

CROESUS

CROESUS LIMITED

22nd May 2007

Manager – Special Projects
ICCC
1st Floor, Garden City
PO Box 6394
Boroko, NCD
Papua New Guinea

Attention: Stanley E Alphonse

Dear Sir,

Re: Issue Paper: Review of the General Insurance Industry in Papua New Guinea.

Further to our meeting at your office on the 9th of May 2007, we certainly appreciate the courtesies you extended to us and the subsequent vigorous exchange of the points of view presented for discussion.

We understand the PNG Insurance Council has provided you with an "Industry" submission on this subject (you recall we are Members of this body). For the purposes of a stimulating discussion, we do not have any particular points to offer regarding the Council's submission, preferring instead to place before the ICCC possible contrary views as we perceive the present working environment as somewhat pedestrian and requires stimulation. The regulatory framework is no longer appropriate to deliver efficiency in the industry; certain reforms are needed. Some of these matters are discussed below:

1. Need for single financial services regulator

- Globally in the last decade there has been a convergence of traditional insurance and funding for financial risks with the emergence of the concept of a risk capital market (eg catastrophe bonds).
- This convergence is now recognised to the extent that most of the major financial centres of the world now regulate insurance and banking through a singular regulator which governs prudential regulation.
- At least one market participant in PNG shelved a capital markets based risk instrument within the last twelve months due to perceived regulatory difficulties and multiple regulators.
- The merger of the office of the insurance commissioner into the bank of Papua New Guinea and the adoption of risk based prudential supervision of the industry will improve efficiency by allowing the insurance industry to fund itself in the most capital efficient manner.
- Insurance Commissioners' Levy is seen as an impost which does not lead to any benefit to the industry. Banks are not subject to this sort of levy on depositors' funds, so why should insurance purchasers be subject to such a levy.

Registered Office:

Level 5 – Defens Haus
Cnr. Hunter St. & Champion Pde.
(P O Box 389)
Port Moresby NCD 121
PAPUA NEW GUINEA
TEL: (675) 320 0630
FAX : (675) 320 0604

2. Interference in Staffing Decisions must be removed

- The Insurance Commissioners office over regulates labour issues in the insurance sector and links interdiction to the Commissioners "general power" to impose conditions on licences. These are matters which are otherwise already and properly regulated by the Department of Labour.
- There are two aspects to this: the 'approval of the principal officer' and the training and localisation plan.
- The model used in the banking industry is one of 'notification' by licence holder and 'veto' by the regulator rather than 'approval'. Industry participants are put to great economic inefficiency and time wasting in dealing with staffing issues.
- The model used in the banking sector by the Central Bank is much more efficient.

3. Annual Licensing must be converted to ongoing Perpetual Licence

- The current system of licensing is for annual licences to be granted. A company has no assurance that it will be in business for than twelve months.
- Annual licensing has at least two effects on industry efficiency. The first is that an inordinate amount of time and energy is spent running around filing documents for licence renewal rather than getting on with the business of underwriting risks and assessing prudential performance progressively during the year. The second is that no company can underwrite multiyear business. Multi-year business is particularly important for premium efficiency as insurers are able to take a longer term view of risks rather than a short term view. Further, capital based instruments are now usually based on a longer term multi-year basis.
- The banking sector runs on perpetual licences which run until either the Central Bank removes them for prudential protection of the community or the holder hands the licence back.
- Provisional licences are a result of this annual system: if there is any issue regarding a participant's practises or financial condition, that should solved through the prudential regulatory system by corrective action rather than precipitous licensing. This sort of intervention occurs all the time in banking supervision.

4. Access to Risk Capital

Access to risk capital in the form of reinsurance or capital markets instruments is not freely contestable and subject to misguided principles.

The present regime distinguishes between reinsurance treaties and facultative reinsurance policies. Once approved a reinsurance treaty allows the local party to the treaty to pass risks without further discretionary regulatory approval. Passing of risks under facultative reinsurance requires a discretionary regulatory approval from the office of the Insurance Commissioner. The Commissioner will not grant this approval unless the reinsurance business has been offered to all local licenced insurers and the prices offered by local companies is more than 17.5% higher than wholesale rates available overseas.

This has a number of inefficient outcomes:

- The large multinational insurers have a treaty with their head office under which they pass their reinsurance risks without oversight and at whatever price they choose;
- The large multinational insurers can bid for another local insurer's reinsurance and increase their rates by up to 17.5% above the international market in the firm knowledge that approval for a direct overseas facultative placement will not be obtained, and having secured the business these multi-nationals then pass the risk to their parents under their treaties without scrutiny.
- Lloyds of London representing its 'names' and corporate underwriters holds a licence as an 'admitted underwriter' in Papua New Guinea but the regulator treats a Lloyds placement as a foreign placement, thereby denying the independent members of the underwriting industry (and ultimately insurance customers) access to the Lloyds market on a basis directly competitive and contestable to the multi-national participants.
- Access to corporate markets outside Lloyds is also similarly discriminated against, theoretically on the necessity to protect the industry from participants who are not subject to the prudential supervision of the insurance commissioner's office but who might otherwise be subject to even higher standards (eg Singapore, UK, US, Australian regulators).

The taxation arrangements for the insurance industry are inefficient when compared to global arrangements. This means that underwriting reserves are constantly eroded from Papua New Guinea by all participants (most notably the major multi-nationals, some of which run only as branches). It is recognised by the OECD that taxation regimes are part of the competitive arrangements for markets and it is appropriate that Papua New Guinea consider this by conducting a further review of the taxation arrangements applicable to the insurance industry. A clear recommendation would be to exempt income on insurance company retained earnings from taxation in the second and subsequent years after those underwriting surpluses have been passed through the profit and loss account and taxed. This will ensure a growing and adequate amount of local capital for risk markets.

5. Anti-competitive practises do exist in the local broking and underwriting market

Brokers consider they have 'ethical obligations' to underwriters. Some of these ethical obligations include:

- An 'understanding' not to tender a clients business to the market generally on a renewal against the underwriter(s) presently on the slip for renewal. This understanding will only be bypassed if the client expressly instructs the whole market be canvassed. For the client to simply instruct "renewal" is regarded as insufficient to oust this understanding.
- Marking up 'differential' commissions to themselves between insurers proposals so that the broker's "favourite" insurer's rates appear the most competitive.
- Taking over-riders (secret rebates) from insurers without disclosing this remuneration to the insured customers.

Some insurers refuse to quote business directly to insured customers and require these customers to engage a broker.

The brokers also bully underwriters by threatening that they will send certain business elsewhere if the underwriters quote direct to the customer or propose to provide reinsurance support to another insurer who may be prepared to write the business directly to the end customer (and thereby cut the broker out).

The matters arise in an ad hoc manner and it is very difficult to generalise about the conduct of the market participants.

6. Existing Proposed Regulatory Reforms

There are two substantial regulatory reforms presently proposed in the insurance industry. One is the establishment of the Insurance Complaints Tribunal. The other is the introduction of legislation similar to the Australian Insurance Contracts Act.

- The Insurance Complaints Tribunal will lead to economic inefficiency. There is an existing legal system and which has difficulty effectively resourcing itself. The introduction of a new tribunal will divert resources away from existing dispute resolution methods and will not add to any greater efficiency, certainty of outcomes or access to justice. No doubt the proposed tribunal would be funded by further imposts on the industry which would be passed on to the insurance buying public.
- There is no demonstrated need to the Insurance Contracts Act and the objectives it is to achieve are not clear. In Australia the insurance industry's response to the Insurance Contracts Act was 'form over substance'. "Form over substance" responses should be taken as a market response to another layer of economic inefficiency. These sorts of developed market regulations are inappropriate for an emerging or developing economy such as Papua New Guinea.

We acknowledge and thank the ICCC for the time set aside to meet with us and will be pleased to meet in the future should you consider our paper deserves further investigation.

Yours faithfully



M.P. SAUNDERS
PRINCIPAL OFFICER