13 December 2002

Commonwealth Debt Management Review
C/- Department of the Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir or Madam

**Reduction in the Commonwealth Government Securities Market**

The Insurance Council of Australia (ICA) is the representative body of the general insurance industry in Australia. ICA members account for over 90 per cent of total premium income written by private sector general insurers.

ICA members, both insurance and reinsurance companies, are a significant part of the financial services system. Recently published statistics from the Australian Prudential Regulation Authority (APRA) show that the private sector insurance industry generates direct premium revenue of $19.8 billion per annum and has assets of $66.6 billion. The industry employs about 25,000 people.

ICA members issue some 37.8 million insurance policies annually and deal with 3.5 million claims each year.

## Background

General insurance companies manage a portfolio of claims, which will have a payment pattern that may stretch out over many years.

The prudent approach to investment of assets is to select a range of investments which is likely to produce a cash flow which matches (or nearly matches) the expected cash flow required to meet claims.

Treasury is considering the implications of the possible elimination of the market in Commonwealth Government Securities (CGS), and has requested submissions on several key questions. Refer Appendix 1 of the Treasury Discussion Paper “Review of the Commonwealth Government Securities Market”, published October 2002.

## Key Question 1

The significance of CGS as a long-term investment vehicle.

**Submission Point 1**

CGS are an unique form of investment for general insurers as they provide a range of maturity terms with sufficient liquidity in an established secondary market, to form the basis for a low-risk investment portfolio which matches the cash flows required to meet claims.

Removal of the CGS market will severely restrict the ability of general insurers to construct an investment portfolio, which has the characteristic of matching the maturity of its claims structure.

**Rationale**

The anticipated claims payment pattern of the general insurance industry spreads over many years. It is estimated that at any point in time, 50% of claims will be paid some time after two years. Slightly more than 5% of claims will occur after 10 years.

The range of maturities of CGS provide a sufficiently wide spectrum to match this range of expected claim terms.

The well established secondary market in CGS provides the flexibility to adjust the maturity profile of a portfolio as the claims profile alters.

Other investment products e.g. corporate bonds do not at present have the width of maturity profile nor do they have the same degree of liquidity in the secondary market to act as a satisfactory substitute to CGS. In fact the likelihood of alternate investment products providing the market volume required to meet existing demand is, at best doubtful.

ICA REQUESTS THAT TREASURY RECOGNISE THE UNIQUE ATTRIBUTES OF CGS IN SATISFYING THE INVESTMENT REQUIREMENTS OF GENERAL INSURERS WHO CARRY OUT PRUDENT BUSINESS PRACTICE WISH TO MATCH THEIR LIABILITY MATURITY STRUCTURE WITH THEIR INVESTMENT MATURITY STRUCTURE.

**Submission Point 2**

A reduction in the availability of CGS, in the absence of any amendment of Investment Capital Factors (ICF) by the prudential regulator (APRA), may compel general insurers to raise premiums.

**Background**

The risk assumed in selecting a particular range of investments is assessed by APRA who, after considering other risks, recommends the minimum capital required to ensure continuation of the appropriate licence.

APRA rates various categories of investments according to risk and through the application of an ICF (expressed as a percentage), assess the amount of capital required to back each category of investment.

Debt obligation of the Commonwealth Government and all Australian State and Territory governments have an ICF of 0.5%. This is the lowest ICF available.

An ICF of 0.5% means a company is required to have at least $5 of capital backing each $1,000 invested in the assets described above.

The next lowest ICF is 1%.

**Rationale**

CGS are extensively used by general insurers who require long-term investments with a low risk profile.

Although State and Territory issuance are rated by APRA as equivalent in risk as CGS, there is unlikely to be sufficient issuance to meet the additional appetite.

Being forced to move up the (APRA) risk spectrum will require insurers to hold:

- double the capital than that required for holding CGS, for highly rated corporate issuance with a maturity less than 1 year,

- four times the capital than that required for holding CGS, for highly rated corporate issuance with maturity greater than 1 year.

The company will require an adequate return on this extra capital commitment.

The expected increase in investment return available from the higher risk investment will be minimal in relation to the return from CGS. This is especially relevant in the current market.

There is therefore the risk that the only way that a general insurer can achieve the required return on additional capital is to increase premium pricing.

If this occurred the resultant pricing increase would be passed on to the purchasers of general insurance, including consumers and small business.

**Conclusion**

The CGS market is critical for the investment of assets of general insurers.

We see no logic in APRA amending their ICF percentages as these are based on the perceived relevant riskiness of each category of asset.

The allocation of extra capital to general insurance businesses due to the removal of an investable asset category is inefficient.

The population at large should not have to pay for the consequences of reduction of the CGS market.

ICA URGES TREASURY TO RECOMMEND TO THE GOVERNMENT THAT IT SHOULD RETAIN THE CGS MARKET AND ENSURE SUFFICIENT SUPPLY OF CGS TO INCREASE THE EFFICIENCY OF THE FINANCIAL SYSTEM.

**Submission Point 3**

General insurers will need a new interpretation of the appropriate discount rate to apply to their outstanding claims liabilities if the CGS market is eliminated.

**Rationale**

Australian Accounting Standard AASB 1023 requires that the provisions for outstanding claims liabilities be calculated as the discounted present value of expected future claims payments. The most commonly adopted interpretation is to use a discount rate(s) equal to the market yield on the valuation date of zero-coupon CGS with a duration which approximately matches the duration of the outstanding claims liabilities.

Further APRA Prudential Standard GPS 210 – 1 (para 30) requires that the yield of CGS is the required rate at which liabilities should be discount.

IN THE ABSENCE OF A CGS MARKET, THERE IS NO OBVIOUS BENCHMARK WHICH CAN BE USED TO DETERMINE THE PRESENT VALUE OF CLAIMS LIABILITIES. THEREFORE ICA RECOMMENDS THAT THE GOVERNMENT SHOULD RETAIN THE CGS SO AS TO PROVIDE A BENCHMARK FOR THE DISCOUNTING OF CLAIMS.

**Key Question 2**

The potential to develop alternative long-term investment instruments in the absence of a sizeable CGS market.

**Submission Point**

Substituting fixed interest investment products issued by the “big four” banks for CGS, will lead to a financially imprudent concentration of risk in the investment portfolios of general insurers.

**Rationale**

The four major banks comprise close to 28% of the market capitalisation of the Australian stock market. Most general insurers managing an equity portfolio will have close to this level of exposure to the banking sector.

In the absence of a CGS market, general insurers (and many other institutional investors) are likely to substitute the least risky alternative counterparty to that portion of their portfolio allocated to CGS. The availability of State Government issuance is unlikely to be able to cater for extra demand.

Investment products issued by banks are likely to be the first preference of general insurers.

If general insurers allocated a significant proportion of their fixed interest portfolio to bank paper, when added to the bank allocation of equities this will lead to an imprudent concentration of investment risk in a small number of companies. Current estimates indicate a concentration of around 65% of total industry assets to the overall banking sector with a concentration of up to 20% in a single bank.

This excessive concentration of assets to the banking sector would operate to increase balance sheet volatility and overexpose the Australian insurance industry to business and economic cycle shocks. The diminution of the CGS market as an important component of the Australian fixed interest market would also therefore serve to weaken the overall integrity of the Australian financial system to the detriment of the Australian community as a whole.

Whatever actual portfolio configuration emerges after the reduction in the CGS market general insurers will be restricted in their use of bank paper by concentration issues.

ICA REQUESTS TREASURY TO RECOGNISE THAT BANK ISSUANCE AS A SUBSTITUTE FOR CGS WILL BE CONSTRAINED IN ITS USE BY GENERAL INSURERS DUE TO CONCENTRATION OF COUNTERPARTY RISK.

**Key Question 3**

The most appropriate approach and timeframe to implement a decision to wind down the CGS market, if this decision is made.

**Submission Point**

If it was necessary to wind down the CGS market, the approach which would reduce the rate of increase in insurance premiums would be to delay commencement of the wind down as long as possible and start the reduction at longer prevailing maturity terms.

**Rationale**

Our estimates of the expected claims profile of the total general insurance industry are:

| | | |
|---|---|---|
| Discounted value of: | Total claims: | $21 billion |
| | Claims expected within 2 years | $11 billion |
| | Claims expected > 2 but within 5 years | $6 billion |
| | Claims expected > 5 but within 10 years | $3 billion |
| | Claims expected after 10 years | $1 billion |

It is clear that the insurance industry requires investment instruments with maturities reasonably spread up to 7 years to match the bulk of its liabilities.

Reduction of securities with remaining terms over 6 years will have the least immediate impact on our matching strategies. Obviously 10 year bonds with a current term to maturity of between two and seven years are highly valuable to the strategy.

Commencing the reduction of the CGS market at the long end will also allow liquidity of alternate product offerings to stabilise. This will improve the take-up of those products by general insurers when required.

ICA SUBMITS THAT DELAYING THE COMMENCEMENT OF ANY WIND DOWN OF THE CGS MARKET WILL MITIGATE THE INCREASE OF PREMIUMS TO THE PUBLIC, AND STARTING THE WIND DOWN WITH A REDUCTION OF ISSUANCE AT THE LONG END, WILL IMPROVE THE EFFICIENCY OF THE NECESSARY TRANSFER BETWEEN CGS AND ALTERNATE PRODUCTS.

Yours sincerely

Alan Mason
**Executive Director**