INSURANCE COUNCIL
OF AUSTRALIA

The Hon. Bill Shorten MP
Minister for Employment and Workplace Relations and
Minister for Financial Services and Superannuation
PO Box 6022
PARLIAMENT HOUSE ACT 2600

29 March 2012

Dear Minister

Consultation Feedback on Reforming Flood Insurance

The Insurance Council of Australia Limited (ICA) welcomes this opportunity to provide a response to issues raised in the consultation paper *Reforming Flood Insurance*, dated November 2011.

Operation of the Proposal in Practice

What other ways could insurers implement the proposal?

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

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?

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

The ICA notes the principles proposed for reforming the delivery of flood insurance in Australia.

The ICA believes insurers should have flexibility and not be forced to provide flood cover. Such a move would be potentially damaging if flood products were beyond a particular insurer's risk appetite. In many ways this may actually work to reduce competition in the insurance market.

The industry is already moving to include flood insurance in most policies and in various forms, such as standard inclusion, opt out or opt in. Every consumer in Australia, regardless of risk level, has a wide choice of providers and models for the acquisition of flood insurance. Combined with a simple Key Facts Statement, consumers will be able to readily access and understand the cover offered by their insurer.

We note the consultation paper statement that *"requiring all insurers to offer flood cover may result in some companies defensively pricing flood cover or simply 'redlining' flood prone areas. This could have a negative impact on competition in the insurance market, at least in areas exposed to flood risk" (p.10).* The ICA does not disagree with this statement and reiterates the importance of government efforts to address flood risk through mitigation and land-use planning.

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The proposal also suggests that insurers should be responsible for informing consumers of any flood risk at their property. This suggestion is rejected by the ICA. Insurance companies do not have a formal role to play in the notification of flood risks to community members[1].

Risk information relating to the approved use of land in Australia is the province of state and local governments. These jurisdictions control the risk through implementing mitigation works and by limiting the exposure of the community through controlled consent for use of hazard-prone land for specific functions. Developing and maintaining hazard information, such as flood maps, is a crucial part of fulfilling this responsibility.

It is important that hazard information is delivered to land users by the authority responsible for planning and consent at that location. Delegation of (or duplication of) this responsibility to industry will result in confusion for the community.

Critically, the appropriate time to inform a person of a flood risk is not at the point they take out an insurance policy. Rather, the person should have this information available to them when they are making a decision to purchase or rent. This would allow them to make an informed decision about the risk posed by flood.

It is important to remember that the flow-on costs from purchasing or renting a property in a flood-prone area can be many. These costs are both monetary and non-monetary (such as the emotional and psychological issues associated with a property being flooded). Consumers are entitled to know the flood risk before they make a considered financial decision about buying or renting a property. Being told at the time of taking out insurance may be too late, since they may already be locked in to a purchase or rental agreement.

The ICA notes the Commonwealth has funded development of a community flood risk portal through Geoscience Australia. ICA submits that this, combined with the regulated responsibilities of states and local governments, is a more appropriate mechanism with which to deliver flood risk information to the community.

That said, insurers can and do assist in highlighting risks to policyholders. Insurers send a price signal based upon the information the insurer gathers both from the insured and other sources of the risk associated with the location of the insured's property. This *canary in the coalmine* warning, delivered through a premium signal, helps individuals to understand how risks may impact upon them. However, it cannot substitute for the regulated responsibilities of government agencies to inform members of the public regarding the risks they face.

Many insurers have also highlighted that though a large percentage of flood mapping in Australia remains unfit for purpose (at a national scale), it is open to insurers to develop their own views regarding flood exposure at an individual property level – they will therefore have different views on risk and pricing[2].

Having alternative views on exposure will give rise to competition in the market place. Requiring insurers to be the flood risk authority (instead of local government) could lead to confusion for local residents. Governments must retain this responsibility.

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1 Note: Insurers are also restricted from providing personal financial advice.

2 Depending on the availability of mapping in that area there could also be a considerable difference in the underlying risk data being used, giving rise to greater confusion in the community.

Increasing the Awareness of Flood Risk and Flood Cover

What benefits are there in offering flood cover to all consumers with an 'opt out' option? What benefits are there in using insurance premiums to provide an indication of flood risk to consumers?

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?

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 benefit of having a system in which insurers can offer flood cover as a standard inclusion with a consumer opt-out is that the consumer will have greater confidence in the extent of the cover they have purchased. However, subject to the insurer clearly informing the consumer about the cover, the insurer should be able to offer flood cover, exclude flood cover or offer the option of opt in or opt out flood cover.

Creating awareness of the flood risk at a location is a role for government. However, the quantum of a premium offered by insurers can provide a consumer with a reflection of the risks perceived by the insurer. For many risks, the size of an insurance premium can act as a secondary flag, signalling the existence of risk to a consumer and prompting them to investigate with relevant authorities.

To enable a consumer to decide if flood insurance is relevant to their circumstances, they would need to receive information from relevant local authorities describing the flood risk in their location. This information is not universally available to all who need it. The ICA and industry have made several submissions to government describing how this could be improved. The ICA notes the Commonwealth has funded a program to improve flood-related information, including a community flood information portal.

Ultimately, the decision to expend a portion of household budget on flood insurance is a matter for consumers to determine themselves. Governments should properly remain focused on ensuring that consumers have received relevant flood-risk information from responsible authorities and that there is a choice of insurance cover available in the market.

The ICA submits that there is no need for additional specific consumer education on the issue of flood cover. Existing disclosure arrangements, combined with the proposed arrangements for a Key Facts Statement, should provide the required level of consumer awareness.

Increasing the Availability of Flood Cover

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.

How prevalent would the practice of offering 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?

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?

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

At present, flood cover is available to all residential consumers. What varies is the extent to which consumers choose a product with flood cover or not. In 2006 about 3 per cent of residential policies purchased in Australia were sold with flood cover. Without government intervention this figure has grown to about 81 per cent at the end of 2011.

However, those with a high risk of flooding may pay a higher premium for flood cover than those with no flood risk. The higher premium charged for the higher risk will naturally lead to changed consumer behaviours, including:

- consumers who accept the flood cover offered and make a purchase
- consumers who elect to purchase cover, from which flood insurance can be opted-out
- consumers who elect to purchase cover with flood cover, but who restrict their sum insured in order to manage premiums
- consumers who elect to not purchase any insurance cover at all

Commercial experience with individual insurer opt-out flood products since 2007 has shown that there is a higher proportion of consumers who opt-out of flood cover where the flood risk (and therefore premium) is high.

Some insurers with this type of product have reported about 2 per cent[3] of customers who are offered flood insurance choose to opt out. About 50 per cent of the consumers who opt out have low flood risks and 50 per cent have high or extreme risks.

The ICA submits that flood cover uptake by the community will naturally increase when there are more products offered with a flood cover option. However, for reasons associated with affordability or personal choice, a consumer segment will continue to elect to opt-out from flood cover, or if they have no opt-out option, they will elect not to purchase any insurance cover.

The ICA holds the view that the current practice of annual renewals of policies should be maintained. That is, when a renewal is due the insurer communicates an offer of ongoing cover to the insured, highlighting important changes in coverage and premium. The insured can elect to pay the premium offered for the continuation of the product as offered, or can insure elsewhere and choose to not renew with the same insurer.

In instances where a consumer has opted out of flood cover in the previous year the renewal notice should identify that the renewal premium does not include flood cover, but that if the consumer wishes to include flood cover that they can make contact with the insurer. An

[3] This is the proportion of consumers who elected to purchase the product with the flood cover opted-out from. An unmeasured number of consumers may have elected to, as a result of the offer, purchase an alternative product with no flood cover options from another insurer. However, an analysis of market share information over time does not indicate any significant drift of the market from providers of flood cover to insurers with no flood cover.

insurer with an opt-out model may choose to present both premiums[4] to the consumer again at renewal, but there should be no obligation for the consumer, if renewing, to actively opt out of the product again. A continued opt out can be signalled by the consumer by paying the opt-out premium.

The precise impact on premiums resulting from the inclusion of flood cover is a matter for individual commercial underwriters, which will naturally take into account a wide range of commercial factors. For comment of a general nature regarding the potential technical pricing of flood premiums, the ICA refers to its submission provided to the Natural Disaster Insurance Review in 2011.

The Storm/Flood Distinction

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

Where an expert opinion on the nature of water damage becomes necessary, experience has shown that the primary factor delaying determinations is the availability of data from government agencies. For example, hydrologists rely upon river and rain gauge data from local agencies and the Bureau of Meteorology. This data is often not made available in a timely fashion, which causes delays.

The ICA has submitted to both the Queensland Floods Commission and the NDIR that there is a strong need for the centralisation of water-related data under the weather bureau, a measure that would require legislative support through the Water Act. Centralised control and responsibility for water-related data would facilitate more timely decision making by experts employed by the insurance industry.

It is also worth noting that during the Queensland floods (December 2010-January 2011) several insurers, in the interests of making quicker decisions for policyholders, innovatively made initial determinations as to causation by using government-supplied aerial photography showing the extent of flood surfaces. These insurers have attracted significant criticism from governments and the community for doing so because they made decisions without all facts in hand. This natural tension between the need to resolve claims quickly and the need to so accurately is difficult to resolve to the satisfaction of all parties.

Insurers determine a claim as quickly as possible, balancing the tension between speed and accuracy. If an insurer makes an incorrect determination, it is corrected through internal and external dispute resolution. To date the Financial Ombudsman Service has received only about 920 claims (0.7 per cent) from the 133,000 flood claims lodged in Queensland for review and final determination. Most have been resolved in favour of the insurer, demonstrating almost all insurers get the balance between speed and accuracy right.

Governments can assist insurers by encouraging their responsible agencies to collect and publish relevant data in a more time-sensitive fashion. Ultimately, the Federal Government should consider centralisation of all water-related data in a single agency.

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[4] With and without flood cover

Industry Capacity to Underwrite Flood

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

What is the likely impact on overall premiums of system costs?
Would insurers need to cross-subsidise parts of their business to make this proposal workable? If so why?

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?

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.

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?

Access to high-quality government flood mapping and digital elevation models remains a key issue for the industry, and the ICA acknowledges the Commonwealth's efforts to coordinate an improvement in flood mapping practices. However, the ability of insurers to underwrite sustainably and accurately will be limited unless the quality and availability of flood mapping and associated data is improved.

The limited quality and availability of government flood mapping creates an unnecessary level of uncertainty for those pricing the flood risk and for those calculating portfolio risks and making consequential reinsurance decisions. In some cases this uncertainty may lead to defensive pricing and, consequently, premium increases.

Providing flood cover comes at a high cost to any insurer. Insurers must build their products, develop their underwriting systems and train their staff. Costs are also associated with systems that offer alternative price regimes for opt-out models. Most importantly, prudential capital needs to be secured in line with the projected uptake of flood cover by consumers to meet current and future APRA capital requirements, as well as market expectations. Each of these elements will combine to add costs to the insurer's operating costs before an insurer entering this market sells a single flood policy. This will flow through to consumer premiums.

Experience with flood products over the past four years has shown the development of flood cover can add about 2 per cent to the operating costs portion of the average premium stack, which is on top of the risk premium payable for the actual flood risk to the insured asset.

At present, there is no market failure in reinsurance cover for flood risks, though reinsurance costs for insurers are increasing significantly. The inclusion of flood cover within a portfolio will exacerbate this affordability issue and will result in ongoing premium increases for consumers.

Some smaller insurers may experience commercial challenges with the development of necessary flood pricing mechanisms and the securing of necessary capital to underwrite the risk. This may give rise to a range of different commercial decisions from smaller insurers.

The ICA cannot rule out the possibility some insurers may determine that the provision of flood cover within existing residential products is not feasible for their portfolio. As a consequence, some products may be withdrawn from the market.

The Transition Period

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?

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 ICA holds the view that two years is a sufficient transition period for most insurers with home and contents product lines, subject to the suitability and detail of the regulations.

It is likely that most of this market will have flood products available because of natural market forces before the transition period expires. Therefore, absolute correlation of the timing of the introduction of the Key Facts Statement and the requirement to provide flood cover does not seem critical, though it is desirable.

Though relatively unlikely, it is possible some insurers with home and contents lines will not be able to adapt commercially to the new requirement to provide flood cover options, regardless of the duration of the transition period.

Further, the transition period proposed may not be sufficient for insurers with home and contents products in rural regions. Underwriters have overcome most of the challenges posed by flood cover for urban domestic risks, apart from the inadequate availability of flood mapping in some areas. However, these challenges are exacerbated in rural environments by poor flood mapping and a correlating understanding of the risk. For example, with farm properties it can be difficult to know exactly where assets are located on the land parcel and if they are exposed to risk.

The ICA submits that the proposed transition period is sufficient for home and contents products in urban areas. However, the ICA would appreciate an opportunity to meet with Treasury to discuss how to address the possibility that insurers with a significant footprint in regional areas may need a transition period longer than the two years currently envisaged.

Assets to be covered by the proposed 'opt-out' regime

Should insurers also be required to offer flood cover in relation to strata title insurance policies? What issues would this raise?

The ICA submits that residential strata policies should not be required to offer flood cover.

Strata cover is unique and specialist in nature, and large premium increases have already had an impact on this market. Strata is a complex product area that includes mixed-use buildings, liability issues, strata consumer practices, limited supply and a trend towards strata development in high-risk areas. Strata buildings that contain commercial properties attract a different risk assessment because the nature of the use of the property can be significantly different. These overlapping factors could lead to significant premium increases.

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Sub-Limits and excesses

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 and excesses in a policy for a specific type of damage can be an important tool for consumers who wish to control premiums through accepting a portion of the risk themselves. The market has different approaches to this issue, with some insurers preferring to offer a sub-limit and others managing the issue through higher excesses.

Both approaches offer consumers a mechanism to manage risk within their financial capacity (by selecting a premium they can afford). Consumers in a high flood-risk area may not be able to afford a policy in which flood cover extends to the value of the policy. Rather than limiting their sum insured and creating an underinsurance issue for all perils under the policy, choosing a product with a sub-limit for flood damage will provide full cover for the non-flood risks and a level of cover for the flood risk. Alternatively, but with the same effect, a higher flood-specific excess may also assist the consumer to manage the affordability of the policy.

The existence of a sub-limit for a specific risk such as flood should be disclosed and be featured as part of any Key Facts Statement, if that sub-limit is material.

If you require further information please do not hesitate to contact me on (02) 9253 5150 or rwhelan@insurancecouncil.com.au.

Yours sincerely,

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