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31 March 2014

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QBE Insurance Group - Financial system inquiry submission

QBE is one of the few domestic Australian-based financial institutions operating on a truly international landscape with a presence in all major regions around the globe. QBE welcomes the Inquiry as an important opportunity to consider how our financial system can position Australia to participate and compete in an increasingly converging and interdependent global market.

QBE is pleased to provide this submission for the Panel's consideration. It outlines in detail our observations on the important role of insurance, the emerging opportunities and challenges for the industry, and the need to take stock of our regulatory framework that QBE considers is curbing Australia's economic growth.

There are three specific matters that we particularly wish to bring to the Panel's attention:

Deregulation and harmonisation of federal and state regulation
Overlapping, duplicative and inconsistent regulation creates inefficiencies and, in some instances, inequities and adds considerably to the cost of doing business in Australia. Additionally, although consistent international regulation will remain important to Australia's reputation as a politically and financially stable location for investment, QBE believes it is not in Australia's best interests for Australia to 'lead the pack' on regulation. If we create a regulatory regime that is more onerous than the rest of the world this will impact on our international competitiveness in a highly contested global market for investment.

QBE is very supportive of the Australian Government's deregulation agenda. QBE also recommends Government consider initiating a regulatory harmonisation program (as outlined in our submission) giving due weight to the need to promote productivity and competitiveness in a dynamic global economy and maintain insurance affordability for our customers.

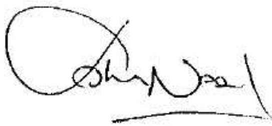
State taxes and levies on insurance
Numerous reviews, including the recent Henry Tax Review, have unanimously found that state taxes, duties and levies on insurance are very inefficient and in fact counterproductive. We estimate these imposts alone add on average $93 to each QBE policy (totalling $455 million in 2013 for Australian consumers). Given the importance of affordability of insurance and the potential implications of non or under-insurance on the public purse, we believe it is time to act to remove all these specific imposts on insurance as has previously been recommended. Further, State and Territory governments should be actively encouraged by the Australian Government to implement this reform within 3 years.

Lenders mortgage insurance
Lenders mortgage insurance (***LMI***) has been a critical component of the housing market since 1965, facilitating home ownership and accessibility to credit for millions of borrowers. LMI enables those who would otherwise have difficulty obtaining a home loan (particularly borrowers with low incomes or low levels of equity), to satisfy responsible lending criteria and purchase a home. 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.

QBE believes the Inquiry should consider the important role that LMI plays in the financial system and recommends that capital relief be provided to IRB lenders that utilise LMI. This would ensure that LMI continues to benefit the housing industry and its customers, and continues to facilitate increased competition between lenders. It would bolster financial and economic stability and importantly improve access to affordable home ownership.

QBE welcomes this Inquiry as an opportunity for Government and market participants to take into active consideration the need for a more productive, innovative and competitive economy. The costs of doing business in Australia should be a paramount concern in this Inquiry, now and into the future. We have submitted a seven-point plan in the attached submission for the Panel's consideration and look forward to participating in the Inquiry.

Yours sincerely



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QBE submission to the Federal Government's Financial System Inquiry

March 2014

Contents

Section 1 - Executive Summary 4

Executive summary 5

The importance of general insurance for the economy and community 5

Australia's place in a changing world 5

Australia as an attractive place to do business 6

Balancing stability, efficiency and national competitiveness 6

Streamlining the regulatory regime 8

Lenders mortgage insurance 10

Focusing forward 10

Section 2 - Submission 12

1. Introduction 13
2. About QBE 13
3. The importance of general insurance for the economy and community 14
   - 3.1. Role and value of general insurance 14
   - 3.2. Pooling and diversifying risk 15
   - 3.3. Understanding risk 16
   - 3.4. Managing risk 16
   - 3.5. Insurable and uninsurable risks 17
   - 3.6. Pricing and risk signalling 17
   - 3.7. Where should risk reside? 18
   - 3.8. Accessibility and affordability 20
4. Emerging opportunities and challenges 24
   - 4.1. Global convergence 25
   - 4.2. Changing demographics and wealth distribution 26
   - 4.3. Technology and big data 27
   - 4.4. Consumer empowerment and protection 27
5. Australia as an attractive place to do business 29
   - 5.1. Government stimulating Australian business in Asia-Pacific 30
6. Balancing stability, efficiency and national competitiveness 30
7. Streamlining the regulatory regime 34
   - 7.1. Harmonising regulation 35
   - 7.2. Our injury compensation systems 36
   - 7.3. Financial system regulators 39
   - 7.4. State taxes and insurance 40
   - 7.5. Quantification of the cost of over-regulation 40
8. Lenders mortgage insurance and system stability 41
9. Focusing forward 42

Section 3 - Appendices 44

Appendix 1 - Historical natural catastrophe statistics in Australia since 2009 45
Appendix 2 - Workers compensation 46
Appendix 3 - Lenders mortgage insurance 53

Section 1 - Executive Summary

Executive summary

QBE welcomes this inquiry as an important opportunity for the Australian Government and market participants to take stock of our financial system and consider how it has and can operate to best position Australia to participate and compete in global markets that are increasingly converging and interdependent.

QBE is one of the few domestic Australian-based financial institutions to be operating on a truly global landscape with operations in and revenue flowing from 43 countries around the globe. This role and our general insurance experience and expertise gives QBE insights across a broad range of financial systems and regulatory regimes that either enable or impede a competitive, innovative insurance sector which is necessary to deliver to its customers in business, communities and governments.

The importance of general insurance for the economy and community

General insurance is a fundamental foundation of a modern economy and touches almost all levels of the community and our individual human and corporate activities. A strong, stable and innovative insurance industry with affordable products is critical for the smooth functioning of the economy. General insurance provides important social and economic support structures which are demonstrated through the industry's role in:

- pooling and diversifying risk;
- facilitating business activities and mobilising savings;
- identifying, understanding and managing risks that help build resilience in society;
- encouraging personal responsibility and risk management;
- delivering productivity gains such as returning injured workers and motor vehicle accident victims back into the workforce; and
- contributing to the economy through direct and indirect employment and the provision of significant capital reserves and assets, typically conservatively invested in longer duration investments.

The insurance industry and QBE accepts its vital role in protecting the financial well being of individual, households and communities restoring their standard of living and helping communities recover after catastrophes. The insurance industry manages and prices social risks and provides insights and advice on mitigating against natural catastrophes. We welcome recent efforts to improve disaster co-ordination between Government agencies and insurers, and steps taken to improve mitigation. With tight public budgets, insurers increasingly have been put under pressure to help develop, implement and spend resources on minimising risk to not only help manage social risks but help fund prevention measures. There also has been an increasing tendency for policy advisers to intervene directly in the market, which has the unfortunate effect of distorting markets and potentially producing unintended consequences for insurers and consumers. The natural disasters experienced in Australia over the last 5 years have shone a spotlight on the industry and also the complex issues of catastrophic natural peril risk in our country. It has raised unrealistic expectations of governments by consumers and unrealistic expectations of insurers by governments.

Although there are no easy, short term solutions on the issue of affordability or accessibility (as evidenced by similar debates around the world), we believe that better communication and collaboration between governments and the industry would help to tackle these complex issues, particularly in relation to land development, risk awareness and mitigation initiatives for exposure to catastrophic natural events for certain areas and risks in Australia. There is a similar situation in the liability classes, where the impact of litigation funding and increasingly adversarial class actions, is being felt in Australia.

Australia's place in a changing world

Globalisation is increasingly rapid with enormous structural shifts underway in countries and regions in terms of demographics, wealth distribution, technology and consumer empowerment through the internet and social media. In particular, we would point to:

- changing demographics and the anticipated rebalancing of wealth and power from the west to the east;
- the impact of digital and mobile technology and processing power to leverage and utilise Big Data, and the consequent privacy implications; and
- the shift of power to consumers who, enabled by the prevalent use of internet, mobile technology and social networks, are demanding more information, choice and autonomy, which is challenging traditional business models and distribution channels.

It is important when refreshing the philosophy, principles and objectives underpinning the development of a well functioning financial system that the Inquiry takes into account the fundamental shifts in demographics, wealth distribution, technology and consumer empowerment in Australia and globally.

Australia as an attractive place to do business

There is no doubt that Australia needs a financial system and regulatory framework that provides system stability and supports our local economy. As we look ahead to Australia's core strengths and future growth opportunities, it is equally clear that we need a financial system and regulatory regime that also enables global businesses, including Australian-owned companies, to operate productively and efficiently so that they can compete and innovate, using our capabilities and resources to best advantage for Australia.

With the challenge of an aging population in Australia and the rebalancing of wealth and power to the emerging countries, Australia is well positioned geographically with Asia to capitalise on the opportunities that will emerge.

However, a number of our Asian neighbours and in particular Singapore and Hong Kong have public policies that are designed to encourage the financial services industry to locate regional and global head offices in their respective countries. These policies include tax incentives, relocation incentives and strong, stable regulatory environments designed to encourage the allocation of international capital to the respective country. These initiatives seem to have achieved some success and put Australia at a cost disadvantage in attracting international capital. While financial incentives may not be an option for Australia for budgetary reasons, a more balanced regulatory environment is feasible.

To compete effectively on the global landscape, QBE understands that it must operate as efficiently as possible compared to its global competitors. As a truly global insurer, for QBE to remain domiciled in Australia requires that we operate in a landscape that does not place us at a disadvantage to our international competitors.

We recognise that the Australian Government is concerned about tackling the cost barriers to investment and growth, and welcome it initiating the National Industry Investment and Competiveness Agenda and the 'root and branch' review of competition laws and policy, amongst other initiatives.

Government and industry should work together to take advantage of our inherent competitive advantages and develop investment and business opportunities locally and abroad and to make Australia an attractive place to do business and supply the services our growing region demands.

Balancing stability, efficiency and national competitiveness

In this dynamic context, it is critical that our financial system and regulatory regimes strike the right balance between stability on the one hand, and national competitiveness and productivity on the other.

Both the HIH Insurance (***HIH***) collapse and the global financial crisis (***GFC***) demonstrated the importance of appropriate regulation and supervision and the need to ensure there is adequate capital support for unforseen events for our financial institutions, given the critical social and economic role of these industries. Over the last decade, Australia's prudential regulator and the regulatory regime applying to banks, insurers and superannuation funds has been entirely transformed and held us in good stead during the GFC.

These reforms were required in times of crisis. Although strong prudential regulation and supervision for Australian financial institutions is essential, the burden of regulation in Australia has increased significantly during this time. Beyond a certain point, additional regulation creates de-minimus social benefit. It continues to add to the cost burden of insurers with no commensurate productivity benefits and in fact, can have negative social impacts on consumers by way of increased premiums exacerbating affordability and accessibility issues.

It is also clear that zero risk disincentives innovation and could mean stagnation.

Consistent international regulation will remain important to Australia’s reputation as a politically and financially stable location for investment. However, in our view, Australia's recent record as an early adopter of the new wave of regulation requires rethinking in this new environment. Although the policy intent to participate and adopt consistent and appropriate international regulation is understandable and indeed commendable from a regulatory perspective, Australia's recent experience with the early adoption of international regulatory regulation has operated to place Australian businesses at a disadvantage compared to our international peers. This has been demonstrated in numerous areas including the early implementation of the Basel accords, IFRS, conglomerate and group supervisory regulation and LAGIC which have been implemented ahead of other jurisdictions, but without commensurate productivity benefits.

We recognise the need and importance to engage and adopt consistent international regulation but think that early adoption should not be regarded as a good in itself. Leading the pack could mean that Australia risks creating an unlevel playing field for businesses operating in and from Australia. In fact, may cause them to fall back and no longer lead in their respective industries.

The focus of past governments and regulators on regulatory reform over the last decade was necessarily on tightening regulation in the wake of the HIH collapse and the GFC. 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. It is not in Australia's best interests if Australia's leading edge regulatory regime is more onerous than those found elsewhere in the globe and impacts on our international competitiveness.

The Australian Government should consider reviewing APRA’s mandate to incorporate a formal objective that the regulator consider the impact of regulatory requirements and reforms on affordability for consumers and on competition, efficiency and innovation in the insurance industry, which operates in a global marketplace.

All regulation creates and imposes costs and in the general insurance industry, these additional costs will result in higher prices to customers and affect shareholder returns. Many Australians either directly, or through their superannuation, own shares in QBE. In the competitive local and 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.

In QBE’s role as an Australian home-grown and headquartered international company, we see this as critical.

Additional or changing regulation on the financial services industry operating in and/or from Australia should be balanced by also explicitly considering the proposed reform in the context of improving and sustaining Australia’s competitiveness and productivity and the cost implications for consumers and the wider community.

Insurance taxes are one of the most inefficient taxes levied in Australia, as has been recognised in numerous reviews including in the 2010 Henry Taxation Review (Australia's Future Tax System review) which recommended all specific taxes on insurance products,

including levies should be abolished[1].These inequitable and inefficient taxes and levies imposed on insurance products impact on affordability of insurance and exacerbate the broader societal issues of non and under insurance.

As we have seen in recent years, in times of catastrophes, there are expectations by individuals and communities, that Government will put its hand in its pocket and provide compensation and assistance. With the level of catastrophe peril in Australia, if people and communities are not insured, or are not adequately insured, this will directly impact the fiscal spend.

The Inquiry should affirm the previous recommendations that all specific taxes on insurance premiums should be removed and that the states and territories should be encouraged to ensure this occur within a three year time frame.

Streamlining the regulatory regime

The Australian Government has made clear in its core political objectives that it is critical for governments, industry and the community to each do what they can to make sure Australia is an attractive place to do business and invest. As Australia looks to equipping its financial system for the decades ahead, the Government will need to also take into account the regulatory compliance burden and ensure that cost imposts are kept to the minimum required to ensure sound practices consistent with a sound financial system.

QBE has recently examined the different running costs and other benefits and disadvantages of operating in a number of jurisdictions. Australia does not compare favourably even against other major financial hub capital cities like New York and London. Australia, as a country, is known to be extremely expensive with relatively poor productivity. Whilst difficult to measure, coupled with excessive or unnecessary regulation, there is a compounding effect on input costs for business.

We have slipped well behind in terms of the costs of doing business, as the Government has recognised.

Overlapping, duplicative and inconsistent regulation between the states and Commonwealth on the same activity creates significant inefficiencies and, in some instances, inequities and adds considerably to the cost of doing business in Australia. Over-regulation at the federal and state levels, including regulatory overlap, is a major contributor to our comparatively high domestic cost structures. The regulatory burden is made more costly and onerous in areas where there is no national consistency or alignment of regulatory regimes, such as in workers compensation, compulsory third party (***CTP***) and certain liability legislation. Differing levels and structures of federal and state Government regulation add unnecessarily to the costs and complexity of providing affordable insurance services. These additional cost burdens often have a direct negative impact on productivity without any material benefit to consumers.

One important consideration in funding Australia's future requirements and establishing the financial systems necessary to support it, is the operation of our key injury compensation schemes. The historical and political dimensions influencing the development of our compensation schemes have tended to obscure the true role and function of the scheme arrangements. These schemes have developed in an incremental fashion often with little regard to the origins or long term rationale for particular developments and there has been very little articulation of the interfaces of the compensation schemes and the wider political and social system. Similarly, the interaction and interface with the operation of the proposed national disability insurance scheme (***NDIS***) is unclear at this stage.

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[1] Recommendation 79 of the Review of Australia's Future Tax System.

QBE believes that the rising cost pressures of injury compensation schemes and other insurance classes would be eased by a national framework that moves toward:

- **establishing national or nationally consistent compensation schemes that interface appropriately with the other compensation schemes (particularly for workers compensation);**
- **rationalising or standardising the disparate state and territory based intervention in various classes of insurance;**
- **recognising that insurance is not "core business" for governments; and**
- **defining the boundaries or role of acceptance of certain risks, where market based acceptance of risk is not viable or not cost effective for consumers.**

In addition to state, territory and Commonwealth overlap, during the past decade there has been regulatory creep with the scope and ambit of the key regulators (APRA, ASIC, ATO and ACCC) for the financial system, with continuous legislative reforms and changes that have been implemented relatively piecemeal and now intertwine and overlap in a number of areas. The objectives of different regulators dealing in the same subject matter are not always aligned which unfortunately leads to confusion, inconsistency, and reworking of the same information for different regulators, all of which adds unduly to the compliance burden on businesses.

Over the last decade, there have been thousands of pages of legislation and regulations passed that apply or impact on the insurance industry. In addition, there have been many Royal Commissions, inquiries, consultations, discussion papers and draft legislation. We place value on making input to these inquiries to put forward our view and educate on the insurance industry and its role in socialising and pricing risk. At times, legislation and regulations have been promulgated by governments and regulators as a reactive response to evolving issues, with insufficient evaluation of the impact on the economy and industry. We would like to see a more coordinated approach to these multiple inquiries and ensure that policy is evidence-based and that the learnings from one inquiry inform the next and so ensure sound outcomes that can be broadly supported.

Ultimately, the additional cost burden of duplicative and inefficient regulation is born by the industry and the consumer, either through increased premiums and subsequent affordability problems or impacting on the availability of insurance. This exacerbates issues around non-or under insurance, accessibility and affordability.

To change this legacy into a pro-productivity and investment agenda will require commitment at all levels of Government, focusing on:

- consistent with the Australian Government's deregulation agenda, rigorously assessing new regulatory proposals and repealing poorly constructed and overlapping legislation, improving effectiveness and reducing unnecessary compliance costs;
- ensuring real cost benefit analysis of proposed legislation taking into account the impact on competition, productivity and efficiency for businesses;
- modernising the regulatory culture within Government departments and agencies;
- ensuring good co-operation and interaction across state and federal governments and political support for national consistency in regulation.

We have made an attempt to quantify the cost of regulation (excluding time which is taken away from running a business and lost opportunity costs). This cost will ultimately be borne by shareholders and/or policy holders and both have a direct link to the competitiveness of our operations.

- The cost of capital for QBE by international comparison is some 0.35% higher due to regulation which is inconsistent with the international norm. At total net tangible assets of US$ 5,923 million at the end of 2013, we are talking a cost differential of US$ 20.7 million or A$ 23 million;
- Cost of compliance in QBE Australia (only) amounts to A$ 25.5 million per annum. This on average adds A$5 to every policy;
- Stamp duty, taxes and fire service levies add an average of A$93 to each policy (totalling A$ 455 million in 2013); and

- Additional cost of reinsurance due to restrictions on use of instruments is difficult to determine but is in the order of 1% of the cost of reinsurance.

We estimate that the total cost stemming from over regulation at an average of over $100 per policy or in the range of 10% and 15%. This has direct repercussions on accessibility, affordability and the economy at large.

QBE strongly supports the Australian Government's recent "red tape" initiative requiring federal regulators to balance any new regulation with a reduction in existing regulation.

QBE would like to see all prospective legislative and regulatory change to the financial services sector submitted to a genuine and rigorous cost benefit analysis that should also include a cost impact analysis on consumers. Regulators' performance could be assessed against this same standard, which would give due weight to the need to promote productivity and competitiveness in a dynamic global economy.

Lenders mortgage insurance

Lenders' Mortgage Insurance (***LMI***) currently plays an extremely important role in the Australian housing market - it enhances the underlying efficiency in the market for housing loans, improves access to home ownership, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), increases competition and innovation among lenders and reduces barriers to entry in the home lending market.

There is currently little capital incentive for the home lending market to use LMI because of the increasing dominance of Internal Ratings Based (***IRB***) banks, together with a lack of regulatory incentive for IRB banks to use LMI when modelling reduction in credit losses.

In the absence of such regulatory or structural incentives, QBE is concerned about the ongoing viability of LMI as a product. This in turn will place at risk both the accessibility to home ownership and affordability of homes within the Australian housing market.

QBE recommends that the Government consider ensuring IRB banks receive appropriate capital incentive for the use of LMI given its important role in providing financial system stability for credit risk in the residential housing market.

Focusing forward

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. The costs of doing business in Australia should be a paramount indicator in this consideration, now and in the future.

QBE offers the following 7 point plan for consideration by the Inquiry and looks forward to further discussions on these matters:

1. **Government initiate a regulatory harmonisation program aimed at removing all forms of duplication, overlap and reporting on the same activity with a view to ensuring our regulatory systems operate effectively, efficiently and productively and ease the compliance burden.**
2. **Additional or changing regulation on the financial services industry operating in and/or from Australia should be:**
   - **subject to a genuine and rigorous cost benefit analysis that should also include a cost impact analysis on consumers;**

- balanced by also explicitly considering the proposed reform in the context of improving and sustaining Australia's competitiveness and productivity. Regulators' performance could be assessed against this same standard, which would give due weight to the need to promote productivity and competitiveness in a dynamic global economy and maintain affordability for consumers.

3. APRA's mandate should be reviewed to incorporate a formal objective that the regulator consider the impact of regulatory requirements and reforms on affordability for consumers and competition, efficiency and innovation in the insurance industry, which operates in a global marketplace.
4. Given the impact on affordability and potential implications for the public purse, all specific taxes, duties and levies on insurance premiums should be removed and the states and territories should be encouraged to implement this reform within a three year time frame.
5. In recognition of the important role that lenders mortgage insurance plays in our economy, Government should ensure IRB banks receive appropriate capital incentive for the use of LMI.
6. Consideration should be given to a national framework that moves toward:
   - establishing national or nationally consistent compensation schemes that interface appropriately with the other compensation schemes (particularly for workers compensation);
   - rationalising or standardising the disparate state based intervention in various classes of insurance;
   - recognition that insurance is not "core business" for Governments; and
   - defining the boundaries or role of Government acceptance of certain risks, where market based acceptance of risk is not viable or not cost effective for consumers.
7. Continued and more effective communication and collaboration between governments and the industry and an in depth understanding of the complexities and societal impacts involved with issues such as accessibility and affordability of insurance is needed.

Section 2 - QBE Submission

1. Introduction

In November 2013, the Australian Federal Government announced the appointment of Mr David Murray AO to head a broad ranging inquiry into Australia's financial system (*Inquiry*). The intent of the Inquiry is to make recommendations to foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, integrity and fairness, optimally resulting in lower costs, lower fees, greater efficiency in the allocation of capital and improved affordability of products to the end consumer.

QBE Insurance Group (***QBE***) welcomes this Inquiry as an important opportunity for the Australian Government and market participants to take stock of our financial system and consider how it has and can operate to best position Australia to participate and compete in global markets that are increasingly converging and interdependent.

QBE believes that it is important to use this opportunity created by this wide-ranging Inquiry to look to the future and consider how our financial systems can best support our country's economic growth and meet Australia's evolving needs in the coming decades. This will be critical to enabling Australia and Australian businesses compete and innovate in a dynamic global landscape.

2. About QBE

QBE is one of the few domestic Australian-based financial institutions to be operating on a truly global landscape with operations in and revenue flowing from 43 countries around the globe. This role and our general insurance experience and expertise gives QBE insights across a broad range of financial systems and regulatory regimes that either enable or impede a competitive, innovative insurance sector, which is necessary to deliver to its customers in business, communities and governments.

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 crises. QBE is proud of its heritage and the support that it has provided to our customers and policy holders during this time.

Our business has been a significant feature of Australia’s commercial landscape since its early beginnings in Queensland.

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.

QBE currently employs approximately 17,000 people in 43 countries with over 3,700 employees in Australia.

Our vision is to be the most successful global insurer and reinsurer in the eyes of our customers, our people, our shareholders and the community. Our business is built on the dedication of our people, the strength of our relationships with our partners and the service we provide to our customers, policy holders and the wider community.

QBE is in the business of managing risk. We understand risk and, in an increasingly volatile world, we believe our ability to manage risk makes it possible for our society to function. Our strategy of diversification by product and geographical exposure is fundamental to managing our insurance and reinsurance risks and has been a vital ingredient in QBE's success.

The observations and comments in this submission come from our perspective as a global general insurance company and are generally limited to our area of expertise and our experience in comparing Australia with other markets.

3. The importance of general insurance for the economy and community

General insurance is a fundamental foundation of a modern economy touching almost all levels of the community and our individual human and corporate activities. A strong, stable and innovative insurance industry is critical for the smooth functioning of the economy. General insurance provides important social and economic support structures which are demonstrated through the industry's role in:

- pooling and diversifying risk;
- facilitating business activities and mobilising savings;
- identifying, understanding and managing risks that help build resilience in society;
- encouraging personal responsibility and risk management;
- delivering productivity gains such as returning injured workers and motor vehicle accident victims back into the workforce;
- contributing to the economy through direct and indirect employment and the provision of significant capital reserves and assets, typically conservatively invested in longer duration investments.

The insurance industry, including QBE, accepts its vital role in protecting the financial well being of individuals, households and communities. The insurance industry manages and prices social risks and provides insights and advice on mitigating against natural catastrophes. We welcome recent efforts to improve disaster coordination between Government agencies and insurers, and steps taken to improve mitigation. With tight public budgets, insurers increasingly have been put under pressure to help develop, implement and spend resources on preventing risk to not only help manage social risks but help fund prevention measures.

In this next section we outline in more depth our views on the role of insurance in the economy and point to some of the important complexities currently under debate.

3.1. Role and value of general insurance

Insurance and the insurance industry play a vital role in the Australian economy. At its most basic level, insurance is an arrangement where an individual or entity is compensated, generally financially, by a risk taking institution (insurer) for a pre-defined event or misadventure. An insurance policy is fundamentally a contractual promise to provide assistance in accordance with the contract in exchange for the payment of a premium.

Insurance is widely used as an accessible and common form of risk management to protect against the risk of uncertain future losses. However, the role that insurance plays in a modern economy is much more complex and multi-dimensional than simply transferring risk from one party to another.

Insurance enables many activities to be undertaken that would not otherwise take place, by mobilising savings and facilitating investment. Having access to insurance enables people and businesses to engage in activities that otherwise would be too fraught with risk, enabling many business initiatives to occur that would not otherwise be undertaken. For example, businesses may not invest in inventory or plant and equipment if insurance was not available to cover the risk of fire and other damage. Freighting and transporting of goods becomes much more viable if insurance covers the risk of theft or damage on route. If adequate liability insurance is not available to protect individuals against accident then the propensity to travel diminishes.

Also important is the behavioural effect that peace of mind provided by insurance coverage gives. People's ability to cope with adverse effects is strengthened and they tend to behave less risk-adversely when they know that certain risks are covered economically.

Natural disasters are an ever present risk for communities in Australia. The contributions of the insurance industry in the expeditious recovery of communities from recent catastrophes are significant not only in terms of the billions of dollars of claims paid, but also in terms of the evolving risk mitigation and emergency management initiatives that build resilience into our communities. The support that private sector general insurance provides for people, businesses and communities is a critical factor in assisting in the expeditious economic

recovery and rebuilding after unforeseen events or loss and misadventure occurs. Included in **appendix 1** is the Insurance Council of Australia's (***ICA***) disaster statistics for natural catastrophe indemnification since 2009, demonstrating the significant contribution of insurers during this time.

The insurance industry in and of itself also plays an important part in the functioning of the capital markets. Insurers are major financial intermediaries converting insurance premiums into investments that also sustain economic growth and provide investment funds and working capital across the economy and across the maturity spectrum. Insurers' own equity (shareholders funds) together with unearned premium and claims reserves is also a significant source of investment capital that contributes to the functioning and liquidity of the economy.

The general insurance industry holds substantial investments, with the December 2013 General Insurance Performance Statistics published by APRA reporting that the industry holds cash and investments of $70.8billion and has total assets of $112.8billion. Approximately 75% of this cash and these investments are held in interest bearing securities issued by government, corporates and banks.

Whilst the statistics are not readily available, it appears that a large percentage of cash and investments are invested in a small number of highly rated investments - government bonds and banks in particular. This creates potential concentration risk and makes it essential therefore that Government:

- maintains a strong financial system that reduces the potential concentration risk to an acceptable level;
- encourages foreign investment within the financial system to reduce the concentration to the Australian financial system; and
- encourages investment in other risk assets such as infrastructure, property and equity markets.

Currently, the risk based capital framework that is applied by APRA in Australia for insurance discourages investment in infrastructure, property and equity markets due to the high capital risk charges associated with such investments. Whilst it is accepted that there is a higher risk associated with these investments, this approach discourages the effective allocation of capital into these investments. By discouraging investment by the financial services industry in these markets, growth is impeded.

In other jurisdictions there are incentives available to encourage the use of innovative investment products. In order to boost productivity and investment it may be appropriate to moderate the capital risk charges on these types of investments.

3.2. Pooling and diversifying risk

As well as facilitating economic activities and providing peace of mind for individuals, private sector general insurance is an effective mechanism for the pooling and transferring of risk. All individuals and organisations face a wide variety of risks but only some of them will actually suffer a loss during the course of the year or during the period of cover. Insurance enables the pooling of such risks so that the risks are spread or shared between the many individuals or organisations that have contributed to the insurance pool. Those at risk contribute a relatively small sum of money for the risk insured based on the insurers' assessment of the nature of the risk and the policyholder's specific risk profile.

An intrinsic feature of insurance is diversification, which can be achieved by aggregating a disparate portfolio of risks, often spread across different products and geographies to lessen the concentration of risk. Insurers then further diversify, investing in assets whose investment risks are uncorrelated, or by reinsuring to reinsurers (who in turn will diversify) which shares and spreads the risk of economic losses across society and regions.

Insurance undertakings that carry on business in different regions in Australia and across the globe lessen the concentration of risk that occurs than if they were restricted to a single region or a single country. By transferring the related risk to an authorised entity, which can then define an equitable pro capita cost at the same time drawing a financial return for its entrepreneurial activity, international diversification enables not only the enlargement of risk

groups but also ensures limited exposure to single countries and events. Many insurers in Australia achieve this through reinsurance protections with large global reinsurers.

3.3. Understanding risk

Insurers provide highly complex products that require in depth understanding of the nature of the risk, the probability of the risk involved occurring, the likely loss that would be experienced and the financial and non financial environmental factors that may affect the provision of the product in the particular economy. For example, property insurers need to know about building codes and materials, flood insurers need to know about geographic features and natural peril risk, workers compensation insurers need to understand about injuries and rehabilitation, lenders mortgage insurers need to know about economic indicators and housing trends, and so on.

Identifying and understanding risk is the central focus of an insurance business. Insurers use a variety of methods and tools to estimate the likelihood or frequency of an event occurring and the severity of loss that is likely to occur from the event. As technology develops and data becomes more available and accessible, insurers are gaining more information and developing better skills utilising modern risk assessment and risk management techniques to better understand, assess and continuously manage the nature of insurable risks.

3.4. Managing risk

Insurers are experts at managing risk. This is the central tenet of an insurance business. As such, insurance companies provide information, education and expertise to society through their work and the specialised nature of their experienced workforce. This accumulation of specialist knowledge and the associated deep understanding of risk exposure, accurate management, prevention and mitigation generates collaborative knowledge and expertise that can be utilised for the benefit of society as a whole.

Individually, and as an industry, the general insurance industry in Australia has over the last 10 years, developed numerous tools and provided extensive information to consumers, communities and governments about the identification, management and mitigation of risks. Examples of some of these tools and information packs are readily available on the Insurance Council of Australia's website[2] which contains detailed information about preparation for storm, holidays, bushfires, coastal vulnerability, flood vulnerability, under and non insurance and strategies to increase business resilience to extreme weather, amongst other things.

Insurers are well placed and are incentivised to share their expertise and knowledge as there is a clear commercial interest for insurers that risks and consequent damage and losses be mitigated. It is important however, that there is also alignment of incentives for individuals and communities. If there is "no skin in the game" there is a danger for moral hazard to occur. Insurers have well been aware of this and address this by the implementation of excess contributions keeping the insured exposed to some risk, making the cover conditional on some risk prevention and similar mechanisms. Also awareness of increases in insurance premiums due to risky behaviour can be an important factor in incentivising cost conscious consumers to take positive action to understand and mitigate risk.

The introduction of telematics in motor car insurance is a good example of how insurance can play this educative role. QBE has recently entered into a joint venture with Insurance Box to introduce the first of such products for private motor car insurance in the Australian market. Telematics insurance is an innovative capability using an in-car device that monitors how, when and where a person drives their vehicle providing a better understanding of driving behaviours such as braking, acceleration, cornering, speed, and so on. This investment in innovation completely changes how the individual thinks about insurance as it engages with each driver on how they use their car. It enables them to look at their personal road skills and challenges them on how they can improve their skills for lower insurance costs. It also offers the opportunity for young and less experienced drivers who are typically considered to be "high risk" to understand how to drive responsibly and will make premiums more affordable for those who can demonstrate they are "good" drivers through this capability.

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[2] Insurance Council of Australia, http://www.insurancecouncil.com.au/for-consumers/how-insurance-works

An effective insurance industry provides an important role in educating and providing knowledge and training in risk matters which has a positive effect on and provides significant value to the economy and society.

3.5. Insurable and uninsurable risks

Not all risks however, are insurable or are risks that insurers opt to insure.

The characteristics of insurable risk include the following:

- *The exposure to loss must be random (in particular, not subject to adverse selection), i.e. the loss must be accidental or the result of pure chance*
- *The loss must be definable and measureable*
- *There should be a large number of similar risk exposures so that individual losses can be aggregated and shared*
- *The premium paid for insurance must be affordable relative to the gain from risk mitigation; and*
- *The risk of catastrophically large losses must be low.*

Risk mitigation through insurance is unlikely to be effective in the following circumstances:

- *Where the loss is inevitable*
- *Where there is insufficient past experience to assess risk*
- *Where the proposer does not have an insurable interest (giving rise to moral hazard)*
- *Where the loss arises from 'fair wear and tear' such as rust or corrosion; or*
- *Where too many factors influence the outcome making it difficult or impossible to predict, e.g. the risk that a newly established business will fail.*

(Roeser, Hillerbrand and Sandin 2012)

Recent urban growth and the growth of urban areas have expanded massively which concentrates people, infrastructure and economic activity. Where the loss is inevitable, when there is insufficient past experience to assess risk, when the probability of the occurrence of the event is very low but the anticipated financial consequence is extremely high, such risks are generally not considered insurable.

Also, as outlined by the Geneva Association,[3] two conditions must be met before insurers are willing to offer coverage against an uncertain event. The first is the ability to identify and quantify or estimate the probability and consequences of the event occurring. The second is the ability to set appropriate premiums or rates for each potential customer or class of customers. If these conditions can be met, a risk can be considered to be insurable, however insurers may still not elect to cover the risk, if it is not possible to specify a premium that is affordable and that will provide sufficient income revenue to cover expenses and claims costs and still yield an acceptable return.

3.6. Pricing and risk signalling

Once risks have been identified and assessed, to enable insurers to provide coverage for such risks, insurers must be able to set rates for each potential customer or set of customers. The premium paid by the insured needs to be sufficient to cover costs of claims, the insurer's internal expenses (inclusive of commissions to intermediaries), reinsurance (insurers' own protection), profit margins (inclusive of cost of solvency capital), taxes, levies and stamp duty. These costs are also partly offset by investment income made on insurance and capital reserves that are held by insurers that are currently at relatively low levels.

In pricing risks, insurance companies give a signal to the market as to how they see that risk. In a competitive market, risks with a greater severity and/or frequency are priced higher than risks with less of each. If a pricing signal is lost or distorted in any way (for example by cross-subsidizing or by Government subsidization and/or regulation), market information is lost.

Claims costs are estimated by insurers based on a combination of claims statistics, stochastic models and economic forecasts. The level of insurance premium will vary from one insured to the other based on individual circumstances as well as the marginal effect of every new policy on the diversification of the insurer's overall book of business.

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[3] The Geneva Association, Risk and Insurance Research No 5, *Extreme events and insurance: 2011 annus horribilis,* March 2012.

Unlike other industries, a large portion of the ultimate costs are uncertain for insurers when they market their products. Uncertainty or ambiguity is a key factor that will influence insurance premiums. If there is a lack of relevant data or imperfect scientific knowledge, this impacts the assessment of the loss probability of the event and the ability to accurately calculate the premium for the specific risk. The higher the uncertainty, generally the higher the premium will be set to hedge against this inherent uncertainty. Similarly, where there is asymmetric information between the insurer and insured, insurers need to protect against adverse selection that can lead to a higher weighting of "bad" risks compared with "good" risks that can affect or taint the pool.

General insurers have traditionally been heavily reliant on historic-based pricing methodologies to derive insurance premiums. This involves analysing past exposure and claims information to derive assumptions that are expected to represent future trends. This allows insurers to build from ground up insurance premiums for homogeneous pools for risks. The aim is to minimise the amount of cross-subsidisation between risk pools so that individual policy holders pay a fair premium commensurate with the risk exposed for the expected loss component of the risks transferred[4]. As the quality of internal insurance statistics has improved over time and the availability of external data and models has increased, pricing models have evolved to move towards greater sophistication and refinement. Emphasis on affordability, market pressure, limitations in technology and political intervention have however, somewhat moderated the implementation in some product lines.

Whilst traditional pricing based on past data provides a solid foundation to predict future claims costs, future experience might differ from what was observed in the past. Changes in the environment in which insurers are operating and different interpretation of policy wording affect the ultimate cost, frequency and incidence of claims. This could invalidate core assumptions made based on historical data or trends. Several factors are currently at play which will require insurance pricing functions to carefully assess the predictive value of past data. Just some of these long term changes include:

- lifestyle changes such as extended travels, busy lives, density living, renovations and extensions on existing dwellings;
- ageing of public and private infrastructure;
- availability of additional data and refinement in peril assessment;
- changes in urban density and urban expansion;
- changes in planning laws; and
- legal developments.

Finally, it is worth noting that short term fluctuations also influence the actual outcome of claim payments against initial expectations. For example, the weather related pricing component of a premium will contain allowances for large infrequent events, say 1 in 50 or 200 years. Due to the annual nature of the contracts, insurers will generate profits out of the allowances. When a major event arises, insurers will generally be in a deficit position as insurers, under Australian Accounting Standards and Tax legislation, are not allowed to build up prospective reserves beyond the expiring term of the policies in force at one point in time. In some jurisdictions, catastrophe reserves are encouraged in order to smooth out the impact of large catastrophic events on the results and capital position of insurers.

The insurance market is very competitive in Australia and, given the uncertain nature of the risk assessment, various insurers will have different views as to the assessment of the ultimate costs embedded in the insurance premiums that are charged. As such, it is not uncommon for insurance premiums to vary significantly between insurers for one particular policy.

3.7. Where should risk reside?

The ICA has prepared a submission to the Inquiry with the advice and assistance of Deloitte Access Economics[5]. In that submission, the ICA outlines a conceptual framework aimed at

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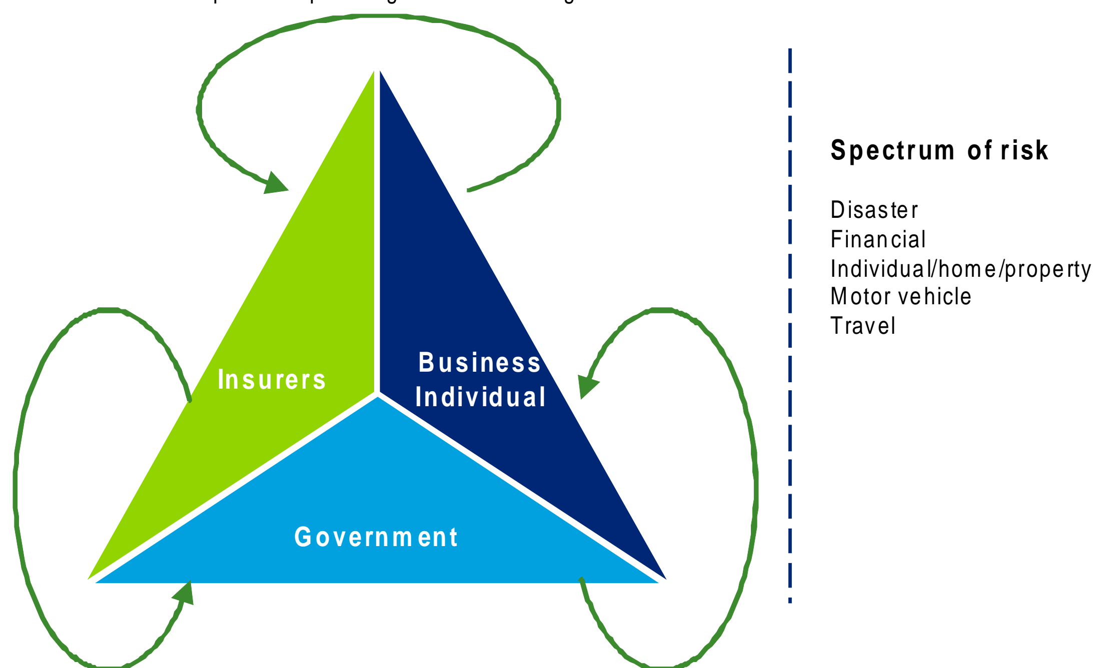
[4] The unexpected or catastrophe loss component is prone to diversification. This diversification is part of the insurer's business model.
[5] Insurance Council of Australia, *Submission to the Financial System Inquiry,* March 2014.

encapsulating a long term understanding about how insurance risk is best allocated and shared among individuals, businesses, insurers and governments.

The ICA outlines in some depth the complexity and challenges that contribute to securing the right balance for the allocation on insurable risk and offers the following conceptual device for consideration in this debate.



QBE refers the Inquiry to the ICA's submission on this issue and does not propose to cover this in any depth, however QBE wishes to make the following comments, particularly on the role of Government.

Clearly not all risks are insurable. Where risk should lie is becoming increasingly complex as economic losses caused by natural and other hazards are continually rising. This is exacerbated by the rapid accumulation and aggregation of risk due to urbanisation, the degradation of our natural environment, the development and build up of infrastructure that occurs as economies grow and, as mentioned in **section 4,** advances of technology and global convergence. With this, comes corresponding pressure on the insurance industry. Insurance is socially valuable and an effective tool for transferring and mitigating risk however, the expectation that insurance alone can bear this risk is not realistic.

Government clearly has a role to play, particularly in ensuring that appropriate incentives are in place for reducing and mitigating risk. Often there can be conflicting objectives which can create considerable tension between Government and consumers' expectations and insurers' appetite for risk and regulatory obligations.

Where risks are insurable or are of limited insurability, finding the appropriate demarcation line between private and public insurance has been cited as one of the central open issues in insurance[6]. The question of government's role in "social"[7] insurance, to provide a social safety net or as an insurer of last resort, also has been debated at length.

QBE refers the Inquiry to The National Climate Change Adaption Research Facility's report on *Adaptor of last resort? An economic perspective on the Government's role in adaption to*

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[6] Baltensperger, Buomberger, Luppa, Wicki, Keller, Zurich Insurance*: Regulation and intervention in the insurance industry - fundamental issues*, 2007, page 37.
[7] Such as health, welfare, personal injury and longevity risks.

climate change and the case studies outlined in the Geneva Association's report I*nsurers' contributions to disaster reduction - a series of case studies* for commentary on this issue. The following provides a useful summation of this debate[8]:

"Certain risks apparently are less suitable for private insurance than others. Public or 'social' insurance has played a major role in most societies for a long time. In some of these cases, it is not necessarily a fundamental inability of private markets to provide workable solutions, but rather the desire of society to combine insurance with considerations of equity and redistribution, which leads to government interference.

Some risks can be intrinsically difficult or impossible to insure through private markets, however, particularly certain risks related to man-made or natural catastrophes. Fundamental reasons which may limit or even prevent private insurability are: insufficient scope for risk pooling (correlated/aggregate risk), informational ambiguity, and (excessive degrees of) moral hazard/adverse selection.

... Guiding principles should be the following ones: Private insurers can and should only be expected to deal with those risks which sufficiently meet the conditions for insurability. Mandatory requirements to go beyond this can only lead to disillusion and, eventually, market withdrawal. On the other hand, government should abstain from interfering in those markets where private insurance is feasible and functional. Desires to combine insurance with redistribution should be resisted and redistribution, if politically desired, pursued through other mechanisms."

QBE appreciates that these considerations are complex and will become more so against the change background outlined in section 4. It is unlikely that there will be a simple solution that can be adopted holistically. QBE, however, supports the ICA's proposed framework as a tool to assist define the boundaries or role of Government acceptance of certain risks where insurance is not viable or cost effective for consumers and also where Government should abstain from providing public insurance where private insurance is feasible and functional.

There has been considerable progress in increasing transparency around the operation of insurance and disclosure of insurance products in recent years. QBE recognises 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.**

3.8. Accessibility and affordability

There has been much recent debate with Government and industry on the topic of accessibility and affordability of insurance, particularly for natural peril risks like cyclone risk in northern Australia or flood risk following the recent Queensland and Victorian floods and with products like travel insurance on the question of age and mental health.

QBE believes it is important for the Inquiry to understand some of the complexities in this debate.

With an ever changing environment, affordability issues are likely to arise as insurers try to provide products that are tailored and priced to suit the needs and risk profile of their customers given the risks to be covered. As insurers on the one hand develop more sophisticated methodologies and data to understand risks at a more granular level, technical pricing and our current prudential regulatory regime demands that insurers in Australia appropriately price for and hold capital for such risks. On the other hand, this inevitably means that those individuals or consumers who are considered to constitute a high risk will have that risk reflected in the higher insurance premium required to be paid to the insurer to cover that risk. The issue is compounded by prudential authorities gradually raising solvency

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[8] Op cit, Zurich Insurance, page 37.

levels and therefore cost of capital to avoid insolvencies in all but the worse possible scenarios as well as the rising value of assets to be insured.

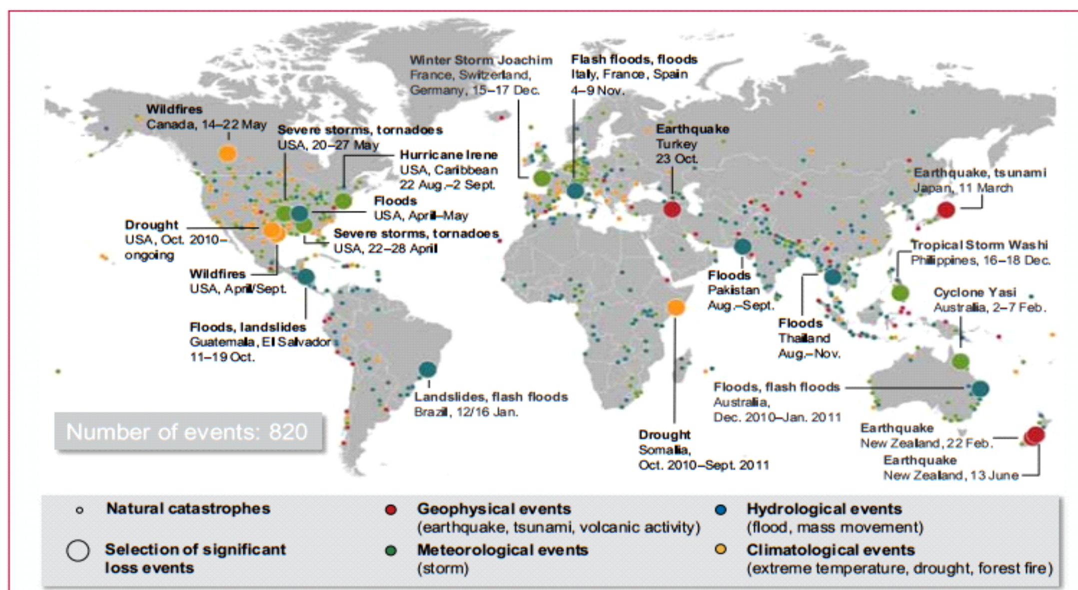
In its submission to the Australian Government's inquiry into recent trends in and preparedness for extreme events, the Actuaries Institute assessed that the overall incremental impact on insurance costs due to changes in the climatic environment change will not be significant. The Actuaries Institute however points out that a small percentage (and over the next 60 years a growing percentage) of policyholders will be severely affected by higher risk ratings of their assets[9]. The availability of relevant data and improved modelling techniques will lead to more refinement in risk assessment and greater differentials between low and high risk areas of profile. This will be exacerbated in the absence of cost mitigation measures.

There is a danger however, when differentiated premiums are viewed by society and politics as unjust and discriminatory and public policy measures are introduced to address the perceived inequity.

It is well recognised that private insurance works best in undistorted markets and markets which allow for price differentiation based on risk assessment. Utilising the framework outlined earlier, a key issue for the general insurance industry and for the Australian economy going forward, is how we will act to balance the community and Government policy pressure for insurers to offer products at prices which involve cross-subsidies between low and high risk profiles.

This is particularly so as insurance pricing plays a critical role for society by signalling to individuals, communities and Government important information about the existence and nature of specific risks. A key tool for insurers is the use of risk based premiums to incentivise risk reduction as described in **section 3.6.**

Australia has experienced a large number of natural disasters over the past few years including cyclones, bushfires and floods. The Christchurch earthquake was a significant natural peril event in New Zealand. In fact, 2011 has been described globally as the annus horribilis in the context of extreme events and insurance.[10]



Statistics of Australian natural disasters have been included in appendix 1 for reference.

As insurers have experienced these events and repriced products to reflect the loss experience and updated information around such natural perils, this has led to significant premium increases, particularly in areas where the exposure to disasters is more prevalent. We have seen this in the aftermath of the Queensland and Victorian floods and recent cyclone and storm experience in northern Queensland. This has exacerbated the debate

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[9] Actuaries Institute, *Submission on Inquiry into recent trends in and preparedness for extreme weather events*, 2013

[10] Op.cit, Geneva Association, page 9.

around non insurance, under insurance and the issue of accessibility and affordability of insurance for natural peril risk which is currently under the spotlight at an Australian political level. This is however a very complex issue that requires considerable unpacking and debate by stakeholders to ensure that all constituent parts of the puzzle are well understood prior to the implementation of policy measures by Government.

Insurers will price according to the risk, based on the latest information in their possession.

When individuals believe that governments will step in and provide a safety net there is significant risk of moral hazard as individuals are dis-incentivised from mitigating or insuring their risk. As the ICA notes:

... in the end, private insurance is not a substitute for social policy. Efficient risk-bearing requires that the true cost of insurance be signalled to those who own insurable risks. The efficiency of the overall system is enhanced when a rational decision is made as to how much risk is self-insured and how much risk is ultimately laid off. Furthermore, the efficiency of the system is not improved if policy makers inadvertently "crowd out" private market insurance markers with social insurance schemes especially if inadequate consideration is given to the implications for risk mitigation across the entire system. Nevertheless, in circumstances where self-insurance becomes the only option for selected groups in society, policy makers may need to turn to measures through the social safety/transfer system to provide assistance in response to such risks[11].

…Choosing the right level and means of intervening to improve the efficiency of insurance markets is an exercise in balance. Intervention may be justified when a liberal market in insurable risk produces too much self-insurance, or too little market insurance and as a consequence leaves government too exposed to the risk of compensating needy citizens. On the other hand, intervention that is too heavy-handed may risk creating the same set of circumstances, this time as a result of insurance, becoming unaffordable, inducing parties once again to self-insure and fall back too quickly on government.

Notwithstanding this, government intervention and regulatory measures are not costless. Regulatory costs imposed on insurers are ultimately passed through to policyholders who, beyond some point, find themselves preferring to self-insure. This induces individuals and businesses to carry more risk than is efficient, and exposes governments once more to calls from citizens to make good their losses[12].

The challenge for policy makers is securing the right balance. Achieving the right balance ensures the promotion of a healthy general insurance sector, carrying its share of insurable risk with integrity and soundness, and meeting the changing needs of customers with innovative products at affordable premiums.[13]

As we have seen in recent years, in times of catastrophes there are expectations by individuals and communities that Government will put its hand in its pocket and provide compensation and assistance.

With the level of catastrophe peril in Australia if people and communities are not insured or are not adequately insured this will directly impact the fiscal spend. Equally problematic and unpopular, are additional taxes or levies imposed by governments post catastrophic events to fund the necessary assistance.

The issue of non insurance, under insurance and lack of private market solutions to the issue of catastrophic natural peril risk is not a new one. Much has been written on this issue both in Australia and internationally and considerable work has been done to date in Australia to address these concerns. Real progress, for example, has been made in the provision of flood cover in recent years including the introduction of a standard definition of flood, progress on the development of comprehensive flood mapping to enable insurers to reduce the level of

[11] Op.cit, Insurance Council of Australia, page 28.
[12] Ibid, page 22.
[13] Ibid, page 23.

uncertainty when pricing for this risk and also increased availability of flood cover, with most insurers now offering flood cover as "standard" with their home building and contents policies.

Significant though, is the increasing concern around the level of premiums being charged by insurers for those individuals who are located in areas of "high risk". As information becomes more readily available, insurers become more able to reflect the level of that individual risk and price accordingly. In an efficient market, this is desirable, with price providing an appropriate signal to individuals, society and governments about the increased level of risk and encouraging risk mitigation. Optimally, this would lead to action being taken to stop allowing development in inappropriate areas or by ensuring that new dwellings and construction in "high risk" areas meet building standards that would significantly reduce the potential damage should a significant weather event occur.

There are numerous examples that demonstrate the effectiveness of "future proofing" against these types of risk. Interestingly, Geoscience Australia[14] has modelled the impacts of the 1974 Cyclone Tracy on Darwin if the same event occurred in 2008 having regard to the reconstruction of the city to new standards with the revision of building codes after that time. It is believed that approximately 80% of residential buildings were either destroyed or rendered unliveable by the impact of Cyclone Tracy with damage estimated at 36% of full reconstruction costs. The 2008 modelling has estimated that the damage from the same event would be 3.5% of full reconstruction costs reflecting a 90% reduction in mean losses compared with the 1974 impact.

The progress in Australia over the last decade with industry/Government initiatives like sharing of flood risk data, flood mitigation projects and studies into strata building risks from cyclonic weather in far north Queensland has increased our understanding and helped reduce uncertainty for insurers when considering and pricing these risks. However, there are areas where legacy issues exist and the risk is very high, like the existing developments and strata in far north Queensland. Further, local council, state and Territory Governments continue to allow development in areas that are considered high risk flood or bushfire zones with limited risk mitigation strategies required of developers. The risk of natural peril in these areas coupled with construction standards of existing buildings and infrastructure results in insurance pricing that can be considered unavailable or unaffordable due to insurers appropriately pricing and complying with regulatory requirements for that risk.

QBE believes there are a number of other important background or behavioural factors in Australia that need consideration in this debate:

- Consumers in Australia often see insurance as a "grudge" purchase. Although, as the ICA states, rational individuals might be expected to weigh the costs and benefits of buying insurance compared with self insuring and appreciate the benefit of paying a relatively small certain amount against the likelihood of a very large uncertain loss, insurance is often not perceived in this way. Rather, individuals consider that paying premiums to insurance companies with no perceived "return" is unfair and insurance cover becomes a grudge purchase (except of course at times of claim). This perception is exacerbated during times of disasters when it is often expedient for media and Government to hold insurers up as scapegoats adding to reputational issues for the industry and furthering the reluctance of consumers to insure adding to the cycle of non and under insurance.

- There is a growing expectation by consumers that governments will intervene and provide protectionist measures for individuals. As outlined above, consumers using new platforms like social media, are relatively more powerful demanding action and intervention by governments. This is often true for small minority groups as well. Extensive media and social backlash from such campaigns then leads to public policy responses that tend to be reactive, focused on quick "solutions" that may not adequately consider longer term

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[14] Australian Government Geoscience Australia, *What would happen if Cyclone Tracy hit Darwin in 2008?,* http://www.ga.gov.au/hazards/our-capabilities/case-studies/what-would-happen-if-cyclone-tracy-hit-darwin-in-2008.html (2011)

impacts and distortions that can lead to exits, reduced competition and potential market failure, pushing risk back to governments (and ultimately taxpayers).

Insurance works best in undistorted markets. When public policy intersects and mandates a social policy response in private markets there is the potential for unintended consequences to eventuate with inadvertent effects.

It is important that:

- **any public policy intervention in insurance markets be carefully considered and tailored to address the specific issue in question rather than a broad brush and reactive response that could operate to undermine the broader market insurance offering; and**
- **individually and as an industry, we continue to work collaboratively with all levels of Government to promote risk awareness, develop better risk data, build resilient infrastructure and embed appropriate incentives to achieve these aims.**

The insurance industry and QBE accepts its vital role in protecting the financial well being of individuals, households and communities. The insurance industry manages and prices social risks and provides insights and advice on mitigating against natural catastrophes. We welcome recent efforts to improve disaster coordination between Government agencies and insurers, and steps taken to improve mitigation. With tight public budgets, insurers increasingly have been put under pressure to help develop, implement and spend resources on preventing risk to not only help manage social risks but help fund prevention measures.

There also has been an increasing tendency for policy advisers to intervene directly in the market, which has the unfortunate effect of distorting markets and potentially producing unintended consequences for insurers and consumers. The natural disasters experienced in Australia over the last 5 years have shone a spotlight on the industry and also the complex issues of catastrophic natural peril risk in our country. It has raised unrealistic expectations of governments by consumers and unrealistic expectations of insurers by governments.

SECTION 3 - CONCLUSION

Although there are no easy, short term solutions on the issue of affordability or accessibility (as evidenced by similar debates around the world), we believe that better communication and collaboration between governments and the industry would help to tackle these complex issues, particularly in relation to land development, risk awareness and mitigation initiatives for exposure to catastrophic natural events for certain areas and risks in Australia. Similarly, in relation to liability classes, litigation funding and increasingly adversarial class actions that we are now seeing in Australia.

This contributes to point 7 in QBE's seven point plan for the Inquiry's consideration.

4. Emerging opportunities and challenges

The world we are now living in is a world undergoing profound levels of change that will challenge the relevance of Australia and the Australian economy over the coming decades. Globalisation is increasingly rapid with enormous structural shifts underway in individual countries that require consideration. In particular we would point to:

- an increasingly interconnected and balanced global economy;
- changing demographics and the anticipated rebalancing of wealth and power from the West to the East;
- the impact of digital and mobile technology and processing power to leverage and utilise Big Data and the consequent privacy implications;
- the shift of power towards consumers who, enabled by the prevalent use of internet, mobile technology and social networks, are demanding more information, choice and autonomy which is challenging traditional business models, distribution channels and consumer behaviour.

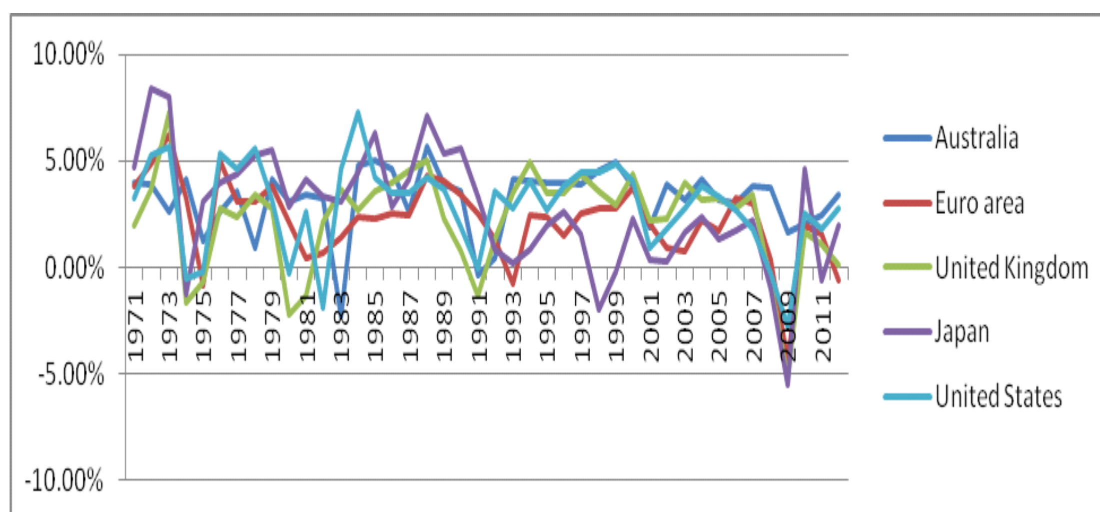
As insurance is interwoven through all parts of the economy and daily lives, QBE recognises that these structural shifts are driving the future of its own business and the insurance industry as a whole. It is critical that they are also taken into account in any refresh of the Australian financial system.

Some useful analysis and more detailed commentary on this topic can be found in the Association of British Insurers *Identifying the Challenges of a Changing World - The Trends Facing Insurers Towards the 2020s* and also in PwC's *Insurance 2020: Turning Change into Opportunity*.

QBE offers some brief observations on these shifts and the implications for the insurance industry as outlined below.

4.1. Global convergence

The world's economies have become much more interdependent with converging economies and economic cycles that are more and more in phase. This is most clearly seen in the developed world where until the beginning of the 90s we saw a clear economic cycle between the Western US to the UK, Europe and over to Japan as demonstrated by the following graph[15]



Year-on-year GDP growth of major economies belonging to the OECD 1971-2012

The GFC has also made it clear that the world is no longer made up of economic silos. The ripple effect of the GFC across the world and the more active role central banks have taken outside their own borders and in co-operation with each other has shown us how interdependent our economies have become.

If a major player like the US Federal Reserve takes policy decisions, the effects can be felt throughout the world, including in Australia. During and in the aftermath of the GFC central banks have collaborated and taken actions that must of necessity be cognisant of impacts beyond their borders. A recent example of this is the effects of tapering of Quantitative Easing in the US as decided by the US Federal Reserve on other, especially emerging, economies. Another is the cooperation of OECD Central Banks at the height of the Euro-crisis. [16]

*C*ross-border investment and trade has also led to increased global participation by corporations. When we consider the insurance industry in Australia, it is interesting to note the breakup of domestic versus international insurance providers in terms of gross earned premium [17] indicates that 8 out of 19 of the companies representing 23% of turnover in

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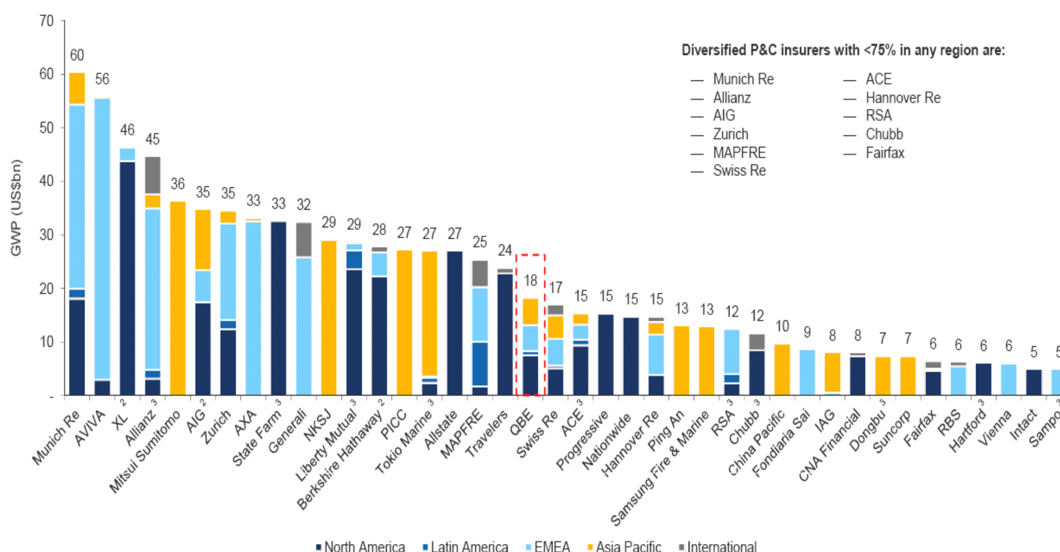
[15] Data from The World Bank, GDP growth from 1960 to 2012. Annual percentage growth rate of GDP at market prices based on constant local currency. EMU depicts those countries united in the European Monetary Union (the so-called Euro area).
[16] The Economist, February 15th 2014: The Loch Ness Consensus
[17] General Insurance Institution Level Statistics, APRA per June 2013 (issued 11 December 2013), www.apra.gov.au/GI/Publications/Pages/General-Insurance-Institution-Level-Statistics.aspx, table 4 supplemented with QBE data

Australia have their head offices domiciled outside of Australia. Only 3 of the 19 insurers who are domiciled in Australia however operate beyond Australia's borders.

The global view is as follows:[18]



(Macquarie 2011)

We can see the effect of global competition clearly in our Australian domestic market however the ability of our Australian domiciled insurers to compete on a global landscape is not so clear.

4.2. Changing demographics and wealth distribution

In just a little over a decade from now, four of the largest 10 economies in the world are expected to be in Asia.[20] According to the Brookings Institution, by 2030 there will be over 3 billion middle class people living in Asia Pacific.

Changes in the breakdown of global GDP, 2010 - 2060[19]

	Proportion of world GDP		
Region	**2010**	**2030**	**2060**
United States	23%	18%	16%
Japan	7%	4%	3%
Other G7	17%	11%	9%
Other OECD	19%	16%	14%
China	16%	28%	28%
India	6%	11%	18%
Other non-OECD	12%	12%	12%

The following table outlines projected changes in global GDP, 2010 - 2060 published by the OECD.

The uncertain growth in the developed world including Australia, compared with the expected growth of the consuming classes primarily in China and India is evident. Coupled with stricter regulatory guidelines in OECD countries post the GFC, this prosperity and demographic shift is likely to have a significant effect on the global allocation of capital. Capital will likely move to emerging market economies and emerging market insurers where it is anticipated there will be very significant demand for investment in infrastructure, new business and wealth creation and as a result, the provision of insurance products to a rising middle class.

This is of real relevance for the Australian economy,

[18] *Source: Macquarie 2011 Note: 1. where regional GWP split unavailable, NWP or NEP has been substituted. 2. NWP used. 3. NEP used*

[19] Percentages of world GDP are real measures at 2005 purchasing power parity (PPP)
OECD Working Paper 1000 "Long-Term Growth Scenarios", page 32
http://www.oecd-ilibrary.org/economics/long-term-growth-scenarios_5k4ddxpr2fmr-en

[20] Australia in the Asian Century: White Paper, Australian Government, October 2012, p 52. Adjusted for PPP.

and for the Australian general insurance industry in particular, providing a stark reminder that in the OECD nations, the old outnumber the young and aging demographics will see the ratio of workers to retirees fall significantly. It will be critical that Australia continues to be seen as an attractive destination for foreign capital.

4.3. Technology and big data

As noted by PwC[21], the adoption of new technologies is leading to greater leveraging of predictive analytic and ‘big data’ solutions and has the potential to enhance operational efficiencies, increase revenue opportunities and improve customer satisfaction. Technological advances in software and hardware are transforming "big data" into actionable insights which if leveraged can translate to better pricing, underwriting and loss control and more tailored and seamless customer experience. This will also lead to greater price differentiation and less cross-subsidisation.

Whereas insurance pricing has historically been informed by relatively broad risk inputs, "big data" opens up a wealth of more targeted risk inputs as the diagram shows.

Insurance providers that adopt this technology early and successfully are likely to experience a significant advantage over their competitors refining pricing and tailoring and converting insurance products targeted at specific customer segments.

This will be of great benefit to certain segments of the market however this focus on “micro-pricing” may also, from a consumer perspective, lead to greater reliance on pricing as a decision making factor.

This risks a ‘race-to-the-bottom’ as insurers compete for the best insureds, reducing margins and driving an even greater focus on internal costs. In this respect, international competitors operating in lower cost environments are likely to enjoy an inherent advantage.

The ability to leverage more and more data, from various sources, will also lead to data ownership and privacy implications. This is an issue that regulators, the insurance industry, and customer advocacy groups will need to address.

4.4. Consumer empowerment and protection

Across the world, power is shifting to consumers who are increasingly demanding more information, choice, autonomy and speed in their interactions with suppliers of goods and services. This power shift has been enabled by the prevalent use of the internet, interactive digital mobile technology, and social networks which is revolutionising the way consumers inform events (about the impact of real time emergencies), wield purchasing power (as buying groups), and influence policy outcomes (with lobbying campaigns).

In this context, it is not surprising that there is a fundamental shift occurring in the nature of the insurance industry's relationship with its customers and the way insurance is bought and sold. With greater access to information through technology and social networks, traditional distribution models are changing as customers’ behaviour changes from seeking advice from insurance agents and advisers to online networks and communities.

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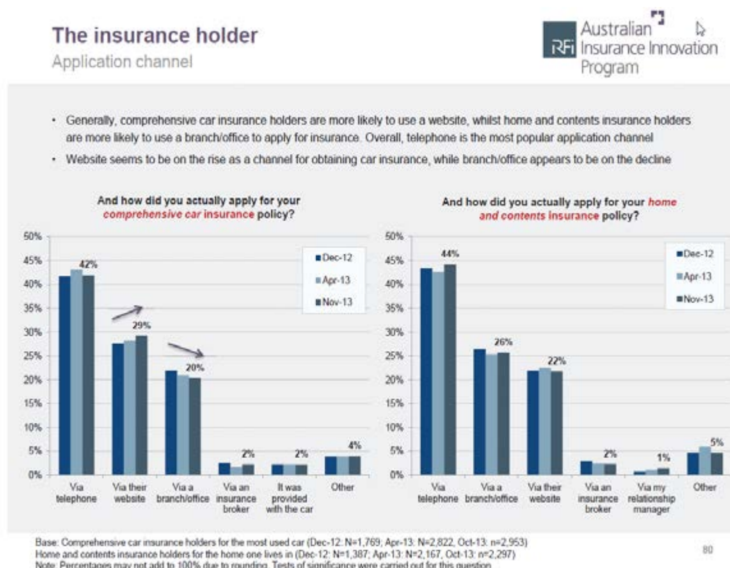
[21] PwC's *Insurance 2020: Turning Change into Opportunity, 2012,. page 5*

In brief, we see the following changes occurring today:



- increasing use of portable devices by consumers;
- online insurance purchasing and claims lodgement;
- use of digital media and marketing influences through that medium;
- demand for more relevant, convenient and cost efficient products and experiences;
- direct customers have the propensity to change their behaviours relating to insurance – using different channels, buying on line, with a predisposition to switching; and
- demand for greater service, more effective communication and prompt issues and complaint resolution.

Notably, we also see among customers, a rising expectation that governments and regulators will continue to provide greater protection to consumers.

QBE believes that consumer reforms in the past decade have generally benefited both consumers and the insurance industry, assisting to increase consumer understanding of insurance and providing increased transparency and disclosure of information about insurance products.

However, consumer protection regulation must keep pace with advancing technology to enable the insurance industry to service the customer in the way customers increasingly demand. If the industry is prohibited from employing new technologies, efficiency gains are impeded to the detriment of the consumer and the industry.

By way of example, until very recently insurers in Australia were prohibited from delivering disclosure information (such as a product disclosure statements and policy wordings) electronically. Changing this regulation to reflect current community standards and acceptable practice has eliminated significant mailing costs for insurers.

This really demonstrates that in some cases we are decades behind the times. More significantly, it also creates the impression for consumers and customers that the insurance industry is lagging badly behind in terms of the speed of society when in fact, it is impeded by restrictive and outdated regulation.

This is and will be particularly important in the context of Australia's national privacy regime and the need to balance the protection of individuals' rights and the ability of our corporations to operate efficiently and compete globally

These are challenging issues, with cybercrime and identify theft now rated the highest and third highest on the Political, Crime and Security risks priority that was developed by Lloyds[22]. Advancements in technology and the increase in mobile devices mean cybercrime will remain a key consideration for organisations large and small.

Australia's focus on consumer protection in this context is understandable. Looking forward, Government must consider the impact on the ability of business to participate globally and compete on a level playing field. As governments respond to more powerful consumer lobby groups there is a continuing increase in ad hoc regulation aimed at consumer protection which is layered over the operation of the insurance industry.

[22] http://www.lloyds.com/~/media/Files/News%20and%20Insight/Market%20Magazine/2012/Market_Magazine_311012.pdf

QBE recently reviewed certain aspects of its global operations to increase efficiencies and leverage its capabilities globally and can provide useful insights to the Inquiry on this topic if desired.

SECTION 4 - CONCLUSION

QBE believes it is important when refreshing the philosophy, principles and objectives underpinning the development of a well functioning financial system that the Inquiry takes into account the fundamental shifts in demographics, wealth distribution, technology, and consumer empowerment and protection in Australia and globally.

This conclusion contributes to points 2 and 7 in QBE's seven point plan for the Inquiry's consideration.

5. Australia as an attractive place to do business

With the challenge of an aging population in Australia and the rebalancing of wealth and power to emerging countries, Australia is well positioned geographically with Asia to capitalise on the opportunities that will emerge.

However, a number of our Asian neighbours and in particular Singapore[23] and Hong Kong have public policies that are designed to encourage the financial services industry to locate regional and global head offices in their respective countries. Similarly, other countries like Ireland[24], the United Arab Emirates and the UK are making concerted efforts to attract and retain international financial companies. These policies include tax incentives, relocation incentives and strong, stable regulatory environments designed to encourage the allocation of international capital to the respective country. These initiatives seem to have achieved some success and put Australia at a cost disadvantage in attracting international capital.

Economy	Ease of Doing Business Rank
Singapore	1
Hong Kong	2
New Zealand	3
United States	4
Denmark	5
Malaysia	6
Korea, Rep.	7
Georgia	8
Norway	9
United Kingdom	10
Australia	11
Finland	12
…	
Central African Republic	188
Chad	189

The World Bank ranks economies by publishing the "ease of doing business rank" where Australia was ranked 11th out of 189 countries but lagging behind our major global and regional competitors such as Singapore, Hong Kong, New Zealand, the US and the UK".[25] In addition, withdrawing capital from the financial services industry is almost impossible due to over-prescriptive regulation which also detracts from the investment decision.

Australia has some way to go in terms of focus and facilitation if it wants to retain and build on its position as an Asian-Pacific financial centre. While financial incentives may not be an option for Australia for budgetary reasons, a more balanced and streamlined regulatory environment for the financial services sector is feasible.

[23] In Singapore, there has been a concerted effort since 2002 to attract international financial companies.23 This task has been appropriated to the regulator itself, the Monetary Authority of Singapore in its dedicated Financial Centre Development Department.

[24] Since 1994 the Irish Development Agency focuses exclusively on the promotion and development of high-quality foreign direct investment (FDI) in Ireland, in the manufacturing and international services sectors. "*More than 250 Global financial institutions have established operations in Ireland, with many located in Dublin's International Financial Services Centre. The IFSC was created by the Irish Government in 1987 to drive the development of the sector. The IFSC now houses many of the world's leading financial institutions along with a sophisticated support network including accountancy, legal actuarial, taxation, regulatory, telecommunications and other services providers.*"[24]

[25] http://www.doingbusiness.org/rankings, © World Bank 2014

As we look ahead to Australia's core strengths and future growth opportunities, it is clear that we need a financial system and regulatory framework that provides system stability and supports our local economy enabling global businesses including Australian-owned companies, to operate productively and efficiently so that they can compete and innovate, using our capabilities and resources to best advantage for Australia.

To compete effectively on the global landscape, QBE understands that it must operate as efficiently as possible compared with its global competitors. As a truly global insurer, for QBE to remain domiciled in Australia requires that we operate in a landscape that does not place us at a disadvantage to our international competitors.

We recognise that the Australian Government is concerned about tackling the cost barriers to investment and growth, and welcome it initiating the National Industry Investment and Competiveness Agenda and the 'root and branch' review of competition laws and policy, amongst other initiatives.

5.1. Government stimulating Australian business in Asia-Pacific

As has been recognised, Australian businesses and their employees have significant opportunities with the emerging growth of the Asia Pacific region. It is important that we work closely with Government to identify opportunities and are nimble enough to capitalise on these as they arise. It will be necessary for Government to work beyond our borders collaborating with foreign governments and regulators to support and improve opportunities for Australian business across the region.

Government should provide more support and be seen to be doing so by host governments for Australian companies operating in this region. Although Austrade assists Australian companies and investors, increased involvement and consultation both at the agency and embassy level on the ground will improve opportunities for Australian businesses in the region. Suggestions include increased:

- participation in local business councils;
- consultation with Australian companies operating in the region (particularly those who have been operating in the area for some time) who can offer valuable insights from their intimate knowledge of the region;
- Australian Government interest and presence at both an embassy and Canberra level.

SECTION 5 - CONCLUSION

Government and industry should work together to take advantage of our inherent competitive advantages and develop investment and business opportunities locally and abroad to make Australia an attractive place to do business and supply the services our growing region demands.

This contributes to points 2 and 7 in QBE's seven point plan for the Inquiry's consideration.

6. Balancing stability, efficiency and national competitiveness

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.

The impact of the recent GFC demonstrates the importance of appropriate regulation and supervision. There is a need to ensure there is adequate capital support for unforseen events for our financial institutions, given the critical social and economic role of these industries.

It is acknowledged that Australia weathered the GFC fairly well compared to some other countries. There are a number of underlying reasons that contribute to this including our robust prudential regulatory regime. Australia in essence benefited from the HIH failure, the

lessons learned and the action that was taken to shore up our prudential regulation of financial institutions.

Although much was learned from the HIH failure, it is however important to bear in mind that, according to Justice Neville Owen, the failure could be attributed to mis-management, under-reserving, poor decision making and hiding, filtering or sanitising of unpleasant information[26]. Two HIH executives received court sentences as a result of this failure. The Geneva Association has considered HIH as a case study examining whether there were any relevant systemic risk implications to the HIH failure and concludes that HIH was a regular insurance failure in the sphere of insurance markets[27].

Since HIH, over the last decade Australia's prudential regulator and the regulatory regime applying to banks, insurers and superannuation funds has been entirely transformed.

In its initial formulation, the APRA Prudential Standards were based on two guiding principles:

- regulation must be principled based; and
- regulation is not designed to prevent failure but only prevent failure within a specific framework – in the case of the insurance industry, the ability to withstand a one in two hundred year event.

It is important to consider that reforms flowing from the findings of the HIH Royal Commission were effectively fully implemented by 2005.

Since that time, APRA has continued to introduce extensive changes to the regulatory framework across all aspects of the operations of our financial institutions introducing what it considers to be leading edge regulation and featuring as an early adopter of international regulatory reforms. When international reforms are subsequently put on hold or not implemented, to date there has been no reversal of these reforms in Australia.

As a result of this regulatory creep, and the regulator's “not on my watch” philosophy, the two guiding principles for our prudential regulatory regime have been significantly eroded. Some examples of these significant and ongoing reforms include:

- The introduction of LAGIC, a risk based capital regime for insurers, developed against the background of the international Basel accords and Solvency II. It should be noted that Australia is at the forefront of these reforms with Solvency II, originally designed to be introduced in 2011, diluted and now proposed for implementation in 2016 in the rest of the world, with some countries unsure now if this will proceed. The introduction by APRA of the insurance concentration risk capital charge (whole of portfolio event measurement (as part of the regulatory capital calculation) is time consuming and results in a higher level of capital than competitors domiciled in other jurisdictions;
- Ongoing changes to the risk and governance framework are becoming more and more prescriptive with increasingly unrealistic obligations required of non-executive directors and boards in areas of operational management of entities. Significantly increased management time and attention on governance and regulatory matters that require numerous levels of review including increasing numbers of independent and peer reviews by consultants add further direct and indirect costs;
- Continually increasing reporting requirements and the desire to disclose more and more information (for example the recent proposal to make all data non confidential by APRA) which is of little benefit and is likely to be misleading for consumers;
- Granular involvement in operational matters like legitimate outsourcing and offshoring arrangements designed to improve affordability through improved cost management;
- Increasing supervisory reviews of entities by the bureaucracy through risk reviews, prudential reviews, board and committee reviews, stress testing and group supervision (and of entities within a group that do not impact Australian policyholders) that involve the production of quantities of information and significant management time and cost for regulated entities.

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[26] The Failure of HIH Insurance, Justice Neville Owen, National Library of Australia, ISBN 097506780X

[27] Systemic Risks vs the 10 Year Old Insurance Failure in Australia, Etti Baranoff, Geneva Association, Insurance and Finance No 8, August 2011

The prudential regulatory reforms were formulated to address specific issues with our regulatory regime and regulatory approach post HIH and have held us in good stead during the GFC. Although strong prudential regulation and supervision for Australian financial institutions is essential, the burden of regulation in Australia has increased significantly with Australia tending to interpret to the extreme. Beyond a certain point, additional regulation creates a de-minimus social benefit. It continues to add to the cost burden of insurers with no commensurate productivity benefits and in fact, can have negative social impacts on consumers by way of increased premiums exacerbating affordability and accessibility issues.

It is also clear that zero risk disincentives innovation and could mean stagnation.

If our regulatory regime is out of sync with other comparable markets, Australian regulated entities are disadvantaged compared with their foreign domiciled competitors.

With the increased interdependence of our global economies there has also been a focus over recent decades by governments and regulators on negotiating and harmonising global regulation of our financial systems. Prior to the global financial crises, most international regulatory standards were developed relatively independently by four key bodies:

- The Basel Committee on Banking Supervision - for financial intermediaries;
- The International Organisation of Securities commissions - for securities markets and participants;
- The International Association of Insurance Supervisors - for the insurance industry; and
- The International Accounting Standards Board - for the accounting industry.

With the ripple effects and contagion of stresses emanating from the global financial crises, the role of the Financial Stability Board (***FSB***) has been transformed with a mandate by the G20 nations to co-ordinate the international response to address flaws and reform global regulation in the wake of the GFC.

Australia has taken an active role in this space with its membership on these bodies and its recent responsibility for chairing the G20 this year. This has been an important opportunity for Australia and as a global citizen we will be under some pressure to implement the reform agendas that will emerge from these international deliberations however we need to be mindful of the cost of "leading edge" regulation.

For the insurance industry, it is critical that the increasing integration of financial market supervision with a single prudential regulator (such as APRA) results in regulation that adequately recognises the fundamental differences between banking and insurance rather than adopting a “one size fits all approach".

This is particularly important with the current international regulatory initiatives considering imposing an additional regulatory overlay for significantly important financial institutions that was originally proposed for the banking sector as is now also being considered in the insurance context.

The Geneva Association's Systemic Risk Working Group has published a very useful report on *Systemic Risk in Insurance - An analysis of insurance and financial stability*[28] that examines the performance of the insurance industry during the GFC and provides an excellent analysis of the differences between the banking and insurance sector during this time and the drivers of these differences. This report has been prepared in the context of "systemically relevant institutions" and concludes that while there may be a trend of convergence of banking and insurance in capital market engagement, there are fundamental differences between these activities and further that insurance has specific features that make it a source of stability in the financial system and not subject to the same systemic risk as banking. In particular, the funding and wind up of insurance activities operates in significantly different ways.

[28] Systemic Risks in Insurance: An analysis of insurance and financial stability- Special Report of The Geneva Association Systemic Risk Working Group, Geneva Association March 2010

Consistent international regulation will remain important to Australia's reputation as a politically and financially stable location for investment. However, in our view, Australia's recent record as an early adopter of the new wave of regulation requires rethinking in this new environment. Although the policy intent in participating in and adopting consistent and appropriate international regulation is understandable from a regulatory perspective, Australia's recent experience with the early adoption of international regulatory regulation operates to place Australian businesses at a disadvantage compared with our international peers. This has been demonstrated in numerous areas including the early implementation of the Basel accords, IFRS, conglomerate and group supervisory regulation and LAGIC which have been implemented ahead of other jurisdictions but without commensurate productivity benefits.

QBE believes it is time to pause and take stock giving careful consideration to whether we should continue our trend of "early adoption", particularly in the context of additional international regulatory overlays which is putting international ventures of Australian insurance companies at a disadvantage.

We recognise the need and importance to engage and adopt consistent international regulation but think that early adoption should not be regarded as a good in itself. Leading the pack means that Australia is creating an unlevel playing field for businesses operating in and from Australia.

The focus of past governments and regulators on regulatory reform 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.

In this respect, QBE has undertaken an analysis of instances where we believe early adoption of international regulatory requirements or a more onerous approach taken by local regulators is impacting on the Australian insurance industry and would be happy to share this confidentially with the Inquiry. Some examples include:

Raising capital *- Australian based international insurers looking to raise capital in international markets pay materially more (approximately) 35bp compared with their international competitors due to unusual funding terms required by Australian regulations. Whilst accepted in the Australian capital markets with only a slight increase in cost such terms are considered more adverse to international investors leading to the cost differential.*

LAGIC and solvency *- The early adoption by APRA of the LAGIC risk based capital regime introduces significant complexity for insurers (and supervisors) and is directly disadvantaging Australian based international insurers in a number of areas which include the Basel III approach to capital charges for investment risk and the whole of portfolio event insurance risk capital charge.*

Reinsurance - *Reinsurance is an important source of risk mitigation for insurers and can be used as an alternative to capital in meeting regulatory capital requirements. As noted above it is important that Australian based insurers have access to robust capital and reinsurance sources on a level playing field with overseas based insurance groups, and this should be assessed on a fair value basis.*

One example where this is not currently the case is alternative forms of reinsurance such as catastrophe bonds which in many cases have equivalent mitigation characteristics as traditional reinsurance.

A further example is the non-economic treatment of reinsurance recoveries from well rated but non-APRA regulated reinsurers, which results in either non-admissibility or the requirement to collateralize the expected recoveries. The collateralisation of these reinsurance recoveries leads to a material additional cost impost and, because of the requirement to have the collateralisation from an Australian Deposit Taking Institution, materially increases the concentration of risk in the Australian economy

Both of these examples make overseas sources of reinsurance more expensive and less attractive, and therefore unnecessarily restrict the availability of capital to Australian domiciled

insurers and groups. This is not in the national interest of Australia, as evidenced in Japan where a large proportion of reinsurance was sourced domestically, and therefore following the Tohoku earthquake little capital support was actually provided from outside of Japan.

Group supervision - *The process of sharing information between regulators has potential merit however, there are significant complexities that arise for group supervision of a global insurance group particularly where actual regulatory policies and processes vary substantially from country to country. Apart from a substantial increase in reporting, information requests and management (and regulators') time, we are seeing some regulators focusing on areas outside their regulatory jurisdiction and making judgements that are not fully informed. This is particularly important when interpreting capital and solvency ratios which vary considerably across jurisdictions. Benchmarking against rating agencies may assist in this respect.*

Corporate governance – *APRA's increasingly prescriptive and onerous approach to corporate governance and the expectations required of boards of regulated entities under its prudential standards is adding additional and potentially conflicting layers of responsibilities on directors (who are already governed under Australian Corporations and common law). It is not clear how these respective duties and responsibilities are to interact, in terms of priority or otherwise, and APRA's expectations of the involvement of non-executive directors in extensive parts of the operations of insurers is blurring the line between management and boards. An example is APRA's prudential standard CPS 220 on risk management that will commence 1 January 2015.*

IFRS - *Whilst the Australian Accounting Standard AASB 1023 is considered to be leading edge accounting disclosure, it creates a distortion when comparing results of Australian insurers with that of international insurers. Specifically, the discounting of claims, the concepts of central estimate and risk margins and the mark to market valuation of investments creates uncertainty in capital markets. Uncertainty in capital markets leads inexorably to higher capital costs.*

Efficiency compared with our peers and specifically efficiency of capital is of real significance for all financial institutions. It is not in Australia's best interests if Australia's leading edge regulatory regime is more onerous than those found elsewhere in the globe. QBE, as one of the few domestic Australian-based financial institutions to be operating on a truly global landscape, stresses the importance of ensuring our regulatory regime does not significantly impede our international competitiveness. Australian businesses are dependent on foreign capital and we need to be mindful of the trade off between promoting stability and supporting innovation and the efficient use of capital.

SECTION 6 - CONCLUSION

The Australian Government should consider reviewing APRA's mandate to incorporate a formal objective that the prudential regulator consider the impact of regulatory requirements and reforms on affordability for consumers and competition, efficiency and innovation in the insurance industry, which operates in a global marketplace.

This contributes to point 3 in QBE's seven point plan for the Inquiry's consideration.

7. Streamlining the regulatory regime

The Australian Government has made clear in its core political objectives that it is critical for governments, industry and the community to each do what they can to make sure Australia is an attractive place to do business and invest. As Australia looks to equipping its financial system for the decades ahead, the Government will need to also need to take into account the regulatory compliance burden and ensure that cost imposts are kept to the minimum required to ensure sound practices consistent with a sound financial system.

The funding of APRA (and certain other Commonwealth agencies and departments) is primarily met through levies imposed on the financial services industry. Each year, the amount of the levy is determined by the Minister for Revenue and Assistant Treasurer after consultation with the industry.

This formal cost recovery policy was introduced in December 2002, with the underlying principle that agencies set charges to recover all the costs of a product or service where it is efficient and effective to do so and where the beneficiaries are a narrow and identifiable group.

Reviewing the APRA Financial Statements from 2002 to 2012 shows the following expense growth from 2002 being the introduction of the current General Insurance Prudential Standards regime.

Year	Headcount	Total expenses ($m)
2002	424	59.2
2003	503	68.6
2004	524	74.2
2005	597	82.0
2006	597	92.1
2007	582	91.1
2008	274	101.5
2009	614	103.3
2010	646	116.3
2011	616	118.3
2012	624	121.1

This table shows that that APRA has increased its expense base by $57.3million or 96.8% over the period and staff numbers from 424 to 624.

It is important to note that during the period under review, the number of licensed entities in the financial sector has generally declined with a significant amount of consolidation particularly in the general insurance industry.

We can see APRA's continually expanding regulatory ambit over this time has led to commensurate increases in costs, and consequently, increases in levies for financial institutions that have been significantly higher than inflation. QBE believes this levy funding design and methodology requires review.

Equally, it is interesting to consider the trajectory of ASIC's expenses and head count during this period. In 2002, ASIC's expenses were $159million and headcount was 573. In 2013, its expenses were $411.3million and headcount 1844.

All regulation creates and imposes costs and in the general insurance industry. These additional costs 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 compared with other industries competing for investment. In turn, this will enable us to provide suitable and more affordable products for customers. A regulatory regime that is unbalanced compromises this outcome.

In QBE’s role as a home-grown and headquartered international company, we see this as a critical.

QBE has recently examined the different running costs and other benefits and disadvantages of operating in a number of jurisdictions. Australia does not compare favourably even against other major financial hub capital cities like New York and London. . Australia, as a country, is known to be extremely expensive with relatively poor productivity. The cost of excessive or unnecessary regulation, whilst difficult to measure, creates a compounding effect on input costs for business.

We have slipped well behind in terms of the costs of doing business, as the Government has recognised.

7.1. Harmonising regulation

Overlapping, duplicative and inconsistent regulation between the states, territories and Commonwealth on the same activity creates significant inefficiencies and, in some instances, inequities and adds considerably to the cost of doing business in Australia. Over-regulation at the federal, state and territory levels, including regulatory overlap, is a major contributor to our comparatively high domestic cost structures. The regulatory burden is made more costly and onerous in areas where there is no national consistency or alignment of regulatory regimes,

such as in workers compensation, CTP and certain liability legislation. Differing levels and structures of federal and state Government regulation also add unnecessarily to the costs and complexity of providing affordable insurance services. These additional cost burdens often have a direct negative impact on productivity without any significant benefit to consumers.

There is extensive literature and debate on the benefits and disadvantages of a federated system. Whatever your view, in the context of lifting national efficiency and productivity there is a pressing need to ensure greater national consistency and uniformity of regulation. QBE recognises this is a complex issue and also that there has been progress in a number of areas. However the degree of economic integration that now exists within the country creates increased pressure for greater uniformity to reduce inefficient duplication of regulations and service delivery (including at the public service level).

Nowhere is this more clear than in our arrangements with employees. Great progress has been made with the implementation of a consistent model for work, health and safety in most states, but the workers compensation arrangement in Australia is an ambiguous, inconsistent and often nonsensical system characterised by multiple regimes. The differences across jurisdictions produce potential inequities between workers in different jurisdictions and added costs for employers operating nationally.

QBE, as a national employer, is obviously directly impacted by these arrangements. Employers that operate across states and territories are faced with the following challenges:

Administrative burden: There are significant differences in legislation across the states and territories, including differences in the definition of “workers”, the definition of wages, the structure of benefits, the level of rehabilitation and so on. All of these differences create an administrative burden for employers who operate across multiple jurisdictions. Organisational expenditure applied to managing the variability in workers compensation schemes across Australia could be better applied to improving the workplace safety environment to prevent injuries and to manage the return to work and rehabilitation of injured workers.

Cross jurisdictional benefit inequity: Each state and territory workers compensation scheme has different benefit structures, including differences in the calculation of benefits, differences in the “step downs” (the periods when wages are reduced), the amounts paid for permanent impairment, access to rehabilitation and the right to sue under common law. The variability in the types of injury covered, and the benefits payable, have the potential to create significant variability in the way in which two employees engaged by the same organisation are treated, depending upon where they are engaged. The impact of this variability creates industrial relations issues within an organisation creating further inefficiencies for multi state employers.

Other inequities: Organisations which operate across jurisdictions are also faced with the challenges of variability in cover (the definition of who is covered and who is not varies from state to state), differences in dispute management approaches and appeal rights.

As one of the few truly national insurers to operate in this space (either as a private underwriter or agent) QBE believes it can provide the Inquiry with some useful insight on this area.

7.2. Our injury compensation systems

A case in point when considering funding Australia's future and establishing the financial systems necessary to support it is the operation of our key injury compensation schemes. Workers compensation, compulsory third party and the proposed NDIS are all schemes that have or are being developed as a response to serious societal problems reflecting the range of socio-cultural, economic and political arrangements made by society to provide for injured people. There is a continual challenge to balance the societal needs and benefits for the injured individual against the rising costs and substantial funding deficits that governments face with these schemes. In addition, the interface between the social security system and the other compensation schemes is far from seamless. The historical and political dimensions influencing the development of our compensation schemes have tended to obscure the true role and function of the scheme arrangements. These schemes have developed in an incremental fashion often with little regard to the origins or long term rationale for particular developments and there has been very little articulation of the interfaces of the compensation

schemes and the wider political and social system. Similarly, the interaction and interface with the operation of the proposed NDIS is currently extremely unclear.

Where the boundaries of one scheme are opaque or there is benefit arbitrage between schemes or where there is stigma associated with certain claims, cost shifting is incentivised with injured persons motivated to seek compensation from alternate systems.

State and territory Governments have been fiscally challenged with unfunded deficits at different times which drives political responses that invariably lead to increased premiums or reduced benefits. The underlying root cause of why claims are still occurring or claims costs are increasing needs further in depth consideration.

In essence, one of the key objectives for an effective personal injury scheme is that the amounts paid to injured parties should constitute the vast majority of the costs which an insurance company will pay out.

Under the current complex arrangements far too much is being spent by insurance companies tailoring to the multitude of schemes. IT requirements vary markedly across the different jurisdictions, driven by both differences in legislation as well as the regulatory requirements imposed in each state and territory. Legal costs and the costs of rehabilitation providers have escalated.

Constant changes to legislation, benefits, administrative coding and similar requirements is costly to maintain, meaning that investment which could otherwise be directed toward capability development or case management innovation is being used to fund systems maintenance across multiple jurisdictions.

At the most operational level, different benefit structures, definitions and case management practices across the states and territories means that operational personnel within the insurance company cannot seamlessly operate across different states and territories. Additional costs are incurred in terms of training and development and affect an insurance company's ability to create synergies and direct more attention to the effective management of workplace injuries.

Australia’s varied compensation schemes mean that there is a significant cost burden borne by insurance companies and agents. A more effective deployment of these resources would be to invest in practices which would assist to reduce risks, for example, focusing on practices to educate drivers on road safety or assist employers remove work health risks or the investment in research to better understand how to improve return to work outcomes for injured persons can be achieved.

Additionally, the layers of regulatory responsibility and overlapping regulatory requirements and objectives between the various state and the federal prudential regulator, APRA, creates complexity, rework, inconsistencies and additional costs and operational issues for insurance companies. As the Inquiry is aware, QBE has recently implemented a transformational project for its Australian and New Zealand division with its establishment of a shared service centre in Manila which involved extensive regulatory liaison and interaction and can provide some useful insights for the Inquiry if that would assist.

QBE is strongly of the view that Australia’s federated approach to the management of injury compensation arrangements creates a range of efficiency, affordability and equity issues. Although unquestionably challenging and complex to address, establishing national (or nationally consistent) compensation schemes that interface appropriately with the other compensation systems will enhance Australia's standing as an attractive place to do business, particularly for workers compensation arrangements.

Using workers compensation as an example, this would:

- remove the administrative and regulatory burden currently faced by employers who engage staff across a number of jurisdictions in Australia, enabling a greater focus on the management of Work Health and Safety practices and workers compensation issues within their own operations, rather than managing administration and regulatory differences;
- remove the administrative and regulatory burden for insurers associated with managing 10 different workers compensation arrangements across Australia. Removing the costs associated with these management challenges, allows a greater investment in innovation

to develop systems and practices to drive for better social and financial outcomes. Innovation developed by insurance companies can be applied across the state and territory boundaries, allowing all employers and employees to benefit, as opposed to the current restrictions which may limit the application of innovation due to state regulatory arrangements;
- remove the current inequity in benefits applied to the same injury, across the states/territories and remove the current inconsistency in coverage ie who is covered and for what;
- remove the volatility in premiums charged; and
- ensure that no one organisation is given advantage over another by virtue of their ability or otherwise to access different insurance options. All organisations would be subject to the same legislation and funding arrangements.

Additionally, it is timely to step back and consider whether it is appropriate or necessary for governments to continue to "insure' such schemes. Insurance is not "core business" for government, arguably detracting focus from core Government administrative functions, creating increased complexity given the inherent conflicts Government faces through the cycle and adding inefficiencies as outlined above.

Having regard to the commentary outlined in **appendix 2**, opening up the statutory compensation schemes to private capital underwriting has a range of benefits over the current arrangements which include:

- greater competition in pricing;
- enables the regulator(s) to focus on regulating the scheme rather than administering (for example Western Australia workers compensation) and the scheme design principles ensuring that those principles are applied consistently recognising that insurance is not "core business" for governments;
- clarity of role between regulators can be achieved between the prudential regulator (APRA) and scheme regulators with clearer delineation of responsibilities. Put simply, APRA can focus on the prudential and capital adequacy aspects of the Workers Compensation insurer and the scheme regulator can focus on the delivery of the scheme legislative and regulatory intent, avoiding any duplication of effort or conversely avoiding gaps in regulation;
- greater innovation in claims management with more incentive for private insurers to invest heavily in systems and practices to ensure that the best community and financial outcomes are achieved for all parties;
- reducing fiscal volatility for governments and the potential for ratings agencies considering compensation class deficits when assessing state credit ratings; and
- small employer community rating mechanisms which provide for rating of better or poorer performing employers, driving employing organisations to invest in Work Health and Safety practices and the management of any workers compensation claims which may arise.

Due to the importance of our employment arrangements in Australia, further detailed analysis on workers compensation arrangements, current challenges and suggested solutions is included in **appendix 2.**

QBE believes that the rising cost pressures of injury compensation schemes and other insurance classes would be eased by a national framework that moves toward:

- **establishing national or nationally consistent compensation schemes that interface appropriately with the other compensation schemes (particularly for workers compensation);**
- **rationalising or standardising the disparate state and territory based intervention in various classes of insurance;**
- **recognising that insurance is not "core business" for governments; and**
- **defining the boundaries or role of Government acceptance of certain risks, where market-based acceptance of risk is not viable or not cost effective for consumers.**

7.3. Financial system regulators

The Australian Centre for Financial Studies has issued a number of reports as part of the *Funding Australia's Future Project.* Its report *Improving Australia's Financial Infrastructure*[29] provides a helpful analysis of a number of relevant matters including the current regulatory arrangements for the financial system, the regulatory reform of the financial sector over recent decades and challenges to improve productivity going forward.

QBE believes the "twin peak" model of regulation for the financial system remains relevant and appropriate but believes that in addition to state and Commonwealth overlap, during the past decade there has been regulatory creep with the scope and ambit of the key regulators blurring. The continuous legislative reforms and changes that have been implemented relatively piecemeal over the last decade now intertwine and overlap in a number of areas. A good example is the governance or "fit and proper" requirements that are now required by the ASX (for listed companies), APRA (for prudentially regulated institutions) and ASIC (for AFSL or ACL holders). Although there are streamlined arrangements that take into account the other regulatory regimes, each regime is slightly different and involves duplication and rework for companies. In addition, the objectives of different regulators dealing in the same subject matter are not always aligned which can lead to confusion, inconsistency and reworking of the same information for different regulators. A further recent example is the different approach taken on the establishment of prudential risk margins between APRA and the ATO. This adds complexity and inefficiencies and increases the compliance and governance burden of business.

Over the last decade, there have been thousands of pages of legislation and regulations passed that apply or impact on the insurance industry. In addition, there have been many Royal Commissions, inquiries, consultations, discussion papers and draft legislation. We place value on making input to these inquiries to put our view and educate on the insurance industry and its role in socialising and pricing risk. At times, legislation and regulations have been promulgated by governments and regulators as a reactive response to evolving issues, with insufficient evaluation of the impact on the economy and industry. We would like to see a more coordinated approach to these multiple inquiries and ensure that policy is evidence-based and that the learnings from one inquiry inform the next and so ensure sound outcomes that can be broadly supported.

Ultimately, the additional cost burden of duplicative and inefficient regulation is born by the industry and ultimately by the consumer, either through increased premiums and subsequent affordability problems or impacting on the availability of insurance. To change this legacy into a pro-productivity and investment agenda will require commitment at all levels of government, focusing on:

- consistent with the Government's deregulation agenda, rigorously assessing new regulatory proposals and repeal poorly constructed legislation to and overlap, improving effectiveness and reducing unnecessary compliance costs;
- ensuring real cost benefit analysis of proposed legislation taking into account the impact on competition, productivity and efficiency for businesses;
- modernising the regulatory culture within Government departments and agencies; and
- ensuring good co-operation and interaction across state, territory and federal Governments and political support for national consistency in regulation.

QBE strongly supports the Australian Government's recent "red tape" initiative requiring federal regulators to balance any new regulation with a reduction in existing regulation.

Additional or changing regulation on the financial services industry operating in and/or from Australia should be balanced by also explicitly considering the proposed reform in the context of improving and sustaining Australia's competitiveness and productivity.

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[29] Australian Centre for Financial Studies, The Funding Australia's Future Project, *Improving Australia's Financial Infrastructure, 2013.*

7.4. State taxes and insurance

Insurance taxes are one of the most inefficient taxes levied in Australia, as has been recognised in numerous reviews including in the 2010 Henry Taxation Review (Australia's Future Tax System review) which recommended all specific taxes on insurance products, including levies should be abolished. These inequitable and inefficient taxes and levies imposed on insurance products impact on affordability of insurance and exacerbate the broader societal issues of non and under insurance.

The general insurance industry in Australia is subject to multiple layers of taxation at federal, state and territory level and acts as the tax collector for the states in collection of stamp duty and fire service levies.

The policyholder is responsible for paying the relevant taxes, GST at the federal level and stamp duty and fires services levies at the state and territory level. These taxes are all separately disclosed on the policy documentation and are therefore visible to the policyholder. In addition, the general insurance industry is also subject to payroll tax at the state and territory level and a number of taxes at the federal level which are not obvious to the policyholder.

When the "ANTS" (A New Tax System) was introduced in 1998, one of the key objectives was to eliminate state taxes and to replace them with GST. The logic for utilising a broad based tax such as the GST is well documented both in the ANTS supporting documentation as well as various other reports including a report completed by the Insurance Council of Australia titled "Victorian Government Green Paper: "Fires Services and the Non-Insured" date 1 July 2010. This paper notes that:

"An efficient tax is a tax that has minimal effect on the allocation of resources and therefore community wellbeing. Put simply, all taxes, irrespective of their incidence, distort the allocation of resources. Taxes serve to drive a wedge between the final price a consumer pays for a good or service and the final price a producer receives for supplying that good or service. This tax wedge directly impacts on consumer and investment decisions resulting in a suboptimal allocation of resources."

One major concern is that the level of taxes applied to general insurance policies impacts the affordability of insurance in the community. By way of example, QBE paid $455million in taxes, stamp duty and fire service levies in the year ended 31 December 2013. QBE wrote 4.9 million policies in 2013. Therefore the average cost of these taxes per policy was $93. If this is compared with the average cost per policy of $1020 (based our gross written premium of $5.0billion), state and territory taxes impose an additional cost to the policyholder in the order of 10%[30].

The Inquiry should affirm the previous recommendations that all specific taxes on insurance premiums should be removed and that the states and territories should be encouraged to ensure this occur within a three year time frame.

7.5. Quantification of the cost of over-regulation

All regulation creates and imposes costs and in the general insurance industry. These additional costs will 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 funds. In turn, this will enable us to provide suitable and more affordable products for customers.

[30] Dependant on the state, the average cost per policy could be significantly higher or lower dependant on the state regulations and rate of tax.

We have made an attempt to quantify the cost of regulation (excluding time which is taken away from running a business and lost opportunity costs). This cost will ultimately be borne by shareholders and/or policy holders. Both have a direct link to the competitiveness of the operation.

- The cost of capital for QBE as shown in **section 7.1** above in international comparison by some 0.35% higher due to regulation which is inconsistent with the international norm. At total net tangible assets of US$ 5,923 million at the end of 2013, we are talking a cost differential of US$ 20.7 million or A$ 23 million;
- Cost of compliance in QBE Australia (only) amounts to A$ 25.5 million per annum. This on average adds 5 dollars to every policy;
- Stamp duty, taxes and fire service levies add an average of A$93 to each policy (totalling A$ 455 million in 2013);
- Additional cost of reinsurance due to restriction on use of instruments is difficult to determine but is in the order of 1% of the cost of reinsurance.

We estimate that the total cost stemming from over regulation at an average of over $100 per policy or in the range of between 10% and 15%. This has direct repercussions on accessibility, affordability and the economy at large.

SECTION 7 - CONCLUSION

QBE would like to see all prospective legislative and regulatory change to the financial services sector submitted to a genuine and rigorous cost benefit analysis. Regulators' performance could be assessed against this same standard, which would give due weight to the need to promote productivity and competitiveness in a dynamic global economy. All specific taxes on insurance premiums should be removed.

Government should initiate a regulatory harmonisation program with a view to ensuring our regulatory systems operate effectively, efficiently and productively and ease the compliance burden.

This contributes to points 1, 2, 4 and 6 of QBE's seven point plan for the Inquiry's consideration.

8. Lenders mortgage insurance and system stability

Lenders' Mortgage Insurance (***LMI***) currently plays an extremely important role in the Australian housing market - it enhances the underlying efficiency in the market for housing loans, improves access to home ownership, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), increases competition and innovation among lenders and reduces barriers to entry in the home lending market.

There is currently little capital incentive for the home lending market to use LMI because of the increasing dominance of Internal Ratings Based (IRB) banks, together with a lack of regulatory incentive for IRB banks to use LMI when modelling reduction in credit losses.

APRA's specific regulatory capital regime in relation to LMI providers is also very high (due to APRA's view of potential losses arising from mortgage defaults in a severe economic downturn). The largest component/driver of LMI premium rates is therefore the high level of regulatory capital that LMI's must hold.

QBE believes in the absence of any regulatory or structural recognition for IRB banks use of LMI, the important role that LMI has and currently plays in the Australian home lending market may be impacted as experienced in New Zealand where LMI is no longer available.

This in turn will place at risk both the accessibility to home ownership and affordability of homes within the Australian housing market.

QBE considers this an important consideration for the Inquiry and as such, a separate submission on lenders mortgage insurance has been prepared (a copy of which is contained in **appendix 3).**

SECTION 8 - CONCLUSION

QBE recommends that the Government consider ensuring IRB banks receive appropriate capital incentive for the use of LMI given its important role in providing financial system stability for credit risk in the residential housing market and increasing residential housing accessibility and affordability.

This contributes to point 5 of QBE's seven point plan for the Inquiry's consideration.

9. Focusing forward

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. The costs of doing business in Australia should be a paramount indicator in this consideration, now and in the future.

QBE offers the following 7 point plan for consideration by the Inquiry and looks forward to further discussions on these matters:

1. **Government initiate a regulatory harmonisation program aimed at removing all forms of duplication, overlap and reporting on the same activity with a view to ensuring our regulatory systems operate effectively, efficiently and productively and ease the compliance burden.**
2. **Additional or changing regulation on the financial services industry operating in and/or from Australia should be:**
   - **subject to a genuine and rigorous cost benefit analysis that should also include a cost impact analysis on consumers;**
   - **balanced by also explicitly considering the proposed reform in the context of improving and sustaining Australia's competitiveness and productivity. Regulators' performance could be assessed against this same standard, which would give due weight to the need to promote productivity and competitiveness in a dynamic global economy and maintain affordability for consumers.**
3. **APRA's mandate should be reviewed to incorporate a formal objective that the regulator consider the impact of regulatory requirements and reforms on affordability for consumers and on competition, efficiency and innovation in the insurance industry, which operates in a global marketplace.**
4. **Given the impact on affordability and potential implications for the public purse, all specific taxes on insurance premiums should be removed and the states and territories should be encouraged to implement this reform within a three year time frame.**
5. **In recognition of the important role that lenders mortgage insurance plays in our economy, Government should ensure IRB banks receive appropriate capital incentive for the use of LMI.**
6. **Consideration should be given to a national framework that moves toward:**

- **establishing national or nationally consistent compensation schemes that interface appropriately with the other compensation schemes (particularly for workers compensation);**
- **rationalising or standardising the disparate state and territory based intervention in**

various classes of insurance;

- **recognition that insurance is not "core business" for Governments;**
- **defining the boundaries or role of Government acceptance of certain risks, where market based acceptance of risk is not viable or not cost effective for consumers.**

7. **Continued and more effective communication and collaboration between governments and the industry and an in depth understanding of the complexities and societal impacts involved with issues such as accessibility and affordability of insurance is needed.**

QBE believes this 7 point plan will position Australia's financial system to better meet Australia's evolving needs and support Australia's economic growth. To assist the Panel's consideration of our submission, we have cross referenced each point of QBE's 7 point plan to the Inquiry's terms of reference (TOR) as follows:

QBE point	TOR paragraph
1	1(3); 2(1); 2(3); 2(5); 3(4); 4(2); and 4(4)
2	1(3); 2(1); 2(3); 2(5); 4(3); and 4(4)
3	2(3); 2(5); and 4(2)
4	6
5	1(3); 2(2); 3(3); and 4(2)
6	1(3); 4(3); and 4(4)
7	1(3); 2(4); 2(5); 4(2); 4(3); and 4(4)

Section 3 - Appendices

Appendix 1 - Historical natural catastrophe statistics in Australia since 2009

Event	Date dd/mm/yy	Location	State	Original Cost (AUD$)
Bushfires	11/01/14 - 14/01/14	Perth	WA	$15,000,000 (early figures)
Bushfires	17/10/13 - 27/10/13	NSW (various locations)	NSW	183,400,000 (early figures as at 05/12/13)
Inundation and Storms	27/01/13 - 30/01/13	Northern NSW	NSW	121,300,000
Inundation and Storms	21/01/13 - 31/01/13	QLD	QLD	977,000,000
Bushfire	13/01/13 - 19/01/13	Coonabarabran	NSW	35,000,000
Bushfire	04/01/13 - 10/01/13	TAS	TAS	89,000,000
Flooding	24/02/12 - 16/03/12	NSW & VIC	NSW & VIC	131,890,000
Flooding	24/01/12 - 15/02/12	SW QLD	QLD	131,432,000
Christmas Day Storms	25/12/2011	Melbourne	VIC	728,640,000
Margaret River Bushfires	22/11/11 to 24/11/11	Margaret River	WA	53,450,000
Perth Bushfires	05/02/11 to 07/02/11	Perth and surrounds	WA	35,128,000
Severe Storms	04/02/11 to 06/02/11	Melbourne and suburbs	VIC	487,615,000
Cyclone Yasi	02/02/11 to 07/02/11	QLD	QLD	1,412,239,000
Flooding	13/01/11 to 18/01/11	VIC	VIC	126,495,000
Flooding	21/12/10 to 14/01/11	QLD, Rural Toowoomba, Lockyer Valley	QLD	2,387,624,000
Perth Storm	22/03/2010	Perth	WA	1,053,000,000
Melbourne Storm	06/03/2010	Melbourne	VIC	1,044,000,000
West QLD flooding	05/03/2010	QLD	QLD	46,700,000
Toodyay Bushfires	31/12/2009	Toodyay WA	WA	7,400,000
Inundation & Storm Damage	21/05/2009	South East Queensland & Northern NSW	QLD/NSW	48,000,000
Flooding	10/04/2009	Northern NSW	NSW	37,000,000
Victorian fires	07/02/2009	VIC	VIC	1,070,000,000
Floods	13/01/2009	Far North Queensland	QLD	19,000,000

Source: Website of the Insurance Council of Australia per March 11, 2014:
http://www.insurancecouncil.com.au/industry-statistics-data/disaster-statistics/historical-disaster-statistics

Appendix 2 - Workers compensation

1. Purpose

Workers compensation schemes exist globally for a range of reasons, including the following. They:

- provide a social safety net for workers who are injured whilst performing their work duties;
- aid employers by providing a risk transfer mechanism. Through the payment of a worker's compensation premium, employers are able to transfer some of the risks associated with the workplace; and
- provide rehabilitation and return to work support to employees injured in the course of employment.

Workers compensation statutes are generally designed to ensure that employees who are injured or disabled on the job are not required to cover medical bills related to their on-the-job injury and are provided with monetary awards to cover loss of wages directly related to the accident, as well as to compensate them for permanent physical impairments.

2. Workers compensation schemes in Australia

Australia has 10 separate workers compensation systems.

Each state and territory has its own workers compensation system. In addition, the Commonwealth has separate workers compensation arrangements covering federal Government employees and some private sector employers who have been allowed to self insure under the ComCare arrangement (having demonstrated that they compete with a current or previous federal Government agency). In addition, Seacare establishes a rehabilitation and workers compensation scheme for seafarers employed on certain ships engaged in trade or commerce either interstate or overseas, and on vessels declared by the Australian Maritime Safety Authority.

Each of the 10 schemes in Australia operate quite differently, but can be grouped broadly into similar arrangements, as set out below.

Managed funds

New South Wales and Victoria are schemes where state workers compensation regulators essentially outsource the management of the scheme to a group of approved agents. The approved agents issue the workers compensation policy, collect the premium and manage the claims which emanate from policies issued by the agent. Premium rating methodologies are established by the scheme regulator and simply applied by the appointed agent. There is no competitive pricing tension in these schemes.

South Australia operates in a very similar manner to New South Wales and Victoria, with the major difference being that the policy issue and premium collection functions are performed by the scheme regulator rather than by the appointed agents.

State Government run monopoly

The Queensland workers compensation scheme is run entirely by Work Cover Queensland, a department within the Queensland Government.

Privately underwritten schemes

Western Australia, ACT, and Northern Territory are privately underwritten schemes. In these schemes, APRA licensed insurers are licensed by the scheme regulators to issue workers compensation policies in those states. Pricing is essentially the domain of the insurer. Western Australia sets a pricing framework to be followed by licensed insurers.

These schemes operate as a normal line of insurance in that a claim under a policy is the liability of the insurer.

ComCare

Workers compensation arrangements for federal public servants are managed under the ComCare scheme.

Self insurance
In addition, a small number of employers who have demonstrated that they compete with a current or previous federal Government agency (referred to as the 'Competition Test') have been permitted to self insure under the ComCare arrangements, meaning that all of their Australian based employees, no matter where they are employed or reside in Australia, are covered under one piece of workers compensation legislation.

Seafarers
A rehabilitation and compensation scheme has been established for seafarers. This cover extends to people employed on vessels which have been declared by the Australian Maritime and Safety Authority. The pricing arrangements for employers required to be insured for workers compensation purposes under the Seacare legislation are similar to that of the privately underwritten schemes, in that pricing is set by the insurer.

3. Principles of an effective workers compensation scheme

Over many years, QBE has considered the principles which it believes form the foundation of an effective workers compensation system.

Firstly, an effective workers compensation scheme must have at its core a focus on incentives for injury prevention and appropriate care for injured workers, whilst ensuring that the premiums payable by employers are affordable and reflect the risks of that employer.

An effective scheme must have balanced return to work incentives for injured workers as well as a clear focus on treatment and rehabilitation, in preference to other forms of compensation. An effective scheme must also ensure that fair benefits are available to all injured workers, with greater support provided for the most seriously injured. In an effective scheme both the premiums and benefits structures are stable, across time.

QBE's view is that the core principles of a “best practice” workers compensation scheme are best expressed by the following.

- Fairness to injured workers by promoting recovery with incentives to encourage return to work.
- Affordability for employers, which requires:
  - appropriate incentives for all stakeholders to improve workplace safety; and
  - appropriate pricing for all employers which contributes to economic growth.
- Sustainability for all, which requires:
  - a fully funded scheme so that there is no burden on the public purse;
  - appropriate governance that separates regulatory oversight from scheme management (to avoid political decisions driving scheme management decisions);
  - consistency in premium rating methodology which ensures a degree of certainty around future premiums payable;
  - a benefits design which is consistent over time and is not subject to continual tweaking as a result of the influence of any lobby group; and
  - support for both employers and employees to ensure that the wider community is not affected by the impact of workplace injuries.

4. Current workers compensation arrangements – the challenges

The current workers compensation arrangements within Australia create a range of challenges, inconsistencies and inequities.

Cost of regulation - employers

Employers which operate across states and territories are faced with two key challenges, which are explained in more detail below.

Administrative burden
There are significant differences in legislation across the states and territories, including differences in the definition of “worker”, the definition of wages, the structure of benefits, the level of rehabilitation and so on. All of these differences create an administrative burden for employers who operate across multiple jurisdictions. Organisational expenditure applied to managing the variability in workers compensation schemes across Australia could be better applied to improving the workplace safety environment in order to prevent injuries and to manage the return to work and rehabilitation of injured workers.

Cross jurisdictional benefit inequity
Each state and territory workers compensation scheme has different entitlement structures, including differences in the calculation of benefits, differences in the "step downs" (the periods when wages are reduced), the amounts paid for permanent impairment, access to rehabilitation and the right to sue under common law. The variability in the types of injury covered and the benefits payable have the potential to create significant variability in the way in which two employees engaged by the same organisation are treated, depending upon where they are engaged from. The impact of this variability creates industrial relations issues within an organisation, which in turn creates further inefficiencies for multi-state employers.

Other inequities
Organisations which operate across multiple jurisdictions are also faced with the challenges of variability in cover (the definition of who is covered and who is not varies from state to state), differences in dispute management approaches and appeal rights.

Options for multi-state employers
The ComCare scheme enables employers who have been able to demonstrate that they compete against either existing or previous federal Government agencies (for example, Optus has been able to demonstrate that it competes against Telstra), to self insure under that scheme.

The advantage of this arrangement is that employers which operate across multiple jurisdictions can manage their workers compensation arrangements under one piece of legislation and regulation. In addition, the ComCare arrangements facilitate equity in relation to the treatment of people employed within the one organisation.

The Rudd/Gillard labor Government placed a moratorium on employers entering the ComCare scheme in 2008. Since that time a demand has been building for employers to self insure under that scheme as organisations seek out opportunities to remove administrative burden and operating costs. The current Abbott liberal Government recently announced that it would lift the moratorium and again allow employers who pass the competition test to be considered for the scheme.

Impacts of exits from state based schemes
In the event that more employers exit the state based schemes in favour of the ComCare arrangement, there are two potential challenges which emerge, as set out below.

Impact on state based schemes
Historically, there have been relatively few organisations that have been allowed to enter the ComCare arrangements. As has been indicated above, market murmurings suggest that there is a pent up demand from employers wishing to exit state based arrangements and to enter instead the ComCare environment. Given that, at present, private sector organisations can only enter these arrangements if they self insure, only larger organisations who meet the self insurance criteria, as well as the 'competition test' will be allowed to enter. The kinds of organisations which may consider entering ComCare are also the organisations which are generally more sophisticated in terms of their WHS practices and workers compensation management. These organisations in the past may have been used to cross-subsidise smaller poorer performing organisations or segments in the scheme. The loss of larger, better performing organisations has the potential to adversely impact the remainder of the scheme.

Impact on competition
As more organisations are allowed into the ComCare arrangements, an increasing divide may begin to emerge between those organisations which have been allowed to enter the ComCare arrangements and those that remain part of the state based arrangements. Those that are able to operate in the ComCare arrangements will be more efficient in terms of their operation (consistent legislation and regulation applied to all employees), and will not be subject to the variability in premiums that occurs across schemes around the country at present. Effectively, as a result of inconsistent Government regulation, an uneven playing field will emerge, creating a competitive advantage for some organisations over others. Equally, if costs in this scheme are more expensive through entitlement provisions, larger firms may find this a less competitive option over time.

Community rating (cross-subsidisation)

In some of the state run workers compensation systems there have been overt attempts to create protection mechanisms for smaller employers who experience claims. Whilst this form of community rating also occurs in privately underwritten jurisdictions, there is a higher degree of commercial judgement applied in these jurisdictions.

The issue with stringent community rating is that there is little or no incentive to drive for improvements in the WHS and workers compensation practices within smaller organisations. When there is no incentive to improve practices, the community is adversely affected as there is a greater chance of workplace injury being sustained and a much smaller chance of getting injured people back to work quickly and sustainably.

Privately underwritten markets will certainly take account of employer size band “chance” claims. In the event however that claims experience is poor, driven by systematic poor work health practices, premiums will reflect the risk. There is an argument that severe penalties should apply to employer organisations which consistently injure their employees with little regard for creating return to work opportunities, either in the form of higher premiums or in the form of penalties from state WHS regulators.

Premium variability across Australia

Under the current federated arrangements in Australia, there is wide variability in relation to underwriting systems and premium rating in place. Combined with the differences in benefit arrangements across the states there is wide variability in average premium rates changed.

The average premium rate charged in the most expensive scheme (ACT) is nearly 3 times the average rate charged in the cheapest scheme (Vic). This kind of variation is causing employers to seriously consider their state/territory of domicile. Not only is the current state of affairs inequitable, there is also the changing state of affairs across time, with the constant tweaking of benefit structures in some jurisdictions, causing significant variability in premiums charged over time.

National Disability Insurance Scheme (NDIS)

With the creation of the NDIS, there is now an unclear delineation in terms of financial responsibility for ongoing liability for injuries which fit the NDIS requirements, creating a potential further area for confusion and administrative burden.

Scheme regulation vs scheme administration

As indicated above, three of Australia's workers compensation schemes are managed fund arrangements (where the management of the workers compensation function is outsourced to private sector organisations on a fee for service basis).

The challenge for regulators under these arrangements is balancing the role of the regulator with the role of the scheme administrator. There have been periods over the past 20 years under these arrangements where the regulators have created onerous process requirements for the private sector organisations which have been licensed to manage the workers compensation arrangements for that state. The result has been that resources are poorly deployed to manage process requirements rather than effectively managing the complexities of individual claims to drive appropriate and sustainable outcomes for injured persons, the insured and the community generally.

During periods where regulators become overly intrusive in terms of process requirement, there is little investment in innovation, or systems, again affecting the ability of the schemes to drive proper community and financial outcomes. When there is an imbalance in the focus on driving for outcomes, inevitably there is a deterioration in scheme performance and, if the scheme performance continues to deteriorate, then governments are forced to act with changes to either benefit structures of premium structures, creating ongoing uncertainty in the community.

Managed fund scheme debt

The managed fund schemes in Australia have created ongoing challenges for the state governments which manage those schemes. Victoria has been the most stable, experiencing a decade of surplus.

New South Wales and South Australia, on the other hand, have experienced extended periods of significant under-funding (where not enough premiums are collected to cover the

cost of running the scheme). South Australia's current deficit is approaching $1.4 billion or approximately two times annual premium. New South Wales, until a recent dramatic overhaul of benefit entitlements, was also approaching a deficit of $4.5 billion or approximately two times annual premium. Whilst state governments would argue that these debts are the responsibility of the employers of the state, ratings agencies are showing an increasing interest in the size of these deficits when determining state credit ratings.

Rectifying these deficit positions becomes a significant political hurdle, requiring either dramatic increases in premium to fund the deficit or reductions to benefits to reduce the scheme cost structures. Either option is politically charged and has the potential to create uncertainty and instability.

Large scheme deficits are also a potential barrier to further investment in the relevant state. Organisations with capital to invest may question the investment in states with large workers compensation deficits, given the uncertainty the deficit creates in terms of potential premium increases to cover the funding shortfall.

5. Cost of regulation – insurance companies

One of the key objectives for an effective personal injury scheme is that the amounts paid to injured parties should constitute the vast majority of total payments made by an insurance company.

Under the current complex arrangements, far too much is being spent by insurance companies tailoring to the multitude of schemes. Information technology requirements vary markedly across the different jurisdictions, driven by both differences in legislation as well as the regulatory requirements imposed in each state and territory.

Constant changes to legislation, benefits, administrative coding etc is costly to maintain, meaning that investment which could otherwise be directed toward capability development or case management innovation is being used to fund systems maintenance across multiple jurisdictions.

At the most operational level, different benefit structures, definitions and case management practices across the states and territories means that operational personnel within insurance companies cannot seamlessly operate across different states and territories, incurring additional costs in terms of training and development and effecting an insurance company's ability to create synergies and direct more attention to the effective management of workplace injuries.

Australia's varied workers compensation schemes means that there is a significant cost burden borne by insurance companies and agents. A more effective deployment of these resources would be to invest in practices which would assist employers to remove work health risks or the investment in research to better understand how to improve return to work outcomes for injured persons.

Not only is there variability in requirements from the various state and territory regulators, workers compensation insurers are also bound by the requirements of the prudential regulator, APRA, imposing a further level of administrative and governance costs.

6. Potential solutions

Workers compensation operates within a complex environment, where there is range of interested stakeholders, from employers, who pay the premiums, to employees (and their representatives) who are the beneficiaries of the policy taken out by their employer. In addition to these primary groups, there is a broad spectrum of other stakeholders who are key in the workers compensation industry, including insurance companies who provide the capital to aid employers in managing their risks, employees who assist in managing claims, the medical fraternity, lawyers, rehabilitation specialists and investigators.

Any alternative to the current arrangements would need to take account of all of these stakeholders but, in particular, the employer and the employee, to ensure that premiums charged are affordable and sustainable and that the benefits payable in the event of an injury are fair.

Considering the many challenges outlined above, there are a number of recommendations which could be considered to improve the affordability and sustainability for employers and also the fairness of benefits to injured persons.

Private capital – state based schemes

Opening schemes up to private underwriting has a range of benefits over existing managed fund arrangements which include:

- greater competition in pricing;
- enables the regulator(s) to focus on regulating the scheme rather than administering (for example Western Australia workers compensation) and the scheme design principles ensuring that those principles are applied consistently;
- clarity of role between regulators can be achieved between the prudential regulator (APRA) and scheme regulators with clearer delineation of responsibilities. Put simply, APRA can focus on the prudential and capital adequacy aspects of the workers compensation insurer and the scheme regulator can focus on the delivery of the scheme legislative and regulatory intent, avoiding any duplication of effort or conversely avoiding gaps in regulation;
- greater innovation in claims management with more incentive for private insurers to invest heavily in systems and practices to ensure that the best community and financial outcomes are achieved for all parties;
- reducing fiscal volatility for governments and the potential for ratings agencies considering workers compensation deficits when assessing state credit ratings;
- recognition that insurance is not "core business" for governments; and
- small employer community rating mechanisms which provide for rating of better or poorer performing employers, driving employing organisations to invest in Work Health and Safety practices and the management of any workers compensation claims focused on return to work.

Private capital – national workers compensation scheme

As far back as 1973, when the Whitlam Government commissioned Justice Owen Woodhouse in relation to a committee of inquiry into workers compensation and rehabilitation in Australia, there have been deliberations on the replacement of the various state and territory workers compensation schemes with a national workers compensation scheme.

As has been outlined in the submission above, Australia’s federated approach to the management of workers compensation arrangements creates a range of efficiency, affordability and equity issues. Currently, large employers who are able to pass a “competition test” are able to access the Commonwealth ComCare system, enabling them to operate consistently under one piece of workers compensation legislation across multiple jurisdictions.

It is timely to step back and consider whether it is either appropriate or necessary for governments to continue to "insure' such schemes. Insurance is not "core business" for government, arguably detracting focus from core Government administrative functions, creating increased complexity given the inherent conflicts Government faces through the cycle and inefficiencies as outlined above.

Establishing a national workers compensation scheme with private capital underwriting which covers all employers and employees in Australia addresses most of the issues outlined above.

In addition to the advantages of a privately underwritten environment (as outlined above) under the state based private capital heading, the following advantages are possible, if national workers compensation arrangements are considered:

- removal of the administrative and regulatory burden currently faced by employers who engage staff across a number of jurisdictions in Australia, enabling a greater focus on the management of Work Health and Safety practices and workers compensation issues within their own operations, rather than managing administration and regulatory differences;
- removal of the administrative and regulatory burden for insurers associated with managing 10 different workers compensation arrangements across Australia. Removing the costs associated with these management challenges allows a greater investment in innovation in systems and practices to drive for better social and financial outcomes. Innovation developed by insurance companies can be applied across the state and

territory boundaries, allowing all employers and employees to benefit, as opposed to the current restrictions, which may limit the application of innovation due to state regulatory arrangements;

- removes of the current inequity in benefits applied to the same injury, across the states/territories. Removes the current inconsistency in coverage i.e. who is covered and for what;
- removes the volatility in premiums charged; and
- ensures that no single organisation is given an advantage over another by virtue of their ability or otherwise to access different insurance options. All organisations would be subject to the same legislation and funding arrangements.

Appendix 3 - Lenders mortgage insurance

Lenders' mortgage insurance

Lenders’ mortgage insurance (***LMI***) currently plays an extremely important role in the Australian housing market - it enhances the underlying efficiency in the market for housing loans, improves access to home ownership, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), increases competition and innovation among lenders and reduces barriers to entry in the home lending market.

There is currently little capital incentive for the home lending market to use LMI because of the increasing dominance of Internal Ratings Based (***IRB***) banks, together with a lack of regulatory recognition for IRB banks use of LMI when modelling reduction in credit losses.

In the absence of such regulatory or structural incentives, QBE is concerned about the ongoing viability of LMI as a product. This in turn may place at risk both the accessibility to home ownership and affordability of homes within the Australian housing market.

Background

LMI is a wholesale insurance product that protects the lender in the event a borrower defaults on a loan and there is a shortfall on the sale of the property. It is the insurance of the credit default risk of a specific loan provided by a specific lender at a specific time in relation to a particular mortgage (borrower, loan characteristics, property and lender or origination attributes).

The lender is the beneficiary under the policy, not the borrower. In insurance terms, the borrower is actually the “risk” against which the LMI policy provides protection.

LMI is generally required by lenders where a borrower has saved less than 20% of the purchase price as a deposit. The once only up front premium is paid directly by the lender to the LMI provider for the provision of LMI. That premium covers the lender for the entire life of the loan (up to 30 years).

Typically (but not always), the cost of the LMI premium is passed on by the lender to the borrower as a fee (similar to other fees incurred by the lender in the mortgage origination process, e.g. valuation fees).

As a wholesale (or business to business) product (i.e. not a retail insurance policy protecting a borrower protecting the lender), it cannot be “transferred” by the borrower if the borrower wishes to refinance their mortgage with another lender.

Benefits of LMI

The main benefits of LMI are set out in more detail in Attachment 1 but in summary, LMI providers:

- make a significant contribution to the community by facilitating home ownership. Since 1965 (when it was first introduced), LMI has helped over 2 million people who have not had at least a 20% deposit purchase their own home;
- contribute to systemic risk diversification across mortgage lenders (by the pooling of risk across geographies and distribution sources);
- play an important role in assisting to maintain credit standards within the financial system by providing a 'second set of eyes' in the mortgage origination process;
- are active in detecting and monitoring potential fraudulent activity within the mortgage industry;
- make their expertise and resources available to assist mortgage lenders improve their mortgage origination processes and service to borrowers; and
- support capital markets by credit enhancing mortgage backed securities, increasing their appeal and reducing wholesale funding costs for some lenders.

The value of LMI is widely recognised by the financial authorities - the Joint Forum has stated that:

> *Mortgage insurance provides additional financing flexibility for lenders and consumers, and supervisors should consider how to use such coverage effectively in conjunction*

with LTV requirements to meet housing goals and needs in their respective markets. Supervisors should explore both public and private options (including creditworthiness and reserve requirements), and should take steps to require adequate mortgage insurance in instances of high LTV lending - e.g. greater than 80% LTV[1]

Regulation of LMI and capital relief for lenders

The provision of LMI in Australia is highly regulated. LMI providers are regulated by APRA and LMI is a general insurance product offered in Australia by providers operating under a monoline licence. LMI operates under the Insurance Contracts Act 1984. As a wholesale or business to business product, LMI is not governed by Chapter 7 of the Corporations Act 2001 (consequently retail disclosure requirements such as for a Product Disclosure Statement do not apply).

LMI is a very capital intensive business. LMI providers are typically highly rated by independent ratings agencies, underpinned by substantial capital strength, both through APRA's local regulatory requirements and through rating agency capital requirements. LMI capital in Australia is typically invested in conservative, highly liquid non-correlated assets and is used as an independent layer of capital or buffer to pool credit default risk and the costs associated with default across time, geography and a large group of borrowers and lenders.

Capital relief for lenders

Under the existing Basel II arrangements, there is no capital incentive for IRB lenders to use LMI on residential mortgages.

The Basel II based APRA rules replaced the Basel I equivalent in 2008. They include:

- a 'standardised approach' with updated risk weightings applicable to residential mortgages;
- an alternative regime being the Internal Ratings Based (***IRB***) approach. This approach allows Authorised Deposit-taking Institutions (***ADIs***) to use their own models, subject to APRA approval, to determine the credit risk component of regulatory capital.

The standardised approach reflects more granular risk weightings for residential mortgages and a reduced level of capital incentive (compared to Basel I) for ADIs to use LMI.

Following the implementation of Basel, APRA has required all IRB banks to maintain a floor of 20% for the Loss Given Default (***LGD***) on residential mortgages. This floor has been the adopted assumption for LGD for mortgages with and without LMI protection, giving no recognition for the use of LMI by lenders and effectively negating any capital benefits for LMI.

Prior to 2008, however, under Basel I, there was a significant capital incentive for the use of LMI. In particular, it enabled ADIs to apply a 50% risk weighting (rather than 100%) to 'standard' loans with greater than 80% Loan to Valuation Ratio (***LVR***) and 'non-standard' loans (primarily low-doc loans) with greater than 60% LVR. This incentive, which halved the capital usage for the lender, reinforced the practice by lenders of insuring high LVR loans.

The current IRB approach has proven to yield a lower regulatory capital requirement for residential mortgages than the standardised approach. At present, all of the 'Big 4" Australian banks have had their IRB status approved by APRA; a number of 2nd tier ADIs have achieved or are seeking IRB status; and smaller ADIs (such as credit unions, building societies and various smaller banks) will continue to apply the standardised approach.

In practice, the vast majority of residential mortgages originated by ADIs are subject to the IRB approach. It is anticipated that this proportion will increase further due to the market dominance of the large IRB banks and anticipating that further ADIs will achieve IRB status over time.

A key element in determining regulatory capital for IRB banks is to ascertain LGD, being the estimated loss in the event that a loan defaults. APRA has set the minimum LGD for

[1] The Joint Forum, *Review of the Differentiated Nature & Scope of Financial Regulation*, January 2010, p.17. The Joint Forum was established under the aegis of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors.

residential mortgages at 20%. This is based on its views of potential losses that would occur in a severe economic downturn.

Individual banks and the LMI and banking industries, through the ICA and the ABA, have submitted extensive claims data, modelling and analysis to APRA on the effect of using LMI in the context of the LGD floor in the event of a severe downturn. Similarly, extensive representations have been made to APRA on the important role of LMI in the Australian market and the need to recognise the use and value of LMI from a capital perspective for lenders in the IRB's LGD model. To date, this has been unsuccessful.

The effect of this is that:

- to the extent that mortgage insurance reduces credit losses, LGD must still be no lower than 20%;
- in determining regulatory capital, there is no incentive for IRB banks to separately model the benefit of LMI; and

IRB lenders do not therefore currently receive any regulatory capital benefit for insuring mortgages.

Viability of LMI product

APRA has developed a specific regulatory capital regime applicable to LMI. This requirement is very high due to APRA's view of potential losses arising from mortgage defaults in a severe economic downturn. The largest component/driver of LMI premium rates is therefore the high level of regulatory capital that LMI's must hold.

There is significant tension between the following objectives:

- keeping LMI premiums affordable for homebuyers who need it to buy a home (typically those who cannot afford a home loan deposit of greater than 20%);
- holding a high level of regulatory capital to fund claims in a severe economic downturn;
- providing adequate returns to LMI shareholders; and
- satisfying lenders that it is worthwhile to insure mortgages. The alternative would be for lenders to leave loans uninsured and charge borrowers additional fees and interest to compensate for the higher risk retained by lenders.

In the absence of any regulatory or structural incentives for using LMI, market forces (reflected in the points above) may drive LMI as a product out of the market. This is the case in New Zealand where LMI is no longer available.

Financial system stability

From a financial system stability perspective, the LMI providers hold significant capital in Australia that provides an additional independent layer of capital that assists in diversifying risk across lenders, across time and across geography. LMI has contributed significantly in ensuring a stable and competitive residential mortgage market during the last 45 years.

The consequences of there not being a strong independent LMI regime (in addition to loss of the benefits referred to in Attachment 1) include the following:

- ***The capital in the financial system would be reduced unless held by the lenders.*** APRA has indicated that it is reluctant to see any capital reduction within the financial system. This suggests that any withdrawal of LMI would necessitate a change in regulations to compel mortgage lenders to carry the additional capital currently held by LMI providers.
- ***The charging by lenders of a low equity fee in lieu of LMI may have adverse consequences for the financial system if it threatens the viability of LMI as a product***.

  Whilst it is difficult to be definitive, the New Zealand experience (where LMI has been progressively replaced by a low equity fee charged by lenders), suggests the following consequences. Competitive pressures and the drive for market share, especially in a low growth environment, can lead lenders to under price the risk or arbitrage the low risk fee away altogether, e.g. through fee waiver.

  Following the GFC and a softening of the New Zealand residential market, apart from Kiwi Bank (which retained LMI over that period), all the major banks withdrew from high LVR lending, requiring at least a 20% deposit for new loans. Such an approach in

Australia would have a calamitous impact on the property market, which in turn would be highly detrimental for mortgage lenders.

The recognition of income/reserving and loss provisioning for LMI providers is generally much more conservative than the treatment of a low equity fee by mortgage lenders.

Because LMI providers are separately capitalised to carry the mortgage risk and need to make an adequate return on that capital, they are better placed than mortgage lenders to adequately price for the associated risks.

An emerging trend in Australia is the selective charging of a low equity fee in lieu of LMI by some lenders (e.g. CBA and ING) on lower risk loans with an LVR >80% at origination. This results in potential adverse selection for LMI providers (i.e. proportionally higher risk lending insured than previously) - this skews the distribution of risk (as lenders bring more good/low risk in-house- holding premiums constant, claims paid will be on average greater than premiums charged), and LMIs may face default risk[2].

While Australian banks subject to the IRB capital approach receive no capital offset for LMI and, allowing for competitive pressures referred to above, in QBE's view, there is a real risk they will under-price the low equity fee. On the other hand, LMI providers will be constrained by competitive pressures in adequately pricing LMI up for the increased risk in their adversely selected LMI book.

- ***There is likely to be an increased volatility for lenders in economic cycles in relation to residential mortgage risk that will likely impact on the broader housing market.***

  For example, during times of downturn, lenders appetite for higher risk lending reduces. LMI operates to smooth these cycles enabling credit to flow during periods of downturns. The role LMI plays in this respect was critical during the Federal Government's first home buyers stimulation of the economy in 2009 which would not have occurred without LMI.

- ***At the economy-wide level, economic efficiency (value-add) and stability throughout the business cycle may be compromised by[31]:***
  - lowered risk-pooling benefits (including lost fungible capital);
  - information asymmetries returning at the cost of economic efficiency;
  - incentives skewing (with potential impacts to capital sufficiency);
  - competition between lenders reduced, at the cost to economic efficiency;
  - reduced counter-cyclical benefits of insurance; and
  - added cost to the public sector finances (at the cost of policy initiatives).

Monoline versus multiline licensing

There may be efficiencies in allowing LMI to operate as part of a multiline insurance entity. In jurisdictions where mortgage insurance operates, the regulatory regime typically includes:

- specific regulatory capital requirements reflecting the need to hold a high level of capital. This is designed to ensure claims are funded in the event that a severe economic downturns generates a catastrophic level of mortgage defaults and claims; and
- the requirement to operate LMI in a separate licensed entity so as to quarantine the LMI product from other lines of general insurance.

Within a broad based, multiline insurance group, the risk profile (and capital requirement) at the group level is likely to benefit from the diversification that arises from insuring many uncorrelated risks. The same is true of reinsurers who cover diverse risks.

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[2] As noted by Deloitte Access Economics discussion paper 2010, *Economic Value of Lenders Mortgage Insurance*, p. 24.

The same argument may be made at the insurance entity level. On that basis, the ability to write LMI business from a multiline insurer (i.e. one licence for many products) as opposed to a monoline (i.e. one licence for one product) may bring benefits, including the following:

- risk diversification at the operating entity level;
- potential capital relief at the operating entity level;
- simplified regulatory oversight and governance; and
- simplified processes and reduced costs.

Conclusion

Lenders mortgage insurance has been a critical component of the housing market since 1965, facilitating home ownership and accessibility to credit for millions of borrowers. LMI enables those who would otherwise have difficulty obtaining a home loan (particularly borrowers with low incomes or low levels of equity), to satisfy responsible lending criteria and purchase a home. Currently 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.

QBE believes the Inquiry should consider the important role that LMI plays in the financial system and recommend that capital relief be provided to IRB lenders that utilise LMI. This would ensure that LMI continues to benefit the housing industry and its customers, and continue to facilitate increased competition between lenders. It would bolster financial and economic stability and importantly improve access to affordable home ownership.

Attachment 1 - Benefits of lenders' mortgage insurance

LMI generally enhances the underlying efficiency in the market for housing loans, it improves access to home ownership, contributes to the smoothing of the effects of economic cycles (primarily because its underlying risk preparedness is very long term), increases competition and innovation among lenders and reduces barriers to entry in the lending market.

LMI makes a significant contribution to the community

Since first introduced in 1965 by the then Government owned "Housing Loan Insurance Corporation", LMI has helped over two million people who have not had at least a 20% deposit, purchase homes.

By transferring the credit loss to an LMI provider lenders do not have to charge a higher interest rate to cover the increased risk a borrower presents without a substantial deposit. By transferring the risk and cost of default away from lending institutions to LMI providers, LMI increases the availability of home loans to higher risk borrowers by freeing up lenders' capital.

This mechanism has given confidence to lenders, allowing them to compete in the marketplace, and it provides a capacity for the lender to stand by the loan in the event of consumer default, potentially allowing time for the borrower to rectify the loan and resume mortgage repayments.

This allows borrowers to have access to the housing market much earlier than would otherwise be the case and at an interest rate that is comparable with that of a borrower who was able to make a substantial down payment.

Accordingly, the LMI industry has played an important role in enabling home buyers (with low equity in the range 0% to 20%) to purchase a home sooner than would otherwise be the case, if they had to save a 20% deposit before being able to obtain a loan. LMI also enables home buyers to accumulate equity in their homes faster.

A large portion of this high LVR market segment is first home buyers. LMI support has been critical for the provision of and ongoing support of the First Home Ownership Boost. Without such a risk offset mechanism through LMI, it is unlikely the First Home Ownership Boost would have been as successful.

LMI smoothes macroeconomic cycles and facilitates the efficient management of capital and risk

LMI smoothes macroeconomic cycles, by facilitating greater amounts of housing lending at the bottom of a cycle but also provides a curb on imprudent lending at the top of a cycle. During the recent global financial crisis, LMI providers were pivotal in the success of the Federal Government's first home buyers' initiative that was introduced to stimulate the economy during this time.

The LMI industry plays a critical role in facilitating efficient management of capital and risk in the banking system and it provides systemic housing loan risk protection by transferring risk outside the banking system.

That capacity is critical at times when the financial system and the residential mortgage component of the system are under stress - as has been evidenced during the recent global financial crisis. Ultimately, it is the consumer that bears the brunt and the cost of such systemic dysfunction.

With a pooling of risk across geographies and distribution sources, LMI contributes to systemic risk diversification across mortgage lenders

Because LMI providers like QBE insure borrowers across multiple lenders, when aggregated, security properties are widely dispersed across the country. This assists in mitigating the financial system's exposure to a lender's geographic concentration. Similarly, the risks associated with a lender's reliance on a particular distribution channel (e.g. mortgage managers) can be substantially mitigated through LMI (except in the case of fraud by the loan introducer or mortgage manager).

LMI covers the lender for 100% of the loan over the full life of the loan (provided the lender has not been fraudulent and has acted prudently in granting as well as administering the loan)

LMI gives mortgage lenders confidence to support market segments it might otherwise prefer not to lend into or only lend on more restrictive terms (e.g. first home buyers; borrowers with only 5% deposit and limited genuine savings).

Evidencing LMI's effectiveness as a risk mitigant for mortgage lenders, in the year ended June 2013, QBE paid 99.6% of all claims.[3]

While LMI applies for the life of the loan, it terminates when the loan is fully paid out and if a new loan is taken out with another lender, a new premium is payable (credit critical modifications to existing loans or additional loans generally attract only a top-up premium which takes into account the previous premium paid).

It is sometimes argued by certain public interest groups that LMI should cover the borrower rather than the lender for loss and that LMI should be transferrable across different lenders and/or new loans. The difficulty with this is that LMI pricing assumes a certain termination rate based on the LMI provider's experience. LMI pricing would need to be significantly increased if it were to be attached to a borrower's new lending. Also, LMI providers have lender specific contracts and agreed LMI pricing based on that lender's credit standards, policies and risk profiles. This non uniformity across lenders makes it impractical to attach LMI to borrowers rather than lenders.

Market discipline - LMI providers play an important role in assisting to maintain credit standards within the financial system

LMI providers in Australia are in a unique position in that they have broad oversight of mortgage lending practices in Australia. LMI providers have a whole of market view given the breadth of the LMI customer base, which includes ADIs, non-bank lenders, mortgage managers, originators, brokers and valuers.

LMI providers play an important role in helping to exert market discipline and encourage the maintenance of prudent lending practices in the Australian residential mortgage market.

This is demonstrated in a number of ways including:

- providing information and expertise to the market and customers;
- providing parameters of “acceptable risks” by setting credit policy and practice boundaries;
- providing a “second set of eyes” on customers’ overall credit operations (policy and practice) for residential mortgages;
- providing post quality assurance reviews;
- working with customers to address and improve compliance issues; and
- working with customers to address and improve default and claims management.

LMI providers are active in detecting and monitoring potential fraudulent activity

In addition to the fraud detection tools available to lenders, LMI providers also have their own fraud detection and investigation capability and (subject to compliance with privacy laws) share information across their customers to reduce the risk of fraud within the mortgage industry.

LMI providers make their expertise and resources available to assist mortgage lenders improve their service to borrowers

While protecting their own proprietary intellectual property as well as that of their customers, LMI providers apply their considerable mortgage performance data and market knowledge to assist mortgage lenders improve their efficiency and market presence. This includes extensive reporting, product development, and systems development/integration to improve product delivery/operating efficiency.

LMI providers support capital markets by credit enhancing mortgage backed securities, increasing their appeal and reducing wholesale funding costs for some lenders

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[3] NB. Where lenders have not acted prudently in approving or administering the loans or there has been fraud by one of their staff or related parties, the LMI provider may adjust or deny the claim.

The growth of the non-bank sector and the use of Residential Mortgage Backed Securities has been a critical factor in providing competition in the mortgage lending market for the past 10 - 15 years.

LMI has played a key role in providing credit enhancement that underpins the mortgage backed securitisation market, enabling non-bank lenders to access funding at competitive rates. Securitisation has promoted competition in the home lending market as mortgage originators and non-bank lenders have been able to compete with the mainstream lenders on price and other features, resulting in a significant fall in margins earned by lenders on housing loans with obvious flow on benefits for all borrowers.

The ability of lenders to obtain LMI for uninsured loans also qualifies loans for the RBA's repurchase liquidity support arrangements.

LMI facilitates competition in the lending market

With the introduction of LMI in 1965, building societies were able to compete effectively with banks and provided high LVR loans (up to 95% LVR) with LMI. Prior to that time, first home buyers were restricted to borrowing up to 66% of the value of the property from the savings bank, and then had to borrow the remainder from either the trading bank arm of the bank or from another finance company – generally at much higher rates and shorter term than the loan obtained from the savings bank.

Following the deregulation of bank mortgage interest rates in 1986, the major banks, with the support of the LMI industry, also entered the high loan to value segment of the home lending market. A number of the largest building societies converted to regional banks at this time.

One of the major benefits of LMI is that it improves access to home ownership, particularly amongst low income earners, low equity or high risk borrowers, who would otherwise have difficulty obtaining a home loan.[4]

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[4] The Allen Consulting Group, *Economic Benefits of Lenders' Mortgage Insurance*, 29 September 2005, Report to the Reserve Bank of Australia, p.6.

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