10 April 2008

Mr Michael Wood
Head of Australia-India FTA Feasibility Study
Department of Foreign Affairs and Trade
John McEwen Crescent
BARTON ACT 0221

Dear Mr Wood

Introduction

Insurance Australia Group (IAG) welcomes the opportunity to make a submission to the Australia-India FTA (FTA) Feasibility Study.

The Study and the potential to commence negotiations between the two economies present an opportunity to strengthen our relationship from the traditional to the substantive, based upon strong economic and commercial links. As a general insurer with a particular focus on expanding our presence in the Asian region, the Indian market offers substantial opportunity based upon core economic indicators (eg GDP and population growth) and the evolving structure of its general insurance market.

IAG believes that a FTA can build upon commitments made by both economies in the multilateral trading environment, and in particular serve to increase the breadth and depth of the Indian general insurance market as it moves through a period of reform and liberalisation.

IAG supports a consultative approach to regulatory review and an approach that engages with industry at all stages of the review process. IAG commends the Department of Foreign Affairs and Trade (DFAT) for its approach to date in relation to both multilateral and bilateral trade negotiations, from commencement through to finalisation and implementation.

Insurance Australia Group

IAG is a leading general insurance group in Australia and New Zealand, and has a growing presence in Asia and the UK. The Group generates annual gross written premium of more than $7.5 billion.

The Group insures more than $1,000 billion worth of property. In Australia, it insures more than five million cars, two million homes, 250,000 businesses and 75,000 farms, and provides workers' compensation services to more than 200,000 employers. In New Zealand, it insures around 950,000 cars, 575,000 homes, 185,000 businesses and 235,000 rural risks.

IAG distributes its products through some of the leading brands in Australia and New Zealand: CGU nationally; NRMA Insurance in New South Wales, Queensland, ACT and Tasmania; SGIC in South Australia; SGIO in Western Australia; RACV in Victoria; and State and NZI in New Zealand.

IAG also has interests in China (China Automobile Association or CAA), Malaysia (AmAssurance), Singapore (Alba), Thailand (NZI Thailand and Safety Insurance) and UK (Equity Insurance Group and Hastings Group).

Customers are served in Australia through a network of 220 branches, franchises and country service centres throughout metropolitan, regional and rural areas, as well as more than 1,000 intermediaries (brokers and authorised representatives), 100 financial institutions and, in New Zealand, through more than 40 sales centres, branches and district offices. More than 15,000 people are employed across the Group.

IAG has a crucial interest in the long-term viability of insurance as a product valued by the Australian community. IAG believes that there are four principal ways in which the insurance industry can best meet these objectives. These are:

- investing in robust risk control frameworks and mechanisms that protect policyholders and provide certainty to shareholders;
- pricing products realistically;
- ensuring that customers understand what they are buying when they purchase a policy; and
- committing to, and supporting, on a continuing basis, a comprehensive and clearly defined regulatory framework that facilitates more affordable premiums and more predictable claims costs.

Australia-India FTA Feasibility Study

As IAG continues to pursue opportunities offshore, we are continually required to negotiate a number of regulatory hurdles both at and behind the border. IAG therefore takes a strong interest in the trade liberalisation debate, and supports the following policy objectives:

- bilateral trade agreements that enhance Australia's trading relationships and remove protectionist barriers that inhibit international financial markets;

- the General Agreement on Trade in Services (GATS), as it provides a minimum standard for all World Trade Organisation (WTO) members to meet. This is particularly important to the liberalisation of international financial markets; and
- a process of bilateral trade agreements that are comprehensive in nature, encompass financial services and complement Australia's efforts in the multilateral negotiation process.

IAG understands that the Insurance Council has made a submission to this study. We agree with the contents of the Council's submission in totality.

In general, we believe that FTA's can provide beneficial commercial outcomes in a timely manner. Please find attached our submission on the proposed Australia-India Free Trade Agreement. If you wish to discuss this matter or make further inquiries please contact me on (02) 9292 9744 or Justin Ward, Senior Advisor – External Relations on (02) 9292 8253.

Yours sincerely

Nola Watson
Head – Government and International Relations
Insurance Australia Group

Insurance Australia Group's comments in relation to the Australia – India FTA Feasibility Study

INTRODUCTION

The Australian general insurance sector has undergone significant reform since the release of the Wallis Report in 1997, and the implementation of the so-called "twin peaks" regulatory model through to the collapse of HIH Insurance (the largest corporate failure in Australia at the time) and the subsequent re-licensing of insurers.

This coupled with significant industry consolidation has provided the basis for the development of an advanced and sophisticated general insurance sector. Notably, AXISS Australia confirmed this, when it published *"Executive Briefing: Insurance in Australia"* and stated the following:

> "*…the general insurance market in Australia is sophisticated and mature. Its underwriters have considerable experience in risk management, claims management and evaluation and its actuaries are acknowledged as world class…"*

http://www.investaustralia.gov.au/NR/rdonlyres/A7AAEC07-BE2A-4875-93DF-8D396B2765A8/0/ExecutiveBriefingInsuranceinAustralia.pdf

Whilst the Australian general insurance market may only be the 12th largest in the world, and the fourth in the region after Japan, South Korea and China, the depth and breadth of skill in the market is substantial. This is the result of:

- the significant regulatory reform process;
- the introduction of private capital and skills through to the management of statutory insurance schemes; and
- significant competition, due to the consolidation process.

As a major Australian insurer, IAG has had significant involvement in the reform and development of the domestic general insurance environment.

IAG believes that as the Indian general insurance market continues to embark on a process of reform and liberalisation, input from market participants operating within liberalised frameworks and market structures will be essential for development success and ongoing industry sustainability. Australian regulators, industry associations and general insurers can be regarded as significantly independent, as Australian participants are not large enough to exert any significant control over the Indian market.

IAG believes that the proposed FTA has the ability to accelerate the reform process, providing for further advances and liberalisation in the Indian market.

EVOLUTION OF INDIA'S GENERAL INSURANCE REGULATORY ENVIRONMENT

In 1991, India's then Finance Minister and current Prime Minister, Manmohan Singh initiated significant macro and microeconomic reforms to ensure that the economy did not run out of hard currency. A major component of these reforms, were those relating to the financial services sector – banking, life and general insurance. This ensured that capital existed for "risk-taking" entrepreneurial activities, coupled with a dynamic insurance industry that enabled risk transfer activities.

Whilst reform in many parts of the Indian economy was welcome, significant debate took place on the need for insurance industry reform, and in particular the privatisation of nationalised general insurers and/or the introduction of private capital to the market. Many of the arguments constructed against reform suggested that:

- only the state could adequately guarantee an insurance contract;
- the balance sheet of the nationalised insurers could and should be used for "nation building" projects; and/or
- low governance standards existed in the nationalised insurers and therefore the threat of bankruptcy was high.

The pro-reformists focussed on one issue – consumers and the absence of real competition. The pro-reformists were assisted by the release of the Malhotra Committee Report in 1994. The objective of this Committee was to *"…examine the structure of the insurance industry and recommend changes to make it more efficient and competitive…"*[1].

Amongst other items, the Committee suggested that the nationalised general insurers should face competition from the private sector to improve customer service and product offering, with the aim of increasing general insurance penetration. To assist in this transition an independent regulator should be put in place to ensure that only "strong and serious" players could enter the market.

In September 1996, the Government moved to the establishment of an interim regulator. Codification of the existence of this regulator, coupled with modifications to allow for the removal of the nationalised monopoly come into effect in April 2000. Whilst the proposed reforms passed largely without

[1] Rao, CS. (2006) *"Indian Insurance Industry – Post-liberalisation Landscape" published at www.irda.gov.in/ADMINCMS/cms/Speeches_List.aspx*

concern, changes to the original Bill relating to foreign ownership were made. Specifically, a foreign equity ownership limit of 26 per cent was put in place.

The regulatory environment (*Insurance Regulatory and Development Authority Act* and amendments to the *Insurance Act 1938)* that commenced in April 2000 continues to exist within India today. Further liberalisation of the market occurred on 1 January 2007, with some relaxation of pricing tariffs with full abolition occurring from 1 January 2008. IAG understands that effective 1 April 2008 general insurers will be able to introduce new insurance products, features and benefits additional to minimum covers prescribed by the Insurance Regulatory and Development Authority (IRDA).

Due to the absence of claims data and technical underwriting skills within the Indian general insurance sector, the pre-conditions for a volatile market conditions existed. IAG's analysis of the market suggests that the lower pricing that has transpired since the removal of tariffs (1 January 2007) will continue through 2008 as market participants compete aggressively in a fragmented operating environment whilst attempting to build scale and market share.

THE INDIAN GENERAL INSURANCE MARKET TODAY

"…While the long debates in the 90s and the twists and turns that surrounded the opening up of the sector for private participation had at times, thrown up serious concerns about the implementation of insurance reforms in this country, once the legislation was put through, the actual process of inducting private players into the market has gone off smoothly. I do not think there is any other sector in this country where the transition from state monopoly to free market has been as hassle free as the insurance sector…"

CS Rao, Chairman – Insurance and Regulatory Development Authority
KLN Prasad Memorial Lecture, Hyderabad 21 April 2007[2]

The comments of CS Rao confirm the widely held view that growth in the sector due to market liberalisation, the establishment of an independent regulator and the introduction of competition has been managed successfully.

Since 2000, the number of licensed general insurers has increased from four (the former stated owned entities) to 18 – 13 of the 14 new entrants having the benefit of a foreign partner. Further, there have been at least three new joint ventures announced and persistent talk within the market that many other large foreign general insurers are in the process of searching for local partners. The foreign partners in existing joint ventures predominantly originate in North America, Japan or Europe, and represent the largest

[2] *Ibid*

general insurance markets in the world[3]. It could therefore be said that the Indian general insurance market is fast becoming a microcosm of the global market.

In monetary terms, the opportunities provided by the Indian general insurance market are substantial and best characterised by:

- IRDA estimating a compound annual growth rate for non-life premiums of approximately 15.1% to 2015. This will result in a total premium pool of approximately $US 19 billion;
- a low penetration rate, represented by premium as a percentage of GDP of 0.60%. As premium growth to 2015 is expected to be greater than GDP growth, the gap between the penetration rate in India and developed economies such as Australia (3.2%) and USA (4.8%) will narrow; and
- a low insurance density, or premiums per capita (US Dollars) of $US 4.40 compared to $US1,205.70 in Australia and $US2,066.60 in the USA.

These three measures demonstrate the attractiveness of the Indian general insurance sector and the opportunities for insurers like IAG to leverage its experience in established markets, into developing markets.

THE PROPOSED AUSTRALIA-INDIA FREE TRADE AGREEMENT

"...insurance is important to economic development – it spreads the cost of risk, promotes economic stability for both families and firms, and mobilises savings. Nonetheless, insurance in emerging markets still remains less well developed than banking, especially in property-casualty lines…"

"Open Doors: Foreign Participation in Financial Systems in Developing Countries", Brookings Institute 2001

As the dominance of the government owned insurers has reduced, market shares have changed dramatically – a direct result of competition, improved efficiency and premiums being more competitively priced to the benefit of consumers. This has been the direct result of the entry of private insurers to the market in 2001. Prior to the establishment of IRDA, government owned insurers held 100% of the general insurance market.

Currently, government owned insurer's hold approximately **60%** of the market with the remainder in private sector hands – a considerable fall since deregulation in 1999. This trend is expected to continue given the influx of new private insurers, the expected expansion of products and the competitive intensity generated by already established players.

[3] USA – 1; Canada – 7; Japan – 4; Germany – 2; UK – 3; France – 5, representing approximately 71% of global non-life premium volume in 2006. *Swiss Re Sigma No. 4/2007, World Insurance in 2006*

All private sector non-life insurance companies reported an operating profit in 2006. This is encouraging, as many have been operating in the market for a maximum of four years. Notably the public sector insurers remain under severe financial pressure.

For India to maintain the continual growth of the sector and general insurance product penetration, IAG believes that the following items should be considered in the FTA:

- **Ownership Limit for Foreign Investors**

In late November 2006, the Indian Minister for Finance, Mr SP Chidambaram introduced a Bill into Parliament that would increase foreign ownership levels in the insurance sector from 26 per cent to 49 per cent. IAG understand that the Indian Government believes that the ownership limit is a “barrier to expansion”. Whilst the Government has expressed optimism that the Bill would pass into law, opposition to reform by non-government parties exists.

Most industry commentators do anticipate the Bill will eventually be passed, but this is unlikely given the current make-up of the Parliament.

IAG management remains concerned that the foreign ownership cap may remain at 26 per cent for a significant period thereby restricting our capacity to generate a significant economic interest that is in proportion to the likely contribution required to support the local Indian partner in establishing and growing a world class general insurance operation.

The restriction in foreign ownership is the entry barrier of the greatest significance to IAG.

We believe that an increase in maximum permissible foreign ownership for Australian insurers would benefit the sector by providing an appropriate incentive to transfer skills and capabilities, given the additional economic value that can be derived. IAG believes this would be a significant stimulant to Australian general insurance interest in the Indian general insurance market.

However, IAG understands that if the foreign ownership limit was lifted then consequential amendments would need to be made so as to ensure that the requirement for a general insurer to list on an Indian stock exchange within 10 years of business commencement *with no one shareholder owning more than 26 per cent* was consistent with the increased limit.

We believe that the FTA should consider increasing the ownership level for Australian domiciled insurers entering into an Indian general insurance joint venture.

- **Business Visas**

At present the Indian Government will not allow Australian businesses to secure an Indian visa for its employees for greater than 12 months unless it has an established business in India.

This is impractical and inefficient when considering the establishment of a "greenfields" business operation.

For IAG to commence a business in the general insurance industry in India we are required to invest significantly in establishing a presence and developing constructive relationships with many stakeholders. During this phase local Indian firms are retained on an advisory and transactional basis from the actuarial, legal and accounting professions.

IAG has had a staff member posted in India since June 2007. A major component of the staff member's role is to develop constructive relationships with stakeholders and undertake analysis associated with the general insurance market. We consider the administrative burden associated with the renewal of a visa every 12 months as inefficient and not in the best interest of promoting strong and expanding commercial relationships between the two economies.

Given the timeframe typically taken to build crucial industry relationships, embark on partner selection processes and engage with government and regulators, we believe it will often take in excess of 12 months to establish a business.

IAG would encourage the FTA to consider expanding the criteria for the issue of Indian business visas for a period of longer than 12 months to include situations where an Australian company is in the process of establishing a business in India.

- **Withholding Tax on Services on "Foreign Investor" Services**

An Indian company may incur expenditure on certain management or service fees to a foreign investor in consideration for services received, and claim a tax deduction for such expenses. These payments will need to be in accordance with Indian exchange control laws.

Under the Indian Tax Act (ITA), such payments would generally be subject to withholding tax at the effective rate of 10.5575%[4]. Such arrangements will also have to be evaluated for service tax implications.

This places foreign investor services provided to a joint venture at a disadvantage. As the Indian insurance industry develops the need for foreign insurer intellectual property, capability development and business support will be significant. This withholding tax will ultimately be borne by the purchasers of insurance as the cost will need to be reflected in insurance premiums as part of the underlying cost of conducting the business. Alternatively, the market will develop less rapidly as foreign invested Indian insurers may be reluctant to invest in this development in order to remain price competitive.

IAG contends that an FTA with a withholding tax exemption in relation to payments for services provided by an Australian investor in an Indian general insurance joint venture to the joint venture would ensure an even playing field for the purchase of intellectual property, capability development and business support between India and Australia.

- **Capital Gains Tax**

Capital gains arising to a non-resident from the transfer of an Indian company's shares or securities would be subject to tax in India under the ITA. If the Indian company is unlisted, the income from transfer of its shares held for 12 months or less would be treated as short-term capital gains, and taxed at the effective rate of 42.23%. Long-term capital gains, earned by a foreign investor from a transfer of shares held for more than 12 months, are taxed at the effective rate of 21.115%. Capital gains tax is often relieved under applicable tax treaties.

This issue should also be considered in relation to the requirement for an Indian general insurance company to list on an Indian stock exchange within 10 years of establishment with no one shareholder owning more than a 26 per cent stake. If the level of ownership was increased for Australian insurers then consideration should be given to how this requirement on listing should be amended.

Indian capital gains tax increases the barriers to entry for Australian investment in India. IAG believes the free flow of capital between the economies will give rise to value creating investments, with both Indian and Australian investors benefiting equally from the relationship.

[4] Currently this rate is lower than the rate prescribed under many of India's tax treaties. Therefore, it would override treaty provisions as it is more beneficial to the assessee

India has a number of these tax treaties, known as “double tax avoidance agreements”, including those with Mauritius and Singapore. Such agreements, subject to satisfying certain criteria, exempt companies in those jurisdictions from capital gains tax on the sale of shares in India.

If Australia were to consider an FTA with India that included double tax avoidance provisions, it would remove a significant hurdle from Australian general insurers investing in an Indian general insurance joint venture.

SUMMARY

The services sector is a critical part of any modern economy. As India continues its rapid development the emergence of a properly functioning and efficient service sector, especially in financial services, will be critical to sustaining its growth rate.

IAG believes that substantial benefits exist for the general insurance sectors in both economies through the finalisation of a FTA.

Notably, we believe that the Australian general insurance sector has the potential to work constructively with our Indian counterparts in contributing to the domestic reform programme that will ultimately benefit Indian consumers.

Unlike our counterparts in Europe and North America, we offer an attractive partner for the reform pathway due to:

- our relative size and therefore the “low risk” of Australian insurers becoming a dominant investor and shareholder in Indian general insurers;
- product and pricing innovation in the Australian market. This is particularly important as India moves to risk based premiums; and
- Australia’s financial sector reform programme, including the “twin peaks” regulatory model and significant reforms to this structure following the collapse of a major Australian domiciled insurer in 2001. Refinements to this regulatory model are ongoing.

Improved relations between the two economies will result if the FTA was to consider, and make meaningful, commercially relevant progress on the issues outlined in this submission, and in particular the increase to the foreign ownership cap.