Observations On Insurance Startup Barriers

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Picnic

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EXECUTIVE SUMMARY

Introduction

Picnic Labs Ltd (Picnic) has been working toward its vision of launching a new insurance company in Australia which provides a genuine alternative for consumers and addresses many of the shortcomings of the insurance proposition as it is currently presented.

In doing so, Picnic has experienced first hand the significant barriers to entry for brining a startup insurer to market. Some of the reasons relate to barriers which exist in the Australian market for start-up insurers generally, regardless of the model they choose to pursue or the products they wish to provide.

The purpose of this document is to provide our observations and potential solutions, so that policy makers may consider options to reduce the barriers to entry and improve competition and choice for the consumer.

About Picnic Labs

Picnic's mission is to harness the power and compassion of communities to deliver insurance with heart. We will seek to achieve this through the creation of a collective of fully-licensed, digital insurance mutuals, owned by customers, where customers have their say & share in the surplus.

Picnic's objectives are to:

1. make insurance **Easy, Fair & Transparent** (insurance policies that simplify and reduce exclusions, and make the Collective transparent and provide a fair claim process);
2. provide an amazingly **simple customer experience** through a **digital first approach**; and
3. continually **lower the cost** of operating insurance and **share this with consumers**.

Picnic works like other mutuals or cooperatives, but it is a digital first insurer, built from the ground up to drive significant efficiencies which are retained by consumers:

1. **Pool Premiums:** Join a Picnic Mutual, become an owner and your premium is added to the Collective's pool of funds.
2. **Have Your Say:** As an owner of a Picnic Mutual, you can voice your opinion on the Picnic Mutual paying tricky claims and other matters.
3. **Pay Claims:** The pool pays for claims and costs to provide protection members of the Collective.
4. **Share Surplus:** Remaining surplus is returned to members (owners) through future discounts on their premiums.

Picnic intends to initially offer protection for home, contents and motor to consumers.

Background

Since founding, Picnic has widely explored the regulatory, technology and competitive landscape in Australia and embarked on an exercise to obtain a General Insurance Licence.

Many barriers to entry for insurance are preventing the Australian public from experiencing truly innovative insurance solutions in a timely fashion.

Picnic is uniquely placed to be able to provide observations on these barriers. Picnic would also welcome the opportunity to engage on potential alternatives or solutions to those barriers.

Observations

The summary of our firsthand observations, and associated recommendations is provided below.

ID	Item	Challenge	Opportunity
1	Outcomes-based Regulation	A 'principles based' regulatory philosophy can result in undue scrutiny without consideration of materiality.	Incorporate an outcomes-based approach to APRA regulation, licensing and supervision, and include goals/metrics for new competition (licensees) coming to market.
2	Reduce Licensing Timeframe	Startups operate with significant constraints and by necessity, must design, build, test and launch their proposed solution with haste. The time to get a licence is significant and ambiguous, conflicting with the need for a more definitive and responsive startup timeline	Commit to a 6 month licensing timeframe, with appropriate restrictions to scale which minimise risk, but also minimise the significant capital burn and barrier to bringing a new licence to market.
3	Practical Governance Under GPS/CPS	The specifications in GPS/CPS standards are framed with 'big' companies in mind and create impracticals for a startup insurer.	Apply practical measures to meet governance requirements with the smaller, 'all hands on deck' teams during the start-up phase.
4	Progressive (Restricted) Licensing	No progressive licensing approach exists for general (or life) insurance to allow proof of market fit and early customer acquisition to demonstrate traction and reduce risk for investors.	Introduce a progressive (Restricted)licensing approach as seen in Banking.
5	Confidential		
6	Enhance Capital Requirements	Minimum Capital Requirements are a significant hurdle. GI Risk Charges (IRC and ORC) don't reflect risks being undertaken.	Varying minimum requirements, as has already occurred in Banking. Permit Surplus Notes as a valid alternative to Paid Up Ordinary Share capital. Create a new licence class for a Cell Licence. Proper risk adjusted capital requirements with more APRA discretion to adjust. Create an insurance risk charge and operational risk charge based on the risk profile.
7	Confidential		
8	Dearth of Investment Due to Known Barriers	Access to and opportunities for marketing to Sophisticated Investors is limited. Lack or / poor early-stage investment incentives exist in Australia (compared to some other countries such as the UK EIS funds) Hurdles and limitations for retail investors and restrictions on CSF limit its usefulness to all parties.	Allow greater advertising by projects to qualified individuals, subject to participation being validated to qualified Wholesale Investors only (with responsibility on the issuer to demonstrate compliance). Improve early-stage investment incentives and structures. Improve the CSF regulations to extend the limit.

ID	Item	Challenge	Opportunity
9	Update Insurance Contract Act	With over 35 years of technological, financial and community evolution since the Insurance Contracts Act was gazetted, it is timely to review and improve it.	Review the Insurance Contracts Act from start to finish to ensure it aligns with community expectations.

CHALLENGES

The following barriers, in no particular order, have been observed over the last 24 months, in Picnic's efforts to establish a General Insurance presence in the Australian market:

1. Outcomes-based Regulation

A 'principles based' approach is used by APRA. This approach sees a very high level of scrutiny during the licence application process around every aspect of a new entity's business. It raises the barrier to entering the market considerably as every element of detail has to be fully resolved before a licence can be granted. Often, some items of focus will not make a material difference to the actual operation of the entity in its early years and can be ironed out over time.

2. Reduce Licensing Timeframe

The time required to obtain the necessary APRA and ASIC licenses can deter a start-up from commencing. This is due to the perception that some innovations are time-sensitive and that there is a first-mover advantage, not to mention the difficulty in projecting funding requirements with an uncertain 'burn period'.

Aside from the significant cost associated with such a long timeline (APRA suggests minimum of 12 months & ASIC 9 to 12 months), it may be the case that an existing licence holder could come to market with a similar solution before the start-up has been able to commence operation. In this case, considerable costs may be incurred during that licensing period to ultimately amount to a business that is no longer as strong as it may have been if it was the first-mover.

In comparison, many EU countries will have granted a licence to an aspiring licensee to finality within 6 months.

3. Practical Governance Under GPS/CPS

The specifications in GPS/CPS standards are framed with 'big' companies in mind. Their application in small startup entities can be completely impractical. For example, requirements in CPS 220 for a role of CRO that is separate to the day to day operations of the business and is separate from the CFO, CEO and Chief Actuary either introduces significant additional cost to a start-up or simply be operationally infeasible due to the very hands-on nature for all staff in a start-up.

Likewise, the required number of board members (5) may represent a significant proportion of the total number of employees in a start-up. Furthermore, the need for separate Board Audit and Board Risk sub-committees may be irrelevant for a very small operation. It is perceived that the relevant board operations could be satisfactorily achieved with 3 board members (at least two of which are independent non-executive) and no sub-committees

4. Progressive (Restricted) Licensing

General (and Life) Insurance licensing has not been amended to include the same progressive approaches recently introduced for Banking licences. Whilst informally APRA may not require all documents to be furnished on the first day of an application process there is still a formal requirement that presents a significantly greater hurdle than is seen in banking. Open Banking is likely to create additional divergence in market opportunities between insurance and banking.

There is no process, such as a Restricted Insurance Licence, whereby a potential new entrant can demonstrate market fit and ability to acquire customers (with suitable risk mitigation in place). This makes it very difficult to attract the necessary level of capital investment 'pre revenue'.

5. Confidential

6. Capital Requirements

Minimum Capital

The minimum capital requirement[1] of $5m for a general insurance licence requires actual capital greater than $5m as insurers normally hold a capital such that the ratio of the capital base to the capital requirement exceeds a given number (Such as 1.62[2]). Realistically, a shareholder-owned start up can't commence without $15m of funding when start up costs and time to reach break-even are taken in to account.

Minimum requirements in the EU are 2.5m Euro for comparable classes of insurance.

Arbitrary minimum capital requirements of $5m for each licence do not reflect the risk being undertaken within that license. For instance, a start-up testing a product with very low volume may have total exposure well less than $5m. Likewise, a nascent portfolio may have reinsurance arrangements in place that limit volatility on any one claim and the portfolio as a whole, significantly reducing the scale of potential adverse deviation in experience. Indeed, at $5m the minimum capital requirement may be equivalent to a probability of ruin approaching 0.

Other jurisdictions have developed flexibility to allow startups to enter the market with more ease. For example, Section 2 of the Solvency II Directive[3] has a series of articles which permit a company to be excluded from the scope of the directive. These articles granting exclusions from scope considers factors such as the size of the company and the risk profile of the liabilities.

Australian regulations in relation to Restricted Banking licences permit alternate capital arrangements during the initial phase of restricted operations. No equivalent exists in Australia for insurance companies.

Surplus Notes in an Insurer's Capital Base

Surplus Notes are a form of debt which have characteristics similar to ordinary shares. As deployed widely in the US, they have the following features in respect of payments of principal and interest:

a) Subordinate to policyholders;
b) Subordinate to claimant and beneficiary claims;
c) Subordinate to all other classes of creditors other than surplus note holders; and
d) Interest payments and principal repayments require prior approval of APRA.

Surplus Notes are now widely used in the US by Mutual insurance companies, emerging in the 1990s in response to stronger risk-based capital requirements and Mutuals not having access to additional Shareholder capital.

Australia's insurance regulations do not contemplate Surplus Notes as a valid alternative to paid up share capital (CET1) for a Mutual insurance company. They also require an insurer's capital base to contain a minimum proportion of CET1. In absence of a Surplus Note being able to be treated as CET1, or the ratio requirements being relaxed, a new **mutual** insurer faces significant challenges in bringing together the necessary level of CET1 to meet regulatory requirements.

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[1] APRA Prudential Standard GPS 110 Capital Adequacy para 23 - for a Category A insurer..

[2] Australia Prudential Regulatory Authority - Quarterly General Insurance Performance Statistics

September 2017 (issued 16 November 2017): Industry average of Solvency Coverage ratio as at year end September 2017 - Direct Insurers from Large Groups

[3] Directive 2009/138/EC of the European Parliament and of The Council of 25 November 2009

Risk Adjusted Capital Requirements

Aside from any minimum level of capital required, the prescribed method of calculation for the Prudential Capital Requirement (PCR) is not necessarily applicable for start-up entities. The following components warrant specific discussion and explanation as to their inappropriateness:

Insurance Risk Charge (IRC[4])	The IRC components for outstanding claims and premium liabilities are flat-rate charges that apply to all insurers in relation to particular classes of business. They take no account for the true distribution of the underlying portfolio's liabilities. Reinsurance arrangements are especially relevant in this context. Reinsurance arrangements can limit the degree of adverse deviation of outstanding claims and/or premium liabilities. In so doing, the outer tails of the underlying distribution may be significantly shorter than the risk charges that must be arbitrarily applied. Whilst the 75% probability of sufficient of technical provisions attempts to address this difference it does not fully resolve the arbitrary flat-rate applied. In many cases a start-up will have significant levels of reinsurance in place to limit potential volatility and as such a much lower capital requirement should apply to the insurance liabilities.
Operational Risk Charge (ORC[5])	The ORC is calculated using an arbitrary 3% charge on the gross written premium revenue for the prior year as well as an additional charge for year on year gross written premium revenue growth exceeding 20%. In the early years of operation, the application of the growth component in particular means that this capital charge can be a significant proportion of the overall capital requirement for a startup. There is no limit on the proportion of the total prudential capital requirement from operational risk to prevent this charge being a significant proportion. By comparison, the Solvency II Directive Article 107[6] subjects the operation risk to a maximum of 30% of the basic Solvency Capital Requirement which prevents operational risk becoming such a large component of the total capital requirement. The ORC takes no account of the underlying business model such as distribution, technology and products written. When implemented in the LAGIC review, APRA described the 3% as an area of ongoing research however there has been no further discussion on this aspect of the capital regime since LAGIC. Given it purports to reflect operational risk, a formula which reflects in some way the risks in the start-up operation which can vary significantly from business to business is appropriate to reduce the capital hurdles faced by a lower risk start-up. Additionally, taking a 3% charge on gross written revenue is not a risk-adjusted approach to calculating capital requirements. For example, a company reducing premiums will reduce its operational risk charge but not necessarily reduce the operational risk. Moreover, the inclusion of levies and other charges in the gross written premium revenue calculation distorts the calculation. Two identical companies with the same operational risk operating in different states would have different operational risk capital due to the differences in levies and other charges.

7. Confidential

8. Dearth of Investment Due to Known Barriers

Access to and Marketing to Sophisticated Investors

Corporations Act and ASIC guidelines in relation to market investment opportunities for Retail investors are very clear and constraining. As such, offerings being made outside these regulations (to Sophisticated and Professional Investors) need to take great care in any marketing they do, to avoid

[4] APRA Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge

[5] APRA Prudential Standard GPS 118 Capital Adequacy: Operational Risk Charge

[6] Directive 2009/138/EC of the European Parliament and of The Council of 25 November 2009: Article 107

being viewed by Retail investors. This greatly limits the ability to market opportunities to these investors, even if there is validation in the application process to ensure that the investor meets the requirements of a 'Sophisticated Investor' that would filter out non-complying individuals.

This has created a murky underworld of 'introducers' who operate under class order relief and charge issuers exorbitant fees for access to a dubious 'list' of investors. Significant costs are incurred by early stage companies to get access to these channels with limited evidence of track record by the introducers and low success rates.

Local Investor Risk Appetite For Early Stage Investments

Australian investors (particularly professional investors) have demonstrated a marked lack of interest in investing in businesses with a significant capital requirement or licensing lead time that are consequently pre-revenue businesses or there remains some execution risk.

In contrast, many overseas locations (such as the UK) have far more significant incentives (often tax-related) for early-stage investment which encourages an appetite for a greater level of risk and a far deeper level of interest in such opportunities.

Local Investor Knowledge of Insurance

Australian investors seldom get the opportunity to invest in start-up insurance businesses. Recent insurance startups have been funded by overseas parent companies[7], meaning local investors simply don't understand how early-stage insurance works. This lack of familiarity means investors are more reluctant to invest in early-stage insurance.

Burden of Preparing a Prospectus on a Startup

To make an offering to Retail investors, significant cost must be incurred to prepare and lodge a qualifying prospectus. Some 'lighter' documentation avenues now exist under the 'Crowd Sourced Funding' regulation, however this also carries limitations on the amount of investment available through this channel (maximum $5m in a 12 month period). Access for 'mum and dad' investors to early stage investments is therefore limited both in number of opportunities and the scale of each opportunity available to invest in.

Overseas Funding Required

All of the above issues combine to a situation where it is more cost effective and more successful for Australian early-stage companies to seek investment overseas. In the case of insurance, this means the US and UK markets where there is considerable start-up insurance investment expertise as well as significant incentives to invest.

9. Update Insurance Contract Act (1984)

The Insurance Contracts Act contains a number of requirements in relation to insurance contracts that do not accommodate alternative business models. The regulations defining products also mean that innovative product design may be difficult without breaching those regulations. In general, it can be said that these contractual requirements stifle the development of innovative products and approaches, further deterring a start-up insurance business.

[7] Auto & General (Budget Direct), Hollard (Real Insurance) and Youi all owned by their respective South African parent companies. Progressive Direct was (until its recent trade sale) wholly owned by its US parent.

OPPORTUNITIES

1. Outcomes-based Regulation

Include an 'outcomes based' philosophy in consideration of new entrants, whereby due consideration is given to the materiality of various aspects in the early period of trading by a new entrant and consequently appropriate weight and effort placed on those aspects, with minutiae resolved in due course.

2. Reduce Licensing Timeframe

Specify a definitive 6 month timeline for the APRA licensing process, which would allow certainty for startups both in terms of expectations, budget and planning.

3. Practical Governance Under GPS/CPS

During an initial start-up period, apply practical measures to meet governance requirements with the smaller, 'all hands on deck' teams associated with a startup phase. This timeline would be established by the prudential regulator, APRA, on a case-by-case basis..

For the Executive, allow duties to be initially carried out by fewer roles, sharing of duties across roles, and for all roles to be involved in day-to-day operations. An example would be that if the current CEO or CFO have sufficient insurance and operational risk knowledge, the prudential requirement for a separate Chief Risk Officer (CRO) might be waived initially during a startup phase.

For the Board, we propose that relevant board operations could be satisfactorily achieved initially with 3 board members (at least two of which are independent non-executive) and no sub-committees.

As the startup business scales and grows in complexity, full compliance with all existing prudential governance requirements would then need to be met accordingly

4. Progressive (Restricted) Licensing

A phased approach would lower barriers to entry, encourage innovation, and facilitate the capital raising process critical to new entrants' survival.

APRA could formally introduce a progressive or restricted licensing model for insurance whereby certain components of licensing are not required until a certain scale is reached. Examples of this include compliance with some of the 'big company' requirements that are currently incorporated in CPS 220.

Allow a restricted APRA licence period whereby the insurer applying for a licence can commence trading and sell up to a certain number of policies. This would be subject to suitable risk reduction measures being in place (such as reinsurance) and satisfactory capital reserves being in place to permit a managed run-off if the entity does not receive a licence by the end of the restricted licence period.

5. Confidential

6. Enhance Capital Requirements

Varying Minimum Capital Requirements

Having a varying minimum capital requirement for a licence that is a function of volume, maximum net exposure per policy and in total (reinsurance arrangements), type and nature of business (Eg as in Solvency II) can produce a suitable risk-responsive approach. Whilst this might reduce licensing certainty insofar that it is specific to a project and will be determined in discussion with APRA during the licensing process, it will go a significant way to reduce the largest financial barrier to a startup.

The formal minimum capital requirement for an entity is then documented and attached to the licence as a condition for a given period of time and/or scale of operations (beyond which the normal arrangements apply).

Surplus Notes as a valid form of CET1 for a Mutual insurer

Subject to the regulator's review of the terms of the instrument, allow a **mutual** insurer to use Surplus Notes as part of the Common Equity Tier 1 (CET1) capital.

New Licence Class (Cell Licence)

Aside from the potential solution of varying the $5m minimum capital requirement, consideration should be given to alternate licence classes such as 'cell licensing' which has been established in some international markets such as Malta and Bermuda. A cell license model would allow a startup entity to occupy a cell under a master licence at much lower cost, with more efficient capital requirements and with less time to market.

The master licence will have arrangements for managing risks within each cell. This greatly reduces the initial capital requirement for the firm occupying the cell as well as reducing some of the effort that might otherwise be required to obtain a full licence.

As a startup entity grows to a point where it either outgrows the appetite of the master licence holder for a single cell or simply wishes to obtain its own independent licence, it can do so with a thoroughly proven business model. At such a point, raising the amount of capital necessary may be easier with the business concept proven.

It should be noted that this is not the same as a Managing General Underwriting Arrangement where an existing licence holder allows an entity to distribute/manage a product on its behalf.

Risk Adjusted Capital

Create an insurance risk charge based on the risk profile. Allow the Appointed Actuary to set a suitable capital factor based on the risk profile of the portfolio but leave the factor unchanged as is for provisioning.

Creating an operational risk charge based on the risk profile would more closely align capital requirements to risk. For example, rather than using gross written revenue (including levies and other charges) using a measure such as the greater of 3% of gross earned premiums during the previous 12 months and 3% of gross technical provisions (Solvency II approach), with the result being subjected to a maximum of the total prudential Capital requirement would allow operational risk to more aligned to risk and less distorted.

7. Confidential

8. Dearth of Investment Due to Known Barriers

Advertising Restrictions for Offerings to Wholesale Investors

Improve an issuers ability to advertise an investment opportunity without a prospectus lodged with ASIC, but require such projects to ensure they validate that investors meet the relevant Wholesale Investor definitions (eg Sophisticated or Professional investor, etc).

Early-Stage Investment Incentives

Implement structures such as those seen in the UK (Enterprise Investment Scheme[8]) to encourage investment into early stage funds as well as a greater number of these funds to create investment competition.

[8] https://www.gov.uk/guidance/venture-capital-schemes-apply-for-the-enterprise-investment-scheme

Review Crowd-Sourced Funding Regulations

Introduce a new type of CSF category where the individual investment (without validation as a Wholesale investor) is limited to (say) $2,000 and / or increase the total amount that can be raised under crowd-sourced funding to (say) $20m and advertising of the opportunity to invest is allowed.

9. Update the Insurance Contracts Act (1984)

With over 35 years of technological, financial and community evolution since the Insurance Contracts Act was gazetted, it is timely to review the Insurance Contracts Act from start to finish to ensure it aligns with community expectations and facilitates the development of products that are more useful to a consumer. A number of recent debates have emerged, such as the unfair contract terms discussion, that reiterate that it is timely to review this framework. It is expected that this in turn will create opportunities for start up entities.

NAII REPORT RECOMMENDATIONS

Many of the observations in the NAII report of December 2018 align with aspects of the barriers and opportunities described above. A small number of recommendations have not been in some way described or supported earlier in this document however and, whilst they are not 'Barriers to Entry', they warrant specific discussion. Picnic also has views on minutiae relating to other recommendations however discussion of that is outside the scope of this document.

Stamp Duty Changes - Recommendation 1 & 2

Picnic recognises the significant proportion of Queensland and Northern Territory government revenue that is collected through insurance duties (9% and 10% of premium respectively). The NAII recommendation to abolish these significant sources of revenue is likely to be met with significant resistance due to challenges for those governments setting up alternatives.

Picnic proposes a different approach, where a $ cap is put on the amount that can be charged per policy for home, contents and strata insurance products. The $ cap could be (say) $120 and thus to achieve the existing level of overall revenue the % rate charged would have to increase. This would see lower premium policies charged more stamp duty whilst policies with higher premiums would be charged significantly less stamp duty.

This approach is similar to the approach used in New Zealand to fund Fire Services.

General Insurance Code Of Practice - Recommendation 13

Aside from ASIC approving the Code, Picnic believes it should be necessary for all insurers to publish detailed information relating to its performance against all aspects of the Code. The frequency of this reporting should be no less than quarterly and include detailed information that can be meaningfully compared across insurers. The information should be published at both the insurance licence level and marketing brand level.