LLOYD'S

Mr Mike Callaghan AM
Review Chair
Northern Australia Insurance Premiums Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

14 September 2015

Dear Mr Callaghan

Review of Taskforce's Interim Report

Lloyd's applauds the intention of the NAIP Taskforce to consider and develop options to reduce home, contents and strata insurance premiums in those regions of Northern Australia that are experiencing insurance affordability concerns due to cyclone risk.

Nevertheless, Lloyd's is concerned that the current proposed options of a mutual cyclone insurer or cyclone reinsurance pool would not deliver the effective, prolonged solution sought by the Australian Government. Lloyd's continues to call on the Australian Government to work with the private market to encourage risk mitigation techniques and procedures, to more appropriately achieve the Taskforce's aim of reducing premiums.

Government Intervention

Lloyd's believes governments have a vital role to play in mitigating and managing both the prevention and aftermath of natural disasters. However, Lloyd's maintains this should not consist of direct, top-down intervention in the market and rather should be positioned alongside the global (re)insurance industry. This aligns with comments in the Taskforce's Interim Report (*the Report*) regarding the need to develop a solution which supports existing insurance arrangements and which encourages a competitive private market for insurance.

The creation of insurance programmes or pools can distort competition, by hampering the application of risk based actuarial principles. Indeed, when the offering and pricing of insurance is not risk based, it inaccurately reflects the risk environment. As noted at page 41 of the Report, government intervention to lower the price of premiums can dampen incentives for mitigation. A key role of the insurance market is to provide price signals about risks. Insurance premiums can act as an incentive for development in areas with lower risk of natural perils.

Government intervention can limit the effectiveness of the insurance industry by reducing rates to uneconomic levels. This in turn can result in government-run schemes expanding beyond their original remit, creating large liabilities for taxpayers both by expanding the number of policyholders and by increasing the implicit subsidy to each (a concern noted at page 23 of the Report).

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Case Studies

FAIR Plans in the United States (Fair Access to Insurance Requirements) and the Beach and Windstorm Plans (which cover mainly wind only risks in selected coastal areas of the US), have over the last forty years experienced considerable growth. Between 1990 and 2005, the total FAIR and Beach Plan policies in force rose from 780,000 to over 2 million. Their exposure to loss rose from US$40.2 billion in 1990 to US$380 billion in 2005. This shift has left some plans with huge concentrations of risk and the potential for severe financial difficulties.

For example, the Texas Windstorm Insurance Association's (TWIA) policy count grew from 77,000 policies in 2001 to 216,000 policies just prior to Hurricane Ike in 2008[1]. The annual growth rate since Ike averaged 4.5 percent, and by 2014 the association held more than 270,000 policies with up to US$77 billion in insurance coverage[2].

Hurricanes Dolly and Ike in 2008 together generated more than 100,000 claims and an estimated US$2.8 billion in losses. Following Hurricane Ike, TWIA's claim volume grew from 10 to 15 claims per day to nearly 93,000 in a 12-month period. More than 7,000 lawsuits were filed against TWIA by Ike claimants, and it is estimated that Ike losses and litigation will ultimately total more than US$2.5 billion. Because of claims handling and other administrative issues following Ike, TWIA was placed under administrative oversight by the Texas Department of Insurance in 2011.

TWIA estimates that a 1-in-100 year storm could cause losses to the association of more than US$4.5 billion. Texas Lt. Gov. David Dewhurst has recently asked state lawmakers to consider shutting down the windstorm insurance provider for coastal Texans, to avoid a "*massive financial tsunami to Texas taxpayers.*"[3]

The Citizens Property Insurance Corporation Florida (Citizens) was similarly established in August 2002 as an insurer of last resort, providing multi-peril and wind-only insurance coverage to Florida homeowners, commercial residential and commercial business property owners unable to find property insurance coverage in the private market.

The scheme has experienced exponential growth since its inception, evolving from a market of last resort to become the state's largest property insurer by 2013. As of 2013, Citizens was the state's leading homeowners' insurer, with a market share of 14.5 percent, and the leading commercial insurer, with an 8.2 percent market share. Citizens had 1,459,344 policies with an exposure of US$229 billion.[4]

Despite the financial buffer Citizens has managed to create, due to recent benign periods, a report prepared by the actuarial firm Milliman concluded that it will face severe problems in the future. According to the report, even under the best of circumstances, Citizens will see

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[1] http://www.insurancejournal.com/magazines/features/2013/02/25/281855.htm
[2] http://www.claimsjournal.com/news/southcentral/2014/09/12/254563.htm
[3] ibid.
[4] http://www.iii.org/article/florida-hurricane-insurance-fact-file

its surplus shrink to the point where it will likely have to borrow significant funds to pay claims.[5]

Both Citizens and TWIA are currently considering ways in which to reduce their policy count/exposure.

Similar issues have developed for the US National Flood Insurance Program (NFIP). The NFIP's rates are well below those the private market would offer to cover flood. It provides overall flood insurance at one-third true risk cost in higher risk areas owing to its rating methodology and is restricted by law in its ability to adjust existing rates and to offer risk-based pricing. According to a March 2011 Report by the US Government Accountability Office, the NFIP owed the Treasury US$17.8 billion and was in serious need of financial reform.

A key disadvantage of the abovementioned schemes is that the availability of insurance encourages development in areas where construction otherwise would not be feasible and where significant tax money must be spent to preserve properties.

Lloyd's has a long history of providing (re)insurance protection against natural catastrophes to policyholders all around the world and has built up considerable expertise in this area. Lloyd's firmly believes it is the private insurance market that should remain the first line of defence for the protection of Australian property owners.

Government Led Risk Mitigation Initiatives

However, this is not to say that the Australian Government does not have a key role to play in this process. For example, in the UK the Government and the insurance industry have cooperated to encourage greater investment in flood prevention measures in return for the ongoing provision of flood cover to domestic policyholders.

Lloyd's supports the principles behind government led risk mitigation initiatives, and in particular supports the following initiatives identified by the local industry and the Taskforce as potential solutions:

- Introducing processes to comprehensively capture and report self-mitigation work already undertaken on older homes, to allow for appropriate premium review;
- Working with experts to design possible retrofit programs to strengthen older North Queensland homes against cyclone impacts[6].
- Supporting comprehensive mitigation research; and
- Promoting steps to reduce small claims (i.e. by introducing higher excesses - to mitigate the aggregate effect of these claims).

[5] http://www.nasdaq.com/article/the-unsustainable-state-of-the-florida-property-insurance-market-part-ii-cm407975

[6] http://www.suncorpgroup.com.au/sites/default/files/pdf/news/Media%20Release%20Protecting%20the%20North.pdf.

By way of example, in Florida, Citizens offers policyholders financial incentives to invest in hurricane-resistant home improvements. Premium discounts range from 3 percent for roof gable and garage door bracing to as much as 18 percent for improvements that reduce the likelihood of materials such as glass shattering when hit with flying debris.[7]

Lloyd's believes that Governments should focus on improving properties and communities in cyclone-prone regions, rather than asking taxpayers from low-risk areas to subsidise premiums in high-risk areas. Any solution should integrate urgent mitigation and building resilience measures that improve the capacity of cyclone-prone communities and individual property owners to withstand extreme weather.

Other Considerations to Reduce Costs

Notwithstanding our misgivings about government intervention, Lloyd's acknowledges that intervention can be justified where there is a social need for cyclone coverage amongst those who would be otherwise unable to afford it. However, rather than creating a central programme or pool, with the inherent potential shortcomings described above, Governments should instead consider selective, means-tested and carefully targeted subsidies for those affected – as suggested at page 39 of the Report. Such programmes should not be extended to commercial policyholders.

We similarly support the suggested reform of taxes and duties applying to insurance, as outlined at page 39 of the Report, to reduce the cost of insurance premiums in those regions experiencing insurance affordability concerns due to cyclone risk.

Conclusion

We would respectfully ask that the Taskforce work with the private market to encourage risk mitigation techniques and procedures, rather than promoting a mutual cyclone insurer or cyclone reinsurance pool.

Lloyd's is grateful for the opportunity to share our feedback on the Report, and hope our comments are of assistance.

Yours sincerely

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7 http://www.iii.org/issue-update/residual-markets