



DEPARTMENT OF TREASURY
Office of the Secretary

Telephone: (675) 312 8812
Facsimile: (675) 312 8804

Vulupindi Haus
PO Box 542, WAIGANI, NCD

28th September 2007

Office of the Commissioner
Received 01/10/2007

Mr. Thomas Abe
Commissioner & CEO
Independent Consumer and Competition Commission
P.O Box 6394
BOROKO
National Capital District

Dear Mr. Abe

RE: Submission on the Draft Report on the Review of the General Insurance Industry in Papua New Guinea

I refer to your letter dated 06th September, 2007 seeking Treasury's comments on the above matter. We have attached herewith a submission outlining our views.

The submission is self explanatory and if you need any clarification, do not hesitate to contact Mr. Clement Kote on telephone number **328 8829** or Mr. Andrew Numbasa on telephone number **328 8831**.

Yours sincerely,

SIMON TOSALI
Secretary for Treasury

Submission on the Draft Report on the Review of the General Insurance Industry in PNG.

1. Introduction

1.1 This submission is made by Treasury in response to the invitation in the Issues Paper of the Independent Consumer and Competition Commission (ICCC) and the subsequent Draft Report for interested parties to do so.

2. Background

2.1 The Draft Report covers a range of matters and this submission does not comment on every issue. Comments are made on those issues that the Treasury Department considers appropriate. Other interested parties can be expected to comment on those aspects of the Draft Report that concern them and for which their experience qualifies them to do so.

3. General comments

3.1 The evidence contained in the Draft Report suggests that there are four categories of participants in the general insurance industry. The participants are basically composed of Reinsurer, Insurer, Brokers and Loss Adjusters which all function in a vertical relationship with each other. It was estimated that Brokers dominate about 70 to 80 percent of the PNG general insurance market segment. However, there is no reliable data available to verify this assertion.

3.2 Apparently there are various insurance products available but marketing and accessibility is quite minimal. Hence majority of average clients are not aware of the type of products the participants in the market offer and their roles and functions. The operations of the markets need to be examined to ascertain the impeding factors and rectify them to create an environment that is conducive for policyholders to access most reasonable premium rates. This draft report would find a way forward for average-income clients to access the market at competitive premiums with or without presence of the brokers.

4. Specific issues and submissions

4.1 Insurance Complaints Tribunal

4.1.1 The Treasury notes the significance of having an insurance complaint tribunal to oversee the grievances and disputes in the industry in a transparent and accountable manner to bring disputing parties to amicably solve any arising issues. The Treasury in this regard supports the formation of the insurance complaints tribunal, given the significant role it would be likely to play in addressing any pressing hindrances and issues to provide efficiency and effectiveness in the market structure. This could be an effective mechanism by which policy holders can channel their complaints and get prompt feedback rather the going through court proceedings which would consume much time and resources.

4.2 Competition in the market for insurance brokerage

4.2.1 The Treasury notes that there are about six licensed general insurance brokers in the market. They operate as intermediaries between their “clients” seeking insurance cover and underwriters (the insurance companies, often referred to as ‘insurers’) to bring potential customers to the insurers. The role of brokers is understood to be to act on behalf of those

seeking to obtain insurance cover (the 'insured'). Brokers are supposed to negotiate the best terms and premium for their clients by putting the risk-proposal to competing insurers and obtaining the best possible combination of cover and premium level. By doing so they are expected to exert pressure on the premium level, cover and service levels. However, it appears that brokers variously charge

- their insured clients for their services in some cases, without taking commission from the underwriter (reflected in a discounted premium);
- brokerage/commission to underwriters in other cases; and, rarely,
- charge both, their insured clients a fee as well as brokerage/commission to underwriters.

4.2.2 It is not clear whether the above typology of transactions also reflects a distinct typology of brokers' practice; or whether most brokers obtain their remuneration from more than one of the above types of pecuniary benefit.

4.2.3 If most brokers are remunerated by more than one of the above types of payments, the lines of fiduciary responsibility become blurred, in turn creating conflicting incentives for brokers.

4.2.4 If the brokerage market is concentrated to the extent that brokers can exert market power, the insurance companies become captive to the brokers. Consequently, brokers may be able to extract rents from insurers and insureds and fail to perform their functions adequately. In this regard, it is advisable for ICCC to explore the pressure exerted by brokers on the premium charged to insureds and the fees charged to insurers, to actually see who really benefits; the consumers or the insurance brokers.

4.2.5 It is also worth examining the actual profit levels of brokers, rather than only the trends in profitability, to establish the degree of competition in the market. Clearly, the insurance brokers' rates of return should be benchmarked, taking into account any particular risks that are likely to be encountered, that are not applicable in the comparator markets.

4.2.6 In addition, it was estimated that brokers account for about 70 to 80 percent of the general insurance market retail premiums in PNG. Given this scenario, there should be a critical analysis of the structure, conduct and performance of the brokerage market, including relative size of brokers, shifts in market share, and profitability. This would depict the degree of competition in the market. However, if the market share is static and profit level is uniform, then the market needs to be thoroughly assessed to ascertain level of competition among the insurance brokers and rectify any entry impediments.

4.2.7 The draft report suggests that the brokerage market is now characterized by new entry and concentration is being diluted. However, no broad size distribution data of the brokerage market has been provided e.g CR4 or Herfindahl-Hirschman index, as used to measure market concentration in the underwriting sector (see p 25 of draft report).

4.2.8 Treasury feels that it is premature, at this stage, to comment on the level of competition in the market, without such an analysis.

4.2.9 A useful first step would be to require disclosure by brokers to both their insured clients and to insurers, of the relevant premium levels and brokerage fees involved, if that is not already

required by law. Such transparency would create the conditions for demand-side responses to any rents being taken either by brokers or by insurers.

4.3 *Accessibility of General Insurance to Customers*

4.3.1 The accessibility of insurance products by the customers seems to be somewhat minimal. This may be due to different contributing factors such as entry impediments, information gap, high premium rates and/or high profitability of the insurance companies. However, there is no reliable data available to examine those assertions. Thus the market needs to be thoroughly investigated to identify any major impediments to the accessibility of general insurance products. The ICCC may wish to consider and recommend ways of increasing awareness of consumers; dissemination of information and empowerment of policyholders to exert pressure on the price for their benefit. When customers are well informed, then they would be sensitive toward any price variation and will be in a better position to compare premium rates to exercise their purchasing power. Thus they could exercise a degree of consumer pressure on premium levels.

4.3.2 However, the profitability of the insurance underwriters is an issue that needs to be explored. For this reason, it is more appropriate for ICCC to explore and examine actual profit levels of the insurance companies operating in the industry which will give an exact financial status rather than the profitability trends alone.

4.4 *The areas or products that would benefit from enhanced competition*

4.4.1 Competition improves efficiency, productivity, service standards, product accessibility; lowers prices; and expands markets. Hence enhanced competition in the insurance industry would be likely to benefit the businesses participating in the market. This would mean that customers would have a choice of competing brokers/underwriters to negotiate with in the insurance market for lower premiums and improved service standards. In light of this everyone agrees that competition is good and to be encouraged. Therefore, Treasury supports initiatives to increase competition in the general insurance market.

4.5 *Reinsurance*

4.5.1 The draft report raises some questions about the legal requirements relating to reinsurance. Treasury considers that the market would be assisted by an examination of the specific legal obligations of underwriters in relation to national placement of reinsurance; exemption criteria; the efficiency with which the current 'waiver' option for reinsurance by the monopoly incumbent works; and, overall, whether an improved system of 'national reinsurance entitlement' could be instituted.

4.5.2 In line with trends worldwide, in many industries, the possibility of liberalization of the reinsurance market should be explored, to enhance efficiency and offer underwriters a meaningful choice of reinsurers.

4.6 *Regulation of Brokers*

4.6.1 Treasury has not analysed the general insurance regulatory framework, but it may well require substantial improvement. Areas for consideration include appropriate regulation of brokers. Clearly, brokers, accounting for up to 80% of primary underwriting business, have the capacity to influence the solvency of underwriters. An examination of the prudential regulatory regime to assure the community that adequate safeguards exist to allow effective solvency

supervision of insurers, in an environment where brokers could hold underwriters' premium income for substantial periods, is necessary.

4.6.2 While the operation and solvency of insurance agents are the responsibility of insurers, that is not the case for brokers. Among any other enhancements to the general insurance industry regulatory regime it considers necessary or desirable, the ICCC may wish to explore the benefits of requiring a strict separation of the brokerage function from the agency function – see discussion of various remuneration structures at paragraph 4.2.1 above, implying a possible blurring between the functions of brokerage and agency.

4.6.3 The ICCC may also wish to review arrangements for prudential regulation of brokers, to ensure that the best possible prudential safeguards are put in place to prevent any financial collapse of a broker, as that could well jeopardize the solvency of one or more insurers.

4.7 The Possibility of Combining Life and General Insurance Regulation

4.7.1 While Treasury agrees with the recommendation to combine prudential regulation of general and life insurers, it considers that *such an objective should be a long term one*, rather than one to be implemented immediately. Treasury, therefore, supports the policy objective to *ultimately* combine prudential regulation of both markets, possibly in conjunction with that of the superannuation sector.

4.7.2 Treasury's immediate concern with that model, however, is that the life insurance and superannuation sector, which is currently regulated by the Bank of PNG, is responsible for a large proportion of investable funds as well as of national financial resources. Those two sectors are being efficiently regulated, as far as can be observed – there has been no concern expressed either in the course of the current ICCC inquiry or in other fora.

4.7.3 Industry-specific consumer protection legislation is being contemplated, in the form of a proposed *Insurance Contracts Act*. There will be some adjustment required on the part of insurers to this initiative, which will necessitate improved internal business monitoring and regulatory compliance systems.

4.7.4 As the proposed single regulator would also have responsibility for the general insurance sector, the regulatory legislation governing which is generally accepted to require substantial reform, the combination of managing extensive new legislative change in that sector, together with taking responsibility for the life and superannuation sectors, could prove to be an unmanageable and unnecessary challenge, accompanied by unacceptable risks.

4.7.5 With the changes in general insurance legislation being contemplated, the Office of Insurance Commissioner will need to manage significant organisational change in terms of acquisition of additional specialized skills and knowledge, design of advanced regulatory techniques and prepare itself for much higher accountability standards. These factors, in combination, suggest that creating a new regulator out of the existing regulatory institutions, will pose severe, and, in our view, undesirable risks. *To suddenly transfer regulation of the life and superannuation sectors, therefore, to a new body would, in Treasury's view, be highly risky.*

4.7.6 The ICCC is requested to give specific consideration to the significant transitional issues to allow a step-by-step programme of change to the regulatory institutional structure – improvement in general insurance prudential legislation and regulation, staged transfer of life

insurance regulation first, and only then, after bedding down teething problems, adding superannuation regulation to the responsibilities of the new, unified regulator.

4.7.7 Regulatory institutional design and implementation are considered to be of paramount importance and, in Treasury's view, a detailed consideration of the pros and cons would greatly assist Government policy-makers.