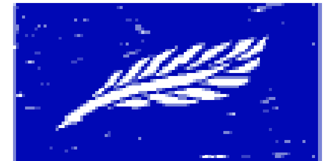

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9 July 07

Mr Peter Hallahan
Secretary
Senate Standing Committee on Economics
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Dear Mr Hallahan

Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007

Thank you for your letter of 27 June 2007 in which you informed the National Insurance Brokers Association (NIBA) that the Committee would be examining the Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Bill 2007 and that the Committing was inviting submissions from interested parties to assist it with its examination of the Bill.

NIBA is pleased to make this submission in response.

NIBA and Insurance Brokers

NIBA is the voice of the insurance broking industry in Australia. Established in 1982, following the amalgamation of earlier broker associations, NIBA represents 300 member firms and 2000 individual Qualified Practising Insurance Brokers (QPIBs) throughout Australia. NIBA members handle approximately 90% of premium transacted by all insurance brokers nationally.

While insurance brokers service the retail market their general focus is the commercial insurance market. Over 80% of all commercial insurance in Australia is placed by NIBA insurance brokers.

Australian insurance brokers are required to hold an Australian Financial Services Licence and are regulated by the Australian Securities and Investment Commission.

Insurance brokers represent the interests of the purchasers of insurance and not those of insurance companies. Insurance brokers are the advocate for their client in arranging

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insurance. Their role is far more than simply being a distributor of products for local insurers. Brokers seek to understand and assess their client's needs and offer solutions (not all of which are insurance) for the risk exposures of their clients.

In putting forward this submission NIBA is representing the purchasers of insurance and is seeking to balance appropriate consumer protection with reasonable access to insurance at affordable prices. Considerable care needs to be taken in introducing "consumer protection" measures for all purchasers of insurance that may limit supply and restrict access to insurance necessary for some to cover their risk exposure. It is only three years ago that insurance premiums in Australia increased rapidly and many people and companies were simply not able to purchase insurance at any cost.

NIBA's General Response to the Bill

Discretionary Mutual Funds (DMFs)

NIBA notes that:

- The Government does not intend to regulate DMFs at this time.
- The Bill provides for the collection of data about the operation of DMFs. This data should allow the performance of DMFs to be monitored over a three year period.
- The Corporations Regulations are to be amended so that DMFs are required to disclose to clients the key characteristics of their product, including that the DMF has discretion whether or not to pay a claim.

NIBA supports this approach to the regulation of DMFs.

Direct Offshore Foreign Insurers (DOFIs)

NIBA notes that:

- The Bill amends the Insurance Act so that anyone carrying on general insurance business in Australia, either directly or through the actions of another, including an insurance broker representing the client, must become authorised and prudentially regulated by the Australian Prudential Regulation Authority (APRA).
- The Bill provides exemptions from the new regime by way of Regulations.
- There is no specific exemption for overseas captive insurance for Australian company groups.
- Australian based insureds will not be prohibited from dealing directly with DOFIs overseas or through an overseas insurance broker.
- APRA is to review its prudential standards.
- Statistics about insurance business being placed overseas is to be collected by ASIC from insurance intermediaries.

NIBA supports the protection of Australian consumers against poorly capitalised foreign insurers operating out of countries with an inferior regulatory regime and agrees that tougher regulation of foreign insurers is needed in Australia. For this reason NIBA does not oppose the DOFI requirements in the Bill. NIBA does, however, have some major potential concerns with the approach adopted in the Bill.

These major potential concerns are:

- The exemption details, one of the most important aspects of the proposed DOFI requirements, have yet to be determined and there is considerable doubt as to just how extensive they will be and to whom they will apply.
- NIBA would not want to see any limiting of access to foreign insurers leading to restricted availability, higher premiums and a significantly lower level of competition in the Australian insurance market.
- Under the Bill insurance brokers are prevented by law from performing functions that their clients are legally able to reform, namely placing insurance with overseas insurance companies not authorised by APRA. The extent of NIBA's concerns in this regard will very much depend on the extent and nature of the exemptions that are put in place.

NIBA does acknowledge that the Minister for Revenue and the Assistant Treasurer has indicated that limited exemptions will exist for DOFIs underwriting risks that cannot be underwritten in Australia, either because the Australian general insurance market is too small or because it is not sufficiently specialised to underwrite the risk. Such statements, however, do not give sufficient clarity to insurance brokers and their clients as to whom the arrangements in the Bill will actually apply.

The Insurance Markets

The insurance markets are, like other financial markets, a mixture of local and global markets. The local market generally caters for the individual and SME segment in Australia. It also provides cover for many of the risks that larger commercial insureds wish to transfer. However the local market tends to be more adversely affected by the insurance cycle; during hard markets, the local market is likely to reduce the cover available, either absolutely by withdrawing from certain products, or partially, by reducing the coverage provided by products.

Global markets are characterised by greater capacity, greater global reach and specialisation, particularly around more complex risks and industries. They tend to continue to provide cover during the full, hard and soft, market cycles. They also focus on more complex risks and industries requiring greater underwriting skills. They can also provide larger Australian-based groups with a global program providing cover and support in all the countries that the group operates in.

Access to global markets is important for Australian larger businesses. They provide these businesses with consistency of cover particularly for more complex risks and in a hard market cycle are often the only markets offering meaningful cover.

These global markets operate out of global financial centres such as, for insurance, London and Bermuda. They are not by any means restricted to Lloyds although Lloyds is part of the global market. While some insurer groups may have branches around the world they focus their specialisation around complex risks and industries in these global centres.

The proposed approach in the Bill is unlikely to result in many of these global market participants seeking local authorisation. Such global players are simply not interested in placing risks in particular country silos or adding another layer of compliance costs and red tape to their businesses.

While some of the larger affected Australian businesses will be able to find ways around any restriction imposed as a result of the new legislation by e.g. either by dealing overseas with foreign insurers or using overseas insurance brokers, many will not. It is not just the 'super' businesses that need to access global markets. It is industries with complex or unusual risks that need this wider market access.

Exemptions

NIBA has for many years been a strong advocate for introducing measures that protect Australian consumers against poorly capitalised foreign insurers operating out of countries with an inferior regulatory regime. NIBA notes, however, that this has historically been a relatively small problem (estimated by the Pottts Review to be 2 ½ % of the total Australian general insurance market) which has been more prevalent in hard markets such as that which occurred in Australia three years ago. In responding to the problem care needs to be taken not to overreact and affect the affordability and availability of insurance for Australians generally.

The Potts Review believed that legislation should target areas of highest risk such as foreign insurance companies operating out of low statutory jurisdictions. The Government, however, has not followed such a targeted approach. Instead, the Bill extends the current definition in the Insurance Act 1973 of carrying on insurance business in Australia so as to include almost all overseas insurance companies covering local risks and then provides for certain exemptions to be made by way of Regulations.

In formulating the exemptions that will be made from the basic requirements it is worthwhile considering the warning of over-regulation given by Gary Potts in his report. He stated that DOFIs provide important additional capacity in specialised insurance lines. He added that DOFIs operate largely out of comparable regulatory jurisdictions, and much of the business written was for large corporate entities less likely to require prudential regulatory protection.

Justice Owen in his HIH Royal Commission Report had a similar warning. He said that in many instances it is unnecessary to regulate insurance written overseas because it

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involves large commercial insurance contracts where the purchaser is well able to judge the risks involved in the transaction.

NIBA suggests that there are three general areas that require exemption, namely:

- Sophisticated purchasers of insurance.
- Captive insurance companies.
- Hard to place business and overseas risks.

Examples of these are contained in an attachment to this letter.

Sophisticated Purchasers of Insurance

NIBA considers that sophisticated businesses should continue to be able to access the world's insurance markets. Such companies have well developed insurance plans and place insurance with well regulated insurers. Many of the insurance companies used offer greater security and have a higher credit rating than their Australian counterparts.

Sophisticated purchasers of insurance choose to insure overseas for a number of reasons including, price, availability, expertise of the insurer, relationship between the insurer and insured and the ability of the insurer to assess and pay claims whenever and wherever required. Those who use overseas-based insurers include businesses operating in the engineering, mining, natural resources, construction, chemical, oil and gas, power and other utilities, financial institutions, pharmaceutical and agribusiness sectors as well as local government and quasi government authorities and the professions.

Restricting access to the world's insurance markets for such companies and organisations will limit the supply of insurance, push up prices, add to red tape and increase the cyclical nature of the local insurance market.

NIBA also considers that any attempt to regulate sophisticated companies purchasing their insurance overseas is likely to, at least in large part, fail. Many companies will continue to purchase insurance overseas either by going direct to overseas insurance brokers or overseas insurance companies or alternatively by using overseas branches or associate companies to purchase their insurance.

Captive Insurance Companies

Wholly owned, captive insurance companies are primarily established by large and sophisticated corporate insurance buyers as a special purpose legal entity. They are formed to retain insurable risks of their corporate parent companies and its subsidiaries. Captives do not market to the general public or unrelated third parties. Company groups normally establish their captive in low cost, low level, regulatory environments with easy access to high quality reinsurance companies, such as that found in Singapore. There are around 60 to 70 overseas captives servicing Australian company groups.

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NIBA considers that there is no necessity whatsoever for a captive insurer with an Australian parent to be regulated by APRA irrespective of whether the captive is situated on or offshore. Reviews such as the HIH Royal Commission and the Potts Review support this conclusion.

The Potts Review stated:

> *"DOFIs operating as captive insurers, for example those insurers established by large corporations in offshore jurisdictions, would not be considered to be marketing insurance in Australia and accordingly would not require to be authorised. These insurers pose little threat to retail policyholders and accordingly exemption from the authorisation requirement would be appropriate."*

The Government has given no indication as to why the Potts Review findings in relation to captive insurance companies were not incorporated into the Bill.

Hard to place insurance and overseas risks

There are some types of risks that local authorised insurers will not insure. In addition there are other risks that local underwriters are prepared to insure but only with conditions and limitations of coverage that makes their product inferior to that available from the world market. Examples of the types of policies that are currently difficult to place on a comparable basis to overseas policies include marine (subject to the Marine Insurance Act), large aviation, shipowner's protection and indemnity, asbestos, kidnap and ransom, malicious product tampering and audit report professional indemnity.

When the market hardens, as it did three years ago and will do again, the scope of the products that are difficult to place in the local market grows significantly. Not being able to gain access to the overseas insurance for difficult to place risk in a hard market is of real concern to NIBA.

Australian companies with overseas operations often choose to insure their overseas risks with insurers that are situated in the same country as the risk. For example, an Australian company with a PNG operation may decide to insure vehicles operating in PNG with a PNG insurer. The PNG insurer is well placed to access and pay claims. Unless an exemption is granted, Australians will not be able to insure in this way.

The Broker's Role

NIBA is concerned that an Australian broker will be prevented by law from performing functions that their clients are legally able to do. Australian brokers will not be able to place insurance with overseas DOFIs while their clients will be able to do so. NIBA is not aware of any other legislation that restricts agents in such a way. It is one thing to place limitations on the agents of DOFIs, it is another to place similar restrictions on insurance brokers acting for their clients.

The approach proposed in the legislation means that Australian insurance brokers will not be able to perform all the services sought and expected by clients. Some clients that have a need to place insurance overseas will bypass Australian brokers and instead seek the services of an overseas broker.

It is NIBA's considered view that having Australian insurance brokers sidelined from international insurance transactions is not in the best interest of the Australian broking industry, the insuring public, the Australian economy, or the Australian insurance industry.

The more restrictive the exemption arrangements, the more likely that Australians will deal directly with overseas insurance companies or overseas insurance brokers.

Insurance brokers should be able to represent the interests of their clients and be able to do all the things that their clients can.

Taxation of Insurance Placed with DOFIs

It is asserted in the Regulation Impact Statement to the Bill that DOFIs are able to under-cut premiums charged by local insurers because DOFIs avoid taxes and charges levied by the Commonwealth and State Governments. There is simply no evidence to support such a statement. There is an obligation on those insuring overseas to pay any relevant taxes and charges. Australian insurance brokers placing business with a DOFI make relevant tax payments (state stamp duty, fire services levy, NSW insurance protection levy and Commonwealth withholding tax) before passing on the premium to the DOFI. Brokers are required to submit returns and are audited. A similar approach is adopted for Lloyd's business.

NIBA's Suggested Approach to Exemptions

The Potts Review concluded that the percentage of the total insurance market going to DOFIs was small, around 2.5%. While it is difficult to obtain exact figures, NIBA's internal estimates, based on a projection of the overseas business by international insurance brokers who are responsible for the bulk of DOFI business, are consistent with the Potts Review figure. Such a relatively small sector of the market does not require draconian measures in terms of the limitation being placed on insurance brokers or in terms of the insurance products to which the arrangements should apply.

NIBA understands the Government's desire to protect unsophisticated insurance consumers. Such customers may not fully understand the implications of their purchases or the warnings that they may be given. Individuals and small businesses firmly fit into this category. On the other hand larger businesses and multi national companies have a well-developed understanding of insurance and should be excluded from any such arrangements.

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This view was also held by the Potts Review when it stated prudential regulation of DOFIs "should seek to avoid prohibiting commercial arrangements that have worked satisfactorily to date and target highest risks such as foreign insurance companies operating out of low status regulatory jurisdictions with minimal prudential requirements and where most of the problems have been originating."

In determining where the line should be drawn between the two groups, NIBA suggests that the basic test should be the size of the premium paid for an insurance policy. Premium is a simple test that is easy to administer. It is far simpler than attempting to establish the value of the assets or number of employees for each of the insureds covered by a policy. An exemption based on premium means that the same arrangements can apply to both property and liability business. Such a system would automatically adjust to changes in the local market. In a hard market insurance premiums increase and more business would automatically be eligible to go overseas.

NIBA cautions against attempting to set the premium level too high. Too high a level would have a significant adverse effect on the availability and affordability of insurance in Australia. It would force companies to go directly overseas, bypassing local insurance brokers. It would add to costs and red tape. It would also hamper the collection of reliable insurance statistics of business going overseas. There is no provision under the proposed new data collection system to gather information about insurance going directly overseas bypassing local insurance brokers.

It is NIBA's view that only a very small number of DOFIs (including captive insurance companies) will choose to be regulated by APRA. DOFIs, on the whole, do not see it as being worthwhile.

Having insurance of a type that is eligible for placement overseas does not mean that local insurers will not be able to hold or compete for that business on their merits. Local insurers do have an advantage in so far as local knowledge is concerned and being on the spot to pay claims.

In a recent letter to Treasury NIBA suggested that insurance brokers should be able to go overseas for their client's insurance where the premium for the policy, including all Government taxes and charges was in excess of $30 000. A premium of $30 000 would purchase around $30 million of insured value for normal commercial property.

A premium level exemption of $30 000 would mean that the great bulk of the market would be fully protected with only a very small percentage of policyholders being able to access overseas insurers. NIBA estimates that less than 5% of the clients of general insurance brokers have a policy with a premium in excess of $30 000.

A premium level exemption set at $30 000 would also mean that there would be less need for other specific exemptions for e.g. difficult to place businesses or captive insurers.

In an attachment to this letter are examples of what a premium of $30 000 will currently buy for liability and professional indemnity coverage.

NIBA has offered to work with Treasury in developing the details for the exemption arrangements.

Conclusion

NIBA does not oppose the Bill. It does, however, have serious concerns about what the exemption arrangements will be for DOFIs under the legislation. No clear indication has as yet been given by the Government as to how the exemption arrangements under Regulations will operate. NIBA believes that there is a possibility of overprotecting insureds thereby making insurance for Australians generally more costly and/or difficult to come by, particularly when the insurance market hardens. There is also the possibility that Australian brokers will be excluded from major international insurance contracts.

NIBA would be pleased if the Committee was to support the adoption of realistic exemptions, particularly for sophisticated businesses and organisations (those for whom the insurance premium is over $30 000).

Yours sincerely

Noel Pettersen
Chief Executive Officer

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Attachment 1

Examples of the use of DOFIs

1 A mid-sized Australian engineering consultancy operates as a private company and provides engineering design and supervision work for wet projects (bridges, tunnels etc). It needs both General Liability and Professional Indemnity insurance.

Because it is often difficult to work out whether claims against it fall under General Liability or Professional Indemnity it wants to have the same insurers on both insurance policies – the advice of the broker. This minimises the risk of insurers trying to argue that the other policy is the one that should pay a particular claim.

Because of the size of its projects the company and its broker have identified that it needs to have at least $A100m of cover under each insurance policy. While there are one or two local insurers who will participate as insurers they only want limited participation. So it's necessary to go into the specialist London market to fill their insurance needs. In the last hard market they were unable to get any local insurer to participate in their insurances.

2 An owner of an Australian timber mill needs property insurance. The broker is able to get two quotes from the Australian market. However, in both cases the insurers want exclusions of some risks which would leave the mill owner not covered for these risks. A specialist London market insurer is able to cover these risks albeit at a higher premium. The mill owner wants the full cover to better protect their business.

3 An Australian company owns and hires out drilling rigs here and overseas. There is no Australian insurer that will offer this insurance. There is one specialist insurance market in London (comprising a number of insurers) and one other new market that are prepared to offer insurance.

4 A large Australian manufacturing company manufactures and distributes chemical related products. It needs to use both local and overseas insurers to provide enough capacity to meet its cover needs (it buys General Liability cover of $A300m). The company retains the first $10m of any claim as this reduces its insurance premiums considerably. The company retains that risk in its Singapore captive to ensure that it is making adequate provision for the ongoing cost of the risk. This is all done with the advice of its broker who provides modelling and risk financing advice about what is the best level of retention in the captive. The broker prepares all the paperwork for the insurance of the risk by the captive as well as the reinsurance of the captive as these must mirror each other and arranges both the insurance and the reinsurance to ensure no gaps.

5 A private Australian technology company has developed technology that it wants to export. It has set up representative offices in HK, Thailand, India and the UK. In

Thailand and India local law requires a local policy. The company's broker arranges this with its overseas offices in India and Thailand acting as it agent.

Examples of why business is placed offshore

Medical Malpractice

Currently there is modest capacity in Australia for these risks. The market for Medical Malpractice collapsed in Australia in 2001/02 with the withdrawal from the market by St. Paul and the failure of HIH. The only available markets at that time were offshore insurers.

Capacity is returning to the Australian market with a small number of insurers now writing this cover. On the larger, more difficult placements, the global capacity will be required to complete placements. With the nature of these placements being claims made, insureds are generally reluctant to move from overseas markets without compelling reasons.

Construction Placements

The majority of construction placements, particularly for building works, can be accommodated in the Australian marketplace. In relation to major projects, particularly infrastructure projects where tunnelling is a key component, the global market is an essential element of any placement. Capacity is starting to increase in Australia for these difficult and complex placements but where delay in start-up insurance is required, some local insurers are unable to provide this element of cover and consequently are precluded from participating at all in the placement.

Political Risks Insurance

With increasing numbers of Australian companies expanding their operations offshore, particularly into countries such as Indonesia, China, Papua New Guinea and India, it is a requirement of financiers that these companies purchase Confiscation and Exappropriation insurance policies. There is limited capacity in Australia for these risks and the global markets generally are utilised due to the specific nature of these risks.

Captive Insurance Companies

The vast majority of captive insurance companies are formed to underwrite the risks of their parent and this is viewed as a very positive initiative by insurers who welcome their clients having some "skin in the game". From a client perspective, the captive provides a structured means of reducing dependence on the retail insurance market. For example, three years ago it was difficult to purchase Professional Indemnity insurance for major

construction companies, particularly in relation to their design and construct exposures. Where cover was available, the cost was very prohibitive. Against this background, a client of a broker that considered their risks were well managed, formed a captive insurer and became a co-insurer on the primary layer Professional Indemnity insurance. Should the cover become difficult or uneconomical to purchase in the future i.e. should the market harden, then this client is well-positioned to assume a higher level of retention on this insurance.

Kidnap, Ransom and Extortion Insurance

This is a specialised insurance product and, as a policy condition, the existence of the policy is to remain confidential. These policies are typically placed in offshore markets due to lack of available products locally.

Terrorism Insurance

Whilst there is a level of terrorism insurance available to insureds in Australia under the Terrorism Insurance Act, a number of large insureds are concerned that the Treasurer may not declare a terrorism event which would invoke this cover. Due to the aggregate limit on the cover available ($10 billion) insureds have a concern that this limit may be inadequate and they may ultimately receive a pro rata portion of their claim. These insureds seek top up cover generally from offshore markets which have specialist capacities in this area.

Interestingly, a number of State or Territory governments which are specifically excluded from the Terrorism Insurance Act coverage provisions, have purchased stand-alone cover or are in the process of doing so for specific target assets. This cover is readily available from offshore markets with limited capacity within Australia. The overseas markets are now starting to offer cover for nuclear events and this cover is unlikely to be provided by local markets in the foreseeable future.

Attachment 2

What would $30,000 in premium buy for Liability and Professional Indemnity Coverage?

Note, this type of exercise can be a difficult one to undertake, and the amounts of cover may vary depending on the industry the client is involved in, its claims experience, deductible levels, and the state of the insurance market cycle at the time of purchasing.

However, the following examples should give some reasonable indication in today's environment:

1. A **Manufacturing Company** with a turnover between $10,000,000 and $20,000,000. For $30,000, you could purchase General and Products Liability with a limit of $20,000,000 and $1,000,000 E&O cover.
   If however you were just looking to purchase General and Products Liability cover and not PI, you could possibly purchase up to $50,000,000 limit for the General and Products Liability cover.
2. An **Hotelier** with five to eight medium sized pubs. A limit of $20,000,000 for General and Products Liability cover.
3. An **Importer and Distributor of Clothing** with turnover between $20,000,000 to $50,000,000. A limit of $20,000,000 General and Products Liability cover with a small limit of $500,000 for Product Withdrawal Expenses (Recall).
4. A **Property Owner** with say ten properties made up of commercial and industrial assets. A limit of $20,000,000 General and Products Liability cover and an E&O limit of $500,000.
   However, if the Property Owner was not looking for any E&O cover, for $30,000 you could probably acquire up to a $50,000,000 limit for General and Products Liability cover.
5. A **Psychologist** with a practice comprising up to ten Practitioners. A limit of $20,000,000 General and Products Liability cover and $10,000,000 Professional Indemnity/Malpractice.
6. A **Tourism Operator** running inbound tours, with a turnover up to $15,000,000. A limit of $20,000,000 General and Products Liability cover and $2,000,000 Professional Indemnity.