

## Northern Australia Insurance Premiums Taskforce: Interim report response

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### Introduction

Dear Task Force members,

The Climate Institute welcomes this opportunity to comment on the task force's frank discussion of this complex problem and, in particular, its underlining of the importance of risk-based insurance premiums in signalling that can support risk avoidance, minimisation and resilience.

Established in late 2005, The Climate Institute is an Australian-based non-partisan, independent research organisation focused wholly on finding solutions to climate change. Our 2050 vision is for a resilient Australia prospering in a zero-carbon global economy, participating fully and fairly in international climate change solutions.

Our 2014 report, *Buyer Beware*<sup>1</sup>, found that high levels of variability exist in home insurance premiums in various parts of Australia – up to 1100 per cent. Some locations with the biggest variance were not in northern Australia, but South East Queensland, regional NSW and Tasmania. It also identified that extremely high insurance premiums can be detected in some of those areas far south of the area under consideration here.

This Task Force is charged with addressing a perplexing policy issue; one which will very likely exacerbated and replicated in future.

In this submission we largely refrain from commenting in detail on financial mechanisms in either the mutual or the reinsurance pool, except where they intersect with a need to promote an evidence-based signal about both historical and future risks of natural disaster to individuals, businesses and governments. We also do not specifically address questions of social equity, but we note that there is considerable research showing that disadvantaged people and those on low incomes are most vulnerable to extreme weather and climate change<sup>2</sup>, and we support policies that address this vulnerability in a sustainable and long-term manner.

### The relevance of climate change to high North Australian home insurance premiums

Cyclone records for Australia are too brief to discern any clear statistical trend<sup>3</sup>. Despite this, climate change must be considered in developing an appropriate, fair and financially sustainable way of addressing this problems faced by the Task Force. Climate change is already identified as contributing to an observed increase in the length and intensity of heatwaves and droughts. There is also high confidence that it is contributing to changes in precipitation patterns, including increasing intensity of downpours. Cyclones are more challenging to model, but science indicates with a medium level of confidence that a changing climate may lead to fewer cyclones, but with increasing intensity and moving increasingly southwards<sup>4</sup>.

This means the types of challenges around high or inaccessible insurance premiums due to cyclone in Northern Australia may well occur in other parts of the country, and for other types of disasters.

### Barriers to action, governments and insurers

There are numerous systemic problems, mostly in the form of information asymmetries and perverse incentives that have led to the problem of high home insurance premiums in Northern Australia. Many of these barriers have been identified by the Productivity Commission's reports into *Climate Adaptation*<sup>5</sup> and *Natural Disasters*<sup>6</sup>; the *Natural Disaster Insurance Review*<sup>7</sup>, the *Business Roundtable into Natural Disaster Resilience and Safer Communities*<sup>8</sup>, and individual insurance companies<sup>9</sup> -- to name just a few.

While most of these reports refer only to historical incidence of natural disaster, they acknowledge such incidence may worsen in the future. As the climate changes over the coming decades, the shortcomings of an insufficiently robust solution will inevitably become more and more costly.

Many of the barriers relate directly to governments, particularly via demarcation of roles and funding sources available to the three levels of government. Another important element of government's role is legislative and regulatory frameworks.

The insurance sector alone is fundamentally unable to address these barriers, either for existing or future incidence of catastrophe and extreme weather events. Indeed many of the barriers relate more to the property sector - particularly in the interaction between residential housing markets and local and state governments. Home building regulations are limited to prevention of loss of life rather than reducing damage; home vendors are not required to disclose detailed information on how resilient the dwelling is to natural disaster damage. Even government-collected information on disaster risk is sometimes difficult or impossible to access<sup>10</sup>.

However as a relatively concentrated and closely-regulated sector which specialises in risk and has an interest in maintaining an insurable market, insurers can play an important role and we believe they will do so in a well-developed policy environment.

To that end, we commend the Task Force for canvassing increased transparency and disclosure around reasons for premium increases, and for discussing ways to capture data on resilience levels of individual properties. These concepts are discussed in more detail in our responses to the Focus Questions.

### What type of government intervention is appropriate?

A degree of government involvement in natural disaster mitigation and recovery is inevitable. Natural disasters tend to be costly both in terms of recovery costs and damage to economic growth. Taking no action and developing no policies means that contingent liabilities weigh on fiscal balance sheets and increase public costs, whether or not they are recognised<sup>11</sup>.

Governments at all levels must play part of a co-ordinated effort to address these barriers; but these efforts must go beyond short-term relief targeting insurance premiums, which are only the symptom of a far more complicated problem.

Although the Task Force's terms of reference are limited to exploration of a mutual or a reinsurance pool, we would question whether these are the only appropriate government interventions to consider in response to home insurance premiums becoming unaffordable for some in the cyclone-exposed parts of Australia.

The Task Force's interim report describes how the costs of insurance premiums in Northern Australia largely reflect risk levels and payout ratios, which in turn means that direct government targeting of premiums is unlikely to reduce total costs and may in fact increase them.

### Government exit

The report notes several reasons why government exit from supporting either a mutual or a reinsurance pool may be difficult, such as other insurers being crowded out, and the structure of the insurance and reinsurance sectors. Changing climatic patterns may further

compound the difficulty of such an exit; if the frequency, type or severity of natural disasters increases.

### Avoiding and reducing risk

Any solution should incentivise individuals, businesses and governments to avoid and mitigate loss. The Climate Institute believes mitigating greenhouse gas (GHG) emissions consistent with limiting warming to less than 2°C above preindustrial levels is a key part of any such serious, cost-effective efforts to minimise increased risks of damage arising from climate change. Increased GHG emissions will lead to increasing uncertainty over many types of natural disaster. Although the effect of GHG emissions is global, regardless of the emission source, the nature of international climate agreements means that nationally determined commitments consistent with 2°C from all major emitters is the only way irreversible and very severe climate change impacts will be avoided. It is therefore in the national interest that countries justifying and advancing their targets with reference to 2°C becomes the norm, not the exception, through time. This will require Australia itself to justify and implement targets consistent with this goal.

However, regardless of the future greenhouse gas emissions trajectory, the world is on track for at least 1.5 degrees of climate change from emissions to date. Research published by the CSIRO and the Bureau of Meteorology shows that this figure could reach as much as 5.1°C by 2090<sup>12</sup>.

### Mitigation and signalling via insurance premiums

The Australian Government Actuary confirmed that North Australian premiums have risen due to increased payouts.

We accept and support the insurance sector's assertion that insurance premiums can serve as a useful market signal of risk levels to property owners.

Signalling can and should be a powerful and necessary effect of normal insurance premiums.

However, as they currently operate, there are two key limits to the effectiveness of this signalling.

Firstly, insurance premiums generally only send a short-term signal, because they are derived from the risk acceptable to insurers over the next 12 months. By contrast, homeowners, banks, and governments of all levels become invested in property and physical assets for much longer time spans - theoretically, up to 30 years for banks and individuals, and even longer for governments which are exposed via public infrastructure. Therefore, while insurance premiums may provide a useful signal of risk to prospective property buyers, this is of limited use to existing owners and lenders who will make up the majority of property holders in any area.

The goal should not simply be to enhance the resilience of existing properties and homes, but also to avoid expansion of property developments in areas that are fundamentally exposed to a relatively high risk of natural disasters. The insurance sector alone cannot do this, but it could be part of an approach that promotes development in more resilient areas, thus reducing future costs for individuals, governments, insurers and other companies.

Secondly, signalling is of little effect if the reasons for high or rising premiums are not communicated to existing or would-be policyholders.

This is particularly the case if there is 1) opacity, and 2) wide variance in premiums offered.

Our 2014 report, “Buyer Beware”, demonstrated that variance in premium pricing occurs in many parts of Australia, but found it was more exaggerated in southern parts of the country. Discrepancies in premiums quoted of up to 1100 per cent were identified for similar products on identical properties, which the report notes “may signal a significant risk that one insurer knows something the other does not. An insurer might decrease their premiums once they have more information”.

Where pricing varies for similar levels of coverage, the astute consumer will naturally choose the lowest premium.

Increased transparency and contestability of insurance premiums and changes in premiums should be further explored. This would serve multiple purposes:

- + provide an incentive to individual property owners to improve resilience
- + reduce confusion for consumers
- + improve understanding of insurance premiums among the public
- + encourage development of a policy approach that supports low-income and disadvantaged residents in vulnerable housing

On the last point, we would support many of the points made in the Financial Legal Rights Centre’s submission to the Task Force.

## Interim report - Focus questions

Option 1: A mutual insurer offering cyclone cover to individuals

1. What are the advantages and disadvantages of a cyclone mutual insurer, 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?

We have no comment on detailed financial structures of the proposed measures.

2. How can a cyclone policy be sufficiently defined to fit neatly with a consumer’s ‘non-cyclone’ policy purchased from a private insurer so there are no gaps in coverage?

We have no comment.

3. How should a cyclone mutual insurer price its policies?

We have no comment.

4. Should insurance from a mutual be open to all or should eligibility be limited, such as to consumers on lower incomes or consumers who take mitigation action?

We have no comment.

5. What would be required for private insurers to be an agent for a cyclone mutual insurer and sell its policies and manage claims against those policies?

We have no comment.

6. What would be a suitable organisational and governance structure for a mutual insurer — a discretionary fund or an APRA regulated entity?

We have no comment.

7. What are the advantages and disadvantages of putting a cap on the payout from the cyclone policy offered by a mutual?

We have no comment.

8. When and how could the Government reduce support for a cyclone mutual insurer?

Changes in incidence, location, frequency and predictability of natural disasters should be considered in planning for government to reduce support via any mechanism.

## Option 2: A reinsurance pool for cyclone risk

9. 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?

We have no comment.

10. 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?

We have no comment.

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

We have no comment

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

We have no comment.

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

We have no comment.

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

Other options

15. Are there any other approaches that could lower premiums in areas where affordability is a concern due to cyclone risk?

See above.

Mitigation

16. What can be done to encourage greater efforts to mitigate the risk of damage from cyclones? Are there impediments to insurance premiums being responsive to mitigation action by property owners?

In addressing the first part of the above question, we refer to the recommendations for governments in our Buyer Beware report:

1. Mandate disclosure of all available hazard mapping including in digital formats, e.g. Global Information System.

2. Require that all dwellings and associated infrastructure be built or renovated as fit-for-purpose for the maximum projected impacts over their design life.
3. Disclose extreme weather and climate change risks associated with a property at the point of sale and legislate the Key Fact Sheet.
4. Disclose current and projected insurance premiums for a property at the point of sale, based on independent metrics (such as those presented in this report).
5. Disclose any settlements where climate change risks make future habitation untenable this century.

17. What are the advantages and disadvantages of establishing an independent assessment process to determine the vulnerability of a house to cyclone damage and to verify what mitigation work has been undertaken? How could such a process be established?

We believe that the Strata Title Inspection Scheme in Queensland may prove to be a model for one part of an effective solution for both historical and future patterns of natural disaster risk. We also note that individual insurers have considered ways to incentivise self-mitigation - notably, Suncorp's initiative announced in April.

However, for such initiatives to be useful and cost-effective, and to protect individuals from investing in vulnerable dwellings, we believe that any such records must

1. be shared or accessible in a co-ordinated, cost-recovery basis,
2. in a standardised digital format
3. take into account projected risks within the useful lifetime of the property.

18. What are the advantages and disadvantages of (a) establishing a rating system for building vulnerability to cyclone damage that could be publicly disclosed at the time of sale, and (b) establishing a centralised database on building information that could be accessed by insurers?

Such a database would have considerable advantages. However, its availability should not be limited to insurers.

19. What are the advantages and disadvantages of using increased excesses or policy exclusions to reduce the number of small claims following a cyclone?

We have no comment.

## ENDNOTES

<sup>1</sup> The Climate Institute, 2014, Buyer Beware: Home Insurance, Extreme Weather, and Climate Change: A report to The Climate Institute in partnership with CHOICE by Climate Risk Pty Ltd, [http://www.climateinstitute.org.au/verve/\\_resources/BuyerBeware.pdf](http://www.climateinstitute.org.au/verve/_resources/BuyerBeware.pdf).

<sup>2</sup> For example, ACOSS's submission to the 2013 Senate inquiry into recent trends in and preparedness for extreme weather events, [http://acoss.org.au/images/uploads/ACOSS\\_submission\\_to\\_Senate\\_Inquiry\\_into\\_extreme\\_weather.pdf](http://acoss.org.au/images/uploads/ACOSS_submission_to_Senate_Inquiry_into_extreme_weather.pdf).

<sup>3</sup> Braganza, K., B. Murphy, B. Timbal, P. Hope, A. Dowdy, K. Hennessy, J. Bhend and D. Kirono, 2015, "Understanding recent Australian climate", in Climate Change in Australia Information for Australia's Natural Resource Management Regions: Technical Report, CSIRO and Bureau of Meteorology, Australia, [http://www.climatechangeinaustralia.gov.au/media/ccia/2.1.5/cms\\_page\\_media/168/CCIA\\_2015\\_NRM\\_TR\\_Chapter%204.pdf](http://www.climatechangeinaustralia.gov.au/media/ccia/2.1.5/cms_page_media/168/CCIA_2015_NRM_TR_Chapter%204.pdf).

<sup>4</sup> McInnes, K., Moise, A., Abbs, D., Timbal, B., Hope, P., Dowdy, A., and Wilson, L., 2015, "Winds, Storms and Extreme Weather," in Climate Change in Australia: Projections for Australia's NRM Regions: Technical Report. CSIRO and Bureau of Meteorology, Australia, [http://www.climatechangeinaustralia.gov.au/media/ccia/2.1.5/cms\\_page\\_media/168/CCIA\\_2015\\_NRM\\_TR\\_Chapter%207.pdf](http://www.climatechangeinaustralia.gov.au/media/ccia/2.1.5/cms_page_media/168/CCIA_2015_NRM_TR_Chapter%207.pdf).

<sup>5</sup> Productivity Commission, 2012, Barriers to Effective Climate Change Adaptation, <http://www.pc.gov.au/inquiries/completed/climate-change-adaptation/report>.

<sup>6</sup> Productivity Commission, 2014, Natural Disaster Funding, Final Report, <http://www.pc.gov.au/inquiries/completed/disaster-funding/report>.

<sup>7</sup> Natural Disaster Insurance Review, 2011, Final Report, <http://www.ndir.gov.au/content/Content.aspx?doc=report.htm>.

<sup>8</sup> Deloitte Access Economics and the Australian Business Roundtable for Disaster Resilience and Safer Communities, 2014, "Building an open platform for natural disaster resilience decisions", July, <http://australianbusinessroundtable.com.au/white-paper>.

<sup>9</sup> For example, Suncorp commissioned research by KPMG on risk apportionment in the insurance industry, summarised in Suncorp's General Insurance submission to the Financial Systems Inquiry, [http://fsi.gov.au/files/2014/04/Suncorp\\_General\\_Insurance.pdf](http://fsi.gov.au/files/2014/04/Suncorp_General_Insurance.pdf).

<sup>10</sup> Accounts of these problems accessing information are chronicled extensively in the Australian Business Roundtable's 2014 white paper, "Building an open platform for natural disaster resilience decisions".

<sup>11</sup> For example, this can weigh on sovereign credit ratings. Standard & Poor's has referred to this several times, most recently in: "Storm Alert: Natural Disasters Can Damage Sovereign Creditworthiness", September 10, 2015.

<sup>12</sup> Braganza et al, op cit.