30 March 2012

The General Manager
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: floodinsurance@treasury.gov.au

Dear Sir/Madam

Reforming Flood Insurance Submission – Response to Consultation Paper

The Actuaries Institute ("the Institute") is the sole professional body for actuaries in Australia, providing independent, expert and ethical comment on public policy issues where there is uncertainty of future financial outcomes. It represents the interests of over 3,800 members, including more than 2,000 qualified actuaries.

Some of the principles that guide the Institute's inputs into public policy are:

- acceptance of public sector involvement where the market does not meet societal needs,
- the need to take a long term policy view, with appropriate transitional arrangements,
- ensuring that consequences of risk taking behaviour are borne by the risk taker,
- issues of intergenerational equity, and
- clear and reliable information available for decision making.

The Treasury released a Consultation Paper in November 2011 titled "Reforming flood insurance – A proposal to improve availability and transparency". We are pleased to submit our responses. The Consultation Paper follows the Natural Disaster Insurance Review (NDIR) to which the Institute put forward a detailed submission.

The Institute would be pleased to expand on or further discuss the issues raised in this submission or to respond to specific questions to assist Treasury in the course of its work. Please contact our Chief Executive, Melinda Howes, on (02) 9239 6106 or melinda.howes@actuaries.asn.au if there is any way we can assist.

Yours sincerely

David Goodsall
President

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Consultation Paper

The following sections contain our responses to the specific questions in the nine sections of the Consultation Paper.

In summary

As a general observation, we note that a lot of natural disaster exposure in Australia arises from inappropriate development around major cities. Further, there is potential for climate change to exacerbate the cost of inappropriate development. However, it is possible to see this as an opportunity to encourage appropriate regional development, a policy supported by every level of government in Australia.

The Institute supports the idea that consumers receive regular advice on the risk of flooding to their property through, amongst other things, an annual flood risk fact sheet. We do not support the idea, however, that the insurance industry should be responsible for preparing this fact sheet. The fact sheets should be prepared on a consistent basis and provided to all consumers, not just those who purchase insurance. Further, different insurers are likely to price the cost of flood cover differently.

It is likely that the cost of full flood cover for high risk areas will be higher than most people can afford. It is therefore likely that most people in high flood risk areas will not have flood cover. As such, the Institute reiterates our recommendation that a temporary national pool be established to help facilitate the offer of flood insurance to consumers, especially the high risk properties. This pool recognises that many people have, in good faith, purchased properties where they were unaware of the extent of flood risk faced, and will be unable to secure appropriate insurance. The expectation is that this pool will be wound up after say 10 to 15 years, once adequate flood risk information and proper risk mitigation measures are made available or established.

Since it is not unusual for people to receive flood warnings days and sometimes weeks in advance, there will need to be agreed rules that restrict consumers from moving between flood cover and opt-out options. The financial viability of insurers may be impacted if people have the option of making short term elections.

1. Operation of the Proposal in Practice

The importance of individual accountability and ongoing education.

The key aims of the proposal are to increase the availability of flood insurance and focus consumer awareness, with the underlying aim of increasing flood insurance penetration.

In order to achieve these aims, the proposal needs to ensure that consumers take ownership of the decision made to opt-out of flood cover.

Allowing the option to opt-out could result in moral hazard if post-disaster charitable and government assistance continues in its current form with consumers being likely to have less incentive to manage risk.

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It is also very important for the proposal to provide emphasis on ongoing education. Public awareness will be enhanced if consumers are consistently confronted with the facts pertaining to their risk and are constantly informed and reminded of the consequences of opting out of flood cover.

Question 1.1: What other ways could insurers implement the proposal?

One plausible alternative to the "opt-out" and "no opt-out" solutions which may still meet the objectives of the proposal is a "partial opt-out" offer.

For example, insurers may choose to offer consumers the opportunity to partially insure their flood risk either through reduced sum insured or a fixed sum enough to provide basic financial support such as basic necessities and temporary accommodation. In effect, they could "dial up" or "dial down" the level of their flood cover according to their ability to afford the cover.

This solution has a number of advantages that include:

- Consumers have some insurance cover to help get through the initial hardship post disaster;
- Potentially quicker cash disbursement from insurers to consumers post disaster; and
- Less financial aid required from charities and government.

This "partial opt-out" solution would require all insurers to take part; otherwise, it also suffers most of the same limitations as the opt-out option.

To help reduce moral hazard arising from the opt-out option, the Government should give due consideration to the idea of "clawing back" some of the financial aid provided to those without insurance – admittedly doing so will be politically challenging but some form of means test is worthy of consideration.

Question 1.2: What other ways could insurers inform consumers about flood risk? How could this be implemented?

As stated in our submission to the NDIR, it may be difficult for consumers to make an informed decision whether or not to opt-out. It is important to help communicate flood facts pertaining to the insured's property in a simple and easy-to-understand manner.

The Institute recommends that information provided to consumers be communicated in language that encourages prudent risk interpretation. For example, the quantitative measures of flood frequency may be better described in terms such as low, moderate, high and extreme, the same way that bushfire risk is communicated.

We suggest that this information be provided in a one-page flood risk fact sheet specific to the insured's property. Risk classifications can be assigned - either Extreme, High, Moderate or Low risk. We do not consider that insurers should be responsible for preparing this fact sheet. Clearly, the consumer may be warned of their flood risk if there is a large margin between the cost of full flood cover and opt-out option, but the insurance industry should

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not carry the responsibility of providing rate payers with official information on their flood risk. The information needs to be provided to all consumers not just those who insure.

We consider that it would enhance the communication to also provide consumers with some information relating to the likely expected repair or replacement cost as a result of their property being affected by flood. This information may be most appropriately delivered via rate notices though other means should be investigated. Advice via insurance policies may be useful but will not capture those most at risk, for example,– those who are uninsured.

When renewal letters are sent out to consumers, they should be provided with a reminder to visit the single access flood portal for flood information. Alternatively, a flood bulletin may be attached to the renewal letter to provide additional flood information.

To meet the Government's aim of greater insurance penetration, it is vitally important to also reach out to the uninsured population. In this instance, Councils and Local Governments have an important role to play by providing the flood risk fact sheets described above when rates notices are sent out. Given that many properties at risk are non-owner occupied, a way of informing the occupants of the risks faced to their contents must also be investigated.

One option that is highly visible would be for Councils to erect different coloured street signs (e.g. fluorescent orange) to constantly remind residents of the flood risk potential of the area they reside in. This would also ensure that those looking to rent or purchase property in the area could clearly identify riskier areas. Whilst this is more controversial, (not least because of the potential impact on property prices) it would be a very effective way of driving home the message. There are clearly issues relating to the granularity/accuracy of the signs that would need to be considered.

Question 1.3: What might be the most effective way for insurers to implement the proposal in terms of engaging consumers in electing to take insurance with or without flood?

The partial opt-out method outlined above may be a more engaging option than a "take it or leave it" approach. This would allow individuals to tailor the amount of cover they receive (perhaps using a sliding bar on a website quotation system) to the amount they can afford, and the amount of loss they are willing to sustain.

In terms of a competitive market, the reality is that insurers will offer free (or almost free) flood cover to the majority of households. Those at risk will be offered a price for flood cover but this price (for all bar the extreme risks) is likely to only be affordable from a small number of insurers. Insurers who deem that they cannot adequately assess the underlying cost in the high-risk areas would be expected to offer a highly competitive opt-out premium but a "conservative" all-in premium.

As an observation, people in high flood risk areas will not be able to afford properly priced opt-in flood cover. They will therefore move or will opt-out and carry their own risk.

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Question 1.4: How could the proposal to inform consumers of their flood risk be implemented?

One way of informing consumers of their flood risk is to require the insurers to always provide two prices for cover, showing the cost with and without flood cover.

These quotes will need to be offered at every renewal and may increase insurer administration costs. Providing annual comparisons may also mean that insurers would need to consider varying their premiums setting basis depending on the expected weather cycles. For example, during a period of extended drought insurers could, in theory, offer a lower premium than the average risk premium for flood, but would need to ensure that the premium during high rainfall cycles (i.e. La Nina) is adequate to cope with the adverse selection likely to occur via a greater take-up of insurance including flood cover. Repricing is an issue for the insurer – and in a free market the consumer is always able to shop around.

We note however that insurance pricing may not be sufficiently granular or precise to accurately inform the insured of their flood risk. Insurers may not have access to adequate flood risk data and hence may miss-price the flood or opt-out options. Further, insurers may not reflect the risk differences in their prices, for example, they may discount or load some premiums in some areas as part of a broader strategic decision to increase or reduce their exposure to certain suburbs. In practice, the Institute believes that the pricing difference between full flood and opt-out premiums may not necessarily reflect actual differences in flood risk.

2. Increasing the Awareness of Flood Risk and Flood Cover

Question 2.1: What benefits are there in offering flood cover to all consumers with an 'opt-out' option?

The key benefit of the opt-out method is, as stated in the Consultation Paper, greater consumer awareness (if the communication is done effectively) and the potential for greater insurance take-up.

In recent months, several insurers have moved to offer automatic flood cover to a broad range of consumers at no or limited additional cost. Given the lack of impact on premiums for these consumers, it seems that providing all consumers with an opt-out option will have limited impact on prices.

<u>Danger of reducing take-up</u>

However, depending on pricing, there is also the chance that insurance take-up or availability could be reduced.

- The level of pricing cross-subsidies will impact the extent of insurance take up and the viability of proposed options. With any increase in premiums, albeit subsidised, there is potential that there will be a reduction in the take up of home insurance;
- The need to offer flood cover will require insurers to be able to assess an appropriate risk premium. This will result in considerable expense to insurers, including the need to develop IT systems. The increased costs could result in some, particularly smaller, insurers exiting the market in high risk areas.

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The take up of the opt-out alternative would be expected to be biased toward those customers of extremely high risk (due to the level of premium required to cover flood).

The mixed event problem – disputed claims will still occur

The opt-out method will not be a silver bullet for the problem of disputed claims. This is because of the "mixed event" problem. Not all damage that occurs at the same time as a flood is clearly from an overflowing watercourse. Many floods occur during a period of prolonged rainfall, often accompanied by strong winds. Clarity will be required as to how the causes of claims will be determined when there is a mixed event.

Disputed claims can be expected to still occur at a significant rate as those most at risk of flood are more likely to opt-out due to the increased premium. Thus, it seems likely that the opt-out method will not resolve the problems of financial and emotional distress that many consumers have experienced in recent times.

We note that this will especially be the case amongst consumers who are unaware of how to, or unable to, adequately assess their own flood risk (who will be more likely to opt-out under this method), and amongst those on low incomes (who will be less likely to be able to afford the cover).

Inadequacy of existing flood mapping data

Whilst we note the Government's intention is to develop a single access point for existing flood mapping data, it is important to recognise the limitations of this data. Current inadequacies of flood mapping may seriously impede insurers being able to offer cover at all, if cover is to automatically include flood cover. It may take 10-15 years for reliable flood mapping data to be available to insurers.

Making flood cover automatic changes the dynamics of the market and exacerbates the issues of inadequate flood mapping. Insurers will lose the ability to deny coverage for unmapped properties and will be subject to potential loss accumulations that they will not be able to monitor. This is likely to have ramifications for the price of reinsurance – the key way in which insurers offload accumulations of risk.

Small and medium sized insurers will be most affected. For these insurers, the cost of filling in the gaps for unmapped areas is proportionately much larger than for the largest insurers. The larger insurers will have a significant competitive advantage in acquiring better data and developing alternative and robust flood models. Small insurers may exit the market or at least particular areas of the market.

Selection against the insurer

Providing consumers a choice to opt-in or opt-out of flood insurance means that insurers may be selected against, at least in the medium term (until information about the elevation of and location of improvements on the land parcel is widely accessible). This is expected because sometimes local knowledge will be better than model projections. Put simply, if you know your house is on the top of a hill you are less likely to insure for flood compared to knowing that your house is at the rear of the same property that is adjacent to a river.

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Anti-selection will occur due to the inadequacies of the terrain/elevation models (DTMs) used as inputs to the flood models. This arises in two main ways. The DTMs used as inputs into the flood models are of varying vertical resolutions. A small measurement error (e.g. +/- 3m) could have a very large impact on the flood risk assigned to the property. Secondly, as highlighted above, the DTMs do not provide an indication of where on the land parcel the property actually is.

Question 2.1 (continued): What benefits are there in using insurance premiums to provide an indication of flood risk to consumers?

There are clearly some benefits in using insurance premiums to provide consumers with an indication of the level of flood risk faced:

- If it assumed that insurers can adequately price the flood risk then there is a clear risk message that can be conveyed to consumers;
- The use of insurance premiums provides a risk measure that is independent of government and of property developers/land owners; and
- In the absence of insurance there will continue to be a significant call on charitable donations and Government funding.

However there are also several disadvantages. Currently, there is a lack of trust of insurers by the community generally and many people would deem the increased insurance premiums to be price gouging by the insurer rather than a true representation of their risk. Thus, much of the "message" may be lost.

For the insurance premiums to work as a communication method to provide a suitable indication of flood risk, insurers and Government would need to be giving the same messages to consumers. That is, ideally the Government would be widely communicating the fact that premiums for at risk areas are increasing and why this is the case (due to coverage of increased risks). If the Government criticises insurance premium costs, the message would be lost.

Negative media in relation to increased premiums could also reduce or remove the effectiveness of price signals.

As noted above, we would not expect it to always be the case that the differences in the price of the flood cover vs. opt-out would be an accurate reflection of the actual differences in risk.

The Institute believes a better communication method, as outlined in our response to Question 1.2 above, is to provide a one-page flood risk fact sheet to all property owners and residents (whether insured or not insured) which is specific to the insured's property. Within these, risk classifications would be assigned as either Extreme, High, Medium or Low risk (and potentially Negligible risk). The local Council or other government organisation would be responsible for preparation of this fact sheet.

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Question 2.2: What information would consumers require to make reasonable decisions as to whether or not to 'opt-out' of flood cover?

Is this information readily available?

Are consumers able to adequately assess this information?

Many purchasers of insurance are not in a position to make an educated determination of the level of flood risk that they face. However there is some information that can be given which will assist in the decision making. As outlined above in our response to Question 1.2, this includes:

- Providing all consumers with a one-page flood risk fact sheet which is specific to their property. Risk classifications can be assigned by the Council or appropriate arm of government - e.g. either Extreme, High, Medium or Low risk.
- Providing the same information through Council rate notices or electricity bills.
- Providing consumers with some knowledge of the likely expected repair or replacement cost as a result of their property being affected by flood. This might be achieved by publishing by range, insurance claims costs from recent floods.
- Providing consumers in their renewal notices with a reminder to visit the single access flood portal for flood information.
- Councils may choose to erect street signs to constantly remind residents of the flood risk potential of the area they reside in (e.g. florescent orange signs for areas at high risk).
- Providing risk fact sheets as part of property contracts at sale.

Accurate flood information is not currently available in all areas and would take some time to develop. However, high level information to classify properties into four risk categories has been produced for most areas. Commencing such communications with the data available would be a good first step, and would be a vast improvement compared with the paucity of information currently available to householders.

Question 2.3: What initiatives would be required with respect to consumer education and financial literacy to assist consumers to make appropriate decisions with respect to 'opting out' of flood cover?

The Institute considers that straightforward and uncomplicated messages need to be provided to consumers to assist in appropriate decisions being made. The general public does not question fire danger warnings that are simply split into a range of categories from Low to Extreme. As outlined above, a similar scaling system could be developed for flood risk.

There is a range of ways in which this could be communicated, as outlined in our response to Question 1.2 above.

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3. Increasing the Availability of Flood Insurance

Core principles of insurance

Before specifically talking about flood insurance, it is worth recapping two core concepts of insurance that, together with the calculation of expected claims cost, make insurance work:

1. First is the concept of the pooling of risk, both across members of a population and across time.
2. Second is the concept of unpredictability of events (i.e. events are random).

Together, random events will impact sub-groups of a population and the pooling of risk will mean the premiums from unaffected members of the population will fund the costs incurred with the impacted sub-group. Over time, whilst random events may cause temporary drains on the premium pool, periods without loss will also occur, meaning that in total there are sufficient funds for the insurance of the population to be viable as a whole.

In the context of flood insurance, claims for consumers in catchments where a flood occurs are at least partially funded by the premiums collected from consumers in other catchments where there is no flood occurring. Further, premiums collected in months where there is no flooding contributes towards the premiums required to fund flood events when they occur.

In a competitive market, however, deliberate cross-subsidies can only exist for homogeneous groups of consumers or where mandated (e.g. such as applies in CTP or health insurance). As the Consultation Paper notes: "For the 93 per cent of homes which are subject to no flood risk, the increase in take-up of flood insurance should be near universal as insurers would not need to collect additional premium to cover the risk".

An insurer charging a higher premium in regions unlikely to flood is likely to lose market share to competitors who do not cross-subsidise to the same extent. Thus, the pooling of risks for flood insurance can only be done from those consumers at risk of flood (in a purely competitive market) unless deliberate cross-subsidies are mandated.

Opt-out breaks insurance principles

When a consumer can selectively opt-out of flood cover, and more importantly opt back in, the fundamental principles of insurance break down.

Take the example of floods in Western New South Wales as a result of heavy rain in Western Queensland. The population in New South Wales generally has considerable warning (many weeks usually) that the flood water is coming and the likely height of the flood water. It is reasonable to expect that consumers who have previously "opted out" of flood cover in these areas would then "opt-in" (i.e. they would go to market for new insurance cover even if it is mid-term of their existing cover). In this way, they only pay for cover when they really need it – as the flood water bears down.

In this case, these flood events are no longer random. Furthermore, those consumers are not contributing to the pooling of funds in non-flood times to enable the effective funding of the pool for other catchments or other times. Insurers do, however, have the option of repricing during these high risk periods. However, given the ability to predict near term flood events in Australia there is clearly an opportunity for consumers to game the system.

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This analogy can be further extended to periods of drought compared to rainy periods. It would be expected that a rational flood-prone consumer would opt-out during periods of drought in order to save money. Then, when rains return, they may opt-in. This switching behaviour again avoids the key insurance concept of pooling of risk.

Insurers would be aware of the risk of selection against them and would either build a margin into their price or would not offer cover in high risk areas. Further, there would be significant risk to the reputation of the insurance industry if, based on say six weeks' notice of a flood in a certain area, insurers withdrew cover or offered cover at almost the full cost of the insured property. There may be cases where the consumer already has full flood cover but their renewal date happens to fall in a period where there is an impending flood. It would seem reasonable that these consumers are able to renew on a long term viable premium whereas consumers attempting to move from opt-out to opt-in, in anticipation of a flood, not be allowed to change their option or would be subject to an imposed waiting period.

Unequal information

Opt-out also assumes that consumers are fully informed about their risk. In other words, they will opt-out when they have no risk, when they perceive the cost of insuring exceeds the risk posed, or when they simply cannot afford the premium.

With imprecise data to calculate flood premium, the insurers expect a degree of cross subsidy. When a consumer knows more about the risk than the insurer and withdraws, the cross subsidies are eroded and the insurer's premium base becomes insufficient to fund the total claims cost. **Consumers who are uninformed and underinsured.**

On the flip side, many consumers are woefully uninformed about their true flood risk. This lack of appreciation of risk may cause the consumer to make decisions on the basis that their risk is less than it really is. In other words, they think the premiums are excessive when in fact they are not.

The result is that these consumers will opt-out to make a saving, and later discover when it floods that they should have had cover.

There is considerable evidence that the majority of flood-exposed consumers are unaware of their risk. We have already discussed the need for better education. On the basis that such information levels can never be expected to be perfect, it can be expected that at least some (if not most) of the current level of disinformation would remain. Allowing these consumers to opt-out will result in most consumers who NEED the cover to continue with no cover and ultimately not solve the problems that the Government is seeking to resolve.

Question 3.1: To what extent would insurers offering flood cover to all consumers (including where an 'opt-out' option is provided) increase the take-up of flood cover?

Is it likely that there would be different take-up rates among groups exposed to different levels of flood risk? Please provide reasons.

As outlined in our response to Question 2.1 above, depending on pricing there is the chance that insurance take-up or availability could be reduced.

- The level of pooling will impact the extent of insurance take up and the viability of proposed options. With any increase in premiums, there is potential that there will be a reduction in the take up of home insurance.

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- The need to offer flood cover will require insurers to be able to assess a suitable risk premium. This could result in higher expenses for insurers, including the need to develop or extend IT systems. The increased costs could result in some, particularly smaller, insurers exiting specific regions.

In addition, as outlined above, savvy consumers can selectively opt-out and opt-in to insurance to get cover only when they need it.

Question 3.2: How prevalent would the practice of offering an 'opt-out' option be?

For insurers — would you envisage providing an 'opt-out' option? Why/why not?

If you intend to offer an 'opt-out' option, who would you intend to offer it to; for example: any consumer with any flood risk, or any consumer who has a flood risk premium above a certain value?

The Institute cannot speak to what individual insurers would do.

Solutions such as only allowing those consumers with high flood risk to opt-out whilst denying the option to those with no or little flood risk (where alternate non-insurance options to fund flood risk are most viable) could create further resentment amongst consumers.

Where price increases are attributed to flood cover, such consumers will seek alternate options (switch insurers or cease buying insurance), further increasing industry costs (through churn costs) as well as potentially destabilising the premium base. The destabilisation can arise for the reasons described earlier, namely insurers require a certain amount of cross subsidy and if these consumers leave, the subsidy is eroded.

Question 3.3: Would an annual decision on 'opt-out' maintain coverage?

If consumers elect to purchase flood cover, should they be provided with an 'opt-out' option the following year or just offered a renewal of insurance including flood cover?

Allowing consumers to regularly change their opt-out decision risks selection against the insurer as discussed above. for example, if there is an impending flood or a predicted change in weather patterns. If flexibility is offered, the insurers will need to protect themselves against adverse selection. Options for protection include temporarily leaving the market for high risk periods or placing restrictions on who can renew.

Suggestions such as "one off election during the life of the policy" or only an annual opt-out option, don't solve the problem as consumers simply cancel and take out a new cover – either with the same insurer or another insurer.

As discussed above, allowing annual opt-in and opt-out options has the potential to undermine the fundamental principles of insurance and hence could lead to higher premiums and less competition

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Question 3.4: What would be the impact on actual insurance premiums for the different categories of flood risk?

The Institute suggests that direct contact is made with some of the larger insurers to answer this question. The costs relating to high flood risk properties are very significant and will be a multiple of the non-flood risk premium.

4. The Storm/Flood Distinction

Question 4.1: What initiatives might assist to resolve, in a timely fashion, disputes about whether damage has been caused by storm or flood?

As outlined in our response to Question 2.1 above, the opt-out method will not be a silver bullet for the problem of disputed claims. This is because of the "mixed event" problem. Not all damage that occurs at the same time as a flood is clearly from an overflowing watercourse. Many floods occur during a period of prolonged rainfall, often accompanied by strong winds. Clarity will be required as to how the causes of claims will be determined when there is a mixed event.

It is possible that Government commissioned hydrologist reports could be a means of limiting disputes. This would mean that there is one view of the cause of the water damage and not differing views across various insurers and consumer representatives.

5. Industry Capacity to Underwrite Flood

Question 5.1: What particular issues need to be addressed before all insurers could be required to offer flood cover?

The most significant issues that need to be addressed before all insurers are able to offer flood cover are, first, the lack of national flood risk information, and second, flood risk mitigation measures.

Without nationally consistent information, insurers will be subject to various interpretations of flood risk across Australia. These different interpretations will create uncertainty for insurers in managing their flood exposure. This uncertainty will be compounded if property development continues to take place without a concerted and coordinated effort from the relevant authorities to mitigate flood risk.

The Institute expects the insurance industry to be impacted in different ways by the Proposal. Whilst larger insurers are likely to be in a better position to withstand losses, smaller insurers are potentially more financially vulnerable should they misjudge their flood risk.

Smaller insurers are known for cherry-picking risks and usually offer more competitive rates in their target market. We believe, therefore, that it is more likely for smaller insurers to refrain from writing business in flood-prone regions. Even so, smaller insurers still face the risk of not adequately exiting the correct flood-prone regions.

In addition, in the absence of mitigation, some risks will never be in a position to be deemed affordable.

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Therefore, without proper risk mitigation measures and/or inadequate information, it will be difficult for the insurance industry to provide affordable flood cover.

As such, the Institute reiterates our recommendation that a temporary national pool be established to help facilitate the offer of flood insurance to consumers, especially the high risk properties. This pool recognises that many people have, in good faith, purchased properties where they were unaware of the flood risk, and will be unable to secure appropriate insurance. The expectation is that this pool will be wound up after say 10 to 15 years, once adequate flood risk information and proper risk mitigation measures are made available or established.

Question 5.2: What is the likely impact on overall premiums of system costs?

The Institute does not have access to this information but it is significant for insurers and more so for smaller insurers.

Question 5.3: Would insurers need to cross subsidise parts of their business to make this proposal workable? If so why?

The competitive nature of personal lines policies in Australia means that it is unlikely that an insurer can deliberately cross-subsidise flood risks from other parts of their business over an extended period. Niche competitors will target the subsidising business and will be able to offer lower premiums in the absence of the need to cross-subsidise flood risk policies.

Question 5.4: Would affordable reinsurance protection be available for all insurers who take on flood risk?

What factors would influence whether affordable reinsurance is available? Would there be any difference between the availability of affordable reinsurance for large and small insurers?

At the time of this submission, the Institute does not believe there is any significant issue with flood reinsurance capacity in Australia. However, the price of flood reinsurance will vary depending on the circumstances of the insurers and, given recent natural disaster events, is not expected to be cheap. We also note that reinsurance is a global business so rates in Australia can also be impacted by events overseas.

Insurers who can demonstrate reasonable technical pricing capability and effective exposure monitoring, with appropriate risk management, are likely to receive more favorable terms and greater capacity from the reinsurance market. These are important qualities and are likely to be sought after by most reinsurers, especially those who are based overseas and have limited knowledge of flood risk in Australia.

Whilst larger insurers are likely to be beneficiaries of better reinsurance pricing, smaller insurers are likely to be penalised by reinsurers as they often lack the capability to manage flood exposure, which creates more uncertainty for the reinsurers.

As a result, the Institute considers that small insures will face greater pressure in gaining the necessary reinsurance than the larger insurers.

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Question 5.6: What other costs might insurers face as a result of the requirement to offer flood cover in all home building and home contents insurance policies? For example, costs of training call centre staff.

Apart from computer system costs, other costs which insurers face as a result of offering flood cover include:

- Cost of educating/training brokers and authorized agents – for intermediated insurers;
- Cost of sending renewal notices with the option of opt-out – compared to current automatic renewal;
- Cost of educating the public on flood risk – e.g. flood brochures or bulletins;
- Cost of receiving feedback and input from consumers on flood risk – this is important to help refine flood pricing if information is inadequate regarding the insured's property; and
- Cost of ongoing maintenance of flood modelling and flood risk monitoring and revising prices.

Whilst these costs are likely to have some impact on premiums (one-off investment, can amortize over a period of time), the Institute believes that the bigger contributor to potentially higher flood premiums is the uncertainty of the underlying flood risk which insurers are required to take on if flood cover is made automatic, and this is made worse by the inadequacy of existing flood maps. This is further exacerbated by ongoing building developments in flood prone areas.

A single definition of flood cover and the ability to offer an opt-out has the potential to reduce claims handling costs in some cases.

Question 5.7: How will smaller insurers be affected by this proposal?

Are they likely to engage in defensive pricing? Are they likely to exit the market entirely in certain areas?

Smaller insurers are known for cherry-picking risks and usually offer more competitive rates in their target market. The Institute believes, therefore, that it is more likely for smaller insurers to refrain from writing business in flood-prone regions than to engage in any defensive pricing, as the risk of getting the defensive pricing wrong remains. Even by doing so, smaller insurers still face the risk of not adequately exiting the right flood-prone regions.

Whilst larger insurers are likely to be beneficiaries of better reinsurance pricing, smaller insurers are likely to be penalized by reinsurers as they lack capability to manage flood exposure, which creates more uncertainty for the reinsurers.

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6. Transition Period

Question 6.1: Is two years a sufficiently long transitional period to enable insurers to build the underwriting capacity required to offer flood cover on all home buildings and home contents insurance policies?

It has been proposed that a period of two years would be allowed for the transition to full flood cover. Insurers with existing portfolios are faced with a choice of either granting cover to the in-force portfolio or providing it on renewal at expiry of the current term.

In granting cover to an in-force portfolio instantaneously, instead of on renewal, the insurer cannot collect additional premiums for the additional exposure in the current term. This means that, on average, 6 months worth of unfunded flood exposure would exist. The technical (unfunded) shortfall will vary from insurer to insurer depending on the mix of existing exposure that is in flood prone areas.

Where significant exposure exists, the unfunded cost may be significant enough to force the insurer to only offer cover on renewal (with an appropriate price adjustment). For a standard 12 month policy, next renewal could be as much as 12 months away. It is useful therefore to work backwards from the end of the transition period to consider this problem effectively.

Where cover is provided on renewal, cover must be offered on renewals that are due up to 12 months before the end of the transition period. With most renewal processes having a six to eight week lead time on the renewal effective date, this means that the insurer must be ready to offer the first renewal with flood cover no later than 14 months before the end of the transition period. This means that insurers effectively only have a transition period of a maximum of 10 months to prepare their systems and policy wordings to offer flood cover.

It is a business decision for each insurer to decide how to price for flood risk and the level of granularity (individual address, street, suburb etc) required to effectively manage risks such as anti-selection. The widespread adoption of risk-address pricing to price flood risk means that an insurer would realistically be very highly exposed if they choose to price more coarsely.

Any insurer that decides to price at a risk address level, yet currently does not have such a capability, would need to embark on a lengthy process and technology re-engineering project. Such a project would ordinarily exceed 12 months in length. In other words, the insurer would need to be well on the way to executing the project before the transition period starts in order to be able to send their first renewal 14 months prior to the end of the transition period.

It is likely that a period of three years is more appropriate and fairer on the whole industry.

Question 6.2: If the Government proceeds with implementing the proposed measure, is there a case for aligning the commencement date of the transitional period of the proposal measure with the commencement date of the Key Fact Sheet?

The Institute does not have a strong view either way.

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7. Changes to the Insurance Contracts Act 1984

There are no questions raised in relation to this section and the Institute has no specific comments to make.

8. Which Assets should be Covered by the Proposed 'Opt-Out' Regime?

Question 8.1: Should insurers also be required to offer flood cover in relation to strata title insurance policies?

What issues would this raise?

In the Institute's submission, *Response to Natural Disaster Insurance Review Issues Paper* dated 24 July 2011, the Institute recommended that strata title and other non-standard residential properties be included as part of any solution developed for flood. That part of the submission is repeated here:

Strata title should be included

a. There are a large number of laterally structured strata properties in Australia where properties are physically similar to a standard home. It will prove difficult to explain to the public why these strata properties are excluded from the flood arrangements.

b. There is a growing trend towards the development of apartment blocks in Australia.

c. The flood risk for apartments may be lower as the risk of inundation would only affect the lower levels of the building. Hence, the accumulation risk in the event of a flood is likely to be lower for apartments relative to that of standard homes.

d. Offsetting this, planning processes often result in concentrations of apartment blocks, often in high risk locations. This could result in accumulations of risk and insurers may decide to withdraw from the market in those areas.

e. To help reduce the risk of flood damage to the fixtures of strata properties, regulations should be modified so that expensive fixtures (e.g. lift motors and controls, ventilation systems, alarm systems and sprinkler pumps) are located above a specified flood level (instead of the basements) or "water-resilient" based on some stipulated standards (we note that Brisbane City Council is currently addressing some of these issues).

f. If strata title is covered for flood, it would be necessary for the owners' corporation to allocate the premium charged to each apartment.

g. In all but a few exceptions, legislation requires the owners' corporation to purchase building insurance. Unlike home owners, the owners' corporation would not be able to avoid flood cover and the associated cost by deciding not to insure.

Mixed use strata properties should only be included if the floor area of the building for commercial activities is below a certain limit/threshold

a. As noted in the Issues Paper, the nature of the cover is essentially commercial insurance and the strata property manager should be able to seek flood cover via insurance brokers.

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b. However, there will be properties where the amount of floor area committed for commercial purposes is not significant, e.g. only a grocery store located on ground floor of a building. In such instances, these properties should be treated like an ordinary strata property and be included in the flood arrangements.

c. Otherwise, it is the Institute's view that larger mixed strata properties should be excluded.

Retirement villages and aged care facilities should have limited coverage

a. Whilst such residences may be in some respects similar to a standard home, these properties may house a range of expensive medical equipment and supplies.

b. It is the Institute's view that coverage for such items is most efficiently provided by the private insurance market. This contains costs for any national pool, and may restrict building such properties in flood prone areas.

Caravans and mobile homes should be included

a. The Institute believes that these properties should be included on the basis that the caravan or mobile home may be the only asset the insured owns.

b. However, many caravan sites are located in high-risk areas, a total loss is likely given the construction type, and there is a risk of moral hazard.

9. Sub-Limits and Excesses

Question 9.1: Should insurers have to offer flood cover without any flood specific excesses or sub limits as an option for consumers to consider?

Should flood specific excesses be permitted in policies which offer flood cover? If yes, should there be a maximum permitted excess? If yes, what should it be?

Should flood specific sub-limits and excesses only be allowed for high flood risk properties?

Are there any other issues raised with respect to sub-limits and excesses?

Sub-limits

Limits on claims for flood vis-a-vis other insured events may be a means to reduce exposure and price; however they are likely to result in the same problem that exists with some insurers offering flood cover and others not. Unless the sub-limits are carefully disclosed many consumers will not appreciate why their premiums are cheaper with a particular insurer until a loss occurs and they discover they are, effectively, under-insured.

The insurance industry has been very vocal about the issue of under-insurance. Under-insurance can occur consciously (as part of an effort to reduce premium) or unconsciously (where the consumer does not realise they have insufficient cover). As is often the case with flood risk, the perception of the risk or potential magnitude of a resulting loss will in most cases be below the true risk and results in consumers accepting an inappropriate cover limit.

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Whilst sub-limits may be effective in reducing cost, they will not resolve hardship situations that frequently occur following a flood event. Sub-limits are also inconsistent with the suggestion provided elsewhere in the Consultation Paper that insurers must offer "Full Replacement Cover". Where there is a sub-limit by definition full replacement cannot be achieved.

A sub-limit on flood claims would also create another potential source of dispute. For example if the limit applies to flood but not storm claims, there will need to be a determination of the cause of the loss thus causing similar disputes to those that already arise with insurers that do not cover flood.

Excesses for flood claims

Earthquake excesses are common in the home insurance market in Australia. In most cases the amounts of these excesses are small (e.g. $500) relative to the size of the resulting claims. These excesses are effective in reducing claims handling costs by eliminating nuisance claims for minor existing cracking that, in most cases, was not a result of the earthquake itself. For material losses they represent such a small proportion of the loss that they do not materially reduce the claim cost.

The severity of flood claims is similar to earthquake claims. Flood claims are much larger than typical "working" home insurance claims. With flood damage there is usually far less opportunity for nuisance claims since the flow of the water can be easily identified and the circumstance of the loss validated. Therefore, the useful purpose of an additional excess in earthquake claims does not apply for flood losses.

Unless the excess is very large (e.g. $5,000), there would be no material reduction in the average claim and likewise the required premium. We therefore consider that special excesses for flood losses are unlikely to be an effective mechanism for reducing premiums.

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