Submission to the Financial System Inquiry Final Report

March 2015

QBE RESPONSE TO FINANCIAL SYSTEM INQUIRY FINAL REPORT

QBE Insurance Group (***QBE)*** appreciates the opportunity to respond to the Financial System Inquiry's (***FSI)*** final report (***Report)*** of November 2014.

QBE is one of the few domestic Australian-based financial institutions to be operating globally, with operations in and revenue flowing from 38 countries. Listed on the ASX and headquartered in Sydney, stable organic growth and strategic acquisitions have seen QBE grow to become one of the world's top 20 insurers with a presence in all of the key global insurance markets.

As a member of the QBE Insurance Group, QBE Australia operates in Australia primarily through an intermediated business model that provides all major lines of insurance cover for personal and commercial risk throughout Australia. For over 127 years, QBE has been an integral part of the Australian business landscape providing peace of mind to Australians during normal business and times of crisis. QBE is proud of its heritage and the support that it has provided to our customers and policy holders during this time.

As a global insurer, QBE believes that Australia must continually look to refresh its financial systems to ensure the nation remains competitive with global financial markets and attractive to investment.

QBE congratulates the Federal Government on instigating the FSI with its wide-ranging terms of reference that provides an important opportunity to re-position Australia in the global financial market. QBE supports the Insurance Council of Australia's submission on the Report and as such, our comments on the Report are focused on the following key areas:

- Global competitiveness
- Lenders mortgage insurance
- Under-insurance and the role of government
- Improved guidance and disclosure in general insurance
- Product development, distribution and regulation
- Regulatory system.

Global competitiveness

The FSI comments that Australia's financial sector is less open and internationally integrated than it could be now – and that it will need to be in the future. As one of the few domestic Australian-based financial institutions to be operating on a truly global landscape, QBE commends the FSI's recognition that unnecessary barriers to international competitiveness and market access should be front of mind in designing and applying Australia's regulatory framework. In particular, QBE **supports** the FSI's following recommendations and observations:

> *…Government and regulators should develop and implement regulatory frameworks in ways that do not impose unnecessary costs on Australian firms operating offshore but support improved access to offshore markets.*[1]
>
> *Government and regulators should identify rules and procedures that create barriers to competition and consider whether these can be modified or removed. (See Recommendation 30: Strengthening the focus on competition in the financial system).*[2]

QBE also commends the Australian Government on its current deregulation agenda. As an internationally active global insurer, QBE considers that the current cost of doing business in and from Australia should be of paramount concern to Government, now and in the future.

[1] Commonwealth of Australia, *Financial System Inquiry - Final Report,* November 2014, page 21.
[2] Ibid, page 21.

It is clear Australia needs a financial system and regulatory framework that provides system stability and supports our local economy. It is also clear, considering the future, that we need a system that strikes the right balance between stability on the one hand and one that enables global businesses, including Australian-owned companies, to operate productively and efficiently so they can compete and innovate in our changing world.

QBE recognises the need and importance to engage and adopt consistent international regulation but believes Australia's recent record as an early adopter of the new waves of regulation requires rethinking. Leading the pack means that Australia is creating an un-level playing field for businesses operating in and from Australia. This operates to place Australian businesses at a disadvantage compared with our international peers.

The focus of past governments and regulators over the last decade in Australia has been on reforming the regulatory landscape in the wake of the HIH collapse and tightening regulatory and capital requirements post the global financial crisis. As we look forward however, we not only should take on board the lessons of the past but also ensure that Australia's financial services sector, including the general insurance industry, is competitive with other advanced economies and our emerging competitors.

Under insurance and the role of government

The Report observes[3] that many stakeholders are concerned about underinsurance flowing from natural disasters and high premiums, especially in disaster-prone areas. The Report also notes that the cost of insurance can be high, especially for coverage in higher-risk areas such as flood plains and cyclone-prone areas, leading to non-insurance and underinsurance.

Importantly, the FSI expresses the view that this issue should be primarily handled by risk mitigation efforts rather than direct government intervention, which risks distorting price signals.

QBE fully **supports** the FSI's position in this respect and agrees with the FSI's view that in most cases, 'the main role of government is to support the market in working as effectively as possible, rather than subsidising prices.[4]'

The higher cost of insurance is obviously a concern for those living in areas that are assessed as "high risk". From an insurance perspective, however, there is an issue when differentiated premiums are viewed by society and politics as unjust and discriminatory and public policy measures are introduced to address the perceived inequity. With the recent debates on the affordability and accessibility of insurance and the potential implications of non or underinsurance on the public purse, finding workable solutions to mitigate risk and build more resilient communities is an important sustainable longer term solution. The best way to reduce premiums for any property is to reduce the risk.

Insurance pricing provides an important price signal of risk to individuals, communities and Governments. There is a significant risk of moral and charity hazard when individuals are not held accountable for their actions and believe that governments will step in and provide a safety net. Without personal accountability, individuals have less incentive to mitigate or insure their own risk.

The Report observes that the costs of natural disaster insurance can be reduced through improved data, further mitigation efforts – such as the construction of flood levees – and in the case of states and territories, by reducing the tax burden on insurance contracts.

Over the last decade, industry and government have progressed initiatives such as sharing of flood risk data, flood mitigation projects and studies in strata risk from cyclonic weather in far north Queensland. These initiatives have increased our understanding of risk and helped reduce uncertainty for insurers when considering and pricing these risks.

[3] Ibid, page 227.
[4] Ibid, page 231.

Governments can also mitigate risk by curbing development in areas of high susceptibility to natural perils, such as some strata properties in far north Queensland, and ensuring appropriate building standards are applied where such development does occur.

This increased concentration of people, infrastructure and economic activity in areas exposed to significant natural peril risk is a key driver of increasing loss, particularly when the urbanisation occurs without appropriate mitigation to reduce vulnerability. Municipal, state and territory governments that continue to allow development in areas that are considered high risk flood or bushfire zones, without accompanying mitigation measures being required of developers, are exacerbating this problem.

QBE strongly considers that any policy intervention by Government should focus on the specific issues or pockets of risk where underinsurance is problematic and address root causes. It should also be appropriate for and commensurate with the specific issue, rather than a broad brush approach that may distort an otherwise effectively functioning market.

This is particularly so given the current debate around insurance affordability in northern Queensland. In this context, the Report notes the Government's intention to "clarify" that brokers can use price as the basis to recommend insurance provided by unauthorised foreign insurers (***UFIs)*** and that UFIs 'may provide some competition and offer lower prices in targeted areas prone to natural disaster[5].'

QBE considers that the entry of UFIs into the retail home building and contents insurance market is likely to have significant unintended consequences. Australia's general insurance industry is already vigorous and competitive - it understands the unique nature of the Australian market and the risk profiles of regional areas.

It is highly doubtful that UFIs would focus their attention on the higher-risk regional markets without government intervention or encouragement, which we suggest would be difficult to achieve given their non-domestic status. The best interests of policy-holders would not be served by the entry of foreign insurers to 'cherry pick' sections of the national insurance market. Consumers who opted for policies offered by UFIs would be choosing providers and products that were untested and untried in the Australian market and that would not be supported by the extensive and rigorous consumer protections that apply to the provision of regulated insurance products in Australia.

QBE is most concerned that this potentially major structural change to the market could be made without careful analysis of the impact on consumers and the industry. Introducing UFIs who are not required to comply with the Australian regulatory regime creates an un-level playing field for Australian insurers and exposes consumers to considerable risk. This presents an anomaly. On the one hand, Government and regulators have spent much of the last decade introducing regulation to ensure post HIH that our regulated insurers are prudentially sound and Australian consumers are protected. On the other hand, Government and regulators may potentially be encouraging unauthorised foreign insurers to enter the market and write insurance without such protections for consumers as their costs are likely to be lower through not being required to meet the stringent Australian regulatory and compliance requirements[6].

Ongoing participation by insurers who are currently operating under the existing regulatory regime, would need to be carefully considered in this context.

The Australian insurance sector is highly regulated, with prudential oversight by Australian Prudential Regulation Authority (***APRA***) and with market conduct of the provision of financial services, supervised by Australian Securities and Investments Commission (***ASIC)***. There has been no market failure or significant consumer detriment that would indicate policy intervention in the market is required.

Government intervention that distorts or destabilises a functioning market runs the risk of thinning or undermining the availability of private insurance. If private insurance cover becomes scarce, it is simply a question of time before the Government will be required to fund peoples' losses, which will have significant implications for budget expenditure.

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[5] Ibid, page 231.

[6] Please also see our further comments on the costs of regulation and the resultant impact on premiums under "Regulatory System" on page 6 of this submission.

Governments clearly have a role to play in ensuring that appropriate incentives are in place for reducing and mitigating risk. High risk legacy issues need to be identified, prioritised and mitigated. Cohesive action needs to be taken to increase the resilience of communities, stop allowing development in inappropriate areas and ensure construction in "high risk' areas meets building standards that would considerably reduce the potential damage, should a significant weather event occur.

It is also open for Governments to reduce insurance premiums and increase affordability of insurance by abolishing taxes and levies, including GST, that are imposed on insurance premiums. QBE also queries whether Government has considered that it is unlikely such taxes and levies would be imposed on premiums charged by UFIs, further exacerbating the un-level playing field and impacting on the revenues of Governments.

Numerous reviews, including the recent Henry Tax Review, have unanimously found that state taxes, duties and levies on insurance are very inefficient and in fact counterproductive. One major concern, is that the level of taxes applied to general insurance policies impacts the affordability of insurance in the community and in all probability, decreases the level of insurance in Australia.

Given the importance of affordability of insurance and the potential implications of non or underinsurance on the public purse, QBE believes it is time to act to remove all these specific imposts on insurance, as has previously been recommended.

Lenders mortgage insurance

QBE appreciates the consideration given to lenders mortgage insurance (***LMI***) by the FSI. LMI has been a critical component of the housing market since 1965, facilitating home ownership and accessibility to credit for millions of borrowers. Currently, internal ratings based (***IRB***) lenders receive no capital benefit for the use of LMI, despite the fact that the LMI providers are required to, and do hold, significant capital for the risk that is transferred. APRA's specific regulatory capital regime for LMI requires LMI providers to hold capital at multiples of that held for traditional property and casualty lines. This significant and independent layer of fungible capital provides support specifically for credit default risk on residential housing, which should be recognised.

The Report refers to LMI in the context of discussion on IRB mortgage risk weights. The Report recommends that APRA should adjust the requirements for calculating risk weights for housing loans, to narrow the difference between average IRB and standardised risk weights. Such adjustment should be 'achieved in a manner that retains an incentive for banks to improve risk management capacity.'

The Report also states that in determining its approach to narrow the risk weight gap, APRA should '*seek to maintain as much risk sensitivity in the capital framework as possible and recognise lender mortgage insurance where appropriate.'*[7]

QBE welcomes the comment on LMI in the Report and strongly **supports** the FSI's view that APRA should appropriately recognise the role and value of LMI when determining the mortgage risk weights for insured loans. LMI plays an important role in the home lending market and appropriate recognition by way of capital relief for lenders utilising LMI would ensure that LMI continues to benefit the housing industry, and its customers, and continues to facilitate increased competition between lenders. QBE also agrees with the FSI's comments on the importance of expanding credit data sharing under the new voluntary comprehensive credit reporting regime which QBE considers will lead to better credit decisions across the system.

Ultimately, the recognition of LMI for capital purposes for IRB risk weights would enable LMI to continue to play its significant risk management role and "second set of eyes" for the residential home lending market. It will bolster financial and economic stability and importantly, improve access to affordable home ownership. Further detail on the important role of LMI is available in our previous submissions to the FSI.

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[7] Op cit, *Report*, page 66.

Improved guidance and disclosure in general insurance

The FSI has recommended '*improve(d) guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance (Recommendation 26).ibid*[8]'

QBE considers it is critical that further engagement and collaboration with consumers and all levels of Government continues to:

- increase understanding and awareness of how insurance operates and enhance the reputation of the industry; and
- ensure the insurance industry understands and operates to meet the needs of its customers and consumers.

QBE **supports** the FSI's recommendation and appreciates the importance of increasing consumers' understanding of the value and operation of general insurance.

The insurance industry is very focused on continuously improving consumers' understanding of general insurance and as noted in the Report, is currently working on enhancing disclosure and improved disclosure documents for home insurance products.

Over recent years, the insurance industry has responded to community concerns in various ways to alert and educate consumers on the role of insurance and of the risks of non and underinsurance. There have been extensive efforts[9] from insurers, industry and governments to increase consumers' understanding of how insurance operates and the importance of being adequately insured.

QBE **supports** the FSI's position that insurers should, as much as practically possible provide guidance to consumers of the likely replacement value for home building and contents. Most insurers now provide building value replacement calculators to guide consumers in this respect and continue to develop and improve on current processes. We note however, these calculators are based on estimates and are predicated on a variety of assumptions and are not tailored to an individual's specific circumstances or individual property. Nor are insurers best place to advise on changes to rebuilding standards. This information is best obtained at the local government level.

Increased transparency and disclosure to purchasers of property by local governments in high natural peril risk areas should also be considered in this debate. Although there are clear legacy issues to consider, looking forward, QBE considers that local governments are best placed to provide risk information to consumers - at times of purchase or occupation - that would enable better informed choices to be made by individuals. Similarly, local government is best placed to advise on changes to rebuilding standards. While insurers can provide tools and calculators to assist consumers, such local information is not specifically and systematically available to insurers.

QBE also believes gaining a better understanding of the drivers of consumer behaviour will be critical in delivering improved outcomes on disclosure. The current regulatory requirements and "one size fits all" regime for financial services are often ill-suited for general insurance products and complicated by the separate and specific legislative requirements contained in the *Insurance Contracts Act 1984*. QBE considers the FSI recommendation on improved disclosure for general insurance creates an important opportunity for Government, regulators and the industry to focus separately on general insurance disclosure without the complexity that arises from more contentious issues that exist in the context of more complex financial products.

To this end, QBE is very **supportive** of the FSI's recommendation to facilitate innovative disclosure (*Recommendation 23*) and for Government to remove regulatory impediments to innovative product disclosure and communication with consumers and to improve the way in which risk and fees are communicated.

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[8] Ibid, page 227.

[9]Some of these initiatives include the recent launch of the industry's *Understanding Insurance website*, the availability of uplift cover, indexation and estimation tools provided by insurers to assist consumers appropriately estimate the sum insured.

Product development, distribution and regulation

QBE notes the Report's recommendation to strengthen product issuer and distribution accountability with the introduction of a targeted and principals based product design and distribution obligation (*Recommendation 21*).

QBE **does not support** this recommendation in relation to the development of general insurance products. General insurance products are generic in nature and are marketed very broadly to consumers. The *Insurance Contracts Act 1984* also provides comprehensive and specific regulation governing the features and operation of general insurance products. In these circumstances, QBE considers the additional operational and compliance costs that will arise if this recommendation is adopted for general insurance products are likely to outweigh any real practical benefit for consumers and ultimately, will increase the cost of insurance and further impact on affordability.

Additionally, QBE **does not support** the introduction of a proactive product intervention power for ASIC in relation to general insurance products. This is particularly so where this power could be used, as suggested in the Report, without a suspected breach of the law. The examples described in the Report where there has been significant consumer detriment all relate to the disclosure and distribution of complex financial investment products that can expose individuals to financial ruin. While targeted early intervention might be merited in such circumstances, given the nature of general insurance products and the history of the industry's ongoing and co-operative interaction with ASIC on issues relating to insurance, we consider that ASIC's existing powers are sufficient and do not require strengthening for general insurance products.

Regulatory system

QBE recognises the need for operational independence of regulators, however, it also considers that regulators should be held accountable for their performance and compliance with their mandates. As such, QBE **supports** the FSI's recommendation that a new Financial Regulator Assessment Board be created to advise Government annually on regulators' performance (*Recommendation 27*). QBE also supports the benchmarking of financial service regulators (such as APRA and ASIC) against their international peers, to ensure that unnecessary barriers to international competitiveness and market access remain front of mind in designing and applying Australia's regulatory framework.

QBE suggests both APRA's and ASIC's mandates should be reviewed to incorporate a formal objective that the regulators must consider the impact of regulatory requirements and reforms on competition, efficiency and innovation in the insurance industry, which operates in a global marketplace. As such, QBE **supports** the Report's *Recommendation 30* which proposes strengthening the focus on competition in the financial system with regular reporting of how regulators balance competition against their core objectives.

While recognising the commitments made by ASIC and APRA in their recent Statements of Intent, all regulation creates and imposes costs. In the general insurance industry, these additional costs will ultimately result in higher prices to customers and affect shareholder returns. In the competitive global market for investment capital, the insurance industry must continue to be an attractive destination that provides adequate commercial returns to its shareholders. To do this, the insurance industry must keep its costs competitive and operate as efficiently as possible in an environment that recognises and supports this goal, so we are not put at a disadvantage to other industries competing for investment. In turn, this will enable us to provide suitable and more affordable products for customers.

As outlined in QBE's initial submission to the FSI, APRA's continually expanding regulatory ambit over time has led to commensurate increases in costs, and consequently, increases in levies for financial institutions that have been significantly higher than inflation. Given this experience, QBE does **not support** the FSI's recommendation to introduce an industry funding model for ASIC (*Recommendation 29*). Particularly given ASIC's broad role as the national regulator of corporate entities with responsibility for market protection and consumer integrity issues across the financial system. Given the breadth of this regulatory role, QBE considers it is appropriate for ASIC to be funded by Government, rather than industry.

QBE considers any move to a more autonomous funding methodology for regulators would need to be implemented with greater transparency, consultation and accountability. As noted by the Insurance Council of Australia in its submission, regulators should consult early with the industry on the proposed activities and priorities for the coming year and enable industry to provide meaningful input and debate. Additionally, there needs to be embedded mechanisms for ongoing monitoring and effective review of regulators' performance to ensure that value for money is provided.

QBE also **questions** the need for strengthened crisis management powers for APRA as contemplated in *Recommendation 5* and considers this should be substantiated. As observed by the FSI, there is a clear recognition that insurers are less likely to generate or amplify systemic risk[10] within the financial system or economy, given the absence of liquidity risk and minimal risk of contagion for insurers. As such, QBE questions the need to give APRA greater crisis powers for the general insurance industry without adequate safeguards to minimise the potential unintended consequences that would be significant for a global insurer, such as QBE.

QBE appreciates the FSI's recognition that the scope and pace of domestic regulatory change in the post GFC environment is a major issue and that unnecessary compliance costs and poor policy processes are a concern. QBE strongly **supports** the Report's *Recommendation 31* which proposes the time for industry to implement complex regulatory changes be increased and also that post implementation reviews of major regulatory changes be made more frequently.

Thank you again for the opportunity to respond to the FSI's Final Report. QBE, as one of the few domestic Australian-based financial institutions to be operating on a truly global landscape, welcomes this Inquiry as an opportunity for Government and market participants to take into more active consideration the need for a more productive, innovative and competitive economy.

Please do not hesitate to contact Kate O'Loughlin at kate.oloughlin@qbe.com or on (02) 8275 9089 if you would like to discuss any aspect of this submission if should you require more information.

[10] Financial System Inquiry - Interim Report, 15 August 2014, chapter 3-6.