INSURANCE COUNCIL OF AUSTRALIA

10 June 2014

Natural Disaster Funding Arrangements
Productivity Commission
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SUBMISSION TO THE PRODUCTIVITY COMMISSION REVIEW OF NATURAL DISASTER FUNDING ARRANGEMENTS

The Insurance Council of Australia (ICA) welcomes the opportunity to provide comment on the challenges of funding responses to natural disasters in Australia.

The ICA would welcome any opportunity to engage with the Productivity Commission (the Commission) on these matters. The ICA stands ready to respond to any request for further engagement.

Role of Government in Natural Disaster Management.

The ICA submits that the proper roles of Government in natural disaster management is to:

- **Limit new community hazard exposures** – by ensuring that regulatory measures prevent development that is not appropriate in areas of high hazard. This should be achieved through an enhanced National Construction Code and state adoption of land-use planning frameworks that require new development to be fortified against predictable hazard exposures in any given location.
- **Reduce existing community hazard exposures** – by implementing mitigation measures that reduce, redirect or remove hazard impacts on existing settlements[1].
- **Protecting public assets** – by risk managing government assets to ensure hazard exposures are minimised.
- **Provide emergency response capacity** – by maintaining appropriately equipped and qualified emergency services.
- **Facilitate community resilience** - encourage citizens and businesses to manage risks and to be economically self reliant in the event of disaster, avoiding the unintended consequence of market interventionist policies and the perception that government may subsidise risk.

The ICA has previously made submissions on these points to the Commission during the 2012 inquiry into Barriers to Effective Climate Change Adaptation and will not seek to repeat them verbatim in this forum.

[1] Examples include capital works such as the recent St George flood levee's, through to policy changes like the NSW Governments decision to allow homeowners to take greater action to protect homes from bushfire, see http://www.rfs.nsw.gov.au/file_system/attachments/State08/Attachment_20140529_B626A1D9.pdf

The costs of natural disasters and their drivers.

From an insurance perspective the primary drivers of elevated disaster impacts (measured through recovery costs) is the increased exposure of the built environment to natural disaster events that have inappropriate mitigation to reduce vulnerability.

The primary driver to increasing loss is how the community has developed and expanded the built environment in areas exposed to hazards. Australia is allowing more brittle and expensive assets to be constructed in locations where natural hazards have historically occurred, and in most cases there is limited recognition (by government) of the potential for those hazards to cause significant economic loss to the assets.

An example of this increased exposure was articulated in June 2014 by the Climate Institute in its report on the link between insurability and climate change. This noted the 1974 Brisbane Flood inundated about 8000 properties. However the 2011 flood of the same river system at 1m lower than 1974 impacted more than 25,000 properties.

Policy Objectives of the Natural Disaster Relief and Recovery Arrangements (**NDRRA)**

The ICA submits that the policy objectives of the NDRRA should be to provide an equitable mechanism to support an individual state that has suffered natural disaster losses beyond its own capacity to respond effectively.

To encourage states to address systemic hazard exposures, these jurisdictions should be required to contribute to the arrangements under the same risk-based pricing principles that are used in free market insurance. States with a higher propensity to claim against the NDRRA should be required to contribute more heavily to the mitigation costs, or be required to take concerted action to reduce the exposures that are causing claims being made on the nation.

Current arrangements appear ineffective in ensuring that all states maintain a threshold capacity to respond to predictable events without resort to the NDRRA in every instance. For example, insurance capacity for state-owned assets typically damaged in natural disasters can be purchased from the free market, but is not employed effectively in states with a preference for making claims on the NDRRA in lieu of purchasing insurance.

The ICA contends that any review of the NDRRA should establish a fundamental and equitable threshold for each state to maintain (in terms of economic recovery capacity) that must be exhausted before a claim is made on the NDRRA. This is similar to household insurance products that set an excess on a claim if an event occurs. Such a threshold should recognise the propensity of each state to make claims, and the programs each state may have enacted to reduce their hazard exposures over time and therefore reduce their financial call upon other states and the Commonwealth.

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Betterment Provisions

Betterment provisions provide capacity for damaged infrastructure to be rebuilt in a manner that reduces future exposure, and therefore the probability that public money will be repetitively called upon to replace the same infrastructure.

The Queensland Treasurer, Mr Tim Nicholls, discussed the principle of Betterment in the 2013-14 Budget speech:

> "It is said that the definition of insanity is to keep doing the same thing but expect a different result ...
>
> "This time it will be different, in partnership with the North Burnett Regional Council a new pumping station and intake will be built upstream at the Claude Wharton Weir, at a slightly greater cost, but a cost that is an investment in the future. It's a smart investment.
>
> "Betterment makes sense, it is better that the town gets clean drinking water and it is better that both the State and Australian Governments don't have to rebuild the same infrastructure twice."

Notwithstanding this statement and the example of the new pumping station, there are few examples of Betterment following disasters in the past decade. The process to receive funding for betterment is overly challenging and can be quickly overwhelmed by political and community pressure to simply replace infrastructure so that the community can return to business as usual in the shortest timeframe possible.

The ICA submits that the Commission should recommend that an audit be carried out on infrastructure repair and rebuilding projects where NDRRA funds have been applied. This will quantify the extent to which Betterment principles and/or funding have been or could have been applied. The same audit should examine reasons why Betterment has not been undertaken in some instances, and make recommendations for procedural changes that might overcome the obstacles.

Governments in post events are rightly focused on restoring the community but it would be ideal to try and also improve the resilience of the community. The ICA submits that this could be more easily achieved if the government had plans ready to go to improve the design/ resilience of public assets (bridges etc) before future disasters occur so they can be improved (if appropriate) versus just copying the previous structure.

This would allow rebuilding to start immediately and not have to wait months/years to design the new structure. This principle should also be applied to domestic properties where current development controls exist. For example floor height for houses on flood prone land. Local government with support from state and federal should explore raising all damaged houses to the current development control flood level as in some flood prone areas this will significantly reduce premiums due to flood risk.

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NDRRA Payments to Individuals, Business and Farms

The ICA has frequently been asked to comment on the propensity for government assistance for disaster victims to act as a disincentive to the uptake of private insurance and therefore acting to reduce community resilience.

ICA members have reported anecdotal evidence of some customers altering their excess arrangements and sum-insured on the basis of an expectation that governments would provide assistance in the event of a large disaster. However, the practice is not widespread. The small payments and grants made will typically not provide for the complete restoration of any loss experienced, a fact that appears to have been grasped well by most in the community. Individual insurer submissions may be able to provide more certain data on this phenomenon.
The aggregate volume of small recovery payments made in the post-disaster environment quickly adds up. Following the 2011 Queensland floods the Commonwealth reported that more than $800 million in emergency payments were made to individuals claiming to be impacted by the flood event. This does not compare well to a combined state and federal fund for mitigation of less than $100 million.

A rational response to the risk of repetitive economic loss is to seek measures to reduce the extent or probability of the loss reoccurring wherever possible to do so. This principle has been underscored by many reviews and inquiries since the 2011 disaster season, yet funding for mitigation activities remains limited.

The ICA contends that the Commission should consider if there is appropriate mutual obligation or economic rationale that could be introduced to drive mitigation in locations where disaster events have occurred. For example, where government payments are made to individuals and businesses following a disaster, government could commit to providing matched funds into the Natural Disaster Mitigation Program (NDMP) to be allocated to mitigation activities in the post-disaster recovery environment. Over time, this would reduce the probability of future damage and repetitive payments.

Mitigation through the National Emergency Management Projects (NEMP)

The management of mitigation programs has traditionally been undertaken by multiple agencies across state and commonwealth jurisdiction, often with different responsibilities and agendas.

The ICA contends that mitigation infrastructure should be managed as infrastructure by agencies with infrastructure responsibilities. Infrastructure agencies in each state have the required expertise and understanding of large-scale projects, but more importantly they have the opportunity to integrate mitigation objectives into other types of infrastructure.

For example, in many nations flood levees are not stand-alone structures – they are rail and highway embankments or other structures with a dual purpose. There are examples around Mackay QLD where poorly coordinated rail infrastructure has reportedly had the opposite effect and has created areas of flood risk for some communities that did not exist before and that only came to light during a flood in 2008.

The ICA submits that consideration should be given to allocating responsibility for physical mitigation projects to state and Commonwealth bodies that have responsibility for large-scale infrastructure works, for example Infrastructure Australia.

Do problems exist in insurance markets that prevent households and businesses from taking out insurance for natural disaster risks? What are the causes and consequences of these problems? What possible solutions might be available?

Insurance premiums act as a market signal of risk. By extension, high insurance premiums may prevent a small number of households and businesses from taking out adequate insurance cover. In these circumstances it is most efficient to focus on risk reduction to sustainably solve the issue, rather than market interference through premium regulation or subsidisation.

Some properties face natural hazards at a greater frequency and intensity than others, yet are constructed using the same principles. Insurers price according to the risk, based on the latest information in their possession. Though insurers are developing more sophisticated data and methodologies to understand risks at a more granular level, claims experience, technical pricing and the prudential regulatory regime demand that insurers price for such risks will continue to mean that some households and business pay more than others by virtue of the hazards that surround them.

Finding measures that address the underlying risk factors faced in high hazard regions is the only solution to sustainable premiums.

As recently identified by the Productivity Commission review of Barriers to Effective Climate Change Adaptation, intervention in insurance markets[2] to alter pricing signals will suppress incentives for the community and governments to address the underlying risk and is reflected in the quote below:

> "Subsidies reduce the incentives that insurance premiums give households to reduce their exposure to risks. This would likely impede structural adjustment required to adapt to climate change — for example, a household might face weaker incentives to protect their property from hazards, or to move to a lower-risk area.
>
> – Subsidies could also encourage excessive development in hazard-prone areas if not restricted to existing properties. This could further impede adaptation.
>
> – Subsidies could distort risk management decisions by households more broadly if funded through cross-subsidisation by lower-risk policyholders.
>
> • There could be potentially large budgetary costs if governments fund subsidies or underwrite risks, such as by insuring households directly or by backing a reinsurance pool. "

[2] For a broader reference on the role of insurance in the Australian Economy, the ICA's recent submission to the Financial Services Inquiry provides a context for how private insurance transfers the residual risk for loss from Business and Individuals.

http://www.insurancecouncil.com.au/assets/submission/2014/Financial%20System%20Inquiry%20-%20ICA%20Submission.pdf

The effect of the insurance price signal on driving risk adaptation has also been recently underlined by a report by the Climate Institute, commissioned by *Choice* and attached for your reference. In this report the Institute identifies that insurance is necessarily driven by an examination of risk, and that in most instances could be said to be operating efficiently. This report also identifies that, if any market failure exists that is driving higher insurance premiums, it is the planning, development and building sectors that are producing high-exposure properties, free of any effective government intervention. A recent report by the Business Roundtable for Disaster Resilience identified that if this market failure continues annual disaster losses will climb by an order of magnitude to $23bn by 2050.

Taxation is another problem in the insurance market that exacerbates issues faced by consumers. The ICA has long submitted that specific taxes on insurance premiums, whether in the form of stamp duties or levies to fund fire and emergency services should be abolished. This view is consistent with the recommendations of the Review of Australia's Future Tax System and the Commission. However, the ICA recognises the revenue implications of such a removal and has put before policy makers several alternative funding arrangements. This includes the option to address revenue shortfalls through improving existing state taxes, such as payroll and land. [3] The latter tax-mix switch model has been successfully deployed in the ACT, where insurance duties are being wound down over five years.

Notwithstanding that the preferred approach to insurance premium taxation remains the complete abolition of all State taxes on insurance, there remains scope for taxation reform options in the transition to their full abolition. In the case of mandatory insurance for strata properties, there remains the viable option that, given the purchase of insurance is mandatory under Queensland law, then the purchase of such insurance be exempt from stamp duties.

An exemption for stamp duty on insurance for strata buildings would be consistent with the treatment of other compulsory insurances required by respective state laws. For example, the requirement to compulsory purchase third-party motor personal injury insurance in Queensland results in this form of policy being exempted from stamp duties.

The ICA contends that the case for compulsory insurance purchase rests on the need to improve the operation of the insurance market in the particular class by avoiding counterparty risk. In the case of strata insurance, the absence of compulsory insurance may impose disproportionate burdens/costs on remaining unit holders in the event that a unit holder had insufficient capacity to meet any losses from an unforseen event. In that regard, it is appropriate that the lowest cost solution is to mandate the requirement for insurance.

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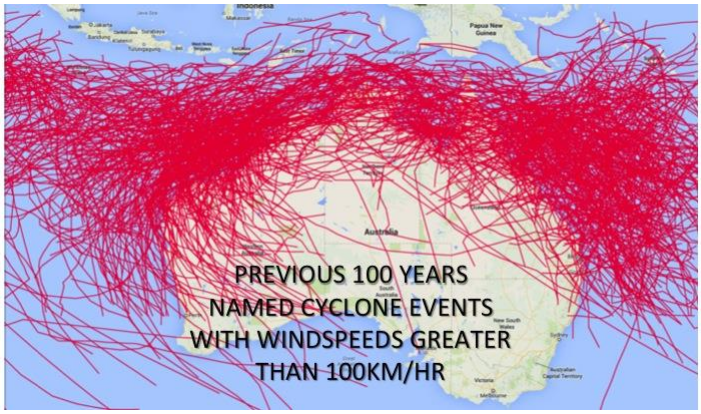
[3] See ICA submissions to the Henry Tax Review, the NSW IPART review in State Taxation, the Victorian parliamentary review in State Taxation, the Tasmanian governments review into State Taxation and the SA Parliamentary Review into State taxation. All available at www.insurancecouncil.com.au

However, equally appropriate would be to ensure that compulsory insurances are not required to pay stamp duties. In the case of North Queensland, relief from stamp duty would provide a fillip to affordability constraints, a benefit that is magnified when considering the compounding effect of GST which is charged on the combined risk premium and stamp duty. Government concerns about how insurance affordability impacts upon its constituents, while continuing and in some instances increasing taxation of policyholders and thus exacerbating the cost, are incongruous and difficult to explain.

Are high insurance premiums for households in some areas reflective of the risk in those areas, or are they reflective of information asymmetries or other problems in the insurance market?

Insurance premiums for households reflect the risk profile at the location. Though other factors are taken into consideration, the hazard signal leads to heightened premiums, especially in high hazard areas.

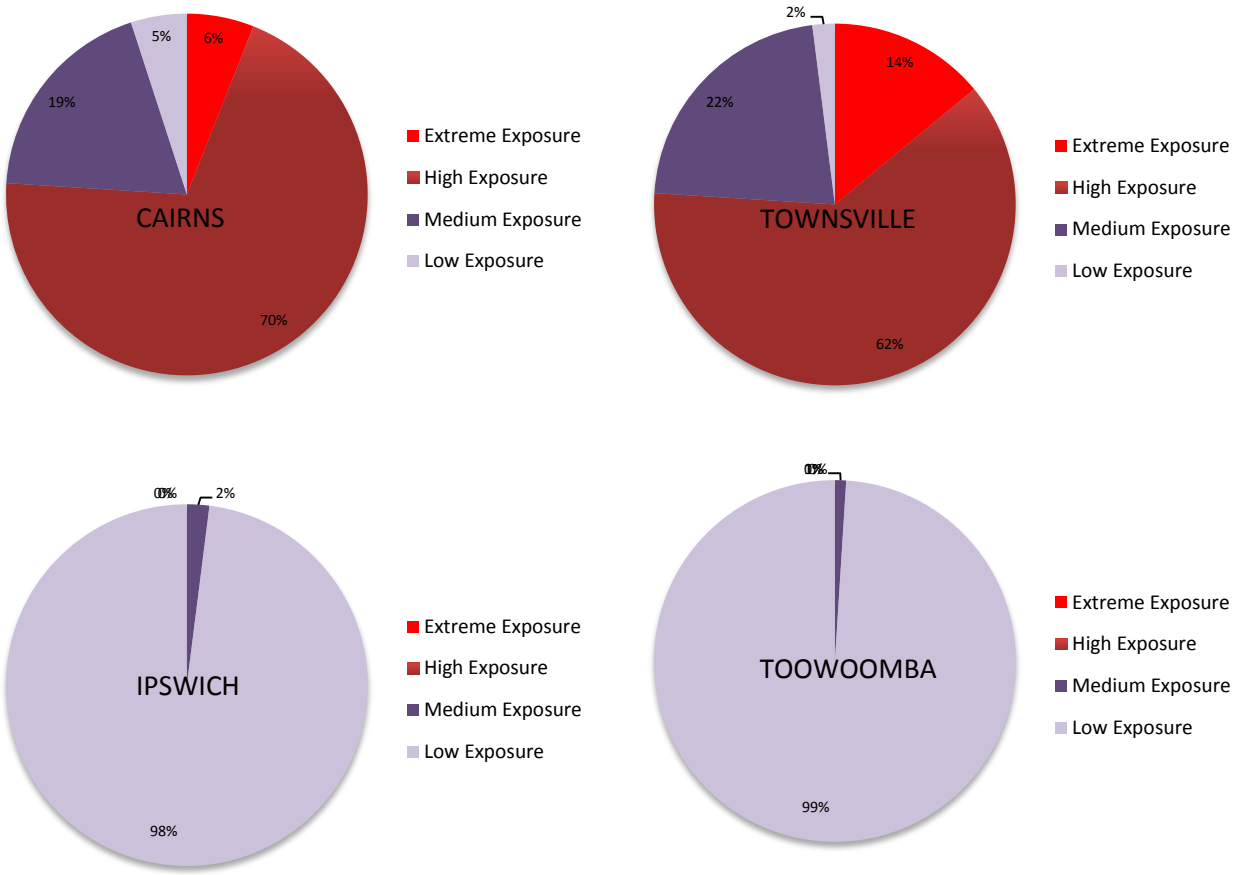
The image below gives a stark example of the hazard differential between regions, in this case for cyclone, that leads to a measurable difference in the price households will face for insurance cover.



Examining average premiums in high hazard and low hazard zones further illustrates that premiums are driven by hazard exposure. The table below provide the average premium and sum-insured in each of these regions.

Northern Queensland Case Study Postcodes		Southern Queensland Case Study Postcodes	
Townsville	**Cairns**	**Ipswich**	**Toowoomba**
Average Premium Paid In Postcode **$2162**	Average Premium Paid In Postcode **$2191**	Average Premium Paid In Postcode **$1314**	Average Premium Paid In Postcode **$1090**
Average Sum-Insured in Postcode **$417K**	Average Sum-Insured in Postcode **$441K**	Average Sum-Insured in Postcode **$392K**	Average Sum-Insured in Postcode **$434K**
Average Premium for $380K **$1970**	Average Premium for $380K **$1887**	Average Premium for $380K **$1273**	Average Premium for $380K **$954**

The hazard drivers behind these premiums have long been understood by insurers and typically can be allocated to individual properties. The images below capture the distribution of extreme to low hazard properties in each of the example locations. In this example, extreme exposure equates to a 1:4 chance of a cyclone event within 50km of an addresses location; low equates to a 1:25 chance of occurrence.



Though this example is for a relatively simple hazard to understand, the principles apply for all hazards. The ICA submits that insurance pricing is manifestly relative to the level of hazard present, a submission recently confirmed by the Australian Government Actuaries (AGA) report into strata insurance pricing in Australia's North. In this report the AGA examined the premium differential in strata insurance between high and low hazard regions and confirmed that pricing follows claims history.

Information Asymmetry

The insurance industry has been working closely with local, state/territory governments on hazard mapping and disclosure and significant progress is being made. Whilst the objective can be achieved at State level, all stakeholders including insurers and consumers could benefit from a national framework for co-ordinating data collection and related activities. The collection, availability and dissemination of disaster information is currently inhibited by ownership and licensing issues, lack of standardisation, varied quality of data and the absence of a central repository.

Currently a number of agencies are actively engaged in natural hazard data research in the public and private sector. We recommend that the roles, responsibilities, co-ordination arrangements and funding sources are reviewed to identify gaps and duplication in the roles of relevant bodies.

Ultimately, the goal is to ensure that communities, planners, emergency services, individuals, property owners and insurers understand the natural peril risks that they face, and that effective risk mitigation measures can be undertaken. Without access to critical data inputs and research findings, communities, business and government cannot make informed decisions on how to target these investments to achieve the greatest impact.

Information asymmetry regarding the nature of the insured asset is a broader issue that is prevalent in all regions, the impacts of which can be amplified in high hazard regions where building vulnerability factors may have a higher weighting in risk-based pricing. Industry and state/local government partnerships are in development to help address the lack of basic information regarding the built environment (for example, floor height acquisition from local governments through the ICA's Property Resilience and Exposure Program).

What impact is mitigation activity likely to have on insurance premiums? What evidence is available to assess this?

The ICA submits that effective permanent and well-maintained mitigation can and has had a direct and highly positive effect on insurance premiums.

The ICA draws the Commission's attention to the completion of flood mitigation works in Charleville QLD, and the subsequent reduction in insurance premiums for residents by Queensland's largest insurers. A media release detailing the premium reductions is attached for reference.

This issue was also addressed in an opinion piece authored by ICA for the Australian Financial Review on January 31, 2013, following flooding in Queensland and Northern NSW:

> "The contrast between the way floods affected Queensland and NSW this week is stark. Many towns in northern NSW were protected by permanent levees, which prevented flooding and potentially a huge recovery bill. Unprotected towns in Queensland suffered widespread damage, with the recovery and restoration bill for governments likely to run into billions of dollars.

The facts are plain. Insurers price and manage risk, and properties in frequently inundated areas of Australia pay premiums that reflect that risk."

Mitigation at a household level through appropriate design can also have a significant impact on premiums if credible data can be obtained, as the following example concerning flood hazards and floor heights shows:

	Low Set Home	*High Set Home*
Example Sum-Insured	*$300K*	*$300K*
Flood Depth at Property	*1.5m*	*1.5m*
Flood Frequency	*5%*	*5%*
Floor Height	*0.3m*	*2.6m*
Estimated Flood Damage on Occurrence	*$150K*	*$5K*
Technical Flood Premium	*$7,500*	*$250*
Combined Technical Premium Other Hazards	*$720*	*$720*
Total Average Premium	*$8,220*	*$970*

Conclusion

Intergovernmental arrangements as constituted through the NDRRA should be reconfigured to achieve greater equity between the states and to parallel risk allocation as it occurs in the private market.
Governments that face higher exposures should be required to retain more risk or to fund mechanisms to assist with post-disaster recovery before calling upon NDRRA, and should be encouraged to focus on programs that gradually reduce state reliance of disaster relief.

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Mitigation programs should be more closely integrated with national and state infrastructure programs, rather than treated as independent activities.

Private market insurance is relative to hazard profiles. Though gains can be made through reducing any asymmetry of information, systemic step changes are only achievable through reduction of the exposures that households face.

If you require further information in relation to this submission, please contact Mr Karl Sullivan, Insurance Council's General Manager Risk & Disaster Directorate, at

Yours sincerely

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