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Natural Disaster Funding Arrangements
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Submission on Household and Strata Title Insurance Matters

This submission relates exclusively to those parts of the Commission's draft report that deal with private insurance markets, principally householders and strata title insurance, in relation to natural disasters and particularly –

1. Flood insurance in flood prone areas,
2. Property insurance in North Queensland and
3. Underinsurance.

The perspective from which this submission is prepared is that of the panel that undertook the Natural Disaster Insurance Review (NDIR) in 2011, of which I was the chairman, but taken in the light of subsequent developments of two kinds, one being the structure and operation of insurance markets in Australia and the other being government responses to date around the subject of natural disaster insurance.

The Commission's report refers to these topics in two places, being –

- *Section 4.3, Insurance Markets,* pp 177 to 184, culminating in Draft Finding 4.2 as follows -

  "DRAFT FINDING 4.2
  "International experience has shown that government intervention in property insurance markets (either through direct provision of insurance or by providing reinsurance) weakens the price signals that insurance premiums send to households and businesses about the level of risk faced. These schemes also create fiscal risks. Governments have had to bear significant costs following large natural disasters because their insurance schemes failed to accumulate adequate reserves."

and

- *Section 6.4, Are private insurance arrangements consistent with effective risk management,* pp 375 to 398.

The draft report appears to make a case for no government intervention in property insurance markets.

The conclusions reached in this submission are that –

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- all three issues considered herein are highly unlikely ever to be resolved without either government intervention or resolute action by the insurance industry that is endorsed by the Government,

but, equally,

- all three issues could be resolved, in part at least or in full, through concerted initiatives from the insurance industry, if the industry were minded to take such initiatives.

1. Flood insurance in flood prone areas

Developments in the household insurance market

At the time of the NDIR in 2011, the primary question on natural disaster insurancewere the availability and the affordability of flood cover.

Since that time, the insurance industry has effectively solved the availability problem, notwithstanding that at the time of the NDIR there was resistance from some parts of the industry to offering flood cover to all home owners.

> At the time, insurers were adamant that the data they need to price flood cover properly was not adequate or not available to all insurers. Subsequent events demonstrate, however, that once insurers turned their minds to this problem, they could solve it. Indeed they have done so since 2011with considerable energy, with many insurers now insisting that their customers have flood cover. The impetus for this initiative can be seen as their desire to avoid disputes in future over whether a particular water event is or isn't classified as flood –when flood cover is included, all water damage is then included irrespective of its source.
>
> It may be worth adding that the industry, to its credit, once confronted by sufficient pressure from both the government and various community interests, responded in the public interest. It is a matter of conjecture as to whether it would have responded as it did without these external influences.

Where to now?

With availability of flood cover no longer a major issue, affordability has become the key issue. It came to the fore in early 2013 when floods again occurred in parts of Queensland and New South Wales. The attached note prepared at that time attempts a concise explanation of the affordability issue in an historical context including recognising the developments in flood cover availability over the last 15 years or so.

The Commission's report essentially advocates no government intervention in the flood insurance market because the market is said to be working well and any shortcomings are said to be largely due to a lack of availability of information or a failure to disseminate that information.

The insurance industry naturally welcomes this kind of statement because it suits the industry to avoid government intervention of any kind wherever possible and it encourages the industry to continue to construct arguments to support this position.

In general I would also support this position but I wish to draw to the attention of the Commission the legacy problem that now exists. It is explained at some length in the NDIR report (qv Chapter 3 in particular). The problem applies to the set of homes in Australia that are subject to flood risk at a level which makes difficult a move from insurance with no flood cover to insurance with full flood cover. Such a move cannot be achieved without some form of transitional process, arguably supported by some form of government intervention.

It is of course a matter for the Government as to whether it wishes to recognise this legacy problem and to act on it. I would urge the Commission, however, to accept that this legacy problem is a real one that is not going away. It will re-emerge when the next major flood occurs.

It is notable that mitigation initiatives, as valuable as they can be, will only ever be a partial solution. The most difficult part of the problem is where lack of affordability is plain: it is for the high risk properties whose owners need to pay multiples of their existing non-flood premiums to obtain flood cover. Many of these properties are owned by lower income families, usually because the land was cheap when originally opened up for housing (and, with the benefit of hindsight, this land was often opened up unwisely by councils or State governments).

What is the solution, what are the options?

The NDIR put forward one possible solution. It is a concept which continues to be favoured by some commentators including some parts of the insurance industry. In advocating that the Commission look again at this legacy problem, I would also note the anti-intervention position expressed in the Commission's draft report . Its comments suggest that market forces will solve any problems, especially if more information and disclosure occur, yet evidence is lacking that the public interest is being adequately supported by the insurance industry on its own. It is difficult to believe that access to additional information would constitute any kind of genuine solution.

For example, the Commission claims on page 181 that it has not found evidence of "defensive pricing" by insurers. It seems to assume that insurance market do and always will function reasonably efficiently, notwithstanding the mass of evidence that can be found through history and across most insurance markets, including Australia, that insurance markets often do not work that way. Reasons include that insurers accept risk, whereas most industries operate by avoiding risk and that insurance is unique in having an "inverse cycle of production": the price is set before costs (being claims) are known, leading to prices at all times being set on estimates of the costs of production and done so in the light of each insurer's risk appetite at the time. The insurance cycle exists because at some times insurers compete strongly with each other for business, perhaps under-pricing it, but at other times they raise prices and withdraw capacity from the market to protect their survival.

In considering possible solutions, I also wish to draw to the attention of the Commission the attachment that explains the difference between premium subsidies and premium discounts. This distinction is important in understanding the concept advanced in the NDIR report. Further, I would contend that the insurance industry itself may be able to find its own solution if pressed by the Government or the community to do so. In the meantime, it suits the industry to clamour for more funding and more action on risk mitigation, for which it need take no particular responsibility: it can then consider afterwards, and at its own discretion insurer by insurer, what credit might be given in their premiums for the mitigation efforts undertaken.

2. North Queensland

The North Queensland problem is different from the flood problem. Firstly, there has never been a major availability issue, only an affordability problem. Secondly, the affordability problem only really emerged in a significant way around the time of Cyclone Yasi in 2011. Prices were already rising sharply, especially for strata title properties, and those price rises were exacerbated following the cyclone.

The underlying problem is not one of competition, as seems to be suggested by the recent Government announcement that it will support an information website for homeowners and will invite UFIs to offer cover. The problem is one of risk appetite: it is a small and unattractive market in which risk is high, reinsurance costs are high and most companies see themselves as protecting their shareholders by not writing business there.

The solution should then be one of delivering greater market capacity. That will not be achieved through UFIs. Indeed, allowing them to write business seems a very odd idea and may well be accompanied by a range of unintended and adverse consequences (if history is anything to go by, any UFIs taking up the opportunity will probably represent "innocent capacity" that is likely to disappear either after the next cyclone or after some other natural disaster elsewhere in the world that causes such companies to retreat from marginal markets).

The most propitious direction for seeking more capacity is probably some kind of industry solution, to be sanctioned by the ACCC, whereby reinsurance capacity might be set up in such a way that a consortium of reinsurers support the whole market above a retention that is low enough to attract a significant number of local insurers back into the market.

Such a solution could probably be put together by the insurance industry itself if the Government were to press the industry to do so, assuming the industry were able to obtain acceptance from the ACCC to develop and implement such an idea.

Without some form of Government influence, most insurers will continue simply to avoid this North Queensland market.

3. Underinsurance

The Commission notes, on page 181 for example, that

> "Underinsurance or noninsurance can be a difficult policy issue to address where high premiums affect disadvantaged households. Subsidising premiums for these households (including through government-backed reinsurance) would reduce policy holders' incentives to reduce their exposure to risks, either through mitigation or moving away from high-risk areas. "

and on page 397 -

> "Although there is evidence that some households and businesses are non-insured or not fully insured for the rebuilding or replacement cost, there is insufficient evidence to conclude that underinsurance is a problem. Some parties are probably making a rational choice to not take out insurance for the full value of their property. Households might also be self-insuring. However, the evidence that some parties do not understand what, and how much, they are insured for is indicative of information asymmetries in the market. Where this is the case, governments and insurers should address this directly (for example, information asymmetries), rather than trying to increase coverage though measures such as mandatory building and contents insurance, or mandatory imposition of total replacement cover. "

The Commission may have misunderstood this issue. It is explained at length in the NDIR report (Chapter 12, page 93). A couple of points made there are worthwhile repeating here –

- no satisfactory solution has yet been found for insurers to assist individual property owners to make a good assessment of replacement value

- The market dynamic works against adequate sums insured and tends towards giving incentives to homeowners to under-insure in a manner that, through the insurer pricing process, tends to perpetuate and increase this tendency (as explained in the NDIR report)

- This market dynamic militates against any insurer being a first mover in dealing with the problem.

The solution?

A process is needed that breaks the current cycle without creating a first mover disadvantage for any one insurer. Mandatory replacement value is the obvious regulatory solution but there may well be others that the industry could devise if pressed by the Government or the community to do so, assuming ACCC acceptance, given that there is insurer interest in solving the problem anyway.

First attachment: "Flood of insurance questions", AFR 7 February 2013

Second attachment: "Flood insurance: Premium subsidies vs Premium discounts", June 2012