19 July 2012

Barriers to Effective Climate Change Adaptation
Productivity Commission
Locked Bag 2, Collins Street East
Melbourne Vic 8003

Dear Commissioners

Barriers to Effective Climate Change Adaptation:
Productivity Commission Draft Report and The role of insurance

We thank you for the opportunity to make a submission to the Commission on the above draft report.

This submission has been prepared by us as individuals on the basis of an interest in and knowledge of the subject matter of parts of the draft report. That interest and knowledge are related to our appointment in 2011 by Minister Shorten as the Panel to undertake the Natural Disaster Insurance Review (NDIR).

Our primary interest is in chapter 12 of the draft report entitled "The role of insurance". This chapter is devoted largely although not exclusively to flood insurance, which was also the focus of much of the NDIR. Regarding flood insurance, this chapter was a surprise to us in two respects –

- The topic of flood insurance and other natural disaster insurance is primarily about managing climate variability as distinct from climate change. We had not originally appreciated, as noted on page 2 of the draft report under Key Points, that "current climate variability reforms should be prioritised" and are therefore an important part of the Commission's focus; and

- In devoting considerable attention to flood insurance in Chapter 12 in the manner that it does, the draft report implicitly challenges and by inference appears to dismiss the primary recommendations of the NDIR and the arguments that support those recommendations.

While we endorse much of the material in Chapter 12, these matters above and others are taken up in the submission attached. It largely represents an analysis of parts of Chapter 12 and it also indicates aspects of the draft that we would ask the Commission to consider amending.

We are concerned that the Commission may not have appreciated the full measure of the NDIR recommendations and the circumstances, explanation and reasoning that stand behind them. We add that the underlying question to be answered, in the context of both Chapter 12 and the NDIR, is whether there is a case for the Government to contribute to a solution to the affordability problem associated with flood insurance. We believe there is. Hence this submission.

Yours faithfully

John Trowbridge | Jim Minto | John Berrill

A. The starting point

Among the key points on page 2 of the draft report is the proposition that –

> "Policy reforms that would help people, firms and governments deal with *current climate* variability and extreme weather events should be prioritised. ... Examples include:
> - reducing perverse incentives...
> - improving information on climate risks...
> - avoiding regulatory distortions in insurance markets."

We endorse these statements and take them as given in this submission.

B. The draft recommendations

Regarding flood insurance, there are two draft recommendations in Chapter 12:

"Draft recommendation 12.2:
The Australian Government should only proceed with reforms that require all household insurers to offer flood cover if it can be demonstrated that the benefits to the wider community would exceed the costs. These benefits and costs should be assessed, and any reforms implemented, after barriers to effective climate change adaptation in other policy areas are addressed."

Draft recommendation 12.2 is not itself specific as to whether insurers, if required to offer flood cover, could also allow house owners to opt out of that cover. Nevertheless, either way, it is hard to disagree with the general thrust of this recommendation.

Incidentally we do query why any reforms that might arise from this recommendation should await the addressing of effective climate change adaptation barriers in other policy areas. After all, the most significant barriers mostly relate to physical infrastructure and risk mitigation actions, by individuals and by governments, which in many cases will be impractical, not cost-effective or long delayed.

"Draft recommendation 12.3
Governments should not subsidise premiums for household or business property insurance, whether directly or by underwriting risks. This would impose a barrier to effective adaptation to climate change."

This Draft recommendation 12.3, taken in conjunction with the preceding material, is problematic in our view. The line of argument appears to be firstly that any form of subsidy or discount would damage incentives and therefore fail to put responsibility where it belongs for homeowners, secondly that intervention in markets is inherently wrong unless there are special circumstances, and thirdly that discounts or subsidies would contravene the cost benefit requirement in recommendation 12.2.

C. **Questioning the essential argument**

The essence of the argument made in Chapter 12 appears to be –

1. Criteria to be met by any new insurance arrangements for flood insurance include -
    - reform should not occur unless benefits will demonstrably exceed costs
    - reform needs a clear policy objective

- subsidies in any form (whether premium subsidies or premium discounts with claim subsidies – see explanation in Section K) should not occur because -
    - they would damage incentives, and
    - "without clear evidence of market failures, or the distribution of outcomes across households, it would be difficult to design or justify intervention in insurance markets that would improve the overall well-being of the community." (p 244)

2. The NDIR recommendations, along with various other proposals, do not meet these criteria because they involve –
   a) market intervention
   b) no clear statement of policy objectives
   c) subsidies (in the form of premium discounts with claim subsidies)
   d) no demonstrable cost benefit outcome (by inference from the various criteria and arguments).

   Hence each of these four aspects appears to be regarded as a "black mark" against the NDIR recommendations.

3. Other initiatives should be taken that would deal with and move us towards a solution to much of the flood insurance problem, in particular –
   - the combination of improved disclosure and improved information collection, as advocated in chapter 12, will satisfy the community need which is essentially that individual homeowners should take full responsibility for their own flood risk.

We only partially accept the criteria at 1 above and we contend by contrast that each of the four aspects at 2 above is not a black mark but instead, by virtue of the proposed design of new flood insurance arrangements and the rationale for them, the NDIR recommendations are indeed well justified.

Dealing with the arguments made against the NDIR recommendations and using the Commission's frame of reference in 2 above, this contention can be explained as follows -

- The proposed *market intervention* has three elements -
  - flood cover as standard
  - premium discounts with claim subsidies on a time-limited basis
  - a Government-backed reinsurance facility

  because -

  - the absence of flood cover is essentially an anomaly in the context of the history of natural disaster insurance in Australia and of the content and spirit of the Insurance Contracts Act- *see **also Section D***
    and
    flood cover can be introduced at little or no cost to the vast majority of homeowners (and indeed several insurers have been adding that cover during the last 12 months - in most cases they simply add it into the policy coverage without asking the policyholder and they are doing so either at nil cost or at such a small cost that is not noticeable to the homeowner).

- without discounts, affordability is a genuine problem for some existing homeowners and these homeowners have no incentive now for improving their flood risk: if obliged to purchase flood cover, even at a discounted price (with the discounts diminishing over time as proposed), such incentives would be introduced – ***see also Section E.***

- the proposed reinsurance facility would be able to deal not only with discounts (for as long as they exist but not indefinitely) but also with any potential future market failures of –
    - reinsurance: the absence of adequate international reinsurance capacity
    - supply: limited or even nil supply of flood cover at fair prices for some homeowners,

  both of which are risks that may well be exacerbated or become more likely over time if climate change leads to more frequent or more severe weather events.

- The *policy objective*, while not stated succinctly in the NDIR report, is nevertheless substantial - affordability is a necessary condition for flood cover to become universal, and the desirability of its being universal can be justified in several ways – ***see also Section G.***

- *Subsidies:* discounts with claim subsidies as proposed in the NDIR will not compromise incentives if the discount system is well designed: the NDIR report contains extensive discussion and proposals aimed at ensuring sound design - ***see also Section H***.

  These proposed subsidies, in the form of *premium discounts with claim subsidies* payable only in the event of flood, are designed in a way that would, we believe, avoid the incentive problem normally associated with prices that are below full cost, as already explained above. This approach also contrasts with direct *premium subsidies,* which we do not support – ***see also Section K.***

- The *cost benefit* equation can, we believe, be shown to be satisfied if a whole of government approach is used to assess costs and benefits; it would be satisfied a fortiori if the Government is prepared to review its total financial assistance approach in times of flood and redirect some of its assistance towards insured homeowners in the manner advocated in the NDIR report – ***see also Section F***.

As to the limitations of disclosure and information collection (see item 3 on the previous page), we are of the view that improved disclosure and information collection, while useful, are not a solution to the flood insurance problem -

- A system in which every insured home has flood cover is a necessary condition for the building up of the full *information base* needed to understand and adapt to flood risk and flood consequences. The historical absence of flood cover and the consequent absence of flood claims have left a vacuum of information and understanding which can never be properly overcome unless the insurance industry is providing and homeowners are receiving flood cover.

- There are references in chapter 12 to the need for and the benefits of *disclosure* around flood cover. Historically disclosure has been shown time and again not to be very effective for most financial products. That is certainly the case for insurance products generally and all the more so when flood cover is an exclusion.

- Apart from dealing with information gaps, improved disclosure and information collection do not deal with affordability issues and simply would not solve much of the flood insurance problem.

D. Insurance regulation in Australia

It is worth recording here some of the history of insurance regulation in Australia.

The Insurance Contracts Act was introduced in 1984. "Australia became the first and probably remains the only OECD country to have developed comprehensive legislation which specifically governs insurance contracts. Importantly, the legislation includes Regulations which spell out the wordings for standard contracts for consumer products including home building and contents policies ('standard cover'). The home building and contents Standard Cover includes full cover for 'flood' without any further definition of the term. Insurance companies were permitted by the legislation to vary Standard Cover provided that they *clearly informed* consumers of any variation (derogation)." [Alan Mason, submission to NDIR – our italics].

This legislation is powerful. It has been very effective generally in standardising insurance cover and improving both standards and the standing of the insurance industry in Australia. Insurance disputes over claims are now generally at a low level (except when floods occur). Nevertheless, in our opinion its value has been diminished by the courts allowing insurers to treat disclosure that is buried in a long product disclosure statement (PDS) as meeting the "clearly inform" criterion.

It so happens that historically most insurers have chosen to vary the standard cover only with respect to flood and otherwise include all main natural disaster risks as standard cover.. It is not possible to buy a home building policy that excludes any of earthquake, storm or bushfire, so that flood has been the one significant risk exclusion under many home insurance policies.

The Government's proposals

These proposals are referred to under Key Points on p 225 and relate to the above history of insurance regulation.

It is the lack of effectiveness of disclosure via the PDS that has led to the Government's recent initiative on a *Key Facts Statement* and it is the lack of a definition of flood in the Insurance Contracts Act that has led to the Government's recent introduction of *standard definition of flood*.

While these initiatives are both useful, it should be emphasised that a standard definition of flood along with stronger disclosure when it is excluded is a minor step forward in dealing with the flood insurance problem that we have in Australia (the only problem it solves is that, if two neighbours' homes are both flooded and are insured with a flood exclusion by different companies, then either both will be paid their claims or neither will be paid). Affordability issues and the underlying problem of the rather arcane distinction that the insurance industry makes between flood and other water damage are left substantially untouched by a standard definition.

It is notable also that, as well as the Insurance Contracts Act, there is a substantial regulatory apparatus around insurance in Australia, as there is in banking, on the basis that markets should be well conducted (under regulations for which ASIC is responsible) and insurance companies should be prudently managed (under APRA requirements), with the latter aimed at avoiding insurance company failure and thereby protecting policyholders and claimants.

E. Availability and affordability of flood insurance

It is clear enough that insurers have excluded flood from standard cover because of both difficulties in pricing the cover and the knowledge that, in cases where the price is high, i.e. materially higher than the cost of insurance without flood cover, most people will not buy the cover.

This situation in Australia can be contrasted with that in the UK where flood cover has always been offered as standard and where, in the 1980s when the industry was becoming concerned at rising flood claim costs, it managed to reach an accord with the government. It was agreed that insurers would continue to offer the cover as standard and at affordable prices if the government would commit to a set of initiatives and associated expenditure on flood risk mitigation (that agreement is still in force but is now at risk of unwinding as a result of continuing rises in flood claim costs as a result of economic development at a time when the government is cutting back on its risk mitigation expenditure).

The NDIR brief was essentially about the availability and affordability of natural disaster insurance and the problem is predominantly about flood insurance. The draft report notes these questions but -

- on availability, it simply notes the figures quoted by the Insurance Council on availability and eventually arrives at the recommendation that it be left to the market (the insurers themselves) to decide on whether they wish to offer cover (and presumably for customers to decide whether to take it)

- on affordability, it makes light of the "small proportion" of households who have high flood risks such that affordability is an issue.

The draft report appears to contend that anything other than homeowners paying the full price for flood cover would represent "perverse incentives" that would compromise the price signals and accountability of homeowners for their flood risk (and incidentally makes no comment on the uncertainty inherent in setting prices, even with good information – see also Section K).

The NDIR Panel spent more than six months on these two questions of availability and affordability. The Panel was also always acutely aware of the need to avoid perverse incentives and we believe that, in its recommendations, it has done so.

On availability, we do not agree that the offer of flood cover should be optional or that its acceptance should be optional. During the NDIR we made a substantial effort, as already noted, to find a solution that would not generate perverse incentives.

The terms of reference for NDIR included as a guiding principle that "Government intervention in private insurance markets is justifiable only where, and to the extent that there is clear failure by those private markets to offer appropriate cover at affordable premiums". In other words, the Panel was always aware that market intervention is not a matter to be taken lightly or to be undertaken in any way other than with great care.

On affordability, we would argue that, although the proportion of houses in flood prone areas is small overall, it cannot be dismissed as unimportant. If it could, the NDIR would have been unnecessary.

Incidentally, the Commission may have misunderstood the affordability discussion in the NDIR report –

- In the Commission's report, affordability is looked at essentially as a question of the means of individuals, whereas

- The NDIR report explains that such an approach is not suitable for dealing with flood insurance and that affordability should be approached in this context by considering what is a reasonable price to charge the policyholder having regard to the price previously paid. The explanation and the justification for this approach are spelt out in detail in the NDIR report.

The insurance industry position on affordability

The insurance Council, in section 12.3 of its submission, states that -

"A long-term artificial or forced reduction in premiums, payable by those exposed to risk would not serve the community well. Without 'paying the price' individuals will not be stimulated to make better decisions about risk and the future.

"However, as the ICA has submitted previously, there was a long-standing failure of governments to manage these community risks in all cases.

"Consequently, there is a considerable legacy problem to be addressed with vulnerable members of the community have been placed in harms way due to a lack of integrated government mitigation, land use and building code policy.

"The ICA submits that short-term targeted subsidies for insurance premiums, payable by governments directly to those individuals facing the highest risks and who lack the capacity to adapt quickly, is a measure worth considering, but only as an interim step loss mitigation is undertaken to remove or reduce the present risks." (our italics)

This paragraph Is a reference to the affordability problem and the need to address that problem until the affected individuals are in a position to handle the risk themselves, whether by risk mitigation or paying higher insurance premiums or both.

These quoted paragraphs are entirely consistent with the NDIR report with one exception, namely that the NDIR recommends premium discounts (with claim subsidies) be granted to the relevant homeowners whereas the Insurance Council recommends premium subsidies for those same homeowners. Appendix A expands on this difference between premium subsidies and premium discounts with claim subsidies.

In other words, both the Insurance Council and the NDIR believe the affordability problem warrants some form of Government intervention, even if they do not advocate the same solution.

F. Cost benefit assessments, "Insurer of last resort" and government relief payments

Pages 237 and 238 contain several paragraphs about Government assistance to meet equity objectives that might be relevant to supporting those individuals who do not have the means to deal adequately with their own risks in time of disasters such as floods.

While we have no disagreement with the content of these paragraphs, we think it is misleading in this context to refer to the idea of Government as insurer of last resort. This term is normally used when a private sector insurance system is operating in such a way that, firstly, not everybody who needs insurance can obtain and afford to pay for it through the insurance market and, secondly, the Government stands as the insurer or reinsurer who accepts those risks that the private sector is unable or unwilling to underwrite itself.

We suggest that this subsection should have a title such as *Government assistance payments and insurance* instead of referring to the government as 'insurer of last resort'.

An important topic or argument that appears to be missing from this section is the opportunity that the Government has to redirect Government assistance in time of disasters. It is well recognised that many disaster recovery payments are not well targeted and yet can be very expensive for the Government. It was beyond the terms of reference of the NDIR to explore this issue from a whole of government viewpoint but a case can be made for a more equitable and targeted set of relief payments. If greater individual responsibility is to be encouraged, including holding insurance, such an approach could well result in reduced disaster recovery payments and could make a substantial contribution to dealing with the insurance affordability problem, particularly in relation to flood insurance. That would represent a more integrated or more holistic approach to the question of disaster management, personal accountability, insurance and community resilience.

On pages 237 and 238, we also note the attempted compartmentalisation in the draft report of the flood insurance market situation and other government assistance programs (Commonwealth and State), pre-planned and ad hoc, that come into play when disasters occur. It is desirable to have a whole of government and integrated approach to public and private involvement in disaster risk management, responsibilities and responses.

Hence there is potential for reallocating government assistance when floods occur in a way that has little or no cost to the Government's outlays while simultaneously generating greater personal responsibility and improving risk management and risk mitigation incentives.

The NDIR position on this topic is quoted in ***Section L*** at the end of this submission.

In the context of Draft Recommendation 12.2, we believe it would be worthwhile to see a study conducted that postulated a number of options or scenarios around alternative government assistance arrangements and insurance discount arrangements. The goal would be to assess them on a cost benefit basis to ascertain whether an allocation of resources to claim-related subsidies would be more cost effective than putting those same amounts into other forms of government assistance.

G. Policy objectives for reform

Box 12.5 that identifies the objectives for reform is arguably incomplete. There are other possible objectives for reform beyond market failure and equity. For example, objectives not mentioned in this box that could be considered are community resilience to natural disasters and regulatory gaps.

Under market failure, there are two bullet points, both of which we endorse. The second, however, which states that "insurance may be unavailable in some cases because the underlying risks are difficult to insure. If no insurer is willing to provide cover for commercial reasons, this does not necessarily indicate a market failure". We would note that the unwillingness of insurers to provide cover may represent a regulatory gap -

> By way of example, we have systems of workers compensation insurance and third party motor insurance in Australia which operate in the private sector and are compulsory. Without the support of a set of regulations that place obligations on insurers about how they should operate, there would probably be many employers or motorists without cover. The regulations in those cases are designed to enable insurers to operate on a normal commercial basis overall while simultaneously meeting the community needs for insurance protection that would not be met under a normal free market system.

We offer a comment also on the statement that "the underlying policy objectives to be met are not clear". In the context of the NDIR recommendations, we wish to challenge this point, notwithstanding that there is not a single concise statement of objectives in the NDIR report. To respond in terms of the draft report's line of reasoning (in effect that objectives for reform need to meet a market failure or equity problem), we comment as follows –

- The existence of "market failure" is debatable as this term is often used in different ways (e.g. it has been claimed that the failure of enterprises to price and pay for the economic cost of carbon dioxide emissions is a market failure)

- It could be argued that the absence of flood insurance does constitute a market failure, and indeed an historical market failure that has been compounded over decades: if flood risk had always been covered and priced into insurance policies, arguably the associated price signals and other consequences would have led to a rather different set of outcomes today regarding not only insurance but land use and planning decisions, responses of councils and State governments etc. On this argument, the NDIR recommendations are an attempt to respond to and rectify, over the next decade or so, a long-standing market failure.

- It could perhaps be classified as a market anomaly more than a market failure but we would still contend that that justifies policy reform.

- Alternatively the flood cover problem could be classified as a regulatory gap. Further, we regard it as a gap in the structure of the economy that the Insurance Contracts Act attempted to tackle in the 19880s but is still a work in progress.

- It could also be classified as an equity problem, although not in the social welfare sense as described in Box 12.5 but in a community resilience sense as essentially a legacy problem that is beyond the resources of many of those affected to rectify.

H. Subsidising insurance premiums

This section in Chapter 12 comprises most of pages 243 and 244.

The assertion is made that premiums that do not fully reflect the risk would reduce incentives to mitigate those risks. The assertion is not substantiated and there are many situations in insurance where this statement would not be valid. More importantly, in this instance the Commission appears to have overlooked the following in the NDIR report:

- the NDIR acknowledges clearly and openly the problems of absent or inadequate incentives and also the moral hazard that can exist in flood insurance arrangements, noting that design details become important here

- the NDIR puts the proposition that such a system can be designed, and it goes to some lengths to propose and explain a system of discounts that would not suffer from the moral hazard or perverse incentive problem.

In summary it proposes the following design criteria for a flood premium discount system designed to respond to the affordability problem which is
simple for policyholders and automated for insurers -

- for policyholders, discounts which are -
    - assessed by reference to an 'affordability threshold'
    - only for existing homes (no discounts for new homes)
    - to be phased out gradually over time
    - avoid a material increase in levels of non-insurance
- for pricing purposes –
    - higher flood risk → higher flood risk premiums
    - nil flood risk → no flood risk premium
    - no premium cross-subsidisation among policyholders
    - smaller discounts for high value homes
- for insurers -
    - discount system compatible with the insurance market
    - insurers hold some part of the flood risk themselves
    - insurers retain full interface with their policyholders.

I. The scale of the flood insurance problem

Incidentally, from a financial viewpoint, we have not been privy to estimates prepared by Treasury or the Government Actuary on the NDIR proposals but, to give our own 'back of the envelope' assessment to put the matter into context –

- if all home owners paid for flood cover, the extra premium volume is likely to be of the order of \$200m to \$400m per annum (part of some \$3bn)

- if the proposed reinsurance facility were in place and it had no material assets (which would be the case in the early years before much phasing out of discounts), the cost to government would likely be nothing in most years, small amounts in some years (say up to \$100m), and between \$1bn and \$2bn in a case like the 2011 Brisbane floods, which on past history might be on average about 1 year in 30

- in maturity, the reinsurance facility would be self-funding and, if it purchased no reinsurance itself (it could and probably should do that, as does the ARPC), one would expect its assets to build to an amount that exceeded \$1bn if there were no major floods for say 10 years or more.

J. Additional observations

Box 12.4 – outline of NDIR proposals

Box 12.4 gives a succinct statement of the NDIR's proposals. We would request that this description be modified by inserting, after the word "discount" the words "on a time-limited basis and supported". It would then read "It recommended that flood insurance be mandatory in all home building, contents and strata title policies, and that flood premiums for existing properties that exceed an ‘affordability threshold’ be discounted on a time-limited basis and supported by a government backed reinsurance scheme.”

It could also be noted that the position taken by the NDIR and the position taken by the House of Representatives Standing Committee are fully consistent with each other in so far as they are dealing with the same question, i.e. both are recommending that all homeowner policies be required to include flood cover.

Page 228, 4th bullet point and the second paragraph – climate change adaptation

Reference is made here to the potential need for extra capital and reinsurance requirements, and also the diminishing value of historical data. The point should be added that insurers are able to adjust their prices and underwriting terms every year, i.e. the industry manages much of the temporal risk of climate change by operating mainly with one year policies. Hence much of the risk of climate change, which has a longer term horizon, is transferred through annual premium increases to the buyers of insurance.

At one level the insurance industry does not have to worry very much about climate change because it generally offers one year policies only and can adjust prices and terms every year. As a result it could be said that the industry needs to look only two or three years ahead in managing its affairs. The more far-sighted recognise well, however, that the insuring community (personal and commercial) depends on insurance cover being always available and affordable and that, whenever the industry seems unable to deliver, government intervention is only a short step away.

Consequently the argument in the third paragraph is of minor importance because of the gradual nature of the expected changes and the ability of both insurers and buyers of insurance to adapt progressively to any effects of climate change.

Page 230, third paragraph – market availability of flood insurance

This paragraph refers to availability of flood insurance. It notes some of the high premiums for flood insurance. It could acknowledge also the experience both before the 2011 floods and since, where several insurance companies have begun offering flood cover, some with and some without an option to exclude the flood cover, and experience is clear that most people in higher flood risk areas elect not to pay the additional premium.

Page 230, fourth paragraph – potential reforms

Is there a reason why the Government’s proposed reforms are referred to but not the NDIR’s?

Page 235 third paragraph – flood information’ portal’

This paragraph refers to a decision by the Government to establish a so-called portal managed by Geoscience Australia for flood maps etc. It may be appropriate to acknowledge that this initiative by the Government has been taken as a direct response to a corresponding related NDIR recommendation (specifically Recommendation 25).

K. Subsidies vs discounts (or premium subsidies vs premium discounts with claim subsidies)

For properties with flood risk such that affordability is seen as an issue, and in the context of the NDIR report –

1. ***Premium subsidies***

   A price for flood cover is arrived at and the insurer receives a portion of the flood premium each year as a cash subsidy, either directly from government or from government through the policyholder.

   The key design aspects here are –

   - Insurers receive the subsidies year in and year out, come rain, hail or shine or, more aptly here, come rain, drought, flood or bushfire
   - The annual cost to government is likely to be somewhere in the range $200m to $400m
   - When there are no floods or minor flooding only, including of course all the drought years, most of this aggregate subsidy would fall into insurer profits (some would go into reinsurer profits in those years and some into expenses)
   - The administrative arrangements needed to operate a subsidy scheme, with many transactions and price assessments needed every year, would be a major undertaking
   - Even if the idea were palatable, price setting for the subsidies could be virtually intractable: how could prices be set such that both insurers and the government thought simultaneously that the prices were fair (it is hard to foresee that any assessment of the price, comprising the cost of flood risk, given all the uncertainties, plus the loadings for reinsurance, expenses and profit, would satisfy both parties, and the longer were any dry periods the more problematic it would be)?
   - In addition to dealing with the pricing questions, insurers would be underwriting the business corresponding to the subsidies and so would need to hold capital and buy reinsurance in respect of that exposure.

2. ***Premium discounts with claim subsidies***

   A price for flood cover is arrived at but the policyholder pays only part of that price; the insurer bears the portion of the risk that corresponds to the price it receives and the government bears the remainder of the risk. No money changes hands in respect of the discount. Instead government underwrites its portion of the risk and pays claims only when floods occur that give rise to claims on its portion of the risk.

   The key design aspects here are –

   - The insurers underwrite their portion of the risk, at their prices, and receive those prices, without any involvement of government
   - For the portion of flood risk ceded to the reinsurance facility, insurers would bear no risk and require no capital
   - In years when there are no floods or minor flooding only, including of course all the drought years, the cost to government would be nil
   - The next time there is a major flood like the 1974 or 2011 Brisbane flood, the cost to government could rise to $1bn or more

- In respect of those occasional years when there are major floods, there is the possibility of government restructuring handouts to mitigate its claims costs under a discount scheme
- Price setting for the discounts would be in the hands of the manager of the reinsurance facility and would be independent of insurers' pricing, underwriting, claims etc for the portion of flood risk that they cover, hence no need for agreement between insurers and government on price setting.

Note also that the Review Panel recommended phasing out the discounts, so that the costs of flood claims guaranteed by the government should eventually be covered by the accumulated pool of premiums (whether held in a pool, as proposed, or simply retained each year as part of Consolidated Revenue).

L. Government disaster relief and flood insurance – NDIR excerpt

The NDIR report in Chapter 11 states the following -

"Charitable and government assistance following natural disasters can also be seen as a premium-free insurance against natural disasters. If a catastrophe occurs, individuals without insurance are the beneficiaries of the financial support they can obtain without having to pay premiums.[1] Providing assistance after a natural disaster also reduces individual incentives to manage risk before the next natural disaster. If households expect to receive relief payments after a loss, they have less economic incentive to invest in mitigation measures or insurance before the next event. This may increase the uninsured losses experienced in the next disaster.

"Charitable and government payments are often reduced according to the amount of insurance payments. There are several natural disaster relief programs for individuals, families and small businesses administered by the States and partially reimbursable by the Commonwealth through the NDRRA which are all reduced in the presence of insurance. Larger natural disaster events in the recent past have seen temporary charitable funds being set up. We are only aware of one instance (the Victorian Bushfire Appeal) where payments were not reduced at all for disaster victims that were uninsured.

"Reducing charity and government payments to disaster victims according to their insurance payouts can be seen as penalising those who insure and creating or exacerbating problems of 'charity hazard'. Nevertheless, the purpose of government and charitable relief is to assist households to recover financially from natural disasters. Not taking insurance payments into account might result in those in less need receiving as much as those in greater need and may result in those affected by natural disasters profiting financially; that is, receiving payments in excess of losses.

"To balance these two needs, the Review Panel recommends that the principle that should guide charitable and government payments is that they should not replace or displace insurance. That is, payments should not penalise those who insure.

"Accordingly, while the presence of insurance should be taken into account in determining the extent of any payments, it should not be the single determining factor. It should instead be considered alongside other indicators of the need for assistance such as assets, liabilities, income and damages.

“This approach could also assist to overcome the issue of delayed payments. For example, there were delays in disbursing funds from the Queensland Premier’s Disaster Relief Fund due to delays in insurance claims being assessed or finally determined.

“To implement this proposed coordinated approach between insurance claim payments and other sources of funds that provide relief and support after natural disasters would require a level of financial coordination that has not occurred in the past. It would require the insurance industry to become a party to Commonwealth and State payment arrangements commencing immediately after the disaster. The Review Panel therefore recommends that the Commonwealth engage with the insurance industry and the States in planning for the future coordination of charitable and government payments to individuals to assist with recovery from a natural disaster and to do so in a way that does not discourage homeowners from holding home and home contents insurance.”