MOTOR ACCIDENT INSURANCE COMMISSION QUEENSLAND

SUBMISSION TO THE STUDY OF FINANCIAL SYSTEM GUARANTEES

January 2004

MAIC SUBMISSION TO THE STUDY OF FINANCIAL SYSTEM GUARANTEES

This submission has been prepared by the Motor Accident Insurance Commission (MAIC), regulator of the Queensland compulsory third party (CTP) personal injury motor accident insurance scheme. The submission does not represent the views of the Queensland Government.

The submission is limited to discussion regarding failure of a general insurer, with a particular focus on general insurers underwriting CTP. The discussion relates especially to four of the study's terms of reference, namely:

(b) the implications of introducing a limited explicit guarantee for the general design of the Australian prudential framework and any existing compensation mechanisms (eg state-based arrangements)

(c) the consequences of a financial institution's failure (which may vary by the sector or sectors in which it operates and the kinds of products that it offers) and the current level of consumer protection provided by the Australian prudential framework

(d) the merits of possible guarantee design variables (whether or not a scheme appears warranted) including general and sectoral applications, private underwriting, product application, capping, benefit limits and co-insurance arrangements

(f) funding arrangements, exploring pre- and post-funding, industry funding, consumer funding, and co-funding models (and the possibility of purchasing financial reinsurance cover for any guarantee)

1. The consequences of a financial institution's failure [TOR (c)]

While general insurers provide a range of insurance products, general insurer failure has greatest impact, in social and dollar terms, on long tail personal injury insurance lines. In the case of third party cover, the impact is not only on the policyholder but also the injured third party, who does not have a direct relationship with, or any choice in, the insurer providing the cover.

In a number of Australian jurisdictions, authorised general insurers provide personal injury insurance lines required by law, such as workers compensation and CTP. In Queensland, authorised general insurers licensed by MAIC underwrite CTP. (Queensland workers compensation is government underwritten, with provisions for self insurance for large employers who meet certain requirements.)

In the event a Queensland CTP-licensed general insurer fails, CTP policyholders and claimants are protected by provisions in the governing state legislation, the *Motor Accident Insurance Act 1994*. Section 33 provides that if a licensed insurer becomes insolvent, the Nominal Defendant[1] becomes the insurer under CTP policies in force.

---

[1] The Nominal Defendant's primary function is to act as insurer for claims arising from unidentified and uninsured vehicles.

As the Nominal Defendant is a government instrumentality, effectively the arrangement means that the State Government bears the financial consequences when a CTP insurer fails. In the case of the collapse of HIH, and its Queensland CTP-licensed subsidiary, FAI, this arrangement has meant that the State Government is paying the cost of FAI's outstanding CTP claims liabilities, estimated to exceed $400M.[2] These costs are being met by reserves in the Nominal Defendant Fund, income from a notional $5 per annum levy imposed on policyholders and funds from Government revenue. The alternative could have been a one-off levy on policyholders of $140.

Currently six insurers are licensed to underwrite CTP in Queensland. They are Suncorp, Allianz, RACQI, AAMI, QBE and NRMA. A considerable imbalance exists between these insurers in terms of market share, with the range being 55% to 1.5% of Queensland CTP premium. In the context of any discussion regarding the consequences of insurer failure, the present level of insurer concentration and market share imbalance in Queensland are important factors for consideration.

In aggregate, Queensland's six CTP insurers collect $863 million in premium per year. CTP claims liabilities are estimated to be $2.7 billion. With the State's exposure to insurer failure being $1.5 billion through one insurer alone, the failure of a major CTP insurer – or two or more of the smaller insurers in a short period – would have significant consequences for the State's finances, especially given the impact already being felt as a result of FAI's collapse.

2. **The consumer protection provided by the Australian prudential framework** [TOR (c)]

The current prudential framework provides a certain level of consumer protection against CTP insurer failure, in that only general insurers licensed by the Australian Prudential Regulation Authority (APRA) may apply to MAIC for a CTP licence. MAIC is empowered with certain supervisory functions under the *Motor Accident Insurance Act 1994,* although the HIH situation illustrated that these functions are largely ineffectual in the context of an insurance group's operations.

Only APRA has the power, under the *Insurance Act 1973,* to prudentially regulate and supervise a general insurer's entire business operations. MAIC's 'supervisory' role is limited to an insurer's Queensland CTP business and includes monitoring the insurer's operations in terms of claims management practices, collection of claims data etc. It has always been considered unworkable to duplicate, at a State level, APRA's functions in respect of an insurer's entire book of business.

In an operational sense, this has meant that MAIC has relied on APRA (and its predecessor, the Insurance and Superannuation Commission) to supervise an insurer's activities, to monitor its solvency and if problems arise, to manage the insurer's orderly exit from the market.

[2] At the time FAI failed, it was underwriter for 23.5% of Queensland CTP policies.

The collapse of HIH highlighted the limitations faced by a state regulator monitoring only a subset of an insurer's business, and the impact an insurer's non-CTP activities can have on a viable CTP scheme. As evidence before the Royal Commission demonstrated, FAI's losses were not in CTP (and especially not in Queensland CTP), yet Queensland is bearing the consequences of the insurer's failure in other areas of its business (eg losses in other business lines, overseas underwriting losses, and inward reinsurance arrangements).

Currently there is no requirement for Queensland CTP insurers to quarantine their CTP funds from other aspects of their business or to restrict the flow of funds from a subsidiary to the group. While there are mutual advantages to having CTP as part of the insurer's larger pool, the downside is that Queensland CTP consumers are exposed to any adverse impacts arising from the insurer's broader operations. This is a key concern for MAIC.

Recent enhancements (and future improvements)[3] to APRA's regulatory powers and its supervisory capacity in relation to general insurers provide for a much stronger prudential framework than that in which HIH operated. Of particular importance are the new prudential standards that took effect from 1 July 2002, which have already resulted in general insurers strengthening their balance sheets.

Enhancements to APRA's prudential framework should improve consumer confidence in the financial soundness of Australia's general insurers. However, a strong framework can only serve to reduce the probability of failure. It can not, nor should it, be seen by governments or consumers as a guarantee against failure.

This is particularly so in light of the changing nature of the insurance industry. General insurance is now a much more global business than it has been in the past (eg. all Queensland CTP insurers have international exposures through investment operations and some insurers have international exposure through underwriting).

Furthermore, the insurance industry faces increasing uncertainty and unpredictability relative to recent decades. As demonstrated in the aftermath of the terrorist attacks on the World Trade Centre and the 2002 floods in Europe, such unexpected, external events can have a serious impact on the balance sheet of an Australian general insurer operating in an international market, if the insurer is not in a position to recapitalise. Likewise the viability of general insurers can be put at risk if there are failures amongst reinsurers.

Domestically, there is also the potential for major natural disasters to impact adversely on the balance sheets of general insurers. With Australia's population concentrated in its major cities on the eastern seaboard, history has already shown the degree of exposure insurers have to cyclones, floods, hailstorms, earthquakes and the like.

Even a strong Australian prudential framework cannot fully protect Australian consumers against risks arising from international events, terrorist attacks and natural disasters.

---

[3] The *General Insurance Reform Act 2001*, a governance restructure from 1 July 2003 and other reforms under development as outlined in APRA's Discussion Paper issued 20 November 2003.

3. The implications of introducing a limited explicit guarantee for the Australian prudential framework and existing compensation mechanisms [TOR (b)]

The implications of introducing a limited guarantee system to protect policyholders (and third party claimants) will be dependent on the design and scope of the scheme. The strength of the system under the most adverse conditions would also be a critical factor.

If the proposed guarantee was such that the Queensland Government had sufficient confidence the system would provide Queensland CTP policyholders and claimants with the same protection currently afforded to them – even if a dominant insurer failed – then the State would remove from its legislation the Nominal Defendant provision for meeting the liabilities of an insolvent insurer.

To the extent that MAIC currently involves itself in the prudential regulation of its insurers, Queensland's acceptance of the guarantee system would make such involvement unnecessary. Any references to prudential supervision of insurers would be removed from the legislation. APRA would be the sole prudential regulator for all aspects of a general insurer's business.

The design variables and funding arrangements that would give Queensland confidence to take these steps are discussed in section 4 and 5 below.

On the other hand, if the guarantee did not extend to statutory classes, or took a minimalist approach to benefits, and/or could not handle a systemic failure, then Queensland would have to consider other measures to mitigate the State's financial exposure to CTP. In this respect, MAIC has been looking at the options available.

During 2002, MAIC released two Discussion Papers on the subject of mitigating the State Government's risk in CTP insurance. More recently, MAIC has been exploring in greater depth several of the options, one of which is a single line of business structure for Queensland CTP. Under this model, general insurers wishing to participate in the Queensland CTP market would have to establish a separate subsidiary that would carry on no other business than CTP in Queensland. The benefit of this model would be that CTP funds would be quarantined in the subsidiary and would not be exposed to the non-CTP risks of the parent, provided exposures via intercompany loans and reinsurance arrangements were minimised. (This may require certain conditions to be placed on the CTP licence). For policyholders, the model would mean an increase in premium to cover the costs of establishing a subsidiary (including the requirement for more capital) in exchange for the added security the new structure would afford in the event the parent company failed. For insurers, there would be some disadvantages, such as the loss of diversification benefits and some additional capital and administrative costs, which would be compensated for in the premium. From a regulatory perspective, the model would require the subsidiary to be supervised by APRA and to comply with APRA's prudential requirements. Additional MAIC monitoring of the subsidiary would be essential, making the most of the opportunity afforded by the transparency of a CTP-only operation.

4. The merits of possible guarantee design variables [TOR (d)]

MAIC considers it useful to examine this section under several headings:

Will one guarantee scheme cover all financial institutions?

It is clear from the study's terms of reference that the question of an explicit guarantee is to be considered in relation to "certain retail financial products" across the entire financial services sector, not just the general insurance industry. As such the scheme could cover deposit taking institutions, life insurers, and superannuation funds as well as general insurers. Presumably different arrangements would apply to different sectors. It is understood the United Kingdom's Financial Services Compensation scheme operates in this way. The alternative to separate arrangements would mean cross–subsidies between sectors depending on the nature of the funding mechanism to be used for the scheme. Depending on the degree of cross-subsidisation, arguments could reasonably be made that this is inequitable.

Would the guarantee apply to third party insurance policies?

Guarantee schemes typically limit the types of policyholders and claimants who can gain access the scheme. While some limitations are to be expected, it is appropriate that third party personal injury claimants, who have not been involved in the purchasing of the insurance policy, should be covered. Without coverage, an injured third party would have to make a claim directly against the policyholder and if the claim could not be met, they would have to rely on the public health and welfare systems for support.

Would access to the scheme be limited to individual policyholders and small business?

The beneficiaries of guarantee schemes operating in countries such as the UK are generally limited to private individuals and small businesses. Similarly, only individuals and small businesses were eligible to receive assistance through the HIH Claims Support scheme set up by the Commonwealth Government. As the primary goal of the scheme was to provide assistance to those people suffering financial 'hardship' as a result of the HIH failure, businesses that did not meet the definition of a small business were excluded.[4]

The criteria for determining eligibility to a guarantee scheme may also reflect the ability of certain policyholders to make informed choices about who they insure with. In this context, medium to large businesses may be excluded on the grounds that they have the resources available to make informed decisions about the strength of insurance companies and therefore should carry the risk if their chosen insurer fails.

Exclusion from a guarantee scheme would mean, in effect, that corporations would have to meet all claims under their first party policies and third party non-statutory insurance policies eg public liability. They would not have to meet their liabilities under statutory products, provided those products (ie CTP, workers compensation and builders warranty) were included in the scheme.

---

[4] Australian small business proprietor – was defined as an individual, partnership or Australian incorporated company or association employing 50 or fewer full-time equivalents as at 21 May 2001 – related entities of larger organisations did not qualify.

In terms of funding the guarantee, the question arises as to whether or not those parties excluded from being beneficiaries will nevertheless be expected to make a contribution.

Would the guarantee apply to statutory products including CTP?

In principle, a guarantee scheme could apply to statutory insurance such as CTP and workers compensation, especially in those states and territories where licensed private sector insurers provide this type of cover. In this event it would be anticipated that the guarantee scheme would replace whatever state-based arrangements are currently in place to protect consumers. However issues may arise with respect to this proposal, especially given the variance that exists between state schemes. For example, only three of the eight Australian CTP jurisdictions involve private sector insurers.

Would limits be imposed on benefits?

Overseas examples[5] and the HIH Claims Support scheme suggest that limits can be expected on the benefits payable by a guarantee scheme. Under the HIH Claims Support scheme only certain insureds were eligible to 100 cents in the dollar. The benefits payable to other insureds were capped (at 90 cents in the dollar) and subject to an income test.

If a guarantee were to include statutory insurance classes such as CTP, whatever benefits are currently available under existing state arrangements would have to apply. In the case of Queensland CTP, claimants are entitled to the benefits payable at common law by virtue of the common law nature of the scheme. The only limits which apply are with respect to loss of income (capped at 3 times average weekly earnings) and general damages capped at $250,000. If an insurer fails, claimants are currently entitled to full benefits through the Nominal Defendant provision. Benefits payable under a guarantee scheme would have to be equivalent. Removal of the Nominal Defendant provision for anything less than the current coverage is likely to bring community pressure to bear on the State Government to address any shortfall.

Would the unexpired portion of policies be covered by the guarantee?

The guarantee scheme would need to cover the unexpired portion of policies for a specified period or else policyholders would have to purchase new insurance cover the day after the insurer providing the cover collapsed. By way of example, in the wake of the collapse of HIH on 15 March 2001, the HIH Claims Support Scheme was announced on 17 May 2001 and policyholders were given to 11 June 2001 to take out replacement policies.

For Queensland CTP, the CTP insurance renewal process is complicated as it is presently aligned to vehicle registration. If a CTP insurer failed, registration would continue and motorists would continue to drive potentially without CTP insurance cover until they had alternative cover in place. This was not an issue for Queensland CTP policyholders when HIH failed as all of FAI's in-force policies (as of 1 January 2001) had been transferred to the Allianz-FAI joint venture.

[5] UK and Canada

Who would be expected to step in if the guarantee scheme got into difficulties?

In a worst case scenario, a guarantee scheme could run into difficulties if a major catastrophe led to the failure of one or more market leaders and there was insufficient viability in the remaining insurance industry to collect an ex poste levy. Though such a scenario may be regarded as remote, it is not improbable. The Australian general insurance market is relatively concentrated, with four or five companies commanding more than half the market share. The experience of consumer protection schemes overseas suggests that very few schemes are able to meet their obligations when a major institution fails in a concentrated market, without resorting to significant Government funding.

If the Nominal Defendant provision was removed from the Queensland legislation and the guarantee scheme got into difficulties the State Government may be left with a moral obligation to step in and pay the claims. Preferably, the Commonwealth Government should agree at the outset to make financial resources available to the scheme if the need for such backup support arose.

5. Funding arrangements [TOR (f)]

An industry-funded guarantee

In their future policy directions submission to the HIH Royal Commission, the Insurance Council of Australia (ICA) proposed an industry-funded guarantee scheme. Under the ICA model, all APRA-regulated insurance entities (including state government insurers) would pay an *ex poste* levy based on outstanding liabilities. Insurance companies would have the capacity to pass on any contribution to the scheme to policyholders through the pricing mechanism.

The ICA model proposes that all insurance products (including statutory insurance) should be covered by the scheme and all general insurance policyholders across all states would bear any cost passed on, irrespective of the business lines covered by the failed insurer.[6] The advantage of such a broad-based levy is that it maximises the funding sources, minimises the contributions required from each policyholder and recognises that all policyholders are potential beneficiaries of a guarantee scheme (even state government insurers).

On the other hand from a CTP perspective (assuming CTP underwritten by licensed insurers was covered by the guarantee), the ICA funding model would mean general insurance policyholders in states where statutory classes are Government underwritten would have to pay the cost of any levy passed on by industry to help pay for failure of an insurer, even if the bulk of the insurer's liabilities arose from underwriting a statutory product in another state. In this regard, MAIC has concerns that political and community issues may arise in those states with Government underwritten schemes.

---

[6] The only distinction the ICA suggests should be made between the different classes of insurers or lines of business is in the context of the calculation and collection of contributions.

A levy on policyholders of like-insurance products

An alternative to a broad-based levy may be to impose a levy only on those policyholders with like-insurance policies to those offered by the failed insurer. Some might argue that this would reduce cross-subsidisation and inequities. However as most general insurers are multi-line companies (with the exception of captive insurance companies) it may be difficult administratively to implement funding in this way. Furthermore, depending on the size of the failure, the pool of policyholders who would be eligible to contribute to the levy may be too small to carry the size of the levy required. It may also put at risk the solvency of particular classes of insurer. For these reasons, MAIC is not supportive of such a concept, especially as for a CTP failure it would theoretically mean that only Queensland, NSW and ACT CTP policyholders would pay the levy if a licensed CTP insurer failed.

Calculating the size of the levy

The size of the funding required is likely to be very difficult to predict. As demonstrated by the failure of HIH, estimating the total of the losses arising from a multi-line insurance company failure can be a difficult task especially with respect to long tail classes of business. Nonetheless, it will be necessary, at the outset, to arrive at a reasonably accurate estimation in order to know how much funding needs to be collected, and over what period of time. Imposing a levy for an undetermined time period would put the long-term viability of the scheme at risk. It would be unpalatable to funders to be still paying a levy for one failure when another failure occurs.

A decision would need to be made on whether a smaller levy was collected over a longer period or a higher levy over a shorter period. The risk of the former approach may be that insufficient funds are available to meet the real-time cost of claims. The risk of taking the latter approach, particularly in the event of a major failure, is that the cost might be such that policyholders opt out of paying, for example, by going uninsured or seeking insurance offshore. The levy would preferably be passed on as a percentage of premium, rather than a dollar amount per policy.

Immediate payments and funding shortfalls

One of the difficulties with funding a guarantee scheme via an ex poste levy is meeting the scheme's immediate cash flow needs without delaying claims payments. To ensure immediate payment of claims and alleviate any strain on the collection of levies from policyholders, the ICA model proposed that the Commonwealth Government would contribute a pre-agreed percentage to the scheme. In the ICA's view Commonwealth contributions would be in recognition of APRA's responsibilities in prudential supervision and 'justify the statutory protection APRA has from claims for damages arising from regulatory failure'.[7]

---

[7] Page 11 of the ICA Future Policy Directions Submission to the HIH Royal Commission titled '*Protection for general insurance policyholders in Australia*', dated August 2002

MAIC agrees that, if the guarantee scheme were to be post-funded, immediate access to funding would be essential and the source for such funding should be the Commonwealth. Further MAIC would prefer to see some pre-agreed mechanism by which any funding shortfalls for the scheme would be addressed so the public can be confident the scheme will be able to meet its obligations to policyholders and claimants.

Commonwealth contributions could be made on the basis that they were non-refundable or alternatively they could be made, in part or full, on the basis that monies advanced would be repaid eg by extending the term of any levy, if this were the funding mechanism in place.

Funding and the magnitude of failure

One of the most important considerations in terms of funding is the magnitude of failure the guarantee is expected to handle. While a pre-funded or post-funded scheme may be able to provide for a small to medium-sized failure, issues may arise under either funding arrangement when the scheme is faced with failure of a large institution or a number of small institutions in a short period of time.

In the face of failure of significant magnitude, MAIC is concerned, for example, that proposals for ex poste levies on policies could not be set at a level sufficient to meet, on a timely basis, the full costs of the promised protection. At such times, the industry is likely to be in a crisis state and/or the remaining players may be unable to collect the levies quickly enough to absorb the cost.

Under these circumstances, the likely outcomes would include the Commonwealth Government providing loans or grants, and emergency amendment to the extent of cover of the scheme with statutory classes possibly being forced back onto State Governments. (On a micro level, this was the situation that arose in the Northern Territory's workers' compensation scheme following the collapse of HIH.)

Models of guarantee schemes would need to be tolerance tested to see the magnitude of failure that could be handled. For example, how would the model have performed in response to the failure of HIH? The ability of a guarantee scheme to minimise any systemic flow-on effects should also be considered, especially in the framework of Australia's relatively small economy. The perceived strength of the model is likely to have implications for stakeholder acceptance of the scheme.

Financial reinsurance cover for the guarantee

Reinsurance – essentially for insurer insolvency – was one of the options considered by MAIC in its first Discussion Paper on mitigating the State's risk to CTP insurance. However responses from insurers and reinsurers indicated this option, though theoretically possible, would be unattractive to the reinsurance market. Moreover, there was agreement that, if such cover were available, the cost would make it uncommercial. As the ICA pointed out in their submission[8] 'exacerbating the availability problem for this option is the current very hard market for reinsurance worldwide. Even traditional reinsurance cover has recently become much more difficult to obtain, and prices have increased dramatically'.

[8] In response to the reinsurance option presented in MAIC's February 2002 Discussion Paper

Finally, reinsurance itself does not completely eliminate risk as the party providing the third party guarantee may become insolvent itself.

Conclusion

Despite the limited focus of the above discussion, it demonstrates that there are a myriad of issues to be examined in relation to a financial systems guarantee. From MAIC's perspective, the strength and effectiveness of any guarantee scheme needs to be beyond doubt to be of value to the Queensland CTP scheme. To assist MAIC to evaluate the strength and effectiveness of such a scheme, it would be critical that the details of the framework/s for a workable guarantee scheme be spelt out in the study report.

In addition, if the technical study found it was in a position to specify the limitations of any proposed guarantee scheme, these limitations should ideally be identified in the study's report. This would facilitate MAIC's process with respect to other options which may mitigate the State's risk to CTP insurer failure.