INSURANCE COUNCIL OF AUSTRALIA

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31 March 2015

Dear Sir/Madam

FINANCIAL SYSTEM INQUIRY FINAL REPORT

The Insurance Council of Australia[1] (Insurance Council) welcomes the opportunity to respond to the Financial System Inquiry's (FSI) Final Report (the "Report"). We appreciate the serious consideration that the Report gave to the issues raised in the Insurance Council's submissions to the Inquiry. We particularly welcome the Report's finding that the overall regulatory settings for general insurance are adequate.

The Insurance Council and its members endorse the Report's focus on "fairness" for consumers as one of the Inquiry's guiding principles and we take seriously the calls in the Report for industry to provide better consumer outcomes. The Insurance Council further approves of the Report's recognition of the benefits of self-regulatory initiatives to strengthen industry accountability and consumer outcomes. This approach complements the Inquiry's carefully considered conclusion not to recommend the roll-out of unrestrained regulation. The changes implemented recently to the General Insurance Code of Practice demonstrate the commitment of Insurance Council members to working in the consumer interest.

We are pleased that the Inquiry recognised the industry's willingness to improve the effectiveness of general insurance disclosure. We acknowledge the responsibility that industry has to better communicate with insureds so that consumers can make good decisions and apply sound judgement to take the appropriate level of risk transfer to suit their preferences. This is becoming increasingly important as insurers become better at scrutinising the large amounts of data available, which can produce insights to improve

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[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. March 2014 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $41.4 billion per annum and has total assets of $111.5 billion. The industry employs approximately 60,000 people and on average pays out about $111 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

consumer decision making. We intend to take a multifaceted approach that goes beyond just disclosure or financial literacy. The work of our members will be facilitated by the attention given in the Report to the need for regulatory change to facilitate innovative disclosure.

While the Insurance Council views the Report as positive overall, there are a number of findings and recommendations of concern to members. These principally relate to the interest in further regulation of product design and distribution and increased powers for ASIC. The danger here is that general insurers will have to comply with additional regulation designed to address problems originating in other financial services sectors.

In addition, we would like to comment on the Report's observations on Unauthorised Foreign Insurers. We are particularly concerned about the unintended consequences of placing Australian licensed insurers at a competitive disadvantage to insurers domiciled in jurisdictions with weak or less developed regulation, and potentially lower and more remote capital requirements. Also of interest to the Insurance Council is the recommendation to narrow mortgage risk weight differences between Internal Ratings Based (IRB) and standardised lenders. We consider that appropriate recognition of Lenders Mortgage Insurance in IRB models could achieve the desired stability objectives with a partially reduced burden to banks.

The Attachment details the Insurance Council's views on the recommendations relevant to its members.

The Insurance Council looks forward to continuing work with Government and regulators on the issues raised and recommendations made in the FSI Report. If you have any questions or comments, please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on tel: 02 9253 5121 or email: janning@insurancecouncil.com.au.

Yours sincerely

Robert Whelan
Executive Director & CEO

ATTACHMENT

COMMENTS ON INDIVIDUAL RECOMMENDATIONS

Unauthorised Foreign Insurers (UFI)

The FSI Report notes the Government's intention to "clarify" that brokers can use price as the basis to recommend insurance provided by a UFI and comments that the stability implications should be revisited if the use of UFIs becomes widespread. Given the magnitude of the likely unintended consequences, the Insurance Council considers that a stronger position should be taken against UFI involvement in the Australian market. Furthermore, while the objective of the proposed clarification is to improve insurance affordability in cyclone prone North Queensland, this is unlikely to occur due to inherent pricing drivers largely caused by the high severity and frequency of catastrophes.

Price is already explicitly listed in legislation as one of the factors that a broker can take into account when considering whether to recommend a UFI policy. Any ill considered amendment could lead to brokers being encouraged to recommend a UFI policy solely on the basis of price. This would be inconsistent with the broker's fiduciary duty to their client to take all relevant factors into account such as the ability to provide support and pay claims after a major natural catastrophe.

For constitutional reasons, any change to the UFI access regime needs to apply nationally, rather than be limited to North Queensland where the issue is confined. The risk is that the undermining of Australia's strong consumer protections and prudential regulation will harm the economic viability of Australian licensed general insurers. The industry believes the only sustainable way to deal with the issue of insurance affordability for those at high-risk of natural peril is to help mitigate the underlying risk driving their premium.[2]

The Insurance Council has consistently argued that the relative imbalance between funding for disaster response activities compared with disaster mitigation is a longstanding economic failure in Australia. Correction of this imbalance, in a manner that incentivises a systemic approach to reducing existing community exposures and preventing future planning mistakes, should be a national priority. The benefits of mitigation are manifold, including improved community safety, economic stability through lower rates of disruption, and lower insurance premiums. As found by the recent Productivity Commission draft report into National Disaster Funding, the long-term solution is to better fund mitigation activity across the country rather than what is currently primarily a disaster response approach.

The Insurance Council has identified a range of consumer protection issues related to insurance products provided by UFIs. There are concerns that policy holders will not have access to the Financial Claims Scheme if an UFI fails or access to an external dispute resolution scheme such as the Financial Ombudsman Service (FOS) in the event of a

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[2] Insurance provided by UFIs in areas of high risk does not reduce the underlying risk. Any expected pricing discount offered by a UFI, if actually realised, cannot be commercially sustainable through periods of significant losses.

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dispute. It is unlikely that the Australian Securities and Investments Commission (ASIC) will be able to ensure that UFIs provide adequate disclosure to policy holders (i.e. through Product Disclosure Statements). Additionally, the provisions of the General Insurance Code of Practice would be unavailable to policy holders.[3]

It is noteworthy that ASIC in 2004 investigated the behaviour of UFIs in Australia because of complaints about non-payment of claims, doubts about the adequacy of home jurisdiction regulation of some UFIs and alleged inappropriate sale practices by insurance intermediaries. Other complaints included concerns about ownership links between intermediaries and UFIs and alleged difficulties in making complaints or enforcing claims against UFIs.

The Insurance Council also notes a range of competition issues that arise from greater UFI access to the Australian market. Australian licensed insurers must meet stringent regulatory requirements that result in significant costs. However, UFIs will effectively be exempt from these obligations, which include prudential behaviour and capital requirements and minimum corporate governance and risk management processes. UFIs will also be exempt for audit and compliance requirements, investment restrictions and industry levies. As a consequence, a UFI access regime that focuses on price alone would put Australian licensed insurers at a significant competitive disadvantage to insurers based in countries with less developed regulation.

Rec 2. Narrow mortgage risk weight differences: Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

The Insurance Council welcomes the comment in the Report that, in the context of maintaining as much risk sensitivity in the capital framework as possible, the Australian Prudential Regulation Authority (APRA) should recognise Lenders Mortgage Insurance (LMI) where appropriate. The Insurance Council submits that if Recommendation 2 “Narrow mortgage risk weight difference” is accepted, appropriate recognition should be given to LMI in Internal Ratings Based (IRB) risk-weight models.

As outlined in our submission (26 August 2014) responding to the FSI Interim Report, the Insurance Council has strong concerns about the inconsistency in LMI recognition between standardised and IRB Banks. Given that in both situations LMI assists stability by increasing capital in the system, little rationale exists for LMI recognition to be treated differently in the two methodologies.

[3] Other concerns include: Consumer’s may face significant difficulties seeking redress in a foreign jurisdiction against a UFI that has no assets in Australia; In a natural disaster situation, a broker may not be able to provide the same level of service to a large number of policyholders compared with an insurer with staff and resources on the ground; and the Insurance Contracts Act 1984 may not apply, which may deny consumers the benefit of the duty of utmost good faith (subject to the determination of what is the “proper law” of a specific insurance contract).

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For standardised banks which have LMI cover of at least 40% of the value of the loan, risk weights are reduced by between 25-30% in recognition of the benefits that LMI provides. The risk-weights applied to standardised banks that do not hold LMI are typically higher than those that do hold LMI, particularly for higher Loan to Valuation Ratio (LVR) loans that are considered higher risk. The exact risk weight reduction varies according to the LVR as outlined in the following table.

Risk Weights applied by APRA under Standardised Approach

LTV	*Risk Weight (no LMI)*	*Risk Weight (with LMI)*
0 to 60	35%	35%
>60 to 80	35%	35%
>80 to 90	50%	35%
>90 to 100	75%	50%
>100.01	100%	75%

Source: APRA Prudential Standard APS112 Attachment D, p29.

In contrast, IRB banks receive no explicit regulatory capital benefit for the use of LMI, which assumes no stability enhancement from LMI. This lack of recognition ignores that Australian LMI providers hold approximately $4 billion in capital which represents approximately 4 times their gross earned premium income of $970 million (2013). This is important as the capital held is released to lenders in the event of borrower default, in accordance with their LMI contract. This provides an independent layer of fungible capital that provides support specifically for credit default risk on residential housing.

A study which was undertaken in 2011 for the LMI industry and Australian Bankers' Association IRB working group by Rhino Risk considered the benefit provided by LMI to lenders in a severe downturn scenario. This study analysed historical payout percentages and modelled the amount that can be recovered by lenders in the event of default by an LMI.[4] The analysis illustrates that a high percentage of any lender claim is covered by the LMI provider's capital, even in the event of an LMI defaulting. Further, in a scenario less extreme than a 1 in 999 event, an LMI provider would cover an even higher proportion of the lenders' claims, even if in default.

To allow a reduction of risk weights for residential mortgage insured loans in line with that allowed for standardised banks, the Loss Given Default (LGD) that is applied in IRB models would reduce by approximately 5 percentage points. IRB banks however are currently subject to a portfolio average LGD floor. To date APRA has been reluctant to recognise the benefit provided by LMI which is suggested to be approximately 5 percentage points as this would result in a reduction of the fixed LGD floor of 20%.

The Insurance Council considers that appropriate recognition of LMI in IRB models, along with standardised models, would be complementary to the recommendation in the FSI

[4] The first model effectively found that LMI capital would be sufficient to cover 62% of bank credit losses for insured loans from a 1 in 999 year event. The second model found that LMI capital would be sufficient to cover 79% of bank credit losses for insured loans from a 1 in 999 year event.

Report to narrow mortgage risk weight differences. Allowing LMI to be adequately recognised in models may partially reduce the burden to IRB banks of holding more regulatory capital, while still achieving the desired prudential and stability objectives.

Rec 5. Crisis management toolkit: Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.

The Insurance Council considers that the need for further work to strengthen APRA's crisis management powers should be substantiated. As outlined in the Insurance Council's submission to APRA (31 January 2013), many of the proposals would extend APRA's powers to matters within an organisation related to a regulated entity without there being a connection to APRA's prudential responsibilities. In considering completion of existing processes for strengthening APRA's crisis management powers, the Insurance Council urges that there be greater recognition of the differences between individual financial services sectors and the way they interact with the other component parts of the financial system.

Work undertaken by the International Association of Insurance Supervisors (IAIS) concluded that traditional insurance poses little risk to the stability of the financial system.[5] It is widely recognised that, despite a stringent regulatory regime, if a general insurer gets into financial difficulty, it is not susceptible to sudden collapse as a bank would be. There is time to take recovery action and, if this is ultimately unsuccessful, to manage the insurer's orderly resolution. In contrast, 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). Furthermore, the failure of a general insurer has less severe and more delayed consequences for the wider economy than of a bank so the need to guard against failure is lower.

Should the Government proceed with further work to strengthen crisis management powers, the Insurance Council requests that the rationale for each proposal be explained and safeguards against the abuse of regulatory power be put in place. The general insurance industry is concerned about giving APRA greater powers without adequate safeguards to ensure they are used properly and to minimise the possibility of unintended and unwarranted consequences for non-Australian or non-insurance entities which are part of an insurance group. Serious consideration should also be given to whether APRA has the expertise and resources to undertake action to be able to adequately assess the likely impact of their control of organisations which lie outside the regulated financial services industry.

Rec 19. Data access and use: Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.

The Insurance Council supports the FSI recommendation that the Commonwealth Government commission the Productivity Commission to commence, by the end of 2015, an inquiry into the costs and benefits of increasing access to and improving the use of data, subject to privacy considerations. We also agree that initiatives to increase access to data

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[5] IAIS, "Insurance and Financial Stability", November 2011

could enhance consumer outcomes, better inform decision making, and facilitate greater efficiency and innovation in the financial system and the broader economy.

The Insurance Council considers that the availability of accurate current data and relevant research are crucial to better understanding impacts of natural perils. We recognise, however, that crucial natural disaster information is often difficult and costly to access, incomplete or out of date and duplicated across multiple sources.

Research set out in the Business Roundtable's commissioned report "*Building an Open Platform for Natural Disaster Resilience Decisions" (2014)* highlights the importance of information to understanding and managing natural disaster risk. New approaches to the collation, co-ordination and analysis of natural disaster information and research are important to the prioritisation of mitigation decisions that will help strengthen and safeguard vulnerable communities. The Business Roundtable argues:

> *Efficient and open - deliver a national platform for foundational data*
> Given that foundational data is used for a broad range of purposes, beyond the scope of natural disaster issues, the Australian Government should provide a single point of access for all Australians. While weather information and data on community demographics is consistently provided by the Bureau of Meteorology and the Australian Bureau of Statistics respectively, allocation of responsibility for consistent topography and geocoded asset data at the national level is required. A national platform for this broader key data provided in a consistent format through a single access mechanism would facilitate the centralisation of data assets generated across local governments and state borders for the national interest. Furthermore, this would provide a platform for the accelerated development of information products and services that would enable Australian organisations and individuals to build increased resilience against natural disasters
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> *Transparent and available - remove barriers to accessibility of data and research*
> Access to data and research is restricted. Greater transparency across the system is required to identify the full range of end users and allow for the development of a system of optimal access which weighs up overall costs and benefits. There is a need for clear delegation of responsibility for hazard and impact data (such as hazard mapping) and a stronger approach for involving end users in research. This should also address concerns with legal liability, unnecessarily restrictive licensing and ensure standardisation across jurisdictions.

There are opportunities to improve consistency, sharing and communication notwithstanding the improvement of information on hazards and risk exposure in recent years. The Insurance Council notes the initiative announced by the Minister for Communications in July 2014 relating to the National Map Open Data Initiative. The initiative provides users access to a single platform for Government geospatial datasets, including those from the Bureau of Meteorology, Australian Bureau of Statistics and data.gov.au. The development of this platform is likely to ensure that critical information is efficient, open, transparent and available to enable effective decision making.

The Insurance Council's submission to the FSI Interim Report explained the strong objections that its members have to governments mandating that general insurers provide proprietary data to commercially operated comparison services. Irrespective of the market virtues of price comparison websites, the case for either regulatory intervention to facilitate their development or even government ownership of these tools is misplaced. Active interventions of this nature represent a form of "infant industry" rationale for price comparison websites not afforded to other forms of intermediation. The Insurance Council believes that

the facts around this issue need to be thoroughly considered and so we welcome the prospect of a Productivity Commission review.

Rec 21. Strengthen product issuer and distributor accountability: Introduce a targeted and principles-based product design and distribution obligation.

While the Insurance Council supports the policy objectives behind this recommendation, we submit that such an obligation on general insurers is unnecessary nor would it provide any practical benefits to consumers in the general insurance industry. A general product design obligation would need to be very broad if it were to apply appropriately to all financial products. A one-size-fits-all type obligation is unsuitable to the general insurance industry due to the very different risk profile and purpose of general insurance products compared with other financial products.

For example, the FSI Report suggests that a key component of the product design obligation is a requirement for the product issuer to identify target and non-target markets. While this concept has traditionally been applied, and is therefore relevant to investment-related financial products where the profile of a target customer relates to their financial circumstances and objectives, such a concept is not as easily applied to most general insurance products that are mass-marketed. It is difficult and unnecessary to artificially construct what a target customer would look like, as most general insurance products will cover the generic risks that consumers would wish to purchase insurance for. The FSI Report has not elaborated on how such an obligation would be applied in a practical sense to the general insurance market.

The key benefit of a considered analysis of a financial product's target market is that it focuses the issuer's attention on the level of sophistication of its target customer to ensure that products are not sold to consumers who do not understand the associated risks. However, mass-marketed general insurance products differ in that they will be relevant to most consumers, regardless of their level of financial literacy.

Another complicating factor is that most direct general insurance business (excluding insurance products sold through insurance brokers) is sold without the provision of personal advice. The FSI Report has not provided any detail around how a distributor accountability obligation will interact with the provision of general advice. We are concerned that any such obligation would require the issuer to conduct some form of due diligence on their customers to ensure that products are being sold to the "target" customer base, which may result in issuers and distributors inadvertently providing personal advice.

Unlike most other financial products, there is already comprehensive legislation regulating product features in the general insurance industry. The *Insurance Contracts Act 1984* (the Insurance Contracts Act) regulates the terms included in an insurance contract, as well as insurers' conduct in relation to such contracts. There has been no demonstrated need for a broad based product design obligation for general insurers, which would duplicate detailed requirements under existing regulation.

While we acknowledge the concerns expressed in the FSI Report about distribution practices related to consumer credit insurance (CCI), many of the shortcomings identified in the referenced ASIC report[6] has since been addressed constructively by industry. The CCI experience suggests that a cooperative and constructive dialogue between the regulator and industry can be effective in bringing about change.

The rationale provided by the FSI for a product design obligation is that mandated disclosure and financial literacy initiatives have not demonstrated to be fully effective in ensuring that consumers do not purchase products that do not match their needs. However, a concerted industry effort to increase financial literacy in the general insurance sector is still in its infancy[7] and the effectiveness of these initiatives should not be discounted yet. The industry is committed to improving the effectiveness of disclosure, as further elaborated in our response to recommendations 23 and 26. These are much more relevant to the general insurance industry than a product design obligation in ensuring that consumers purchase products that appropriately meet their needs.

The Insurance Council submits that any product design and distribution obligation should be much more targeted than recommended by the FSI Report, and simple financial products such as general insurance should be excluded from its scope. However, if the Government were minded to introduce a product design and distribution obligation applying to general insurers, the Insurance Council agrees that it should have the key features identified by the FSI including that the requirements are principles-based, scalable and do not impact on the types of products that could be developed and issued. The new obligation should only apply to new products, and not the suite of existing products already in the market. This will assist in ensuring that associated compliance costs are minimised.

Rec 22. Introduce product intervention power: Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.

The Insurance Council would have significant concerns if this recommendation were to be implemented, particularly about the wide range of circumstances suggested by the FSI Report in which such a power might be used. The FSI Report suggests that a product intervention power could be used to require or impose:

- amendments to marketing and disclosure materials;
- warnings to consumers, and labelling or terminology changes;
- distribution restrictions; and
- product banning.

ASIC and the general insurance industry already have a cooperative and constructive dialogue in relation to a wide range of compliance issues, including marketing and disclosure materials. Using its existing regulatory toolkit, ASIC has been widely influential in effecting change. For example, following a review by ASIC in 2005 on home building underinsurance, ASIC acknowledged that the industry had embraced change by developing a range of

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[6] ASIC (2011), Report 256: Consumer credit insurance: A review of sales practices by authorised deposit taking institutions.
[7] The Insurance Council's "Understand Insurance" website was launched in November 2013.

initiatives to improve consumer experience.[8] We submit that the existing regulatory toolkit available to ASIC has been used effectively in the general insurance industry.

The FSI Report's recommendation that such a power should only be used as a last resort or pre-emptive measure suggests that the intention is for such a power to be used in the most serious instances of misconduct. Certainly, the Report notes that the objective of a product intervention power is to reduce the risk of significant detriment to consumers. However, this does not seem to be reflected in the circumstances listed by the Report in which the power may be used. We are particularly concerned about the suggestion in the Report that the power could be used without a suspected breach of the law.

We understand that one of the key concerns sought to be addressed by this recommendation is ASIC's inability to take timely action, and such issues were brought to the fore with recent experiences in leveraged financial products as referenced in the FSI Report. However, we note these concerns about the need to take timely action to prevent additional consumer losses from the magnified effects of leverage over a short period of time do not apply to the general insurance industry.

The FSI Report suggests that ASIC would be expected to issue general policy guidelines describing when the power may be used, the process of engagement with affected parties, consultation with other regulators before the use of the power, transparency in its use and public reporting of the review of each use of this power. If the Government were minded to introduce a product intervention power, we suggest that the parameters described above should be set by the Government in legislation, and needs to be much more targeted in scope than as recommended by the FSI.

Rec 23. Facilitate innovative disclosure: Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

The Insurance Council supports the recommendation to remove regulatory impediments to innovative product disclosure. Technological advances provide the opportunity to consider more innovative ways of making financial product disclosures but the current regulatory regime does not provide sufficient flexibility for product issuers to consider providing mandated disclosures that deviate from the traditional paper-based form of disclosure.

In its recent Consultation Paper 224, *Facilitating electronic financial services disclosure*, ASIC identified a number of legislative barriers to innovative and electronic forms of disclosure and proposed relief and guidance on aspects of the *Corporations Act 2001* (the Corporations Act) to facilitate such disclosure. However, insurers will not be able to take full advantage of ASIC's proposals, as disclosure requirements applying to the general insurance industry are not confined to the Corporations Act, but are also contained in the

[8] ASIC (2007), *Report 89: Making home insurance better*.

Insurance Contracts Act. The key issues in applying ASIC's proposed relief are set out in detail in the Insurance Council's submission to ASIC.[9]

We understand that it was not ASIC's intent to limit the scope of the proposals in relation to insurers. Rather, ASIC is not able to provide relief under the Insurance Contracts Act as it is under the Corporations Act. Nevertheless, there is no compelling policy reason for there to be a different regulatory approach to electronic disclosure for insurers relative to other providers of financial services.

We understand that ASIC intends to further the work already initiated to broaden the application of its recent proposals on electronic disclosure, which may be of benefit to the general insurance industry. Facilitating electronic disclosure for general insurance products is likely to require legislative amendment, and this program of reform should be initiated as soon as possible.

Rec 25. Raise the competency of advisers: Raise the competency of financial advice providers and introduce an enhanced register of advisers.

This recommendation, as well as the recommendations from the recent Parliamentary Joint Committee on Corporations and Financial Services, on competency standards for financial advisers is of marginal relevance to members of the Insurance Council. Most general insurers do not provide personal advice, and all but one general insurance product (personal sickness and accident insurance) are classified as less complex 'Tier 2' products by ASIC. The Insurance Council though would like to draw attention to several possible implications for its members.

As a general comment, we note that there needs to be a clear distinction between issues relevant to insurance brokers/advisers and those concerning financial planners. Recent public discussions about the competency of financial advice providers have used the term 'financial adviser' in a broad sense that includes insurance advisers. However, the risks associated with a general insurance product are very different to other investment-based products such as superannuation, margin lending or funds management. Further, financial planners usually advise on a range of products (ranging from investment-based to general insurance products) and are required to have the requisite knowledge and product expertise across these products.

In contrast, brokers and other insurance advisers frequently only advise on general insurance products and some advisers adopt a general advice only model. While the proposed reforms are intended to address issues in relation to advice provided on investment products, we submit that there has been no demonstrated need for the training requirements for insurance advisers and brokers to also be increased.

Personal sickness and accident (PSA) insurance is the only general insurance product currently classified as a 'Tier 1' product under ASIC Regulatory Guide 146. This classification has been an ongoing concern for our members. We believe the current

[9] Insurance Council of Australia (2015), *Submission to Consultation Paper 224: Facilitating electronic financial services disclosure*, <http://www.insurancecouncil.com.au/submissions#2015Jan>

classification of PSA insurance as a Tier 1 product is based on a mistaken impression that PSA insurance is similar to life insurance. The Insurance Council submits that there is currently not an appropriate distinction being made between the nature of the PSA product sold by general insurers and those by life insurers.

Key differences relate to:

- duration: PSA is limited to annual contracts;
- assessment process: PSA does not require medical assessment however life insurers will;
- premium: reflects that the benefits are limited in duration.

Insurance Council members advise they typically offer PSA as part of a broader general insurance package for farms, small businesses and tradespersons. Members have highlighted that the current classification results in a complex situation where advice can be provided on some aspects of an insurance package (Tier 2 components) but not the PSA component. This means the Tier 1 classification, which was intended to improve the quality of advice, has the perverse outcome of preventing advice and consumers make cover choices without the benefit of an opinion or recommendation from a knowledgeable insurance adviser.

The Insurance Council strongly supports the reclassification of PSA insurance as a Tier 2 product, and has made a submission accordingly to ASIC's consultation on the topic[10]. This would align PSA with all other general insurance products, encouraging advice, while streamlining and reducing compliance costs.

Rec 26 Improve guidance and disclosure in general insurance: Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.

Consistent with the position taken in both its submissions to the FSI, the Insurance Council endorses the recommendation to improve disclosure for general insurance. The Insurance Council Board has approved the establishment of a Disclosure Taskforce to consider how disclosure can be made more effective and we are currently putting in place the practical arrangements for its operation. The shortcomings perceived in mandated disclosure in general insurance are similar to financial services in general, including that documents have a tendency to be overly complex, lengthy, and may not be effective in facilitating product comparison.

However, general insurance differs from other financial services in that mandated disclosure requirements are not confined to those contained in the Corporations Act, but also the Insurance Contracts Act. The existence of two separate pieces of legislation reflects the very different nature of general insurance products compared to other financial services. The establishment of the Disclosure Taskforce will provide a useful opportunity to consider how disclosure can be made more effective specifically for the industry. Our experience has been

[10] ASIC (2013), *Consultation Paper 212: Licensing: Training of financial product advisers – Updates to RG 146.*

that a one-size-fits-all regulatory regime for financial services is often ill-suited for general insurance.

The Disclosure Taskforce will consider the effectiveness and role of mandated disclosure within the context of the broader consumer experience, such as the provision of advice, advertising, financial literacy and consumer risk assessment tools and aids. The objective of the Disclosure Taskforce is to raise the effectiveness of disclosure in enabling consumers to choose general insurance products which are appropriate to their needs. The first priority for the Taskforce will be to address the FSI recommendation on disclosure.

The Insurance Council agrees with the FSI Report that underinsurance flowing from natural disasters and high premiums, especially in disaster-prone areas, are issues that need to be addressed. While underinsurance is a significant issue for those affected, the small number of cases of underinsurance relative to the number of insurance claims resolved needs to be kept in context. Underinsurance only manifests in total loss situations, and total loss claims form a very small proportion of all claims made on home building insurance policies. We note that insurers have a strong commercial incentive to minimise underinsurance but can only have a limited influence on consumers consciously making a decision to underinsure.

Importantly, we concur with the FSI's observation that underinsurance in disaster prone areas should be primarily handled by risk mitigation efforts rather than direct government intervention, as discussed above in the section on UFIs. We are concerned that recent proposals aimed at improving insurance affordability in North Queensland are superficial short-term solutions for a problem that requires a much more committed policy response. Underinsurance and insurance affordability in disaster-prone areas are complex issues that cannot be addressed by way of the simple solutions offered.

The development of a North Queensland comparison website for home and contents insurance seeks to address the affordability issue by attempting to increase competition, when the problem is not a lack of competition but the heightened cyclone and flood risks present in the region. At best, the proposal diverts policy resources away from more worthwhile and much needed mitigation initiatives. At worst, the proposal has the potential to exacerbate underinsurance by encouraging consumers to focus on price to the detriment of policy features and coverage.

The Insurance Council is encouraged by the FSI's suggestion that the consequent reduction in competition and potential disincentive for innovation does not warrant the introduction of standardised or default insurance products. Households currently have a choice of policy type in Australia, including:

- Sum-insured cover, where compensation is fixed at a level selected by the policyholder;
- Sum-insured plus margin cover, where compensation is fixed at a level selected by the policyholder and where an additional margin is available under certain circumstances to assist with rebuilding and other costs; and
- Total replacement cover, where no sum-insured operates to limit the compensation available.

We submit that maintaining consumer choice provides households with greater flexibility in tailoring a policy to suit their needs and avoids cost pressure on premiums that will likely result from mandating default insurance products, such as total replacement cover.

The Insurance Council agrees with the FSI that insurers should, as much as practically possible, provide guidance to consumers on the likely replacement value for home building and contents. However, we note that providing specific guidance to individual households on rebuilding costs that is reasonably accurate and reliable is not a straightforward and simple proposition.

Insurers do currently offer guidance on replacement costs. This guidance typically comes in the form of web calculators and from insurance professionals (brokers) who tailor insurance products to a customer's circumstances. The Insurance Council also offers its own free calculators through its "Understand Insurance" consumer financial literacy website. Web calculators are becoming increasingly sophisticated, with many now factoring in additional rebuilding costs that are a result of new building standards. Though nearly all insurers make web calculators available, an increasing number of insurers have now integrated use of a calculator as part of the insurance pricing process. Market forces are driving change in this space to the benefit of consumers, and ongoing competition is likely to deliver a better product than a regulated solution.

While we acknowledge the potential for increased use of calculators to address the risk that consumers select a substantially inappropriate amount as their sum insured, we note that estimates of replacement costs, as they are subject to various assumptions, can never be guaranteed in reflecting actual rebuilding costs. For example, an accurate estimate of replacement costs will need to factor in detailed features of the property, including information that households may not easily have to hand such as the slope of the land. Calculators will also be limited in taking account of any cost increases caused by post-catastrophe building inflation.

The accuracy of insurer rebuilding estimates is also affected by a lack of information about what rebuilding standards will apply in each specific location and how these change over time. For example, where bushfire is a prevalent hazard, the local council may introduce development controls on specific land parcels that dictate the need for new standards to be met (when building or rebuilding). This information is only available at the local level to the property owner, and is not available at scale for insurers. Insurers will not be able to systemically incorporate the effect of changes to building codes into calculators without this information being made more accessible in a coordinated fashion by local councils. Advances in technology provide the opportunity to consider potential solutions to these issues, and the Insurance Council would be keen to explore these jointly with all levels of government.

While the Insurance Council is willing to lead work in considering ways in which replacement cost estimates can be standardised, we note that the limitations in estimating accurate and reliable replacement costs would still be present. As acknowledged by the FSI Report, insurers have innovated to address these estimation risks, such as providing sum insured indexation and up lift cover.

Rec 27. Regulator accountability: Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates. Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.

The Insurance Council agrees that the Government should create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates. Industry would also benefit from Government setting out more clearly how regulators should interpret their mandates in Statements of Expectation (SOEs) and the increased use of outcomes-focused performance indicators.

The Insurance Council also believes that the Government would benefit from the establishment of a body similar to the former Financial Sector Advisory Council (FSAC) which brought together a range of financial market participants to provide advice to the Government on policies to facilitate the growth of a strong and competitive financial sector.

Rec 28. Execution of mandate: Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration, boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.

The Insurance Council supports the recommendation for regulators to be subject to stable levels of funding and a model based on periodic reviews. However, we strongly argue that there needs to be more appropriate accountability mechanisms to ensure that regulators deliver value for money. This submission outlines, under Recommendations 29 and 31 below, the Insurance Council's concern with the lack of existing accountability mechanisms. These issues should be carefully considered by Government.

Rec 29. Strengthening the Australian Securities and Investments Commission's funding and powers: Introduce an industry funding model for the Australian Securities and Investments Commission (ASIC) and provide ASIC with stronger regulatory tools.

In principle, the Insurance Council holds that financial regulators provide a social good and so should be government-funded. Consequently, the Insurance Council does not endorse the FSI Report's recommendation to introduce an industry funding model for ASIC.

The Insurance Council's objection to industry funding for ASIC stems in practical terms from shortcomings observed with the model currently used for APRA. There has been a long running lack of meaningful consultation on the level of industry funding to be provided to APRA and a lack of accountability for its efficient and effective use. This is despite the Australian Government having had a formal cost recovery policy since December 2002.[6]

Given the momentum world-wide for industry funding for regulators, the Insurance Council recognises it is likely that industry funding will be introduced for ASIC. In this case, we consider it essential to have an appropriate framework in place to ensure ASIC delivers value for money. The Insurance Council has requested in previous submissions to the Federal Treasury on the Financial Industry Levies that APRA (and this can be extended to other regulators, including ASIC) should consult early with industry on the proposed activities for the year ahead that have led it to recommend to the Government a particular level of funding.

The opportunity for debate on priorities would result in higher industry understanding and commitment to regulators' work programs.

A move to a more autonomous funding model for regulators must be accompanied by greater consultation, accountability and transparency. To comment meaningfully on the appropriate level of funding, industry requires adequate dialogue with regulators on how they see the regulatory landscape and what their priorities are for the coming year. The Insurance Council considers that early in the budget development process industry should be given an opportunity to provide feedback on the specifics of a regulator's work program planned for the year ahead and the level of associated resourcing proposed. Once account had been taken of industry views, the final regulator budget and the levies required to fund it would be submitted to Government, with a summary of the feedback received from industry and the regulator's response.

The Insurance Council supports the recommendation that regulators must also be required to publish detailed, and multi-year, budget projections as a basis for the consultation process. We consider that improved processes would provide greater certainty and stability of regulators' funding from year to year. The enhanced external consultation process would also drive greater internal and external scrutiny of the allocation of regulator resources across functions, and assist regulators in identifying opportunities for efficiencies.

Rec 30. Strengthening the focus on competition in the financial system: Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in the Australian Securities and Investments Commission's mandate.

The Insurance Council supports the recommendation for strengthening the focus on competition in the financial system. We strongly agree that regulators should demonstrate that they have fully considered the trade-off between competition and regulatory objectives in the development of new regulations. This should be evidenced by more explicit reporting about the competition implications of regulatory and legislative decisions.

We welcome recognition in the Report that regulatory frameworks can limit competition domestically as well as hinder the ability of Australian domiciled firms to compete on the international stage. The Insurance Council notes that the objective to increase UFI access to the Australian domestic market (discussed above) is an example where the competitive process is likely to be harmed through creation of an uneven playing field.

Rec 31. Compliance costs and policy processes: Increase the time available for industry to implement complex regulatory change. Conduct post-implementation reviews of major regulatory changes more frequently.

The Insurance Council strongly supports the recommendation to increase the time available for industry to implement complex regulatory change. We consider that Government and regulators should provide industry at a minimum one year to begin implementing change once arrangements are finalised. In some cases, longer should be provided in order to allow organisations to effectively make complex technology changes to their systems and enable a smooth transition through lengthy planning and testing requirements. As specified in the

FSI Report, the Insurance Council supports additional transition periods of 12-24 months as appropriate, with scope for widening where more complex issues arise. This will help reduce industry costs (and ultimate cost to consumers) by enabling firms to more efficiently implement change, for example by more smoothly managing costs through better procurement and utilisation of existing staff.

The Insurance Council also strongly supports that Government and regulators carry out more post-implementation reviews of major changes to analyse their cost effectiveness and help develop better processes for future interventions. We consider that post-implementation reviews are essential to best-practice policy making to ensure policy objectives are met in a cost effective manner.

We also support the Productivity Commission Regulator Audit Framework for use to improve overall regulator performance. We consider that regulator audit plans should be developed in consultation with industry, and have performance against it made public. Relevant regulators, such as APRA and ASIC, should also be benchmarked against their peers to help ensure that Australian based companies are not unnecessarily being put at a global competitive disadvantage due to domestic over regulation.

Rec 34 Unfair contract term provisions: Support Government's process to extend unfair contract term protections to small businesses. Encourage industry to develop standards on the use of non-monetary default covenants.

The Insurance Council acknowledges that, in regards to some sectors of the economy, it may be beneficial for the unfair contract terms (UCT) protections to be extended to small business. However, as we argued in our submission to the Government's consultation on the matter[11], any such extension should retain the existing exemption for insurance contracts under the UCT laws applying to consumers.

The policy rationale to exempt consumer insurance contracts from the UCT provisions applies equally to small business insurance contracts. Like consumers, small businesses have been well protected for some time by the Insurance Contracts Act, supplemented by other laws such as the Corporations and *ASIC Act 2001* (the ASIC Act). We submit that these laws collectively provide equivalent, if not greater, protections to small businesses from UCT in relation to insurance they purchase. Further protection includes the free (to consumers) external dispute resolution avenue provided by the Financial Ombudsman Service (FOS) and the General Insurance Code of Practice (the Code).

Statistical data points to the effectiveness of the consumer protection currently provided to general insurance policyholders. The FOS Annual Report on the General Insurance Code of Practice for 2012-2013 shows that of 540,936 claims lodged with insurers in relation to all commercial classes of business (not just small business), only 4,862 (0.9%) were declined. Only 1,598 (0.29%) involved an internal dispute raised with the insurer.

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[11] ICA submission on extending unfair contract terms protections to small businesses, August 2014, <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Extending%20Unfair%20Contract%20Term%20Protections%20to%20Small%20Businesses/Submissions/PDF/Insurance%20Council%20of%20Australia.ashx>

The Insurance Council is not aware of any complaints from small businesses about UCT in general insurance contracts. To apply the UCT remedy to general insurance would result in unwarranted layering of regulatory requirements on insurers and would lead to operating inefficiencies, the cost of which ultimately is passed on to the insured. The application of a UCT remedy to insurance contracts, rather than assisting small businesses, will create uncertainty in the application of insurance terms to claims, which will likely lead to further disputes resulting in inconvenience and delay, increasing costs and possibly premiums.

As well as small business insurance contracts where the insurer is supplying the service, small businesses also enter into contracts where they are the supplier of goods and services to general insurers. In principle, the Insurance Council does not object to an appropriately scoped extension of the UCT provisions to contracts covering the supply of goods and services by small businesses. Any such extension needs to be appropriately designed to ensure that the regime is practical to comply with and associated compliance costs are contained. Importantly, appropriate processes need to be established to ensure that vexatious and illegitimate claims are minimised. We note that an overly onerous compliance regime could result in the perverse outcome of reducing incentives to engage with small business.

Rec 40. Provision of financial advice and mortgage broking: Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.

While the Insurance Council shares the concerns that led to the recommendation to rename 'general advice', rather than a simplistic rebadging, the Insurance Council submits that a much more comprehensive review is required of how some activities currently seen as general advice are regulated. As noted in our submission to the FSI's Interim Report, the experience of our members as general insurers is that the current regulatory framework unnecessarily constrains the ability of licensees to provide simple product information. Renaming of 'general advice' will not of itself address the issues faced by general insurers around the advice definitions in the Corporations Act.

The problem is not limited to the operation of general advice. The current regulatory regime around personal advice is expensive and time consuming. This may be necessary for investment products, but seems overly cumbersome for general insurance. Consequently, the majority of general insurance sold directly through insurers is on a 'no advice' business model, or where advice is provided, care is taken that it falls within the less onerous definition of 'general advice'. Inevitably, the focus of training for employees and agents is on phrasing information so as to allow them to remain within the definition of the advice model they are operating under, rather than on delivering information that is of the most assistance to the customer's inquiry.

Where, prior to introduction of the current FSR regime, simple insurance products could be offered with some basic advice around product information and needs, the legal requirements now attached to the provision of advice, personal or general, have resulted in the consumer being provided with limited or no advice at all. The Insurance Council considers that this lack of simple product advice has hindered consumers in choosing policies with cover suited to the risks they face.