase an insurance contract, but rather the risk factors applying to all persons within the market as a whole. In a community rated market, the insurer evaluates the risk factors of market population, and not those of any one person when calculating premiums². In a community rated market those with a lower risk of claiming effectively cross-subsidise those with a higher risk.

In Australia, the private health insurance market is the primary example of community rating. Insurers cannot consider a range of factors that are relevant to the likelihood and cost of claims in determining premiums for individual consumers³.

Historically, pricing in general insurance involved elements of community rating to the extent that some risks were considered to be attributable to each insured within the market at more or less the same rate. For example, a burst water pipe could happen in any house and as there is a more or less an equal chance that any insured could make a claim for the damage, the cost is spread across all insureds. Where data is not available, or the statistical analysis not reasonable to use at an individual address, price was deployed through community rating. The definition of “community” in terms of homogeneous risks will vary.

Factors that influence the pricing of premiums

The retail or commercial premium for an insurance product offered by any given insurer to a consumer will be influenced by a number of factors:

These include:

- Risk rating – each risk is assigned a relativity, depending on how it impacts claims;
- Claims inflation - Post event inflation is contributing to rising costs to repair damages to buildings sustained both during recent events;
- Reinsurance costs– buying cover from other insurance companies to spread the risk from large major event claims;
- Expenses – includes cost of estimating, collecting and managing each insurance policy, government taxes and charges;
- Legislative/regulatory changes; and
- The cost of capital.

Other considerations that may influence the final premium include:

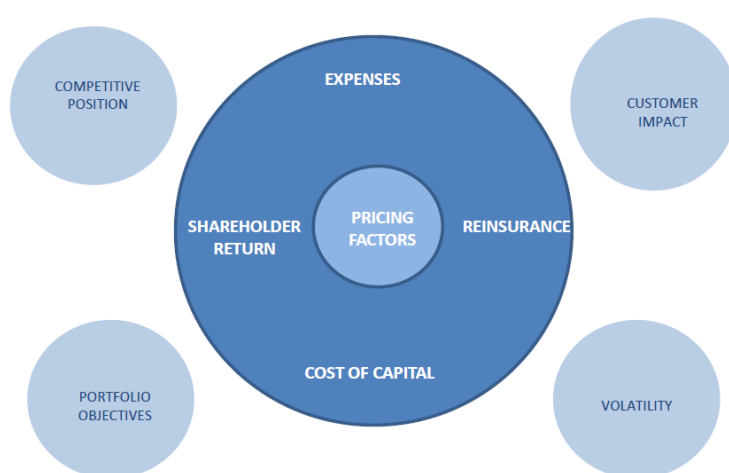
² Neuhaus, Walther (November 1995). "[Community rating and equalisation](#)". *ASTIN Bulletin* 25 (2): 95–118. doi:10.2143/AST.25.2.563242.

³ See www.privatehealthcareaustralia.org.au/news/risk-equalisation-and-community-rating/

CONSUMERS AND INSURANCE (CONTINUED)

- Portfolio objectives (growth or profit);
- Competitive position;
- Volatility (normally measured by risk of natural perils and deviation of underlying risk); and
- Customer impact (for example insurers may choose to adjust pricing based on individual customer impact by applying a cap on premium).

Figure 5: Premium components



Source: IAG Direct Insurance

Notwithstanding these factors, risk rating means that those with a higher risk exposure to a particular event will have a higher price attached to cover for that event.

Advances in understanding risk and granular pricing

Technological advances have contributed to insurers' being able to price more accurately to reflect risk. This has enabled insurers to develop fast, efficient and accurate pricing systems that enable consumers across Australia to access dynamic quotes through their preferred contact channel (online, on the phone or in person).

As collecting and storing data has become more efficient and cost-effective, insurers can collect vast amounts of data on the personal characteristics of policy-holders and their surroundings as well as more general information.

Critical statistical and other information such as claims data has been digitized and is more easily integrated into pricing. The impact of improved access to data, advances in scientific research and digital modeling has been particularly important in understanding natural hazards and other catastrophic risk.

With the technology now available to insurers they can process and analyse data in unprecedented volumes at unparalleled speeds.

Household pricing and location based risk

Building on this technical capacity, IAG prices at the household or address level for personal lines insurance (building, home and contents) for flood and cyclone risk. Some of IAG's other businesses

CONSUMERS AND INSURANCE (CONTINUED)

such as NRMA Insurance also price at the household level for risks such as theft and domestic house fires.

Similarly, we also use location-based factors for motor vehicle insurance to assess and price the risk of collisions. For example, a car owned by a customer who lives near a traffic black spot is more likely to be involved in a collision.

The foundation of this pricing is geocoding – the process of finding associated geographic coordinates (often expressed as latitude and longitude) from other geographic data, such as street addresses, or postal codes.

This is done by accessing a national data-set of addresses⁴ and using geospatial software to attach a coordinate to each property point. Once this is done we are able to assess pricing factors relevant to the location of the property and consider the modeled natural or weather event factors at the address level.

Many insurers are gradually expanding the range and precision of location based pricing factors as new data sets come to hand. (See confidential appendix for further information).

Understanding and pricing the risk of flood

IAG's industry leading approach to understanding and pricing flood risk is an example of how increasing access to accessible data and technologically driven analytical capabilities has resulted in a more granular and dynamic risk rating model.

IAG has deployed household pricing for flood cover across the country – the premiums we offer are based on the specific risk of an individual property. We expanded flood cover to all our home and contents customers across Australia in 2012.

Flood is quite different to other risks in that flood hazard is very specific to the exact location. The flow of flood water across a property and the depth of water can vary greatly between properties located as close as next door to each other. Many factors will influence the potential impact of flooding on any individual property including:

- the elevation of the land,
- the elevation of the property itself and the floor height,
- the location of a property on the parcel of land,
- the size of the property,
- the existence of a flood levee conforming to accepted engineering standards; and
- building materials

Digital technology, particularly the development of digital elevation models through Light Imaging Detection and Ranging (LiDAR) system has been instrumental in improving IAG's capacity to understand how these factors can affect the flood risk of an individual property.

Digital elevation modelling and LiDAR

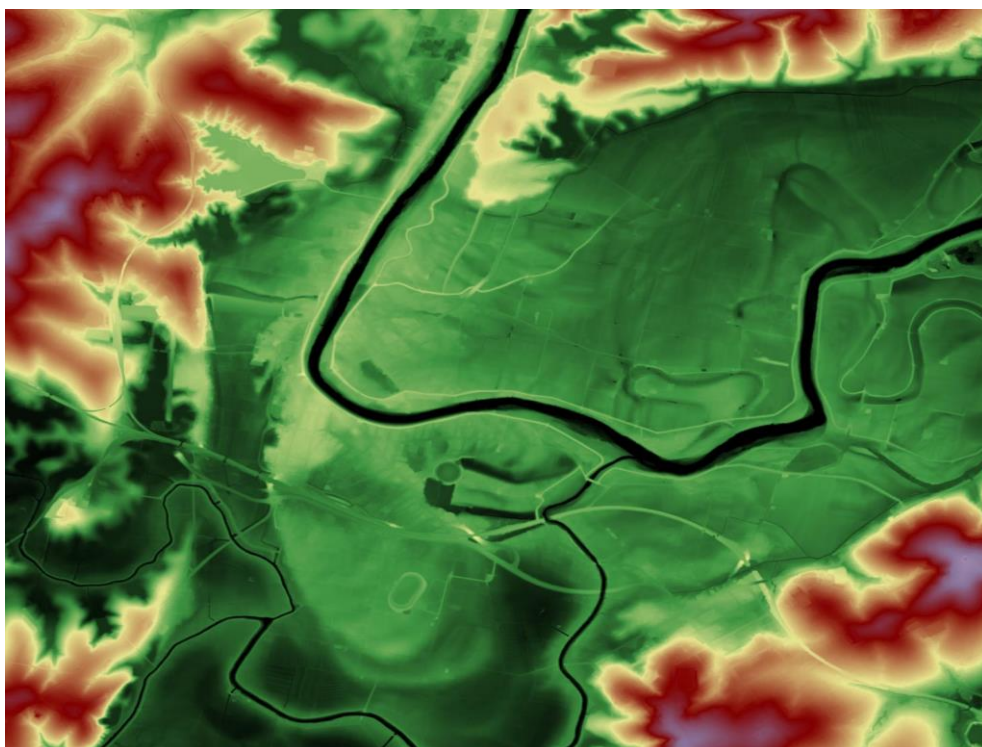
Elevation data is used to understand the topography of an area. The LiDAR system uses aircraft-mounted lasers to scan the earth from a height of a few thousand metres, calculating the distance

⁴ The Geocoded National Address File (GNAF) is the authoritative address dataset for Australia and is produced by PSMA Australia, which is jointly owned by state, territory and Australian Governments.

CONSUMERS AND INSURANCE (CONTINUED)

between the sensor and the ground or other targets including water. It can also be used to scan the floor of rivers, lakes or other bodies of water.

The end result is a digital elevation model (DEM) which describes the shape of the earth's surface – essentially a 3D snapshot for use in computer programs.



The above LiDAR DEM for Maitland shows the extensive system of flood levees and control structures and has enough detail to capture the raised pads that individual farm houses are built on. In addition the highly accurate LiDAR DEM shows low elevations in the middle of the town of Maitland around the highway and railway, indicating areas with the highest flood hazard in the event of levee overtopping or failure.

A DEM is critical in understanding flood risk because the impact of flooding depends on where exactly floodwater flows as it moves downstream through a water catchment. The location of a building or other object determines whether it has any flood risk according to its elevation and the nearby land where floodwater may flow.

LiDAR data can be accurate to several centimetres. It can also provide building footprints and attributes (for example building heights) which can help refine the exact size and location of a building. LiDAR data also has the benefit of showing modifications to the land for example. A new housing estate where the land has been raised above the height of a major flood.

When combined with flood height information from a flood study or other flood modelling, LiDAR data can be used to accurately determine the potential depth of flooding for a house (or whether there is any flooding at all). There is a direct relationship between the depth of flooding and the cost of damage. The cost of the damage increases rapidly according to the depth of the water above the floor and can mean the difference between repairing fences and replacing hot water systems, to

CONSUMERS AND INSURANCE (CONTINUED)

replacing entire kitchens, contents and a substantial structural repair. Some areas only have very shallow flooding, which makes the centimetre-level accuracy of LiDAR data very important.

IAG has invested heavily in sourcing quality data and researching flood risk to accurately understand all the factors involved in flood risk. We have derived data from a large range of diverse and independent sources; and employ publicly available and off-the-shelf technology as well as our own programs to utilise this information.

As our technical capability has improved, the differentiation of pricing even in 'flood prone' areas has become more accurate. We have seen both increases and decreases in premiums for flood cover in specific geographic areas. Properties we assess as being without a flood risk do not pay extra for flood cover.

The data used to price risk is constantly evolving and is driven by technology and competition. Lack of clear data or uncertainty about risk generally leads to a more conservative approach to pricing; that is, insurers will be likely to price risk at the higher end of the spectrum. Having comprehensive and accurate data means insurers will be able to be more certain about the extent of risk they are taking on and can price more appropriately.

User-based pricing – telematics and big data

User-based pricing for motor vehicle insurance built on telematic vehicle tracking⁵ is another key development in granular and dynamic pricing. Telematic technology monitors driver behaviour and vehicle activity – distance driven, speed, time of day, cornering, swerving, braking, speed and acceleration – and transmits this information back to the insurer. Having access to this data allows an insurer to gain a picture of the individual's specific risk profile, based on that individual's actual driving habits rather than broader profiles of risk such as age or gender.

Telematics based products are available in the Australian market but have not yet had the traction seen in other countries such as the United States, United Kingdom, South Africa and Canada. This is partly because of differences in the market – in the UK and US bodily injury and motor vehicle insurance are packaged together⁶ - yet it is expected that there will be greater opportunity for telematics as the cost of technology decreases and consumers become more comfortable with the concept.

'Big data' involves the real-time analysis of large volumes of structured and unstructured data sources. The potential impact of big data on insurance pricing is limitless, subject to privacy considerations and other consumer protection considerations. Today insurers largely use historical data to estimate what might happen in the future. We use prior experiences and observed outcomes to set prices and target customers. Big data and big-data analytics have the potential to provide fully dynamic insurance pricing by using real time information about customer behaviour. It could enable insurers to better determine risk by referencing information drawn from datasets, helping to identify the decisions people make⁷.

Benefits of risk rating and granular pricing

⁵ Telematics refers to the integration of solutions that integrate mobile computing and telecommunications. See Dr Richard Tooth, Director, Sapere Research Group "*An insurance based approach to safer road use*" <http://www.srgexpert.com/Insurance%20and%20road%20safety%20%20-%20Working%20Paper%20Sep%202012.pdf>

⁶ See Ruth Liew "*Holland's the name, telematic cars the game*" Australian Financial Review 11 Feb 2014 p 24

⁷ See Phani Nagarjuna, "*The big data approach to telematics insurance*", Insurance & Technology <http://www.insurancetech.com/business-intelligence/the-big-data-approach-to-telematics-insu/240164351>

CONSUMERS AND INSURANCE (CONTINUED)

Technological advances have given general insurers the capability to implement more accurate and granular risk based pricing. There are also significant consumer and commercial benefits as well as broader social and economic policy reasons reinforcing this industry trend.

User pays approach

The improved capacity to understand risk means general insurers are increasingly able to attribute costs previously spread across a large number of customers to a smaller group or particular customer. This reduces cross-subsidisation and ensures those customers exposed to risk, bear the cost of that risk. Address level pricing for flood cover is an example of this principle in practice.

This can be contrasted with the March 2011 European Court of Justice decision that determined that gender-based discrimination was no longer legal. As a result the cost of comprehensive car insurance for a first time female driver in UK has risen 104% since the Court's decision while the same insurance for a first time male driver has fallen by 27%⁸.

The growth of big data and technology such as telematics will push this concept further as insurers are not only able to more accurately predict risk at an individual level but 'know' risk. There will be less reliance on statistical and demographic risk factors and reduced information asymmetry between insurers and consumers.

From a consumer perspective it is important to acknowledge that there are 'winners and losers' from risk pricing. As the cost is shifted from less risky to more risky consumers, issues around access and affordability begin to emerge. We have seen this in the context of coverage for flood and other natural events and will explore further below.

Sustainability of our business and stability of the Australian general insurance market

An insurer pricing at a community (for example suburb) level could be significantly disadvantaged if competitors are pricing at individual risk address, particularly for large catastrophic exposures such as flood. It also threatens the ongoing sustainability of cover for hazards like flood and the market more generally if the process of adverse selection is taken to its logical conclusion.

For example in Figure 6 the competitor wins the lower risk business, the insurer without capability wins the higher risk business but is not appropriately pricing the risk. This leads to deterioration in risk selection and further price increases.

⁸ Sunday Times 17 February 2013 referring to research by insurance broker Chill.ie

CONSUMERS AND INSURANCE (CONTINUED)

Figure 6: Home Pricing Example



Closer alignment of price to risk is also in line with our prudential obligations to ensure that adequate reserves of capital are held against all insured risks.

Insurers are under pressure from global reinsurers to more closely align premiums with risks particularly for weather related events as they are increasing in cost and frequency. A recent trend for insurers is to allocate the cost of reinsurance to particular insurance policies on a risk-weighted basis rather than by simple apportionment.

In Australia, there has been an upward trend in natural disaster costs, particularly since 2000 (Figure 7). At present, the total economic costs of natural disasters in Australia are estimated to average around \$6.3 billion per year. In real terms, this total is forecast to grow by 3.5% annually. This is primarily due to the likely impact of further population growth, concentrated infrastructure density, and the effect of internal migration to particularly vulnerable regions. With this growth rate, the annual total economic cost of natural disasters in Australia is expected to double by 2030 and reach \$23 billion in real terms by 2050⁹.

The expected future costs of natural disasters highlight the need for governments to invest further in resilience measures. As the government does not currently account for future disaster costs in the forward estimates, it is difficult to recognise the true cost advantages of building resilience. *Building our Nation's Resilience to Natural Disasters* shows that the budgetary impact of responding to and recovering from natural disasters could potentially be significantly reduced through carefully considered and directed investment in pre-disaster resilience.

A simple cost-benefit analysis demonstrates how government funds would be saved in the long run by bringing forward expenditure on natural disaster recovery and placing a greater level of investment in pre-disaster resilience measures. Assume, for example, that carefully targeted programs of resilience expenditure in the order of \$250 million per annum achieved an overall Benefit-Cost Ratio (BCR) of around 1.25. This implies that this program of expenditure would incur costs in the order of \$5.3 billion over the period to 2050 (present value terms) but would generate

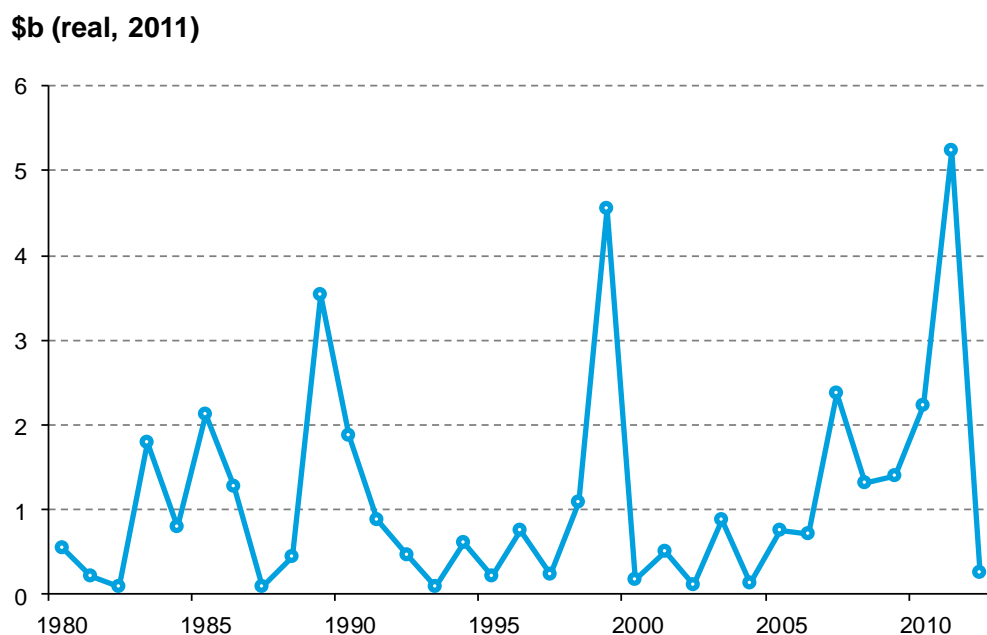
⁹ Australian Business Roundtable for Disaster Resilience and Safer Communities commissioned Deloitte Access Economics Report "*Building Our Nations Resilience to Natural Disasters*" 20 June p 19

CONSUMERS AND INSURANCE (CONTINUED)

budget savings in the order of \$12.2 billion for all levels of government (or \$9.8 billion when looking at the Australian Government budget only). If successfully implemented, this intervention could see Australian and state government expenditure on natural disaster response, fall by more than 50% by 2050.

Importantly, there are a number of factors contributing to the increased economic and community impact of natural perils. We are seeing marked increases in population density, especially in areas that are prone to natural disasters (particularly around coastal areas), leading to more damage and a rise in the quantum of damage. The increasing value of building and contents and sub-par building standards, also contribute to a rise in the cost of natural disasters.

Figure 7: Australian insured costs of natural disasters, 1980-2012



Source: Australian Business Roundtable for Disaster Resilience and Safer Communities commissioned Deloitte Access Economics Report “Building Our Nations Resilience to Natural Disasters” (2013).

Price signalling - encouraging risk awareness and reduction at individual, community and economy wide level

The price of insurance premiums provides an important signal that can help individuals and communities understand their exposure to a range of risks and provide an incentive to implement preventative and protective measures to reduce their vulnerability. Any distortion of this signal through community rating, or hidden subsidies, will work against good risk management, and act to discourage product innovation by insurers. There is significant moral hazard involved with very low risk or zero risk subsidising the costs of those with high risk.

For example, at an individual level the price of motor insurance can create an incentive to reduce risk by purchasing a safer car which in turn reduces the societal cost of road accidents.

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At a community level, risk based premiums for home insurance can assist in ensuring the potential impact of natural hazards and other risks are a priority consideration in planning and development decisions.

Further, short term benefits such as decreased building costs need to be balanced against long term costs such as the cost of reconstruction and recovery and higher insurance premiums over many years. The price signal helps make these trade-offs clear and enables informed decision making about the level of risk a community is willing to tolerate.

Recent government investment in flood mitigation programs in Queensland towns repeatedly flooded between 2009 and 2013 (including Roma, St George and Charleville) also offers an illustration¹⁰.

In these towns where flood mitigation projects (e.g. building of flood levees) have been completed, insurers are now able to reduce their premiums to reflect the reduced risk exposure in those areas. More importantly, these communities will be less exposed to the social and economic disruption caused by flooding and there will be less and less frequent, public expenditure on rebuilding these communities after an event. In a community rated market, this action may not have been taken.

Product features and access

Insurers are able to offer new cover for weather related events as we now better understand the risk and can price it. In Australia flood cover is the primary example of this. Prior to 2009, flood data was so poor that flood risk was effectively uninsurable. Now 93% of all home building and/or contents policies have flood as a standard feature¹¹. This would not have been possible without vast improvements in understanding flood risk at a household level and the ability to deploy that understanding. Cover for other natural perils including storm surge is also likely to become more widespread as insurers have more confidence in their ability to understand their exposure and price the risk.

Big data and user based insurance will also improve the opportunity for insurers to create more closely tailored or bespoke products that meet the specific risk profiles of our customers. Telematics based risk pricing can improve accessibility for those drivers otherwise assessed as very high risk. An insurer might not be willing to offer a premium based on the age, sex or driving record of an insured but if able to track and monitor behaviour the insured is given an opportunity to reduce premiums. Telematics in motor insurance is likely to create an opportunity for those with a high risk to change their behaviour and ultimately become low risk drivers.

The future of risk rating

Insurers must continue to innovate and ensure they have products that adequately reflect new and emerging risks. If insurers lose touch with the risks affecting their customers, more people will take the risk by opting out of insurance. This would have an economic impact beyond the insurance industry and would ultimately harm the economy. As a consequence, governments would be increasingly pressured to intervene and assist individuals following economic loss.

Granular and dynamic pricing will only become increasingly more sophisticated as insurers access new technologies and datasets, and build on their analytical capabilities. This could ameliorate at least some of the issues we are seeing around affordability and accessibility discussed below. That

¹⁰ Federal, State and local governments have committed over \$32 million in flood mitigation programs for these three towns which include both flood levees and other mechanisms such as house raising.

¹¹ See Insurance Council of Australia Aggregated Flood Policy Data as at May 2013
<http://www.insurancecouncil.com.au/industry-statistics-data/flood-cover>

CONSUMERS AND INSURANCE (CONTINUED)

said, it is also expected that further advances in the industry's ability to understand, assess and predict risk – fuelled by the growth in big data– will exacerbate the situation for some consumers. The current capacity and appetite to invest in and use this granular pricing varies across insurers. It is clear, however, that the market both in Australia and internationally¹² is heading in this direction and is unlikely to turn back.

Affordability and availability of general insurance in Australia

Over the past three years, the shift toward data driven risk pricing combined with other factors has generated significant and rapid premium increases for home and building contents insurance (as well as strata insurance) for some consumers in specific geographic locations across Australia.

In the years immediately following the series of major disasters of 2010-11, substantial industry wide premiums increases were seen across the market.

These were largely driven by insurers responding to increased cost pressures such as reinsurance, natural hazards claims costs and claims inflation that occur after significant weather events.

This also coincided with the extension of flood cover throughout the market in 2011 and 2012 and various insurers reassessing their exposure in and level of appetite for certain markets particularly those exposed to natural hazards.

For some consumers, the confluence of these events saw premiums rise at a speed and to level that was both unprecedented and unexpected.

Lack of strategic investment in disaster mitigation – or the failure to reduce the impact of natural hazards – in vulnerable communities has also been a major contributor to higher premiums.

North Queensland Case Study

North Queensland has experienced a number of high frequency, high impact events including; Tropical Cyclone Larry (2006), Tropical Cyclone Yasi (2011), Storms and Floods of Oswald (2013), and the Mackay Floods (2008). While Queensland has long been exposed to natural hazards, the frequency of extreme weather events and their level of destruction appear to have risen significantly since 2006.

The Australian and Queensland Governments have incurred over \$7.5 billion in reconstruction and recovery costs related to the 2010-11 Queensland floods and Cyclone Yasi¹³. Insurers have paid out more than \$3.7 billion to policyholders for the same events.

NQ is more vulnerable than any other part of the country to extreme weather events such as cyclone, storm and flood. Insurers have had to increase premiums to offset the costs of covering these weather events. While NQ represents less than 2% of the national home insurance market, it has been a source of significant claims payouts by insurers in recent years.

¹² See "Data: A Smarter Approach to Flood Risk: Sam Barrett The Post 4 March 2014

¹³ Queensland Reconstruction Authority Strategic Plan 2012
<http://www.qldreconstruction.org.au/u/lib/cms2/strategicplan-2012.pdf>

CONSUMERS AND INSURANCE (CONTINUED)

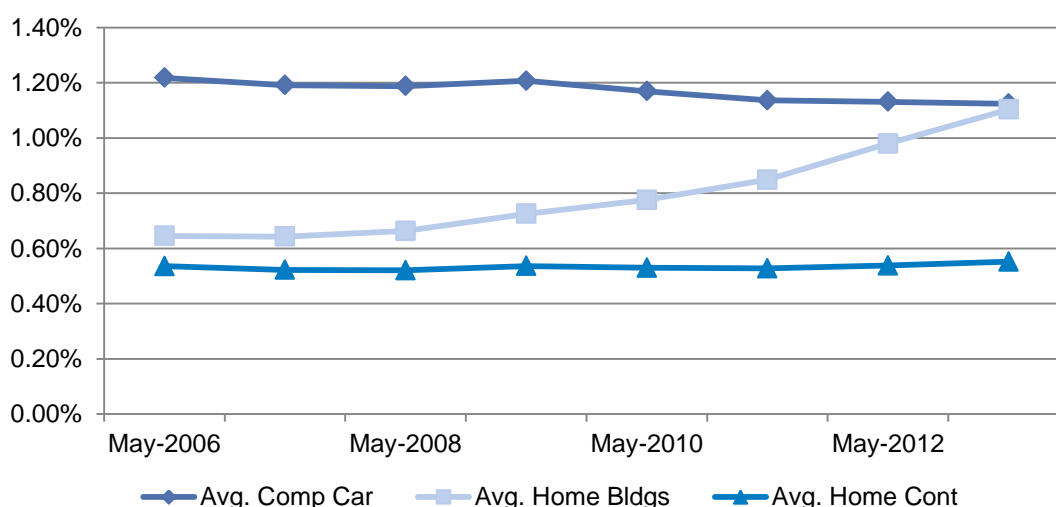
While North Queenslanders have endured a significant number of extreme weather events over the past years and as such have felt the brunt of insurance premium increases, overall there are a number of factors including a steep rise in reinsurance costs that have combined to increase insurance premiums.

The impact of the premiums increases has generated community concern and public discussion around the affordability of insurance, and what should be done to address the issue. Before the issue can be effectively addressed, however, it is essential to more clearly identify and articulate the scope of the problem.

Understanding the affordability issue

The evidence suggests the issue is mainly limited to home insurance (with strata insurance in North Queensland being another major but separate concern). Based on the below information, we see significant premium increases only in the home insurance product, with motor and home contents insurance remaining relatively stable in comparison. As at May 2013, the average cost of home insurance still represents only 1% of the proportion of annual income across the country.

Figure 8: Insurance cost as a proportion of annual income



Source: IAG, based on Insurance Statistics Australia data.

General insurance products are largely available and affordable to the majority of the Australian community as such IAG does not believe there is market failure in the provision of insurance in Australia.

Historically, home insurance premium increases have been lower than CPI, with increases above the CPI only occurring in the last few years (*Refer to Confidential Appendix – to be provided*). Although there has been a significant increase in premiums in the last few years, the average home insurance premium when compared to other household expense remains relatively affordable (\$11.33 compared with total household weekly spend of \$1236.28).

CONSUMERS AND INSURANCE (CONTINUED)

Table 3: ABS Household Expenditure 2009-2010 (latest available)

EXPENSE (SAMPLE)	HOME INSURANCE	HOME REPAIRS	FUEL & POWER	FOOD	ALCOHOL	TOBACCO	HOUSEHOLD SERVICES	MV INSURANCE	PERSONAL CARE
\$per week	11.33	23.04	32.52	204.20	32.35	12.57	69.93	12.31	24.06

Source: ABS: 6530.0 Household Expenditure Survey, Australia: Detailed Expenditure Items, 2009-10.

While flood cover was extended to the market during the same period, the overall cost impact of this industry wide development across all insured consumers was minimal.

Although non-insurance and underinsurance have been enduring problems with little improvement over the last 10 years, they cannot be entirely attributed to affordability. The IAG commissioned research on household insurance in 2012 indicated that non-insurance is highly correlated with non-insurance of parents and also family and friends, suggesting that cultural factors (and, possibly, language barriers) are part contributors to non-insurance¹⁴.

A comparison with motor insurance also demonstrates that affordability is not the only consideration when purchasing insurance. Although motor insurance is more expensive (home insurance as a proportion of annual weekly earnings remains less than motor insurance), consumers have less underinsurance on their motor vehicles compared to home and contents.

However, it is clear that there are segments of the population where affordability is the primary barrier to accessing insurance. A proportion of the Australian population has long been excluded from mainstream financial services, including insurance. In 2011 approximately 17.2 percent of the adult population was excluded from financial services with 18.9 percent not having access to general insurance (home contents and comprehensive motor)¹⁵. A 2011 study by the Brotherhood of St Laurence also demonstrated that levels of non-insurance among low-income Australians are well above the national average¹⁶.

Recently a second group has emerged – those with significant exposure to natural hazard risk who previously have been able to access home insurance cover but are now finding it increasingly difficult.

What we have seen is sharp premium increases for some consumers in areas of exposure to natural hazards and weather risk. The focus has been on flood as it is a relatively new product for many insurers and the first step to granularity of pricing is the most acute. It must be reiterated that increases for flood cover have not been uniform. Some consumers have actually seen premiums decrease as granular pricing has shown that exposure to risk even in a natural hazard area is actually lower than previously thought (particularly for NRMA Insurance customers in NSW where flood cover has been available as an opt-out feature since 2009).

We have also seen some insurers withdraw from or red-line geographic areas as they have readjusted their risk appetite. In some instances, this has reduced the range of brands and products available. We note that IAG businesses do not red line any parts of Australia.

¹⁴ Sapere Research Group and Roy Morgan Research - *Australian Household Insurance: Understanding and Affordability* - February 2012

¹⁵ Measuring Financial Inclusion in Australia, The Centre for Social Impact for National Australia Bank, May 2012

¹⁶ Collins D 2011 *Reducing the Risks, Improving access to home contents and vehicle insurance for low income Australians*, Brotherhood of St Laurence

CONSUMERS AND INSURANCE (CONTINUED)

IAG understands that accessing affordable insurance is a very real issue for some Australians and is a priority cost of living issue for policy makers. Further the impact of large scale uninsured losses to communities, Government budgets and the Australian economy is substantial and will worsen.

Reducing risk and increasing resilience – long-term solution

For those consumers in this emerging second group, the long-term most sustainable way to reduce premiums is to reduce the impact of these natural hazards and disaster events. Increasing weather volatility and demographic consolidation in areas of most risk underscore the need to take a long view.

This requires a sustained, coordinated and collaborative national approach based on shared responsibility among all stakeholders including Government at local, State and Federal level underpinned by:

- improved understanding of natural hazard risk – ensuring vulnerable communities have contemporary information, making it publicly accessible and using it to inform decision making. This information has significant economic value, as it reduces risk, will benefit planning authorities, developers, banks and financiers and allows insurers to underwrite the risks with maximum certainty;
- greater risk sensitivity of land use planning – risk appropriate new development in high-risk areas and addressing legacy issues through coherent and well-funded relocation and other strategies;
- Increased resilience of our buildings – through building codes, retro-fitting and other mechanisms; and
- boosting investment in mitigation infrastructure – to address residual risk that cannot be addressed through land use planning and where the benefit outweighs the potential cost to the community.

IAG supports the government's announcement that it will ask the Productivity Commission to conduct an inquiry into disaster prevention and recovery funding arrangements¹⁷. This is in line with the recommendation arising from the Commission's Report on Barriers to Effective Climate Change Adaptation. Each year an estimated \$560 million is spent on post disaster relief and recovery by the Australian Government compared with an estimated consistent annual expenditure of \$50 million on pre-disaster resilience: a ratio of more than \$10 post-disaster for every \$1 spent pre-disaster¹⁸.

IAG continues to demonstrate its commitment to influencing policy outcomes and investing in risk awareness on a number of fronts including:

- Founding the Australian Business Roundtable for Disaster Resilience and Safer Communities;
- Being the only major insurer to join the Floodplain Management Association;
- NRMA Insurance piloting flood and insurance education programs in high flood risk communities in NSW;
- CGU and NRMA Insurance partnering with the Queensland Government on its 'Queensland Get Ready' disaster resilience and preparedness campaign; and
- CGU's strata insurance project to assist residential strata insurance affordability in North Queensland (see below for details).

¹⁷ <http://www.ministerjustice.gov.au/Mediareleases/Pages/2013/Fourth%20Quarter/20December2013Governmenttointroducenewinquiryintonationaldisasterfundingarrangements.aspx>

¹⁸ Australian Business Roundtable for Disaster Resilience and Safer Communities commissioned Deloitte Access Economics Report "*Building Our Nations Resilience to Natural Disasters*" 20 June p 19

CONSUMERS AND INSURANCE (CONTINUED)

Options for increasing affordability– cooperation v intervention

IAG's businesses are addressing the issue of affordability and emerging risks on multiple fronts. IAG supports joint industry-government action to consider how to assist consumers dealing with affordability and availability issues and develop a national plan for investment in disaster resilience. We are focusing on providing practical solutions for customers while ensuring we maintain the most appropriate price for the risk.

For example, CGU is implementing a project to fund independent building risk assessments by a certified engineer for all the strata properties it and its wholly owned subsidiary Strata Unit Underwriters (SUU) insures in North Queensland. The assessments will cover risks such as building construction type and method, exposure to direct wind-driven rain, as well other hazards and possible defects.

Following completion of each building assessment, insureds will be provided with a list of the recommendations on the repairs required to improve the property's resilience and risk rating, enabling these properties to potentially be re-priced so that customers receive sustainable premium discounts. The findings from the project can then be shared with government, councils and other interested stakeholders to improve knowledge and awareness of building codes, materials, and other mitigation, all of which impact insurance premiums. There are also important spin-offs from this project through its broader contribution to community resilience, returns on investment, and sustainable property values.

More broadly, IAG believes that we must proactively seek to understand how the risk environment is changing, so our products are appropriately designed and priced.

We also recognize that reducing the impact of natural hazards may involve significant costs – economic, social and political – particularly in areas with severe legacy issues and that it may not be possible/feasible in some circumstances. In these circumstances options such as means tested government subsidies may be appropriate.

However, artificial premium reductions – either through regulatory intervention or industry led – without a long-term plan to address legacy issues and invest in future risk reduction will only aggravate existing issues. A knee jerk regulatory response could undermine the benefits of risk rating and distort the market in a way that threatens the stability of the general insurance sector and is contrary to risk pricing and danger signaling.

Pricing transparency and community education

IAG understands the emergence of granular pricing and recent premium increases have had an impact on some parts of our community and has generated public concern. The general insurance sector has perhaps been found wanting in explaining why and how this is happening. IAG businesses will take steps to be more proactive and transparent in its communication with consumers around pricing and premiums as well as the value of insurance. We explore this further in the context of consumer protection in the section below.

The way forward

Affordability must be understood not just as an insurance issue but as an environmental and economic adaptation issue. Consequently, the policy response must go beyond insurance and also focus on prevention. More and cheaper insurance products will not prevent natural disasters from occurring nor will it stop communities from being devastated by these events. Continuing

CONSUMERS AND INSURANCE (CONTINUED)

government handouts will not address the root cause of inappropriate mitigation awareness and expenditure.

Consumer protection and consumer confidence – disclosure, advice and education

The Australian general insurance sector has a strong record in consumer protection under the post Wallis Inquiry consumer protection framework.

In 2013 Australian general insurers were ranked third highest in the world for customer satisfaction (coming behind the United States and South Africa) with 74% (12% were unsatisfied, 15% were neutral)¹⁹.

Regrettably, we anticipate that there will always be examples of poor practice or misconduct in any industry, we have not seen issues on the scale of those experienced in managed investments (particularly agribusiness schemes) in Australia or the payment protection insurance mis-selling problems still unfolding in the United Kingdom.

The general insurance industry in Australia is well regulated and there may be little cost-benefit in the short-term to overhaul the post-Wallis consumer protection regime if reforms lead to further compliance costs.

An alternative is to work within the existing framework to streamline its operation to better meet consumer needs. For example by:

- facilitating insurers use of shorter and more tailored disclosure documents;
- reducing regulation and compliance costs around providing advice;
- enhancing the role of, and investment, in financial literacy and insurance education;
- ensuring policy responses take account of technological advances and consumer preferences; and
- more clearly tailor the regime to meet the type of product offering in question.

Post Wallis consumer protection framework for general insurance

The Wallis Inquiry identified transparency and informed decision-making by participants as a critical part of a well-functioning financial system.

It considered consumer protection regulation (alongside market integrity regulation) as a key component of supporting these objectives and recommended:

- functions previously distributed among a number of agencies brought under one regulator (ASIC);
- a combination of regulatory approaches – legislation, regulatory guidance and self-regulation (for things like dispute resolution);
- disclosure requirements consistent and comparable within and between sectors; and
- a single licensing regime for providers and single set of requirements for financial sales and advice.

¹⁹ CapGemini World Insurance Report 2013 p 20

CONSUMERS AND INSURANCE (CONTINUED)

These proposals were implemented in the Corporations Act and in the ASIC Act by the *Financial Services Reform Act 2001* (FSR) – all financial products and services are now regulated at a generic level in Chapter 7 of the *Corporations Act*.

As noted previously, the general insurance industry is subject to both this broader regime and industry or product specific legislation and regulation. Most relevantly the *Insurance Contracts Act 1984* (Cth) offers a comprehensive framework for protecting consumers of general insurance products and services. The sector has also established a strong self-regulatory system built around the General insurance Code of Practice and the external dispute resolution mechanism administered by FOS.

While the general insurance sector has performed well in terms of consumer confidence there is scope for improvement.

There have been industry wide challenges such as the concerns around the disclosure and consumer understanding of flood insurance following the Queensland flood of 2010-11. More recently, funeral insurance and consumer credit insurance have been subject to regulatory and public scrutiny.

Further, despite consumers' self-reported confidence in their financial literacy (82% of respondents in a 2011 ASIC survey had confidence in their ability to understand and choose appropriate insurance products)²⁰ the evidence that many consumers do not read their policies or product disclosure statements and the prevalence of underinsurance and non-insurance suggest there is still significant work to be done on insurance education.

Underpinned by the Insurance Contract Act, the consumer protection framework in place prior to the FSR reforms already regulated disclosure and conduct between insurers and consumers including:

- sections 35 and 37 of the Act which focus on clearly informing the insured about their cover;
- sections 13 and 14 which deal with utmost good faith. Section 13 implies into a contract of insurance a provision requiring each party to the contract acts toward the other with utmost good faith; and
- section 54 which restricts the ability of the insurer to rely on provisions in the contract to refuse to pay a claim if an act or omission of the insured did not cause or contribute to the loss being claimed or cause the insurer prejudice.

The preamble to the Act explains its overall intent “An Act to reform and modernize the law relating to certain contracts of insurance so that a fair balance is struck between the interests of insurers, insureds and other members of the public and so that provisions including in such contracts, and the practices of insurers in relation to such contracts, operate fairly...”.

The post-Wallis FSR regime placed an additional layer of generic product disclosure and financial advice requirements over the top of the Insurance Contracts Act with little accommodation of the unique nature of insurance contracts or the framework already in place.

It is not clear the extent to which the implementation of the product neutral disclosure and advice regimes has improved consumer outcomes for general insurance in contrast to the pre-Wallis system. Analysis of the measurable benefit to consumers achieved through this additional regulation

²⁰ ASIC Report 230 Financial literacy and behavioural change March 2011 p13.

CONSUMERS AND INSURANCE (CONTINUED)

against the considerable implementation²¹ and ongoing compliance costs would be beneficial particularly given these costs are ultimately passed through to consumers through higher premiums. Nevertheless, insurers have invested heavily in this regime and in integrating disparate and overlapping regulatory requirements. In addition, the initial one-size fits all approach has gradually been modified with policy makers recognising that different types of products and services can benefit from a more specialized or discrete disclosure regimes.

Amendments to the Corporations Act and regulations have facilitated more streamlined product disclosure and scaled advice. For example, reform in 2005 identified distinct classes of financial products (including general insurance) and recognised that disclosure laws should differ between these classes of products²². Further, general insurance products do not have the same degree of risk nor require the same level of consumer protection as investment based products such as managed investments, margin lending or superannuation, all of which carry a much higher level of risk for a retail investor.

Product Disclosure

Disclosure was a critical area for reform post Wallis. The policy objectives of the FSR was to create a disclosure regime under which retail clients would receive information enabling them to comprehend and compare functionally similar financial products and services, thereby promoting informed consumer choice and competition between service providers²³.

There are some excellent examples of product disclosure statements in the market – clear, simple and easy to understand. NRMA Insurance pioneered the plain English insurance policy in the mid 1990's and has implemented consumer testing to assist in understanding how types of disclosure work in documents. IAG's businesses regularly review policy documents and PDSs to ensure they are meeting both regulatory requirements and, most importantly, are providing our customers with clear and relevant information about our products and services. We note that FOS figures indicate that a consumers' 'chance of dispute' with IAG businesses about their policies or services about IAG businesses' policies or services is lower than the industry average across the most popular personal insurance lines²⁴.

Yet there is considerable anecdotal evidence and research indicating that many consumers do not use PDSs (or other disclosure documents) for the purpose or in the way intended. That is, they do not use them as one of the primary sources of information in their decision making process.

Consumer reliance on product disclosure statements

The Insurance Council of Australia commissioned research in 2010 to better understand consumer attitudes to product disclosure in the context of general insurance. The research found that consumers identified the PDS as one of the least important information sources to help inform a purchasing decision (31% for car insurance and 33% for home and contents).

²¹ One estimate of implementation costs \$200 million for all financial services (Pamela Hanrahan 'Tinkering with FSR Design May Get Model Right' AFR 1 June 2005; in Pearson 120

²² See Corporations Amendment Regulations 2005 (No 5) Regulation 7.9.15D, 7.9.15E and 7.9.15F

²³ Andrew J Serpell, *The Impact of the FSR Refinements Regulations on Disclosure*," eLaw Journal Vol 13 No2 2006

²⁴ The Chance of a Dispute Coming to FOS is a measure of how likely a consumer was to come to FOS with a dispute about this type of product from this FSP between 1 July 2012 and 30 June 2013.

See Financial Ombudsman Comparative Tables 1 July 2012-30 June 2012 for Insurance Australia Limited, CGU Limited and Insurance Manufacturers Australia.

CONSUMERS AND INSURANCE (CONTINUED)

Although they did not cover general insurance, consultation undertaken by the UK Financial Services Authority (now the Financial Conduct Authority) in the early 2000s found that product disclosure requirements (through a mandatory 'Key Features Document') had not been effective in terms of providing consumers' information about financial products and whether or not they should purchase them. The research found that 'only a quarter of the sample claimed to have read the KFD, even in part'.

A consumer survey conducted by the ICA following the Queensland floods of 2010-11 found that 40% of flood-exposed households who did not have flood insurance cited that they did not know their policy would not cover flood. The ICA survey also found that less than 50% of insured households had read the PDS before purchasing the product²⁵. Concerns around the effectiveness of disclosure and consumers understanding of their insurance policies following the Queensland floods led to the development and introduction of a mandatory Key Fact Sheet for Home and Contents Policies (the KFS) and the implementation of a legislative standard definition of flood.

Non-insurance (including high opt-out rates for flood insurance where it is offered) and underinsurance also point to a lack of understanding and/or that consumers are focusing on price to an extent that they are leaving themselves open to significant risk.

Enhancing product disclosure – length and complexity

The publicly available results of the ICA research identified length, density and complexity of the documents as the main barriers to consumers using PDSs to inform decision making and make product comparisons²⁶.

ASIC's 2011 report on Financial Literacy and Consumer behaviour found "[p]eople (including investors) are often overwhelmed by the volume and complexity of investment information available to them, including disclosure material such as Product Disclosure Statements (PDSs), prospectuses and annual reports"²⁷.

The Wallis Financial System Inquiry Report made the following observation:

*"Measure of effective disclosure is its ability to inform the decisions of customers. Disclosure regulation is at the core of any scheme to protect consumers as it allows them to exercise informed choice. However, it is the quality and usefulness of information which are important not its quantity. Excessive or complex information can be counterproductive as it may confuse consumers and discourage them from using disclosure documents. Complex disclosure requirements also increase industry's compliance costs which are ultimately borne by consumers"*²⁸

Many PDSs for common products such as home and contents and comprehensive motor insurance are between 40 and 80 pages long. It is unrealistic to expect consumers to find such documents beneficial particularly where consumers are increasingly turning to online and digital platforms to buy insurance and expect to do it quickly.

²⁵ ICA Submission to the NDIR: the survey was an internet based survey, conducted by Roy Morgan over the first week of April 2011 on behalf of the insurance council. There were 397 respondent households in the flood affected area of Brisbane, 407 respondents in the non-flood affected area of Brisbane, 415 respondents in the rest of Queensland and 415 respondents in the rest of Australia. The total number of respondents was 1634.

²⁶ ICA Year in Review 2010 p 17

²⁷ ASIC Report 230 p 22

²⁸ Wallis Report Chapter 7 p 261

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Refinements to product disclosure introduced in 2005, were in part intended to address concerns that “disclosure documents being prepared by financial service providers were too long and complex, making them difficult for consumers to understand and unnecessarily costly to prepare”²⁹

For general insurance, the amendments required the policy terms and conditions to be part of the PDS – this meant it was no longer possible to provide a PDS as a separate document to summarise the insurance cover, with the policy terms as a separate referenced document.

While product issuers for managed investments and superannuation were given the ability to issue ‘short form PDSs’, general insurers are still required to comply with the tailored PDS regime.

We believe the tailored PDS regime has not resulted in significant consumer benefits. The priority for most insurers is to meet the needs and expectations of consumers. However, the broad nature of the legislative requirements and the desire to avoid non-compliance can undermine the intention to create consumer-friendly documents. There is potential for over-disclosing and under informing.

There is opportunity to review the present regime to encourage insurers to build on current practice and encourage them to innovate and compete with each other in meeting the information needs of consumers and exploiting advances in information technology and communications as smart business.

Central to achieving this is to give insurers regulatory comfort in taking a less cautious more customer-centric approach. There are several options that could be considered including:

- a regime similar to the shorter, simpler PDSs currently required for superannuation products simple managed investment schemes, and standard margin lending facilities; and
- a modified version of the Key Fact Sheet (summarising the cover – benefits, exclusions, pre-existing, cooling off period etc) that can be used for a broader range of products and where the ‘key’ content is determined according to a risk assessment of which matters are statistically most likely to be of concern to consumers.

Alternatively, regulatory reform could accommodate a layered approach where information is provided to meet different needs that a consumer would expect to have at different points in their engagement cycle (decision-making and post-purchase). This could then be supported with generic product information provided by the insurer via its website or links to other resources. This proposal would be similar to the incorporation by reference regime currently in place.

In reviewing alternate disclosure models, it is important to understand the limitations of mandated disclosure as a mechanism to promote consumer confidence within the financial system. As Dimity Kingsford-Smith wrote in the Handbook on Research on International Consumer Law:

“..we are beginning to see from the research the short-comings of disclosure in mass consumer markets. Some of these shortcomings, such as behavioural heuristics that have been identified, are so thoroughgoing that it is unlikely that any amount of tinkering with the form and presentation of financial disclosure will make much difference”³⁰.

²⁹ See *Serpell* cited above p 82

³⁰ Dimity Kingsford-Smith “*Financial services regulation and the investor as consumer*”, Handbook on Research on International Consumer Law;’ p 450-451.

CONSUMERS AND INSURANCE (CONTINUED)

Kingsford-Smith is quick to emphasise that she does not suggest “doing away with disclosure. It is like democracy: it does not work very well, but it is still the best we have.” Rather, the message is that that disclosure will be an imperfect response to a complex policy issue. To avoid piece-meal regulatory reform - the cost of which is ultimately borne by consumers – the issue of disclosure must be considered holistically with regard to the role of financial advice, consumer financial literacy and the impact of technology on consumer preferences and trends.

Financial advice

The availability of accessible financial advice is an important component of the financial services industry. Consumers should have the option to avail themselves of advice either through a financial adviser or in the case of insurance, a broker, to be able to determine what product best suits their needs and personal circumstances.

There has been a trend in recent years within the industry for insurers to distribute products directly to consumers and rely on a ‘no advice’ model, providing factual information rather than advice. The lack of clarity in the distinctions between the various forms of advice and the restrictions around the provision of financial advice has acted as a disincentive for some insurers to offer advice due to the compliance risks and costs involved. Further, the distinction between general advice, scaled advice and personal advice can often be artificial and impractical, raising a compliance risk for financial service providers.

The sometimes artificial distinction between factual information and personal advice is illustrated in the below example from ASIC’s Regulatory Guide 244:

Scenario

A client contacts an insurer’s call centre and requests a quote for comprehensive car insurance. Noting the client’s car is old and of low value, the call centre operator mentions the possibility of third party property damage cover and explains the difference between it and comprehensive cover. At the client’s request, the call centre operator provides a quote for the annual premiums for each product.

Commentary

This is factual information. Although the call centre operator has been provided with some personal information about the client, and has used this information to provide relevant information to the client about an alternative product, the operator has not given an opinion or made a recommendation that is intended to, or that could be reasonably regarded as being intended to, influence a decision about a financial product

Some may say that by taking into account the client’s individual circumstances (the old car of low value) and then raising the possibility of third party property damage cover, the consultant has steered the customer in a discussion and arguably provided advice.

As the ICA noted in its submission to the National Disaster Insurance Review, general insurers dealing in more common general insurance products should be exempted from the advice provisions of the Corporations Act specifically to encourage more direct general insurers to provide advice to consumers. The current advice model as applied to general insurance does not support more informed consumers (and may exacerbate problems such as underinsurance). Consideration should be given to relaxing the general advice training and disclosure requirements. This would provide regulatory support to those insurers who want to consider how they might integrate advice into their business model.

CONSUMERS AND INSURANCE (CONTINUED)

Insurance education and financial literacy

Regulatory reform can only ever be part of the answer.

A co-ordinated, strategic response is required to increase community understanding of insurance. This includes:

- Community insurance education programs are necessary to support and complement risk awareness and risk reduction. Consumers need to understand that price is a reflection of risk;
- Promoting the value of insurance— insurance protects the individual, promotes financial stability by alleviating the welfare burden on governments and stabilises the economy as a whole by allowing for quicker reconstruction and reestablishment following natural disasters; and
- Encouraging consumers to read their policies so they understand the cover being provided and can satisfy themselves that the cover is appropriate for their needs.

The insurance industry has made progress in this area with ANZIIF's Know Risk program and the ICA's Understand Insurance campaign launched in June and November 2013 respectively. ASIC's MoneySmart website also contains a section on insurance.

NRMA Insurance and CGU have been involved in a number of education initiatives including You Tube videos, seminars for non-English speaking customers and a web-based learning resource for high school students on disaster preparedness and insurance through the Australian Financial Review on-line platform.

While these programs are valuable, given the “problems financial literacy seeks to address are multifaceted...the tools used to change behaviour need to be multifaceted”³¹. Further, greater investment and focus on financial education at school level and insurance literacy more broadly is also required.

Impact of technology and consumers preferences

The challenge of ensuring the regulatory framework effectively supports confident and informed consumer decision-making must be considered in the context of technological advances since the Wallis Inquiry.

“Advances in technology and communications, combined with the explosive growth in data and information, have given rise to a more empowered global consumer”³². The rapid development of the internet, smart phone technology and social media since has created fundamental changes both in insurers' business models and consumer behaviour and preferences.

Broadly speaking trends are towards digital and online services and interactions that are high-speed, self-service and lower-contact. However the picture is fragmented and evolving.

There is a growing appetite for digital channels including smart phones and tablets. However there is still a role for phone and face-to-face channels. One study has found that only about half of customers currently use digital channels as the primary means of interacting with their financial services providers.

³¹ ASIC Report 230 p 48

³² Ernst & Young: The journey toward greater customer centricity 2013

CONSUMERS AND INSURANCE (CONTINUED)

Consumers want the ability to interact with their providers through multiple channels such as the traditional channels of telephone and face to face via a branch, broker or financial adviser as well as through the internet and digital platforms. Additionally, they want to be able to seamlessly move from one channel to the other and be able to deal with each channel in a way that is suitable to the nuances of the channel³³.

Channel preference varies by interaction point - there is greater demand for digital at certain interaction points. Many customers are using multiple channels to complete a particular interaction and/or using multiple channels across the customer journey.

Online networks are now preferred for activities such as finding the best rate/price, comparing policies and services, and accessing information, but customers still have a strong preference for physical distribution networks when it comes to gaining trust in their insurer³⁴. Approximately 55% of younger consumers use digital as the primary channel early on, but only about 30% of older consumers do³⁵.

Customers want to have the choice on whether to self-serve. Any self-serve capability needs to be designed to meet customers' needs for that particular interaction. The demand for self-serve is greater for particular interactions – for example customers are migrating online for simpler interactions such as obtaining quotes.

Consumers are also (either implicitly or explicitly) demanding that the insurance industry moves from a product focus, to a customer focus. By harnessing big data, insurers will increasingly be able to tailor and personalise their services and products subject to the privacy law restrictions on the use of personal information.

We also know that the growth of online shopping and the ability to access vast amounts of information online means that consumers are now more likely to shop around and compare products and prices including financial services products.

There is vast potential for improving how we deliver consumers the information they want, in the way they want it, when they want it. However, the preference for seamless multi-channel interactions creates challenges for insurers and regulators in ensuring consumers also get the information they need at the right time. Consumers are at risk of being swamped by excess information that only further complicates their decision-making processes and ability to understand their rights and responsibilities. As the migration to digital and online platforms increases it is expected that consumers will also have less time and tolerance for lengthy documents, which are ill-suited to digital platforms. We have only just seen legislation enacted facilitating electronic delivery of PDSs for general insurance products.

As consumers look to self-serve and use online resources there is potentially less opportunity to provide advice. Recent research shows that small and medium businesses are becoming less likely to seek advice as they turn to online channels³⁶. However, the scope for personalisation through big data and mechanisms such as web-chats could encourage a counter movement toward advice.

³³ Bain & Company: Digital strategies in Australian financial services: Peter Stumbles and Gary Turner 2013 p 1

³⁴ Gemini World Insurance Report 2013

³⁵ Bain & Company: Digital strategies in Australian financial services: Peter Stumbles and Gary Turner 2013 p 1

³⁶ Business and commercial insurance brokers are under threat from the use of online channels to purchase new policies or to switch existing policies, according to Roy Morgan Research's Business Single Source in March 2013.

CONSUMERS AND INSURANCE (CONTINUED)

Moreover, we have already seen insurers use technology to develop resources, such as sum-insured calculators to assist consumers within a 'non-advice' model.

While price comparison websites or aggregators offer customers the ability to compare insurance prices the consumer benefit of aggregators needs to be carefully examined. Current aggregator models provide only a simplistic and often inaccurate overview of insurance policies and their coverage. Due to the variation in business models, covers and pricing approaches, it is difficult for online aggregators to accurately and fairly make "like with like" product comparisons, although this is what they purport to do.

Aggregator sites encourage consumers to base their purchase decision on price alone while disregarding other important factors such as coverage levels required, type of coverage (e.g. flood cover), excess limits, claims service capabilities and exclusions that apply. Further, commercial aggregator sites often do not adequately disclose their relationship with insurers who pay them a commission for distribution rights. Ultimately, commercial aggregator sites are driven by profit and the regulators in Australia and the United Kingdom have expressed concerns about the transparency, conduct and consumer benefit of aggregators³⁷.

Regulatory recalibration and planning for the future

In response to growing consumer preference for digital platforms, lower interaction and self-service, we need to evaluate whether the post-Wallis disclosure and advice models are fit for purpose into the future.

These issues should be considered in a comprehensive, coherent way that takes account of the broader regulatory regime applying to general insurance. A lack of awareness or understanding of existing regulation of general insurance products and services has been a factor in recent criticisms of the industry and subsequent proposals for new regulation. The lapsed Unfair Contract Terms Bill is as example here³⁸. There could be a case for consolidating requirements for general insurance (e.g. in the Insurance Contracts Act) while still retaining consistency with other financial services.

As previously noted, it is crucial that any reform or recalibration is undertaken in a methodical way with regard to the overall principles and objectives of regulation in the general insurance sector and underpinned by a cost-benefit analysis.

³⁷ See ASIC Regulatory Guide 234 "*Advertising financial products and services (including credit): Good practice guidance*". In December 2012 and again in May 2013 ASIC publicised specific concerns about comparison websites. The UK Financial Conduct Authority is currently undertaking a review of aggregators. See <http://www.fca.org.uk/news/the-fca-launches-review-into-price-comparison-websites>

³⁸ The Insurance Contracts Amendment (Unfair Terms) Bill 2013 lapsed with the dissolution of Parliament on 5 August 2013.