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Mr David Holly
Head of China FTA Study Task Force
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Dear Mr Holly

Thank you for the opportunity to provide input into the Department's submission on the China Free Trade Agreement.

Insurance Australia Group (IAG) welcomes the opportunity that formal negotiations with China present in terms of working on access to the China general insurance market for Australian insurers, and, more importantly, IAG sees it as an opportunity to encourage the Chinese authorities to undertake regulatory reform in this critical sector, with the help of Australia, that will benefit China's economy, insurance sector and consumers.

IAG strongly supports a free trade agreement, which will cement our ties with the world's fastest emerging economy.

Introduction

Australia has a very advanced, sophisticated and large general insurance sector. Australia's market is widely considered one of the most competitive in the world because the majority of insurance is bought directly from companies. This has encouraged product innovation and price competition.

Australia represents some two per cent of the world's insurance market – about twice its share of world gross domestic product. The Australian industry is ranked 11 in the world, and second in our region after Japan.

There are around 150 private general insurers and reinsurers operating in the Australian market, employing around 35,000 people. Net premium revenue for the year ended 30 September 2004 was $20.8 billion, of which $19.1 billion (92.0 percent) was written by direct insurers.

For the 12 months to September, the Australian general insurance industry paid out $12.5 billion in claims incurring underwriting expenses of $5.0 billion.

For these reasons, IAG believe that there is much more we can offer the Chinese economy than more insurance companies. IAG believes there is a role for us to play in helping the Chinese undertake the difficult process of reform that will need to be done in the next few years.

Importance of the general insurance industry

The financial measure of the contribution of the general insurance sector to national income provides little indication of the real value to the economy of general insurance activity. Instances of weakness in the general insurance industry are important not only for their implications for employment, net assets and profits in the insurance sector. The true significance of the insurance industry lies in the fact that it enables a large proportion of the rest of the economy to operate effectively. Without a reliable mechanism for pooling and transferring risk, much economic activity simply would not take place; neither would social activity such as fairs and play grounds.

Another way of saying this is that when the insurance industry is in difficulty so too, unavoidably, is much of the rest of the economy. It is not overstatement to say that society is weakened. A safe, stable insurance industry is vital for underwriting stability and confidence in economic and social interaction – in underwriting the economy and society.

Purpose of Prudential Regulation and Oversight

The prudential regulation of general insurers aims to provide policyholders with a degree of confidence those insurers will be in a position to honour their financial commitments.

All financial products involve exposure to risk. An efficient financial market will manage, allocate and price this risk, rewarding those willing to bear it. Government regulation of financial markets does not aim to remove this risk. It does not aim to prevent an insurer from going out of business.

The prudential framework seeks to balance the objectives of maintaining efficient, dynamic and competitive financial markets, and ensuring the continuing stability and integrity of the financial system. This balancing act requires, on the one hand, that the government does not guarantee the future of any particular player in the financial system; and, on the other, that the failure of one player does not threaten systemic stability.

The implications of systemic failure are severe and long lasting. In Western Europe, the United States and other market economies, this was last witnessed during the Great Depression of the 1930s. While a stock market crash in 1929 is commonly accredited as being the cause of the Great Depression, it was the less exciting banking system failure, and its associated credit squeeze, that prolonged and exacerbated the economic downturn.

While systemic risk usually concentrates on the payments system and banks, it also applies as much to the management of risk and general insurance. Therefore, systemic stability is a critical element of any market economy, which makes getting prudential regulation right critical.

Prudential policy frameworks are based on the premise that ultimate responsibility for the prudent operation of general insurers rests with the management and board of each institution. Hence, if a general insurer fails the presumption has to be that the management and board of the institution have failed.

While the design of the prudential framework seeks to reduce the likelihood of failure, there should be no pretence that it can prevent all such instances. Similarly, there must be no pretence that the authority charged with administering the prudential framework can prevent all instances of failure.

The role of the regulator is to prevent a system wide failure, usually described as systemic risk. Australia's prudential regulator does, through a number of mechanisms, try to lower the level of systemic risk. APRA typically does this by ensuring quality assurance of control systems and risk management practices more generally.

Issues for a China FTA

The Australian general insurance industry has a very good relationship with China's insurance authority. Currently, one of IAG's staff is a member of the China Insurance Regulatory Commission (CIRC) Technical Advisory Board. IAG has always found China's regulators to be interested in understanding how Australia undertakes financial service regulation including that of general insurance.

In terms of operating within the Chinese market IAG has a number of issues it would like the FTA to resolve. Under the WTO Ascension Agreement, China agreed to make it easier for foreign insurers to enter the Chinese general insurance market. To a certain extent this has happened, however, the Ascension Agreement made no mention of regulatory reforms, capital controls, or critically, access to the third party liability market of which compulsory motor insurance is the largest component.

What the WTO process has shown is that it is not possible to talk about meaningful market opening in the insurance sector without also talking about the regulations and prudential controls that underlie that market. It is these underlying issues that IAG would like Australian negotiators to focus on.

IAG believes the following issues are of great importance for any Australian general insurance company looking to make an investment in this sector. As is the case with many of these agreements, successful resolution of these issues will have a greater benefit for Chinese consumers and society than any other group.

Foreign Ownership Rules and Market Access

Under previous international agreements China undertook to permit foreign insurers to apply for licences as wholly owned subsidiaries by June 2004. This has now occurred. There do remain a number of impediments for Australian general insurers gaining total access to this market.

One such regulatory impediment is the definition of what constitutes a Chinese insurer. For the moment, an Australian insurer is limited to an effective investment cap of 24.9 per cent in any current Chinese insurer. If the investment exceeds this threshold, then that insurer becomes a foreign insurer. The implications of this are significant.

A foreign insurer is prevented from participating in the third party liability insurance market. This means that as a general insurer you are excluded from a part of the market that represents as much as 60 per cent of China's non-life insurance market.

IAG would urge the Australian government to seek special treatment from China's authorities on this definition issue for Australian general insurance companies seeking to make an investment.

In addition, we understand that foreign equity ownership in insurers handling large scale commercial risks, marine, aviation and transport insurance, and reinsurance is limited to 50 per cent. We understand that this limit is scheduled to be increased to 51 per cent three years after China's accession to the WTO and completely eliminated after five years. IAG would like to seek some assurance that this timetable is currently being followed and likely to be implemented.

The Chinese Government through CIRC, NDRC and the State Council are currently undertaking to review third party liability schemes with a view to designing a scheme that meets the goals of consumers, society and the economy overall. Australia, and IAG in particular, has a very good record of designing and implementing sustainable third party liability schemes. As good judgements often come from bad experiences, Australian authorities also have a wealth of experience in the pitfalls of a badly designed and implemented scheme. A badly designed scheme can run into billions of dollars worth of debt, and basically bankrupt an entire sector.

Put another way, implementing an unsustainable third party liability scheme in China would be the next banking crisis, requiring just as much financial resources to fix the problem. Australia's experience would also suggest that when a scheme does become unsustainable everyone suffers. Society losses its ability to underwrite risk, which means many events cease. In Australia, this resulted in street stalls, fairs, fundraising events and many other good works being stopped, while public playgrounds were shut.

Further, the genuinely injured also suffer as the scheme becomes one in which people seek monetary awards rather than solutions that help people recover their health. In short, the outcomes are terrible: the injured don't get better, many important voluntary activities in society stop, and the State is forced to step in and bail out the scheme, usually amounting to a cost of billions.

Effective Prudential Regulation

IAG has already noted the importance of proper prudential regulation in any general insurance sector. The benefits flowing from prudential regulatory reform are multifarious. An efficient, well-run and transparent general insurance sector allows an economy to reduce risks cost effectively, price risk appropriately, protects consumers and their goods, while promoting economic activity by allowing investors to reduce risk and protect assets.

IAG understands that Australian Prudential Regulation Authority's (APRA) is considered to be leading edge and has recently had its framework adopted by the UK regulator. Core elements of this regime include risk based minimum capital requirements, strong actuarial standards for liability valuation, flexible rules around investments and reinsurance arrangements that ensure a assets relate to the risk profile of liabilities, open reporting and disclosure, and effective audits, supervision and oversight.

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IAG believes that an FTA with China presents an opportunity to promote regulatory reform, and offer Australian expertise in this exercise. The reform could include, but not be limited to, implementing a fit and proper director's test, removing the eight per cent commission cap for taxation purposes, and the introduction of a uniform insurance contracts act that makes the rights and obligations of insurers and the insured consistent and transparent.

Actuarial Standards

The existence of consistent audited actuarial standards is critical to the stability of the insurance industry. The basis of actuarial standards and approval of the actuary are key elements of prudential oversight and form the basis for effective liability valuation and pricing of risks. IAG would seek to have strong standards in place in China, and recognition of Australian trained actuaries as Approved Actuaries.

Investment Rules

Critical to effective asset management is the ability to match asset investments to the risk profile of liabilities. Current rules governing investments by insurance companies, which state that capital must be invested in China and then in a limited number of investment classes, significantly limit the ability of insurers to effectively match risk profiles. IAG would seek greater flexibility in investment rules, which would allow for a safer and more efficient insurance sector, as risk weighted capital lowers the amount of capital generally allows a company to carry lower levels of capital.

Conclusion

The service sector is a critical part of any modern economy. As China continues its rapid development the emergence of a properly functioning and efficient service sector, especially in financial services, will be critical to sustaining its growth rate.

In general insurance, the China market has been opened up substantially since its ascension to the WTO. What this process has highlighted is that the regulations underpinning the general insurance sector are just as important as market access issues.

It is not possible to have a negotiation on Free Trade with China and exclude the service sector. Equally, it is not possible to have a discussion about the service sector without talking about the regulations that support that sector, which can create artificial barriers to entry.

IAG believes that there are great benefits to be derived from a FTA with China. We believe that the benefits flow mostly to the consumers of both countries, which can only foster the great friendship that both nations have developed over the recent past.

If I can be of any further assistance, please contact me on 02 9292 8645.

Yours sincerely

Ian Brown
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