APRA

Australian Prudential Regulation Authority

Insurance and Superannuation Bulletin

September 1997

WTO agreement on financial services

World Trade Organisation (WTO) negotiations on Financial Services which were concluded in Geneva on 12 December 1997 has resulted in a landmark agreement covering more than 95 per cent of world trade in banking, insurance, securities and financial information. In all, 102 members of the WTO now have multilateral commitments in this sector.

The WTO is an inter-governmental organisation created in 1995 as the successor to the General Agreement on Tariffs and Trade (GATT) organisation. It is the only international agency overseeing the rules of international trade. Since its creation, the WTO has been the forum for successful negotiations to open global markets in telecommunications and in information technology equipment. Financial Services can now be added to that list.

Announcing the new agreement the Deputy Prime Minister and Minister for Trade, Mr Fischer, said the new trade agreement on global financial services was 'a victory for Australian businesses and a victory for Australian trade policy'.

'This WTO agreement will mean the Australian financial sector will be able to invest more easily, with more confidence and more security in the Asia-Pacific region and across the world,' Mr Fischer noted.

The signatories to this historical agreement will have until January 1999 to ratify their commitments and must implement the measures by March of that same year. The outcome reached in Geneva is also important in terms of achieving future liberalisation, particularly in the WTO negotiations on services commencing in the year 2000.

Particularly pleasing from an Australian perspective was the positive attitude towards liberalisation adopted by our neighbour countries in the Asia-Pacific region. At a time of considerable financial, and in some cases political, turmoil these countries were nonetheless prepared to make significant offers to improve access to their financial sectors. This reflects both the recognised importance of free trade flows worldwide and the understanding that the only long term solution to re-establishing stability in the region is through further liberalisation of financial markets.

Two brief examples serve to demonstrate the approach taken by the Asia-Pacific countries:

- Malaysia is to allow foreign owned insurance companies to hold aggregate shareholdings of up to 51 per cent in domestic companies - an offer which would guarantee continued investment by Australian companies including QBE. New provisions allowing foreign participation in a range of financial activities and the granting of additional re-insurance licences also formed part of the Malaysian commitment.

- Similarly, in Indonesia (where both AMP and ANZ are major investors) overseas companies now have guarantees that respect current conditions of ownership and permission to take up to 100 per cent equity in publicly listed insurance and other non-bank financial institutions.

Australia has played a key role over many years in securing the successful outcome of these negotiations. It is a generally held view that the Prime Minister's announcement of Australia's strengthened WTO offer at the APEC conference in Vancouver provided impetus for other nations to seek a positive outcome in Geneva.

The Australian offer reflected the very open nature of the Australian market for financial services but was conditional on our key trading partners, both developed and developing, undertaking significant liberalisation in the negotiations. This set the scene for other WTO members to think seriously about their offers.

The Government believes international competition acts as a catalyst to lowering the cost and increasing the range of financial products and services available to those seeking to do business in Australia without sacrificing the integrity or stability of the Australian financial system.

The WTO agreement complements the Government's recent decisions, flowing from the Wallis Inquiry, regarding the reform of the financial sector. Australia will have a more stable, more competitive and more efficient financial system that will not only be positioned to compete strongly in the global economy, but will result in lower costs and an increased range of products and services on offer for those seeking to do business in Australia or to use Australia as a focal point for regional activities.

These initiatives will ensure Australia's financial system provides the best possible foundation for the continued development and growth of the economy and will put Australian institutions in a sound position to take maximum advantage of the improved international market opportunities flowing from the WTO agreement.

ISC supports Australian Investment Performance Measurement and Presentation Standards (AIPMPS)

The AIMPS have now been published in their final form ready for the commencement date of 1 January 1998. These important standards establish a common methodology for measuring and presenting investment performance in the wholesale marketplace and have been developed by an industry working party after extensive consultation and review.

The ISC has maintained a close interest in the development of the standards throughout and congratulates all involved in attaining this landmark. As well as the significant work put in by the industry, the ISC is also supportive of the self regulatory approach which has been adopted. While the standards themselves are fairly technical, the progress so far illustrates how a self regulatory approach can be developed even in such a complex area.

The existence of the standards should greatly assist users of performance information, particularly trustees of superannuation funds. A common basis for the preparation and presentation of results means that the usefullness of the information can be maximised and made more effective.

Whilst not mandatory, the existence of the standards means that trustees will be able to ascertain whether they are being provided with information in accordance with the standards and, if not, can be aware of the risk that they will be less able to compare investment managers who are not reporting using the standards than those that do.

The ISC looks forward to following the progress of the standards and their implementation.

The four pillars supporting the insurance sector

International Monetary Fund (IMF) in a 1996 publication 'Bank Soundness and Macroeconomic Policy', outlined four principles that help determine safety and stability in the financial system. While the IMF authors, Carl-Johan Lindgren, Gillian Garcia and Matthew I Saal had banking in mind, the IAIS considers that these principles have a wider application to the insurance sector.

Each country is concerned to have (among other things) a safe and stable insurance sector, to protect policyholder interests in particular and to avert financial instability more generally. At the same time, governments are keen to ensure that arrangements put in place to provide safety and stability in the financial sector also promote competition, efficiency and innovation.

An effective framework for a sound and efficient insurance sector has four pillars: internal governance, market discipline, prudential regulation and international coordination. These four pillars should be regarded as complements rather than substitutes, as mutually reinforcing rather than mutually inconsistent.

1. Internal governance

An insurance company practises good internal governance when its conduct is prudent, open, honest and fair. Companies should have internal structures and processes in place to demonstrate that the commitment to corporate governance, and the certification of compliance, are occurring at the highest levels.

Internal governance is essential to public confidence in the insurance sector, because the soundness of an insurance company is first and foremost the responsibility of its owners, directors and senior managers. Insurance companies should have in place a system of internal standards and controls to manage risk and encourage prudence in the conduct of the business. There should be mechanisms for checking and certifying compliance with the standards and controls.

When an insurance company gets into trouble, and possibly fails, the cause can generally be traced to lax management, or in other words, poor internal governance.

Insurance is a long-term business, and an insurance company's owners, directors and senior managers are responsible for capitalising the business with sufficient resources to meet commitments, absorb shocks and remain viable. Each company needs to ensure that its directors and senior managers are competent and ethical, are motivated to run the business efficiently and prudently, and are encouraged to keep the company in a profitable, liquid and solvent condition.

Directors and senior managers should be made aware that failure to practise good corporate governance will expose them to the risk of losing control of the business through bankruptcy, takeover or official intervention.

Lax management in an insurance company can take the form of incompetence, negligence or fraud. Internal pitfalls are less likely if companies have effective policies and procedures for monitoring and controlling risks, and checking and certifying compliance. Internal controls would include measures such as: 'fit and proper' tests for directors and senior managers; techniques for measuring and limiting exposures; and arrangements for internal and external auditing.

Good internal governance is more likely to occur when companies are also subject to strong market discipline.

2. Market discipline

Market discipline can provide an incentive for directors and senior managers to not merely pay lip service to good corporate governance, but to actively practise and promote it.

In a competitive insurance market, consumers, creditors and analysts can reinforce the incentives companies have to operate safely and soundly by monitoring performance, exerting discipline and, as a final step, forcing poorly managed or unsound insurers out of the market.

However, market discipline cannot work as an effective means of keeping companies prudent in their business conduct if insufficient information is available to market participants, or if there is a widespread perception that the Government will always bail out an insurer which runs into serious trouble.

Disclosure of timely, comprehensive and clear information about an insurance company's products, prices, profits and financial soundness is essential if market discipline is to be effective. While individual consumers may not be well equipped to monitor companies on the basis of published financial statements, creditors, analysts and competitors will be able

and keen to use the information to rate companies, and these assessments will in turn feed into the company's reputation and standing in the marketplace.

Market discipline can also fail if investor compensation schemes are excessively generous, since companies are less risk averse, and customers and creditors are less vigilant, where there is a perception that troubled companies will be rescued by the authorities or losses will be recouped from the government. Failing companies should be allowed to exit in an orderly manner without any guarantee that policyholder losses will be fully compensated; otherwise there is a perverse incentive for poor internal governance. Shareholders should, of course, bear the losses.

While good internal governance and strong market discipline go a long way towards encouraging efficiency and soundness, most countries consider that official regulatory and supervisory oversight of the insurance sector is also necessary to protect policyholders and maintain public confidence.

3. Prudential regulation

Prudential regulation of insurance by the official supervisor is not a panacea; but it can be an effective means of limiting the risk exposures of companies, and encouraging proper and prudent management of those risks. However, prudential regulation should be designed so as to avoid being anti-competitive or commercially intrusive.

For example, entry barriers created in the insurance sector for prudential purposes should not be so high as to unduly limit competition and protect large companies. Restricting competition in this way rarely improves soundness, since lax and lazy managements thrive in protected environments.

Prudential regulation can provide assurance that directors and senior managers are competent and ethical, that adequate risk management systems are in place, and that compliance with the standards is monitored and certified at the highest levels. Further to this, prudential regulation results in the preparation and publication of additional information which can be used by the market (as well as the regulator) to discipline under-performing companies.

The role of prudential regulation in supporting internal governance is to require and check that companies institute adequate internal control policies and procedures, and that senior managers are familiar with and responsible for the risk assessment and management process. While the fine detail of internal control can be left to insurers' own discretion, it is essential that accounting and auditing standards are adequate in enabling senior managers to detect and remedy weaknesses, and that regulators conduct on-site inspections to satisfy themselves about the quality of the company's management and systems.

Finally, globlization and technology have in recent years created new dangers for financial consumers and new threats to financial stability. Responding to this requires an unprecedented degree of international cooperation and coordination among financial regulators, including insurance regulators.

4. International Coordination

Insurance groups are increasingly operating in multiple jurisdictions. This raises the spectre of regulatory arbitrage by companies seeking bottom level standards, and of the potentially rapid transmission of shocks in crisis situations.

There are no international laws governing insurance, and country based regulation inevitably results in inter-country differences in accounting standards, in exit procedures, and in supervisory rules generally. Therefore, harmonisation of standards is desirable if international financial stability is to be protected from the threats posed by weak jurisdictions with lax supervision.

Reinforcement of market discipline at the international level has come chiefly in the area of information disclosure. Improved disclosure standards and additional information on the condition of individual insurance companies would better permit market participants to assess their financial soundness, paving the way for improved market discipline.

It is notable that there are no international agreements on closure standards for failing financial institutions. As a result, the resolution of a failed insurance group operating in several jurisdictions could be a fragmented and contentious process. Thus, exit policy as an adjunct to market discipline functions only at the national level, with international cooperation essentially occurring only on an ad hoc basis.

While international standards are generally desirable, there are some practical limitations to full regulatory harmonisation. In particular, countries with high economic volatility and

permissive accounting conventions may be better served by stricter regulatory standards than are prescribed by international minimums. Also, arrangements for investor compensation (the official safety net) will vary from country to country.

International coordination is not yet sufficiently developed to offset these differences in economic conditions and regulatory environments across jurisdictions. Nonetheless, there is much value to be gained in the identification and dissemination of best practices in insurance regulation, and even more so in the practical application of such international standards to create a sound insurance sector in each of the various jurisdictions.

The International Association of Insurance Supervisors (IAIS) is in the process of developing prudential standards for insurance supervision. The standards would take the form of principles or guidelines of best practice that insurance supervisors and regulators could choose to adopt and apply as they see fit in their different jurisdictions. The standards would not be black letter law: they would not be compulsory, but there would be market pressures for their application around the world. The existence of IAIS standards would encourage regulators that have regulations falling short of the IAIS standards to improve the quality of their regulations and supervision. Improved prudential regulation internationally would help strengthen the global financial system.

Y2K - the millenium bug and superannuation

The year 2000 is rapidly approaching and the ISC is concerned many superannuation funds and insurance companies may not be adequately prepared to manage the millenium computer bug. This article contains the main features of an ISC guidance note that was recently released to super funds advising them of their responsibilities about this issue.

The main issue regarding the Y2K problem - the millenium bug - is to ensure that your fund's or company's computers can accurately record, manipulate and interpret data and produce accurate outputs from the Year 2000 onwards. Many computer systems, especially older ones and new systems dependent on older or legacy systems, will need their program logic to be modified. Normal business operations could be significantly disrupted. An additional complication is to provide for 2000 being a leap year.

Trustees and funds which rely on vendors for many applications may need to replace their hardware and operating systems in addition to upgrading their software. This is because software upgrades which are Year 2000 compliant may not run on old hardware, or may run but with significantly adverse implications for achieving agreed service standards.

The ISC's primary concern is protecting the interests of members from suffering any detriment due to any deficiencies in resolving Year 2000 issues. As such, the ISC considers it is critically important to have all systems which will affect fund members to be ready and tested well before the Year 2000 (ideally by the end of 1998). Examples of these include accounting systems, administration systems, investment systems and systems for communicating with members.

Dependencies on, or links with, external parties are also important when considering Year 2000 issues. These external parties include employer sponsors who may communicate electronically with the trustee or administrator, custodians, administrators, investment managers, mailing houses and employer sponsors. Should any of these external parties have significant problems dealing with Year 2000 issues it could have flow on effects to the superannuation fund. Where funds rely upon information conveyed electronically from such sources they should insist on written assurances being provided by the party responsible. Trustees should expect external service providers to have undertaken a 'computer audit' to assure themselves that their systems are Year 2000 compliant and compatible with those of their customers. The issue of compatibility of solutions is critical to ensure that the approach adopted to resolve identified issues will ultimately work in respect of the fund.

The Year 2000 issue will affect more than just major computer systems. Problems may also arise with applications such as spreadsheets written and maintained by individuals within the trustee or administrator. In addition, non-IT systems such as security systems and communication networks (utilising embedded chips) could have trouble coping with the Year 2000. Notwithstanding appropriate forward planning and strategies to resolve this issue it is also vital that disaster recovery programs are updated to deal with any contingencies which might arise.

The scarcity of technical resources is an important issue when estimating the timing of preparations for and the cost of the Year 2000 problem. As the Year 2000 draws closer this will become an increasing problem with the potential to cause costs to increase significantly.

It is also extremely important to allow adequate time for testing and re-testing programs. Every system component which is made compliant has to be tested alone and in interaction with all other system components. Tests of interaction with external parties have to be coordinated. Due to the need for ongoing operations of the fund and external parties, the time available for testing may be restricted to weekends. Interrelated applications have to be coordinated as to when they go into production.

Finally, while appropriate legal safeguards should be incorporated in agreements with external service providers, *anticipation and prevention* of problems rather than settlement of disputes, should be the focus of trustees' attention.

Action plan

In its paper titled "The Year 2000 - A Challenge for Financial Institutions and Bank Supervisors" the Basle Committee on Banking Supervision outlines the steps institutions need to follow to resolve the Year 2000 problem.

Although the focus of the Basle paper is on the banking industry, the ISC believes the main recommendations of the paper can be applied to the superannuation industry through the following six steps:

1. Developing a strategic approach

This phase includes establishing Year 2000 as a strategic objective at the highest level within the organisation, developing a process to communicate the strategic objective throughout the organisation, and assessing the resource implications of the Year 2000 at a very high level.

Organisations should now be well past this phase in addressing issues. This phase should have entailed the development of a proper business plan for this problem - some possible stepping stones which could be used in such a plan are:

- Prepare a strategic plan to underpin Year 2000 activities on a 'whole of group' basis for the critical period ahead. The plan should include a full risk analysis, key objectives and milestones, performance measures and desired outcomes, and acquital of performance against the plan in the annual report/ accounts
- Develop a model to reliably and accurately estimate Year 2000 costs
- Examine guidelines which already exist and which can be used to assist with the management of purchase risks arising from common use and unique supplier arrangements for IT and non-IT goods and services
- Seek written assurances about Year 2000 compliance from suppliers
- Document the Year 2000 assessment and planning activity to allow an assessment of the appropriateness and sufficiency of the approach from a whole-of-business perspective
- Establish appropriate mechanisms to ensure governance of the Year 2000 activities and to provide appropriate assurances to stakeholders in relation to the business implications of the Year 2000 problem. This should include assurances about the use of resources, efficient operations, financial integrity and validity, compliance with legislation, accountability to members and other stakeholders
- As part of an overall risk management approach, develop and document a strategy for the management of Year 2000 risks that incorporates an analysis of the operating, compliance and external environment which are potentially affected by the Year 2000 problem, the identification of possible sources of risk, an assessment and ranking of risks, options for the treatment of identified risks, and measures to monitor and review identified risks.
- Review the Year 2000 project management and take remedial action to ensure the project is governed by clear and achievable milestones which are regularly reviewed, all staff responsible for aspects of the Year 2000 project operate within clear authorities and lines of accountability, and the project has top level commitment, including for adequate resources and strategic direction.

2. Creating organisational awareness

Making certain that the strategic importance of the Year 2000 project as a business objective is understood and appreciated throughout the organisation may be the most important phase in the action plan. The recognition that this may be a survival issue, requires not only a visible commitment from top management for its successful resolution as a strategic priority, but also an awareness of its importance by staff at all levels. Line management needs to understand the issue and its implications and accept ownership of the issue. Responsibilities should be clearly assigned. This phase has four objectives: creating visibility; ensuring commitment; identifying resources; and specifying specific strategic objectives at a business line level. Organisations should also be past this phase now in their Year 2000 project.

3. Assessing and developing detailed plans

This phase moves from project concept to concrete actions. Detailed inventories of what must be done are developed, covering centralised and decentralised hardware, software, and networks as well as equipment embedded with computer chips and logic. The inventories should include all aspects of business line activities whether internal to the organisation or external to it. Risks should be quantified and priorities set based on these risks.

Organisations are expected to have completed this phase or be very close to completing it by now otherwise they are unlikely to meet the ultimate deadlines.

4. Systems, applications and equipment

During this phase, the necessary fixing of operating systems, applications, hardware and equipment takes place. The development of contingency plans that identify alternative approaches if renovations lag or fail is an important part of this phase.

Organisations should be well into this phase at this time. Renovation work for significant applications that need to be tested with third parties must be completed with enough time to allow for thorough testing. Completion of this high priority work should be targeted for mid-1998. Typically all renovation work would be targeted to be completed no later than the end of 1998.

5. Validating the renovations

Testing represents the largest single task in the Year 2000 project. Detailed test schedules must be developed and coordinated with third parties. Data flows, internally and with third parties must be thoroughly tested while both the sender and receiver simulate Year 2000 conditions.

At least for larger institutions and all significant applications, the validation phase should be targeted for completion by the end of 1998. All validation work should be completed by mid-1999. Only with this schedule will there be sufficient time for industry wide testing with all third parties during 1999.

6. Implementing tested, compliant systems.

Implementation requires careful planning to make sure that interrelated applications are coordinated as to when they go into production. This implementation phase also requires monitoring of progress by service providers and vendors.

Industry questionnaire

In July 1997 the ISC sent a questionnaire on Year 2000 computer issues to all administrators who look after 100 or more funds (about 200 administrators in number) plus all Approved Trustees (about 180 in number). From the mailout the Commission received 142 responses.

The responses were split into two groups. The first group are the smaller agencies comprising the small to medium superannuation funds, accountancy practices, administrators and credit unions. The second group comprises larger superannuation funds, banks and key administrators.

Smaller organisations

There were 67 responses placed in this category. Despite the questionnaire specifically asking for further details by way of attachment these responses were typically just the return of the questionnaire without detailed covering letters or any attachments. A minority provided a covering letter and only 3 included a detailed attachment. Only 24 of the 67 respondents stated that they had undertaken a formal review of their IT systems. Another 21 state they plan to during 1997 or 1998 (with one as late as 1999).

The remaining respondents are not planning an assessment or are leaving this assessment solely in the hands of external providers.

Those organisations that have undertaken an assessment of the impact have typically completed this assessment in late 97 and expect to resolve any issues discovered in the review by on average mid 1998. On average those organisations who had not undertaken an assessment of their systems planned to do so in the next 12 months.

Other information from the survey suggest that these organisations are currently unable to identify the expense associated with making their systems Year 2000 compliant. Many respondents left this question blank. Some of the accountancy partnerships mentioned they will be upgrading their hardware and software prior to 2000 and thus these expenses will be absorbed by their general IT budget.

Larger organisations

There were 70 responses listed in this category. 48 respondents stated they had completed or are currently undertaking a formal review of their IT systems and a further 18 provided a date stating when they would start. 28 of the respondents provided detailed attachments while others provided brief comments in either a covering letter or on the questionnaire. Generally speaking this group of larger respondents provided a far superior detailed response to the smaller respondents. The large banks and insurance companies who replied to the survey typically have a dedicated Year 2000 team reporting to management on a regular basis. Budgets for solving the Year 2000 problem range from no budget to $250 million.

Findings

It would appear from the survey results that many organisations in the superannuation industry are not taking the Year 2000 issue seriously. Many of the questionnaires contain blanks. Many respondents when given the opportunity to expand their answer in an attachment did not do so. A number of organisations seem to be ignoring the problem and the low response rate to the survey is not encouraging. Interestingly two of the smaller agencies claim to have assessed their systems as early as 1994 when there was scant information on this problem.

Some of the agencies both small and large will need to clarify their target dates for reaching year 2000 compliance. Some dates for rectification were quoted as late 1999 or even the year 2000 itself. This is too late as computing resources are expected to be in short supply at this time. Additionally, the nature of superannuation may require rectification prior to 2000. For example benefit quotations may be issued 12 months before a member's exit date in 2000.

Conclusion

Despite wide spread media coverage of the year 2000 issue the poor response to the Commission's questionnaire suggests many participants in the superannuation industry are not taking this issue seriously enough. It would appear small to medium organisations in particular are not addressing this issue in a proactive manner and are preferring to wait and see what happens closer to the date. This is neither acceptable nor a proper demonstration of trustee responsibilities.

Infrastructure investment

One of the strongest growing asset classes for superannuation funds is infrastructure investment. In this article we provide a recent snapshot of this important investment class.

According to a survey recently published in Super Review magazine the Australian and New Zealand infrastructure investment management market now totals A$5.3 billion.

This infrastructure investment represents around two per cent of super assets compared to an ASFA estimate of around five per cent, and an AIMA estimate for the end of December 1996 of 0.3 per cent. Determining the levels of infrastructure investment is complicated however by the difficulties investment managers' accounting systems have in differentiating specific infrastructure equity and debt investments from other more traditional equity and debt investments.

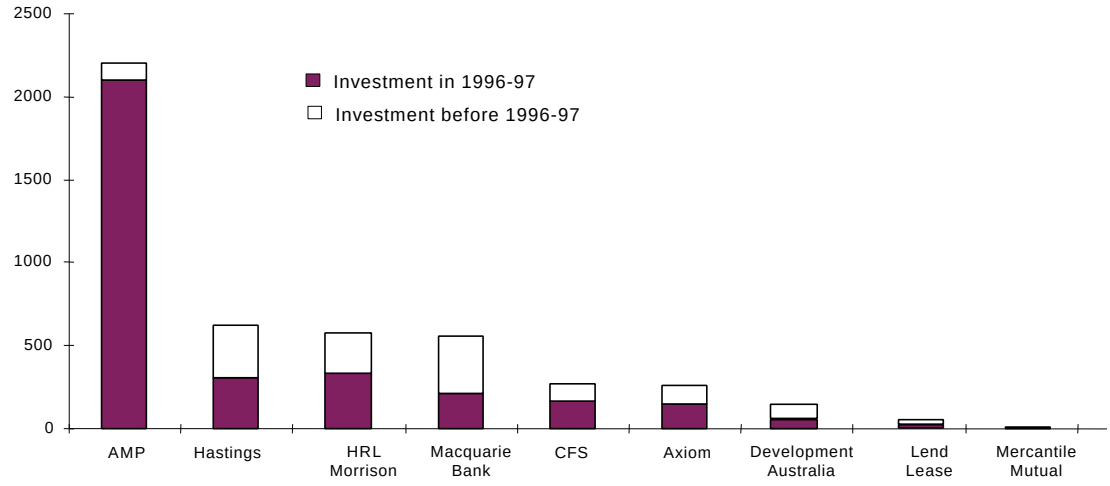
The infrastructure investment market is extremely concentrated as the largest manager is responsible for nearly half of this total infrastructure investment with $2.2 billion invested in infrastructure. See figure 1. In 1996-97 infrastructure investment experienced rapid growth increasing by $1.5 billion or 39 per cent, nearly twice as fast as the overall superannuation industry.

Infrastructure investment is becoming more attractive to superannuation fund trustees and other investors. For example, most infrastructure investment managers experienced growth in assets under management of around 100 per cent. Emphasising this trend some institutions have reported making significant provision for further infrastructure investment as opportunities arise.

Most infrastructure investment is made via equity investment. The value of infrastructure equity is $3.6 billion (68 per cent of total investment) compared with only $1.6 billion invested in infrastructure debt. Some equity investment is in the form of direct investment in infrastructure projects. Many investment institutions limit themselves to providing less than 50 per cent of the investment capital in any particular infrastructure project.

All companies prefer to invest predominantly in infrastructure projects in local markets, however infrastructure investments have also been made in New Zealand and Asia.

Figure 1: Infrastructure investment by investment managers



Source: Super Review September 1997.

Using investment managers - the US experience

While comparisons between the use of investment managers by Australian superannuation funds and their US equivalents (pension funds) are influenced by the large differences in both the size and maturity of their respective investment management markets, the US experience may nonetheless provide some possible directions for the Australian industry.

The manner in which superannuation fund trustees approach the investment of their fund's assets and the relationship that they build with their investment manager(s) has an important bearing upon the investment returns achieved by the fund. Recent surveys conducted in Australia by the Association of Superannuation of Australia (ASFA) on fund investment patterns[1] and in United States (US) by Pensionforum[2] have focused on this trustee/investment manager relationship. This article analyses some of the major findings of these two surveys.

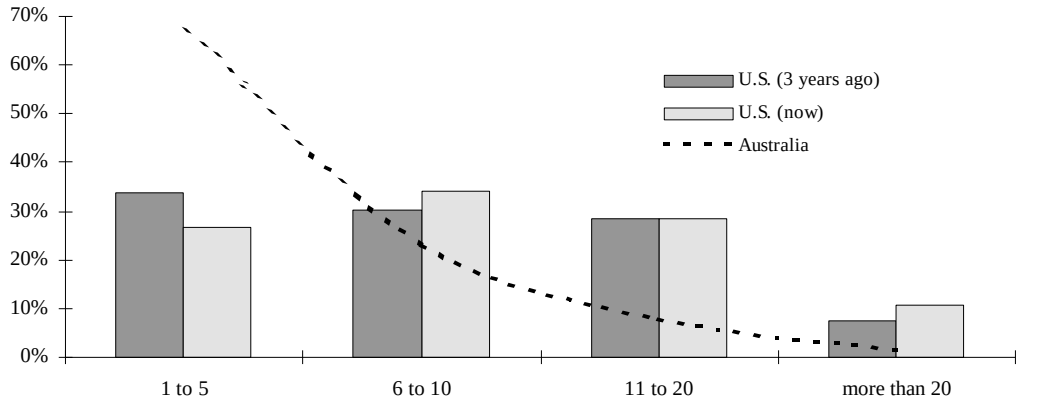
US pension funds on average use around twice the number of investment managers used by Australian superannuation funds, at around 10 and five investment managers respectively. Moreover over two thirds of Australian super funds use between one and five managers, compared to around 27 per cent of US pension funds.

This result most likely reflects the greater average size of the US pension funds, which leads in turn to improved access to wholesale investment management markets and greater ability to diversify among managers. In fact, use of investment managers by Australian funds varies dramatically with the level of assets under management (AUM). For example, Australian funds with less than $70 million AUM on average use around three investment managers, compared to funds with more than $70 million AUM who on average use around seven managers.

However, perhaps of more interest to the Australian industry is that over the last three years US pension funds have been increasing the number of investment managers that they use. During this time more pension funds shifted to using more than five investment managers, with the result that the average number of investment managers has increased from nine to ten. See figure 1.

This trend for US pension funds shows no sign of abating in the near future, as twice as many funds indicated that they intend to increase the number of investment managers they use than funds that indicated they intend to reduce the number. For example, 30 per cent of US funds indicated they intend increasing their number of investment managers by the year 2000 while only 15 per cent indicated that they intended reducing the number. This result clearly

Figure 1: Use of investment managers



Source: ASFA Investment Patterns survey, July 1997 (Australia)
Pensionforum, Institutional Investor, October 1997 (US)

1. ASFA Research and Statistics committee Investment Patterns survey, July 1997.

2. Pension forum results published in *Institutional Investor*, October 1997.

indicates a strong and increasing preference by US pension funds for having a number of specialist investment managers, for example a specialist equity manager, a specialist fixed interest manger and so on, in preference to a 'macromanager'.

A macromanager is a single large investment manager who provides investment management services across a range of asset classes. Funds taking the macromanager approach may be able to achieve lower investment management fees and improved service, however the macromanager may not have as high expertise as specialist managers across all the asset classes that it offers.

Manager review and monitoring

Regardless of the approach taken by the fund, there is constant pressure on investment managers to perform. Reflecting these market pressures, over each of the past two years nearly 50 per cent of US pension funds have terminated at least one of their investment manager contracts.

In Australia as well, investment managers are closely monitored by their superannuation fund clients, with 58 per cent of super funds indicating that they monitor their managers constantly. Issues of special interest to superannuation funds include poor performance during a reporting period or a significant shift in staff away from an investment manager.

Defined benefit funds tend to review their investment managers less than frequently than accumulation funds. For example defined benefit fund often review their investment managers review their managers at the same time as they have their actuarial review (usually every three years).

Once a new investment manager has been appointed, over 75 per cent of Australian funds indicated that they would have reviewed the new manager's performance within 12 months, with this figure rising to 98 per cent within two years.

The vast majority of Australian super funds (around 80 per cent) measure the performance of their investment manager against an individual preset benchmark. Other performance measures used by funds include comparisons with other investment mangers (used by 58 per cent of funds) and comparison with CPI plus some variable percentage return (used by 33 per cent of funds).

While poor performance will most likely lead to a contract with an investment manager being terminated, it is not the sole reason funds use when deciding to terminate a manager. While poor performance accounted for some 57 per cent of contract terminations by US funds, other significant reasons included a realignment of asset allocation by the fund, a change in ownership of the manager and a change in portfolio management talent (staff) at the manager. See table 1.

Allocating investment returns

Once the investment managers have produced an overall return for a super fund, it is then a matter for the fund trustees to determine the investment return to be credited to each member. Funds may credit the full return to members, or else may use the actual return to calculate a crediting rate taking into account the funds' averaging or reserving strategy. These strategies are used by funds to smooth the returns credited to members, by reducing the fluctuations between high and low performing years.

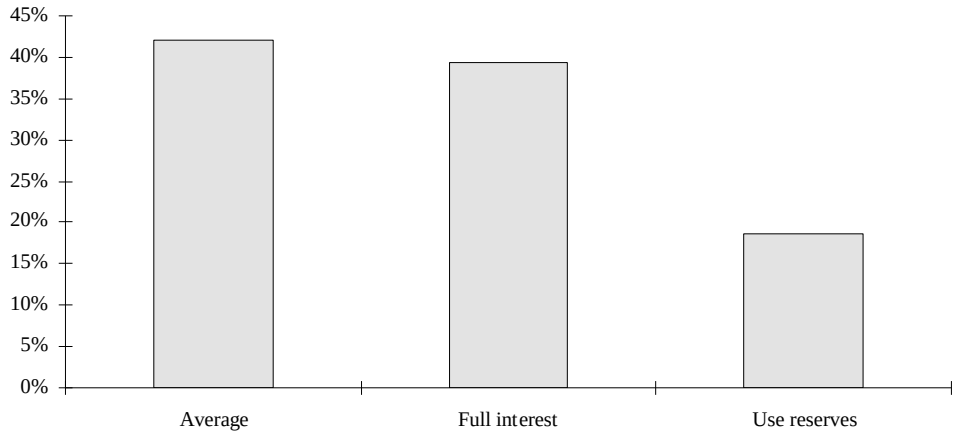
Table 1: Reasons for terminating investment manager contracts

Termination reason	Proportion of terminations
Poor performance	57%
Realignment of asset allocation	18%
Change in portfolio management talent	11%
Change in ownership at manager	7%
Other	7%

Source: Pensionforum, Institutional Investor, October 1997

Around 61 per cent of large Australian super funds utilise some form of averaging or reserving strategy when determining the crediting rate to apply to their members. See figure 2. These funds tend to be predominantly defined benefit and combination (funds with both defined benefit and accumulation elements.) The majority of funds (55 per cent) that use averaging methods do so over three years, however some funds indicate they average over five years.

Figure 2: Method of determining the fund's crediting rate



Source: ASFA Investment Patterns survey, July 1997

Focus on corporate superannuation

After the introduction of the SIS legislation it appeared that many corporate funds reviewed their overall position in the market and took the opportunity to restructure. In this article we profile the corporate superannuation market and examine the important consolidation trends that the sector is experiencing.

Corporate superannuation funds are funds sponsored by a single non-government employer or group of related employers. Corporate funds, usually being standard employer-sponsored funds, are legal entities in their own right. This is in contrast to employer sponsored superannuation arrangements that make use of mastertrusts. In these cases each employer arrangement usually operates as a sub-fund within the mastertrust, while the mastertrust itself is considered to be a retail fund.

Traditionally, employers established corporate funds as a means of providing additional benefits (and 'golden handcuffs') to selected employees and as a means of differentiating themselves from other employers in the labour marketplace.

However, the advent of award superannuation, followed by the introduction of the superannuation guarantee (SG) has made superannuation a standard entitlement for virtually all workers. This has led many employers to reconsider the commercial costs and benefits of providing employees with superannuation over and above the compulsory minimum.

After the introduction of the SIS legislation it appeared that many corporate funds had reviewed their overall position in the market and taken the opportunity to restructure. This process is likely to accelerate with the introduction of member choice of fund. Nonetheless, for a number of employers the provision of quite generous superannuation benefits remains an integral part of their overall remuneration packaging strategy.

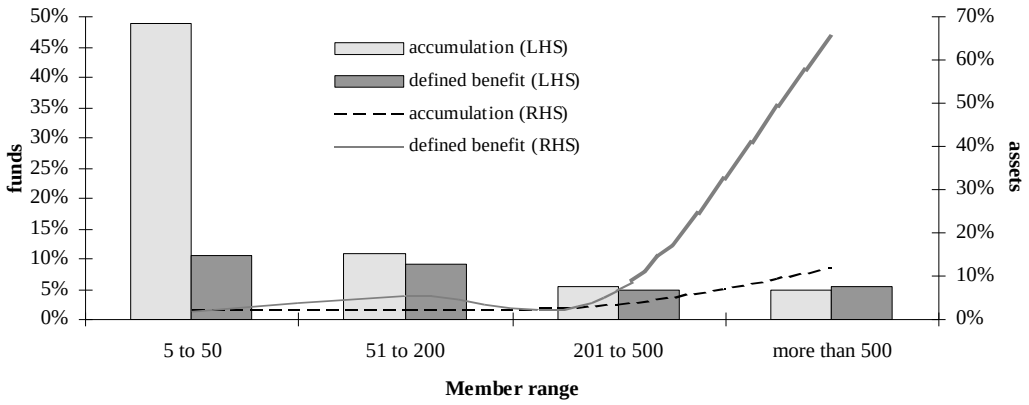
Corporate fund profile

Corporate funds are by far the most common type of large superannuation fund, representing around 85 per cent of all non-excluded funds; accounting for over $63 billion, or 24 per cent of all superannuation fund assets, at June 1997 and of all superannuation accounts. Previous analysis published by the ISC indicates that around three per cent of private sector businesses employing more than five employees operate their own superannuation fund.

The most recent census of corporate superannuation funds available is that provided by the 1995-96 ISC Annual Returns. The following profiles are based upon an analysis of that information.

At June 1996 there were around 4 670 corporate superannuation funds, managing over $55 billion on behalf of their members. Concentration in the corporate funds is not as

Figure 1: Corporate superannuation fund profile 1995-96



pronounced as for superannuation funds as a whole. The majority of funds (around 60 per cent) are in the five to 50 accounts range and the majority of assets (77 per cent) are with funds in the 500 and above accounts range. Even though the majority of corporate funds (70 per cent) are accumulation funds, the majority of corporate fund assets (79 per cent) are managed as defined benefit funds[1] See Figure 1.

Corporate accumulation funds have significantly different per account profiles compared to corporate defined benefit funds. For example, on average, defined benefit fund assets per account and expenses per account are around twice their accumulation fund equivalents within each member range[2]. The level of expenses per account also falls as membership grows for both accumulation and defined benefit funds, most likely reflecting the economies of scale available to funds with larger memberships. Anecdotal evidence suggests the greater level of assets per account experienced by both accumulation and defined benefit funds with the smallest membership most likely reflects the corporate executive schemes that are contained in this category. See Table 1.

Table 1: Corporate fund assets and expenses 1995-96

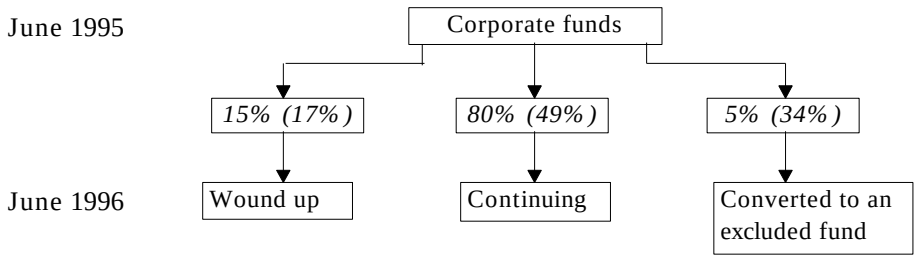
	Assets per account ($)		Expenses per account ($pa)	
Account range	Accumulation	Defined benefit	Accumulation	Defined benefit
5 to 50	50,771	116,562	340	996
51 to 200	26,465	65,760	249	518
201 to 500	24,045	53,329	197	365
more than 500	13,210	57,177	85	250
Overall	*17,073*	*58,111*	*122*	*287*

In terms of asset size, only four per cent of corporate funds have more than $50 million assets under management (AUM), with these funds managing around 68 per cent of corporate sector assets. The vast majority of corporate funds (85 per cent) have less than $10 million AUM, including the 49 per cent (around 2 290) of corporate funds that have less than $1 million AUM. These smallest funds collectively manage less than $1 billion (around one per cent) of all corporate sector assets.

Consolidation trends

During 1995-96 around 15 per cent of corporate funds wound up, a rate only slightly below the 1994-95 wind up rate of 17 per cent. While during 1994-95, many continuing funds undertook significant restructuring as a result of the introduction of the SIS legislation, often splitting into a number of excluded funds, in 1995-96 the incidence of restructuring was significantly reduced. See figure 2.

Figure 2: Corporate sector dynamics 1995-96 (1994-95)



1. Defined benefit funds and combination funds (ie. funds containing both accumulation and defined benefit elements) are jointly described as defined benefit funds in this article.
2. As defined benefit funds are unallocated and do not technically have an account for each member these figures are notional and indicative only.

This result suggests that any fund restructuring brought about by a perceived regulatory arbitrage under SIS dissipated during 1995-96. However, some industry commentators have suggested that when, as foreshadowed in the Treasurer's Statement on Financial System Reform of 2 September 1997, the regulatory supervision of excluded funds is transferred to the Australian Taxation Office (ATO) this may possibly cause a further round of restructuring within the industry.

Previous analysis published by the ISC indicated that transfers from elsewhere within the superannuation system accounted for nearly 60 per cent of deposits into mastertrusts, compared with around 15 percent of deposits into industry funds. This result strongly indicates that mastertrusts rather than industry funds received the largest share of the assets becoming available for management elsewhere in the superannuation system as a result of corporate fund rationalisation.

A further factor influencing the decrease in corporate fund numbers may have been through larger employers rationalising their various superannuation arrangements. For example, this restructuring may have occurred where, through mergers and/or acquisitions, an employer that sponsored several funds with similar member profiles may have taken the opportunity to rationalise these arrangements into a single fund.

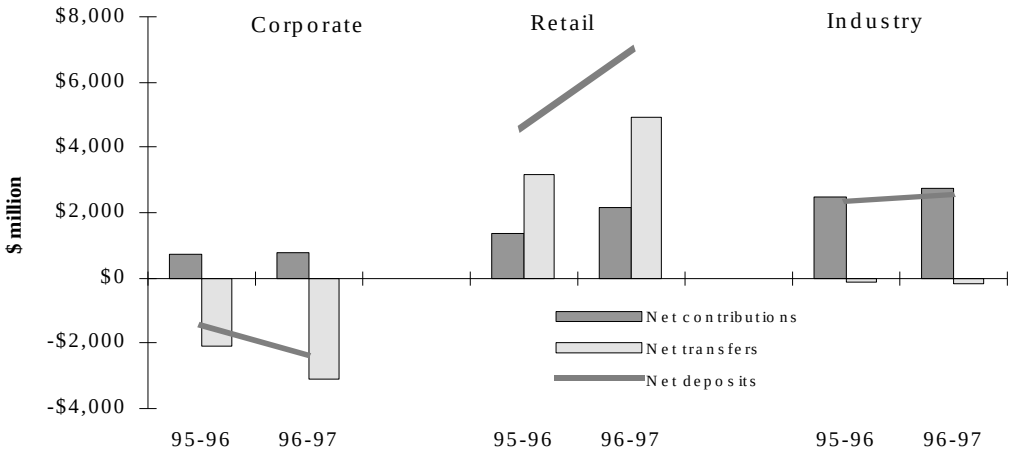
In overall terms the number of corporate funds fell from around 5 090 at June 1995 to around 4 670 at June 1996, a decrease of slightly more than eight per cent. The difference between the wind up rate of 15 per cent and the decrease in overall corporate fund numbers of only eight per cent is explained by the number of new corporate funds that established during 1995-96 (representing nearly four per cent of June 1996 corporate funds) and by funds increasing their membership size and moving from being an excluded fund at June 1995 to being a corporate fund at June 1996 (representing four and a half per cent of June 1996 funds).

The account range (i.e. membership size) profile of the newly establishing corporate funds is similar to the continuing corporate fund profile. For example, 70 per cent of the corporate funds established during 1995-96 had between five and 50 members. The establishment of funds with low numbers of accounts, and most likely with relatively high operating costs, suggests strict commercial considerations are not the sole determinant for an employer in the decision of whether or not to operate a superannuation fund as a distinct legal entity. Moreover, a small number of these new funds may be funds that are rolling out from a mastertrust, perhaps as a result of a desire by the employer to have greater control over their superannuation arrangements than they were able to within the mastertrust.

Retail and corporate consolidation differences

While much of the focus on fund rationalisation has been on the corporate sector, the reality is that the number of retail funds has been decreasing at an even faster rate. For example, while the overall number of corporate funds decreased by eight per cent during 1995-96, the number of retail funds decreased by more than 26 per cent over the same period. However the reasons behind the consolidation of retail funds are very different to those for corporate funds.

Figure 3: Superannuation financial flows, 1995-96 to 1996-97



Retail funds regulated under the SIS legislation are often legal umbrella structures that sit over the top of a number of individual retail products. Members joining these retail funds do so indirectly through purchasing a particular product that is considered to be part of the legal fund. In the case of many of the larger providers of retail superannuation products, particularly life offices, their wide range of products had in the past been covered by a number of legal umbrella funds. Moreover, these funds were usually all managed by the same Approved Trustee company, usually a subsidiary of the product provider. The rationalisation of retail funds has overwhelmingly been due to these large retail superannuation product providers consolidating their legal structures so that all their products now reside within a much smaller number of funds, in some cases just one. In these cases, the number of individual products usually remains unchanged despite these new legal arrangements. This means that while the number of retail *funds* has decreased dramatically, the number of retail *products* offered has not.

Anecdotal evidence suggests that the industry fund sector may also begin to experience a rationalisation in fund numbers over the short to medium term.

Figure 3 shows that during 1996-97 the net outflows from the corporate sector increased by 68 per cent, while in contrast the net inflows (deposits) to the retail sector and industry fund sector increased by 56 per cent and nine per cent respectively over the same period.

Retail consolidation has therefore been very different to the corporate sector consolidation, which has seen large outflows from the sector as funds have wound up and employers have outsourced their superannuation arrangements. In other words, the retail consolidation has been in fund numbers only, with no net cashflow component, while the corporate consolidation has been characterised by a net cash outflow from the sector as well as a decrease in fund numbers.

How reliable are the figures in the ISC Bulletin

Many of the figures published in the ISC Bulletin are derived from a combination of statistical estimates from the ISC Quarterly Survey of Superannuation (for large funds) and projected trends from prior year's Annual Returns (for small funds). In this article we assess the reliability of these estimates against the actual 1995-96 Annual Return figures.

The ISC Bulletin contains estimates for the structure of the superannuation industry based upon the results obtained from the ISC Quarterly Survey of Superannuation (the Survey) and prior year statutory Annual Returns. Importantly, these estimates are published within three months of the end of the reporting period, so that June 1997 estimates for the structure of the superannuation industry are available in September 1997.

In contrast, up to date results from the audited Annual Returns required by the ISC for the purpose of supervision do not become available until some 12 to 18 months after the end of the reporting period (depending on the type of fund). However, being audited information, the Annual Return provides a useful benchmark against which to evaluate the validity of the estimates published in the ISC Bulletin.

Reliability of the ISC Bulletin

The close correlation between the previously published estimates and the results obtained from the 1995-96 Annual Return confirm the overall robustness of the methodology used to produce the superannuation industry estimates published in the ISC Bulletin. Nonetheless, these derived figures appear to underestimate the Annual return results across the superannuation sector with the exception of public sector funds and assets of the corporate sector.

Previously published figures appear to have underestimated the Annual Return result by around two per cent for total assets and one per cent for total members. See table 1. The difference between the published and Annual Return results for contributions is around seven per cent. See table 2. This suggests the ISC measurement methodology may in fact be rather conservative.

There is however greater variability in accuracy of estimates between different fund types. For example, survey results for corporate fund estimates of assets and contributions are almost identical to the annual return figures. In contrast, excluded and retail funds assets were underestimated by five and nine per cent respectively in June 1996.

Contributions into retail funds were underestimated by seventeen per cent and contributions into excluded funds were underestimated by twelve per cent in June 1996.

The implication of this is that the ISC Bulletin may be underestimating contribution flows by several billion dollars.

Exempt public sector super funds

Due to strict solvency provisions in the SIS Act, not all constitutionally protected funds are in a position to satisfy all SIS requirements. As a result, some of these public sector funds operate as "SIS exempt" schemes and consequently they do not lodge Annual Returns with the ISC. Nonetheless, many "SIS exempt" funds are included in the Quarterly Survey of Superannuation.

For example, while the June 1996 survey includes 65 public sector funds, 31 are actually "SIS exempt" and do not lodge Annual Returns with the ISC. As a result it is not possible to test the accuracy of survey results against an audited benchmark. SIS exempt schemes account for around 60 per cent of public sector assets and 80 per cent of public sector contributions. The higher ratio of contributions to assets amongst the SIS exempt schemes may reflect the unfunded nature of some of these schemes.

Excluded funds

Since excluded funds (with less than five members) are outside the scope of the Survey, their quarterly estimates

Table 1 : Published estimates of assets and actual Annual Return results

	Previously published estimates June 1996	Annual Return results 1995-96
Fund type assets	*($billion)*	
Corporate	55.4	55.2
Industry	14.2	14.2
Retail	59.7	62.6
Excluded	25.3	27.6
Public sector	59.4	59.5
Total assets	214	219.1
Total members (million)	16.2	16.3

Table 2 Published estimates of contributions and actual Annual Return results

	Previously published estimates June 1996	Annual Return results 1995-96
Fund type contributions	*($billion)*	
Corporate	3.6	4.0
Industry	3.1	3.1
Retail	6.9	8.1
Excluded	3.8	4.2
Public sector	8.9	8.8
Total contributions	26.3	28.2

are based upon previous years' Annual Returns and fund establishment data. 'Per fund' asset and contribution ratios are estimated on the basis of previous Annual Return data. Estimates are obtained by applying these ratios to fund numbers.

There were close to 106 000 excluded funds that lodged annual returns with the Commission in the financial year 1995-96, from a total of 110 000 superannuation funds, ADFs and PSTs.

Table 3: Survey Estimates
Public Sector superfunds, June 1996

	Assets	Contributions
	($billion)	
SIS Exempt	35.4	6.8
SIS Regulated	24.1	2.2
Total	59.4	8.9

The underestimation of excluded fund assets an contributions arises from the ISC's conservative estimation methodology. While much of the increase in assets or contributions is driven by the increase in the numbers of excluded funds, ISC makes the assumption that 10 per cent funds are discontinued each year.

Moreover, investment income for excluded funds is also conservatively estimated. For example, one third of excluded fund assets are assumed to be held as cash deposits and a further 13 per cent of assets are estimated to increase only in line with the CP1. Holdings in equities or direct property are estimated to increase in line with national indicies.

Life insurance asset allocation profiles

In 1997 the ISC introduced a new statutory reporting regime for life insurance companies. In this article we report on the June 1997 asset allocation profile, particularly focussing upon the structure of overseas asset holdings.

Following the introduction of the *Life Insurance Act 1995*, the ISC has been working with life offices to redevelop and improve the statutory returns that companies lodge with the ISC and to also improve the quality of statistics available from these returns.

While these new data collections have been underway for some time now and have been incorporated into the processes by which the ISC prudentially monitors the life insurance industry, only a small amount of this new information has to date been widely published.

In June 1997, there were 51 companies operating in the Australian life insurance market accounting $139.7 billion in assets under management. Superannuation assets make up $111 billion, or 76 per cent of these assets. Viewed from another perspective, life insurance companies hold 38 per cent of all superannuation assets.

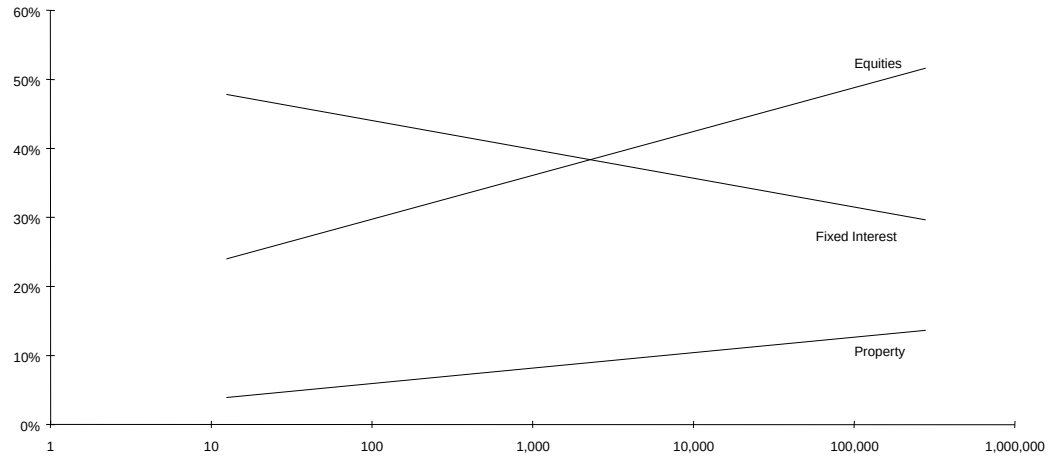
Asset allocation

The majority of life office assets are held as either equities or fixed interest securities, with 39 per cent held in equities and 37 per cent held in fixed interest. Direct property accounts for nine per cent of assets, loans account for six per cent and cash accounts for five per cent. The remaining four per cent is held in other miscellaneous asset classes.

Further analysis also reveals that larger companies tend to be more aggressive investors with higher equity weightings than smaller companies. Conversely, smaller companies tend to have higher weightings towards interest bearing securities. Larger companies also have property weighting up to three times as high as small companies, possibly reflecting their ability to construct more balanced portfolios through more sophisticated and diversified investment management operations. See figure 1.

The proportionally larger fixed interest weighting and lower equity weighting of the smaller companies may be due them having to protect their solvency ratios by limiting exposure to the more volatile higher risk assets.

Figure 1: Asset allocation trends and assets under management (AUM)



Overseas asset holdings

Life office investments in Australia at June 1997 amounted to $117 billion, or 84 per cent of total statutory fund assets.

Nearly three quarters, 73 per cent, of the $23 billion that is invested overseas by life offices in Australia is held in equities. The remaining portion of overseas assets are held predominantly in interest bearing securities, accounting for 19 per cent of overseas assets. Directly held property accounts for only three per cent, and the remaining five per cent of overseas assets is held in cash, loans and miscellaneous classes.

The proportion of overseas assets reported as being held in equities is also very similar to figures reported by the Australian Investment Managers Association in their December 1996 Funds Under Management Report, which revealed that 80 per cent of overseas investment are held in equities.

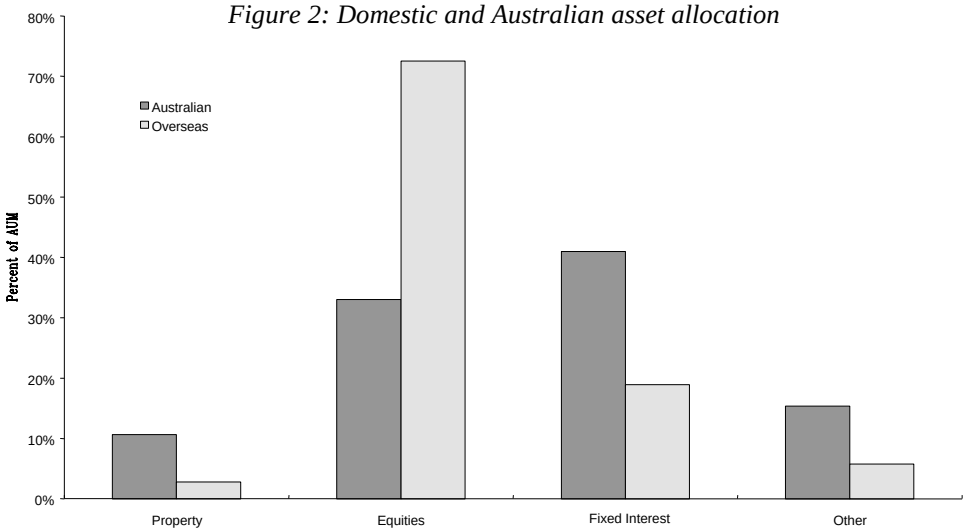
The significant equity weighting for overseas assets is more than twice as high for the equity weighting of domestic assets. See figure 2.

The overseas holdings of life offices are distributed across Europe with $6.1 billion invested, the United States and Canada with $5.9 billion, the Pacific and New Zealand with $2.9 billion, the Pacific and New Zealand with $2.9 billion, and South East Asia with $2.3 billion. However, the value of life office statutory funds' "minor" overseas holdings - which are held in other portfolios - nonetheless aggregates to $5.4 billion, or 24 per cent of all overseas holdings. Under current prudential reporting rules, the country where the minor holding is placed, if the value is less than one per cent of the statutory fund, is not required to be separately identified.

More importantly, the value of investment exposure to overseas countries, especially South East Asia, should not be seen exclusively in terms of direct investments in those countries, as many of the investments in Australian companies are made on the basis of their export exposure to those economies.

Thus the real exposure of Australian policy holders to South East Asian economic events is likely to be somewhat higher than is initially suggested through only two per cent of their assets being invested there. However, the financial strength of Australian life offices is such that this does not raise any concerns.

Figure 2: Domestic and Australian asset allocation



General Insurance Industry Update

In recetnly released December 1996 "Selected Statistics on the General Insurance Industry" the ISC General Insurance Group reported on the major trends impacting this important sector of the financial system. This article is a summary of their key findings.

General insurance business (i.e. insurance other than life and health insurance) was written in Australia by 170 private sector insurers and 16 public sector insurers as at 30 June 1997.

A key indicator of general insurance activity is the rate of growth of direct premiums. Direct premium is the amount paid by business and consumers for their insurance cover. It includes stamp duties and other Government charges, as well as intermediary commissions.

The rate of growth of total direct premiums over the past 5 years has exceeded the growth in GDP by an average annual factor of 1.35 percentage points. Growth in premium revenue nonetheless varies significantly between the different classes of general insurance business.

Growth in compulsory classes of business for example was largely due to CTP Motor Vehicle insurance which accounted for almost half of the total increase in premium revenue. The increase in CTP premiums reflects rate increases necessary to address the significant underwriting losses in the CTP class of business.

The largest insurance classes, motor vehicle and domestic home insurance, which together account for almost 40 per cent of private sector direct premium have continued to grow strongly. The rate of growth of domestic classes is greater than for commercial classes, which may reflect a trend towards increasing use of non-insurance risk management strategies and the degree of price competition in the commercial area.

There has also been a continuation of the movement of business from public sector to private sector general insurers. See figure 1. During 1996, total private sector direct premiums increased by $954 million, double the rate of growth of the previous year.

Underwriting Performance

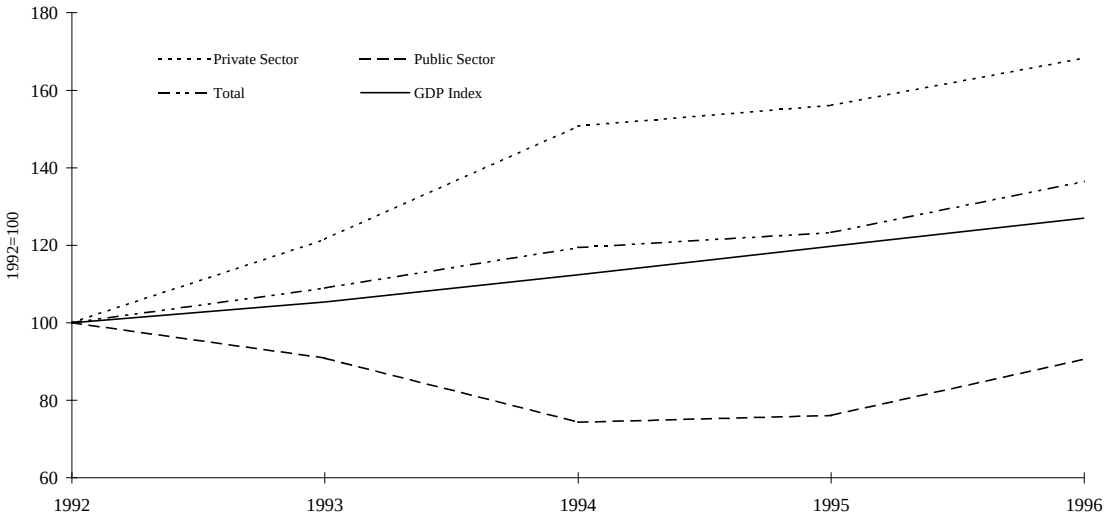
General insurance business performance can be measured by the underwriting result, that is, premiums less reinsurance, claims and other underwriting expenses have made underwriting losses throughout the 1990s to date, even though there was a slight improvement in the underwriting loss in 1996, down to $807 million from $890 million in 1995 (an improvement of nearly 10 per cent).

In the case of direct underwriters, insurers who deal with the public at large, the underwriting deficit fell to $799 million in 1996 from a deficit of $987 million in 1995. This improvement in underwriting performance can be attributed to an increase in the CTP Motor Vehicle class of business where premium revenue increased from $1.1 billion in 1995 to $1.5 in 1996, while claims expenses remained constant at $1.8 billion.

Underwriting results vary widely across different classes of business with the compulsory classes (employer liability and CTP motor vehicle) as well as domestic motor vehicle insurance continuing to make the largest losses. In contrast, some niche classes, for example, Loan, Mortgage and Lease insurance have generally made underwriting profits in recent years.

Nonetheless, in 1996, Loan, Mortgage and Lease insurance experienced the greatest deterioration in performance by a particular class of business as the net claims expense increased by 178 per cent, while net premiums increased by only 14 per cent. Consequently, the underwriting result declined from a profit of $14 million in 1995 to a loss of $6 million in 1996.

Figure 1: Premium Growth



Investment Returns and Profitability

During the 1990s private sector general insurers' underwriting losses have been more than offset by investment income, thus enabling insurers to return overall profits while losing money on their insurance business.

Overall profits are sensitive to fluctuations in investment income such that the industry has been generally dependent over the last five years on investment returns for profitability. See figure 2.

Net profits after tax fell sharply in 1994 when bond market losses caused significant decline in investment income. Since then, improved investment returns have led to an improvement in general insurers' profitability.

Reflecting intense price competition and strong investment skills, general insurers have not exited the industry or raised premiums sufficiently to ensure that underwriting losses are not incurred. This suggests there is limited scope for unilaterally raising premiums, so that investment income is likely to continue to play a crucial role in maintaining general insurer's profitability.

Income from invested premiums can also be considered part of the insurer's risk business and so it is therefore useful, for management and other decision making purposes, to apportion the investment income between policyholders' and shareholders' funds.

Using this approach, this notional allocation of investment income to policyholders' funds converts an underwriting loss in 1996 of $807million to a profit of $1,015million. Similarly for 1995, an underwriting loss of $890 million converts to a profit of $939 million.

These results relate to premium revenue of $14.3 billion in 1996 and $12.8 billion in 1995. The notional return on shareholders' funds, on the other hand, represents a return of $1.3 billion in 1996 and $1.2 billion in 1995 on net assets of $10.2 billion and $9.3 billion respectively. See table 1.

Assets and Liabilities

Total assets of private sector insurers increased from $23 billion to $38 billion during the last five years, representing annual growth of nearly 11 per cent. This compares to a six per cent annual growth in premiums over the same period. Net assets have also increased over the same period because total liabilities have only grown at an annual rate of nine per cent, to $10.2 billion in December 1996.

Around one third of assets are non-income producing such as unpaid premiums and reinsurance recoverable on outstanding claims. Investment assets of private sector insurers continue to be well spread over the different categories of investments.

General insurers seem to be more conservative in their investment strategies than superannuation funds and life offices which have a noticeably lower weighting in debt securities and higher weighting in equities. This is primarily due to a larger portfolio of shorter term liability risks which generally necessitates a more liquid investment portfolio relative to life insurers and superannuation funds.

For example, the share of equities and unit trusts in total investments of super funds and life companies is 39 and 34 per cent respectively compared to only 25 per cent for private general insurers. See figure 3. Debt securities were 44 per cent of private sector general insurers' total investment assets and have also. been the most important source of investment revenue. Consequently investment returns for general insurers could be expected on average to be less variable, though lower, over time.

Figure 2: Trends in Profitability

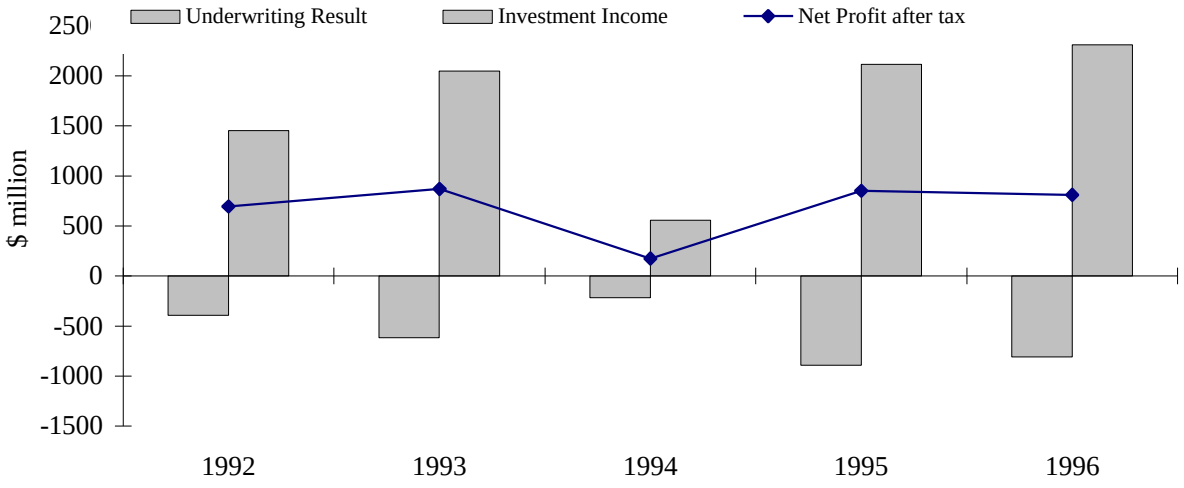


Table 1: General Insurers' Profitability 1992-96

Actual	***1992***	***1993***	***1994***	***1995***	***1996***
Underwriting Result	-393	-616	-216	-890	-807
Investment Income	1,452	2,047	558	2116	2,312
Net Profit after tax	694	870	175	852	811
Notional					
Investment Income for Policy holders	655	790	240	939	1,015
Insurance' Surplus (Deficit)	262	174	24	49	208
Shareholders Investment Income	797	1,257	318	1,177	1,297

Note: the 'actual results do not add through because certain items (e.g. administrative expenses) are not shown.

Solvency

The Insurance Act requires authorised general insurers to maintain an excess of assets over liabilities of not less than $2 million, 20 per cent of premium income or 15 per cent of the outstanding claims provision, whichever is the greater. For most insurers, the required solvency margin is based on 20 per cent of premium income which for the general insurance industry was $ 3.1 billion at the end of 1996.

In aggregate, the industry comfortably meets the statutory requirement with a solvency surplus of $3.1 billion. This surplus is the largest since industry wide solvency margins were first published in June 1994. However changes in the methodology used to compile industry wide solvency measures makes it difficult to establish a trend.

Market Concentration

The general insurance industry is still only moderately concentrated but the level of concentration continues to rise. In 1996, 75 per cent of direct premiums were written by the 20 largest insurers, compared to 77 per cent in 1995 and 74 per cent in 1994.

Most classes of general insurance business are dominated by underwriters who specialise in that particular class of business and therefore the concentration within individual classes of business is higher than the average concentration across all industries.

For example the share of direct premiums written by the top 10 insurers in each class of business is greater than 60 per cent compared to only 52 per cent for all classes of business.

This characteristic of the market can also seen in four of the smallest classes of general insurance business: Trade Credit; Loan Mortgage and Lease; Extended Warranty and Consumer Credit, where the ten largest insurers, wrote 100 per cent of the business in 1996.

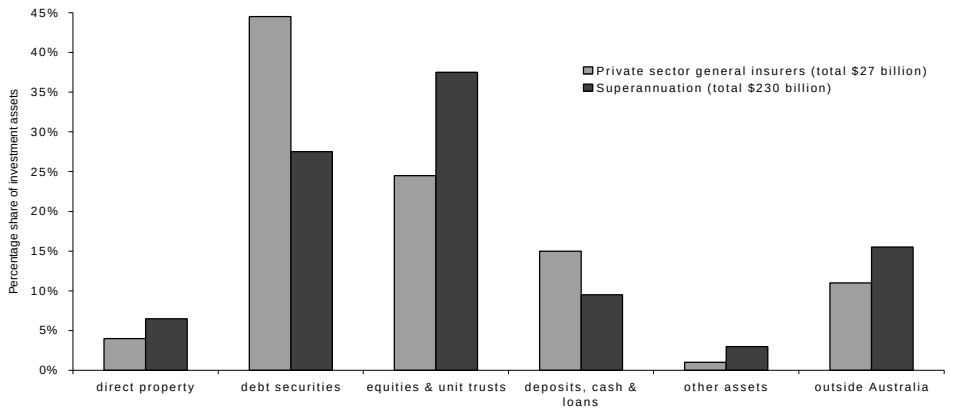
Product Distribution

General insurance business in Australia is written both 'over the counter' (without the use of intermediaries) and also through intermediaries acting as agent of the insurer, or the insured. Insurance brokers, acting as agent of the insured, are required to be registered under the Insurance (Agents and Brokers) Ac 1984.

There are currently around 1,020 registered general insurance brokers who play a significant role in the sale of general insurance policies. During the last five years brokers accounted for between 43 per cent and 51 per cent of annual direct premiums collected.

Brokers however tend to play a more minor role in domestic insurance classes, as these products are often sold without an intermediary.

Figure 3 : Share of major asset classes



Superannuation survey highlights - September 1997

Main features

- Total superannuation assets had reached $316.7 billion by end September 1997, representing growth of 4% during the quarter, or 20% during the year ended September 1997.
  - note that the effects of the October slump in capital markets are not reflected in these figures.
- Capital market performance during the September quarter caused net earnings to be the main component of growth, accounting for 76% of net growth. Net deposits accounted for only 24% of the growth.
- Contributions this financial year were up 11% compared to the previous 12 months, increasing from $27.3 billion to $30.3 billion (this represents a very slight decrease in the growth of contributions compared to previously reported figures).
- Even after discounting the rapidly growing excluded fund sector, contribution growth for large funds is still 10% per annum.
- The strongest growth came from member contributions, increasing by 17% over the previous year to $10.4 billion. Employer contributions increased by 8% to $19.9 billion.

Industry structure

The assets managed by small self-managed funds (ie, excluded funds with less than 5 members) grew fastest during the year ended September 1997 increasing by 36% ($9.7 billion). This was closely followed by industry funds which grew by 32% ($5.1 billion) during the last year.

Corporate fund assets grew by only 15%, or $8.5 billion during the year. Retail assets grew by 23% ($14.6 billion) and public sector assets grew by 24% ($14.3 billion).

Retail funds currently hold around 24% ($77.2 billion) of total superannuation assets, public sector funds hold 24% ($74.9 billion), corporate funds 21% ($65.0 billion), excluded funds 12% ($36.9 billion), and industry funds 7% ($21.2 billion).

The excluded fund market segment share has grown from 10% to 12% during the year ended September 1997. However most market segment shares remained relatively stable except for a decline in the market segment which represents annuity products, fund reserves and unallocated profits of life office statutory funds. The proportion of the superannuation industry represented by these 'balance of statutory fund' assets has reduced to 13%.

Contributions and benefits

During the September quarter, employers contributed slightly over $5.1 billion into superannuation, up 9.0% on the 1996 September quarter. In contrast, the $2.7 billion employees contributed into superannuation during the same period was up 15.5%.

The contributions into small self-managed funds were 17.6% higher during the year ended September 1997 than the year ended September 1996. Growth in net inflows to these funds was 44.4% higher than in the previous 12 months, being largely fuelled by the strong growth in the number of excluded funds, eg. the number of excluded funds increased to 163,173 by September, up 4% during the quarter.

Reflecting very strong consolidation in corporate and retail fund numbers this quarter, inward transfers accounted for 65% of all money deposited into superannuation during the September quarter, which is considerably higher than the normal average of around 36%.

Lump sums, excluding outward transfers, accounted for 81% ($4.6 billion) of the benefits paid during the September quarter. The remaining 19% ($1.1 billion) of benefits were paid as pensions. Outward transfers, for reasons referred to previously, accounted for 70% of all fund withdrawals during the September quarter.

A major contributor to the rapid growth in transfers between super funds has been changes in the structure of public sector super funds. However, this strong growth in public sector transfers overwhelmingly reflects significant restructuring and rationalisation, in particular in relation to governments seeking to manage their potential defined benefit liabilities.

Benefit payments, excluding transfers, during the year ended September 1997 were up by 11% compared to the previous 12 months.

Despite the higher growth rate of benefit payments as compared to contributions, net contributions (ie., contributions less benefits) were 7% higher for the year ended September 1997 as compared to the previous 12 months. In other words, during this period more than $11 billion in net contributions flowed into superannuation than flowed out.

Manner of investment

Assets directly invested by trustees, showed the strongest growth during the quarter, increasing by 6.4%. Assets placed with investment managers which grew by 3.8%, while assets invested through the statutory funds of life offices grew only 2.1% during the quarter.

Investment managers had 39.5% ($125.1 billion) of total superannuation assets at the end of September 1997, unchanged from September 1996. The share of directly invested superannuation assets increased marginally to 24.2% ($76.8 billion) , with the statutory funds of life offices falling marginally to 36.2% ($114.8 billion).

Asset allocation

The share of superannuation assets invested overseas declined slightly to 16.5% (46.6 billion) at the end of September 1997, largely due to the 1.5% appreciation of the AUD during the quarter.

Superannuation investment held in equities has continued to increase, growing by 4.3% during the September quarter. Since the ASX accumulation index grew by only 2.4% in the September quarter, it follows that there was a small net inflow of around $1.6 billion into the equities markets by superannuation funds. Superannuation equity holdings overall increased marginally to 28.9% of total superannuation assets.

Unit trust holdings increased by 5.2% ($1.5 billion) in the September quarter. They are now a record 10.8% of the total value of superannuation assets.

Reflecting the decline in long term bond yields during the September quarter, holdings of long term debt securities increased by 3.8% ($1.7 billion). The proportion of superannuation assets held as long term debt securities has fallen slightly to 16.6%.

Holdings in short term debt securities rose by 1.7% ($0.4 billion) during the September quarter, partly reflecting falls in short term yields from 5.3% to 4.7%. The proportion of superannuation assets held as short term debt securities declined slightly to 8.9%.

Holdings of cash, deposits and placements grew most strongly of all asset classes increased by 4.5% in the September 1997 quarter. This growth was well in excess of cash rates which declined below 5% during the September quarter.

These movements would appear to indicate that during the September quarter superannuation funds were net sellers of Australian long and short term debt securities, but were net purchasers of Australian equities.

This result suggests that superannuation funds are participating in profit taking in the strong bond markets and after some profit taking in the equities markets in the previous quarter superannuation funds are increasing their cash reserves and exposure to Australian securities while generally maintaining existing weighting in foreign securities.

The value of assets held in direct property continued to fall in the September quarter. The share on total superannuation assets fell to 4.9% at the end of the September 1997 from 6.4% a year earlier. Other investments account for around 4% of total superannuation savings.