

28 November 2002

Ms Ruth Smith
Department of Treasury
Langton Crescent
PARKES ACT 2600

Dear Ms Smith

**Insurance Council of Australia (ICA) submission
Commonwealth Treasury Issues and Options Paper
Compensation for Loss in the Financial Services Sector, September 2002**

ICA welcomes the opportunity to provide a response to the Issues and Options Paper released in September 2002.

It is ICA's submission that the proposals for compensation arrangements should not apply to general insurers authorised under the Insurance Act 1973. In general, the arrangements should not be targeted at bodies regulated by the Australian Prudential Regulation Authority (APRA).

Chapter 2A of the Issues and Options Paper identifies the problem to be addressed, namely that "financial services licensees do not always have assets to meet claims arising from clients losses which result from misconduct in the course of providing financial services – for example, defrauding clients of their funds or financial products".

ICA submits that the scope of the problem of not having assets to meet claims for losses in relation to general insurers and their authorised representatives is significantly negated by existing legislation. The commencement on July 2002 of major reforms to the Insurance Act 1973 brings new prudential standards, including more stringent capital adequacy and risk management requirements to the operations of authorised general insurers.

The likelihood of a general insurer not having assets to meet a client's losses is negligible, and the capacity of a general insurer to cause a client significant financial loss because of negligent or dishonest conduct (eg defrauding clients of their funds) is also negligible compared with other industries in the financial services sector.

Importantly, the retail clients of general insurance companies pay a premium to transfer a financial risk to an insurer under the terms and conditions of an insurance contract. Thus, clients make a payment for service rather than make an investment of funds. The ability of the insurer to honour the terms and conditions of the insurance contract is the prime consideration of the reformed Insurance Act 1973.

The new prudential standards place new and onerous conditions on authorised general insurers' that are designed to:

- Improve risk management;
- Prevent under-capitalisation in general insurance;
- Discourage poor management and improve corporate governance; and
- Improve public confidence in the industry.

Details of these reforms and the new prudential standards are set out in the Commonwealth Government's submission to the HIH Royal Commission.¹ The Commonwealth Government states that:

The over-arching objective in developing a new framework for the prudential supervision of general insurance is to provide a more secure environment for policyholders. The revised Insurance Act strengthens the requirements for general insurers to conduct insurance business and increases APRA's enforcement powers to undertake its regulatory responsibilities. ...

Overall, the Commonwealth considers the significant reforms to the Insurance Act represent an appropriate response to concerns about the former framework. They can be expected to reduce the likelihood of failure of a general insurance company in the future.²

Within the framework of this existing legislative protection, the quantum of any loss to an individual resulting from breaches by a general insurer of obligations under the Corporations Act 2001, is likely to be significantly less than any loss that may be suffered by a retail client of other financial services licensees.

Equally, any potential breach of Chapter 7 obligations by a general insurer is likely to affect one individual only. Dishonest or negligent behaviour in relation to an investment fund or misleading financial advice is more likely to affect a group of investors and produce losses of considerably greater quantum.

Retail clients of general insurers have a further level of protection under the Insurance Contracts Act 1984. Whilst the requirements of that Act do not specifically refer to the matter of compensation, there are, nevertheless, prescribed courses of action to be followed by general insurers which provide significant protection to retail clients when entering into or renewing a contract of general insurance.

The General Insurance Enquiries and Complaints Scheme (an original initiative of ICA) provides yet a further level of significant consumer protection.

This national scheme, with free access by claimants, is established to resolve claims disputes arising out of a range of general insurance consumer products. The Scheme is formally approved by the Australian Securities and Investment Commission. In the year ended June

¹ Commonwealth Submission to the HIH Royal Commission, October 2002, pp 19-34.

² Above, pp 28-29.

2002, 13,562 disputes were referred to the Scheme. This represents about 0.5% of all claims covered by the Terms of Reference of the Scheme. 32.4% of the determinations made by the independent Claims Review Panel were in favour of the consumer.

In claim disputes involving Consumer Credit insurance, 68% of determinations were in favour of the consumer. In Personal Valuables insurance, 54% of determinations favoured the consumer, whilst in Pleasure Craft, the consumer was favoured in 55% of determinations.

The costs of requiring any change to the current consumer protection arrangements for general insurance could significantly outweigh the benefits, given the relatively limited scope for loss to retail clients caused by general insurers in the context of the broader financial services sector. Currently, general insurers directly meet claims for breaches of Chapter 7 obligations by insurers or their authorised representatives.

Finally, ICA notes that the Issues and Options paper does raise the issue of compensation for retail clients in the event that there is a deficiency (on insolvency/inability to pay) in funds and financial products held *on trust*. It is generally not part of the business of a general insurance company authorised under the *Insurance Act* to hold funds for retail clients on trust. However, in the context of the potential for general insurer insolvency, ICA has made a submission to the HIH Royal Commission in support of the establishment of a policyholder protection scheme for individual or small business policyholders.³ Both the Commonwealth Government and the Australian Prudential Regulation Authority have raised the issue of policyholder protection arrangements in their respective submissions to the HIH Royal Commission.

ICA makes this submission to set out initial views of the general insurance industry on the broad issues raised in the Treasury Issues and Options paper. ICA would appreciate the opportunity to make further submissions on these issues if necessary.

Yours faithfully

Robert Drummond
General Manager, Regulation

³ ICA submission to HIH Royal Commission, 'Protection for general insurance policyholders in Australia' - August 2002