

Home and strata insurance in North QLD

Submission to Treasury

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Dear Treasury Officials

The high cost of home and strata insurance in North QLD

This submission sets out Finity's views on the best approach for the Commonwealth Government to respond to the high cost of home and strata title insurance in North Queensland. We appreciate the discussion paper issued on 9 May 2014 and thank the Treasury for the opportunity to make a submission on this important topic for the people of North Queensland and the insurance sector.

We would be pleased to answer any questions you may have on this submission; Geoff Atkins can be contacted on 02 8252 3337. We are also available to meet informally with Treasury staff to discuss our thoughts.

Yours sincerely



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Part I Summary

We agree that the continuing high cost and restricted availability of insurance for homes and strata title properties in North Queensland is worthy of a government response.

There are two propositions on which our submission is based:

Two Propositions:

1. *That many prices currently quoted exceed the 'true risk transfer cost'*
2. *That if the true risk transfer cost is unaffordable, then government should not provide a subsidy but may provide temporary transition assistance*

We explain the reasons why we suggest the insurance market is not currently offering insurance at a true risk transfer cost¹, although it is important to note that we do not have empirical evidence to demonstrate it. The persistence of the problem for three years now is an indication that it is more than a temporary reaction and has structural underpinnings.

Our proposed solution is market-based, with the role of government being limited to stimulating that market with directional support and some seed funding.

The proposed market-based solution:

1. *Separate the natural perils risk from the other components of house and strata title insurance (several mechanisms are outlined)*
2. *Establish a group buying facility or pool for the natural perils risk*
3. *Access specialist international markets that specialise in insuring and reinsuring windstorm risk*
4. *Provide good quality information to those markets*

The submission explains in more detail how the solution would work, the specific options available for different components and outlines a project plan that could potentially have a solution in place for the 2014/15 cyclone season (or at least the latter part of that season).

We also briefly add our comments on the suggestions made in the discussion paper.

¹ 'True risk transfer cost' is the term we use to describe an actuarially fair premium – a premium that would be quoted in a competitive, well informed and rational market

Part II Detailed Submission

While general insurance can sometimes be a volatile and cyclical market, occasionally there is a structural issue creating market problems that needs more than 'market forces' to resolve. In our view the fact that the post-Yasi issues in North Queensland have persisted for three years is an indication that it will take more than market forces to resolve the situation.

1 Diagnosis and underlying causes

1.1 Is the problem real?

Our view is that it is reasonable to act on the basis that the problem is real. Home and strata owners in North Queensland are facing more difficulty in buying property insurance and are being required to pay much higher prices than in other parts of the country, and it is fair to say that there is not an active and competitive market for insurance in the region.

The first proposition on which this submission is based is:

Proposition 1:

That many prices currently quoted exceed the 'true risk transfer cost'

The 'true risk transfer cost' is the term we use to describe an actuarially fair premium – a premium that would be quoted in a competitive, well informed and rational market. Such a premium would be based on the 'best estimate' of the a priori expected annual claim cost plus the expense costs of the insurance transaction and an additional amount reflecting the economic value of the risk transfer (in effect the expected profit margin for the insurer).

It is important to note that we do not have empirical evidence to support or challenge this proposition. It is likely that the best available evidence is already in the hands of the Australian Government Actuary.

The nature of insurance is that it is not possible to accurately know the true risk transfer cost and so it is difficult to analytically prove or disprove the proposition. Nevertheless we think it is a reasonable basis from which to work.

1.2 Should the government intervene?

The answer to this question is not analytical. It is a matter for the government of the day to decide, and there will always be different views in the community about the appropriate answer.

Based on our observations of government policy and behaviour, we have prepared this submission on the basis of the second proposition:

Proposition 2:

That if the true risk transfer cost is unaffordable, then government should not provide a permanent subsidy but may provide temporary transition assistance.

1.3 What are the underlying causes?

Like many crises there are probably several underlying causes operating at the same time. In this respect there are many parallels with the liability insurance crisis of 2001 and 2002 which was triggered by the failure of HIH but had other underlying causes that were resolved by the program of tort reform which followed.

In the case of property insurance in North Queensland it is reasonable to start with an empirical observation about the cause, which is that there is **little appetite for the risk among insurers**. Insurance, like many other markets, is influenced by supply and demand and since 2011 the supply has been very low.

So why is there little appetite? Probably a few different reasons:

- The general insurance industry in Australia is cautious and not entrepreneurial (perhaps partly a function of the last ten years of regulation)
- It is regarded as too risky (to reputation, management credibility and profits) to take a substantial position in this market
- The opportunity is relatively small in terms of the ambitions of the insurers
- The economics in terms of the pooling of risk and the cost of reinsurance do not stack up
- The increasing knowledge of the true level of risk at a granular level has highlighted that past premium rates have been inadequate.

It is fair to say that the problem would not be nearly so serious if Yasi had not coincided with the much more costly catastrophe events in South East Queensland (floods), New Zealand (earthquakes) and Thailand (floods). This coincidence of events changed the market behaviour of reinsurers and caused a market disruption that in some respects has still not resolved.

1.4 What is the prognosis?

While the market place will continue to adapt, some of the causes described above indicate that the adaptation will not be rapid and may never be satisfactory.

A parallel can be drawn with insurance for hurricane damage in Florida and other states in the south east of the US. The risk level is such that there is not a sustainable and competitive insurance market that meets the needs and expectations of the community and therefore a range of government interventions has been established. As with many government interventions in a market, there are often unintended consequences and most solutions are imperfect.

The first three reasons listed above are not amenable to government intervention. The fourth reason (the economics) is worth a detailed understanding, and that understanding should guide the nature of any intervention.

The fifth reason is an inevitable outcome of technology. This development cannot be stopped, and in our view any intervention should aim to harness the improved knowledge of detailed risk levels to its advantage rather than regarding it as a barrier or impediment.

1.5 What is the problem with the economics?

The fundamental economic structure of insurance is about risk pooling. Relatively homogeneous risks can be successfully pooled, and a sufficient number of risks in the pool makes the process economically efficient. The nature of the North Queensland cyclone and flood risk is so much more extreme than in other parts of the country that the pooling does not work well. The insurance market works through a process of direct insurers and reinsurers. The direct insurers pool risk at a local level, while the economic basis of reinsurance (the insurance of insurers) demands global pooling.

The 'peak risk' is always the one that most influences the economics and the risk profile of an insurer. If the marginal cost of the peak risk, in terms of reinsurance and capital requirements, is high then a rational response by the insurer is to reduce (or even avoid) exposure to that peak risk.

In commercial insurance there are many players in the Australian market and many of them are part of international insurance groups. For these insurers a limited exposure to North Queensland does not create a peak risk and so they are able to write a modest amount of business without difficulty. The nature of the market at present is that the commercial insurers are happy to provide this capacity to risks in their target market, but there is no incentive for them to move into the domestic (home and strata) risks.

In domestic insurance, on the other hand, there is a greater concentration in the industry. The largest two insurers are believed to have about 60% of the Australian domestic market between them and both of them are listed Australian companies with little international diversification. There are smaller competitors to these companies, which have less capital resources and in many ways are less well placed to take on the peak risk in North Queensland.

This economic issue plays out mainly through the reinsurance market, but also in the risk modelling undertaken by insurers during recent years. The reinsurance market has changed a lot in its sophistication, in particular by the development of 'catastrophe models' that enable a much more specific assessment of the cost of risk at a segment level. In turn the cost of reinsurance for an Australian insurer is directly influenced by the outcomes from these models. North Queensland risks are shown to be costly and reinsurance premiums are charged accordingly. When this outcome is translated back to the decision making of the local insurer, the cost of reinsurance looks like poor value for money and the economically sound decision is not to write North Queensland risk.

We contend that with an understanding of the market and the economic issues that arise it is possible to craft an intervention that is sustainable without transferring risk or subsidies to the government. In the next section we outline how such an intervention may work.

2 The structure of a market intervention

The solution that we propose is based on the following principles:

- Align any intervention as much as possible with the underlying market and economics
- Temporary and least cost role for government
- Minimal disruption to normal market forces
- Easily reduced or withdrawn if the need diminishes.

The elements of the proposed solution are outlined below with more specific options explained in the next section.

2.1 Separate the natural perils risk

There is no problem of availability or affordability for home insurance or strata title insurance in respect of risk other than natural perils (cyclone and flood). The first step, therefore, is to separate out the problematic piece (the natural perils risk) from the remainder of the insurance and let the normal market deal with the normal risks. Section 3.1 outlines some ways in which this can be achieved.

2.2 Establish a 'group buying' facility or pool

By putting the natural perils risk into a single pool the process of buying protection for that risk in the international reinsurance market will be facilitated. This part of the solution is one that the insurance market cannot achieve on its own, partly because it is illegal under competition laws and partly because the insurance companies are competitors and don't naturally co-operate. Section 3.2 gives some options for achieving this step.

2.3 Access specialist international markets

The windstorm (variously called cyclone, hurricane or typhoon) risk exists in many parts of the world. The largest area of risk is the South-East of the USA – Florida at the heart but extending to many nearby states.

While it is a difficult risk to insure, there is an extensive specialist market, both of direct insurers writing hurricane-exposed business and of reinsurers writing business protecting against larger events.

It is our belief that the ability to access these markets for North Queensland risk is the key to a market-based solution given that:

- It is a business that these insurers will understand and be comfortable with
- It offers these insurers diversification that does not add to their 'peak risk' and so the economic cost of the risk transfer is much lower.

Section 3.3 outlines how this can be achieved, and it is worth noting here that step 2 (group buying) is important because it makes the transaction large enough to get their attention.

2.4 Provide good quality information

Because the essence of insurance is risk transfer, the availability of information to assess and quantify the risk is critical. Failure to provide sufficient and correct information can sometimes enable buying of cheap insurance but that is not a sustainable situation. Sustainable and effective insurance markets depend on sharing of good and accurate information about the nature of the insured risks.

The experience of the ARPC (the terrorism insurance pool) is a good example. ARPC has been able to buy a lot of reinsurance cover (about \$3 billion) at an economical price (currently less than \$70 million dollars per annum). Availability of the reinsurance has been improving and the price has been falling. It is generally accepted that one reason for this success is that ARPC has done an excellent job at providing good quality information to the market. It has invested relatively modest amounts in collecting more granular information from insurers about the particular risks and in modelling that helps quantify the risk levels. The return obtained in the form of high amounts of cover at reducing premium cost is likely to be many times the investment.

Section 3.4 explains in a little more detail what this would entail.

2.5 Summary of the proposed solution

The suggested solution for the insurance affordability problem in North Queensland is based on four key steps.

The proposed market-based solution:

1. *Separate the natural perils risk from the other components of house and strata title insurance (several mechanisms are outlined)*
2. *Establish a group buying facility or pool for the natural perils risk*
3. *Access specialist international markets that specialise in insuring and reinsuring windstorm risk*
4. *Provide good quality information to those markets*

This policy initiative would respond well to the principles described at the start of this section.

Principle	Response
Align any intervention as much as possible with the underlying market and economics	Fits neatly into current market practices and deals directly with the 'peak risk' issue by carving it out
Temporary and least cost role for government	Government cost limited to initial seed funding and can be left entirely to the private sector within the first year
Minimal disruption to normal market forces	Leaves distribution of insurance, all of the non-peril risks and claim handling unchanged
Easily reduced or withdrawn if the need diminishes	Optional for insurers and therefore can scale down or cease depending on market conditions

3 Implementation Options

In this section we outline some of the specific options that can be used to achieve each of the steps described in Section 2, along with some other practical issues.

3.1 Separating the natural perils risk

Property insurance covers a range of different causes of damage ('perils') including fire, explosion, wind, rain, water damage, earthquake, burglary and others. The problems in North Queensland are caused by the cyclone exposure (wind, rain and potentially storm surge) and to a lesser extent flooding. All the other perils are similar to the rest of Australia and cause no problems in terms of availability or affordability of insurance.

Separation of the natural perils risk can be done in two ways:

- By issuing two insurance policies within a package (one covering natural perils and the other covering all other perils)
- By the insurer specifically reinsuring the natural perils part of the cover and retaining the remaining risk in its normal business model.

The separation can be done based on two alternative definitions:

- Any claim arising from a defined natural peril (which we prefer for simplicity)
- Any claim arising from a disaster event, not just a minor storm.

Any of these alternatives would be possible, and the choice would depend on other aspects of the selected structure.

3.2 Establish a group buying arrangement

There are several ways in which the group buying arrangement or facility could be structured.

One example would be an Underwriting Agency that issues the natural perils policies on behalf of an insurer or a panel of insurers.

Another example would be a Reinsurance Pool that combines the reinsured natural perils risk from all the participating insurers and places it with a reinsurer or a panel of reinsurers.

In any case the skills needed are readily available in the market and can easily be obtained on a 'contract management' basis. There are many current examples of this type of structure, such as in local government.

One option would be for the 'risk pool' to keep a certain level of risk itself and to buy reinsurance only for larger events. This structure is common, for example, in local government pools. We would not recommend it, though, for the North Queensland facility.

3.3 Access specialist international markets

This process is usually undertaken by a professional reinsurance broker. It is a contestable market with several credible global providers and the service can be purchased on the basis of an agreed fee.

It is our expectation that the relevant markets to access would include:

- Insurers specialising in US windstorm risk
- Reinsurers (mostly domiciled in Bermuda) that provide a lot of reinsurance cover for US windstorm risk
- The Lloyd's, London and European reinsurance markets, which may include some reinsurers with existing presence in Australia
- Asian insurers (particularly Japan) that have their own windstorm exposures and would value some diversification.

3.4 Good quality information

It will be important that the facility, however it is structured, is able to provide good quality information to the international insurance and reinsurance market in order to get a good value and sustainable arrangement.

This information would include:

- Physical risk information about the location, construction, age and value of each property to be insured
- Meteorological information specific to the region
- Hazard exposure such as building standards and the vulnerability studies being done with James Cook University.

Collation and provision of this information would require activity by several stakeholders but is not technically difficult to prepare.

3.5 Possible structures for the facility

The skills needed to develop and operate a facility of the kind proposed are readily available in the market. They are core insurance skills that are currently applied in many situations and are contestable.

Corporate structure can, for example, be a company limited by guarantee. Alternatively it could be 'owned' by the Insurance Council of Australia with a contractual basis for participation.

Operation of the facility is most likely to be successful on an outsourced basis. There would be a number of interested parties who could be selected by tender.

Governance of the facility will be important. The governance structure will need to be able to balance the interests of various stakeholders and avoid capture by any one segment (including the contracted operator). A suitable governing board (commercial rather than stakeholder) and use of a small number of complementary professional advisers has been shown to be an effective model. An element of local input (perhaps through local government in the region) will be helpful.

3.6 Enabling requirements

If this solution is favoured by government, then the steps to implementation are reasonably straightforward:

1. A scoping study prepared by an expert that tests the feasibility and recommends a specific structure (including some market testing)

2. Procurement of the relevant services and expertise
3. Legal establishment and enablement – we think the legislative requirements can be minimal, with the most obvious need being in respect of competition law.

If executed well and with a sense of urgency the plan could be put into place:

- Potentially in time for the 2014/15 cyclone season, or at least for the latter part of that season (which would be say a 1 January 2015 start date)
- At a total cost to government of much less than \$5 million, perhaps only \$1 million or \$2 million
- With government involvement not being required beyond 2015.

4 Other comments on the discussion paper

4.1 Focus question 1: Compliance cost

The Queensland government can make a direct cost-reduction contribution to the solution by rebating stamp duty on the component of premiums paid for the natural perils cover.

4.2 Focus question 5: Uncertainty about risk

We suggest that the lack of competition or contestability is actually being affected by *greater certainty* of the level of risk in the region.

4.3 Focus question 9: Impediments to a comparison website

In our view there will be serious practical difficulties in establishing a comparison website that meets market needs. For example, insurance of high risk properties is increasingly sophisticated and may involve address-specific factors, which side of the hill, proximity to the ocean and other water and property characteristics such as roof construction and floor level elevation.

A comparison website will not capture all of this risk information and so is unlikely to give helpful quotes to potential insureds. We would also expect insurers to be reluctant to participate because of the implied promise that insurance will be available at the quoted price and a greater risk of anti-selection.

At the end of the day if only two insurers are actively seeking business then a comparison website with two product providers is not going to assist with capacity.

4.4 Focus question 12: A live quote aggregator

Aggregators are most effective in markets for products that have very similar of the same features. The variety in home and contents insurance products, and the array of rating and underwriting factors mean that an aggregator could not fairly reflect the offerings available to consumers. Most strata corporations use a professional reinsurance broker and they are very likely to be knowledgeable about what is available in the insurance market. Aggregator and comparison sites also tend to diminish innovation.

4.5 Focus question 27: Unauthorised foreign insurers

There are numerous international insurers authorised in Australia including Lloyd's of London which is arguably the world's most flexible insurance market.

The UFI rules were introduced mainly to protect consumers from scams – premiums collected on behalf of offshore companies that offer no security and may well be fraudulent. We think it is most unlikely that any increase in capacity would be available through this route. Then what happens if there is a cyclone and the UFI fails to pay claims?

As outlined in sections 2 and 3 of this submission the proposed group buying solution is the best method of tapping into global capacity that is not currently provided in the Australian market.