Submission to the Productivity Commission's inquiry into Australia's natural disaster funding arrangements

June 2014

1. About QBE

For over 127 years, QBE has been an integral part of the Australian business landscape providing peace of mind to Australians during normal business and times of crises. Our business has been a significant feature of Australia's commercial landscape since its early beginnings in Queensland. QBE is proud of its heritage and the support that it has provided to our customers and policy holders during this time.

Listed on the ASX and headquartered in Sydney, stable organic growth and strategic acquisitions have seen QBE grow to become one of the world's top 20 insurers with a presence in all of the key global insurance markets. QBE today is one of the few domestic Australian-based financial institutions to be operating on a truly global landscape with operations in 43 countries around the globe.

As a member of the QBE Insurance Group, QBE Australia operates in Australia primarily through an intermediated business model that provides all major lines of insurance cover for personal and commercial risk throughout Australia.

2. Natural disasters and insurance

Natural disasters are an ever present risk for communities in Australia. The contributions of the insurance industry in the recovery of communities from recent catastrophes are significant not only in terms of the billions of dollars of claims paid, but also in terms of the evolving risk mitigation and emergency management initiatives that build resilience into our communities. The support that private sector general insurance provides for people, businesses and communities is a critical factor in assisting in the expeditious economic recovery and rebuilding when natural disasters occur. Also important is the behavioural effect that peace of mind provided by insurance coverage gives. Peoples' ability to cope with adverse effects is strengthened and they tend to behave less risk adversely when they know that certain risks are covered economically.

The progress in Australia over the last decade with industry/Government initiatives like sharing of flood risk data, flood mitigation projects and studies into strata building risks from cyclonic weather in far north Queensland has increased our understanding and helped reduce uncertainty for insurers when considering and pricing these risks.

This benefits the majority of insureds in areas of low or medium to high risk, however, there are areas where legacy issues exist and the risk is relatively high, for example, some existing developments and strata in far north Queensland. Further, local council, state and territory governments continue to allow development in areas that are considered high risk flood or bushfire zones with limited risk mitigation strategies required of developers. This increased concentration of people, infrastructure and economic activity in areas exposed to significant natural peril risk is a key driver of increasing loss particularly when the urbanisation occurs without appropriate mitigation to reduce vulnerability.

Insurance is socially valuable and an effective tool for transferring and mitigating risk however, the expectation that insurance alone can bear this risk is not realistic. QBE believes the current Productivity Commission's Inquiry into Natural Disaster Funding (***Inquiry***) together with the Australian Government's current Financial System Inquiry provides a real opportunity at this time in Australia to increase understanding and awareness of the complexities of managing natural disaster risk. This would then provide an informed platform for all levels of government and industry to collaborate to promote risk awareness, develop better risk data, build resilient infrastructure and embed appropriate incentives to achieve these aims.

QBE's submission to the FSI explores these issues in some depth and is available on the FSI website[1].

[1] http://fsi.gov.au/files/2014/04/QBE.pdf

3. Risk and insurance pricing

General insurance is a fundamental foundation of a modern economy and touches almost all levels of the community and our individual human and corporate activities. A strong, stable and innovative insurance industry is critical for the smooth functioning of the economy.

Identifying, understanding and managing risk is the central focus of an insurance business. Insurers use a variety of methods and tools to estimate the likelihood or frequency of an event occurring and the severity of loss that is likely to occur from the event. As technology develops and data becomes more available and accessible, insurers are gaining more information and developing better skills utilising modern risk assessment and risk management techniques to better understand, assess and continuously manage the nature of insurable risks.

As insurers on the one hand develop more sophisticated methodologies and data to understand risks at a more granular level, technical pricing and our current prudential regulatory regime demands that insurers in Australia appropriately price for and hold capital for such risks. Similarly, regulators are directing insurers to purchase more reinsurance than ever before. On the other hand, this inevitably means that those individuals or consumers who are considered to constitute a high risk will have that risk reflected in the higher insurance premium required to be paid to the insurer to cover that risk.

Australia has experienced a large number of natural disasters over the past few years including cyclones, bushfires and floods. As information becomes more readily available, insurers become more able to reflect the level of that individual risk and price accordingly. As insurers have experienced these events and repriced products to reflect the loss experience and updated information around such natural perils, this has led to significant premium increases, primarily for sectors of the community where disasters are more frequent and costly. This has occurred in the aftermath of the Queensland and Victorian floods and persistent cyclone and storm experience in northern Queensland.

This issue is compounded by prudential authorities gradually forcing insurers to raise solvency levels (and therefore cost of capital) to avoid insolvencies in all but the worst possible scenarios, as well as the rising value of the assets to be insured.

This has exacerbated the debate around non insurance, under insurance and the issue of accessibility and affordability of insurance for natural peril risk which is currently under the spotlight at an Australian political level. This is however a very complex issue that requires considerable unpacking and debate by stakeholders to ensure that all constituent parts of the puzzle are well understood prior to the implementation of policy measures by Government.

Insurance pricing plays a critical role for society by signalling to individuals, communities and government important information about the existence and nature of specific risks. In pricing risks insurance companies give a signal to the market as to how they see that risk. In an efficient market, this is desirable, with price providing an appropriate signal about the increased level of risk and encouraging risk mitigation. Optimally, this would lead to action being taken to stop allowing development in inappropriate areas or by ensuring that new dwellings and construction in "high risk" areas meet building standards that would significantly reduce the potential damage should a significant weather event occur.

Recent increases in insurance premiums for areas of high natural peril risk in Australia are providing an important and clear price signal of risk of which individuals, communities and all levels of Government need to be cognisant. The higher cost of insurance is obviously a concern for those living in areas that are assessed as “high risk” from an insurance perspective, however there is a danger when differentiated premiums are viewed by society and politics as unjust and discriminatory and public policy measures are introduced to address the perceived inequity. With the recent debates on the affordability and accessibility of insurance and the potential implications of non or underinsurance on the public purse, finding workable solutions to mitigate risk and build more resilient communities is an important sustainable longer term solution.

Conversely, if pricing signals are lost or distorted in any way (for example by cross-subsidizing or by Government subsidization and/or regulation), market information is lost and risk is likely to increase. When individuals believe that governments will step in and provide a safety net there is significant risk

of “charity” hazard as communities and individuals are dis-incentivised from mitigating or insuring their risk and abdicate personal responsibility.

4. Where should risk reside?

Clearly not all risks are insurable. Where risk should lie is becoming increasingly complex as economic losses caused by natural and other hazards are continually rising. This is exacerbated by the rapid accumulation and aggregation of risk due to urbanisation, the degradation of our natural environment and the development and build up of infrastructure which occurs as economies grow. With this, comes corresponding pressure on the insurance industry. The issue of non insurance, underinsurance and lack of private market solutions to the issue of catastrophic natural peril risk is not a new one. Much has been written on this issue both in Australia and internationally and considerable work has been done to date in Australia to address these concerns.

Insurance is socially valuable and an effective tool for transferring and mitigating risk however, the expectation that insurance alone can bear this risk is not realistic. Increasing natural peril risk and loss feeds directly into an increasing requirement for recovery funding with direct impact on the fiscal spend for Government. According to the study by Deloitte Access Economics in 2013, the economy wide cost of natural disasters in Australia was over $6 billion in 2012 alone. Disregarding the effects of possible climate change, this was estimated to double by 2030 and to increase to a yearly average of $23 billion by 2050[2].

Government clearly has a role to play, particularly in ensuring that appropriate incentives are in place for reducing and mitigating risk. Cohesive action needs to be taken to stop allowing development in inappropriate areas or by ensuring that new dwellings and construction in “high risk” areas meet building standards that would considerably reduce the potential damage should a significant weather event occur. High risk legacy issues need to be identified, prioritised and mitigated. Often there can be conflicting objectives which can create considerable tension between governments, developers and consumers' expectations and insurers’ appetite for risk and regulatory obligations.

Where risks are not insurable or are of limited insurability, finding the appropriate demarcation line between private and public insurance has been cited as one of the central open issues in insurance[3]. The question of government's role in "social"[4] insurance, to provide a social safety net or as an insurer of last resort, also has been debated at length.

QBE refers the Inquiry to The National Climate Change Adaption Research Facility's report on *Adaptor of last resort? An economic perspective on the Government's role in adaption to climate change* and the case studies outlined in the Geneva Association's report I*nsurers' contributions to disaster reduction - a series of case studies* for commentary on this issue. The following provides a useful summation of this debate[5]:

> *“Certain risks apparently are less suitable for private insurance than others. Public or ‘social’ insurance has played a major role in most societies for a long time. In some of these cases, it is not necessarily a fundamental inability of private markets to provide workable solutions, but rather the desire of society to combine insurance with considerations of equity and redistribution, which leads to government interference.*
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> *Some risks can be intrinsically difficult or impossible to insure through private markets, however, particularly certain risks related to man-made or natural catastrophes. Fundamental reasons which may limit or even prevent private insurability are: insufficient scope for risk pooling (correlated/aggregate risk), informational ambiguity, and (excessive degrees of) moral hazard/adverse selection.*

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[2] Deloitte Access Economics, *Building our nation’s resilience to natural disasters – Prepared for the Australian Business Roundtable for Disaster Resilience and Safer Communities*, 2013.
[3] Baltensperger, Buomberger, Luppa, Wicki, Keller, Zurich Insurance*: Regulation and intervention in the insurance industry - fundamental issues*, 2007, page 37.
[4] Such as health, welfare, personal injury and longevity risks.
[5] Op cit, Zurich Insurance, page 37.

... Guiding principles should be the following ones: Private insurers can and should only be expected to deal with those risks which sufficiently meet the conditions for insurability. Mandatory requirements to go beyond this can only lead to disillusion and, eventually, market withdrawal. On the other hand, government should abstain from interfering in those markets where private insurance is feasible and functional. Desires to combine insurance with redistribution should be resisted and redistribution, if politically desired, pursued through other mechanisms."

QBE appreciates that these considerations are complex and will become more so against the future change background. It is unlikely that there will be a simple solution that can be adopted holistically. There has been considerable progress in increasing transparency around the operation of insurance and disclosure of insurance products in recent years. QBE recognises it is critical that further engagement and collaboration with consumers and all levels of Government continues to:

- increase understanding and awareness of how insurance operates and enhance the reputation of the industry; and
- ensure the insurance industry understands and operates to meet the needs of its customers and consumers.

5. Role of government in natural disaster management

Clearly delineating the role of government in comprehensive natural disaster management is complicated by the different layers of government in Australia with policy, operational and budget responsibilities for varied aspects of natural disaster management split across federal, state and local governments. Policy objectives across different levels of government are not necessarily aligned which can create gaps and tensions impacting on achieving a cohesive strategy.

Optimally, the role of "government" in natural disaster management should encompass the following:

- Facilitating the identification and disclosure of data to increase understanding and transparency around areas of high natural peril risk. This will help reduce uncertainty around natural peril risk and assist individuals, communities and insurers to make more informed choices;
- Ensuring future use and development in areas of high risk are appropriately regulated and managed (such as land use, zoning, the application of more resilient building codes, betterment of legacy issues etc) so that the vulnerabilities to natural peril risk are identified and mitigated so as to limit new community hazard exposures;
- Developing and implementing a planned program of structured mitigation of existing and legacy urbanisation targeted at the highest risk areas to remove or reduce hazard impacts where feasible;
- Effective emergency management and response co-ordination and implementation to minimise loss of life, damage and loss experience when disasters occur;
- Ensuring appropriate incentives are embedded to facilitate community resilience by encouraging individuals, communities and businesses to minimise exposure, build resilience and be economically self reliant in the event of disaster.

Policy objectives, regulatory measures and incentives need aligning across all levels of government for disaster management. This is necessary to effectively ensure that regions of high natural peril risk are identified and managed and that future use and development is undertaken in a manner that mitigates this risk and builds resilience in our communities.

6. Promoting resilience and mitigation funding

There are numerous examples that demonstrate the effectiveness of "future proofing" against these natural hazard types of risk. Buildings that are designed to withstand the impacts through building regulations, zoning restrictions and improved design and materials have been proven to reduce the vulnerability to natural peril risk.

Interestingly, Geoscience Australia has modelled the impacts of the 1974 Cyclone Tracy on Darwin if the same event occurred in 2008 having regard to the reconstruction of the city to new standards with

the revision of building codes after that time. It is believed that approximately 80% of residential buildings were either destroyed or rendered unliveable by the impact of Cyclone Tracy with damage estimated at 36% of full reconstruction costs. The 2008 modelling has estimated that the damage from the same event would be 3.5% of full reconstruction costs reflecting a 90% reduction in mean losses compared with the 1974 impact. This demonstrates the importance of ensuring that building and construction codes for development in areas of high risk recognise and reflect measures to increase resilience of property and infrastructure.

Additionally, there have been a number of studies that have considered the economic benefits of building resilience, particularly when targeting high risk locations using appropriate combinations of infrastructure, policy and procedure.[6]

Deloitte Access Economics[7] undertook an indicative benefit cost analysis of three areas in Australia exposed to different natural disaster risk concluding:

> *There are practical resilience measures which would create net benefits for society:*
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> *· A program focussing on building more resilient new houses in high cyclone risk areas of South-East Queensland would reduce the risk of cyclone-related damage for these houses by around two thirds, and generate a benefit cost ratio (BCR) of up to 3. Existing houses are particularly challenging to retrofit but the BCR of retrofits approaches one in high risk areas*
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> *· Raising the Warragamba Dam wall by 23 metres would reduce annualised average flood costs by around three quarters, and generate a BCR of between 2.2 and 8.5. This would result in a reduction in the present value of flood costs between 2013 and 2050 from $4.1 billion to $1.1 billion, a saving of some $3.0 billion*
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> *· Building more resilient housing in high risk bushfire areas generates a BCR of around 1.4; improved vegetation management results in a BCR of around 1.3, and undergrounding electricity wires results in a BCR of around 3.1.*

Clearly the need to focus more on mitigation and building resilience into our communities is paramount. How to prioritise and fund these initiatives is more problematic.

The structuring of disaster funding is complex. As noted in the Issues Paper, the level and composition of resources allocated to natural disaster risk is also inevitably influenced by political economic realities with research suggesting that political incentives for mitigation funding are not strong. Greater upfront expenditure is required to invest in mitigation strategies. Although these methods have been shown to be cost effective and contribute to a safer, more resilient and economically sound community, there are factors that may dis-incentivise allocation of funds to mitigation and building resilience issues.

In addition to structural budgeting issues and the implications that flow from this, as posed in the Inquiries issues paper, Governments gain more "political capital" from spending on disaster relief, which is immediate, observable and provides private benefits to individuals[8].

Given the demonstrated economic benefits of allocating funding and resources to pre natural disaster mitigation and resilience, QBE believes it is important that the Inquiry consider any structural barriers that are preventing governments at all levels from under-investing in disaster mitigation and resilience initiatives and recommend measures to reverse this.

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[6] Deloitte Access Economics, *Building our nation's resilience to natural disasters,* Australian Business Roundtable for Disaster Resilience and Safer Communities, 2013.
The Geneva Reports, Risk and Insurance Research, *Insurers' contributions to disaster reduction – a series of case studies,* 2013.
KPMG, Suncorp Group, *Risk Apportionment in the Insurance Sector,* 2014.
[7] Ibid, Deloitte Access Economics, page 37.
[8] Issues paper, page 24.

7. Increasing consumer transparency

QBE believes that increased transparency and disclosure to purchasers of property in high natural peril risk areas should also be considered in this debate. There is a significant risk of moral hazard when individuals are not held accountable for their actions and believe that governments will step in and provide a safety net. Without personal accountability individuals are dis-incentivised from mitigating or insuring their own risk.

Although there are clear legacy issues to consider, looking forward, local government disclosure of natural peril risk to consumers - at time of purchase or occupation – will enable better informed choices to be made by individuals enabling individuals to assume more personal accountability and responsibility.

8. Conclusion

The natural disasters experienced in Australia over the last 5 years have shone a spotlight on the insurance industry and also the complex issues of catastrophic natural peril risk in our country. Although there are no easy, short term solutions on the issue of catastrophic natural peril risk (as evidenced by similar debates around the world), we believe that better communication and collaboration between governments and the industry would help to tackle these complex issues, particularly in relation to land development, risk awareness and mitigation initiatives for exposure to catastrophic natural events for certain areas and risks in Australia.