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Study of Financial System Guarantees
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INSURANCE AUSTRALIA GROUP'S RESPONSE TO THE GOVERNMENT'S DISCUSSION PAPER ON FINANCIAL SYSTEM GUARANTEES

Insurance Australia Group (IAG) welcomes the Government's *Discussion Paper* on Financial System Guarantees (May 2004) released by the Federal Treasurer, the Hon. Peter Costello. IAG is encouraged that the purpose of the *Discussion Paper* is to provide all stakeholders with a suggested framework for commenting on the issues raised by Professor Davis in his Report (*Study of Financial System Guarantees, March 2004*) released on 27 May 2004.

IAG notes that the Government's overall objective remains one of "encouraging a financial system that appropriately balances financial system safety, efficiency and competitiveness" and that the diverse needs of the industry and consumers need to be adequately addressed. Importantly the Australian Government recognises that "the regulatory framework should not entail an open-ended financial commitment from governments or taxpayers".

No need for a Financial System Guarantee

As you are aware, the *Study of Financial System Guarantees* (Davis Report) noted that the "vast majority of formal submissions to the Review did not support the introduction of an explicit guarantee to the Australian financial system on the grounds that a case for change is yet to be made. Many of the submissions cited the rejection of a guarantee by the Financial System Inquiry in 1997".

The Davis Report also noted "there was a consistent theme that institutions should be allowed to fail and that Australia's existing prudential and regulatory arrangements provides appropriate frameworks for markets to operate competitively".

The Report stated "those not in favour of a scheme argued that it would impose an additional cost on consumers as well as 'honest' industry participants".

Indeed, the Report noted, " a widely held vision of an efficient financial system is one that is competitive and contestable, offers a broad spectrum of risk and return opportunities, promotes and rewards innovation, punishes failure and avoids artificial regulatory distortions. Consistent with the FSI vision, Australia's financial sector regulatory framework is geared to delivering these outcomes".

IAG stated in its submission to the Davis Study:

"IAG is not, and should not be, responsible for the financial promises of its competitors. IAG believes the concept of taxing viable insurance businesses through the introduction of financial system guarantees to cover the costs of the failure of a competitor is inconsistent with a market competing for the delivery of a product to consumers. IAG does not support the introduction of financial systems guarantees for the Australian insurance industry".

This remains our position.

Funding of a Financial System Guarantees Model

It is significant that Davis Report stated in relation to financial system guarantees funding models that in the "case of insurance guarantee funds, pre-funding is much less common, perhaps reflecting the uncertainty associated with calculating the quantum and timing of policy liabilities..."

The Report highlighted that a post-funded system, "particularly in light of Australia's limited experience with financial institution failure, was strongly favoured. Issues of adverse effects of cross-subsidisation were also raised."

IAG notes that the recently released Productivity Commission Inquiry Report into National Workers' Compensation and Occupational Health and Safety (June 2004), stated in relation to a post-funded financing model:

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

Should the HIH Royal Commission's proposed policyholders support scheme be implemented by the Australian Government, the Commission considers there would be little need for the various State and Territory schemes to continue nominal insurer arrangements to cater for the consequences of insurer insolvency. However, the proposed policyholders support scheme would not obviate the need for individual schemes to have nominal insurer arrangements where (say) an employer has not taken out a policy of workers' compensation insurance".

IAG stated in its submission to the Davis Study of Financial System Guarantees,

"...Again, IAG does not see merit in the establishment of financial systems guarantees for the insurance sector. However, should a financial systems guarantee scheme be established IAG believes that such a scheme should only be considered in relation to the package of reforms proposed by the HIH Royal Commission Report and be funded on a post-funded basis".

We at IAG are happy to discuss this submission and to assist the Government in making a decision whether any form of financial guarantee scheme should be introduced for the Australia insurance sector. Moreover, should a decision be made to undertake such financial system reform, IAG would welcome the opportunity to participate in the design of any system.

If you wish to discuss this matter or make further inquiries please contact Barbara Hayes, Head of Government Relations & Policy, on (02) 9292 9744.

Yours sincerely

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