Northern Australia Insurance Premiums Taskforce

Interim Report

Submission by

Allianz Australia Insurance Ltd

Background

Allianz welcomes the opportunity to provide a submission on the Interim Report of the Taskforce. Allianz has for several years been concerned that the cost of home insurance in areas that are vulnerable to property damage arising from cyclones and/or floods has become unaffordable for some homeowners.

To state the obvious, the cost of home insurance is directly related to the risk of loss faced by a property from extreme weather events. In many cases, the cost and frequency of that loss comes down to how well the property is protected from the effects of damaging natural weather events. This protection can come about from two types of mitigation:

- protection of the property against damage in the first place, for example, a levy bank that prevents inundation of a property by flood waters; and/or
- making the property more structurally resilient to the forces (eg wind and rain) inflicted on it by an extreme weather event, such as a cyclone.

Thus, the starting point in any discussion about the price of property insurance should focus on mitigation. In this regard, Allianz concurs with the various comments in the Interim Report about the importance of mitigation and the role it has to play in any overall policy framework designed to ensure that all Australians have access to affordable home insurance. In this regard, Allianz draws the Taskforce's attention to the research that has been undertaken by the Insurance Council of Australia (ICA) and, independently, some of its members, which can be used to inform the Taskforce's work in addressing its Terms of Reference.

Allianz supports the focus on mitigation in the submission by the Insurance Council in response to the Interim Report and, in particular, the support for mitigation at the property level within the proposed Mitigation Assessment Scheme.

Option 1: A mutual insurance company offering cyclone cover to households

Allianz does not support the establishment of a Cyclone Mutual Insurer. Allianz does not believe that a "new insurance entity that would be 'owned' by the people of northern Australia" is either practical or feasible. Previous work by the Australian Government Actuary (AGA) has indicated that home insurance premiums offered by insurers over the last decade or so have not produced sustainable returns, Allianz does not believe that a Mutual Insurer could offer financially sustainable cyclone insurance cover "at premiums below the cost of existing insurance policies", even in the absence of a need to produce a dividend to shareholders. For example, insurers generally target a profit margin of around 5% of premium on home insurance, so if all a mutual model did was negate the need for a shareholder return, the maximum reduction in premiums it could expect to deliver would be 5%.

As the Interim Report notes, "a government guarantee would likely be required". Allianz suggests that other financial support (in addition to a guarantee of losses) would be required to establish such an entity that would also need to be provided by the Government. The real question therefore is whether the Government needs to establish and run a Government Cyclone Insurance Company in order to address the issue of home insurance affordability in northern Australia? Allianz suggests that this is not necessary and that alternative mechanisms such as a Government Cyclone Reinsurance Facility or the measures proposed by the Insurance Council of Australia would be significantly more effective, efficient and less disruptive to insurance markets, than a Government Cyclone Insurance Company.

Allianz supports the comments on the specific disadvantages of a 'mutual insurer' contained in the Insurance Council's submission and, as a result, will not duplicate those in this submission.

Option 2: A reinsurance pool for cyclone risk

Having briefly set out our position in relation to mitigation and a Government Cyclone Insurance Company above and, mindful that these issues are comprehensively covered in the ICA submission, Allianz's submission will focus on the reinsurance pool option.

Allianz is of the view that an appropriately designed Government Cyclone Reinsurance Facility would be an effective and efficient way of reducing the cost of insurance to those property owners that the government deemed deserving of premium assistance, in a way that would not cause undue inconvenience to policyholders or disruption to insurance markets.

Our submission takes the form of providing information in response to various questions and issues raised in the Interim Report (bolded/italicised text) about the reinsurance pool option.

"What are the advantages and disadvantages of a cyclone reinsurance pool, supported by the Government, with the objective of lowering consumer premiums for home, contents and strata title insurance for people experiencing affordability problems due to cyclone risk? What form of Government support would likely be required?"

The major part of the difference between the premium charged to insure property in northern Australia compared to southern and/or inland areas of Australia is driven by the additional cost to insurers of reinsurance related to cyclone and related perils (ie riverine flooding and storm surge). This reinsurance cost reflects insurers' exposure to property damage arising from the frequency and severity of cyclonic events impacting Northern Australia.

The key factor impacting the cost to insurers of providing cover for cyclone relates to the cumulative exposure to cyclone risk. This is comprised of the probable maximum loss from a cyclone event, which drives the maximum amount of reinsurance cover required, together the exposure created by the frequency of events. Frequency also drives the cost of cyclone reinsurance but also creates what insurers call 'sideways' exposure, which relates to the cost retained by insurers from multiple events.

Natural catastrophe reinsurance treaties have an 'attachment point', that is, the cost of claims the insurer has to pay before reinsurance is triggered. The reinsurer pays (up to the limit of cover provided) the cost of claims above the insurers retained limit. Among other things (eg the insurer's cost of capital), depending on the frequency and severity of the claims cost associated with different natural catastrophe events and an insurer's risk appetite, there is a natural commercial minimum attachment point below which it is

uneconomical for an insurer to go when setting their retained limit. As this minimum point is approached, the cost of the additional reinsurance cover becomes what insurers describe as a 'dollar swapping exercise'. In simple terms, this describes the situation where the extra dollar of reinsurance cover (in terms of a lower attachment point) costs the insurer an extra dollar of premium.

This commercially efficient level of the attachment point impacts on an insurer's exposure to losses differently depending on the frequency and severity of different types of natural catastrophes. Losses up to the reinsurance attachment point have to be paid by insurers own premium pool. Events that use the reinsurance program require insurers to pay a reinstatement premium subsequent to a claim on a reinsured layer. As a result, even with reinsurance, the frequency and severity of events an insurer is exposed to will impact the premiums it needs to charge policyholders.

For a low frequency, high severity event, such as a large, destructive metropolitan earthquake, very little 'sideways' exposure exists. As a result, the level of the attachment point will have only a minor impact on the amount of a home insurance premium attributable to the cost of earthquake reinsurance. While Australia occasionally experiences smaller earthquake tremors that do very little damage, the last significant earthquake in Australia, and the first for which reliable insurance loss data is available, was the 1989 Newcastle earthquake.

For a high frequency, medium to high severity peril, such as cyclone risk in northern Australia (particularly Nth Queensland), the commercially efficient attachment point results in significant 'sideways' exposure due to the cumulative cost to the insurer of a large number of events that produce losses up to the attachment point as well as the cost of reinstating reinsurance cover for the events that exceed the attachment point (even if only by a modest amount). Northern Australia experienced 30 cyclones between 2005 and 2015, three of which (Larry, Yasi and Marcia) resulted in insured losses in excess of $2.5 billion.

An advantage of a Cyclone Reinsurance Facility (or 'pool') supported by the Government is that, by lowering the cost of cyclone reinsurance to insurers, such a facility would reduce the cost of cyclone reinsurance, which is the main cost driving premium differentials between Northern Australia and elsewhere and, hence, reduce those premium differentials.

In addition, if a Facility provided cover to an insurer at a substantially lower attachment point (say, $5 million) than the commercially efficient one currently dictated by their existing reinsurance treaty,[1] the Facility would also substantially reduce insurers'

[1] Which for larger Australian insurers would generally be in the range of $50m to $200m.

sideways exposure to cyclone risk. This would further reduce the cost to insurers associated with cyclones, which would flow through to lower premiums for relevant customers.

Another advantage of a Government Facility is that it would be able to build up a pool of funds over multiple years to fund claims arising from a large loss event or to increase its level of retrocession retention, hence, lowering the cost of retrocession. Insurers are not able to do this. Under accounting and taxation rules, insurers cannot create multi-year catastrophe reserves to cushion the financial impact of future large events. Any unused funds insurers have allocated for natural catastrophe events in a given accounting year cannot retained and held in reserve for future years, but must be recognised as a profit of that year.

"How will the reinsurance contracts for cyclone losses mesh with existing reinsurance arrangements?"

If the perils, property/policies, geographic area, trigger for cover and period of cover are clearly defined, reinsurance from such a Government Facility could be relatively easily 'meshed' with insurers existing reinsurance arrangements. Insurers generally combine a range of different types of reinsurance arrangements (eg Facitultive, Treaty, Obligatory, Facitultive-Obilgatory, Property, Liability, Australian Reinsurance Pool Corporation) in order to create a comprehensive set of reinsurance arrangements to cover all the potential losses an insurer wishes to reinsure. Incorporating the cover provided under a Government Cyclone Reinsurance contract would not be a particularly difficult exercise. If a Government Cyclone Reinsurance Facility covered an insurer for losses (in full or part) arising from cyclones (clearly defined), an insurer's catastrophe reinsurance treaty could be negotiated accordingly.

The Taskforce's Interim Report 'contrasted' reinsurance treaty arrangements with 'loss-sharing' agreements, which are often called 'quota share' agreements. While such arrangements allow an insurer to share risk, they don't generally negate the need for the insurer to have a catastrophe reinsurance treaty. So their existence wouldn't necessarily create a particularly significant additional level of complexity when it came to incorporating the existence of a Government Cyclone Reinsurance Facility.

How should a cyclone reinsurance pool be designed to best fit with insurance companies' existing arrangements, including reinsurance arrangements? For example, how could cyclone and cyclone damage be defined so as provide certainty about what is covered by the reinsurance pool?

To bring about a reduction in insurer's exposure to the frequency and severity of losses from cyclones, the cover provided by a Government Cyclone Reinsurance Facility would

best be structured in a way that removed insurers' exposure to a large proportion of potential cyclone losses. For example, a Facility that provided cover for Named Cyclones at an individual insurer attachment point of $5 million up to a total industry insured loss event limit of $1.5 billion would remove insurers' exposure to around 80% of the insured losses from cyclones that have impacted northern Australia since 1975.

The only cyclone impacting northern Australia that would have exceeded this limit was 1974's Cyclone Tracy. While insurers would have still been exposed to losses associated with several small cyclone loss events over that period (ie cyclones that caused industry losses of up to $30-40 million), a Facility with the above insurer attachment point and limit would substantially reduce insurers' exposure to cyclones and consequently the cost of insurance for property owners in northern Australia.

Limiting the Facility's cover to losses associated with cyclones (ie from storm surge, riverine flooding (as defined by Insurance Contracts Act Regulations), wind, rain, impact etc) to a Named cyclone would provide a clear definition of the insured damage that would be covered by a Government Cyclone Reinsurance Facility.

"When does the cyclone event finish?"

Traditional catastrophe reinsurance treaties generally use a time-based definition. One example is coverage for damage that occurs up to 168 hours after the first loss. This would be suitable for a Government Cyclone Reinsurance Facility. Having said that, a Facility that covered a single peril like cyclone could in a range of ways clearly define the circumstances (eg types of losses or geographical area) in which cover was provided.

How can the definition draw a clear distinction between damage caused during the period of a named tropical cyclone and damage caused after a cyclone has deteriorated below cyclone status (for example, 'blue sky' flooding in downstream areas).

These distinctions can be drawn quite easily using traditional reinsurance principles, the standard definition of flood and a Cyclone Facility's geographical coverage arrangements. The issue of deterioration and 'blue sky' flooding in downstream areas would be resolved by a combination of the time limit applying to any Cyclone Reinsurance coverage and the Standard Definition of Flood.

The issue of a Cyclone Reinsurance Facility's coverage for damage caused by a deteriorated cyclone that has moved inland and/or south could also be addressed through the geographical coverage arrangements underpinning the Facility. For example, one option for insurer participation in a Facility is that insurers cede all policies related to the property insurance classes covered by the Facility (eg home, contents,

residential strata, landlords) to the Facility on a postcode basis. If the Facility charged a below market premium for its cyclone reinsurance cover, this would create a 'market based' geographic coverage area. For example, all things being equal, insurers would not generally cede a postcode to the Facility if, for example, by virtue of its location (eg its 'sourtherness'), the insurer's private market cyclone reinsurance cost related to that postcode was less than the premium being charged by the Government Facility.

An approach where insurers voluntarily decided which postcodes they wished to have covered by the Facility might also negate the need for the Facility to determine its geographical coverage. This may address any potential Constitutional issues that might arise from an Australian Government entity itself determining that it would only cover particular geographical areas of Australia.

"What is the area affected by the cyclone?"

For the purposes of a Government Cyclone Reinsurance Facility, the area affected by a cyclone would be determined by the terms of the reinsurance contract in respect of duration of cover and geographical coverage in terms of property losses ceded to it by an insurer that is participating in the Facility.

"What types of damage are caused by cyclones (for example, wind, water ingress, flood, storm surge)? What types of damage are typically covered by insurance policies?"

The general sorts of damage caused by cyclones are those listed above. Insurance policies generally cover damage from those causes, with some exceptions, depending on each insurer's policy wording. Those exceptions are storm surge, where coverage may vary among insurers, and flood, which may be covered, excluded, or optional, depending on the insurer's policy wording. As discussed elsewhere, it would be desirable for reasons of equity, clarity and affordability for a Government Cyclone Reinsurance Facility to cover all losses associated with cyclones, including from causes such as riverine flooding and storm surge.

How should the price insurers pay for reinsurance from a reinsurance pool be calculated?

"Setting a single price for reinsurance based on an assessment of the national cyclone risk."

The following discusses the issue of "a single price for reinsurance" from a number of perspectives, including the one alluded to in the Taskforce's report.

There would not be merit in setting a single price for reinsurance based on an assessment of national cyclone risk if that means insurers were required to pay an amount related to their national property portfolio for coverage from the Facility. The main reason for this is that cyclone is not a 'national' risk. It is largely confined to 'northern' Australia.

The Taskforce's report suggests that setting a single price for reinsurance would reduce price signals and may dampen the incentive for mitigation. One option for setting the price for reinsurance would be to charge insurers a proportion (eg 10%) of the pre-tax premium associated with each property that has been ceded to the Facility. If such a charging approach was applied to an insurer's whole national property portfolio, price signals and incentives for mitigation would be dampened to the extent that any of the cost of cyclone reinsurance was applied to properties outside northern Australia, which do not have a cyclone risk.

In terms of just those properties in northern Australia with a material cyclone risk that insurers have ceded to the Facility, applying a single price for cyclone reinsurance will still have implications for price signals and mitigation incentives. Standalone residential houses in northern Australia have different cyclone risk depending, among other things, on their date of construction. Specifically, houses built prior to the introduction of improved cyclone resilience building standards, which were introduced in the early 1980s (following Cyclone Tracy), are materially less resilient to cyclone damage than houses built to the revised standards. This is generally reflected in insurers' pricing which, all things equal, will generally charge post-1980 houses a premium of around 20% less than older properties.

A single price for cyclone reinsurance charged for all houses regardless of construction date, might reduce the price differential between older and newer houses and reduce the incentive for owners of older houses to invest in upgrading their property to current, more resilient standards. This concern however needs to be viewed in light of other considerations. For example, insurers would retain differential pricing based on year of construction if they retained exposure to cyclone damage. This would be the case because insurers would still presumably have some level of retention before a Facility was triggered and would still be exposed to losses that exceeded any Facility's event limit or individual property caps. The owners of older properties would therefore still have a price incentive to invest in property-level mitigation.

Another consideration relates to the issue of home insurance affordability. If the alternative to a single price for cyclone reinsurance is a differential price, this suggests that the price should be higher for older houses and lower for newer ones. The result would be that any premium reduction flowing from the provision of Government

subsidised cyclone reinsurance would be smaller for older houses which, all things equal, face higher premiums, and larger for new houses, which face relatively lower premiums. Such differential pricing of cyclone reinsurance would seem to work against an objective of improving affordability for property owners (ie the owners of older houses) that have been more adversely impacted by increases in home insurance premiums.

"The alternative is to set the price for reinsurance for each insurer based on an assessment of the risk in their portfolio. This would require insurers to provide information about their portfolios to the reinsurance pool."

It was suggested above that the price paid by an insurer for cover from the Facility could be based on a percentage of the pre-tax premium for each property ceded to the Facility. The premiums associated with older properties or those more prone to cyclone damage for other reasons (eg proximity to the coast with a higher risk of storm surge) will be higher than less vulnerable houses. If the Facility's charge was based on a percentage of premium, the amount paid for cyclone reinsurance cover for more vulnerable properties would be higher, all things equal, than the amount paid in respect of an insurer's less vulnerable properties. As a result, the price an insurer would pay for reinsurance would reflect the risk in their portfolio, without the need for insurers to provide additional, detailed information about their portfolios to the Reinsurance Facility.

"If pricing is set at technical cost (that is at the long-term break-even level), it may still not lead to a reduction in insurance premiums".

The accuracy of this statement depends on what is meant by "the long-term break-even level". The above statement might be true under a scenario where the Facility sought to:

- hold capital against the risk equivalent to a private underwriter;
- hold an additional APRA-equivalent capital margin;
- obtain an appropriate private underwriter shareholder return on this capital;
- obtain retrocession from the private market (rather than fund some part of any shortfall from Consolidated Revenue); and
- use traditional natural catastrophe retrocession rather than alternative, potentially lower cost, risk transfer instruments (eg catastrophe bonds).

If the Facility adopted alternative approaches to that of a private insurer in respect of any of the matters above, the 'technical cost', and hence the reinsurance price needed

to fully fund losses over the medium-long term, might be lower than the current price paid by insurers for cyclone reinsurance.

"This is because the pool would be a concentrated risk with little diversification, so that the technical cost could be quite high."

The accuracy of this statement depends on a range of considerations, not least the issue discussed above, that is, the extent to which a Government Facility purchased retrocession from the private reinsurance market as opposed to the Government carrying potential shortfalls on its own balance sheet. Other relevant considerations, particularly to the comment that the cost could be "quite high", include the following:

- While the Facility might have a concentration risk in terms of the perils covered (ie cyclone and cyclone-related storm surge and flooding), it has a wide geographical spread across the whole of northern Australia;
- What the net cost of reinsurance/retrocession would actually be, for example, if a similar number of reinsurers that currently provide cyclone cover to primary insurers, provided a similar level of cover to the Facility;
- whether the Facility's attachment point for its retrocession was higher than the attachment point that some primary insurers currently operating in northern Australia have for their natural catastrophe reinsurance treaties; and
- whether the Facility used Alternative Risk Transfer instruments to as an exposure management tool as opposed to traditional retrocession.

Reduction in premiums

"It may be that in order to achieve a significant reduction in insurance costs, the reinsurance contract would need to be priced at below market rates."

This statement is obviously true. If the Facility charged insurers premiums for cyclone reinsurance that were the same as current market rates, there would be no reduction in home or residential strata insurance premiums.

"If an insurer needs to buy additional reinsurance to cover areas of uncertainty in the cyclone reinsurance contract then this will reduce the potential reduction in consumer premiums."

This statement is true in principal, but there is no reason that the terms and conditions of any cyclone reinsurance provided by a Government Facility could not be made clear and thus mitigate against any such uncertainty. For example, insurers have at various times purchased additional terrorism reinsurance, to the extent available, (eg for residential and mixed use multi-story buildings) to cover gaps in the coverage (when limited to commercial office buildings) provided by the Australian Reinsurance Pool

Corporation (ARPC). This additional reinsurance cover could be purchased without the undue creation of areas of uncertainty due to the contractual clarity provided by the ARPC.

"How quickly reinsurance contracts can be renegotiated will determine when consumers may benefit from any new arrangements."

Reinsurance contracts are generally annual and may be based on either a calendar year or financial year. It would also be possible to renegotiate reinsurance contracts mid term to take account of substantial changes in the regulatory environment, such as the establishment of a Government Cyclone Reinsurance Facility.

"How much the cost of non-cyclone reinsurance decreases once cyclone losses are excluded from the contracts will be a factor determining the extent of the reduction in insurers' costs. Some stakeholders have indicated that the overall cost of reinsurance would not decline, and may actually increase."

Whether the overall cost of reinsurance increased or decreased if cyclone reinsurance was separated from remaining natural catastrophe perils would depend on the pricing of cyclone cover provided by a Government Reinsurance Facility. If the Facility charged a price below that currently charged by the private reinsurance market, the consequent reduction in an insurer's cost base would flow through to the final premium.

An Australian Government Actuary (AGA) report on home insurance prices in Nth Queensland found that:

- Catastrophe reinsurance could account for "20 to 40 per cent of the underlying (ie pre tax) premium" in Nth Qld; and
- In Nth Qld, the vast majority, around 95%, of this catastrophe reinsurance cost is attributable to cyclone risk.

Taken together, these figures suggest that the cost of cyclone reinsurance can account for approximately 19 - 38% of the pre-tax premium. The analysis of the options being commissioned by the Taskforce should be able to verify and provide a more precise figure of the average cyclone reinsurance cost currently paid by insurers.

Due to the cumulative impact on the final premium of costs such as reinsurance (ie, the 'grossing up' impact of Profit, Commission, Stamp Duty and GST), the cost of cyclone reinsurance substantially increases insurance premiums in Nth Queensland.

A significant reduction in the cost cyclone reinsurance through a Government Facility would lead to a substantial reduction in the premium paid by the policyholder. For example, if the cyclone reinsurance component of a premium was, say, 30%, the

elimination of such a cost would flow though to a greater than 50% reduction in the post-tax premium paid by the policyholder. This reduction would be reduced to the extent that the Facility charged insurers for cyclone reinsurance, but substantial reductions in premium could still be achieved if the Facility charged for its cover.

"Some stakeholders expressed concern that there may not be sufficient competitive pressure to force the pass through of lower costs."

Home insurance, like all classes of insurance is highly competitive. Indeed, Australian Government Actuary reports into home insurance and residential strata insurance in Nth Queensland have provided evidence that these classes of insurance have been so competitive to have been largely unprofitable for insurers over at least the last 8 years or so, and are currently priced, at best, at 'break even' levels. There is no evidence to suggest, indeed quite the reverse, than any reduction in insurers' costs (eg from the provision of cheaper cyclone reinsurance by a Government Facility) would not be passed fully and quickly through to the premiums charged by property owners.

"Others, however, suggested that if a low-cost reinsurance contract for cyclone risk was offered then new entrants would be attracted to the market, increasing competition."

An earlier government initiative in relation to the affordability of home insurance in Nth Queensland was the establishment of a Nth Queensland home insurance premium comparison website administered by ASIC. The site sought to include premium comparisons for all insurers selling home insurance online in Nth Queensland. In many of the postcodes covered by the site, consumers are limited to around half a dozen underwriters willing to sell home insurance online. This is substantially less than the number of insurers selling home insurance in southern areas of Australia. The reason for this is that some insurers avoid northern Australia or are highly selective about the risks they will underwrite. The reason for this difference in the level of market participation between northern Australia and elsewhere is largely explained by a more limited appetite among insurers for exposure to cyclone risk. A Government Cyclone Reinsurance Facility that substantially reduced insurers exposure to cyclone risk would have a commensurate increase in the level of market participation and competition in northern Australia.

Managing the risk to the Government

"The reinsurance pool is likely … to need the support of a Government guarantee."

A Government Reinsurance Facility would most likely require a Government guarantee. The size of such a guarantee, at least in the early stages, would depend, among other things, on the following factors:

- whether the Facility purchased retrocession from the private reinsurance market, the price of that cover and the level of the attachment point that triggered the retrocession;
- what the attachment point was for insurers that purchased reinsurance protection from the Facility;
- how much the Facility charged insurers for its cover;
- the number of cyclone events that triggered payments by Facility (in any one year and over time) and the amount of those payments; and
- whether the cover provided by the Facility was capped (eg on a per event and/or annual basis) and at what level.

The Taskforce has indicated that it has engaged expert advice to financially assess the two options in its terms of references and, presumably, design variations for each of those options. Such expert advisers should be able to provide options for the design of a Reinsurance Facility, including options that minimised the size of any required Government guarantee.

One option for limiting the Government's exposure is to set a cap on the payout available under the scheme.

Setting a cap on the cover provided by a Facility (eg on a per event basis) would be a practical way for the Government to limit its exposure. For example, a per event cap of $1.5 billion would have covered the insurance losses associated with all the medium to high severity cyclones[2] which impacted northern Australia for the period for which reliable data exists, with the exception of 1974's Cyclone Tracey[3].

[2] Depending on the attachment point for insurers to access a Government Cyclone Reinsurance Facility, many lower severity cyclones would not trigger cover by a Facility. For example, 13 of the 25 cyclones since 1975 on the Insurance Council's database of natural catastrophes resulted in total insured losses of less than $50 million (in 2011 dollars and adjusted for increased urbanisation).

[3] ICA estimates the current cost (in 2011 dollars and adjusted for urbanisation) of Cyclone Tracy at around $4 billion but this does not take account of improvements to the building stock, which were substantial in the rebuilding of Darwin post that event and in subsequent construction. Estimates taking this into account suggest the current cost of a Cyclone Tracy would be $1-2 billion.

What are the advantages and disadvantages of limiting payouts available under a reinsurance pool arrangement?

The main advantage of limiting payouts under a Government Reinsurance Facility would be to reduce the Facility's exposure to loss. This would reduce the cost of any retrocession it chose to purchase and, ultimately the cost to the government of any shortfall that might result in a need for the Facility to draw on any Government guarantee.

In addition, limiting payouts in respect of individual property owners through a per property cap could be used to achieve other government objectives. For example:

- If set at a building sum insured that covered the vast majority of properties in northern Australia, (say $400,000 for a standalone house[4]) a cap would focus the bulk of the cover (and any government subsidy) on 'average' homeowners. This would inject an 'equity' measure into the subsidy, which may also serve as a proxy for capacity to pay, as the owners of more expensive properties would be subject to normal insurance pricing for their risk of loss above the cap.
- If a cap was set at an amount materially lower than the sum insured (eg $150,000 per house or some equivalent percentage of sum insured), the subsidy would be more effective at reducing premiums for more resilient properties (that have lower average claims costs). This could help maintain (or even increase) the level of the premium differential between houses built to current building standards compared to older (pre 1980) houses and, hence, the incentive to undertake property level mitigation.
- Both the above objectives (equity and mitigation incentive) might be achieved if a Facility adopted both capping measures, that is, a cap based on a percentage of sum insured up to an maximum dollar amount.

When and how could the Government reduce support to the market through a cyclone reinsurance pool?

The main way the Government could reduce support to the market would be to assist in improving the resilience of properties to damage from cyclone. Ultimately, it is the cost of insurance claims and drives the price of insurance and this is evident in insurers' current pricing structures that result in houses built to current building standards being charged around 20% less than those that are not. There are two ways a house in northern Australia gets built to current standards:

[4] An 'equivalent' cap, say based on a per unit basis, could be developed for residential strata properties.

- First, by being built after those standards come into effect, which was circa 1982; and
- Second, by being largely rebuilt to current standard (eg after being severely damaged by cyclone) or being retrofitted to meet the current standards. The latter generally requires upgrades or other measures being taken to improve the structural integrity of rooves, windows, doors (including garage doors) and to otherwise prevent rainwater entering the property.

The second point above leads to the issue of encouraging mitigation. Allianz supports any cost efficient measures the Government might consider to assist householders undertake mitigation through retrofitting their properties to bring them up to current building standards. Such a measure deserving of consideration is the Mitigation Assistance Scheme (MAS) proposed by the Insurance Council of Australia (ICA).

How could a cyclone reinsurance pool scheme be structured to provide an incentive to policy holders to mitigate the risk of cyclone damage?

The discussion above has covered the ways in which a premium differential between older and new houses could be retained under a Reinsurance Facility (eg through insurers retaining some exposure to cyclone losses). There has also been discussion as to how various design characteristics of a Facility (eg property caps) could be used to ensure that a building standard-driven premium differential was maintain. As a result, a Facility could be structured to provide an incentive for policyholder mitigation. Indeed, property level caps could be used, while reducing the cost of insurance to address affordability, to increase this premium differential and hence provide even greater incentive than the current circa 20% premium difference the market currently provides.

Another way to encourage mitigation would be to establish the Facility as a temporary measure with a life tied to a government mitigation assistance through a scheme such as the ICA's MAS.