APRA

Australian Prudential Regulation Authority

Insurance and Superannuation Bulletin

December 1996

Overview of the general insurance market

There are 169 private sector companies and 17 public sector authorities operating in Australia's $57 billion general insurance market. In this article we present an overview of this important market and seek to explain some of its key characteristics.

General insurance refers to an insurance contract that covers the purchaser against financial loss caused by damage or destruction to property, accident or illness, or legal liability.

The general insurance market has $57 billion in assets under management, of which $36 billion is held in private sector companies and $21 billion in public sector authorities. During 1995-96 the industry received premium revenue of $19.3 billion and paid claims amounting to $17.3 billion.

These assets, premiums and claims were managed by 183 insurers, of which 169 are ISC authorised private sector companies and 17 are public sector authorities. Lloyd's of London, also operates in Australia.

The Australian general insurance market is highly price competitive with many companies actually losing money (ie, making underwriting losses) on their insurance portfolios. The industry relies on investment returns derived from its insurance reserves and shareholders' funds for overall profitability.

The market is relatively concentrated with the largest 20 private sector insurer holding 70 per cent of assets and writing 67 per cent of premiums. The remaining 30 per cent of the market is covered by mostly small insurers with premium income of less than $10 million. Australia's general insurers account for two percent of the world's premium pool. The Australian general insurance market ranks in the top 12 of the global market.

Companies

Participation in the general insurance market is restricted to ISC authorised private sector insurers, public sector insurers, or Lloyd's underwriters. These can be either direct underwriters (sellers of insurance to the public) or reinsurers (companies that insure a percentage of the insurance portfolios of other insurers). See table 1.

Private sector

While the majority of direct underwriters write multiple classes of business under one corporate banner, other insurance groups have separate specialised companies to write only one class of business or write business for a select group of companies. These companies include specialist mortgage insurers, captive insurers and reinsurers. Captive insurers are companies that insure risks only or predominantly within a group of related companies which the insurer belongs. Co-operative insurers write insurance specifically for their members.

There has been a gradual increase in the number of authorised general insurance companies since 1992, reversing a major downward trend after company numbers peaked at 202 in 1982. The recent increase in market participants has been caused by the privatisation of government insurance offices, as well as demand by organisations wishing to establish new insurance operations. See figure 1.

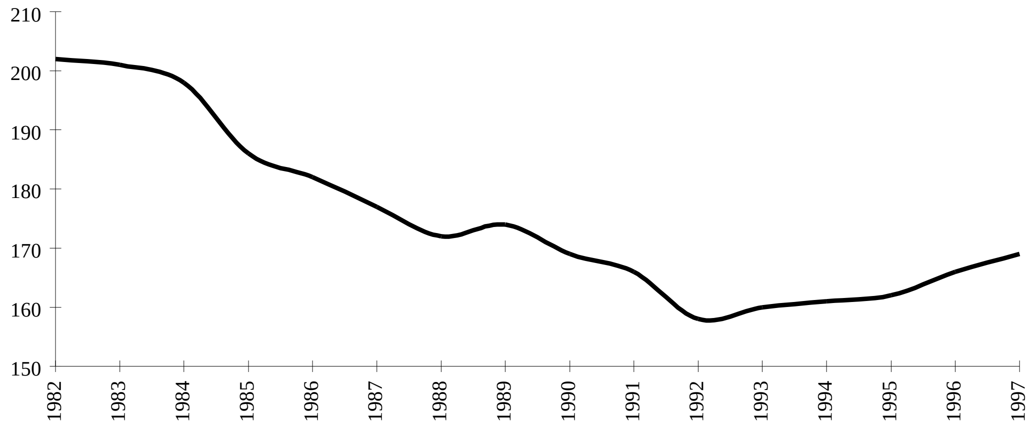
An insurance group may contain, for example, four separate authorised insurance companies involving a mainstream direct underwriter, a mortgage insurer, a reinsurance company, and another a niche direct underwriter, each competing in a different segment of the market.

On a group basis, using a test of 25 per cent of ownership, the 169 private sector insurers can be

Table 1: General insurers, December 1996

Type of insurer	
Direct underwriters	121
Reinsurers	27
Mortgage insurers	12
Captive insurers	5
Cooperative insurers	4
Total private sector	***169***
Total public sector	***17***
Total	***186***

Figure 1: Number of authorised (private sector) general insurers



classified as 23 insurance groups (together accounting for 77 companies) and 92 individual companies that do not form part of an insurance group.

Foreign insurers are active participants in the Australian general insurance market accounting for 56 per cent of all insurers operating in Australia. Of the foreign owned insurers, 38 per cent are branches of overseas insurers, and 68 per cent are Australian based subsidiaries of foreign corporations.

The Australian general insurance market is open to international competition, with no statutory barriers to overseas business being written by Australian insurers, or Australian business being written by overseas insurers. A number of unauthorised foreign insurers operate in the Australian market through underwriting agencies.

Public sector

A substantial share of the general insurance market is held by public sector insurers. For example, the 17 Commonwealth or State controlled general insurers at 30 June 1996 accounted for 37 per cent of total industry assets and 30 per cent of premiums. These insurers do not come under the supervisory regime of the Insurance Act 1973, but are guaranteed by the State and Commonwealth governments that own them.

While private sector insurance companies have on average $200 million in assets under management, the public sector insurance authorities are on average more than six times larger, with an average of $1.2 billion in assets under management. This is due to the composition of the business written by public sector insurers, in large part, CTP or employers liability schemes. There are many more small private sector insurers than there are small public sector insurers.

The number of public sector insurers has fallen since 1992 due to a general trend towards privatisation of government insurance offices.

Lloyd's of London

Lloyd's is a society of individual and corporate members who form syndicates to accept insurance risks. Lloyd's is a major international insurance market and a significant participant in global reinsurance, and is authorised to operate in Australia.

Assets and Premiums

Although the general insurance industry assets are significant, they comprise only a relatively small component (around five per cent) of the overall financial system.

As indicated earlier, at 30 June 1996, private sector general insurers held $36 billion in assets. During 1995-96, total premium revenue received by private sector general insurers amounted to $13.6 billion.

Similarly, as at 30 June 1996, assets held by public sector general insurers totalled $21 billion. During 1995-96, total premium revenue of public sector general insurers amounted to $5.7 billion.

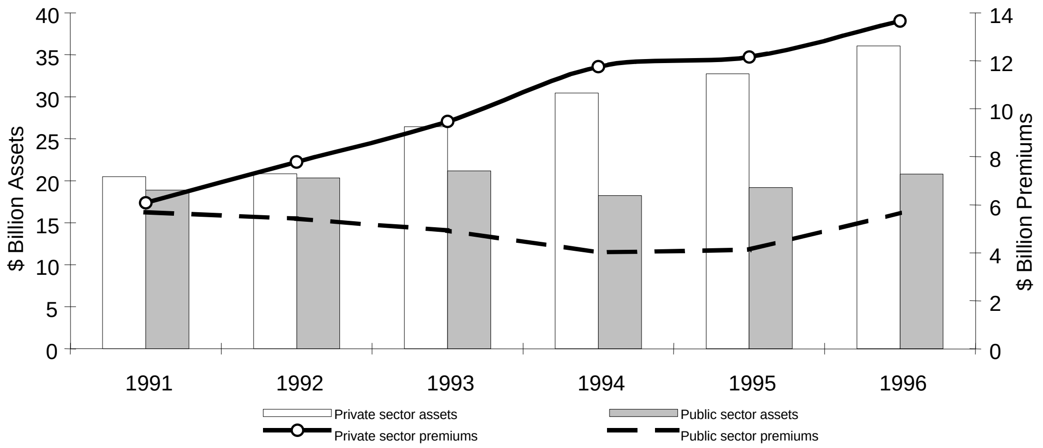
Even though the relative performance of the private and public sectors respectively has varied considerably, the general insurance industry overall continues to experience positive asset and premium growth.

For example, private sector insurers' premiums increased 225 per cent during the five year period 1991-96 from $6.1 billion in 1991 to $13.7 billion in 1996, representing an average annual increase of almost 18 per cent. Largely as a result of the privatisation and the consequential shift of public sector business to the private sector, public sector insurers' premiums decreased 28 per cent from $5.6

billion in 1991 to $4.1 billion in 1995. By 1996, however, public sector premiums returned to their 1991 level. See figure 2.

The increasing premiums for compulsory third party or M insurance, and possibly the expansion of direct underwriting and reinsurance operations into overseas markets, particularly in the emerging Asian markets, have been major factors fuelling the strong growth in premium revenue in recent years.

Figure 2: Assets and premiums 1991-1996



During the five year period 1991-96, private sector insurers' assets under management increased 76 per cent from $20.5 billion to $36 billion, representing average annual growth of 12 per cent. In contrast, assets held by public sector insurers increased by only 10 per cent during the same period from $18.9 billion to $20.7 billion, representing average annual growth of only two per cent.

In overall terms, between the years 1991 and 1996, the general insurance industry grew by an average of eight per cent per annum, from $39 billion to $57 billion. While the public sector accounted for half of all general insurance business in 1991, it now only accounts for slightly more than a third.

Classes of business

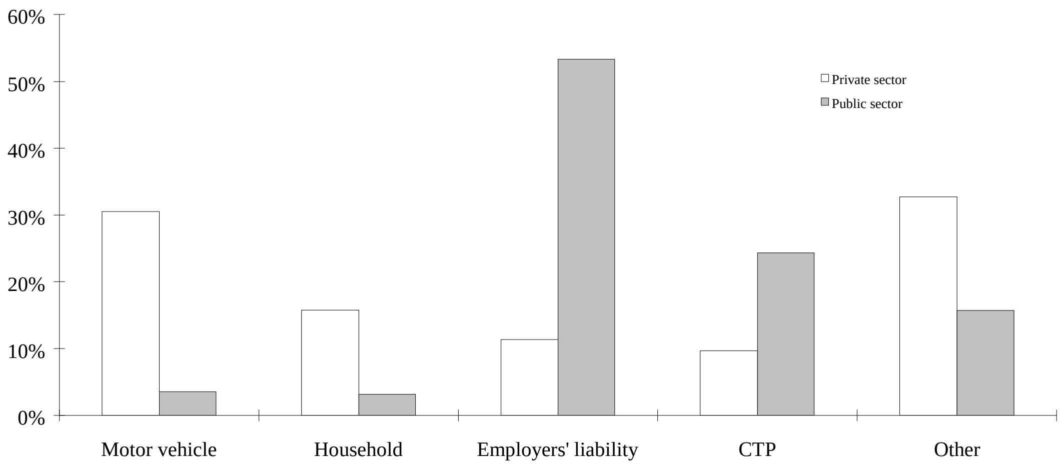
Authorised general insurers write 23 different statutory classes of insurance business, the five largest being motor vehicle, house owner/house holder, employers' liability, compulsory third party motor vehicle, and domestic motor vehicle.

Public sector insurers compete in most classes of business, and enjoy statutory monopolies in the CTP and employers' liability classes in certain states. Figure 3 shows the relative involvement of public and private sector insurers respectively in different types of business. For example, 53 per cent of contracts written by public sector insurers are employers' liability insurance, while this product line represents only 11 per cent of private sector insurance contracts.

Payment trends

During 1995-96, private sector insurers paid $10.4 billion in claims on 26.4 million policies.

Figure 3: Premiums by class of business



Public sector insurers. during the same period, paid $6.9 billion in claims on 4.3 million policies.

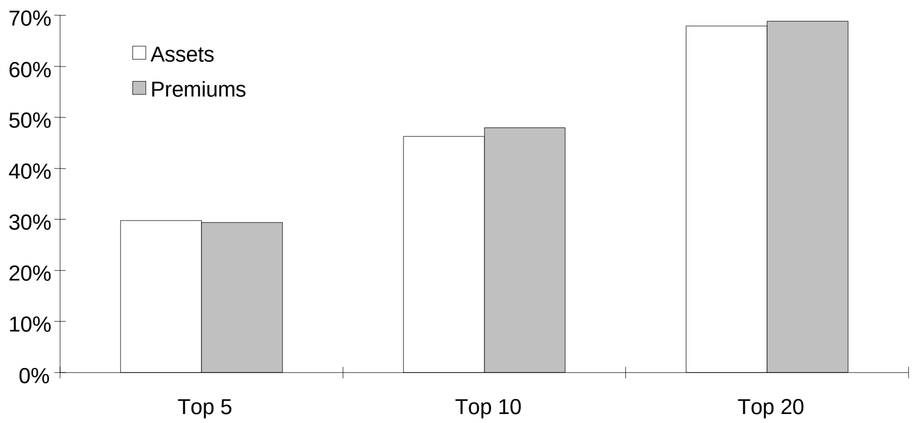
While private sector insurers' claims are spread across most classes of business, public sector insurers' claims are concentrated in only two classes. For example, over 70 per cent of public sector claims were paid on employers' liability policies, and 20 percent were paid on CTI? claims.

Even though public sector insurers issue only 14 per cent of all insurance contracts, they pay 40 per cent of total industry claims. Public sector insurers' average payments are thus considerably higher than those in the private sector.

Concentration

The general insurance industry is relatively concentrated, with a small number of large

Figure 4: Concentration of the general insurance industry



insurers holding a substantial proportion of industry assets under management, while a large number of smaller insurers hold a much smaller proportion of industry assets.

In the year to 30 June 1996, the largest five private sector insurers together held 30 per cent of total private sector assets, the largest 10 private sector insurers held 46 per cent, and the top 20 private sector insurers held 68 per cent.

The general insurance industry is also polarised in terms of premium income, with large insurers (not surprisingly) receiving the largest proportion of industry premiums. In the year to 31 June 1996, the largest five private sector insurers wrote 29 per cent of total private sector premiums, the largest 10 private sector insurers wrote 48 per cent, and the largest 20 companies wrote 69 percent. See figure 4.

At the low concentration end of the industry, 39 per cent of private sector insurers receive less than $10 million in premium revenue. These companies tend to be small niche insurers that specialise in a particular segment of the market. By way of contrast, only around 22 per cent of private sector insurers have premium revenue in excess of $100 million.

Lloyds of London

In the year to 30 June 1995, Lloyds received Australian premium income of $258 million, compared with $282 million in 1994. This represents a nine per cent annual decrease, which is in sharp contrast to the strong overall general insurance industry upward trend in premium revenue of 5 per cent.

Profitability

In recent years the strongest influence on industry profitability has been poor investment performance, particularly following the downturn in the bond and equities market in 1994 and 1995. However, underwriting results (ie, insurance profits or losses) have been relatively stable.

Since 1993, public sector insurers have nonetheless experienced reduced profitability. While the major factor has been the deterioration in their underwriting result, they have been able to report buoyant investment returns which have enabled them to contain these losses.

More about the investment management industry

The Australian Investment Managers Association and Super Review magazine have just released the 1996 investment management industry yearbook. In this article we present some industry characteristics that are revealed by the yearbook.

The latest investment management industry yearbook just released by the Australian Investment Managers Association (AIMA) and Super Review magazine contains some useful information profiling major investment managers in Australia.

Number of investment managers

There are now around 98 specialist investment management companies operating here, of which 38 are Australian owned and 60 are foreign owned. The ongoing development of local financial markets, especially the rapidly growing superannuation sector, appears to have made Australia an attractive place for investment managers - especially overseas based investment managers.

Even though only 40 per cent of investment management companies in Australia are locally owned, they represent around 60 per cent of the Australian sourced assets that are managed by the Australian investment management industry.

The average Australian owned company also manages more than twice the assets that are managed by the average foreign owned company.

This confirms much anecdotal evidence suggesting that many of the newer foreign owned managers are in fact specialist niche companies - at least within the Australian market - wishing to specialise solely in the wholesale rather than more complex retail market.

Further illustrating this, while Australian owned investment managers tend to have an equal focus upon both the retail and wholesale markets, the yearbook reveals that overseas managers have two thirds of their business in the wholesale market and only one third in the retail market. See figure 1.

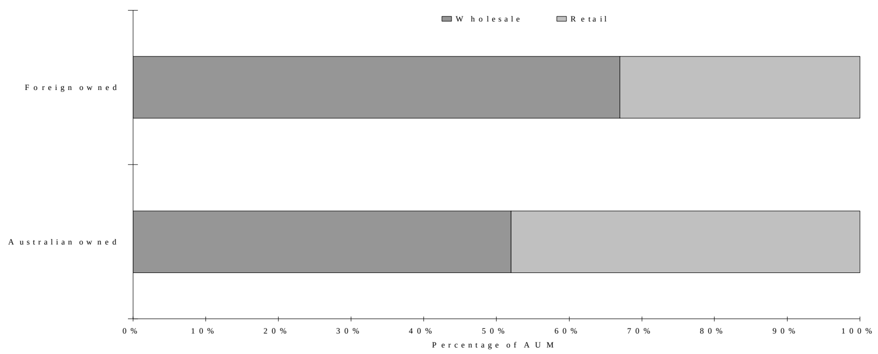
Foreign owned operations include fully staffed Australian subsidiaries of large foreign managers as well as those comprising only a single branch office in Australia staffed by a small number of sales and marketing personnel.

Banking and insurance groups

Another important aspect of Australia's investment management industry is the traditional domination by banking and life insurance groups, which together account for around 77 per cent of the investment management market in Australia today.

The domination is largely because such organisations have over time established extensive distribution networks, giving them a comparative advantage in accessing potential customers to attract funds.

Figure 1: Australian and foreign owned investment managers



However, since the retail investment management market has traditionally been more akin to life insurance than banking, the majority of retail investment management (59 per cent) is channelled though insurance group investment managers with only 33 per cent being captured by banking group investment managers. The share for the overall market (ie, including wholesale) is nonetheless much more even.

The retail market accounts for a roughly similar proportion of each group's investment management business (56 and 63 per cent respectively).

The low proportion (eight per cent) of retail investment management captured by other types of investment managers illustrates the potential difficulties faced by these companies should they wish to operate in this market.

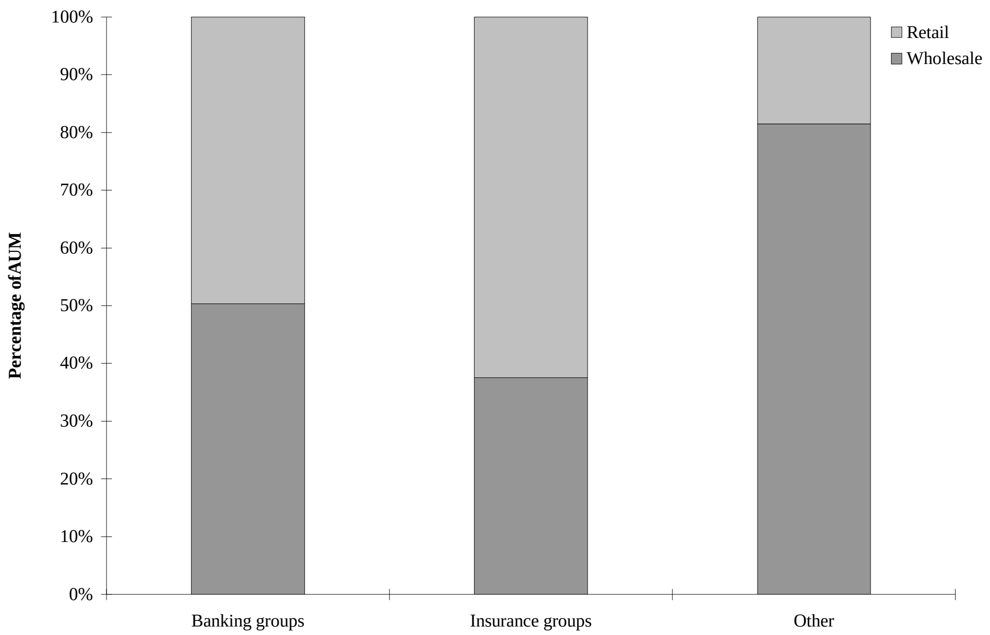
As would be expected therefore, this lack of access to a retail customer base obviously results in these managers focusing more on the wholesale investment market. For example, the wholesale market represents 83 per cent of the business of these companies - nearly twice the proportion this market represents to banking and insurance related investment managers. See figure 2.

Export income

As the investment management industry in Australia develops further in size and sophistication, it is able to attract more funds from overseas clients seeking to have some of their investments managed in Australia. Indeed, based upon information within the yearbook, it appears Australian owned investment managers are now managing over $15 billion worth of investments for overseas clients - and this figure is on top of the foreign sourced money managed in Australia by foreign owned investment mangers.

While it is very difficult to quantify these flows precisely, rough estimates put the revenue earned from the export of these services to at least $200 million annually.

Figure 2: Investment managers and their core markets



Sales distribution in the life insurance industry

The ISC conducts an extensive annual survey of life insurance companies and brokers to monitor how effectively the new Life Insurance Industry Code of Practice is being implemented. In this article we review the major findings of the latest survey.

The Life Insurance Code of Practice was introduced in 1995-96 and aimed to increase standards of professionalism in how life insurance products are marketed and sold to consumers. The Code covers adviser training and complaints handling, as well as sales conduct. The introduction of the Code followed extensive consultations between life insurance companies, life insurance advisers, government and consumer representatives.

The ISC monitors compliance with the Code via an extensive annual survey of the life insurance industry as well as via its regular company compliance inspections. The industry itself also monitors the Code through a range of specially commissioned surveys and research initiatives.

The changing sales distribution market

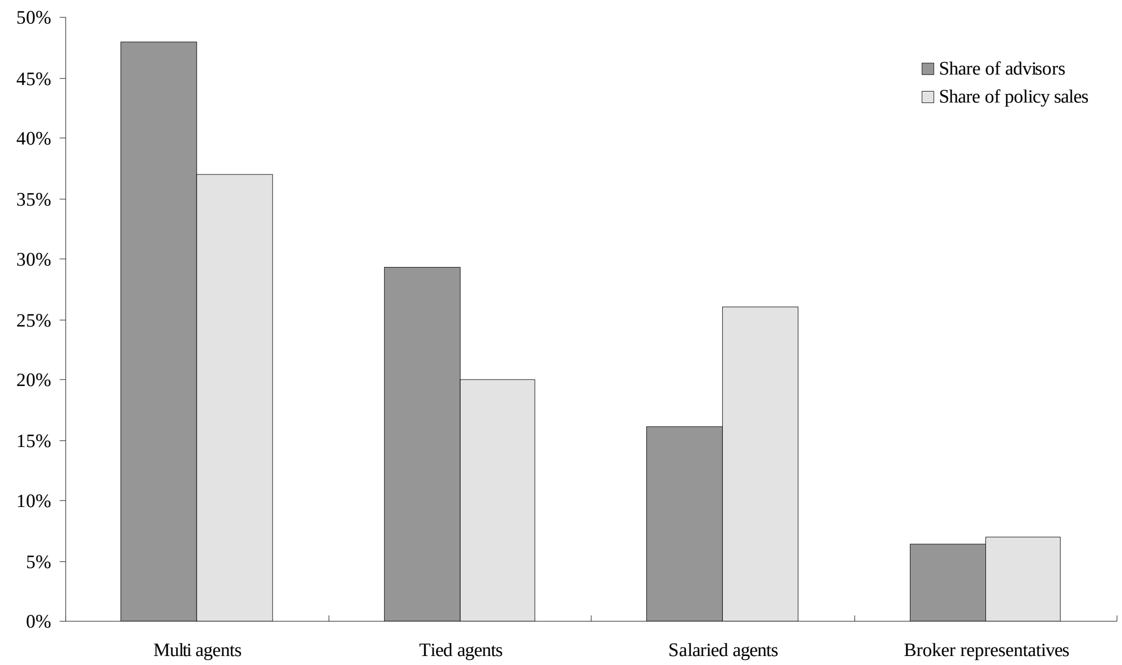
With increased price and product competition in the savings and insurance markets in Australia, largely as a result of financial deregulation and the increasing spread of superannuation, companies are now under pressure to offer more competitively priced products. And with many consumers now focusing upon the level of fees charged for financial products, companies are being forced to trim their cost structures so they can pass on these savings to their customers via reduced fees.

Following on from this, many companies have become acutely conscious that since sales commissions account for around one third of overall operating costs across the industry, there may be significant cost efficiencies to be had from reviewing how they distribute their products.

An example of how companies are responding to this challenge is that while life insurance policies were traditionally sold predominantly through agents acting on behalf of specific life insurance companies, many companies are now turning to direct marketing, and in some cases electronic (internet) marketing, to attract new customers. At the same time, companies have been increasing their numbers of multi agents and salaried sales representatives while reducing their numbers of tied agents.

While it has been very difficult to reliably and precisely assess the impact these structural changes have had upon the mix of the insurance salesforce, some observers have suggested the number of tied agents within the life insurance industry now may only be around 25 per cent that of five years ago.

Figure 1: Policy sales and the adviser salesforce in 1996



Number and type of advisers

The 1996 Code of Practice survey conducted by the ISC revealed there to be around 14 000 life insurance advisers in Australia, although the number actively selling could be lower.

Drawing together information compiled from the ISC Code surveys and other special industry surveys, for example those conducted by the multi-agent auditing company THP Services, it appears the average number of agency agreements each multi-agent held with their sponsoring companies may actually have been less than was. assumed for 1994-95. Nonetheless, companies in aggregate reported only a slight increase in the number of multi-agent agreements even though there was a noticeable increase in the number of individual multi-agents.

This could also confirm anecdotal evidence within the life insurance industry that suggests companies are acting to compress or contain their distribution costs by streamlining their multi-agency agreements.

It is also apparent from the ISC surveys that most tied agents are actually 'first option' agents, which generally means that they are required to place around 85 per cent place around 85 per cent of their sales through the specified company in order to receive their preferential status.

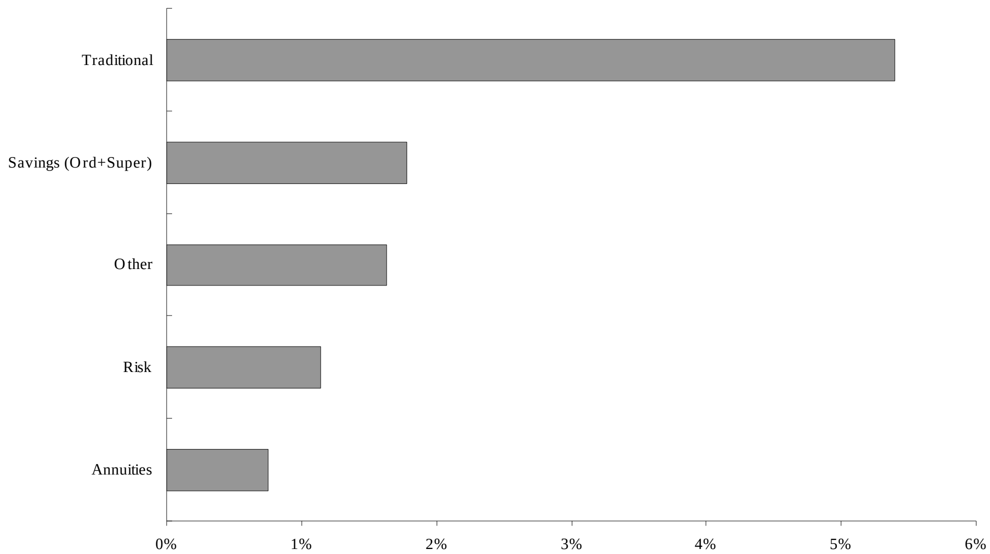
Further reflecting the ongoing restructuring in life insurance sales distribution, the survey also revealed that the number of tied agents decreased by 11 per cent (530) during 1995-96, and the number of salaried company sales representatives increased by 24 per cent (440).

Companies also indicated that around 18 per cent of life company advisers are ASC licensed securities dealers' representatives (or proper authority holders). Moreover, 71 per cent of life insurance brokers are reported as being licensed securities dealers' representatives or proper authority holders.

Given that the restructuring in the life insurance salesforce has been significant in recent years, it may be useful to review the impact these changes have had upon the sales mix. One issue which arises, for example, is whether the shift by companies towards salaried sales representatives has attracted sufficient new sales to justify the costs of restructuring.

In fact, results from the survey indicate that it has been quite successful. Even though salaried representatives account for only 16 per cent of life insurance advisers, they actually account for 29 per cent of policies sold through advisers. In contrast, while tied and multi agents account for 77 per cent of life insurance advisers, they actually account for only 63 per cent of policies sold through advisers. See figure 1.

Figure 2: Early terminations in the cooling-off period 1996



As a possible indicator of things to come, policies sold through direct marketing now account for 11 per cent of policy sales. Direct marketing includes telemarketing and targeted mail campaigns whereby companies use their customer database, or those of their related companies (eg, related banks), or other commercially available mailing lists, to contact potential customers.

While internet marketing is growing, to date it represents only a very minor proportion of direct marketing sales, especially as, based upon figures from a recently published AGB McNair survey, only one per cent of Australians use the internet to purchase goods and services. Also, a distinction needs to be made between internet advertising and internet transactions (the latter is far less common).

Industry complaints

During 1995-96, there were 21 647 complaints made to life insurance companies and handled by internal company complaints handling mechanisms. Reflecting most probably increased awareness by consumers that such complaints handling mechanisms exist, that companies are now better equipped to deal with complaints, and that the recording of complaints improved significantly following the introduction of the Code, this figure represents a noticeable increase over the number of complaints received during the previous year.

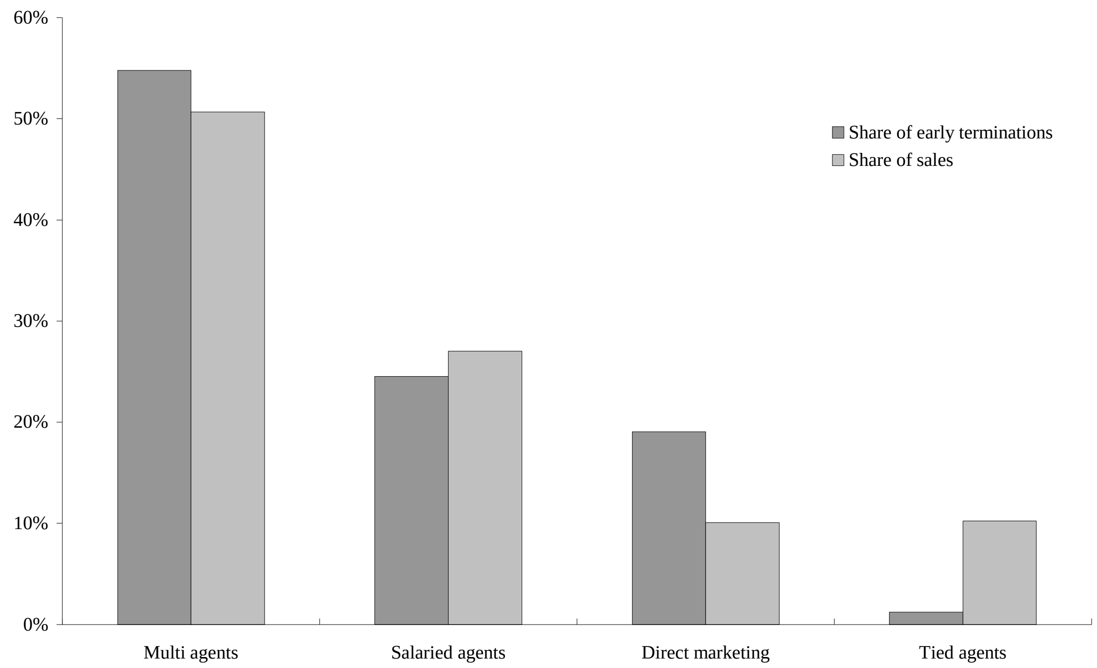
Savings policies (including superannuation and ordinary business) accounted for 59 per cent of complaints, traditional policies for 31 per cent, annuities for five per cent, and risk business for four per cent. The policy mix for complaints was very similar to that revealed in surveys conducted by the ISC prior to the introduction of the Code.

The fact that 93 per cent of complaints in 199596 were resolved within 45 days indicates that companies are managing these new mechanisms quite effectively. The corresponding figure for 1994-95 was also high at 92 per cent. There was no noticeable variation in complaint resolution times amongst the different types of policies.

Life insurance companies have also advised that of the 21647 complaints they received in 199596, companies and consumers found it necessary to refer only 1 147 (five per cent) to external complaints handling bodies such as the Life Insurance Complaints Service. The corresponding figure for 1994-95 was six per cent. In 88 per cent of cases the decision of the internal complaints mechanism was endorsed by the external complaints handling body.

The standard of company service accounted for 48 per cent of complaints, adviser misrepresentation for 20 per cent, policy valuations for 13 per cent, while other types of reasons accounted for the remaining 19 per cent.

Figure 3: Early terminations in the cooling-off period and



Terminations

One major reason behind the introduction of the Code of Practice was the widely held suspicion that the differential commission structure for remunerating life insurance agents may have been resulting in some consumers being sold policies that were inappropriate for their needs.

In fact, the survey indicated that policies sold largely through high up-front commission based arrangements, for example, traditional life insurance products such as whole of life and endowment policies, had far and away the most significant level of early terminations during the cooling off period at nearly six per cent of policies sold. The cooling-off period is the two week period immediately following formal receipt of the policy by the purchaser.

In contrast, other policies recorded much lower levels of early termination during the cooling off period at around one to two per cent. See figure 2.

It is unclear whether the high early termination rate for traditional policies is due to sales practices, or if they are due to customers exercising their rights under the Code to cancel policies within the cooling-off period at no cost.

It is also important to note that advice based sales of traditional (for example, regular premium) products are not the only source of concern. The relatively rapid increase over recent years in the use of direct marketing by life insurance companies has also been accompanied by a disturbing increase in the number of early terminations during the cooling off period for products sold in this way.

In fact, the survey reveals that direct marketing sales account for nearly twice the amount of early terminations than should be expected, based upon their share of sales. For example, while direct marketing now accounts for 11 per cent of new policies sales, it also represents 19 per cent of early terminations. See figure 3.

Since policies sold through direct marketing tend to be simple low premium, risk only policies, it may be that the relatively high early termination rate during the cooling-off period for these sales reflects weaker commitment to these products than to the longer term, higher value products such as superannuation savings policies. It may also indicate that companies have room to improve their research and precision in targeting their direct marketing campaigns.

Possibly reflecting the close personal contact and high degree of trust many tied agents have with their customers, policies sold through tied agents accounted for only one per cent of early terminations even though they accounted for a much higher proportion of sales in 1996.

Discontinuance rates

While the overall rate of terminations during the first year of a policy is around eight per cent, the Code survey reveals that some policy types have first year termination rates which are considerably higher. For example, the first year termination rates during 1995-96 were 18 per cent for group superannuation policies, 15 per cent for disability insurance policies and 12 per cent for savings plans.

Further reflecting problems with retaining customers over the long term in today's very competitive investment market, the survey also found that on average 20 per cent of policies are terminated by the customer within two years.

Direct derivative usage by superannuation funds

In 1996 the ISC conducted a special survey to investigate the extent to which superannuation funds use derivatives. In this article we present the results of the survey, and also discuss the reasons for derivative use, major instruments used, and the regularity of reports on exposure.

In April 1996, the ISC conducted a special survey to investigate the use of derivatives by superannuation funds. The survey was directed at large and medium sized superannuation funds that indicated in their 1994-95 Annual Return that they directly invested in the capital markets using derivative instruments. Funds with less than five members (excluded funds) were specifically omitted from the research.

While the survey revealed that four per cent of funds used derivatives, only two per cent used them directly. The remaining two per cent used them indirectly through wholesale trust arrangements which are externally managed.

The main findings from the survey are:

- the trustees of superannuation funds generally do not directly undertake investment in derivatives themselves but do so through investment manager arrangements or collective investment schemes;
- 'plain vanilla' instruments are the principal derivatives used;
- derivatives are overwhelmingly used by super funds for risk management purposes; and
- public sector funds and Pooled Superannuation Trusts (PSTs) comprise the largest direct users of derivatives.

Derivatives usage and type of fund

The proportion of superannuation funds that use derivatives varies between different types of funds (eg, corporate, industry, public sector and retail). For example, public sector funds have the highest proportion of derivative usage with 39 per cent directly using derivatives. Industry funds by comparison are not major users with only 9 per cent directly using derivatives. Retail and corporate funds are also not significant direct users of derivatives, with only one percent of retail funds and one percent of corporate funds directly using derivatives.

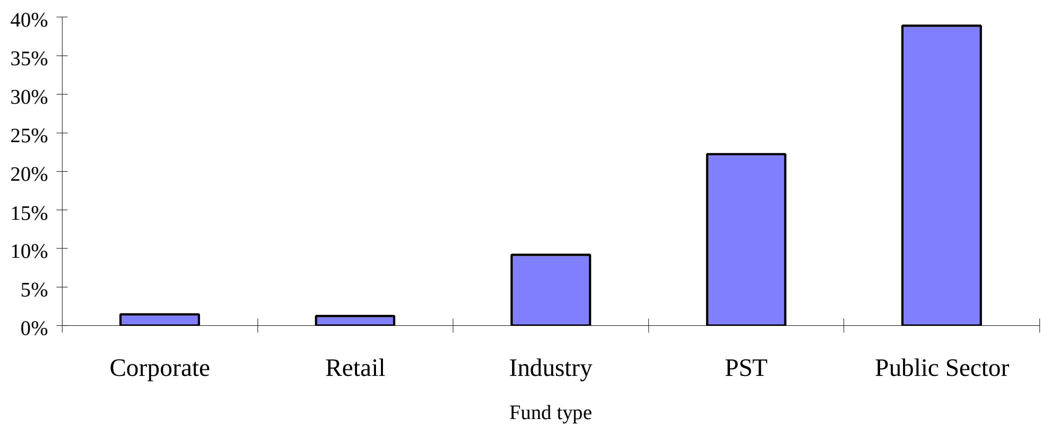
The low proportion of direct derivative use by retail and corporate funds may be due to these funds making relatively greater use of PSTs and other wholesale investment products. Wholesale managers would tend to be high users of derivatives as they may seek to hedge and manage market exposures. Illustrating this, 22 per cent of PSTs reported directly using derivatives.

Similarly, large public sector funds which predominantly directly invest tend to report a high direct usage of derivatives, presumably because many of them are sufficiently large enough to run sophisticated, in-house treasury operations which are capable of managing such investment instruments.

Derivatives usage and fund size

Larger funds directly use derivatives more frequently than smaller funds. By far the biggest direct users of derivatives are funds that have assets greater than $250 million, of which 86 percent directly use derivatives. This high rate reflects the fact that 35 per cent of their assets are invested directly (the remaining 65 per cent being invested through life policies and investment managers).

Figure 1: Direct derivative use and fund type



Since these funds make more use of direct investment this perhaps reflects a more sophisticated approach to investment strategy by larger funds. Another possibility is that larger funds may directly use derivatives to achieve quick, cost effective reweighting of portfolios. In other words, since large directly investing superannuation funds are often their own investment manager, they are usually in a better position than smaller funds to directly manage derivatives.

Consistent with this finding, among funds with lower asset holdings, direct derivative usage tends to drop as asset size decreases. See figure 2.

Limits on derivative use

Of the funds surveyed, 77 per cent explicitly permit the use of derivatives in their governing rules, and only a third of funds have rules that restrict the type and exposure amount of direct derivatives which may be used or invested.

The remainder of the funds have governing rules which are silent on the use of direct derivatives. For example, they may pre-date routine derivative use or may give unfettered investment discretion to the trustee. In these cases, many funds nonetheless took the view that direct derivative use was not prohibited.

Where a fund's governing rules restrict the type of derivative used, it was generally found that the rules also limited the amounts invested using derivatives.

Type of derivatives used

The main derivative instruments used were broadly 'plain vanilla' financial instruments such as futures, options and currency forwards. Share ratios, swaps and warrants appeared to be little used by the industry. There was little evidence of derivatives use in relation to commodities.

The principal reasons for using derivatives were to control or hedge risk, manage transactional cost efficiency, and to gain or reduce exposure. Indeed, about 20 per cent of trustees claimed that derivative use improved the return on their investment portfolios.

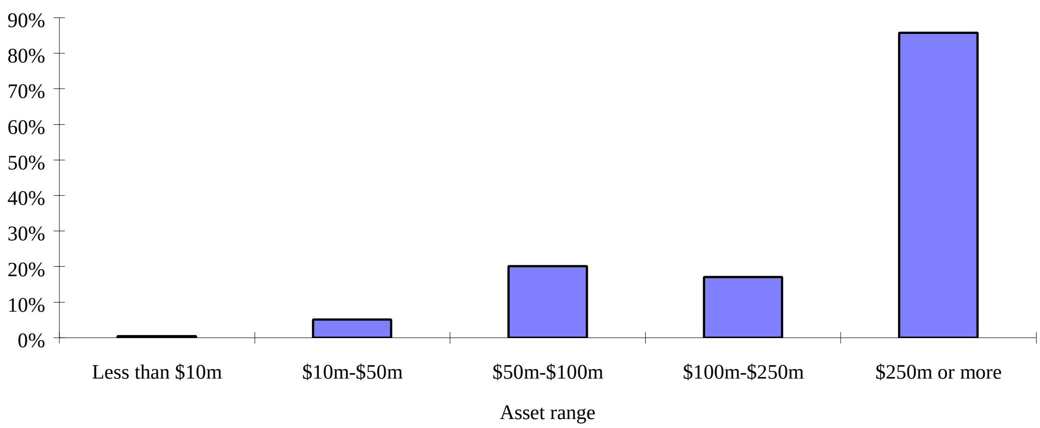
Control and monitoring

Superannuation funds using derivatives must have in place a Risk Management Statement covering the fund's objectives in using derivatives, exposures and limits to derivatives positions. This is to ensure that the use of derivatives is not considered in isolation, but as a part of the fund's overall investment strategy.

In accordance with this requirement, the survey found that 86 per cent of funds receive regular written reports on their derivative exposure. It was notable that of the funds which directly invest using derivatives, only 25 percent received daily up-dates and 33 percent received monthly updates of their derivative exposure. The rest of the trustees received either weekly, quarterly, or annual reports.

Trustees should ensure that they obtain sufficient information from fund managers to ensure that they are aware of the exposure of their funds to derivative investments. ISC review experience to date is mixed, but generally it appears that information provided would not be sufficient for trustees to be able to make this assessment.

Figure 2: Direct use of derivatives and fund asset size



Update on superannuation fund numbers

The number of superannuation funds supervised by the ISC continues to rise, particularly the number of small self-managed funds. This article describes the latest trends in fund growth.

At December 1996 there were more than 147 000 superannuation funds and ADFs registered with the ISC. This represents an annual growth in fund numbers of 24 per cent.

Around 97 per cent (143 000) of these funds were small self-managed (excluded) funds while the remainder were larger funds containing at least five members.

During the 1996 calendar year around 28 900 trustees notified the ISC of the establishment of new funds, an average of around 2 400 per month. This result represents an increase of 15 per cent over 1995, when around 25 000 funds were established at an average of around 2 100 per month. Small self-managed funds accounted for more than 98 per cent of these newly establishing funds, indicating continued strong demand for the flexibility and control that can be associated with this type of fund.

Since the number of new funds being established is not uniform throughout the year, industry observers should note that it can be very misleading to compare June monthly growth and annual average monthly growth figures. This is because June is by far the busiest month for the establishment of new funds, accounting for 32 per cent of annual fund registrations during 1996. This result reinforces the strong interaction between a self-managed fund and the efficient management of taxation affairs. See figure 1.

Reflecting the continuing growth in fund numbers, a further 9 380 funds have been established during the first half of 1996-97. This result represents a slight increase (of four per cent) on the number of funds established during the first half of 1995-96.

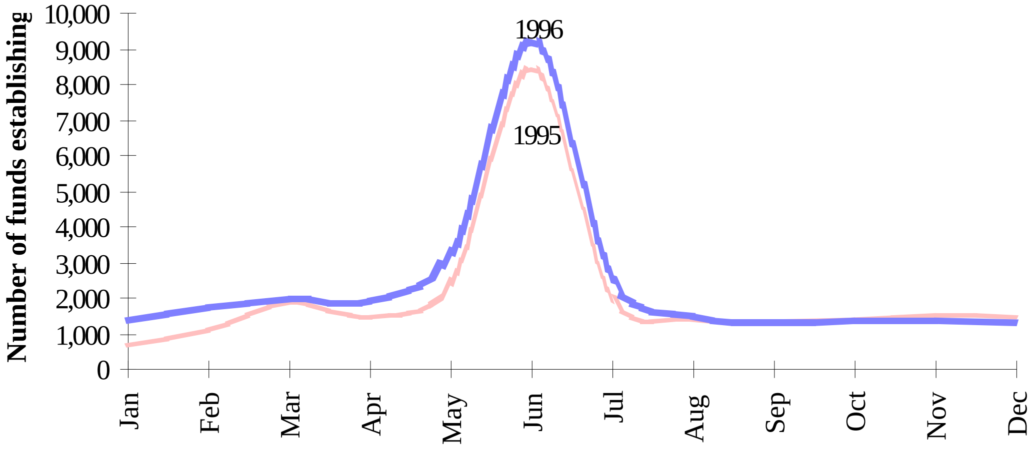
Long term trends

The ISC is now supervising a greater number of superannuation entities (superannuation funds and ADFs) than at any other time in the Commission's history. The number of superannuation entities regulated by the ISC is now almost double the lowest number of 74 000 which existed in 1991. At June 1996 there were around 138 000 entities being regulated by the ISC, compared to the previous high of around 127 000 which occurred during the first year of the Commission's operations in 1987. See figure 2.

The decrease in fund numbers from 1987 to 1991 was due to a falling number of small funds during this time. The introduction of the *Occupational Superannuation Standards Act (OSSA)* in 1987, where funds were required to meet compliance standards before being granted taxation concessions, may have discouraged many people from operating small funds and many were subsequently wound up. In contrast, the introduction of the *Superannuation Industry (Supervision) Act (SIS)* appears to have coincided with an increase in small fund numbers, which has occurred primarily since 1994. The SIS legislation required all existing superannuation funds wishing to claim concessional taxation in the future to notify the ISC of their existence by 'electing to become regulated'.

While the numbers of small self-managed funds have been growing strongly, the larger funds (containing 5 or more members) have been consolidating and declining in number. In fact, preliminary analysis conducted by the ISC suggests

Figure 1: Growth in superannuation funds - 1995 and 1996

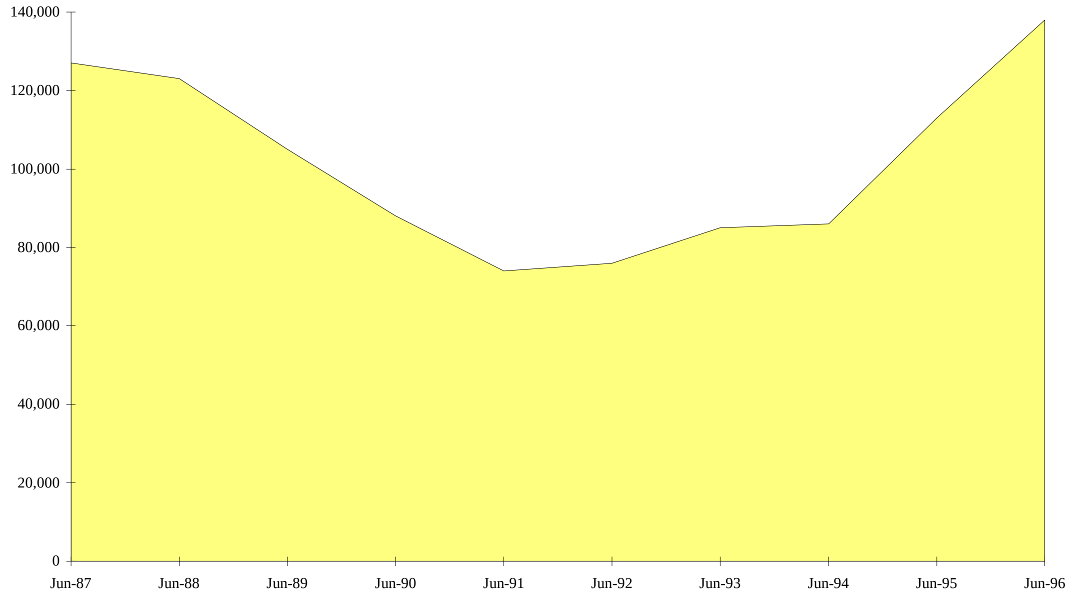


that the number of large funds fell by 23 per cent (from around 5 200 to around 4 000) during 1995-96.

This analysis has also found that it is primarily the smaller corporate funds that have been decreasing in number, for example, the fund becomes a small self-managed fund for the business owner and their spouse with any employees being transferred to an industry fund or a mastertrust. Alternatively, a fund may have been split into a number of smaller funds, taking advantage of the SIS provisions that exclude small funds from having to comply with some of the more rigorous requirements that apply to the larger funds.

Both these strategies have had the dual affect of adding to the number of small funds while at the same time subtracting from the number of larger funds. These results suggest that the introduction of the SIS Act has seen the industry stratify into a smaller number of very large funds and a large (and growing) number of small self-managed funds.

Figure 2: Number of superannuation entities 1987-1996



Superannuation coverage and contributions

The latest results describing superannuation coverage in Australia have recently been released by the Australian Bureau of Statistics. In this article we review the findings in this report and consider the level of voluntary employee 'top up' contributions over and above those paid by employers.

As at August 1996 around 6.3 million employees were covered by superannuation. This means overall coverage for all employees is 89 per cent, up marginally from 87 per cent two years ago. The slowing in the spread of superannuation indicates coverage has probably plateaued. See figure 1[1].

The coverage rates for employees is now more than double the rate of the late 1980's, when only 42 per cent of employees were covered by superannuation. The factor most responsible for the large increase in coverage during this time was the establishment of Award superannuation (introduced during the late 1980's and early 1990's).

The introduction of the Superannuation Guarantee (SG) in July 1992, while having an impact, clearly did not have as much impact as the introduction of Award superannuation. For example, from the introduction of Award superannuation up until the introduction of the SG, the coverage rate increased by 39 percentage points, whereas following the introduction of the SG there has only been an increase in coverage of eight percentage points.

Full time and part time employees

There remains a significant difference between the coverage for full time employees and the coverage for part time employees. The overall coverage rate for full time employees is 96 per cent (the same for both male and female employees), while the coverage rate for part time employees is much lower at only 70 per cent. This difference is most likely due to the seasonal or cyclical nature of much part time work, and the increased likelihood of the income received by a part time worker being below the threshold requiring superannuation contributions to be made on their behalf.

Significantly, part time male employees have a coverage rate of only 59 per cent compared to the part time coverage rate for females of 74 per cent. The industries which have low coverage for part time males include the agriculture, construction, retail and recreational industries, which historically have demonstrated particularly seasonal or cyclical employment patterns.

Largely reflecting the greater proportion of females that work part time as compared to males, rather than any gender differences per se, overall superannuation coverage for males (at 91 per cent) is slightly higher than for females (at 86 per cent). Nonetheless, growth in female employment accompanied by increases in female superannuation coverage has seen the gender gap in superannuation coverage reduce from 14 percentage points in 1990 to only five percentage points now.

Age differences

Apart from the youngest and oldest employees, there are only relatively minor differences in the coverage rates of employees across the different age groups. See table 1[2].

The relatively low coverage rate for the youngest and oldest employees reflects their largely part time employment status. Moreover, the legislative requirement for superannuation contributions to be

Figure 1: Employee superannuation coverage 1988 - 1996

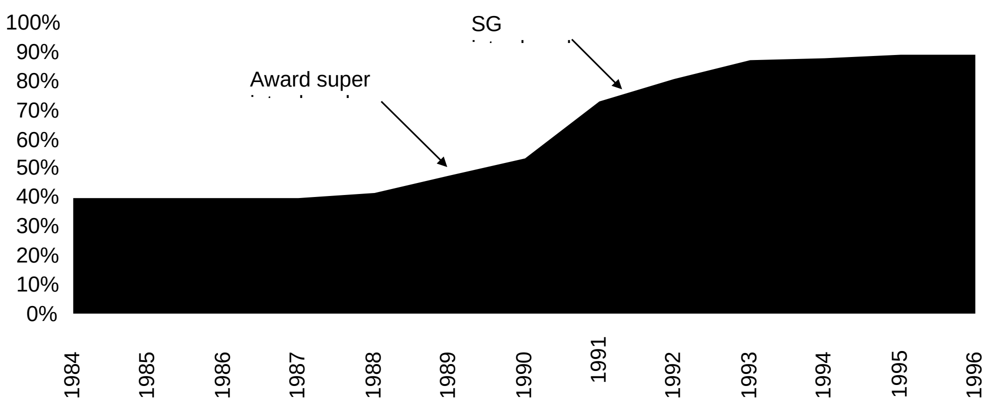


Table 1: Employee superannuation coverage

Age range	Superannuation coverage
15-19	53%
20-24	87%
25-59	93%
60-64	85%
65 and over	53%
All	*89%*

made on behalf of employees currently ceases at age 65. These two groups represent less than 10 per cent of all employees.

In contrast, the 25-59 age range, which have a coverage rate of 93 per cent, represent more than three-quarters of all employees.

Contributions

Around $26 billion (excluding transfers) was contributed into superannuation funds during 1995-96 both by employers on behalf of their employees and by employees themselves. Since previous ISC analysis has suggested that compulsory, or SG, contributions during this time amounted to around $12 billion, the implication is that Australians in aggregate are contributing more than twice the minimum amount necessary under the SG.

While it is most likely that these figures are influenced by the savings behaviour of higher income earners, the figures clearly demonstrate that overall, superannuation is seen as a very attractive long term savings vehicle.

Indeed, other preliminary analysis conducted by the ISC indicates that aggregate contributions in the first half of 1996-97 are 16 per cent higher than they were in the first half of 1995-96. More importantly, the fact that contributions now appear to be growing at a faster rate than superannuation assets overall may suggest renewed interest by Australian workers in their retirement savings.

During 1995-96 employees made around $8 billion of additional 'top up' contributions into superannuation. This is in addition to the $6 billion of 'top up' employer contributions paid on behalf of employees.

This result suggests that overall, employee 'top up' contributions into superannuation are equivalent to around four per cent of salary. This level of employee 'top up' contributions is broadly consistent with employee contribution results published by the ABS. See table 2[3].

As would be expected, the proportion of employees making a 'top up' contribution increases with income, while the level of personal contribution tends to decrease with income. This may be because higher income earners have more access to flexible contribution arrangements such as salary sacrifice.

The level of explicit employee 'top up' contributions may therefore be lower for employees who have access to salary sacrifice arrangements rather than those who do not. This could be because salary sacrifice contributions are made from pre-tax income and are treated as 'deducted' employer contributions (which are taxed at 15 per cent), while 'undeducted' employee contributions are made from after-tax income. Employees on higher marginal tax rates would therefore probably prefer to make any additional contributions through their employer rather than separately.

While the level of 'top up', or voluntary, employee contributions can be expected to be maintained, it is possible that the level of voluntary employer contributions will diminish. For example, where an employer considers that their current contribution level is sufficient, as the level of SG or compulsory contributions rises, the level of voluntary contributions will therefore most likely decrease.

Footnotes.

1. Employment Benefits Australia, ABS No. 6334 Weekly Earnings of Employees Australia, ABS No. 6310 Superannuation Australia, ABS No. 6319 Trade Union Members, ABS No. 5325
2. Trade Union Members, ABS No. 5325
3. Superannuation Australia, ABS No. 6319

Table 2: Employee 'top up' contributions of those aged 45 years and older

Gross weekly wage ($)	Proportion of employees making 'top up' contributions	Level of employee 'top up' contributions	Average 'top up' contribution across all employees
less than 400	32%	7%	2%
400 to 800	58%	5%	3%
more than 800	76%	5%	4%
All employees	*57%*	*6%*	*3%*

Direct marketing of general insurance products

Many general insurance companies have been asking the ISC for its view as to how direct marketing should be handled. In this article we canvass direct marketing of general insurance products from the perspective of the Insurance and Contracts Act. This article also appeared in the Insurance Institute of Australia Journal.

Industry representatives and their legal advisers have, over the last year or so, raised a number of questions about the application of the *Insurance Contracts Act 1984* to the direct marketing of general insurance products.

These questions arise because, unlike the life insurance industry which has a fairly prescriptive disclosure regime, direct marketing for general insurance products is subject only to the provisions of the Act.

What is direct marketing

Even though direct marketing is not defined in the Act, we take it to include such things as sales by mail, telephone, internet, cable television and similar technologies, including direct response advertising and door to door sales.

Crucial elements are that sales are made when the purchaser is not on the seller's premises and the contract may come into effect on the first contact between seller and purchaser. Given the intangible nature of the insurance product, there is a particular need to ensure that policyholders are fully informed of their rights and obligations in these circumstances.

The questions raised reflect concerns about the application of the Act to direct marketing, particularly in the context of sales by phone. The purpose of this article is to provide our understanding of the intention and spirit of the Act as it applies to direct marketing.

Insurance Contracts Act requirements

The *Insurance Contracts Act* deals with communication between insurers and their clients, and the fairness in relation to the insurance contract. It codifies duties of utmost good faith and disclosure.

A number of provisions of the Act provide a framework for the provision of information to intending customers and hence have the potential to impact on direct marketing practices. These provisions include:

- *Section 22* - the duty of disclosure provision requires that insurers inform prospective policyholders in writing of their duty of disclosure before a contract is entered into. If this is not done, the insurer is prohibited from exercising any right in respect of a failure to comply with the duty, unless the failure was fraudulent.

  The insurer's obligations may be met by the use of a form of words prescribed in the Regulations to the Act. Use of these words is not mandatory but the courts have dealt harshly with insurers who do not adequately convey the information required;

- *Section 35* - the Standard Cover provisions ensure that unexpected exclusions or limitations in contracts of domestic general insurance are brought to the attention of policyholders before the contract is made. Insurers whose contracts differ from the prescribed Standard Cover must clearly notify intending customers in writing of the departures from Standard Cover (by providing a plain language copy of the policy or otherwise) unless they are satisfied that a reasonable person in the insured's circumstances would be aware of those departures;

- *Section 37* - which deals with unusual terms and conditions in contracts other than those classes of business to which Standard Cover applies, allows insurers to rely on such provisions only where an intending insured is clearly informed before the contract is entered into of the existence and effect of any such provision;

- *Section 38* - which deals with interim contracts, exempts insurers issuing cover notes from the need to comply with the section 35 and 37 notification requirements. The duty of disclosure requirements continue to apply to interim contracts;

- *Section 69* - allows insurers, where it is not practicable to give notices such as those required by sections 22, 35 and 37 in writing before the contract is made, to provide this information orally and to follow this up with written information within 14 days. The Law Reform Commission report on which the Act is based provides the issue of a cover note over the telephone as an example of the use of section 69.

Key Principles

The scheme of the Act provides for contracts to be made at the time of an initial direct marketing contact, or subsequent to the initial contact, on the basis of the following key principles:

- *Disclosure and misrepresentation* - where an insurer does not clearly tell an insured about their duty of disclosure, the insurer cannot rely on an innocent (as distinct from fraudulent) failure to disclose information on the part of the insured to subsequently avoid or adjust the contract. However, it still has access to remedies where the non-disclosure was fraudulent.

A key direct marketing disclosure and misrepresentation issue is to establish precisely what was said by the insurer and by the insured. This requires the use of properly trained and supervised staff using clearly established and verifiable procedures and underwriting guidelines and a reliable record of representations made by each party.

- *Standard Cover* - insurers may provide cover at the time of the initial contact by relying on the Standard Cover provisions.
- *Cover notes* - the Standard Cover provisions do not apply to cover notes. Thus, insurers may avoid the Standard Cover provisions by issuing a cover note and subsequently (within 14 days) providing full documentation in writing to bring their particular contract into effect;
- *Oral advice* - If clear oral advice of the duty of disclosure is given when a contract is made by telephone, and appropriate documentation is given within the 14 day period as required by section 69, then our view is that, sections 22 and 35 are satisfied.

  If appropriate documentation is not given within the 14 day period then the Act applies as if no written notices were given for the period following the end of the 14 day period until the notices were given. Thus, Standard Cover would apply if the derogation notice was issued late.

The Act clearly envisages traditional 'paper based' transactions. However, it allows insurers to market their products using Standard Cover and interim cover arrangements and by providing information orally in accordance with section 69. It is a matter for individual insurers to determine how best to work within the requirements of the Act in the development of direct marketing arrangements.

Other issues

The following points may also be relevant to the application of the Act to contemporary direct marketing arrangements:

Oral information - the view has been put that it is not open to insurers to rely on section 69 for direct marketing purposes because it may be reasonably practicable to market insurance using more traditional means. While this has not been tested, our view is that section 69 provides a reasonable compromise between the need for written documentation up front and the convenience and commercial efficiency of direct marketing arrangements.

Paperless transactions - sections 22, 35, 37 and 69 refer to information being given in writing, or customers being clearly informed in writing. By section 11(1), *writing* means the English language or another language agreed between the insurer and the insured. By section 25 of the Acts Interpretation Act, *writing* includes any mode of representing or reproducing words, drawings or symbols in a visible form. This would include electronic forms of communication such as the internet.

Duty of disclosure notice - use of the prescribed duty of disclosure notice is not mandatory. It follows that it is not necessary to read this in full for the purposes of section 69 providing that customers are clearly informed of their obligations. That said, we are developing a revised and simplified statutory duty of disclosure notice which better meets contemporary needs. We are also seeking the introduction of a non-mandatory 'oral' duty of disclosure notice.

Review issues - the ISC has considered contemporary direct marketing arrangements in the context of its review of the Act. Our view is that there is no need to amend the Act (beyond providing for a prescribed oral duty of disclosure notice) to further accommodate direct marketing. Introduction of an abbreviated 'oral' duty of disclosure notice will make clear that the policy intention of the Act is to accommodate contemporary telemarketing practices.

Claims Review Panel - General Insurance Claims Review Panel Annual Reports have drawn attention to direct marketing transactions which are not supported by a written record verified by the customer and the resulting difficulties in dispute resolution. We understand their particular concerns to be that proper and verifiable procedures and underwriting guidelines are established and followed.

Sound practice would seem to require that policyholders be provided with a copy of their proposal form for verification, possibly by signature. Where this does not occur, the benefit of any doubt as to what was or was not said at the time of a transaction should favour the policyholder.

General Insurance Code of Practice - there may be scope for a direct marketing guideline to be developed under the General Insurance Code of Practice. In any event, the Code encourages insurers to rely on specific and clearly targeted questions rather than broad or open ended questions that may disadvantage the insured.

Conclusion

The Act provides no significant impediment to the development of direct marketing arrangements for insurance products, whether initiated by an insured, an insurer or an intermediary. It allows contemporary marketing arrangements to operate while providing a balance between insurers' commercial needs and consumers' needs to be properly informed about the duty of disclosure and the key features of the cover involved.

The issues canvassed in this article are not exhaustive but rather are intended to provide an overview of the application of the Act to direct marketing. Where issues of technical or legal interpretation arise, reference should be made to the Act and regulations and legal advice sought where appropriate.

Superannuation survey highlights - December 1996

Main features

- By end December 1996, total superannuation assets had reached $271.3 billion, representing annual growth of 13% or 3.6% during the quarter.
- Contributions this financial year are on track to be around 16% higher than they were in 1995-96.
  - This is in spite of employment growth being subdued and the SG levy remaining unchanged at 6%.
- Total contributions during the quarter were around $7 billion, of which 67% were paid by employers and 33% by employees.
- For the first time in many years, the number of superannuation accounts actually decreased during the quarter (down 130 000 or 0.8%). The decrease was however largely artificial, being primarily due to a number of large superannuation funds 'cleansing' their databases of erroneous account records. There are now 16.1 million accounts.
- Account turnover during the quarter was around 1.9 million (nearly 12% of all accounts). This includes the creation of 915 000 new accounts and the closure of over 1 million old accounts.
- Growth in superannuation fund assets during the December quarter can be disaggregated into net earnings (accounting for 68% of the growth) and net deposits (accounting for the remaining 32% of growth).

Industry structure

Small self-managed (excluded) fund assets grew fastest during the December quarter, increasing by 7% ($1.8 billion). This rate of increase was closely followed by the 6.3% ($1 billion) growth in industry fund assets and the 5.4% ($3.4 billion) growth in retail fund assets. Trailing these market segments, public sector fund assets increased by 4% ($2.7 billion) and corporate fund assets increased by 3.5% ($1.8 billion) during the December quarter.

Public sector funds presently hold nearly 26% ($69.1 billion) of total superannuation assets, retail funds hold 24% ($65.9 billion), corporate funds 20% ($52.8 billion), excluded funds 10% ($27.6 billion), and industry funds 6% ($16.7 billion). The remaining 14% ($39.0 billion) of superannuation assets represent annuity products, fund reserves and unallocated profits of life office statutory funds.

The combined category of annuity products, fund reserves and unallocated profits held in life office statutory funds, fell by around 3% ($1.2 billion). This was the only market segment to record a decrease in assets during the quarter.

Contributions and benefits

During the December quarter, employers contributed $4.6 billion into superannuation while employees contributed $2.2 billion. Inward transfers accounted for 39% of all money deposited into superannuation during the December quarter.

Lump sums, excluding outward transfers, accounted for 79% ($3.5 billion) of the benefits paid during the December quarter. The remaining 21% ($0.9 billion) of benefits were paid as pensions. Outward transfers accounted for 43% of all fund withdrawals during the December quarter.

Contributions into superannuation are now growing at a faster rate than total superannuation assets. Contributions during the first half of 1996-97 were up by 16% compared to the first half of 1995-96, while annual growth of superannuation assets is lower at 13%.

Benefit payments are also growing at a slower rate than contributions. Benefit payments, excluding transfers, for the first half of 1996-97 were up by 13% compared to the first half of 1995-96. The lower growth rate of benefit payments as compared to contributions has had the effect of net contributions (ie., contributions less benefits) being 21% higher for the first half of 1996-97 as compared to 1995-96. In other words, significantly more money is flowing into superannuation than is flowing out.

Manner of investment

The investment style showing the strongest growth is that of direct investment by trustees, which grew 5% by asset value during the quarter. This style of investment is becoming more popular among large and small funds alike. The value of placements with investment managers also grew strongly with 4% growth during the quarter.

In contrast, the value of life policies held by superannuation funds and their members had the slowest growth at only 2%. The life policy growth rate was around half that of the overall industry.

At the end of December 1996 investment managers held 40% ($109.3 billion) of total superannuation assets, with the statutory funds of life offices holding 37% ($101 billion). The remaining 23% ($60.9 billion) of superannuation assets are directly invested.

The proportion of total superannuation assets held in life office statutory funds fell by one percentage point during 1996. Since June 1992 the proportion of total superannuation assets held in life policies has been falling at an average of around 1.5% per annum.

Asset allocation

Superannuation assets invested overseas increased slightly to 16.2% at the end of December. With the TWI increasing by 1.5% during the December quarter (acting to automatically decrease the AUD value of overseas investments), it follows that trustees invested an additional net $3.1 billion overseas during the quarter.

Superannuation investment in equities increased (by 8.2%) during the December quarter. Since the ASX accumulation index rose by 7.5% during the quarter it follows that there was a net flow of around $0.5 billion into the equities markets by superannuation funds. As a result of this increase, superannuation equity holdings now account for 28% of total superannuation assets.

Holdings of long term debt securities decreased by 4.9% ($2.2 billion) during the December quarter, despite long term bond yields falling from 7.8% to 7.4% during the quarter. As a result, the proportion of superannuation assets held as long term debt securities has dropped to 17%.

Holdings in short term debt securities rose by 3.9% ($0.8 billion) during the December quarter, reflecting the fall in short term yields from 6.9% to 6.0%. The proportion of superannuation assets held as short term debt securities remains at 9%.

These movements would appear to indicate that during the December quarter superannuation funds were net purchasers of Australian equities and overseas assets. In contrast, they were net sellers of long term debt securities. This result reverses the trend of previous quarters, when superannuation funds were net sellers of Australian equities and net purchasers of long term debt securities, perhaps suggesting that trustees and investment managers expect that the interest rate cycle has bottomed.

The proportion of superannuation assets invested in cash, deposits and placements remained steady (at 9%), as did assets held as direct property (at 6%). Unit trust holdings increased to 10%. Other investments account for around 4% of total superannuation savings.