



**Australian Government**

---

**The Treasury**

Northern Australia Insurance Premiums Taskforce

# **FINAL REPORT**

November 2015

© Commonwealth of Australia 2015

ISBN 978-1-925220-76-6

This publication is available for your use under a Creative Commons Attribution 3.0 Australia licence, with the exception of the Commonwealth Coat of Arms, the Treasury logo, photographs, images, signatures and where otherwise stated. The full licence terms are available from <http://creativecommons.org/licenses/by/3.0/au/legalcode>.



Use of Treasury material under a Creative Commons Attribution 3.0 Australia licence requires you to attribute the work (but not in any way that suggests that the Treasury endorses you or your use of the work).

### **Treasury material used ‘as supplied’**

Provided you have not modified or transformed Treasury material in any way including, for example, by changing the Treasury text; calculating percentage changes; graphing or charting data; or deriving new statistics from published Treasury statistics — then Treasury prefers the following attribution:

*Source: The Australian Government the Treasury*

### **Derivative material**

If you have modified or transformed Treasury material, or derived new material from those of the Treasury in any way, then Treasury prefers the following attribution:

*Based on The Australian Government the Treasury data*

### **Use of the Coat of Arms**

The terms under which the Coat of Arms can be used are set out on the It’s an Honour website (see [www.itsanhonour.gov.au](http://www.itsanhonour.gov.au)).

### **Other uses**

Enquiries regarding this licence and any other use of this document are welcome at:

Manager  
Media Unit  
The Treasury  
Langton Crescent  
Parkes ACT 2600

Email: [medialiaison@treasury.gov.au](mailto:medialiaison@treasury.gov.au)

# CONTENTS

<b>Acronyms and glossary .....</b>	<b>v</b>
<b>Acknowledgements .....</b>	<b>vi</b>
<b>Executive summary and recommended way forward .....</b>	<b>vii</b>
Context and approach .....	vii
Threshold issues .....	viii
Feasibility of a cyclone mutual or reinsurance pool for cyclone risk .....	ix
Mitigation .....	xiii
Other approaches.....	xv
Recommended way forward .....	xvi
<b>1. Context and approach .....</b>	<b>18</b>
1.1 The context: managing the rise in insurance premiums in northern Australia .....	18
1.2 Insurance premiums and market conditions in northern Australia.....	20
1.3 The approach: assessing the feasibility of the options .....	22
<b>2. Threshold issues .....</b>	<b>25</b>
2.1 Regions of northern Australia experiencing affordability concerns due to cyclone risk .....	25
2.2 Types of insurance to be covered .....	26
2.3 Defining a cyclone for the purpose of insurance .....	27
2.4 Estimates of potential cyclone damage in northern Australia .....	28
2.5 Current cyclone premiums and cost to government .....	36
<b>3. Insurance option 1: Mutual cyclone insurer .....</b>	<b>38</b>
3.1 A possible design.....	38
3.2 Criteria 1 and 2: the potential reduction in premiums and cost to Government.....	41
3.3 Criteria 3 and 4: effect on insurance and reinsurance markets and the potential for Government exit .....	47
<b>4. Insurance option 2: Cyclone reinsurance pool.....</b>	<b>48</b>
4.1 A possible design.....	48
4.2 Criteria 1 and 2: the potential reduction in premiums and cost to Government.....	50
4.3 Criteria 3 and 4: effect on insurance and reinsurance markets and the potential for Government exit .....	55
<b>5. Mitigation of cyclone damage .....</b>	<b>57</b>
5.1 Benefits and challenges of cyclone mitigation.....	57
5.2 Reducing the vulnerability of buildings to cyclone damage .....	58
5.3 Options to reduce the vulnerability of houses in northern Australia .....	62
<b>6. Other approaches raised by stakeholders.....</b>	<b>74</b>
6.1 Direct subsidy.....	74
6.2 Reducing state insurance taxes and duties.....	76
6.3 Regulating commissions to strata managers .....	77

- 6.4 Policy contestability and disclosure .....79
- 6.5 Responses to insurance availability issues in the Indian Ocean Territories .....80
- 7. Comparison and summary of options .....82**
  - 7.1 Direct subsidy.....82
  - 7.2 Insurance options.....82
  - 7.3 Mitigation.....86
  - 7.4 Recommended way forward.....88
- Appendix A: Terms of reference .....91**
- Appendix B: Reference Panel members .....92**
- Appendix C: Report by Finity Consulting.....93**
- Appendix D: Alphabetical list of submissions.....94**
- References.....95**

## ACRONYMS AND GLOSSARY

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
AGA	Australian Government Actuary
APRA	Australian Prudential Regulation Authority
ARPC	Australian Reinsurance Pool Corporation
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
Catastrophe reinsurance	Insurance purchased by insurers on the global market to protect them from large losses due to a catastrophe. Under the contract the insurer will meet the first portion of claims and claims above this level are covered by the reinsurer.
CRC	Co-operative Research Centre
CTS	Cyclone Testing Station, James Cook University
Discretionary mutual fund	Discretionary mutual funds offer an insurance-like product that often involves a contractual obligation to consider a claim, but provides the fund with discretion whether to pay the claim. They are not subject to the same level of prudential regulation by APRA as Australian authorised insurers.
ICA	Insurance Council of Australia
NEXIS	National Exposure Information System, Geoscience Australia
Reinsurance	Insurance for insurers. Under a reinsurance agreement an insurer ‘cedes’ or passes on risks to a reinsurer, who, for a fee, covers an agreed a share of claims incurred by the ceding company.
Retention or attachment point	If a catastrophe causes an insurer to claim on a reinsurance contract, the retention is the amount the insurer must pay before the reinsurer will refund further amounts. This amount is often called the attachment point of the reinsurance.
Retrocession	Where a reinsurance company insures another reinsurance company by accepting risk the other company has underwritten.
Treaty reinsurance	Reinsurance contracts where the insurer agrees to ‘cede’ a defined class or classes of risk to be covered by the reinsurer, as opposed to the reinsurer individually underwriting a defined risk or a package of defined risks.
Excess-of-loss reinsurance	Excess-of-loss reinsurance covers losses above a defined limit. The insurer has to cover any claims up to that amount themselves, but can claim from the reinsurer for losses above the limit — often called the retention or attachment point (see above).

## ACKNOWLEDGEMENTS

The Taskforce thanks all the members of the Reference Panel (listed in Appendix B) for their dedication and assistance in reaching out to stakeholder groups and ensuring a wide range of views were heard and incorporated. The Taskforce acknowledges the important advisory role played by the Panel, noting responsibility for the final report and its recommendations rests solely with the Taskforce.

The estimate of cyclone exposed buildings and contents provided to the Taskforce by Combus used data from the Geoscience Australia National Exposure Information System (NEXIS) and the ABS Basic Community Profiles Datapacks and Digital Boundaries from the 2011 Census.

Estimates of damage from cyclones provided to the Taskforce by three firms, Combus, Risk Frontiers and Guy Carpenter, have been used by the AGA and Finity Consulting to calculate the expected cost of cyclones.

# EXECUTIVE SUMMARY AND RECOMMENDED WAY FORWARD

## Context and approach

The Northern Australia Insurance Premiums Taskforce was established as part of the response to the rapid rise in insurance premiums in areas of northern Australia subject to cyclone risk.

Over the past few years, some regions in northern Australia experienced a significant increase in premiums over a short period of time. This has been particularly noticeable in northern Queensland, the most populated part of northern Australia, and in some parts of north Western Australia. A range of inquiries have looked at the causes of the rise and have found, as has this Taskforce, that insurers are now increasingly pricing premiums to align more closely with the risk of damage to (and therefore claims by) individual properties. At the same time, losses from a number of cyclone events prompted insurers to reassess cyclone risk, and this has been a key reason for premium increases in northern Australia.

The Taskforce was asked to explore the feasibility of options to address insurance affordability concerns arising from cyclone risk. Specifically it was to assess the feasibility of two options — a mutual cyclone insurer and a cyclone reinsurance pool — and to consider other options put forward by stakeholders during consultations.

In accordance with its terms of reference (Appendix A), the Taskforce was to assess the feasibility of the options regarding:

- the potential reduction in consumer premiums;
- the likely cost and risks associated with using the Commonwealth balance sheet to lower the cost of insurance to consumers;
- the potential effect on the operation of the insurance and reinsurance markets in northern Australia, particularly the likely effects on competition; and
- how the role of the Government can be gradually reduced over time.

The Taskforce applied the following principles to guide its assessment: the options should be responsive to individuals experiencing affordability issues associated with cyclone risk, without discriminating between states or parts of states; they should support a competitive insurance market; encourage risk mitigation; and result in maximum impact at minimum cost and risk to the Commonwealth balance sheet.

In order to assess the options, the Taskforce undertook extensive consultation, involving consumers and consumer groups, members of the insurance and reinsurance industries, state, territory and local Governments, the Australian Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC) and Productivity Commission, and other departments within the Australian Government. The Taskforce received 37 written submissions in response to its interim report. The Taskforce has been greatly assisted by its Reference Panel in reaching out to stakeholder groups and ensuring a wide range of views were heard and incorporated into its work.

In addition, the Taskforce, assisted by the Australian Government Actuary (AGA), commissioned modelling to estimate the likely reduction in premiums and the likely cost and risk to the Government's balance sheet if either a cyclone mutual or reinsurance pool were created with support from a Government guarantee. As a first step, three modelling firms (Combus, Guy Carpenter and Risk Frontiers) provided estimates of the potential damage from cyclones across northern Australia to home and strata buildings and contents. On the basis of these estimates, a specialist insurance consultant (Finity Consulting) assessed the potential cost to the Government and the potential reduction in premiums that could be achieved by a cyclone mutual or reinsurance pool under a range of scenarios.

## Threshold issues

The initial task outlined in the Taskforce's terms of reference was to establish which regions in northern Australia are experiencing insurance affordability concerns due to cyclone risk for the purpose of potential policy actions.

The *National Construction Code* identifies areas exposed to cyclonic winds. Based on the code and the available data on premiums and affordability, the Taskforce recommends that the region in northern Australia experiencing insurance affordability concerns due to cyclone risk should be defined as the regions north of the Tropic of Capricorn (23.5 parallel) with some accommodation for regions in Western Australia that are in the top wind zone.

The concept of 'cyclone damage' would also need to be clearly defined should a cyclone mutual insurer or reinsurance pool be created. The Taskforce recommends cyclone damage be defined as damage caused by a *named tropical cyclone* in the geographic area that experiences wind speeds equivalent to Category 1 or faster. Within this area, damage caused by high winds, flooding, storm surge and water ingress (for example, through windows or the roof) should all be considered cyclone damage and claims for all such damage could be made under the cyclone insurance or reinsurance.

In order to determine the potential to reduce insurance premiums and estimate the potential cost to Government of creating a cyclone mutual insurer or reinsurance pool, the Taskforce had to estimate the potential losses due to cyclone damage in northern Australia and the value of the current premium pool paid to insurers for 'cyclone cover' (that is, the component of premiums related to the risk of cyclones).

- Insurance losses due to cyclones (as per the definition outlined above) in northern Australia over the past 20 years have totalled \$2.4 billion, which is around \$115 million on average per year. This comprises many years of small losses and a few years of relatively large losses, such as the \$1.2 billion in losses relating to residential properties and contents from Cyclone Yasi in 2011. However, looking back at the damage caused by cyclones over a relatively short period does not provide a good indication of the potential magnitude of the risk of cyclone damage, largely because cyclones that cause major damage (due to a direct hit on a town) are rare.



- To obtain a more comprehensive assessment of this risk, modelling work commissioned by the Taskforce indicates that the expected long-term *future* losses from cyclones in northern Australia are around \$285 million per year. Again this is an average and is made up of many years of nil or small losses and a few years of large losses. These models are the best currently available and are used by the insurance companies as a basis for setting their premiums. Nevertheless, as with any future projection, the predicted losses are very uncertain.
- Work commissioned by the Taskforce estimates the current cyclone premium pool for home, contents and strata insurance to be around \$480 million per year, compared with a total premium pool for northern Australia of around \$1 billion, although these numbers are subject to a degree of uncertainty. The total cyclone premium pool reflects a range of different premiums being charged across northern Australia depending on the level of cyclone risk.

## Feasibility of a cyclone mutual or reinsurance pool for cyclone risk

### Potential designs for the mutual insurer and reinsurance pool

Taking into account feedback from stakeholders, a possible design for each of the insurance options was developed to the degree necessary to test their feasibility and likely premium reductions. Further development would be needed before either could be made operational.

- The cyclone mutual was designed to offer a cyclone policy that private insurers could sell with their non-cyclone policy to residents of northern Australia. Participating private insurers would be the sales agent and manage all claims, in return receiving a commission and claims handling fee. The mutual would charge a premium that reflects the individual risk of the property, but at a subsidised level facilitated by a Government guarantee. The cyclone policy would provide the same additional benefits as standard insurance policies (such as temporary accommodation) and claims on the policy would not be capped. The governance structure for the mutual would need to contain conditions for the use of the Government guarantee.
- A reinsurance pool was designed to operate through a Government owned statutory corporation, such as the Australian Reinsurance Pool Corporation (ARPC). The pool would offer reinsurance to private insurers for cyclone damage losses above a certain threshold for all home, contents and strata policies written on buildings in northern Australia. The insurers would retain responsibility for losses below the threshold. The prices charged by the pool to insurers would be based on the risk of the insurer's portfolio, but at a subsidised rate facilitated by a Government guarantee.

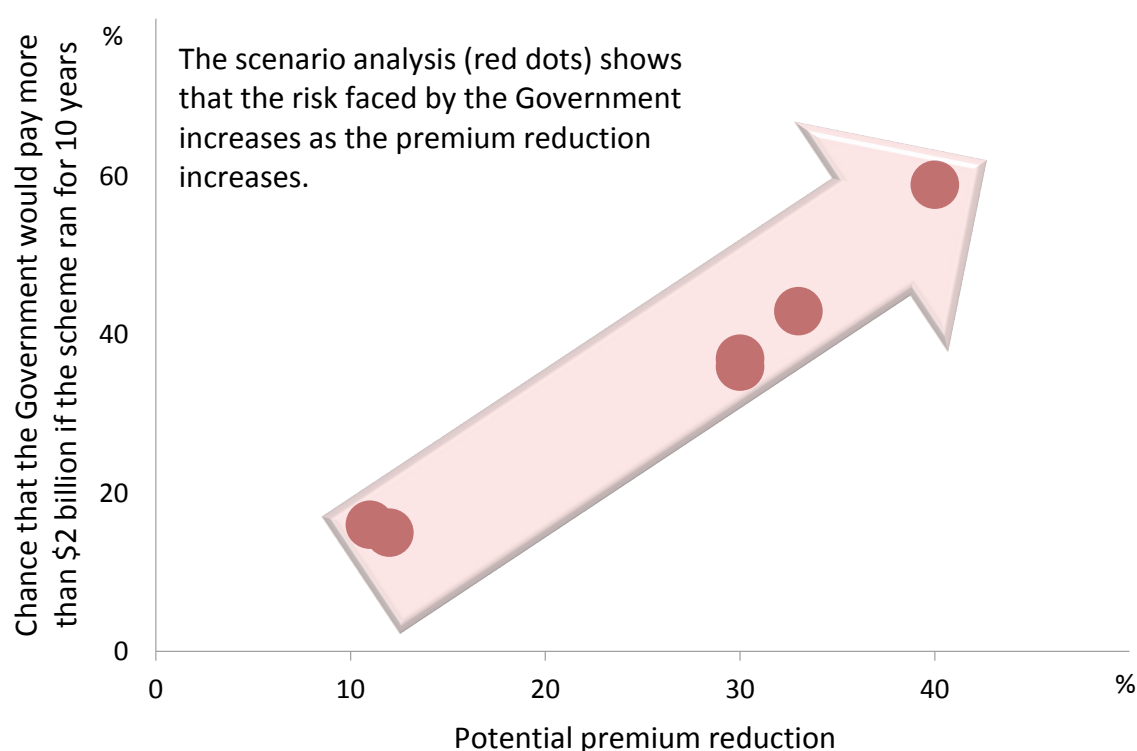
### Reduction in premiums and cost to Government

The Taskforce commissioned Finity Consulting to model the potential premium reductions and cost to Government of the cyclone mutual and the reinsurance pool for scenarios involving different levels of Government support.

The analysis showed that:

- The mutual and reinsurance pool options generate a similar premium reduction and similar potential cost to Government over 10 years.
- If either option were to run along commercial lines, there would be no reduction in premiums.
- In order for a cyclone insurer or reinsurer to provide a reduction in premiums, the Government would have to provide a subsidy through the use of its balance sheet.
- The larger the reductions in consumer cyclone premiums, the larger the likely cost to Government from taking on increased risks from cyclone damage (Figure 1).

**Figure 1: Potential reduction in premium and cost to Government**



Notes: Information on the scenario analysis undertaken is contained in Box 1.

Source: Finity Consulting

In terms of a trade-off between achieving a reduction in consumer premiums and cost to the Government, the Taskforce focused on a scheme that charges sufficient premiums to cover the estimated long-term cost of claims and operating costs, but with the risk of all additional claims (the result of more severe or more frequent cyclones) covered by a Government guarantee. This option is referred to as a 'partially funded scheme' in the report. It is expected that a partially funded cyclone mutual or cyclone reinsurance pool could reduce consumer premiums in northern Australia on average by around 10-15 per cent.

The premium reduction would come at a significant cost to the Government, although as noted in Figure 1, the cost of options to achieve a larger reduction in premiums would be even higher. The cost would be the risk of calls on the Government guarantee. Each year

the Government would face the possibility of no calls on the guarantee (with cyclone claims being met from the premium pool) and a very large call on the guarantee (the result of a major cyclone hitting a significant population centre and resulting in large insurance claims). Estimates of the potential cost of the scheme to the Government are based on probabilities of these outcomes occurring, as derived from the modelling exercise. If a partially funded scheme was set up for 10 years there would be a:

- 50-60 per cent chance that the Government guarantee would be called on at least once;
- 30-40 per cent chance that the scheme would cost the Government money when closed (that is outlays under the guarantee would exceed reserves returned to the Government when the scheme is wound up);
- 10-20 per cent chance that the scheme would, over a 10 year period, cost the Government more than \$2 billion; and
- 5-10 per cent chance that the scheme would, over a 10 year period, cost the Government more than \$5 billion.

An alternative strategy suggested by stakeholders to limit risk to the Government was to cap the claim payable to each policyholder under the scheme. However, the costings indicate that such a scheme would limit the reduction in premiums without significantly lowering the risk faced by the Government.

To reduce the risk of large calls on the Government guarantee, the schemes could purchase reinsurance or retrocession. If a large claim occurred, the scheme would pay the claim first from its pooled reserves, then by drawing on its reinsurance and only after that by drawing on the Government guarantee. While this would be effective at reducing large calls on the guarantee, it would likely increase the chance of smaller calls on the guarantee because the cost of purchasing the reinsurance or retrocession would decrease the pool of reserves available to pay claims.

The 10-15 per cent premium reduction under a partially funded scheme refers to the average reduction in total consumer premiums. However, the schemes being considered only reduce the *cyclone component* of premiums. The *cyclone component* of their total premium will vary for each policyholder, depending on their property's risk from cyclones. As a result, policyholders with high cyclone risk should receive discounts above the average and policyholders with low cyclone risk will receive smaller discounts.

## Effect on insurance markets and potential for Government exit

### *Cyclone mutual*

The impact of a cyclone mutual on the insurance market in northern Australia is likely to involve the following:

- While the removal of cyclone risk may encourage the entrance of new players competing to provide non-cyclone cover, a subsidised mutual insurer is likely to crowd out private sector cyclone cover.

- Integration of the mutual into the operation of private insurance companies would be complicated and potentially costly, reducing the potential premium reduction.
- If the mutual was set up as a discretionary mutual, the protection offered to consumers would not be as secure as a standard insurance policy and policyholders would not have the consumer protections attached to insurance in Australia, including access to the Financial Claims Scheme. There is also the potential for claims to fall within a gap between a cyclone insurance policy offered by the mutual and a non-cyclone policy offered by the private insurer.
- An advantage of a mutual noted by some stakeholders is that it could be effective in encouraging mitigation in the community, including by developing pricing that takes into account mitigation actions.
- The potential for the Government to exit from providing support to the mutual appears to be low. It is unlikely that the mutual could raise the required capital to ensure that it was financially viable in the event the Government removed support.
- If the mutual exited the market, private insurers would have to return to providing cyclone cover, yet private sector capabilities to understand, model and price cyclone risk are likely to have deteriorated during the period they did not offer cyclone cover.

### ***Reinsurance pool***

The impact of a reinsurance pool on insurance markets in northern Australia and reinsurance markets nationally is likely to include the following:

- A cyclone reinsurance pool could encourage new entrants into the northern Australia insurance market, by reducing insurers' exposure to cyclone risk. One major insurance company has expressed support for a reinsurance pool. Competition between insurers for both cyclone and non-cyclone risk could increase.
- Demand by insurers for private sector reinsurance to cover cyclone risks would fall. However, cyclone risk for home, contents and strata is only part of the natural catastrophe risk that insurers in Australia face and there is no real likelihood of reinsurers exiting the Australian market.
- A cyclone-only reinsurance scheme may create some uncertainty and friction for insurance companies as they seek to incorporate 'cyclone' risk reinsurance with their current arrangements. This would increase their costs, thereby reducing the potential reduction in premiums.
- It would be difficult to assess whether insurers fully pass through the lower reinsurance costs to consumers. This will depend on the extent of competitive pressures. A mechanism to monitor pass through may be needed, although this would add to costs.
- As the scheme has no adverse impact on insurance markets, it is feasible that the Government could gradually withdraw support for the scheme. However, overseas experience demonstrates that withdrawal from any subsidy scheme is very difficult.

In summary, compared to a mutual insurer, a reinsurance pool would have the same cost to Government for the same premium reduction, a lower impact on the insurance market and a greater potential for Government exit. For these reasons, a reinsurance pool is a more feasible option compared to a mutual insurer for cyclone risk. Either option would take some time to generate premium reductions.

## Mitigation

Mitigation to reduce the risk of damage from cyclones is the only way to reduce premiums on a sustainable basis. It was widely considered by stakeholders that encouraging mitigation should be part of any Government response to the rise in insurance premiums. A concern is that policy measures that work only to reduce premiums may dampen incentives for mitigation. Further, without action on mitigation, the benefits of any measures taken by the Government to lower premiums would be reversed upon Government exit.

There are significant benefits from mitigation. Reducing the vulnerability of older buildings (those built prior to the introduction of the current building codes) to cyclone damage by strengthening roof structures could yield reductions in claims and, therefore, premiums. Strengthening and sealing openings in modern buildings would reduce damage from water ingress, which is a significant source for claims. Further, the efforts of residents to secure properties to reduce debris damage to their own and neighbouring buildings could lower claims and premiums. Insurance companies estimate that mitigation actions could reduce premiums for some properties by up to 20 per cent.

The benefits of mitigation are much wider than reducing the likelihood of insurance claims. Property owners benefit to the extent that less vulnerable properties are associated with reduced chance of physical injury, as well as reduced emotional trauma that is associated with individuals experiencing significant damage to their home and contents.

Motivating property owners to undertake mitigation is complex. While the cost of mitigation is mainly borne by individual property owners, the full benefits are spread across a number of parties. For example, in addition to benefiting the property owner, mitigation work will also benefit neighbouring home owners (by reducing collateral damage to their property), insurance companies (by reducing claims) and governments (by reducing demands on emergency resources). Further, the property owner may not see the benefit of mitigation in the form of lower premiums if mitigation action is not adequately captured by insurer pricing. Homeowners may also face a lack of information about what they can do to reduce the vulnerability of their property to cyclone damage. Cost effective and aesthetically acceptable ways to strengthen the resilience of properties may also not be available.

As a result, a multipronged approach to improving incentives and facilitating mitigation is required. The approach should include improving communication and cooperation between homeowners and insurers (especially making insurance premiums more responsive to mitigation actions), improving policyholders' knowledge of risks and retrofit options, and expanding the range of cost-effective and acceptable retrofit options.

## Encouraging greater mitigation

Options to encourage mitigation include a range of relatively low-cost options:

- **Strengthen building standards:** Building standards currently focus on protecting individuals during a cyclone. The standards could be raised to reduce the prospect of cyclone damage to buildings. In particular, there is scope to strengthen standards for windows and doors to reduce the risk of water ingress, but more research is required before this could be implemented.
- **Better retrofits:** There is scope to develop better retrofitting options for older houses. Better information for households and further research to develop effective and attractive options are required.
- **Government public works:** The provision of additional mitigation grants to local councils for water management and flood protection infrastructure would assist in reducing cyclone-related flood damage to property.
- **Making insurance premiums more responsive to mitigation:** Policyholders would be more likely to undertake mitigation if there was a clearer link between mitigation and lower insurance premiums. Some insurers are developing systems to better capture information about mitigation and to have this reflected in premiums. This needs to be encouraged. State and territory governments could help by modifying existing building certification forms so mitigation activities are more easily recognised.
- **Property owners to share more risk:** Insurers could offer lower premiums if items like shade sails, garden sheds and outdoor structures were excluded from policies, or if there was an option for the policyholder to accept a higher excess for cyclone damage (and retain a lower excess for other damages, such as from fire and theft). If consumers took more responsibility for the risk of cyclone damage to their properties through higher excesses, insurers indicate that the reduction in premiums could be up to 30 per cent.
- **Resilience rating tools:** Better and more accessible information about building resilience measures would help enable and motivate homeowners to take action to protect their property.
- **Mitigation awareness campaigns:** Events that bring homeowners together with researchers, builders, manufacturers and the insurance industry would help build a market for retrofitting options and demonstrate how this can impact on insurance premiums.

Even with recognition in premiums and full appreciation of the benefits of mitigation, some property owners may still have insufficient financial resources to fund the required work. The insurance industry has proposed schemes for the Australian Government to directly subsidise mitigation action by property owners.

A measure to directly fund mitigation by households would involve significantly more cost to the Government than the mitigation options outlined above. The likely cost of any scheme to subsidise mitigation would vary substantially depending on the design chosen. By way of example, a scheme that provided \$10,000 grants to owners of properties built prior to 1980



in northern Queensland for strengthening roofs is estimated to cost around \$1 billion (or \$500 million if targeted at only low-income households). The implementation cost component of such schemes would be significant.

Any scheme would need to be carefully designed and would require cooperation between governments at all levels. Design considerations include: determining eligibility criteria for households; the type of work that would be eligible for the subsidy (recognising that a one-size-fits-all retrofit option would not be effective in reducing risk for all homes); the ability of the building industry to meet increased demand; and the appropriate regulatory framework for ensuring that the work is done to a sufficient standard and protecting the health and safety of the people undertaking the work. These are key lessons from the experience of the Home Insulation Program. Another lesson was that such schemes are more appropriately delivered by state and territory governments.

Focusing a mitigation subsidy program on strengthening the resilience of older properties offers the scope for lowering insurance premiums for these properties. However, some of the options to retrofit roofs which are currently available are not considered to be attractive by property owners. Before introducing any mitigation subsidy program, it would be appropriate to first support additional research to identify retrofit options that are low cost, effective and attractive to home owners.

## Other approaches

A number of other approaches to reducing premiums were raised by stakeholders during consultations.

- **Direct subsidy:** Most stakeholders who supported making direct payments to consumers emphasised that this should be directed at subsidising mitigation action rather than subsidising insurance premiums. A smaller group of stakeholders called for a means-tested, geographically-targeted subsidy on the grounds of social need. If the concern is that some households in northern Australia are experiencing financial hardship, with insurance premiums being a contributing factor, it may be more appropriate to respond in the context of the broader social security safety net rather than introducing a specific cyclone insurance subsidy. Implementing an insurance subsidy would also involve significant administrative costs. For example, a 10 per cent subsidy to low income households would cost as much to administer as the value of the payments themselves.
- **Reducing state insurance taxes and duties:** There were numerous calls to reduce taxes and duties on insurance. The appropriate tax treatment of insurance is best considered in the context of the Australian Government Tax White Paper process.
- **Regulating commissions to strata managers:** Commissions paid to strata managers when they purchase insurance on behalf of an owners' corporation are generally calculated as a percentage of price, which means they may act as a disincentive to seek best value for money. In most states and territories, legislation already requires strata managers to act in the best interests of their clients and to disclose commissions. However, in New South Wales, reforms are proposed to enable owners' corporations to vote to pay fees instead

of allowing the strata manager to receive commissions. Similar reforms could be considered by other state and territory governments as a means to strengthen the enforceability of strata managers' duties.

- **Insurance policy contestability and disclosure:** Some submissions called for reforms to increase transparency around the pricing of insurance premiums. As part of its response to the Financial System Inquiry, the Government has agreed to support industry-led initiatives to increase guidance and disclosure in general insurance. Depending on the outcomes of industry initiatives, the Government could consider further action to increase transparency around pricing and availability.
- **Responses to insurance availability issues in the Indian Ocean Territories:** Unique situations in the Indian Ocean Territories indicate the need for tailored solutions. The Taskforce has investigated options for the West Island of the Cocos (Keeling) Island that could be pursued further through action by local residents. On Christmas Island, ambiguity around the application of strata laws is obstructing strata unit holders from purchasing insurance. Action by the Australian Government to clarify the application of strata laws could assist residents.

## Recommended way forward

The Taskforce was asked to consider the feasibility of options to lower insurance premiums in areas subject to high cyclone risk and to make policy recommendations. This report has identified the most feasible options, recognising they achieve different objectives and have distinctly different benefits and risks.

There is no simple answer to sustainably reducing premiums in northern Australia. Through the process of this Taskforce, it was evident that there have been some positive developments in insurance markets in northern Australia, with insurers introducing products which provide greater scope for consumers to achieve lower premiums. The aim should be to enhance this momentum.

The recommended way forward involves the following components:

1. A sustainable way of reducing premiums over the long run is through mitigation. The reduction in premiums that could be achieved from mitigation will depend on individual circumstances and the mitigation action taken. However, such reductions can only be achieved by household action.
2. Governments can take a range of relatively low-cost (compared to other options) measures to promote mitigation. Additional funding could be provided for research to improve mitigation options particularly for roof strengthening and water ingress. In addition, there is the potential for additional education campaigns to encourage and support property owners to undertake mitigation and for public works spending to reduce the risk of some forms of cyclone damage, such as flooding.



3. The insurance industry should develop insurance pricing systems that provide greater recognition of mitigation action and be more proactive in offering a range of policy options that provide increased scope for policyholders to assume more responsibility for risk of cyclone damage in return for lower premiums. For example, policies could exclude cover for certain outdoor items or offer higher cyclone excesses.
4. The insurance industry should engage more effectively with property owners in northern Australia. This requires improved disclosure of risks and greater responsiveness to policyholder concerns. The industry has already taken steps in this direction. Governments could support these moves by, for example, organising information sessions to bring together insurers and property owners. Potentially, there is also a role for legislating enhanced requirements around the disclosure of risks if industry efforts do not yield meaningful results for consumers.
5. Some property owners may not be able to realise premium reductions from mitigation because they do not have the financial capacity to undertake the necessary work. One option to address this situation is governments directly subsidising the cost of mitigation for low income households. The mitigation action subsidised should be tailored to individual circumstances and could cover such options as protection of windows and doors. The cost of more extensive subsidised mitigation could be substantial. For example, a retrofit scheme for strengthening roofs for older properties in northern Queensland is estimated to cost around \$1 billion (or \$500 million if targeted at low-income household). Any mitigation subsidy scheme should be developed in consultation with the state and territory governments, who (supported by local councils) are best suited to deliver such a program. Any scheme would need to be phased in having regard to the ability of industry to meet increased demand. A subsidy scheme would also benefit from the outcome of further research into identifying cost effective and acceptable mitigation measures.
6. Of the two insurance options the Taskforce was asked to assess, a reinsurance pool represents a more feasible approach than a mutual. In contrast to the mutual, the reinsurance pool could promote competition through new entrants to the northern Australia market. A reinsurance pool which charged premiums to cover the estimated long-run cost of claims from cyclones and was supported by a Government guarantee might offer a premium reduction for consumers of 10-15 per cent. It would be difficult, however, to ensure that cost reductions for insurers did in fact flow through to premium reductions for customers. The Government would assume significant risk in order to achieve any reduction in premiums. The cost to the Government would depend on the number and severity of cyclones during the life of the scheme and whether they hit major population centres. It is estimated that the Government would face a 50-60 per cent chance of having to make a payment under the guarantee if the scheme ran for 10 years and a 10-20 per cent chance these payments would exceed \$2 billion in total. While there is greater potential compared with a mutual for the Government to withdraw support for a reinsurance pool, overseas experience demonstrates that it is very difficult for governments to exit from any intervention in insurance arrangements. If the Government did exit the market, any premium reductions would be reversed unless households had undertaken mitigation during this time.

# 1. CONTEXT AND APPROACH

## 1.1 The context: managing the rise in insurance premiums in northern Australia

The Northern Australia Insurance Premiums Taskforce was established by the Government with the specific remit to assess the viability of certain options to lower consumer insurance premiums in regions of northern Australia where insurance affordability has been affected by the high risk of cyclones. The Taskforce was to assess the feasibility of two specific options — a mutual cyclone insurer and a cyclone insurance pool — along with other options raised in the course of its consultations.

To put the work of the Taskforce in context, its establishment was part of the response to dealing with the implications of the significant rise in insurance premiums in parts of northern Australia in recent years.

Over the past few years, some regions in northern Australia experienced a step change in the way insurance premiums are set, which resulted in a significant increase in premiums over a short period of time. This has been particularly noticeable for certain properties in northern Queensland, the most populated part of northern Australia. A range of inquiries have looked at the causes of the rise.<sup>1</sup> These inquiries have found, as has this Taskforce, that insurers are now increasingly pricing premiums to align more closely with the risk of damage to (and therefore claims by) individual properties. In northern Australia, insurance premiums have significantly increased so as to more accurately reflect the high risk of damage due to cyclones.

This change in the setting of insurance premiums is not the result of any change in the behaviour of households, but has been driven by the growth in technology and competition in insurance markets and reassessments of the risk of cyclone damage. In recent years, insurance companies have increasingly set premiums on properties in northern Australia in line with the risk that the individual property brings to the pool. This has been facilitated by more complete datasets regarding risk, greater computing power and improvements in models to estimate risks. It has also been influenced by the experience of losses from some recent events, such as Cyclone Yasi. Another recent change reported by insurers is that they have moved toward allocating the cost of catastrophe reinsurance more in line with the risk attributed to each policy. This process has been informed by advances in catastrophe modelling. With a higher frequency of cyclones in northern Australia than, say, earthquakes in capital cities, a higher proportion of the cost of reinsurance has been allocated to premiums in northern Australia. This trend is also a consequence of competition in the market and is consistent with prudent practice.

---

1 *Natural Disaster Insurance Review: Inquiry into flood insurance and related matters*, 2011; House of Representatives Standing Committee on Social Policy and Legal Affairs inquiry reports *In the Wake of Disasters Volume One: The operation of the insurance industry during disaster events*, and *In the Wake of Disasters Volume Two: The affordability of residential strata title insurance*, 2012; AGA Report on *Investigation into Strata Title insurance Price Rises in North Queensland*, 2012, with an update in 2014, and *Report on Home and Contents Insurance Prices in North Queensland*, 2014; Productivity Commission Inquiry Report *Natural Disaster Funding Arrangements*, 2014.

The result is that that insurance premiums in northern Australia have increased to be more in line with the risk of potential losses caused by cyclones. The very significant increase in strata premiums suggests that this segment of the market was previously particularly under-priced, in the sense that premiums were below the cost faced by insurers to provide that cover. Following events in northern Australia in 2010-11, including Cyclone Yasi, when global reinsurance prices were also increasing following a series of international natural disasters, a number of companies withdrew from parts of the insurance market in northern Australia, particularly insurance of residential strata properties.

In two reports conducted in 2014, the AGA found that the higher premiums in northern Queensland compared to east coast cities largely reflected higher losses in the region and did not represent excessive profits to insurers (AGA 2014a and 2014b). The modelling commissioned by the Taskforce also suggests that current premium rates are not out of step with estimates of the magnitude of the risk.

If the level of insurance premiums now better reflects the higher insurance risks in northern Australia because of cyclones, the question that has been posed by the insurance companies, in submissions and consultations with the Taskforce, is 'what is the problem?' The industry has stressed that there is no market failure in the insurance industry in northern Australia. Moreover industry representatives, along with other stakeholders, have stressed that any intervention that lowers premiums will disguise underlying risks and result in less mitigation efforts to reduce the vulnerability of property to damage and promote inappropriate property development.

However, there is a human dimension associated with the rise in premiums. This is reflected in the submissions to the Taskforce from individuals and consumer groups who say many people in northern Australia are angry and distressed over the sharp rise in their insurance premiums. The change in the way insurance companies have priced their premiums has had a significant impact on a number of people in northern Australia.

In particular, the increase in insurance premiums has occurred over a very short space of time in some regions, such as northern Queensland, so that households have had difficulty in absorbing, understanding or planning for the rise. This is particularly the case because the change is not due to any change in the nature of the risk or the behaviour of households. For example, strata owners corporations report difficulty in planning for annual premium increases and some have needed to take out bridging loans to meet the shortfall in compulsory building insurance. For some households, particularly those on fixed incomes, the rapid growth in insurance premiums has led to considerable hardship.

While insurance premiums now appear to be more in line with the level of risk in northern Australia, which is appropriate, there may be grounds for seeing if communities can be assisted to adjust to the significant increase in premiums. Adjustment would include putting in place long-term strategies to lower risk due to cyclones and sustainably reduce insurance premiums.

## 1.2 Insurance premiums and market conditions in northern Australia

The interim report provided a picture of insurance premiums and affordability based on the available data. Since the interim report, some additional data has become available that provides further information.

The interim report outlined that regions of northern Australia experienced a stark rise in insurance premiums between 2010 and 2013, although more recent increases appear to have been more gradual. Newly available data confirm this picture.

- Based on the AGA reports (AGA 2012, AGA 2014a, AGA 2014b) *premium rates*<sup>2</sup> on home and contents insurance in northern Queensland rose each year by between 10 per cent and 25 per cent from 2009-10 to 2012-13. For strata insurance, following three years of stability, the annual increase in the premium rate each year ranged from around 15 per cent to 65 per cent over the period 2009-10 to 2012-13.
- While data on *premium rates* is not available for Western Australia, available data suggest that the pattern of *premium* increases has been similar in northern Western Australia. Data published by the Western Australian government indicate home building premiums across a range of towns have increased by between 60 per cent and 100 per cent over the four year period 2011-2015. Regional Development Australia indicated in their submission to the interim report that a sample of strata buildings in Port Headland experienced price rises of around 350 per cent between 2010-11 and 2012-13, but premiums have since stabilised.

Premiums across the north of Australia are generally elevated compared to southern cities.

- For home and contents insurance, the available data indicate premium rates in northern Queensland were on average around 1.5 times those in Brisbane and 2.5 times those in Sydney and Melbourne in 2012-13 (AGA 2014b). Data from the Western Australian Government indicates that premiums in northern Western Australia were about 2-4 times those in Perth.
- Strata premium rates in northern Queensland were around five times those in southern cities in 2012-13, and the AGA indicates that premium rates being charged in Western Australia could be higher (AGA 2012).

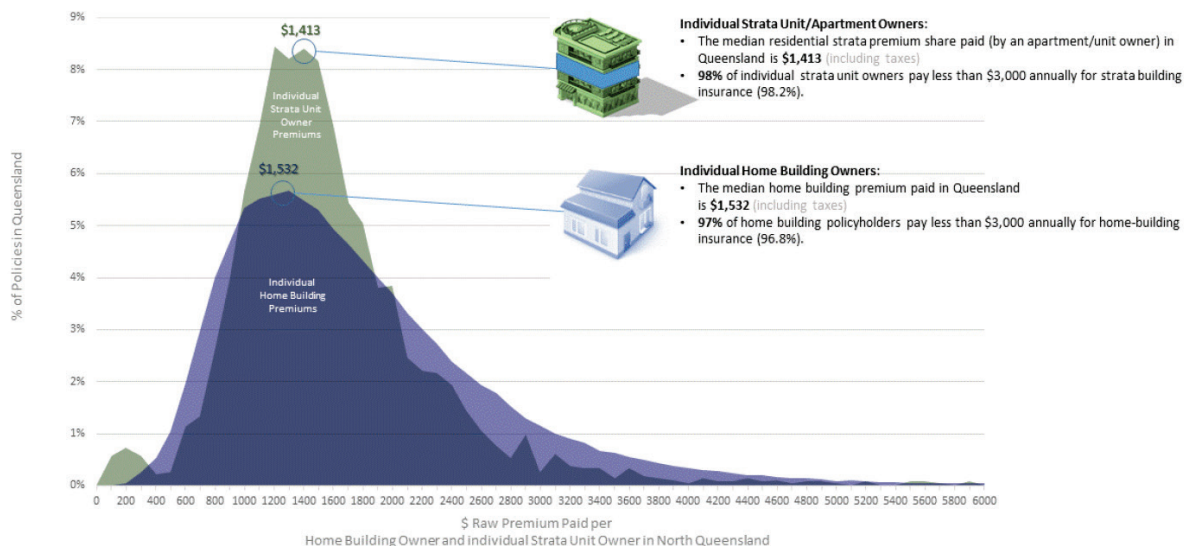
The submission from the Insurance Council of Australia (ICA) provides further information on premiums. While the data above focus on average insurance premiums and premium rates, the ICA data provide detail on the distribution of premiums across northern Queensland. There are some differences in the analysis across reports. In particular, the region covered by the ICA data extends further south than the region analysed by the AGA and includes homes that have a lower risk of cyclone damage. Nonetheless, the ICA data indicate that

---

2 The premium rate analysed by the AGA is the premium per \$1,000 of sum insured. This is different to the premium paid, which depends on the sum insured of the house. One reason why premiums vary across States and regions is that rebuilding costs can be higher in remote locations and where building codes require stronger buildings to withstand cyclones, raising the replacement value of the house and the sum insured. Growth in premiums can be different to growth in premium *rates* if the sum insured also changes, for example if building costs increase.

high average costs reflect a wide range across properties — many people in northern Australia face below the average cost, but costs are very high (upwards of \$3,000) for a small proportion. This proportion is likely to be those dwellings in particularly high risk locations (such as sea front properties) or older buildings that are assessed to be less resilient.

**Figure 2: Distribution of premium costs across households north of Maryborough in Queensland**



Source: ICA

In their submissions, residents of north Queensland have highlighted that affordability remains a concern, and that they seek action to lower premiums:

Many Queenslanders have been forced out their homes or are having difficulty meeting household budgets due to unaffordable increases in insurance premiums and excesses. *Consumer*

I have owned my house since 1993 and have never made an insurance claim. I have spoken with long term residents in [name removed] St and none can recall making insurance claims due to tropical cyclones in the last 50 years ... My household insurance premiums from the one insurance company increased from \$770 in 2006 to \$4406 in 2014. *Consumer*

Our house is of recent cyclone resistant construction and out of the way of flooding ... If premiums rise any further we will have to 'self-insure' because we are pensioners and cannot afford these crazy premiums. If we then have a claim, the government and community will have to come to our rescue — which defeats the whole purpose of having insurance. *Consumer*

I am an Owner in a Strata Property and also a Body Corporate Committee Member in [name removed]. Therefore, I have witnessed the wholesale increases in premiums in 2011 following Yasi ... This year we already had a Bankruptcy Case finalised as a direct result of Insurance Premium increases. *Consumer*



Data available from the ABS for 2011-12 indicate that the percentage of income spent on insurance is highest in northern Queensland and northern Western Australia (1.7 per cent and 1.5 per cent of household income respectively, compared to the national average of 1.2 per cent) and that the proportion of people spending more than two weeks' income on insurance in northern Queensland and Darwin is over 12 per cent. With economic conditions weakening as the mining boom ends, it may be expected that these ratios could rise.

Since the interim report was published there have been some changes in market conditions reported by consumers and brokers. A new strata insurance product with lower premiums is being offered directly (rather than through brokers) to smaller strata complexes in northern Queensland by Suncorp. The Suncorp submission indicates that 140 strata complexes have taken up this policy. Brokers report that the increases in premiums to technical levels have seen some new underwriters operating in the strata market and that competition for properties valued at over \$50 million has increased. However, differentiation between risks perceived to be 'good' and 'bad' continues. For older strata properties, brokers report that insurance remains very costly. They note that many strata buildings in the north of Australia are now approaching 30 years old, at which point insurance becomes more costly. Further, brokers report that conditions in northern Western Australia have not changed noticeably.

In the housing market, insurers have announced new products that provide more options and flexibility to households looking for home insurance. Suncorp has announced a scheme to rate the resilience of housing, and build the resilience rating score into pricing. IAG has introduced a new product, 'InsureLite', that offers lower cost cover for a limited insurance product, providing an alternative to traditional insurance. Good Shepard Microfinance and Suncorp have jointly announced a contents insurance policy for households on very low incomes who need protection for contents of modest value. These new and innovative products are a step toward providing more affordable insurance to some customers. The market for home insurance has also seen new entrants since the beginning of 2015.

### **1.3 The approach: assessing the feasibility of the options**

As specified by its terms of reference (Appendix A), the Taskforce has evaluated the feasibility of options to lower insurance premiums in regions of northern Australia where insurance affordability has been affected by the high risk of cyclones.

The Taskforce has considered the feasibility of two specific options — a mutual cyclone insurer and a cyclone reinsurance pool — along with other options that were raised in the course of its consultations. Those further options included the Government making payments to property owners to subsidise the cost of mitigation and direct payments to policyholders to help them meet the cost of insurance. Each option is discussed in subsequent sections of the report.

The terms of reference specify that the options be evaluated having regard to: the potential reduction in consumer premiums; the likely cost and risk associated with using the Commonwealth balance sheet to lower the cost of insurance to consumers; the potential effect on the operation of the insurance and reinsurance markets, particularly the likely effects on competition; and how the role of the Government can be gradually reduced over time.

The Taskforce identified a number of key factors that underlay how it should approach its assessment of the feasibility of options to respond to the rise in insurance premiums in northern Australia. These include:

- Measures to assist property owners to deal with the rise in premiums should, if possible, be linked to them taking mitigation action, along with careful future development planning by governments. Mitigation is key to providing a sustained reduction in risk and, in turn, lowering insurance premiums.
- Incentives for property owners and communities to take mitigation action should be strengthened as much as possible. These should include recognition of mitigation by insurance companies in calculating premiums.
- Any intervention by the Government in insurance markets aimed at lowering premiums must be temporary and preferably phased out, otherwise the incentives to take mitigation action will be blunted and even reversed. The need for a clear Government exit strategy is highlighted from overseas experiences, which suggest that once governments intervene in insurance markets it is difficult for them to withdraw.
- There is a role for governments at all levels to facilitate mitigation efforts, this can extend from providing information to individuals on mitigation, facilitating community awareness, and could include providing financial assistance to property owners to alleviate the cost of mitigation.
- Any government response to the rise in premiums should be consistent with maintaining a private, competitive insurance market and preferably should boost competition. A competitive insurance market is in the best long-term interest of the people of northern Australia.

In forming recommendations for this report, the Taskforce has interpreted its terms of reference as being to identify what are the most feasible options consistent with the above factors.

The Taskforce undertook extensive consultation, involving consumers and consumer groups, members of the insurance and reinsurance industries, state, territory and local governments, regulators and the Productivity Commission, and other departments within the Australian Government. This included meeting with home owners, strata owners, brokers, businesses and local government representatives in northern Queensland and learning about the damage caused by cyclones and what can be done to reduce that damage at the Cyclone Testing Station (CTS) at James Cook University in Townsville. The consultation covered the nature of the issues, the potential design of the schemes (and in particular how they might mesh with existing insurance arrangements), and views on how each the various options would impact on consumer premiums and the insurance market in northern Australia.

The Taskforce issued an interim report on 17 August 2015, which outlined recent developments in insurance markets in northern Australia and a number of issues that needed to be considered in developing and then assessing options to reduce consumer premiums. A number of specific focus questions were identified and comments were invited. The Taskforce received 37 written submissions in response to the interim report. The interim report and all submissions received are available at [www.treasury.gov.au](http://www.treasury.gov.au). The Taskforce continued to consult widely after the interim report was released.

The Taskforce was greatly assisted by its Reference Panel (members are listed in Appendix B) in reaching out to stakeholder groups and ensuring a wide range of views were heard and incorporated into its work. Reference Panel members were also active in assisting the Taskforce to develop various options. The Taskforce thanks all the Reference Panel members for their dedication and input. The Reference Panel was, however, an advisory group, and responsibility for the final report and its recommendations rests solely with the Taskforce.

One of the elements that the Taskforce considered in assessing the feasibility of the options to lower insurance premiums was the likely cost and risk to the Government's balance sheet. In undertaking this assessment, the Taskforce commissioned modelling from three private sector specialist firms (Combus, Guy Carpenter and Risk Frontiers) to estimate the potential damage from cyclones across northern Australia to home, contents and strata. On the basis of these estimates, the Taskforce commissioned a specialist insurance consultant (Finity Consulting) to assess the potential cost to the Government of providing support to a cyclone reinsurance pool and a mutual insurer, along with the potential reduction in premiums that could be achieved under both options. Details on the modelling commissioned by the Taskforce are outlined in Box 1.

The Taskforce has also considered the other options raised during consultations, including assessing the costs and benefits. In doing so, the Taskforce drew on the submissions from industry and consumer groups, and assistance from other government departments. The Taskforce would like to thank the governments of the states and territories for providing information and assistance.



## 2. THRESHOLD ISSUES

### 2.1 Regions of northern Australia experiencing affordability concerns due to cyclone risk

The initial task outlined in the Taskforce's terms of reference was to establish which regions in northern Australia are experiencing insurance affordability concerns due to cyclone risk, for the purpose of considering policy options aimed at reducing consumer premiums. In addition to relying on the data on premiums and affordability, the Taskforce took into account whether the Constitution of Australia limited the capacity of the Commonwealth Government to develop policies to target regions exposed to high cyclone risk. Other factors considered were the cost of possible schemes to lower insurance premiums, the practicality of defining regions and feedback from stakeholders.

Taking into account all these considerations, the Taskforce recommends that the regions should be identified as those where there is a high risk of cyclone and where premiums have either risen quickly in recent years or are elevated due to the high risk of cyclones.

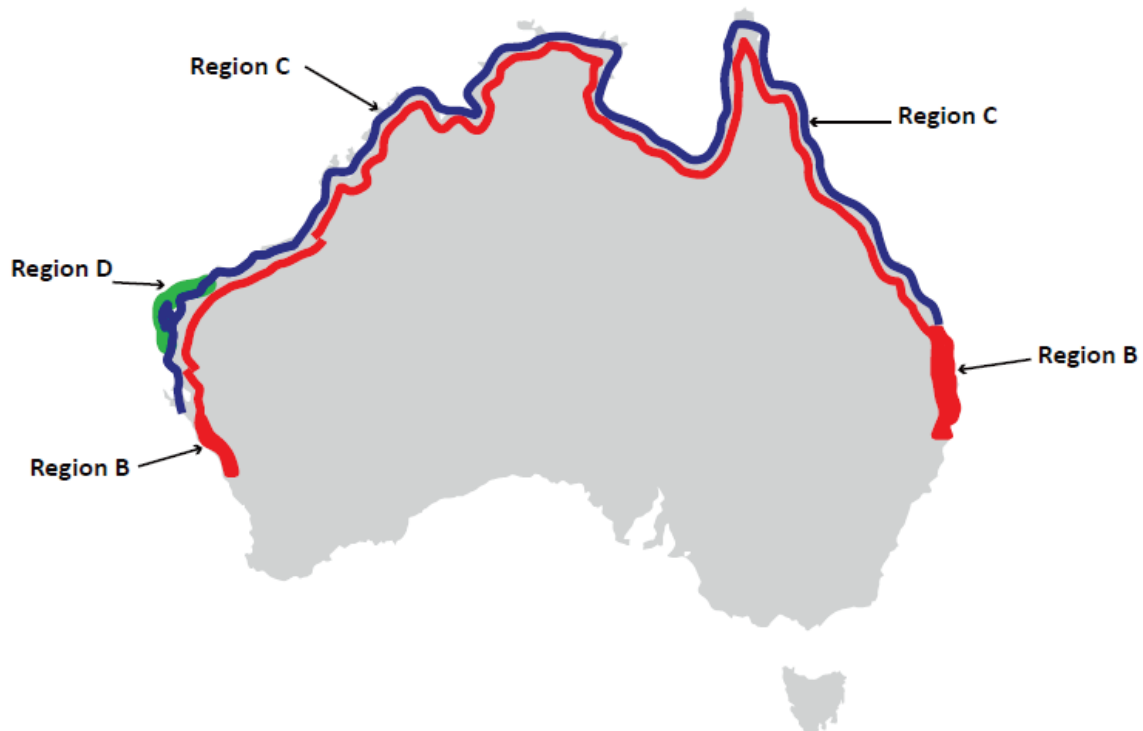
The *National Construction Code* identifies areas of high wind risk in Australia corresponding with the areas of high probability for cyclones and classifies them into regions based on their exposure to cyclonic winds. These regions are illustrated in Figure 3. All of coastal northern Australia is covered by at least Region C, which is the second highest level of exposure, with small parts of coastal northern Western Australia covered by Region D, being the highest level of exposure.

The information on insurance premiums presented in the Taskforce's interim report and summarised in the previous section, indicates that insurance premiums have risen strongly or are elevated across the Pilbara, Kimberly, around Darwin and in coastal regions of northern Queensland. As a result, the Taskforce recommends that any policy response to concerns around insurance affordability due to cyclone risk should focus on northern Australia above the Tropic of Capricorn. This approach is consistent with information provided by insurers, who view the region north of Rockhampton on the Queensland coast as having a higher cyclone risk than the region south of Rockhampton and price accordingly.

While this is a workable definition for assessing the feasibility of options aimed at dealing with the rise in insurance premiums due to cyclone risk, the implementation of any scheme may require some modification to deal with some regions which fall on or close to the Tropic of Capricorn, such as the regions of Western Australia south of the Tropic that are in the top wind zone.

**The region in northern Australia experiencing insurance affordability concerns due to cyclone risk is the area north of the Tropic of Capricorn (23.5 parallel) and some Western Australian regions south of the Tropic that are in the top wind zone.**

**Figure 3: Australian wind zones for the purpose of building code**



Sources: Cyclone regions as identified in AS1170.2-2002 Wind Load Standard. Diagram sourced from Planning for a stronger, more resilient North Queensland Part 2 Wind Resistant Housing.

## 2.2 Types of insurance to be covered

The terms of reference for the Taskforce specify that the options must be evaluated based on their potential for reducing premiums for home, contents and strata insurance. Some submissions to the Taskforce suggested that this definition was not broad enough due to the diverse types of buildings that consumers live in. For example, people also live on farms, and in rental properties, caravan parks and nursing homes. Concerns regarding business insurance costs were also raised by stakeholders in submissions, but again fall outside the terms given to the Taskforce.

The scope of insurance to be covered in any policy measure is a decision for Government. However, the Taskforce has costed the options covering all home buildings and contents and all residential strata buildings and contents. Except where otherwise stated, home and residential strata buildings were included regardless of whether they were owner-occupied or investment properties. One reason is that it is very difficult to separate investment unit and owner occupiers within a strata complex. Another reason is that low income households are often renters who experience higher rents due to higher building insurance premiums. Other types of insurance were not included in an assessment of the feasibility of the options.

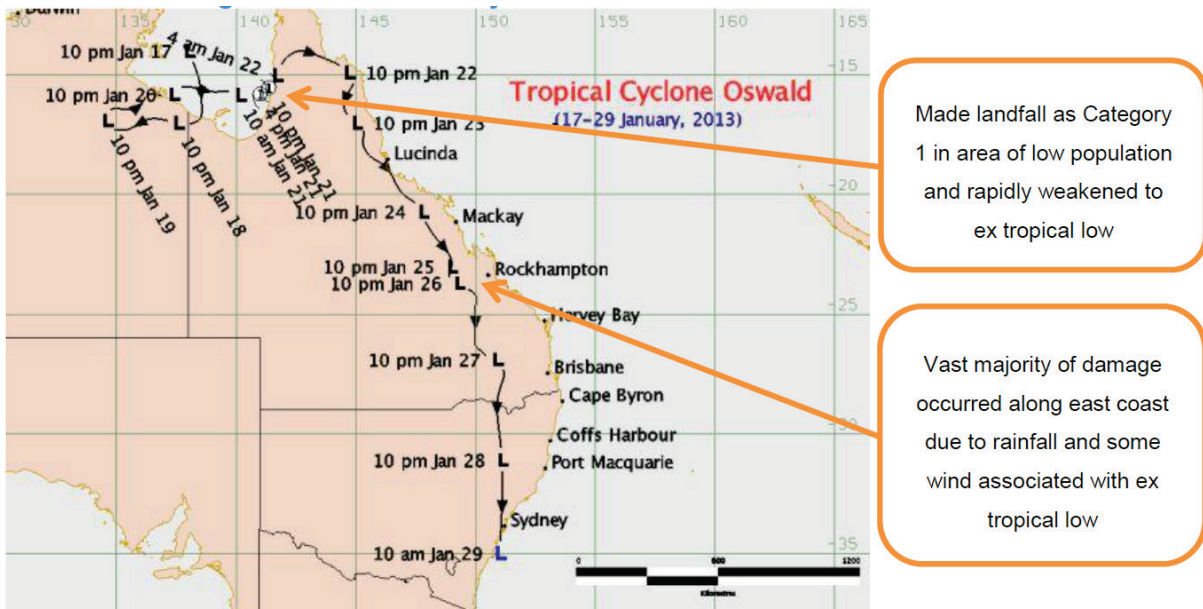
## 2.3 Defining a cyclone for the purpose of insurance

Existing insurance arrangements in Australia do not in general distinguish cyclones as a distinct peril. The interim report outlined that the option of introducing either a mutual cyclone insurer or a cyclone reinsurer would involve creating a new type of insurance that exclusively covered damage resulting from a cyclone. The concept of 'cyclone damage' would need to be clearly defined for the purpose of insurance contracts. Any definition would need to capture the bulk of cyclone damage, be easy to understand and allow the relationship between cyclone insurance (or reinsurance) products and complementary (non-cyclone) insurance products to be as seamless as possible.

The approach proposed by the Taskforce is to define cyclone damage as that caused by a *named tropical cyclone* in the geographic area that experienced wind speeds equivalent to Category 1 or faster. Within this area, damage caused by high winds, flooding, storm surge, water ingress through windows or the roof would all be considered cyclone damage and claims for this damage could be made under the cyclone insurance or reinsurance. However, claims outside this area would not be covered under the cyclone policy.

An example of how this definition would be applied can be gained from considering Cyclone Oswald in 2013. This cyclone crossed the coast in northern Queensland while it was classed a category one cyclone, but quickly deteriorated to a persistent 'ex-tropical low' as it moved down the coast (see Figure 4). The flooding caused by Ex Tropical Cyclone Oswald outside the areas of high winds would fall outside the definition of cyclone damage for the purpose of a 'cyclone policy'.

**Figure 4: Track of Cyclone Oswald**



Sources: Bureau of Meteorology, Finity Consulting

A practical issue is whether it is possible to readily identify the region affected by cyclone damage. The Bureau of Meteorology publishes data on tropical cyclone tracks, including data covering position, mean radius of winds of force Category 1 and higher and uncertainty measures. These data can be used to estimate regions that experienced cyclone-intensity

winds. The Bureau may revise initial draft data sometime after a cyclone event. If the concept of cyclone insurance was introduced, contracts would need to carefully stipulate when the region affected by cyclone damage would be identified and what would be the implications (if any) of revisions.

Within this region, if there was no distinction between losses caused by wind or water damage, this should avoid disputes of the kind that occurred following Hurricane Katrina in the United States where it was unclear whether policyholders should claim for flood damage resulting from the hurricane under the flood policies issued by the National Flood Insurance Program or their private non-flood insurance policies. These disputes led to significant delays in settling claims.

The approach outlined above for identifying cyclone damage may need to be refined if a cyclone mutual or reinsurer was introduced, but it is considered to be a feasible starting point. 'Named cyclone' is already a term used in strata insurance, in that some policies have a higher excess in the event of damage from a named cyclone. If this approach was adopted as the basis for a cyclone mutual, it would be important to test the definition to ensure it is clear and comprehensible to consumers.

There would need to be a plain language (and consumer tested) standard definition for cyclone damage, cyclonic winds, storm surge and all of the incidental damage that might flow from a cyclone event. A guidance document with recognised scenarios would be helpful for consumers as well as for adjudicators. *Financial Rights Legal Centre*

**Creating a new type of insurance for cyclones is feasible. Uncertainty needs to be minimised through careful design of the insurance contracts.**

## 2.4 Estimates of potential cyclone damage in northern Australia

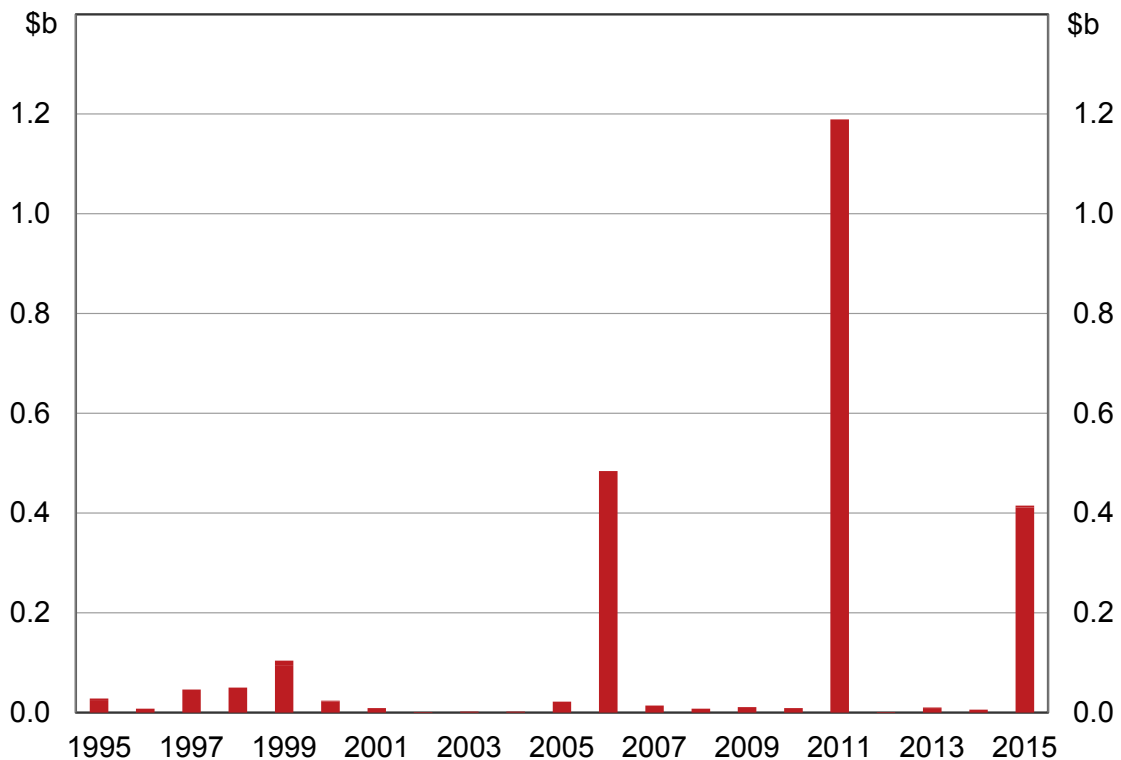
A central piece of information required to assess the potential reduction in premiums and cost to the Government of introducing either a mutual insurer or reinsurance pool is the potential cost of claims due to cyclones in northern Australia.

One way to gauge the extent of damage that cyclones can cause is to look at the history of large losses for home, contents and strata caused by cyclones. Over the past 20 years losses due to cyclones across northern Australia (as per the definition outlined above) have totalled \$2.4 billion, which is around \$115 million on average per year (see Appendix C). However, year on year, losses have varied significantly. Between 1995 and 2005 losses caused by cyclones in northern Australia totalled \$282 million and ranged from a loss of \$1 million in 2002 to \$95 million in 1999. Between 2006 and 2015, the total losses caused by cyclones in northern Australia was \$1.7 billion and largely reflected the damage caused by cyclones in three years; \$484 million from Cyclone Larry in 2006, \$1.2 billion from Cyclone Yasi in 2011 and \$411 million from Cyclone Marcia in 2015. These losses are illustrated in Figure 5.

While the damage caused by cyclones can be significant, it is impossible to predict whether the loss in any year will be zero or billions of dollars. On average about 13 cyclones form in the Australian region each cyclone season, and typically about four cross the coast. Half of the cyclones that form become severe. Whether a cyclone causes significant damage will depend not only on its severity, but whether it hits a populated centre, as did Cyclone Tracy when it hit Darwin in 1974. Australia has been 'lucky' in that the vast majority of major cyclones that have hit the Australian mainland have missed major populated centres. But it is impossible to predict if, and when a cyclone will impact on a populated area.

**Over the past 20 years, losses from cyclones in northern Australia were \$2.4 billion or around \$115 million per year when averaged over the period.**

**Figure 5: Insurance claims costs of cyclone events over the past 20 years**



Sources: Finity Consulting, ICA

Looking back at the damage caused by cyclones over a relatively short period does not provide a good indicator of the magnitude of the risk of cyclone damage. The estimate will depend on what period is included in the calculation. For example, if the period for measuring losses included Cyclone Tracy, the total loss would be significantly higher. Similarly, even though it has a small probability, the loss from a cyclone directly hitting a large population centre such as Cairns or Townsville would raise the average cost over time by a very large amount. It is the events that are unlikely but can generate large claims that any insurance company must prepare for in order to remain solvent.

The Taskforce commissioned three cyclone modellers to estimate the potential damage and insurance claims by stimulating a large number of cyclone events over a very long period (see Box 1). These models of *future* losses due to cyclones indicate that the potential damage is higher than just looking at the past 20 years. This result is to be expected. From a statistical perspective, the observed mean of a sample is less than the mean of the underlying population when the underlying distribution is skewed. The distribution of insured cyclone losses is skewed — the most expensive 5 per cent of cyclones contribute around 60 per cent to the overall average cost.

The models indicate that over the very long run total claims from cyclones in northern Australia may be in the order of \$285 million per year when averaged over time. As an indication, this equates to around \$600 of cyclone-related claims per year for a \$350,000 house and around \$500 of cyclone-related claims per year for a \$250,000 strata unit (Figure 6).<sup>3</sup>

These models are the best currently available and are used by the insurance companies as a basis for setting their premiums. However, there is a high degree of uncertainty associated with these estimates (see Box 1).

**Models estimate that future losses from cyclones in northern Australia could be around \$285 million per year when averaged over a very long time. This is due the risk of much larger catastrophes than have occurred during the past 20 years.**

**While it is possible to measure the average loss, it is impossible to predict in any year whether losses will be zero or billions of dollars.**

This average yearly loss estimate is over a very long period and represents many years of little damage mixed with a few years of significant damage. The models estimate that an extreme event (defined as an event that has a probability of less than half a per cent chance of occurring in any year or a 5 per cent chance of occurring during a 10-year period) could cause losses of over \$5 billion. Examples of such extreme events include a category 5 cyclone making landfall directly over Cairns, Townsville or Darwin or a cyclone which travels down the coast damaging a number of towns. The longer an insurance scheme operates, the chance of having to meet claims resulting from damage from a cyclone hitting a major population centre increases. Moreover, Cyclone Tracy is a reminder that severe cyclones can hit cities in northern Australia.

**Cyclone losses are very ‘lumpy’. In most years, losses will be small. But in some years losses may be very high. An extreme event in northern Australia could lead to losses of over \$5 billion. These extreme events drive up the estimate of the average loss per year. Insurance companies have to provide for such events.**

---

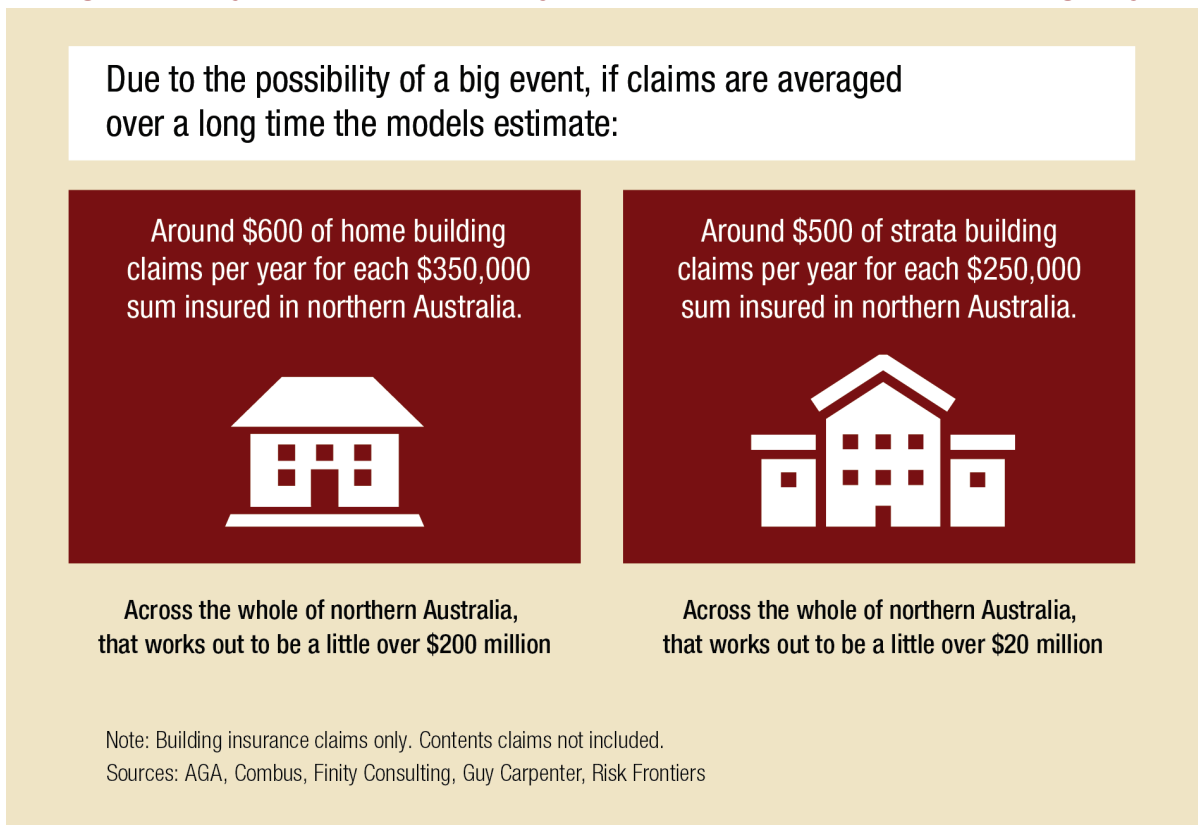
3 Note that these figures refer to the replacement cost of the building and not the building’s market value.

The area of Australia below the Tropic of Capricorn also faces some cyclone risk, but this is much lower than in northern Australia. The models estimate that losses in this part of Australia over a very long period could be around \$210 million per year. This average reflects a small risk of cyclones making landfall near the Gold Coast and Brisbane in the east and near Perth in the west. Although the chance of a cyclone hitting these regions is small, the high population density implies that the damaged caused would be substantial. However, measured per house the expected damage due to cyclones in southern Australia is significantly less than that in northern Australia.

The risk of cyclone damage varies across regions in northern Australia. The region of highest risk for houses or units is the northwest of Australia, which experiences the highest frequency of cyclones and the strongest winds. The modelled risk of damage to regions around Cairns and Townsville is also high.

Estimates of total claims for housing building damage are larger than that for strata damage because the housing stock is much larger than the stock of strata units.

**Figure 6: Projected losses due to cyclones in northern Australia (building only)**

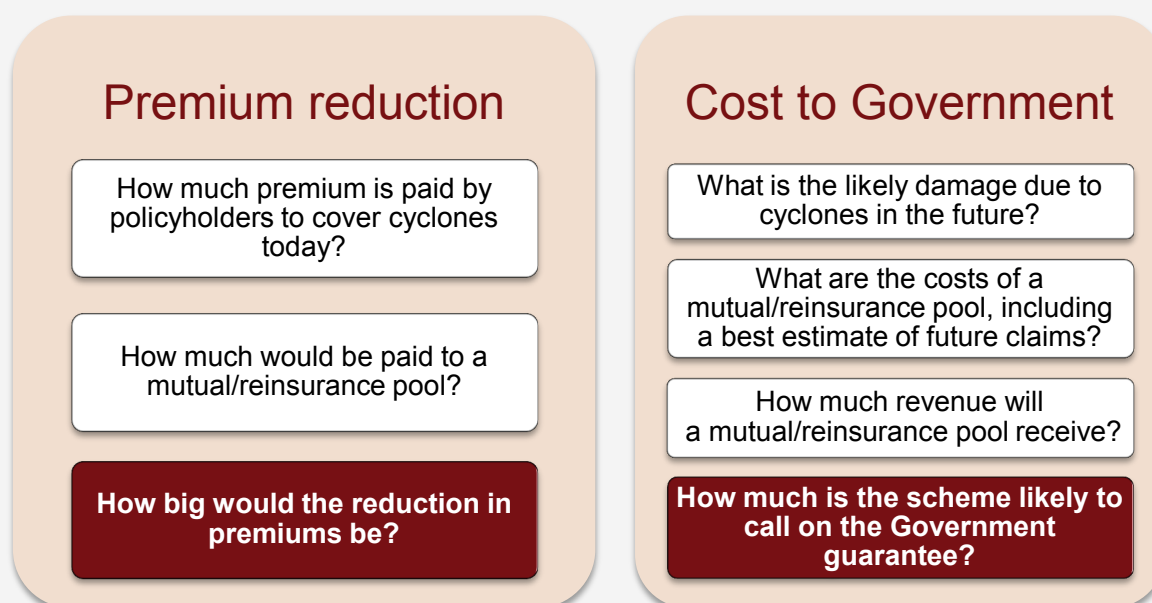




### Box 1: Modelling approach

Estimating the potential reduction in premiums and cost to Government of creating a mutual cyclone insurer or a reinsurance pool for cyclone risk involved a number of steps. As shown in Figure 7, in order to calculate the reduction in premiums it is necessary to estimate how much premium is currently paid by policyholders to cover the ‘cyclone component’ of premiums and to estimate how much premium revenue would need to be charged by a mutual insurer or reinsurance pool. To estimate the cost to the Government, it is necessary to estimate the claims and operating costs of the mutual insurer or reinsurer and compare this with the revenue received (which is equal to the premium paid).

**Figure 7: Steps required to estimate premium reduction and cost to Government of a mutual insurer or reinsurance pool**



In order to estimate these steps, the Taskforce commissioned a series of insurance sector specialists to undertake modelling work. This work involved four stages:

1. Estimating how much households currently pay for the ‘cyclone component’ of insurance premiums. This is the component of the premium that can be lowered by creating a mutual cyclone insurer or a reinsurance pool.
2. Estimating the likely claims on a mutual insurer or reinsurance pool due to cyclones in the future.
3. Estimating the operating costs (such as staffing and sales) of both the mutual insurer and the reinsurance pool and the amount of capital that would need to be held by a mutual to be financially secure.
4. Undertaking a ‘dynamic financial analysis’ to estimate the likely cash flows of the mutual insurer and reinsurance pool to work out the potential calls on the guarantee.



### Stage 1: Estimating the current premium pool

Finity Consulting estimated the size of the current premium pool for cyclone risk by comparing premiums in cyclone prone areas with premiums for similar risks in areas with negligible cyclone risk in order to create a model of insurer pricing. Using the model and information from the Taskforce on the type of properties in northern Australia (see below), Finity Consulting estimated the 'cyclone component' of premiums as well as the total premium for each property. The sum of all premiums is the total premium pool in northern Australia.

### Stage 2: Estimating the likely claims due to future cyclones

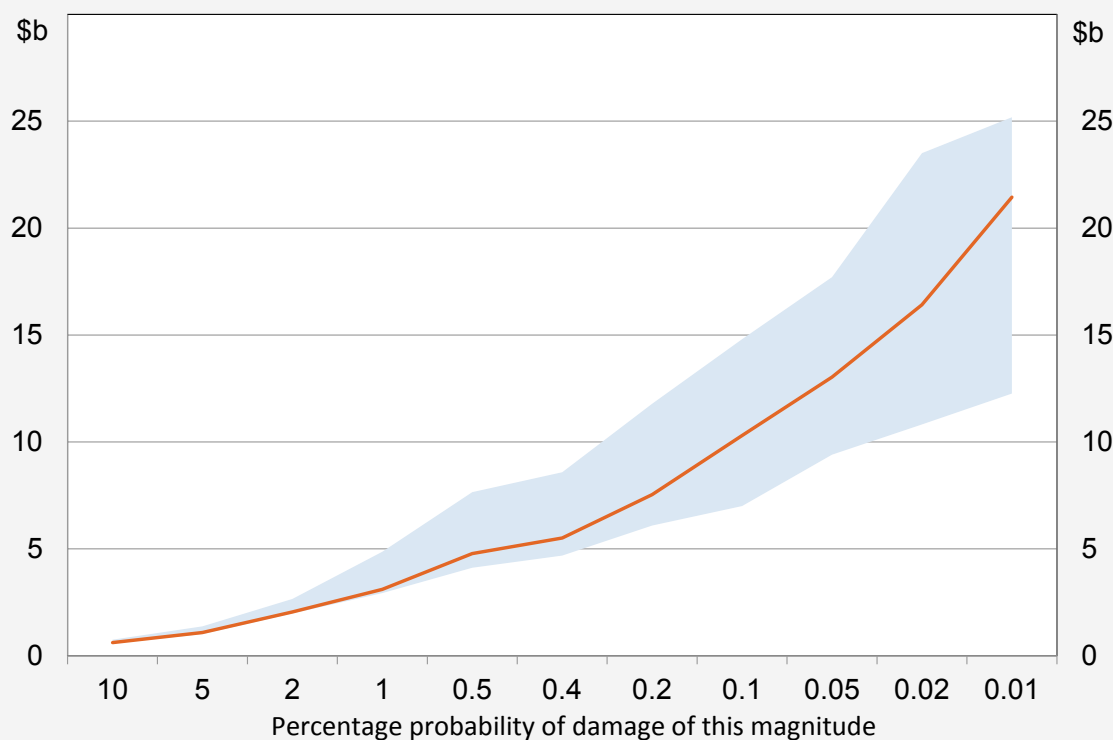
The Taskforce engaged three consultants (Combus, Guy Carpenter and Risk Frontiers) to estimate the potential damage and insurance claims from cyclones using four models that predict *future* losses over a long time period. These models use engineering information about the vulnerability of buildings and historical information about cyclone frequency, intensity and location to estimate the probability of different size losses. These models estimated losses specifically for home, contents and strata.

This modelling exercise asked how much damage cyclones could do in each region of Australia by simulating cyclone events over a 10,000 year period (which is the standard approach for such modelling) and seeing where those events caused damage to the houses and apartments. This approach estimates the potential size of large, although rare, losses and the average loss per year over a very long time horizon.

In order to ensure consistency between the models, the modellers all used the same information on residential buildings in Australia. This information included the location, age, wall type, roof type and number of floors of each building. This information was developed by Combus from NEXIS, a national database from GeoScience Australia that contains information about the stock of houses in each suburb across Australia.

The models that estimate the damage caused by cyclones are the best available, and are widely used by the insurance industry. However, there remains uncertainty about the potential cost of cyclone damage. In part, this is because the models use different assumptions about future cyclone activity and the level of damage that cyclones would cause to particular building types. Uncertainty is also an inherent part of any forecasting exercise.

Figure 8 highlights the uncertainty associated with attempting to predict cyclone losses in northern Australia. The figure shows the potential losses predicted by the models for different probability events. More extreme events are less frequent but have a greater predicted loss. The solid line represents the average predicted loss across all the models. The shaded area shows the range of predicted loss across the models. The range between models indicates that, in spite of the technical sophistication of the models in assessing cyclone risk, insurance companies have to deal with significant uncertainty. The Government would face the same level of uncertainty if it were to provide support to a reinsurance pool or direct insurer.

**Figure 8: Predicted cyclone losses by event probability**

Sources: AGA, Combus, Guy Carpenter and Risk Frontiers.

### Stage 3: Estimating the costs of the mutual or reinsurance pool

Finity Consulting estimated the operating costs of the mutual and the reinsurance pool. The expected cost of claims is an average of the modelling results across four separate models. Further details are available in the report by Finity Consulting at Appendix C

### Stage 4: Estimating the likely reduction in premiums and the cost to the Government

Finity Consulting used scenario analysis to identify a relationship between premium reductions and the potential cost to the Government. For each of the mutual insurer and the reinsurance pool, Finity Consulting estimated the growth of the scheme's reserve pool and the potential claims on the scheme over a 10 year period under four different scenarios. From this information, they calculated the likelihood that the Government guarantee would be called on and for how much.

The same four scenarios were used for both the mutual insurer and reinsurance pool:

- **Scenario 1 — a commercially-viable scheme.** The scheme would operate as a commercially-viable entity meaning that it has sufficient capital to meet the expected cost of claims without recourse to a Government guarantee. The scheme would set premiums to cover operating costs, expected claims and the costs of reinsurance and capital.
- **Scenario 2 — a partially funded scheme.** The scheme would charge sufficient premium to cover operating expenses and an estimate of long-run expected claims costs, but the risk of any additional claims (the result of more severe or more frequent cyclones than expected) would be covered by the Government. Under this scenario, the Government guarantee would meet any losses above the reserves pooled in the scheme.

- **Scenario 3 — a 30 per cent reduction in premiums.** The scheme would receive Government support with the aim to reduce premiums on average by 30 per cent in northern Australia. The Government guarantee would meet any losses above the reserves pooled in the scheme.
- **Scenario 4 — a full subsidy.** The scheme would raise enough premium revenue to cover operating costs only. It would not charge anything for the cost of cyclone related claims, which would be met by calling on a Government guarantee.

### **Caveats**

There are a number of caveats to these estimates of the cost to the Government of the cyclone mutual and reinsurance pool.

There is a significant degree of uncertainty around modelling possible losses from cyclone damage. While northern Australia normally experiences a number of cyclones every year, the damage caused will depend on the severity of the cyclone and whether it hits a larger population centre. A severe cyclone occurring in Australia is a rare event and it is inherently difficult to estimate the severity and location of a cyclone and the insured damage that results. The costings are based on estimates of the probability of a range of cyclone damage claims.

The estimation assumes that the schemes will immediately operate at full capacity. No allowance has been made for the scheme operating below capacity in the early years as it builds a client base. During these years, the reserves pool will build up more slowly than is assumed by the modelling. As a result, the modelling is likely to underestimate the cost to the Government at the margin.

The modelling assumes the schemes run at full capacity for 10 years. Changing this assumption (for example, by assuming a slower take up of the scheme) would impact the estimated cost to Government.

The estimates assume that insurance premiums will fall by the full amount of the reduction in the cyclone component of the premium under each option. However, this is likely to overestimate the reduction in premiums. Insurers achieve some economies of scale in bundling different types of risk together, particularly in the purchase of reinsurance. Insurers have indicated that their costs may not fall by as much as expected by reducing or removing cyclone risk from their customer policies or reinsurance contracts. The result is that the overall costs of providing both cyclone and non-cyclone cover could rise, reducing the size of the premium reduction.

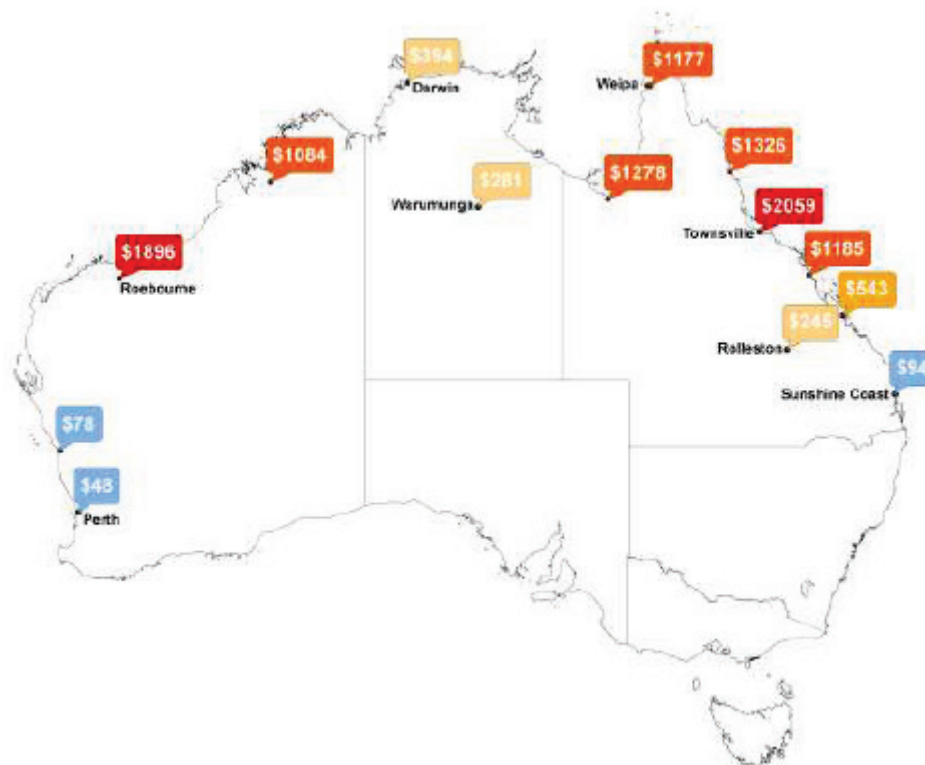
The results are presented for northern Australia as a whole. It is difficult to reliably estimate the reduction in premiums for sub-regions or individual buildings. The magnitude of the reduction for each region and policy will depend on the cyclone premium being charged by private insurers currently operating in that area. This will be affected by how the private insurer rates the risk of cyclone damage, whether the household is an existing or new customer, the type of construction of the building, the age of the building, whether there is a high flood risk independent from cyclones and a range of other factors.

## 2.5 Current cyclone premiums and cost to government

Another required step in assessing the extent to which insurance premiums in northern Australia can be reduced through the introduction of a mutual cyclone insurer or a cyclone reinsurance pool is to estimate the extent to which current premiums charged by insurers reflect cyclone risk.

Finity Consulting was commissioned by the Taskforce to assess the proportion of current premiums paid by consumers to cover cyclone risk. They did this by first comparing premiums in cyclone prone areas with premiums for similar properties in areas with negligible cyclone risk and by second comparing premiums for different types of dwellings in the same location. Figure 9 illustrates the extent of differences in the estimated cyclone component of premiums for home building insurance across northern Australia.

**Figure 9: Cyclone online premium for home building insurance by location**



Notes: Based on a \$350,000 sum insured for a brick home built in 2000.

Source: Finity Consulting

Taking into account home, contents and strata, the current premium pool for cyclone risk in northern Australia is estimated to be around \$480 million per year, compared with a total premium pool for northern Australia of around \$1 billion. That is, the cyclone component of the premium is estimated to be around half the total premium pool, although this number is subject to a degree of uncertainty.

**The current premium pool for cyclone risk in northern Australia is estimated to be around \$480 million per year. This is around half the total premium charged in northern Australia.**

Uncertainty arises because the premium pool is an estimate based on the available data. In their report, Finity Consulting notes the challenges in estimating the premium pool for home and contents insurance from online data and the limited availability of data for strata building insurance across Australia. At an aggregate level, the estimates are consistent with national and state-level data on insurance company revenue published by APRA and broadly consistent with the AGA reports on insurance premiums in northern Queensland (AGA, 2014a and 2014b). Estimates are less reliable at a regional level.

### 3. INSURANCE OPTION 1: MUTUAL CYCLONE INSURER

[T]he mutual model is designed to make affordable insurance cover accessible to populations whose needs are insufficiently catered for by the existing insurance market, whether it be availability, cover or price. *Regis Mutual Management*

#### 3.1 A possible design

The interim report identified several issues in the design of a mutual cyclone insurer and asked for feedback. Based on discussion with insurers, consumer advocates and regulatory agencies, the Taskforce identified a range of issues that need to be taken into account when considering the design of a cyclone mutual.

- The consumer claims experience should not be negatively affected by the scheme. In particular, there cannot be any gaps between the cyclone and non-cyclone insurance policies. This would lead to consumer confusion and possibly non-coverage compared to current arrangements. Drawing from the experience of the Earthquake Commission in New Zealand, consumers need clarity over when a cyclone policy is triggered and how to make claims.

The mutual could result in a complex claims experience, for example as seen in the aftermath of the Christchurch earthquake where disaster victims had to deal with multiple claims managed by government and then private insurers. *ICA*

- The pricing of policies by a mutual should maintain the incentive for consumers to mitigate risk. In order for premiums to remain at lower levels once any subsidy is removed, households, communities and governments must take actions to lower risk during the life of the scheme.

It is critical that potential policyholders are encouraged to undertake long-term mitigation strategies to protect their homes from damage. Building this into the structure of the final model recommended will not only protect homes from damage but will reduce premiums and the need for further (or increasing) government intervention over time ... If northern Australian homeowners and communities have not undertaken appropriate mitigation strategies during a period where premiums have been artificially made more affordable, premiums will simply return to the current high levels once that government assistance is withdrawn or tapered off. *Financial Rights Legal Centre*

- A mutual would need a governance structure that takes into account the Government's, and in turn taxpayers, exposure to risks. Decisions by the management of the mutual would directly affect the risk faced by the Government under the guarantee provided.
- Any scheme should be voluntary. Creating a compulsory mutual cyclone insurance scheme would likely have a major impact of the insurance market in northern Australia.

Taking into account the above considerations, a possible cyclone mutual was designed in order to estimate the possible cost to the Government, the reduction in consumer premiums and the impact on the insurance industry. A considerable amount of further refinement would be needed if a mutual were to be established.

Under the option costed, a mutual insurer would offer a cyclone policy that private insurers could sell combined with a non-cyclone policy to residents of northern Australia. Private insurers could elect to partner with the mutual or sell their own full-cover policy (cyclone plus non-cyclone), but could not do both.

Private insurers would also act as the mutual's claims managers. In the event of a cyclone, a policyholder would make a claim for cyclone damage to their private insurer. The private insurer would undertake the loss assessment and arrange and manage the works to fix any damage. If the claim was for cyclone damage within the event radius, the full claim (less the excess) would be paid for by the cyclone mutual. For claims that did not fall into this category, the private insurer would judge whether the claim was within the policyholder's non-cyclone policy cover.

The mutual would need to work closely with the private insurer partners to ensure the definition of cyclone damage was incorporated into their policies so as to ensure there were no potential holes for claims to fall through. To minimise gaps in coverage related to cyclones, the cyclone policy would cover expenses related to the claim that are standard in insurance policies, such as temporary accommodation, debris removal, legal liability, contents removal and storage.

**A possible cyclone mutual could offer a cyclone policy for private insurers to sell with their non-cyclone policy to residents of northern Australia. The private insurers would be the sales agent and manage all claims. The mutual would charge a premium that reflects risk, but at a subsidised level. The subsidy would be possible if there was a Government guarantee.**

Under this scheme, claims on the mutual would not be capped. Claims would be paid up to the full sum insured as nominated by the household for their cyclone and non-cyclone policies, including an allowance above the sum insured to allow for higher building costs following a disaster (what is known as demand-surge pricing). A first-loss scheme has been proposed, but this is less effective in reducing premiums than an uncapped scheme (see below).

By acting as sales and claims agents for the mutual, private insurers would incur costs. The mutual would pay a commission to private insurer agents, as occurs with other similar schemes (such as the Earthquake Commission in New Zealand). Typically, a sales commission is paid as a percentage of the premium and a claim handling fee is paid in the event of a claim as a percentage of the claim amount.

To maintain incentives for mitigation, the mutual could charge higher premiums for those dwellings with a greater risk of cyclone damage. Further support to mitigation could be achieved by offering a premium reduction for mitigation works to buildings that lower the likelihood of damage. In order to do this, the mutual will need to purchase or build pricing modules.



In addition, the mutual could also work to raise community awareness of cyclone risk and facilitate mitigation efforts within its community of members. Some additional costs of community awareness campaigns has been factored into the costs of a mutual. However, any large-scale funding of mitigation activity has not been factored into these costings.

*The key advantage a mutual option has over a government reinsurance pool is that it will be easier to link eligibility for the scheme to mitigation efforts or affordability criteria than it will be to link mitigation under the reinsurance pool option. Financial Rights Legal Centre*

It is proposed that the mutual would have a Government guarantee to ensure that it can meet all claims. The mutual would receive revenue through premiums every year. It is assumed that in most years there would be no severe cyclones resulting in major insurance claims, so the premiums received would exceed claims paid, and remaining premium income would be pooled in a reserve to meet future claims. However, in a year where there are one or more large cyclones, the reserves may not be sufficient to meet claims (especially in the early years of the scheme before the pool has built up). Without a guarantee, the mutual would need to raise more funds from its members to meet all the claims or be forced to pay out only a proportion of the claims. A Government guarantee would ensure the mutual can always meet its claims without seeking additional funding from members.

There remain a number of issues in designing a mutual insurer.

Access to a Government guarantee raises the question of the appropriate governance structure for the mutual. Typically, a mutual is owned and controlled by its members. In this case, conditions around the use of the Government guarantee would need to be embedded in the constitution of the mutual. For example, there would need to be controls to prevent the mutual from making discretionary payments to members or lowering member premiums and thereby increasing reliance on the guarantee to meet claims.

Some proponents of the mutual option have suggested that it should be a discretionary mutual structure rather than an APRA-authorized mutual company. Other stakeholders have argued that a discretionary mutual is inappropriate because it cannot provide a guarantee of payment (that is, a discretionary mutual has a legal discretion not to pay claims in order to ensure that it remains solvent) and because consumers would lose a range of consumer protections under insurance law, including access to the Financial Claims Scheme. In addition, cover from a discretionary mutual does not meet the legislative requirements on body corporates of strata complexes to purchase insurance under state laws.

*[I]n the event [a discretionary mutual] was the chosen option to implement, it is imperative that the potential limitations of the cover be clearly communicated to consumers, as there is the risk of poor consumer experience, potentially resulting in a consumer backlash and damage to both the Government brand and that of the product distributor. RACQ!*

For these reasons, an APRA-authorized insurer may be preferable to a discretionary mutual. However, the costs of such a scheme may be higher because an APRA-authorized mutual would need to meet APRA's minimum capital requirements. In order to meet APRA's minimum requirements, the mutual may require initial and ongoing capital injections from the Government. If the mutual did not hold a sufficient capital pool, the scheme would need to be carefully designed to ensure that reliance on a Government guarantee could be treated as a form of capital to meet minimum capital requirements.



If a cyclone mutual was to be implemented, it would require further development in close collaboration with the insurance industry. A suitable mutual manager would need to be found, involving a transparent procurement process to ensure probity.

### **3.2 Criteria 1 and 2: the potential reduction in premiums and cost to Government**

The first criterion for assessment of the options is the potential reduction in insurance premiums and the second criterion is the likely cost and risk associated with using the Commonwealth balance sheet to lower the cost of insurance to consumers.

The mutual option has been costed on the assumption that whether it is either an APRA-authorized or discretionary mutual, it would not need to raise capital aside from the guarantee. It is also assumed that the costs of either structure are the same. If a mutual were to be implemented, this assumption would need to be tested further. Further, the estimated costs are in addition to other payments the Government would be liable for in the event of a cyclone (such as payments under the Natural Disaster Relief and Recovery Arrangements).

There is a possibility (although not certain) that there would be a pool of reserves left in the scheme when the Government exited. The treatment of these reserves would influence the cost to the Government of the mutual. The option has been costed on the assumption that these reserves would be provided to the Government if the scheme closed when the Government withdrew support. (As noted below, it is highly likely the scheme would close if the Government withdrew support.) The return of the reserves would represent deferred compensation for the Government providing a free guarantee through the life of the scheme. However, there is likely to be a perception that the funds remaining in the pool belong to the people of northern Australia and should not go to the Government, particularly if withdrawing the funds was seen as resulting in the mutual being wound up. If these funds were to remain with the mutual or used in some other way for the benefit of the people of northern Australia, the estimated costs to the Government would be significantly higher than estimated below.

#### **3.2.1 Could a commercially-viable mutual cyclone insurer reduce consumer premiums?**

It has been suggested by some stakeholders that a commercially-viable mutual could offer premiums below current levels. To be commercially-viable, an insurance company needs to hold a sufficient level of capital to be financially viable. It is assumed that the mutual insurer would need to hold a similar level of reinsurance and capital to that held by private insurers in order to provide sufficient security to its members, regardless of whether it is an APRA-regulated mutual or a discretionary mutual. As a result, its ongoing premium revenue would need to be sufficient to cover operating costs (including to pay commissions and fees to insurers acting as sales agents and claims managers), expected claims and the costs of reinsurance and capital.

The modelling commissioned by the Taskforce indicates that it would not be possible for a commercially-run cyclone mutual to offer premiums below the current rate, and there is a possibility that premiums may be higher. This would be because the mutual would have higher costs than a private insurance company that is able to achieve some efficiencies through diversification across different types of risks. Table 1 details the costs of a

commercial entity operating in northern Australia, as estimated by Finity Consulting. The current premium pool is around the same size as the premium pool that would be required to ensure the commercial cyclone mutual is profitable. As a result, a cyclone mutual would require ongoing Government support if it were to continue to offer premiums below current levels.

**A mutual without Government support could not offer premiums below current levels. Premiums may actually be higher.**

This result does not change if the entity was established as a discretionary mutual operating for its members and earning zero profit, as even a discretionary mutual would need to retain sufficient capital in order to enable claims to be paid in the case of a large event.

**Table 1: Costs and revenue for a commercially-run cyclone insurer**  
\$ millions

<b>Annual cost = required premium pool</b>	<b>565</b>
Net claims costs	124
Reinsurance expense	329
Capital servicing	30
Operating expenses	81
<b>Current market premium pool for cyclone risk</b>	<b>around 480</b>
<b>Expected reduction in cyclone component of premium</b>	<b>increase of 10-20%</b>
<b>Expected reduction in total premiums (cyclone plus non-cyclone)</b>	<b>increase of 5-10%</b>

Sources: ABS, AGA, Combus, Finity Consulting, Geoscience Australia, Guy Carpenter, Risk Frontiers

Notes: Net claims costs have been estimated using cyclone catastrophe models and are equal to the yearly average of claims over the long run less the yearly average amount that is expected to be received back over the long run from reinsurance.

Advice was sought from Finity Consulting about the magnitude of the other costs. More details on how these costs are estimated is included in the report from Finity Consulting at Appendix C.

A commercially-run mutual insurer would require initial capital. It has been estimated that a scheme covering all homes in northern Australia would likely require a capital base of around \$960 million (Finity Consulting, see Appendix C). This is because the mutual would need to have sufficient funds to meet the excess on its reinsurance policies (assumed to be \$200 million per event). The initial capital would need to be raised from the members of the mutual or provided by the Government.

Over a 10-year operating period, there is around a 60 per cent chance that this entity would need additional capital injections (with an up to 5 per cent chance that total capital injections could exceed \$2 billion over the period) to bring its capital pool back to maintain capital at a suitable level. Again, there is the question of whether the entity would be able to raise sufficient capital from members, particularly if the reason for the capital raising is a large cyclone that has caused major damage in the region.

### 3.2.2 Could premiums be reduced with a Government guarantee?

For consumer premiums to be reduced, the costs of the mutual will have to be lower than a commercially comparable insurer. This can be achieved by providing an implicit subsidy through a Government guarantee at below the commercial value of the guarantee. The extent of the reduction of premiums will increase with the size of the implicit subsidy.

The following estimates of the potential costs to Government of such an arrangement assume that the mutual does not purchase reinsurance. The purchase of reinsurance is considered in more detail below.

The commissioned modelling indicates that a ‘partially funded’ mutual<sup>4</sup> would generate a reduction in the total consumer premiums (that is, the sum of the cyclone and non-cyclone insurance premiums) of around 10–15 per cent on average across northern Australia. As the scheme is not charged for its reinsurance nor for any return on the capital the scheme is retaining, it has a lower cost base than a commercial scheme and could charge less than the current market premium for cyclone risk (Table 2).

**Table 2: Costs and revenue for a partially funded cyclone insurer**  
\$ millions

<b>Annual cost = required premium pool</b>	<b>366</b>
Average claims each year over the long run	285
Operating expenses	81
<b>Current market premium pool for cyclone risk</b>	<b>around 480</b>
<b>Expected reduction in cyclone component of premium</b>	<b>20-30%</b>
<b>Expected reduction in total premiums (cyclone plus non-cyclone)</b>	<b>10-15%</b>

Sources: ABS, AGA, Combus, Finity Consulting, Geoscience Australia, Guy Carpenter, Risk Frontiers

The premium reduction is achieved through a Government subsidy. This scheme assumes no immediate Government outlays to establish the mutual, and it is possible that there would be no call on the Government guarantee over the life of the arrangement. But, this is unlikely. The Government would be taking significant risk onto its balance sheet without receiving a fee. In the first year, there is around a 20 per cent chance that the Government guarantee will be triggered. There is up to a 5 per cent probability the payout could total more than \$2 billion. The probability of a call on the Government guarantee does fall over time, as the pool builds up. Over a 10-year period, there is around a 60 per cent chance the guarantee would be called on at least once.

While premiums in this scenario are priced with the aim of covering the long-run cost of claims, there remains a risk that the Government would lose money even if it recoups the pool of funds left in the scheme upon closure. If the scheme is closed at the end of 10 years, for example, the chance that the Government will have lost money (that is, paid out a greater amount under the guarantee than it received back from the scheme at closure) is in the order of 40 per cent. Over the 10 year period, there is a 10-20 per cent chance that the scheme

<sup>4</sup> Under the partially funded mutual, the mutual would price premiums to cover administrative costs and an estimate of long-run average expected claims, with the government guarantee meeting all claims in excess of the premium pool.

would cost the Government more than \$2 billion and about a 5-10 per cent chance of the scheme costing more than \$5 billion. The chance that the scheme would break even or return some reserves to the Government if it was wound up in 10 years is just over 60 per cent.

To achieve a larger reduction in consumer premiums than the 10-15 per cent estimated for the partially funded scheme, the costs of the mutual will have to be further reduced. One of the scenarios modelled (Scenario 3), involved the Government targeting a reduction in premiums of 30 per cent on average across northern Australia (around double the reduction in premiums achieved under the partially funded scheme). This requires a larger subsidy by the Government and in turn the potential cost to the Government is increased.

After reducing premiums by 30 per cent, the total annual premium revenue for the cyclone mutual insurer would be around \$180 million, which is a reduction of about 60 per cent against current level of cyclone premiums (Table 3). This level of revenue is below the long run estimate of average claims per year, so that the chance that the Government guarantee would be called on during the life of the scheme is increased to around a 90 per cent (from about 60 per cent for the partially funded cyclone insurer).

Similarly, the risk that the scheme will cost the Government money over a 10-year lifetime (at around 70 per cent) is higher than for a partially funded mutual insurer (at around 40 per cent) and the chance that the scheme could cost more than \$5 billion over 10 years would increase to 10-20 per cent (from 5-10 per cent).

**Table 3: Costs and revenue for a mutual insurer that would reduce premiums by 30 per cent (\$ millions)**

Required reduction in total premiums (cyclone plus non-cyclone)	30%
Implied annual premium pool	181
Average annual cost of scheme over the long run	285

Sources: ABS, AGA, Combus, Finity Consulting, Geoscience Australia, Guy Carpenter, Risk Frontiers

There is an upper limit to how much premiums could be reduced through a mutual. If the cyclone mutual charged premiums to cover only the administrative costs, with all cyclone-related claims costs to be met using the Government guarantee, the *cyclone* component of premiums in northern Australia would be almost zero. As a result, *total* premiums could be reduced by around 40 per cent on average across northern Australia. However, the risk that the Government would need to make substantial payments to support the mutual would be very high. In the first year, there would be around a 60 per cent probability that the guarantee would be called on, and an up to 5 per cent chance that the call would exceed \$2 billion. For a scheme operating for 10 years, there is a 100 per cent chance that the Government guarantee would be called on, and a greater than 20 per cent chance of the calls exceeding \$5 billion in total.

### 3.2.3 Using reinsurance to lower the cost to Government

Scenarios 2, 3 and 4 for the cyclone mutual estimate the cost to the Government if the mutual did not purchase reinsurance, but instead pooled all funds in the scheme. The mutual could purchase reinsurance to reduce the extreme risks of large calls on the Government guarantee, although it would raise the likely cost of the scheme. For example, if the mutual in Scenario 2 were to purchase reinsurance cover for losses above \$1 billion up to \$2 billion,

the overall costs of the mutual would rise by around \$90 million due to the need to pay reinsurance costs. Due to the reinsurance, the probability of the Government losing money over the life of the scheme falls to 40-50 per cent and the risk of losing more than \$5 billion over the life of the scheme would fall from around 6 per cent to 3 per cent. However, the probability of the guarantee being called on during the 10-year period would increase to around 75 per cent (from around 60 per cent).

It appears counterintuitive that the probability of a call on the Government guarantee would rise due to the purchase of reinsurance. However, since the mutual would have to pay for the reinsurance, the pool of reserves available to meet claims would build up more slowly. With a smaller pool of reserves, it is more likely that the Government guarantee would be called on to enable the mutual to pay the retained loss (around \$200 million per event) before the reinsurance could be claimed on.

Alternatively, the scheme could build the cost of reinsurance into premiums. But if so, the premium reduction would be eroded and the scheme would not achieve the goal of lowering premiums.

### 3.2.4 Capping payouts by the mutual

Some stakeholders have proposed that payments under the scheme could be capped in a way that would lower premiums but also manage the risk to the Government (a 'first-loss' scheme). The Taskforce considered a scheme where payments were capped at \$30,000 per dwelling. Based on analysis of claims by Suncorp following Cyclone Yasi, this level is expected to cover a high proportion of claims from most events. However, the modelling and feedback suggests such a scheme may have low impact and cause consumer confusion.

The modelling suggests that capping the payments at this level would reduce the size of any reduction in premiums. Although explicit costs for a mutual were not modelled, the premium reduction for a reinsurance pool that offered a capped \$30,000 payment was estimated at around half the reduction in premiums of an uncapped scheme. Further, it was found that this did not noticeably reduce the risk to the Government.

The experience in New Zealand following the Christchurch earthquake indicates that a first loss scheme can cause confusion to consumers and delay claims. In that event, the allocation of losses to private insurers and the New Zealand Government took a long time and there are still cases relating to loss allocation being managed in the courts in 2015 (Johnstone 2015).

### 3.2.5 Individual reductions in premiums

The above estimates describe the average reduction in premiums that could be achieved across northern Australia. The actual reduction experienced by each policyholder will vary significantly. One cause of variation is that the scheme works to reduce the *cyclone* component of premiums. Those individuals with high cyclone risk should therefore receive the largest discounts. This means that some people with low cyclone risks will not receive the same degree of discount, although these policyholders should have a lower premium to start with compared to those in high cyclone areas. There will also be additional variation because it is not possible to know exactly the premium that is currently being charged to each policyholder by their current private insurer. An example of how the premium reduction will vary across households is provided in the report by Finity Consulting (Appendix C).

Table 4: Summary of estimated premium impact and cost to Government from a cyclone mutual

	Partially funded scheme	30% premium reduction scheme	Partially funded scheme with reinsurance
<b>Potential Premium Reduction</b>	<b>10-15%</b>	<b>30%</b>	<b>10-15%</b>
<b>PROBABILITY OF ...</b>			
... a payment under guarantee in first year	AROUND 20%	30-40%	20-30%
... paying more than \$2 billion in first year	UP TO 5%	UP TO 5%	UP TO 5%
... a payment under the guarantee over 4 years	40-50%	60-70%	50-60%
... paying more than \$2 billion over 4 years	5-10%	10-20%	AROUND 5%
... a payment under the guarantee over 10 years	50-60%	80-90%	70-80%
... paying more than \$2 billion over 10 years	10-20%	40-50%	10-20%
... the Government recouping all payments under the guarantee at end of 10-year scheme	60-70%	20-30%	40-50%
... unrecovered losses at end of 10-year scheme	30-40%	70-80%	50-60%
... unrecovered losses could exceed \$5 billion at end of 10-year scheme	5-10%	10-20%	UP TO 5%

Source: AGA and Finity Consulting



### 3.3 Criteria 3 and 4: effect on insurance and reinsurance markets and the potential for Government exit

The third criterion under which the options are to be assessed is the potential effect on the operation of the insurance and reinsurance markets, particularly the effect on competition, and the fourth criterion is how the role of government can be gradually reduced over time.

Stakeholders have raised a number of concerns about how a mutual cyclone insurer with a Government subsidy would impact on the insurance market in northern Australia. These concerns are also relevant as to whether the Government would be able to reduce support for a mutual over time.

One of the principles guiding the Taskforce's assessment of the options is that any Government intervention should be structured to support competition in the market for cyclone risk. However, stakeholders report that a mutual is likely to reduce competition for cyclone risk. The mutual option would provide an advantage to a single provider of cyclone insurance such that other insurers may find it difficult to operate in that market at similar prices. A likely outcome is that there would only be one provider of cyclone insurance. Insurers could and would still provide non-cyclone insurance.

Depending on the scope of cover provided, [the mutual option] is likely to crowd out private sector insurance. *ICA*

Integration of a mutual into the operation of private insurance companies would also be complicated and potentially high cost for insurers. For example, for customers to receive online pricing options from the private insurer for both cyclone and non-cyclone cover, the mutual's premiums would need to be integrated into the online pricing modules of the private insurers. Although, insurers who agreed to sell the policies of the mutual would be doing so voluntarily, the agency fees payable to private insurers would need to be set to cover such costs. There may also be considerable time required to set up systems.

The potential for Government exit from support of a mutual cyclone insurer appears to be low. If the mutual became the sole provider of cyclone insurance, it is difficult to see how Government support could be withdrawn without limiting the ongoing viability of the mutual. Withdrawal of Government support would be likely to require the mutual to raise a large amount of capital in order to operate as a commercial entity, which members may be unwilling or unable to provide. Further, while the presence of the mutual may encourage new entrants into the market for non-cyclone risk, if the mutual stopped providing cyclone cover the new entrants would need to pick up cyclone risk under their own policies and it is not certain if these insurers would remain in the market.



## 4. INSURANCE OPTION 2: CYCLONE REINSURANCE POOL

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. *Allianz*

[O]f the two main options identified in the Interim Report, a carefully designed cyclone risk reinsurance pool would be likely to be of most benefit to consumers experiencing affordability challenges in northern Australia. *National Insurance Brokers Association*

### 4.1 A possible design

As for the mutual, the interim report identified several issues in the design of a reinsurance pool and asked for feedback. Based on discussion with insurers, consumer advocates and APRA, the Taskforce has identified a range of issues that need to be taken into account when considering the design of a cyclone reinsurance pool.

- Insurance contracts offered by the reinsurance pool would need to mesh efficiently with existing agreements between insurers and reinsurers. This is to ensure that the scheme is efficient and that the maximum reduction in cost and premiums is achieved.
- The design of the cyclone reinsurance pool should avoid creating a situation where only the high risk properties are allocated to the pool and, if possible, maintain incentives for mitigation in the pricing of the pool.
- The scheme should be voluntary.

Taking into account the above considerations, a possible cyclone reinsurance pool was designed in order to assess the possible cost to the Government, and the possible reduction in insurance premiums. As for a mutual, if a reinsurance pool were to be introduced, further refinement of the design would be necessary.

A potential reinsurance pool scheme could operate through a statutory corporation owned by the Government that offered treaty (that is, whole of portfolio), excess-of-loss reinsurance for cyclone damage. An option is to expand the remit of the ARPC to offer cyclone reinsurance and build a cyclone reinsurance pool. The existing terrorism reinsurance pool would be completely segregated from any new scheme.

The reinsurance contract would provide cover for cyclone risk as defined above for damage to home buildings, contents and strata buildings. The reinsurance contract would not contain an hours clause (such as a clause stipulating a maximum number of hours for each event), as the cyclone event is already very specifically described by the region experiencing category 1 winds. Insurers would then be able to exclude this particular risk from their private reinsurance contracts.

The reinsurance contracts would stipulate that in the case of an event, the industry would cover the claims up to a certain level. This 'retention' would ensure that for smaller events the Government guarantee was not called upon. The costing assumes an industry retention per event of \$100 million, well below the \$1 billion aggregate retention across insurers in private catastrophe reinsurance contracts (refer to Appendix C). Setting the retention at this level is aimed at balancing the competing requirements to reduce the claims costs of insurers and to ensure that calls on the pool are not too frequent. If a reinsurance pool was established, individual insurer retentions (that is the amount of loss from cyclones retained by the insurance companies) would need to be worked out at the start of each period based on some metric of market share, such as the share of the reinsurance premium of the reinsurance pool.

Unlike private sector catastrophe reinsurance, there would be no limit to the payment under these contracts. That is, if an insurer had a large presence in northern Australia they would be able to purchase reinsurance to cover the full risk. This should act to reduce the pressure on insurers to limit the number of policies they offer in northern Australia.

The pricing of contracts would be on the basis of risk. The insurance pool would follow the standard industry practice and provide portfolio information to the cyclone reinsurer who would then quote based on a risk assessment of the portfolio. The reinsurance pool would not cross-subsidise premiums across households. By maintaining risk pricing, insurers would be incentivised to continue to provide risk signals to households through consumer premiums (thereby providing an incentive for mitigation).

The premium reduction consumers would receive would depend on how far the costs of insurers can be lowered and the ability of insurers to pass through the price reduction.

The reinsurance pool would require a guarantee from the Government in order to ensure that it could pay out claims in the event of a large cyclone. As for the mutual, the reinsurer would receive premiums each year and (after paying expenses) collect these in a reserve pool for future claims. In years when there are few claims, the premium pool would rise. These reserves could be drawn upon in years when there are a large number of cyclone claims. There is a risk that a severe cyclone or a series of smaller claims would drain the reserves and the Government guarantee would need to be accessed to ensure that claims can be met.

A range of issues remain in designing an efficient reinsurance pool.

The Government guarantee for the reinsurer, as for the mutual, would need to be carefully designed. The choice of a legislative guarantee versus a contractual guarantee would need to be investigated. It would be important to ensure that minimum capital requirements for participating insurers are not increased due to purchasing reinsurance from the pool rather than from the private sector.

Government exit from the reinsurance market would likely need to be designed and announced in advance. Insurers have noted that exit should be staged and announced in advance to facilitate insurers returning to the international reinsurance market to purchase cyclone insurance without incurring significant costs. Staging could be facilitated, for example, by gradually increasing the share of claims retained by insurers under the reinsurance contract with the reinsurance pool. This would gradually increase insurers' reliance on the private sector reinsurance industry prior to Government exit from the reinsurance pool.

## 4.2 Criteria 1 and 2: the potential reduction in premiums and cost to Government

The first criterion under which the options are to be assessed is the potential reduction in insurance premiums and the second criterion is the likely cost and risk associated with using the Commonwealth balance sheet to lower the cost of insurance to consumers.

As for the mutual, the costing assumes that assets in the pool are the property of the scheme and will be returned to the Government upon closure of the scheme as a delayed payment for the guarantee. Further, the estimated costs for the reinsurance pool are in addition to other payments the Government would be liable for in the event of a cyclone (such as payments under the Natural Disaster Relief and Recovery Arrangements).

### 4.2.1 Could a commercially-viable cyclone reinsurance pool reduce consumer premiums?

It has been suggested that a cyclone reinsurance pool could offer premiums below current levels without relying on Government support. However, commissioned analysis indicates that if the cyclone reinsurer purchased a level of retrocession (where the cyclone reinsurer transfers part of the risk to another reinsurer), similar to a commercial entity, then there would be no reduction in costs that could be passed on to consumers through lower premiums. Table 5 details the estimates of the cyclone-related costs of the reinsurance pool. The table shows that the current premium pool paid by consumers is around the same size as the premium pool that would be charged if the reinsurance pool was run similar to a commercial entity.

Table 5: Costs and revenue for a commercially-viable reinsurance pool  
\$ millions

<b>Annual cost = required premium pool</b>	<b>423</b>
Net claims costs	52
Reinsurance expense	329
Operating expenses	15
Cost of capital	27
<b>Required premium pool plus private insurer premium revenue to cover the first \$100 million in cyclone damage</b>	<b>558</b>
<b>Current market premium pool for cyclone risk</b>	<b>Around 480</b>
<b>Expected reduction in cyclone component of premium</b>	<b>increase of 10-20%</b>
<b>Expected reduction in total premiums (cyclone plus non-cyclone)</b>	<b>increase of 5-10%</b>

Notes: Net claims costs have been estimated using cyclone catastrophe models and are equal to the yearly average of claims over the long run less the yearly average amount that is expected to be received back over the long run from reinsurance. Advice was sought from Finity Consulting about the magnitude of the other costs. More details on how these costs are estimated is included in the report from Finity Consulting at Appendix C.  
Sources: AGA, Finity Consulting

**Modelling results indicate that the Government would need to provide a subsidy and use its balance sheet in order for a cyclone reinsurance pool to reduce consumer premiums.**

#### 4.2.2 Could consumer premiums be reduced if a cyclone reinsurance pool was supported by a Government guarantee?

The costs of the reinsurance pool could be lowered by the Government providing an implicit subsidy through a Government guarantee at below its full commercial value. The costs to Government have been estimated on the assumption that the reinsurance pool does not purchase reinsurance (retrocession) to cover its risk. Options regarding retrocession are discussed below.

The commissioned modelling indicates that a partially funded scheme, in which the reinsurance pool charges a price to cover the expected long run cost of claims and operating costs (Scenario 2), would generate a reduction in total consumer premiums (that is, the sum of the cyclone and non-cyclone insurance premiums) by 10-15 per cent on average across northern Australia (Table 6).

Table 6: Costs and revenue for a partially funded reinsurance pool  
\$ millions

<b>Annual cost = required premium pool</b>	<b>228</b>
Average claims each year over the long run	213
Operating expenses	15
<b>Required premium pool plus private insurer premium revenue to cover the first \$100 million in cyclone damage</b>	<b>363</b>
<b>Current market premium pool for cyclone risk</b>	<b>Around 480</b>
<b>Expected reduction in cyclone component of premium</b>	<b>20-30%</b>
<b>Expected reduction in total premiums (cyclone plus non-cyclone)</b>	<b>10-15%</b>

Sources: AGA, Finity Consulting

Assuming there are no Government outlays to establish the reinsurance pool, the scheme would have no immediate budget impact, and it is possible that there would be no call on the Government guarantee over the life of the arrangement. But the Government would be taking significant risk onto its balance sheet without receiving a fee. In the first year, it is estimated there is around a 20 per cent chance that the Government guarantee would be triggered, although this probability falls over the life of the scheme. There is up to a 5 per cent chance that the payment under the guarantee would be greater than \$2 billion. Over a 10-year period, there is a 50-60 per cent chance the guarantee would be called on at least once and 10-20 per cent chance that the total value of calls would be over \$2 billion.

If the scheme is closed at the end of 10 years, the modelling suggests that over the life of the scheme there is a 30-40 per cent chance that the scheme would have lost money (that is, paid out a greater amount of claims than received in premium revenue, with the difference met through the Government guarantee). It is estimated that the chance of a loss above \$5 billion is 5-10 per cent.

One of the scenarios modelled (Scenario 3) has the target of achieving a reduction in premiums of 30 per cent on average across northern Australia (around double the estimate of the reduction in premiums achieved by the partially funded scheme). Achieving a larger reduction in premiums involves a greater potential cost to the Government. The probability that the Government guarantee would be called on over 10 years is high, at around

90 per cent. The probability that this scheme would lose money over a 10 year period is 80-90 per cent, and the probability that the loss will be greater than \$5 billion is 30-40 per cent.

**Table 7: Costs and revenue for a 30 per cent premium reduction reinsurance pool**  
\$ millions

Required reduction in total premiums (cyclone plus non-cyclone)	30%
Implied annual premium pool	46
Average annual cost of scheme over the long run	213

Sources: AGA, Finity Consulting

As for the mutual, the total premium reduction that can be generated by creating a cyclone reinsurance pool is capped by the extent to which cyclone risk is a component of insurance premiums. If the reinsurance pool charged no premiums at all for cyclone reinsurance (as per Scenario 4), the maximum reduction in consumer premiums on average across northern Australia is estimated to be 30-40 per cent. However, the risk of the Government guarantee being called on is very high. It is estimated that the probability of the guarantee being called on in the first *four* years of the scheme is 90-100 per cent and the probability of the calls totalling more than \$2 billion over 10 years is 40-50 per cent. At the end of a 10-year scheme, the chance that the scheme would have cost the Government more than \$5 billion is estimated to be 10-20 per cent.

#### 4.2.3 Using reinsurance to lower the cost to Government

The partially funded and 30 per cent reduction scenarios above estimate the cost to the Government if the cyclone reinsurance pool did not purchase retrocession (reinsurance for reinsurers), but instead pooled all funds in the scheme. The reinsurance pool could purchase retrocession to reduce the extreme risks faced by Government although it would raise the likely cost of the scheme. For example, if the reinsurance pool in Scenario 2 were to purchase retrocession cover for losses above \$1 billion up to \$2 billion, the overall costs of the reinsurance pool would rise by around \$90 million per year due to the need to pay the retrocession costs. Due to the retrocession, the probability of the Government losing more than \$5 billion over the life of the scheme would fall from around 5 per cent to 2 per cent. However, the probability of the guarantee being called on during the 10-year period would increase from 50-60 per cent to 70-80 per cent.

As explained earlier, it appears counterintuitive that the probability of a call on the Government guarantee would rise due to the purchase of reinsurance or retrocession. However, the reinsurance pool would have to pay for the retrocession and so the pool of reserves available to meet claims would build up more slowly. With a smaller pool of reserves, it is more likely that the Government guarantee would be called on to enable the reinsurance pool to pay the retained loss (around \$200 million per event) before the retrocession could be claimed on.

#### 4.2.4 Capping payouts by the reinsurance pool

As for the mutual, some stakeholders have proposed that payments under the scheme could be capped in a way that would lower premiums but also manage the risk to the Government. The Taskforce has considered the implications of capping the payments at \$30,000 per dwelling. Based on analysis of claims with Suncorp following Cyclone Yasi, this level is expected to cover a high proportion of claims from most events.

The modelling suggests that capping the payments at this level could not provide a significant reduction in premiums. The premium reduction for a reinsurance pool that offered a capped \$30,000 payment was estimated at around half the reduction in premiums of an uncapped scheme. Further, it was found that this did not noticeably reduce the risk to the Government.

#### 4.2.5 Individual reductions in premiums

The above estimates describe the average reduction in premiums that could be achieved across northern Australia. The actual reduction experienced by each policyholder will vary significantly. As explained for the mutual, one cause of variation is that the scheme works to reduce the *cyclone* component of premiums. Those individual with high cyclone risk should therefore receive the largest discounts. An example of the distribution of reductions across households is provided by Finity Consulting in their report (Appendix C).

Another source of variation exists for the reinsurance pool compared to the mutual. The reinsurance pool relies on the insurer to assess to what degree the lower reinsurance costs apply to each dwelling. Different insurers will allocate costs of reinsurance across dwellings differently depending on their assessment of the relative risk of those properties. Thus, across different insurers the reinsurance pool may generate a different discount for the same household.

Table 8: Summary of estimated premium impact and cost to Government from a reinsurance pool

	Partially funded scheme	30% premium reduction scheme	Partially funded scheme with reinsurance
<b>Potential Premium Reduction</b>	<b>10-15%</b>	<b>30%</b>	<b>10-15%</b>
<b>PROBABILITY OF ...</b>			
... a payment under guarantee in first year	10-20%	20-30%	20-30%
... paying more than \$2 billion in first year	UP TO 5%	UP TO 5%	UP TO 5%
... a payment under the guarantee over 4 years	30-40%	60-70%	50-60%
... paying more than \$2 billion over 4 years	5-10%	10-20%	UP TO 5%
... a payment under the guarantee over 10 years	50-60%	AROUND 90%	70-80%
... paying more than \$2 billion over 10 years	10-20%	AROUND 40%	10-20%
... the Government recouping all payments under the guarantee at end of 10-year scheme	60-70%	10-20%	40-50%
... unrecovered losses at end of 10-year scheme	30-40%	80-90%	50-60%
... unrecovered losses could exceed \$5 billion at end of 10-year scheme	5-10%	10-20%	UP TO 5%

Source: AGA and Finity Consulting



### 4.3 Criteria 3 and 4: effect on insurance and reinsurance markets and the potential for Government exit

The third criterion under which the options are to be assessed is the potential effect on the operation of the insurance and reinsurance markets, particularly the effect on competition, and the fourth criterion is how the role of government can be gradually reduced over time.

Some stakeholders have expressed support for the reinsurance pool, arguing that it would encourage new entrants into the northern Australia insurance market. Increasing participation should enable greater competition for both cyclone and non-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. Allianz*

If the scheme purchases no reinsurance, there may be a reduction in premium revenue for the reinsurance industry. However, cyclone risk forms a relatively small component of the total risks faced by the Australian insurance industry. Hence, although the scheme is likely to add complexity, it is unlikely to cause the exit of reinsurers from the industry. In contrast, if the scheme purchased retrocession cover for the cyclone risk it held, stakeholder feedback suggests that the impact of a cyclone reinsurance pool on the reinsurance market may actually be to increase the volume of reinsurance purchased.

*By removing cyclone risk from the insurer's portfolios, this will reduce the diversification impact the latter benefit from when purchasing reinsurance, with the net effect of increasing the reinsurance spend per unit of risk for insurers. Swiss Re*

Other stakeholders have commented on the increased costs associated with introducing another entity to the marketplace. Increased costs for insurers could arise if the definition of cyclone was uncertain and insurers were required to buy reinsurance that overlapped with the reinsurance offered by the scheme. Insurers would also have to provide information to an additional reinsurer.

*Complexities of coverage, frictional and administrative costs are likely to be introduced. ICA*

However, other stakeholders suggest that these costs are manageable and should not add significantly to total costs.

*[T]here 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. Allianz*

The reinsurance pool may take some time to have an impact on prices. Several issues have been raised by stakeholders. The first is that insurers would need to renegotiate different catastrophe contracts with their current private sector reinsurers to exclude cyclone risk from those contracts. Estimates of how long this could take vary from a few months (if it is possible to renegotiate mid-term) or a few years for those insurers with locked-in arrangements.

A second issue is that insurers have indicated that the cost reduction that they experience may be less than implied based on the full removal of cyclone risks. Insurers benefit from diversification across a range of risks in the price that they pay for reinsurance. Thus, they may not be able to reduce premiums by as much as has been estimated.

The ICA is concerned that the expectations that government may have of insurers, may not equate to the cost of operating the scheme. Segregation of cyclone risks from other natural perils could reduce the scope of premium relief. *ICA*

Depending on the model adopted by the Commonwealth, a cyclone mutual or reinsurance pool will reduce the level of income earned by insurers without the proportionate reduction in associated costs. Frictional and claims costs cannot reduce by the same proportion as premiums, resulting in a higher retained cost ratio for insurers. *Swiss Re*

Other stakeholders have indicated that it will not be transparent how much of the reduction in premiums is passed on by insurers. To address such concerns, a mechanism to monitor pass through to consumer premiums may be required, such as asking the Australian Competition and Consumer Commission to review pass through after a specific period (as after the removal of the Fire Services Levy in Victoria).

The potential for Government exit from this scheme is problematic. There is a mechanism to slowly reduce support to the scheme and, if the scheme did not have an adverse impact on the capacity of the reinsurance industry, the private sector should return to providing cyclone reinsurance. The mechanism to withdraw support would be to gradually raise the retention level of insurers or require insurers to share an increasing proportion of the claims (through a cost sharing arrangement). Insurers would turn to the private market to manage these risks. Insurers have noted that a gradual reduction would be important for managing their own costs of returning to the private market to purchase cyclone reinsurance. However, overseas experience suggests it is difficult for a government to withdraw from any arrangement providing subsidised insurance.

## 5. MITIGATION OF CYCLONE DAMAGE

Insurance premiums, in large part, are a function of the expected cost of claims. Stakeholders have emphasised that the way to reduce insurance premiums on a sustained basis is to reduce the level of expected claims. In the case of cyclones, this means either reducing the exposure of properties to cyclone activity or making buildings less vulnerable to damage from cyclones.

[M]itigation strategies should be encouraged wherever and whenever possible. Any government intervention must be directed to ensuring homeowners and communities in regions affected by cyclones and other extreme weather events mitigate their risks.  
*Financial Rights Legal Centre*

[T]he only sustainable approach to premium reduction is to mitigate the underlying risks. *ICA*

### 5.1 Benefits and challenges of cyclone mitigation

Mitigation will generally be undertaken if the benefits of such action exceed the costs. There has been some recent research testing the benefits and costs associated with specific cyclone mitigation measures, particularly in reducing the vulnerability of older properties to cyclone damage (Urbis 2015). The research indicates that there can be a high ratio of benefit to costs associated with certain forms of mitigation, depending on the type of house and the expected level of cyclone activity.

The costs associated with cyclone mitigation are generally fairly easy to measure. These represent the additional building costs associated with either strengthened building standards for new properties or the costs of undertaking measures to individually strengthen existing properties. These costs will be borne by the property owner. There is also the potential for governments to undertake public works to mitigate cyclone damage — primarily in flood-prone areas.

The benefits are more diverse and spread across a number of parties:

- A key benefit is the reduction in potential damage to a property. Reducing the vulnerability of a property to cyclone damage benefits insurance companies to the extent it results in lower claims payments following an event. For the property owner, it should lead to lower insurance premiums as well as increasing the value of the property. To the extent that buildings are underinsured (or not insured), financial hardship following a catastrophe should be reduced.
- The benefits of mitigation are much wider than reducing the likelihood of insurance claims. Property owners benefit to the extent that less vulnerable properties are associated with reduced chance of physical injury, as well as reduced emotional trauma that is associated with individuals experiencing significant damage to their home and contents.
- The broader community benefits from measures that reduce the vulnerability of a particular property to damage. For example, the debris from one property losing its roof can cause significant damage to other properties, as can unsecured items in a person's yard.

- Governments, particularly at the state and local levels, may benefit from less strain on emergency services after an event and through the creation of safer, more resilient, communities. However, the Commonwealth Government is likely to see limited benefits in terms of reduced Natural Disaster Relief and Recovery Arrangement payments from the mitigation of private property because these payments are primarily directed at fixing public infrastructure (not private property) after a disaster.

Despite the benefits of mitigation flowing to a broad range of parties, the costs generally rest with a single party, the property owner. Property owners may only undertake mitigation if the benefits that directly flow to them outweigh the costs. If households do not perceive mitigation to be sufficiently beneficial, this can result in an underinvestment in mitigation to the detriment of all parties.

Some of the key elements in encouraging mitigation include:

- reducing the cost of making buildings less vulnerable to cyclone damage;
- enabling more of the benefits of mitigation to flow directly to property owners, for example, through lower insurance premiums; and
- ensuring property owners fully appreciate all the benefits, both financial and non-financial, associated with mitigation and are better empowered to take necessary action.

What motivates people to undertake mitigation is complex and varies among individuals and communities:

These motivators will differ between individuals and communities based on their level of experience with extreme weather events, perceptions of risk and responsibility, connectedness and trust towards others and the availability of assistance and resources. *CTS*

A 'one-size-fits-all' approach to motivating people to undertake mitigation is not appropriate. Individuals' needs and circumstances are different and they are motivated by different incentives. To be effective in changing behaviour, any mitigation program needs to improve the information available to households about the resilience of their dwellings, increase their knowledge of what can be done, increase the options as to what they can do and provide incentives to take action. That is, a multipronged approach to change is required.

**Cyclone mitigation actions are shown to have positive benefit cost ratios. However, motivating property owners to undertake mitigation is complex and a multipronged approach is required.**

## 5.2 Reducing the vulnerability of buildings to cyclone damage

Effective ways to reduce the vulnerability of buildings to cyclone damage is for development to take place in areas of reduced exposure to cyclones, including the risk of flooding, and for buildings to be built to a standard that reflects the potential risk. The first involves appropriate land-use planning and the second requires appropriate building standards.

Building standards in Australia are determined by the *National Construction Code* (referred to as 'building standards'). They are set at the national level by the Australian Building Codes Board. Building standards have evolved over time and now provide a higher quality of construction than in the past. Building standards apply to new construction, but they do not require existing properties to be brought into line with the changes.

Building standards with respect to wind were significantly strengthened between 1975 and 1984 following the devastation to buildings caused by Cyclone Tracy (the precise date varies between jurisdictions as building standards were not set nationally at the time). In particular, the changes significantly improved the construction processes that attach the roof to the rest of the house.

Research commissioned by the Taskforce indicates there are around 300,000 residential buildings in northern Australia that are located in cyclone-prone areas.<sup>5</sup> The majority (70 per cent) of this stock is located in northern Queensland. This research suggests that around 40-50 per cent of the residential property stock in northern Queensland is not built in compliance with modern building standards. This is supported by analysis of claims data following Cyclone Yasi (Smith and Henderson, 2015a). Given a large proportion of the residential building stock in Darwin was replaced following Cyclone Tracy, it is expected that a very high proportion of the stock in Darwin would be compliant with modern building standards. This is also consistent with feedback that the Taskforce has received from insurers. Estimates of the proportion of residential buildings built in accordance with modern building standards in northern Western Australia were not available.

**Available data indicate that a significant proportion of houses in northern Australia were built before building standards were strengthened. The largest stock is in northern Queensland.**

A barrier to undertaking mitigation work on housing has been a lack of information about what actions will work to reduce the risk of cyclone damage. In recent years, industry has funded research by the CTS to identify effective mitigation measures. These studies suggest three areas where mitigation can be cost effective.

### 5.2.1 Roof strengthening for older properties

The roof is a key area of vulnerability during a cyclone. Analysis of Cyclone Yasi claims data shows that roof failures are associated with moderate or severe damage to properties. Roof failures were four times more likely to occur in pre-1980 houses than post-1980 houses (Boughton 2011).

The CTS focused on two approaches to strengthen the roof of an older property. The first involves replacing the existing cladding (covering) and strengthening the connections between the battens, rafters and top-plate connections (using screws and strapping). The net effect of this approach will bring the roof up to modern building standards. This is estimated to cost in the range of \$30,000 to \$53,200 (Smith and Henderson 2015b).

---

5 This includes both house and strata buildings (including investment properties).

The second approach is referred to as over-batten installation. This involves a piece of re-enforced steel that sits across the roof cladding on the exterior of the roof anchored by tie rods that run down the side of the house. This is estimated to cost between \$11,000 and \$17,000 (Smith and Henderson 2015b). Figure 10 provides an illustration of over-batten installation. The Suncorp submission indicated concerns about the aesthetics of over-batten installation noting that while less expensive than other options '[r]esilience solutions such as over-battens, while effective, can be unsightly'. This can detract from the appeal of the measure to property owners.

**Figure 10: Over-batten installation**



Source: Smith and Henderson 2015b

### **5.2.2 Protecting windows and doors**

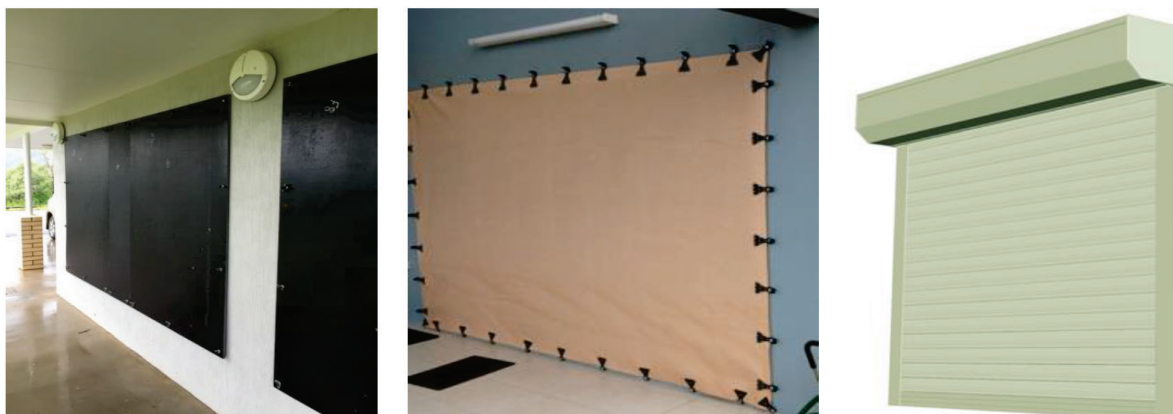
Damage to windows and doors can result in substantial water damage to a property. In addition, an opening in the building structure during a cyclone will increase the pressure on the roof making roof failure more likely.

Various options for opening protection have been identified. During Cyclone Yasi, there was extensive damage recorded to garage doors in the affected region (Boughton 2011). This resulted in a change to the standards covering new garage doors to improve their wind resilience. However, there is still the existing stock of garage doors that are not up to this standard. The cost to bring garage doors to the new standard is estimated to be around \$300 per door (Smith and Henderson 2015b).

In terms of window protection, there is a range of shutters and other covers that are available that can either be permanently affixed to the window or temporarily installed in advance of a cyclone. The estimated cost of window protection for a house ranges from \$1,360 for temporary plywood shutters to \$3,200 for commercial window protection (Smith and Henderson 2015b). These are illustrated in Figure 11.



**Figure 11: DIY and commercial window coverings**



Source: Smith and Henderson 2015b

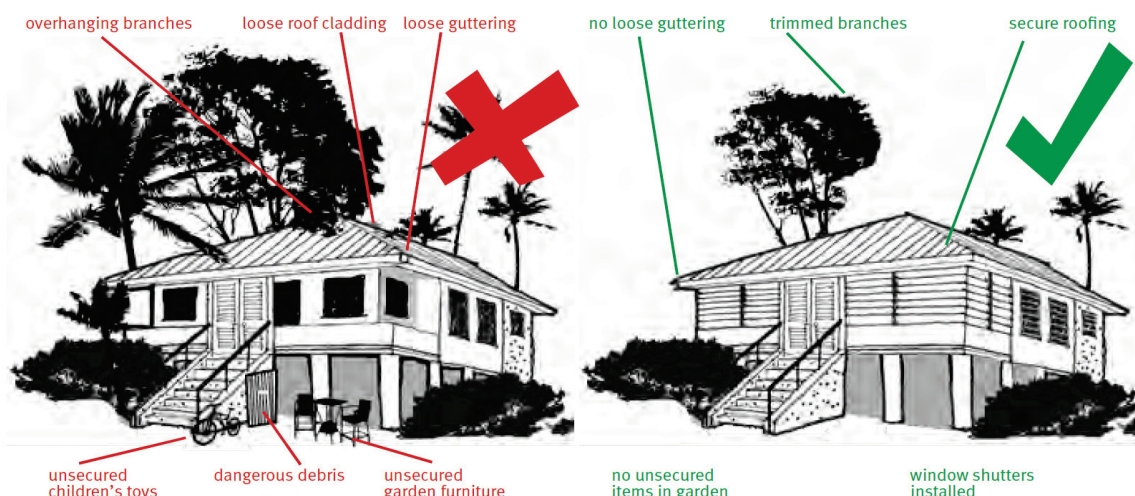
Increasing the resilience of doors would also increase the overall resilience of the house. For doors that swing open, the single door lock in the centre of the door (between floor and ceiling) may not be strong enough to keep the door closed against very strong winds. The gap at the base of the door is also an area where water can penetrate the house. Doors can be reinforced by spreading the load using bolts or braces. For sliding doors and windows, the strength of the bolts holding the door into the wall and the seal around the doors are areas of weakness that can be improved with reinforcement and maintenance.

### 5.2.3 Preparing the outside of buildings for cyclones

Research indicates that the benefit from relatively low cost community awareness campaigns can be high if they result in property owners better preparing their property for a cyclone (Urbis 2015).

There are a range of activities all property owners should undertake to better prepare for a cyclone which would reduce the prospect of some damage. These include trimming branches, cleaning gutters, securing outdoor items, removing sail shades, securing sheds and standard property maintenance. These actions are outlined in Figure 12.

**Figure 12: Disaster preparedness activities**



Source: Queensland Reconstruction Authority



**Effective ways to reduce the vulnerability of property to cyclone damage include: 1) roof strengthening; 2) protecting windows and doors, and 3) preparing the outside of the house.**

## **5.3 Options to reduce the vulnerability of houses in northern Australia**

### **5.3.1 Strengthen building standards**

Improvements in building standards have played a major role in reducing the vulnerability of buildings to cyclones. Research by Macquarie University found that ‘the improved building standards have been enormously successful, with our calculations suggesting that they have been responsible for reducing annual average cyclone-related losses by nearly two thirds’. Macquarie University estimated that this equates to a present value benefit of future loss reductions equalling \$14.2 billion (Australian Building Codes Board 2014). Consistent with this, analysis of the claims data following Cyclone Yasi shows that buildings constructed before 1980 were more likely to lodge a claim, and that claim was more likely to be for severe damage (Smith and Henderson 2015a).

Despite these findings, numerous submissions to the interim report, particularly from insurers, argued for these standards to be raised. The main objectives of current building standards relate to health and safety and not to reducing damage to the building per se. Insurers suggest that there was potential for building standards to be more focused on reducing damage to the building.

A further strengthening of modern building standards would add to building costs in northern Australia. The cost of construction is already higher than in other parts of the country. However, a particular area where building standards could be strengthened is to reduce the vulnerability of properties to damage from water ingress during a cyclone. That is, to reduce water entering the property around windows and other openings during high winds.

Research indicates that even modern properties are susceptible to significant damage from water ingress (Smith and Henderson 2015a). Measures targeted at reducing potential damage from water ingress could potentially lower insurance premiums across a wide range of properties.

**Wind driven rain water ingress damage has been demonstrated from CTS damage surveys and reports based on insurer data to be a considerable driver of loss in terms of interior damage to housing and strata properties ... CTS**

Other benefits would also flow from stronger windows and doors. Reducing the risk of water ingress during a cyclone has the potential to reduce the strain on emergency services during the event. It could also reduce distress, as owners could more confidently seek shelter away from windows and doors rather than trying to protect property.

Besides the impact on cost, another barrier to strengthening standards is information about options to strengthen windows and doors and the appropriateness of commercial products. There is scope for further research targeted at creating more affordable and visually pleasing products to strengthen windows and doors. The cost of funding such research is estimated to be \$0.5 million.

**Water ingress can be a significant driver of damage during a cyclone even for modern properties. Building codes could be updated to further strengthen doors and windows against water damage.**

### 5.3.2 Better retrofits

As noted previously, there is a large stock of properties in northern Australia (particularly northern Queensland) that were not built in accordance with current standards. For these properties, strengthening the structure, particularly the roof, may be needed to bring these properties up to the current standard. Further, regardless of construction date, there is the potential for retrofits to provide better protections for openings.

A barrier to retrofits is the cost and the fact that some options are considered 'ugly' and could lower the value of the property for sale, despite the increase in safety. Further research could identify more cost-effective and visually attractive mitigation options for properties, particularly in strengthening roofs.

[T]here is no easily accessible, publicly available, aesthetically appropriate upgrade measures that can be used as a deemed-to-satisfy solution ...<sup>6</sup> CTS

Some research in this area is already underway through the Bushfire and Natural Hazards CRC research program. The primary objective of this research is to develop cost-effective strategies for mitigating damage to housing from severe windstorms across Australia. Outputs from this project will target a range of users from policy development through to homeowners and builders on recommended actions to improve resilience of existing housing. This research could be accelerated with additional funding.

Another barrier to mitigation work is that households do not have knowledge of which particular retrofits are needed on their property. To fill this void, tools for households to assess the quality of different aspects of their dwellings (such as the roof, windows, doors) and identify appropriate retrofit options would assist (see discussion below on resilience tools).

A key aspect in encouraging mitigation is the recognition of such action in insurance premiums. This is discussed in further detail below.

**Further research could identify more cost-effective, aesthetically acceptable mitigation options to reduce the vulnerability of properties to cyclone damage.**

6 'Deemed-to-satisfy' in this context means a solution that is deemed to satisfy the current building standards.

### 5.3.3 Government public works and land-use planning

Governments play a key role in protecting communities from the dangers posed by natural disasters. This is done through a variety of means including public works spending and land use planning. For example, the construction of a flood levee or the creation of a fire break can be effective at reducing the risk exposure of existing properties to flood or bushfire risk.

Wind-related damage makes up the majority of the property damage from a cyclone. Unlike other forms of natural disasters, governments have limited ability to reduce the exposure of existing properties to wind damage through public works. The construction of a cyclone shelter by a local government will be effective at saving lives during the event; however, it will not assist in mitigating damage done to properties.

In contrast, public works spending on water management/flood protection will have flow on benefits in terms of reducing property damage during a cyclone to the extent that there is also cyclone-related flooding and storm surge. Governments can also reduce the risk exposure for new construction through identification of and land use planning around flood-prone areas. Some regional councils in northern Australia are taking action in this regard. For example, the Cairns Regional Council has funded \$9.5 million in flood mitigation work through the construction of a detention basin and downstream levees and is limiting development in high storm-surge risk areas. There is the potential for further work of this nature to assist in reducing cyclone-related property damage.

Such mitigation actions should be recognised in insurance prices. Local councils that undertake mitigation work to reduce their flood and storm surge risks should share this information with insurance companies through initiatives like the Property Resilience and Exposure Program.<sup>7</sup> Better communication between councils and insurance companies (and vice versa) will help ensure that the benefits of public mitigation work flow through to lower premiums for local residents.

Councils have indicated that further funding would allow them to increase their mitigation activities. Additional funding from the Australian Government would be most effectively managed through existing state/territory programs, for example through the Community Resilience Fund in Queensland. Funding criteria could be established so that projects must have a suitable benefit cost ratio and would assist in lowering insurance premiums for residents in cyclone-prone areas.

**Government public works spending and effective land use planning can reduce cyclone property damage in flood-prone areas, but is not effective against wind damage.**

---

<sup>7</sup> The Property Resilience and Exposure Program is operated by the ICA and provides local governments and the insurance industry with more robust information on the resilience of housing stock. Local governments can use the Program as a mechanism to engage with the insurance industry on the issue of insurance affordability, where the primary driver may be poor quality hazard data or lack of information on development controls and existing buildings.

### 5.3.4 Making insurance premiums more responsive to mitigation

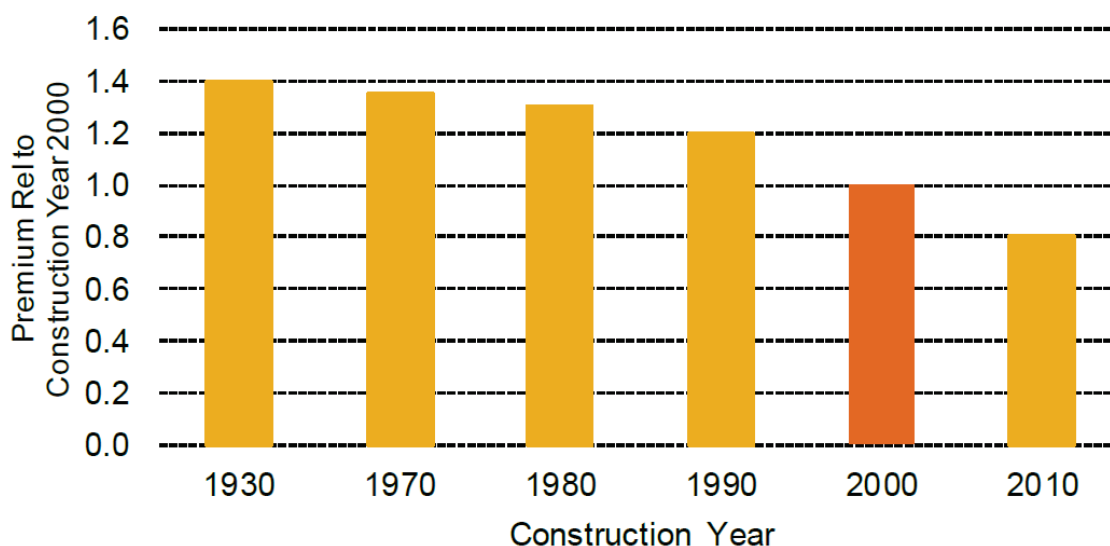
Numerous submissions highlighted that in order to motivate people to undertake mitigation it would be essential that insurers pass the prospect of reduced claims costs through to property owners in the form of lower premiums.

I believe in mitigation so long as it gets recognised by insurance companies through a reduction in premiums. *Margaret Shaw*

Homeowners will only be incentivised to undertake mitigation projects on their own properties if there is a corresponding reduction in premiums. *Financial Rights Legal Centre*

In general, insurance premiums have been responsive to changes in building standards. Insurance premiums for properties built after 1980, when new building standards were introduced, are lower than those for older buildings (Figure 13). Newer properties are also likely to obtain lower premiums because of improvements in construction materials and because newer properties are likely to be in better condition than older ones (as a result of deterioration from the passage of time).

**Figure 13: Premiums relative to building construction year**



Note: Based on \$350,000 sum insured in Townsville  
Source: Finity Consulting

Insurance premiums appear far less responsive to mitigation action undertaken to the property since the date of construction. This is because insurance companies may need to be satisfied that the mitigation action will reduce the vulnerability of the property to damage, and in turn the risk of insurance claims, before they will reduce premiums.

One barrier indicated by insurance companies is that the efficacy of mitigation is difficult to measure without being able to see how the buildings withstand a cyclone event, which are infrequent for any single location. However, valuable information on the effectiveness of mitigation measures can be gained by testing combinations of structures in wind tunnels.

A second barrier relates to the way in which insurers capture information about the vulnerability of individual properties, including what mitigation work has been undertaken post construction. Insurers are starting to develop more comprehensive systems to capture this information. For example, Suncorp is developing a 'resilience rating system' for properties. This system will ask customers questions about mitigation work they have undertaken to determine their buildings resilience rating, which feeds into the insurance quote. Suncorp expects premiums to be reduced by up to 20 per cent for buildings with strong resilience ratings. While only one insurer is currently developing a rating system to recognise mitigation, once it is established competitive forces should encourage other insurers to introduce similar systems to retain customers that are good risks. Competition will likely drive similar innovations by other insurers. The introduction of resilience ratings for individual properties by insurers will help to raise awareness among policyholders by specifically identifying how types of mitigation work can result in reducing premiums. A visible link between how certain mitigation action can result in lower premiums, which is currently not available, could be a significant step in encouraging greater mitigation efforts. Resilience rating tools are discussed further below.

The Suncorp system relies on a self-assessment by consumers regarding their mitigation efforts. Some insurers have indicated that verification that the mitigation work has been adequately undertaken may be required before it could be reflected in premiums. Further, some property owners may not be aware of what mitigation work that has been undertaken (for example, roof upgrades that are not visible). Various assessment schemes have been proposed as a way around these constraints.

Insurers have indicated that individual inspections of houses by insurance companies would be costly given the time required for an inspection and this would raise insurance premiums. Some submissions have suggested that government, either the Commonwealth or state governments, could develop and fund an inspection and verification program for houses in northern Australia. Such a scheme would also be costly and it would be appropriate to first explore less costly options. For example, developing more online systems and tools could support households self-identifying mitigation work, such as what roof strengthening work has been undertaken to their property and what additional work may be appropriate. Another approach would be for insurance companies to work with local councils to identify a range of people, such as licenced builders and tradesmen, who could assist consumers in verifying mitigation action taken. Governments could also assist by more clearly indicating mitigation work on existing building work certification forms to enable mitigation to be more readily recognised in the insurer's resilience rating system.

**Insurance premiums must be more responsive to mitigation undertaken to the property since construction in order to motivate households to undertake further mitigation activity.**

### 5.3.5 Property owners share more of the risk

Better prepared properties can lower the risk of cyclone damage. Local council and emergency services representatives indicate that some households prepare extensively, but it is not universal. Yet if the majority of property owners better prepared for a cyclone, this could result in a significant reduction in insurance claims, particularly from less severe cyclones. Lower insurance losses should flow through to reduced premiums, but insurance companies are unlikely to take into account good preparation by property owners when setting premiums. Preparation is difficult to assess or guarantee in advance of a cyclone.

If, however, property owners were confident that they could reduce the vulnerability of their property to cyclone damage, they may be prepared to take a higher excess in their policy (that is the amount the property owner must pay before making a claim) if this resulted in lower premiums. The ICA submission indicates the median excess for home buildings in cyclone areas is around \$500, which is not significantly different from the level of excess in non-cyclone areas. ICA estimates indicate that increasing the level of excess has the potential to substantially decrease premiums. For example, increasing the level of excess from \$500 to \$3,000 can reduce premiums by around 30 per cent.

A number of submissions cited examples of policyholders electing to increase their excess to manage the rise in their premiums. However, as noted, very few policyholders in north Queensland are taking out large excess arrangements in order to reduce premiums.

**Residents are not selecting higher excesses that can significantly compress premiums, indicating that they are either accommodating the higher premium required and/or aware that they have significant exposure to natural perils and understand that they may need to make more frequent claims. ICA**

Under current arrangements, increasing the excess on a home and contents policy will not only transfer more of the risk of damage from a cyclone to the policyholder, but also the risk of any damage to their property from non-cyclone events (for example, damage from fire or theft). There is currently no capacity for policyholders to opt for a higher excess only for cyclone damage in order to reduce their premiums. A range of approaches have been suggested which could allow policyholders to accept higher risks of cyclone damage in return for lower premiums. These include:

- Exclude certain items from cover under the insurance policy. Excluded items could include shade sails (which can be removed before a cyclone), garden sheds and outdoor structures (which can be firmly secured) and garden furniture (which can be moved inside or put in a pool). Excluding these items could reduce small claims for cyclones, which are shown to make up a large proportion of claims (Smith and Henderson 2015a), without raising the excess payable for damage to the house itself.
- Introduce 'named cyclone' or 'peril' excesses. These would be higher than the excess for damage from non-cyclone events (such as fire or theft). The definition of cyclone could be similar to the one proposed in this report, but it would be important to ensure that consumers understood the implications of taking out a higher cyclone excess. Cyclone excesses are already used in strata insurance.



- Introduce 'no-claims bonuses' for building insurance as a means by which insurers could reward customers that do not make a claim in a period. Insurers note that a person's claims history is already taken into consideration when policies are priced. That is, a person with an extensive claims history is more likely to be charged a higher premium than someone with a lower claims history. However, there could be potential to make this link more transparent to policyholders.

Consumers would have more choice and ability to indicate to insurers their level of preparedness if insurers offered a greater range of policy options by which they could obtain lower premiums. Feedback suggests there is support from some consumers for insurance products that enable them to take greater responsibility for mitigating the risk of damage from a cyclone.

I think the exclusions should apply to any insurance policy in a cyclone area. If people don't prepare properly then they shouldn't be covered for lack of preparation.

*Margaret Shaw*

**Insurers need to develop more flexible insurance products that enable property owners to take greater responsibility for protecting their property from cyclone damage in return for premium reductions.**

Some insurance companies have recently taken some steps toward offering alternative home insurance products aimed at reducing premiums. For example, IAG recently released InsureLite, which is a policy that provides more targeted coverage and includes a high threshold before a claim can be made and excludes many outdoor items from cover. This policy is specifically designed to offer a low insurance premium and may suit lower income households or investors.

However, there is the potential for more tailored products to be designed for the broader market that will accommodate greater sharing of cyclone risk between the policyholder and the insurer. This may be advanced if there is more open and frequent communication between property owners/consumer representatives and insurers. The insurance industry has recognised the need to increase communication with households in northern Australia.

QBE acknowledges the concerns expressed by consumers to the Taskforce that they did not understand or were unconvinced by the reasons given for the rapid increase in insurance prices. QBE also accepts that communication by insurers to consumers can be improved to assist consumers better understand natural peril risk, how insurance works and how consumers can take action to mitigate their risk. *QBE*

As part of a mitigation proposal in its submission, the ICA proposed a community briefing by an insurance team that would visit regional centres in north Queensland to hold community information sessions on insurance issues and 'to provide an open and frank opportunity for community members to raise concerns and to receive a response directly from industry representatives'. These sessions would provide an opportunity for consumers to provide feedback on product design and features that they consider desirable as a means of enhancing innovation.



### 5.3.6 Resilience rating tools

There is some information about building resilience available on the internet, but there is scope to improve its accessibility and expand it to include information about potential mitigation action. Information provided to people on how to prepare their property is largely generic in nature (see for example *Wind Resistant Housing* issued by the Queensland Reconstruction Authority). People do not necessarily have the expertise to make an assessment of this information to determine the most effective measures for their property. Information that links assessment and action has the potential to enable and motivate people further, particularly if this can also be more clearly linked to potential benefits from undertaking such work, such as through lower premiums.

Resilience rating tools could tell people about the current resilience of their dwelling and link to steps that could be taken to improve resilience. Online rating tools specifically designed for cyclones are being developed in other jurisdictions. For example, in Florida a mobile phone application called 'Resilient Residence' is being developed that will provide a personalised wind assessment of the user's property including the anticipated losses that would occur during a specified event (such as a category 5 cyclone). The application would also provide retrofit solutions for that home.

The ICA has built a similar application called the Building Resilience Rating Tool. This Tool allows the user to input the building characteristics and outputs a resilience rating for the building for each of a range of hazards (such as flood, cyclone winds, bushfire). A version of this application is currently available for use by builders, but a similar tool may become available in the future for households.

Online resources could be improved by linking resilience to existing retrofit solutions. Existing websites could be enhanced with a generic rating tool to assess buildings and provide information about retrofits (from small to large actions) that could be undertaken to target common issues.

**Property owners need access to information specific to their own circumstances about what retrofits they can make to their property and the benefits of undertaking such work.**

### 5.3.7 Mitigation awareness campaigns

There has been significant investment in cyclone awareness campaigns, particularly in Queensland following the natural disasters in 2011. For example, the Queensland Government's *Get Ready Queensland* provides \$2 million per annum in total funding to local councils to improve community awareness. The focus of many community awareness programs is instructing people how to protect themselves and their families by being aware of warning systems and evacuation areas. Households are also given information about preparing their yards to reduce damage. Feedback from local councils is that local people widely attend these sessions and many local residents undertake preparation for cyclones.

Nonetheless, there is potential for programs aimed at helping owners take steps to increase the resilience of homes (above preparing ahead of a cyclone) and to strengthen the links between mitigation and insurance. These sessions should also emphasise the non-financial benefits of people taking action to strengthen their properties in terms of promoting safer families and communities.

A regional 'cyclone expo' is one approach that could bring the public together with researchers, builders, manufacturers of building products (such as shutters) and the insurance industry. The goal of such an expo would be to better inform consumers about the measures they can take to reduce the vulnerability of their properties to cyclone damage and how this might be recognised in their insurance policies, including premiums. Providing consumers with more information about what could be available would be a catalyst for insurance companies to offer a wider range of insurance policies. An expo would also provide an avenue for companies to explain the resilience ratings schemes they use in setting premiums as well as an opportunity for them to receive feedback from property owners. Product manufacturers could also engage with property owners about options they can take to strengthen their homes and receive feedback about products. The cost of running an expo is estimated to be around \$50,000 per event. It would be necessary to hold events in numerous locations across northern Australia.

An advantage of such an expo compared with the information sessions proposed by the ICA is that they would involve a wider range of people, and being organised by a third party, may be more acceptable to consumers. They may also attract a different cohort of people to the existing cyclone awareness days by focusing on the link with insurance premiums.

**Public cyclone awareness measures could be enhanced through regional expos that focus on mitigation actions and the link to insurance premiums.**

### 5.3.8 Directly subsidising mitigation

Even with recognition in premiums and full appreciation of the benefits of mitigation, property owners may still have insufficient financial resources to fund the required work. A number of submissions called for the Government to directly subsidise some of the cost of mitigation:

While there is a strong return on investment for activities such as the installation of roof strapping, these benefits may not be fully realised for many years if a damaging cyclone does not occur in the area. To overcome this barrier, Suncorp advocates for government investment in a large-scale retrofit subsidy program ... *Suncorp*

If home owners simply look at the cost of doing the work and the premium reduction that they could get, they will never do it. A sweetener — e.g. government funding or zero interest loans for mitigation ... may be required to start a cultural shift. *CTS*

There are international precedents for governments to subsidise direct mitigation action by households. For example, the *Coastal Retrofit Mississippi* project provides grant funding for up to 90 per cent of the retrofit costs per house and the *My Safe Florida Home* project provides free house assessments and the ability to apply for \$5,000 grants to retrofit homes. These programs are often coupled with legislated insurance price reductions to ensure premiums respond.

The likely cost of any scheme to subsidise mitigation would vary substantially depending on the design chosen. By way of example, the estimated cost of a scheme that targeted older properties in northern Queensland to strengthen their roofs would be around \$1 billion without income testing and \$500 million with income testing. Such a scheme would provide owner occupiers with grants of up to \$10,000 to assist in funding mitigation. The Government could elect to fund less substantial mitigation actions, such as window and door protection, as a means of reducing the cost to Government.

In response to the interim report, both the ICA and IAG provided outlines for how the Government could directly subsidise mitigation. Both schemes would only apply to properties in northern Queensland. The key characteristics of each scheme are outlined in the Table 9.

**Table 9: Summary of mitigation subsidy schemes proposed in submissions**

	ICA	IAG
<b>Houses eligible</b>	House must be owner-occupied, built prior to 1980 and currently subject to higher than median insurance prices	House must be owner-occupied and built prior to 1980
<b>Income targeted</b>	Annual household income must be below the following thresholds: <ul style="list-style-type: none"> <li>• individual: \$47,289</li> <li>• couple: \$65,423</li> <li>• couple, one child: \$81,063</li> </ul>	No income targeting
<b>Estimated cost of mitigation</b>	\$15,000	\$12,000
<b>Government subsidy</b>	75 per cent	50 per cent
<b>Number of houses upgraded</b>	27,895	49,000
<b>Number of strata units upgraded</b>	10,781	Not eligible
<b>Life of program</b>	7 years	10 years
<b>Indicative cost</b>	\$555 million*	\$345 million

Notes: \*The ICA Submission states that the cost of the program is \$361.2 million. This figure has been discounted to generate a present value cost over the life of the program. The figure of \$555 million represents the undiscounted cost of the project.

Source: ICA and IAG submissions

In addition to the features outlined in Table 9, the scheme proposed by the ICA also included the Government providing a two-year direct insurance subsidy of 20 per cent to provide immediate premium relief while mitigation work is being undertaken. Neither submission provided an indication of the level of premium reduction that people could expect once the mitigation work has been completed. The ICA scheme did include the establishment of a database that would collate information on the mitigation work completed so that it could be reflected in premiums.

The implementation of a subsidy scheme would likely be costly, particularly if it was targeted at low income property owners facing high insurance premiums and involving specific mitigation actions. Arrangements would be necessary to match information regarding the incomes of households and their insurance payments. In addition, any roof strengthening program would have to be coordinated with local building approval processes. Some of these issues in relation to the ICA proposal are discussed in Box 2.

Developing any government-funded scheme to subsidise work to private property involves risks that governments must carefully manage. In relation to funding mitigation for cyclone damage, the types of issues that should be considered include:

- **Determining the type of work that will be eligible for subsidy:** As outlined above, there is a range of retrofit options. What works best for a property will need to be based on an assessment taking into consideration the construction style, materials used and the current state of those materials. A government sponsored scheme providing funding for just one retrofit measure (such as the ICA scheme, see Box 2) may not be effective. Not all properties may be suitable for the proposed retrofit or there may be more effective options. The visual impact of the proposed retrofit also needs to be considered as it can have an impact on house values. As noted previously, the over-the-batten approach to strengthening roofs, which is the mitigation approach to be subsidised by the Government in the ICA and IAG proposals, has been described as unsightly. Such concerns may be one of the reasons there is currently little demand for this approach. Further research is needed to identify more effective and acceptable mitigation measures.
- **Ability for industry to meet demand:** Retrofitting properties to mitigate cyclone damage would involve builders, engineers and certifiers. Before implementing any program of this nature, governments would need to ensure that the industry has the capacity to scale up to meet the expected increase in demand that will result from the government subsidy. This was one of the concerns in relation to the implementation of the Home Insulation Program (Hanger 2014). In order to help manage this issue, any program would need to be rolled out over an extended period so as to give industry time to adjust.
- **Appropriate regulatory frameworks:** As part of rolling out any mitigation subsidy program, it is critical to ensure that appropriate regulatory frameworks are in place and that the entities responsible for enforcing these frameworks have sufficient resourcing to manage the increase in activity that will flow from the introduction of a government subsidy. Appropriate engagement with regulatory bodies was another key lesson from the Home Insulation Program (Hanger 2014). This is necessary to ensure not only that work done is of sufficient standard but also to protect the health and safety of the people engaged to conduct the work. While builders in Australia are required to be licenced, if any government sponsored retrofitting scheme was introduced, additional training on retrofitting properties may be necessary as many builders will not have experience with this work.

### Box 2: The ICA mitigation scheme

In its submission to the Taskforce, the ICA submitted a detailed proposal for a roof retrofit program in northern Queensland. The proposed scheme is an example of what could be undertaken, although it raises a number of issues that need to be addressed before any such program could be implemented. These include:

- The scheme proposed implementation of an over-batten to all unreinforced pre-1980's roofs. This one-size-fits-all approach may not be effective for all properties. Some roofs may be of insufficient quality for an over-batten approach to be effective, while for others an alternative option may be more cost effective. Stakeholders provided feedback that over-batten retrofits were unpopular as homeowners considered them ugly.
- The proposal involved a Government sponsored mitigation scheme administered through the Australian Tax Office (ATO). In addition to constitutional issues, the ATO would face a number of significant challenges in administering such a program. In particular, the ATO has no experience with building work and does not have access to the information necessary to assess other eligibility criteria (such as the level of insurance premiums paid by policyholders). Furthermore, not all policyholders would lodge income tax returns, making it difficult for the ATO to assess whether they met income eligibility requirements. Other measures would have to be introduced to cover 'non-tax lodgers'.
- The proposal assumes that the administrative costs of the scheme would be 10 per cent of total costs. Feedback from government departments suggests that administrative costs of a bespoke scheme would be significantly higher.

This program serves as a useful example of the required components of such a scheme and has informed the principles for development of a more appropriate scheme.

Regulation of the building industry and occupational health and safety requirements predominately occurs at the state and territory level (though local government also play a role in building approvals). As such, state and territory governments would be best placed to ensure that any mitigation scheme is supported by appropriate regulatory frameworks. Further, states and territories have a comparative advantage in delivering services in disaster areas given their existing responsibility for managing disaster relief payments. The comparative advantage of states and territories (relative to the Commonwealth) in program delivery at the operational level was noted in the Report of the Royal Commission into the Home Insulation Program (Hanger 2014). Consistent with this, states and territories generally have responsibility for implementing mitigation initiatives in their jurisdiction. A recent example is the Community Resilience Fund announced by the Queensland Government as part of its 2015-16 Budget.

**Any government-subsidised mitigation scheme should be targeted at low income households living in high risks areas. Mitigation action should be tailored to the particular property. The scheme should be delivered by state and territory governments.**

## 6. OTHER APPROACHES RAISED BY STAKEHOLDERS

### 6.1 Direct subsidy

Some stakeholders supported the Government making direct payments to policyholders to help them deal with the cost of insurance, but most said any consumer subsidy should be directly linked to taking action on mitigation. The issues associated with the Government subsidising a mitigation program are covered in the previous chapter. However, one submission did propose a selective, targeted and means-tested subsidy on the grounds of social needs arising from high insurance costs from cyclone risk. It was proposed that a subsidy be calculated as a percentage of each household's premium and be delivered either directly or via insurance companies.

The costs of the scheme would depend on the number of people receiving the subsidy. Of the approximately 200,000 owner-occupier households (houses and strata units) in northern Australia, around 30 per cent (64,000) have an income around \$50,000 (ABS 2015). It is more difficult to assess the proportion of people paying high insurance premiums. The ICA submission suggested that around 57 per cent of households in high-cyclone risk areas in Queensland may be paying above the average premium for Queensland as a whole. The cost of any scheme would also depend on the size of the subsidy.

The cost to Government of a range of possible subsidy schemes is outlined in Table 10. A subsidy targeted at low income households is estimated to cost between \$35 million and \$80 million per year, depending on the size of the subsidy (\$350 million to \$800 million over 10 years). If there were no income targeting, the subsidy would cost from \$70 million up to around \$220 million per year (\$700 million to \$2.2 billion over 10 years) depending on the size of the subsidy.

The above costs include the cost of implementing a direct subsidy program. Such a program would face many of the same implementation challenges as a mitigation subsidy. Targeting by income, location and premium levels adds to administrative complexity and cost. Further, there are no existing government delivery mechanisms that could be used to make such payments, so bespoke arrangements would be needed. In general, administration costs as a proportion of total costs increase as a subsidy is more tightly targeted — for example, implementation and administration of a 10 per cent subsidy to low income households would likely cost as much as the subsidy payments themselves.

**A direct subsidy would require bespoke payment arrangements, adding significantly to administrative complexity and cost. For example, implementation and administration of a 10 per cent subsidy to low income households would likely cost as much as the subsidy payments themselves.**



Table 10: Estimated cost of direct subsidy scheme for owner-occupier home, contents and strata insurance policyholders in high cyclone risk regions of northern Australia<sup>8</sup>

<b>Targeted subsidy: income cut off around \$50,000 per annum (est. 64,000 households)</b>	
Size of subsidy (as % of premium)	Estimated annual cost to Government
10%	\$35 — 40 million
20%	\$50 — 60 million
30%	\$70 — 80 million

<b>Non-targeted subsidy (est. 200,000 households)</b>	
Size of subsidy (as % of premium)	Estimated annual cost to Government
10%	\$70 — 85 million
20%	\$120 — 150 million
30%	\$175 — 220 million

Sources: ABS 2011 Census data, Treasury

If a subsidy was paid directly to insurance companies, this would reduce some of the administrative expenses, but there is a risk that it would not be passed on in full to consumers. If the subsidy was paid direct to consumers, there is still the risk that insurers would increase premiums to absorb the subsidy. This may be more likely if there is low competition in the market. A direct subsidy would have no impact on competition in the insurance market.

Exit from a subsidy scheme may be difficult. The scheme could be explicitly created as a fixed term program to provide 'breathing space' to allow people to adjust to higher premiums, for example by undertaking mitigation activities. Even then, there would be pressure to continue the subsidy for those who have not made adjustments.

A number of submissions noted the risk that subsidising cyclone insurance may create a precedent for other perils (for example, bushfire). If subsidised insurance for natural perils were to become the norm without incentives to mitigate risk, it would represent a substantial ongoing cost to the Commonwealth.

Other stakeholders have argued that affordability is a much broader issue than one of social welfare, with sharp premium increases impacting many people and effecting wider economic activity.

The significant premium increases since 2008 have placed considerable cost pressures on householders in the North ... there are follow-on consequences for the economy including possible stagnation of investment and labour immobility.

*Queensland Government*

<sup>8</sup> Ranges calculated using information on average premiums provided by the ICA and Finity Consulting.



If the primary concern is that some low income households in northern Australia are experiencing financial hardship, with high insurance premiums being a contributing factor, then the appropriate response may be to treat insurance costs alongside other cost of living pressures in the context of the broader social security system.

The 2015 Report of the Reference Group on Welfare Reform (the McClure Report) found that a multitude of payments and supplements make the welfare system difficult to understand, navigate and administer. The report found that changes to the system, such as the addition of special payments, have led to unintended complexities and inconsistencies, which can undermine confidence in the fairness of the system. There is a risk that a direct cyclone insurance subsidy payment would compound this situation. Not only would it work against efforts to simplify the welfare system, but it could be seen as inequitable in that it would only relieve housing cost pressures for a specific and relatively small section of owner-occupied households. If the policy goal is to relieve housing cost pressures, this may be better addressed in the broader context of housing policy and the social security safety net.

**Concern that some low income households in northern Australia are experiencing financial hardship is best addressed in the context of the broader social security safety net.**

## 6.2 Reducing state insurance taxes and duties

A number of submissions called for the removal of stamp duties from insurance premiums, and/or for review or reform of taxes.

Insurance is subject to the GST and to stamp duties imposed by states and territories. Both are applied as a percentage of the premium, with the state or territory levy charged after the GST is applied. These taxes add either 19 per cent or 20 per cent to the cost of insurance premiums in northern Australia (depending on the jurisdiction).

The Australian Government is currently undertaking a Tax White Paper process to promote a community-wide conversation on how to create a fair tax system that supports higher economic growth, higher living standards and jobs. This process includes Commonwealth, state and territory taxes. The discussion paper *Re:think*, released in March 2015, observed that stamp duties, including those on insurance, are some of the most inefficient taxes levied in Australia (<http://bettertax.gov.au/publications/discussion-paper>).

The next step in the tax review process will be the release of an options paper. This will undergo further consultation with the community and state and territory governments, on possible reforms to improve the tax system. Any changes to state and territory taxes and duties, including insurance duties, will have to be agreed to and implemented by state and territory governments. The best place for this debate to occur is within the Tax White Paper process.

**Any changes to state and territory taxes and duties will have to be agreed to and implemented by state and territory governments and are best considered within the Tax White Paper process.**

### 6.3 Regulating commissions to strata managers

Some stakeholders have called for stricter regulation of commissions paid to strata managers when they purchase insurance on behalf of a strata owners corporation. As commissions are generally calculated as a percentage of the cost of insurance, the payment of commissions could act as a disincentive for strata managers to obtain the insurance that represents the best value for money.

It is a clear conflict of interest for management companies to be receiving commission, payments or kick-backs of any kind by a third party for acting on behalf of owners who are already paying them to do a job. *Margaret Shaw*

Activities of strata managers are governed by state and territory legislation. In general, there are two principles of the regulation. Strata managers:

- have a duty to act on behalf of their clients as their agent; and
- must disclose any commissions paid, including by insurance companies.

It is also possible for an owners corporation to bypass their strata manager and purchase insurance directly through a broker or from an insurer. Details of the regulations across Queensland, Western Australia and the Northern Territory are in Box 3.

Strata reform is being, or has recently been, considered by a number of state and territory governments. Regulation of commissions has been raised in consultations through those processes, but has generally been of minor interest. Where action has been either mooted or taken, it has been to strengthen commission disclosure requirements rather than ban commissions. The central argument against banning commissions is that they provide income to strata managers, minimising the need to charge management fees directly to owners corporations.

There are limits to the effectiveness of disclosure as a means of regulating commissions. In particular, merely disclosing the value of commissions may not sufficiently empower owners corporations to address issues associated with potential conflicts of interest. New South Wales has proposed law reforms aimed at more effectively empowering owners corporations. The NSW strata reform bills<sup>9</sup> require strata managers to disclose at the annual general meeting whether any third party commissions have been paid to them for the previous 12 months. Further, the reforms allow owners corporations to vote on whether to move to a fee-based system to pay for strata management services or allow the strata manager to accept commissions for the next year. If a fee based system is chosen, strata managers would not be allowed to receive any nominal gifts or benefits over a certain dollar amount in connection with their role.

<sup>9</sup> Strata Schemes Development Bill 2015 and Strata Schemes Management Bill 2015

### **Box 3: Regulation of body corporate managers<sup>10</sup> in northern Australia**

Queensland currently has commission disclosure laws. If a body corporate manager is considering entering into a contract on behalf of the body corporate for the supply of goods or services, such as insurance, sections 132-135 of the *Body Corporate and Community Management (Standard Module) Regulation 2008* require the body corporate manager to disclose in writing to the body corporate any commission, payment or other benefit they are entitled to receive under the contract before the body corporate makes a final decision to approve the contract. If the body corporate manager is an associate of the supplier, and the body corporate is not already aware of this, the body corporate manager must also disclose that relationship in writing.

The conduct of body corporate managers is governed by a statutory code (set out in schedule 2 of the *Body Corporate and Community Management Act 1997*), which requires managers to take reasonable steps to ensure goods and services are competitively priced. Contravention of the code entitles an owners' corporation to terminate their contract with the manager.

There is also nothing in the law to stop the body corporate approaching a broker directly to seek insurance for their building without going through a body corporate manager.

Northern Territory laws are similar to those in Queensland. Body corporate managers are in breach of the Agents Licencing Act if they fail to disclose the exact nature of any interest they have or are likely to obtain from entering into a transaction on behalf of the body corporate. They are also governed by a code of conduct, under which they must act in the best interests of the body corporate and ensure goods and services are supplied at competitive prices.

Western Australia is proposing to introduce strata reform legislation in 2016 that will require strata managers to disclose any commissions they receive.

One benefit of the proposed NSW changes is that it brings the question of commissions to the attention of owners corporations, and offers an alternative — that is, a fee-based system. Other states could consider a similar approach. States could also look at ways to inform owners corporations of existing disclosure laws, which are designed to protect them from unscrupulous behaviour by strata managers, and how to enforce them.

**State governments could consider reforms that highlight alternatives to commissions, such as fee-based systems, as a means of payment for strata management services.**

---

<sup>10</sup> In Queensland and Northern Territory a strata owners corporation is referred to as a 'body corporate', and strata managers as 'body corporate managers'.

## 6.4 Policy contestability and disclosure

Some stakeholders, including the Consumer Action Law Centre, Financial Rights Legal Centre and QBE, have called for reforms to increase transparency around the pricing of insurance.

The 2014 Financial System Inquiry report recommended that the insurance industry ‘improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance’ (Australian Treasury 2014). In response, the Government has agreed to support industry-led initiatives, including supporting specific proposals put forward by industry to increase guidance and disclosure in general insurance, recognising that work is already underway (Australian Government 2015). The 2014 Productivity Commission inquiry into natural disaster funding also recommended that the ICA develop guidelines for insurers to provide additional information to help consumers understand their risk (Productivity Commission 2014).

**The Government has agreed to support industry-led initiatives to increase guidance and disclosure in general insurance, recognising that work is already underway.**

In this context, the ICA established an Effective Disclosure Taskforce to ‘explore potential improvements to general insurance disclosure documents to help consumers make better informed decisions about their insurance’ (ICA 2015a). The ICA has indicated this as a first step in delivering on a commitment to lead an industry project on effective disclosure.

The ICA Effective Disclosure report (ICA 2015b) recommends the ICA establish a committee to determine how industry natural hazard data can be provided to consumers to help them understand risk specific to their property (including cyclone risk), in line with the Productivity Commission recommendation. There are complexities in providing this information to consumers, for example there is a question of whether it should be based on low resolution modelling generally available to all insurers, or on insurer’s high resolution proprietary modelling, which may give a different picture for particular properties.

In response to consumer lobbying, the ICA report recommends the ICA coordinates a trial to provide a reminder of the previous year’s premium at the time of renewal. The report also recommends insurers provide built-in calculators as part of the online renewal process to address the issue of underinsurance.

More generally, the report recommends that the industry shifts from a minimum mandated disclosure approach to best practice transparency to better assist consumers to choose products that meet their needs, and that the industry develop guidance on principles of transparency to fulfil the General Insurance Code of Practice objective of building more informed relations between insurers and customers. The ICA has indicated that, given the complexity of the issues being dealt with, many of its recommendations will be subject to further research, consultation and consumer testing in order to ensure they promote the best outcomes for consumers and have no unintended consequences.

While market led solutions are preferable, depending on the outcomes of industry initiatives, the Government could consider further action to increase transparency around pricing and availability through legislative or regulatory change.

Further, in the mitigation chapter, the Taskforce indicated that while there have been steps in the right direction, there needs to be more effective communication between insurers and property owners (as discussed in the mitigation chapter). Communication should cover not only mitigation but broader affordability concerns. The insurance industry is already developing promising products, like the IAG's 'InsureLite' and 'Essentials by AAI' linked with Suncorp, to help improve affordability.

## 6.5 Responses to insurance availability issues in the Indian Ocean Territories

Stakeholder consultations indicated it is difficult to obtain insurance in the Indian Ocean Territories. The Administrator of the Indian Ocean Territories stated that many residents are assessed by insurers as generally uninsurable. The Taskforce identified two specific areas of unmet demand for building and contents insurance in the Indian Ocean Territories. First, insurance does not appear to be available for private homes on the West Island of the Cocos (Keeling) Islands. This makes it difficult to build or sell houses, which inhibits economic diversification by making it hard to attract and accommodate business operators on the island. Second, insurance is not available for strata units on Christmas Island. This appears to be the result of ambiguity in the application of strata laws.

**Unique situations in the Indian Ocean Territories indicate the need for tailored solutions.**

On the Cocos Islands, scale and remoteness are reportedly the most significant disincentive for insurers to enter or remain in the market for private home and contents insurance. Although risks from cyclones are considered to be reasonably high, it is not clear that a Government subsidy for cyclone insurance alone, either through a mutual or a reinsurance pool, would be sufficient to make the market attractive to insurers. Should a mutual cyclone insurer for northern Australia be established, it would face the same market conditions which currently preclude existing insurers from operating in the Indian Ocean Territories, and would therefore require a large and ongoing subsidy from the Government. Furthermore, a cyclone mutual would not fill the gap in general home and contents cover in the Indian Ocean Territories. Consequently, the Taskforce investigated alternative options to deal with the insurance challenges confronting the Cocos Islands. In particular, the Taskforce canvassed the potential for home owners on West Island to purchase insurance under the umbrella of other larger scale insurance arrangements on the Cocos Islands, such as those of the Shire or the Cocos Island Co-operative. Discussions with stakeholders on the islands and insurance brokers suggest this may be a workable solution. Although not without challenges, for example with regard to the structure of legal agreements, it is an option that could be explored by the parties involved.

**There should be further investigation of local options to access home insurance on the West Island of the Cocos (Keeling) Islands.**

As with Cocos, the Christmas Island Tourism Association noted that the reasons for the lack of availability of insurance are varied, 'with cyclone risk being only one element'. Strata unit holders on Christmas Island face a unique problem in obtaining insurance: stakeholders indicated that not all strata unit owners want to purchase insurance, and no insurers will provide insurance for individual units on strata title (although one firm will insure individual duplex units if they are on separate title). Stakeholder discussions indicated there are currently no workable mechanisms to enable strata unit holders who want insurance to seek agreement of all unit holders or to enter into a contract to insure an entire complex. The Western Australian *Strata Titles Act 1985* (the ST Act) has theoretically applied in the Indian Ocean Territories since 1992. While the Act requires creation of an owners corporation and the purchase of insurance, questions remain about the obligations of unit owners who purchased units before 1992. Enforcement of the ST Act is not part of the Indian Ocean Territories Service Agreement with the Western Australian Government. It is possible these questions would only be resolved by legal action to test application of the ST Act. The Taskforce recommends the Australian Government work to clarify these ambiguities in the application of the strata law as a step towards helping strata unit holders on Christmas Island obtain insurance. Discussion of the issue with community members may be a good starting point.

**There is a need to clarify the ambiguity around the application of strata laws on Christmas Island, which is obstructing purchase of insurance by strata unit holders.**

## 7. COMPARISON AND SUMMARY OF OPTIONS

This chapter compares the feasibility of the two insurance options the Taskforce was specifically asked to assess and also schemes to promote mitigation and a direct subsidy option.

As suggested by the many inquiries on the issue of insurance affordability in northern Queensland, there is no easy way to reduce insurance premiums in areas subject to high cyclone risk. In terms of the specific issues the Taskforce was to consider when assessing the options, there are trade-offs between the criteria. The most obvious is that the largest reductions in premiums will involve substantial costs to the Government.

### 7.1 Direct subsidy

Some stakeholders have argued that the question of affordability is primarily an issue for people on low incomes who are facing high insurance premiums. A subsidy targeted at low-income households could help address affordability issues for this cohort.

Other stakeholders have argued that affordability is a much broader issue, with sharp premium increases impacting many people and effecting economic activity. A tightly targeted subsidy may not be sufficient to address these economic impacts, implying that a wider subsidy would be needed.

A 10 per cent direct subsidy targeted at low income households is estimated to cost around \$35 million per year, and a less targeted subsidy around \$80 million per year (between \$350 and \$800 million over 10 years). A 30 per cent subsidy could cost from \$70 million up to around \$220 million per year (\$700 million to \$2.2 billion over 10 years), depending on the degree of targeting.

While potentially addressing a welfare issue, a direct subsidy would not achieve an increase in competition in the insurance industry in Northern Australia nor reduce risk in the longer run. At most, it can provide short-term breathing space for low income households. A risk with a direct subsidy is that prices will rise to absorb the increase.

For households facing financial hardship in northern Australia, the most feasible response may be through the welfare system rather than linking direct subsidies specifically to insurance.

### 7.2 Insurance options

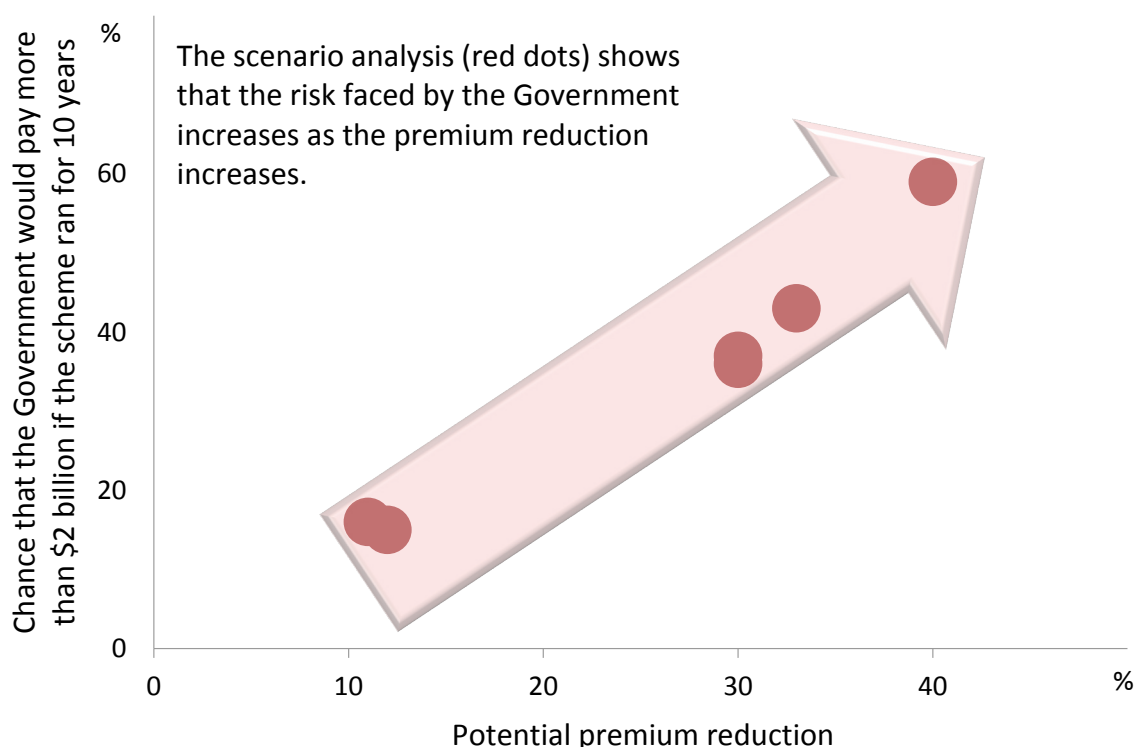
The insurance options provide an opportunity for a wide spread subsidy to be provided through the industry with a lower risk that prices will rise to absorb the increase. However, these options require a balance between the potential cost to the Government and the potential premium reduction that can be achieved, as well as the likely impact on the insurance market in northern Australia and the ability of the Government to exit.



The Taskforce commissioned modelling of the potential premium reductions and cost to Government of the cyclone mutual and the reinsurance pool for scenarios involving different levels of Government support. Key messages from this analysis are:

- The mutual and reinsurance pool options generate a similar premium reduction and similar potential cost to Government over 10 years.
- It is not possible for a commercially-run entity, either a cyclone mutual or reinsurance pool, which meets required capital standards, to lower premiums to consumers.
- In order for a cyclone insurer or reinsurer to provide a reduction in premiums the Government must provide a subsidy and use its balance sheet. That is, the Government must provide a guarantee to cover cyclone risk.
- To achieve larger reductions in consumer cyclone premiums, the Government has to cover increased risks from cyclone damage. The more cyclone risk the Government guarantees, the greater the reduction in premium but also the greater the probability the guarantee will be called on, and the greater the size of the call. This increases the potential cost of the scheme to the Government (Figure 14).

**Figure 14: Potential reduction in premium and cost to Government**



Notes: Information on the scenario analysis undertaken is contained in Box 1.  
Source: Finity Consulting

**In order for a cyclone insurer or reinsurer to generate a reduction in premiums the Government must provide a subsidy and use its balance sheet. The size of the premium reduction will be greater if the Government assumes greater risk, which in turn increases the potential cost of the scheme to the Government.**

In terms of the insurance options and the trade-off between a reduction in consumer premiums and cost to the Government, the Taskforce has focused on a partially funded scheme — that is, a scheme that charges sufficient premiums to cover the expected long run cost of claims and its operating costs, but with the risk of any additional claims (the result of more severe or more frequent cyclones than expected) covered by a Government guarantee. A partially funded cyclone mutual or cyclone reinsurance pool could reduce consumer premiums in northern Australia on average by around 10-15 per cent, although it would be difficult to ensure that the reduction in insurer costs was fully passed through to consumers.

**In terms of the trade-off between lower premiums and cost to the government, the Taskforce has focused on a scheme where premiums are set to cover the expected long-term cost of claims and operating costs, but with the risk of any additional claims (the result of more severe or more frequent cyclones than expected) covered by a Government guarantee. The costs of a mutual or reinsurance pool designed on these terms are similar.**

The premium reduction would come at a sizeable cost to the Government, through the risk of calls on the Government guarantee. The schemes would charge premiums (which would be below current premiums) and build a pool of reserves to meet claims. However, they would be exposed to large claims that exceed the reserves, and in these situations they would call on the Government guarantee. In each year the Government faces the possibility that there will be no claims (if there are no cyclones) or potentially very large claims (for example, if a large cyclone occurs). If a scheme was set up for 10 years there would be a:

- 50-60 per cent chance that the Government guarantee would be called on at least once;
- 30-40 per cent chance that the scheme would cost the Government money when closed (that is outlays under the guarantee would exceed reserves when the scheme is wound up); and
- 10-20 per cent chance that the scheme would cost the Government more than \$2 billion.

The risk that there will be a call on the Government guarantee could be lowered through purchasing reinsurance for the scheme. This would change the risk profile faced by the Government, but at a cost. If a scheme purchasing reinsurance was set up for 10 years to achieve a reduction of 10-15 per cent, the probability of the scheme costing more than \$5 billion would fall from 5-10 per cent (without reinsurance) to less than 5 per cent (with reinsurance). However, because of the cost of purchasing reinsurance, the probability:

- of there being any call on the Government guarantee increases from 50-60 per cent (without reinsurance) to 70-80 per cent (with reinsurance) and
- the scheme would cost the Government money over its life increases from 30-40 per cent (without reinsurance) to 50-60 per cent (with reinsurance).

**Either a mutual or a reinsurance pool could feasibly generate reductions in premiums in the order of 10-15 per cent. The cost over 10 years could be nil or in excess of \$5 billion. The risk to the Government depends on the frequency and severity of cyclones.**

While the costs of the mutual and reinsurance pool and the potential premium reductions are similar, this is not the case in terms of effect of the schemes on the insurance and reinsurance industries.

The reinsurance pool would be more likely than a mutual to increase competition in the market for cyclone insurance in northern Australia. One insurance company has indicated that it would enter the market if a cyclone reinsurance pool was introduced. A cyclone reinsurance pool would be accessible to all insurance companies and would not create an uneven playing field across insurers for cyclone reinsurance. Nor is it likely to adversely impact on the reinsurance market in Australia. The reinsurance market provides many billions of dollars of protection to Australian insurers across a range of risks, so that the creation of a reinsurance pool focusing on one risk is not likely to lead to the exit of reinsurers or a reduction in competition in that market. In contrast, there is a strong likelihood that a Government-supported cyclone mutual insurer offering subsidised cyclone insurance would crowd out private insurers from offering cyclone insurance, a major component of insurance contracts in northern Australia. Some insurers have indicated that there is a risk of insurers in the market exiting if it is unprofitable to compete against a subsidised mutual.

A reinsurance pool could potentially enable a more feasible Government exit than the mutual cyclone insurer. Both the mutual and the reinsurance pool would require ongoing support to remain viable in the market. However, the support to the reinsurance pool could potentially be gradually reduced via an increase over time in the cyclone claims costs borne by insurers. To cover this cost, insurers would return to the private catastrophe reinsurance market. New entrants who had partnered with the cyclone reinsurance pool may stay in the market once they have built up sufficient market share and sufficient expertise in managing the cyclone risk despite the exit of the Government-backed reinsurance pool. In contrast, it is unlikely that a mutual could operate without Government support. A cyclone mutual would have to have sufficient capital to meet regulatory standards. It is unlikely that a sufficient capital base could be provided by members of the mutual. However, overseas experience suggests that in practice, it is extremely difficult for a government to extract itself from any arrangement providing subsidised insurance.

The reinsurance pool option has disadvantages relative to the mutual. A mutual may be more effective in encouraging mitigation in the community and could potentially price mitigation into premiums to further incentivise mitigation. In contrast, this feature is difficult to build into a reinsurance pool. Further, it is uncertain whether all the premium reductions generated by a reinsurance pool will be passed on to consumers, as a reinsurance pool does not have direct control over consumer premiums. Pass through will depend on the level of competition in the market. A mechanism to monitor the pass through of cost reductions may be required to ensure that the reinsurance pool generates the anticipated premium reductions. This may result in additional administrative costs.

**The reinsurance pool is more feasible than a mutual. Although the reinsurance pool would not offer the same potential to encourage mitigation, it has a greater potential to increase competition in the northern Australian insurance market. It would be difficult, however, to ensure lower costs offered by the reinsurance pool are passed through to premiums.**

### 7.3 Mitigation

Mitigation was identified by many stakeholders as fundamental to achieving sustainable reductions in premiums in the long term. The Taskforce agrees that reducing risk is essential to delivering long-term reductions in premiums; however, cyclone mitigation is complex, possibly more so than other forms of natural disaster mitigation. This is because cyclone mitigation primarily requires action by individuals to improve the resilience of their own properties, but the benefits are diverse and shared across a number of parties. A multipronged approach by governments, industry and consumers is needed.

There are a range of relatively low cost actions that can be taken by governments and industry to facilitate and encourage mitigation:

- Governments and the insurance and building industries could fund research to identify cost-effective measures to reduce water ingress for new properties and retrofit options for older properties.
- Governments could fund public works to reduce the risk of cyclone-related flooding.
- Insurers could give greater recognition to post-construction mitigation work when calculating insurance premiums. Policyholders are more likely to undertake mitigation if it is directly linked to lower premiums
- Insurers could design insurance products with more flexibility to enable greater risk sharing between policyholders and insurers, enabling policyholders to achieve lower premiums by engaging in their own cyclone preparation. This could take the form of higher 'cyclone' excesses in policies or items being excluded from coverage under the policy.
- Governments could develop more effective public awareness campaigns focused on providing more tailored information to property owners on options to strengthen their property.
- The insurance industry together with governments can develop tools to help households understand the specific hazards they face and the resilience of their properties.
- Better communication between insurers and households could increase people's understanding of insurance pricing and facilitate product innovation. This could include more effective disclosure of information between insurers and policyholders in relation to changes in premiums and risk exposure.

Of the mitigation actions listed above, greater recognition of post-construction mitigation work by insurers in insurance prices and more flexible insurance policy design have the greatest potential to yield premium reductions in the near term. The other measures also have the potential to lead to a reduction in premiums, but over a longer timeframe.

The size of the premium reduction from mitigation will depend on individual circumstances and the action taken. The reductions could be comparable to those achieved under the insurance options. The insurance industry refers to mitigation lowering premiums for some properties by up to 20 per cent. Increasing the level of excess in a policy from \$500 to \$3,000 can result in a 30 per cent reduction in premiums for the property. In contrast to a direct subsidy and the insurance options, people will generally only receive a premium reduction from mitigation if they are willing to do something to either lower their risk or share in the risk. However, any subsidy or insurance option to lower premiums should be linked as far as possible to encouraging mitigation. A package of mitigation measures should accompany any subsidy scheme, which should only run for a fixed term, and include advice to consumers that the only way to maintain lower premiums at the end of the subsidy is through mitigation. If consumers maintained lower premiums, this would facilitate Government exit from any subsidy scheme, although any exit will be challenging. The lower premiums as a result of the subsidy would provide property owners with additional financial capacity to undertake mitigation.

The cost and risk to the Government of the above mitigation measures are low, relative to the direct subsidy and insurance options. Of the mitigation actions, funding additional public spending on mitigation is likely to be the most costly. As an example, recent flood mitigation work in Cairns cost \$9.5 million. The cost of funding for existing research projects of this nature is around \$0.5 million, and the cost of funding existing public community awareness campaigns (such as 'Cyclone Sunday' in Townsville) is up to \$50,000.

The impact of the mitigation actions on the operation of the insurance and reinsurance markets is limited. Insurers will incur some costs in order to enable greater recognition of post-construction mitigation work and introduce more flexible policy design. However, as noted previously the industry is already heading in this direction. The measures would have no impact on the level of competition in the market (either positive or negative).

Unlike the direct subsidy and reinsurance options, the mitigation measures do not present any issues with Government exit.

**There are a range of relatively low cost measures that both governments and insurers could undertake to promote mitigation.**

A more costly option is for the Government to directly subsidise mitigation expenses for property owners. Some households are unlikely to be able to afford the cost of substantial mitigation work to their property without some form of direct assistance (regardless of what other measures are implemented by insurers/governments). The mitigation subsidised should be tailored to meet the circumstances of the property and the owner. However, unless the subsidy is 100 per cent of the cost of mitigation, there will still be property owners unable to afford to undertake mitigation.

The costs associated with directly subsidising mitigation are likely to be significant. Costs vary depending on the design of the program. For example, a scheme targeted at roof strengthening of older properties in northern Queensland is estimated to cost around \$1 billion without income testing and \$500 million with income testing. This cost could be lower by providing a reduced subsidy for less costly mitigation (such as opening protection). However, this would have a less significant impact on premiums.

Directly subsidising mitigation is potentially more costly than a direct subsidy or an insurance option. It is also administratively complex, particularly if targeted on low income households facing high premiums and focused on the specific needs of individual properties. It would be substantially more complex to implement compared with the insurance options, particularly the reinsurance pool. However, unlike the direct subsidy or insurance options, directly subsidising mitigation will result in a sustainable reduction in insurance premiums.

As noted previously, there is currently research underway to identify more cost-effective and acceptable ways to mitigate cyclone damage in older properties. It would be appropriate to delay any consideration of a program to directly subsidise mitigation so that the outcome from this work could be taken into consideration.

While any subsidised mitigation scheme may not have a significant impact on the competitiveness of the insurance industry in northern Australia, it would have a substantial impact on the building industry in the areas where the scheme is delivered. The implementation of any scheme must take into account the potential impact on the building industry including whether the industry has the capacity to scale up in order to meet the increase in demand particularly in regional areas.

The scheme would need to run for a number of years after which the Government could exit.

**A government subsidised mitigation scheme is costly and risky. However, it is the only way to enable low income households to complete substantial mitigation work to their property.**

## 7.4 Recommended way forward

The Taskforce was asked to consider the feasibility of options to lower insurance premiums in areas subject to high cyclone risk and to make policy recommendations. This report has identified the most feasible options, recognising they achieve different objectives and have distinctly different benefits and risks.

There is no simple answer to sustainably reducing premiums in northern Australia. Through the process of this Taskforce, it was evident that there have been some positive developments in insurance markets in northern Australia, with insurers introducing products which provide greater scope for consumers to achieve lower premiums. The aim should be to enhance this momentum.



The recommended way forward involves the following components:

1. A sustainable way of reducing premiums over the long run is through mitigation. The reduction in premiums that could be achieved from mitigation will depend on individual circumstances and the mitigation action taken. However, such reductions can only be achieved by household action.
2. Governments can take a range of relatively low-cost (compared to other options) measures to promote mitigation. Additional funding could be provided for research to improve mitigation options particularly for roof strengthening and water ingress. In addition, there is the potential for additional education campaigns to encourage and support property owners to undertake mitigation and for public works spending to reduce the risk of some forms of cyclone damage, such as flooding.
3. The insurance industry should develop insurance pricing systems that provide greater recognition of mitigation action and be more proactive in offering a range of policy options that provide increased scope for policyholders to assume more responsibility for risk of cyclone damage in return for lower premiums. For example, policies could exclude cover for certain outdoor items or offer higher cyclone excesses.
4. The insurance industry should engage more effectively with property owners in northern Australia. This requires improved disclosure of risks and greater responsiveness to policyholder concerns. The industry has already taken steps in this direction. Governments could support these moves by, for example, organising information sessions to bring together insurers and property owners. Potentially, there is also a role for legislating enhanced requirements around the disclosure of risks if industry efforts do not yield meaningful results for consumers.
5. Some property owners may not be able to realise premium reductions from mitigation because they do not have the financial capacity to undertake the necessary work. One option to address this situation is governments directly subsidising the cost of mitigation for low income households. The mitigation action subsidised should be tailored to individual circumstances and could cover such options as protection of windows and doors. The cost of more extensive subsidised mitigation could be substantial. For example, a retrofit scheme for strengthening roofs for older properties in northern Queensland is estimated to cost around \$1 billion (or \$500 million if targeted at low-income household). Any mitigation subsidy scheme should be developed in consultation with the state and territory governments, who (supported by local councils) are best suited to deliver such a program. Any subsidy would need to be phased in having regard to the ability of industry to meet increased demand. A subsidy scheme would also benefit from the outcome of further research into identifying cost effective and acceptable mitigation measures.
6. Of the two insurance options the Taskforce was asked to assess, a reinsurance pool represents a more feasible approach than a mutual. In contrast to the mutual, the reinsurance pool could promote competition through new entrants to the northern Australia market. A reinsurance pool which charged premiums to cover the estimated long-run cost of claims from cyclones and was supported by a Government guarantee might offer a premium reduction for consumers of 10-15 per cent. It would be difficult, however, to ensure that cost reductions for insurers did in fact flow through to premium reductions for customers. The Government would assume significant risk in order to



achieve any reduction in premiums. The cost to the Government would depend on the number and severity of cyclones during the life of the scheme and whether they hit major population centres. It is estimated that the Government would face a 50-60 per cent chance of having to make a payment under the guarantee if the scheme ran for 10 years and a 10-20 per cent chance these payments would exceed \$2 billion in total. While there is greater potential compared with a mutual for the Government to withdraw support for a reinsurance pool, overseas experience demonstrates that it is very difficult for governments to exit from any intervention in insurance arrangements. If the Government did exit the market, any premium reductions would be reversed unless households had undertaken mitigation during this time.

## APPENDIX A: TERMS OF REFERENCE

The Taskforce is charged with exploring the feasibility of options that use the Commonwealth balance sheet to reduce home, contents and strata insurance premiums in those regions of northern Australia that are experiencing insurance affordability concerns due to cyclone risk.

The Taskforce will:

- establish which regions in northern Australia are experiencing acute insurance affordability concerns due to cyclone risk;
- outline options to reduce the cost of home, contents and strata insurance that stems from cyclone risk in these regions, including a mutual cyclone insurer and a cyclone reinsurance pool as well as other options that are put forward during consultation;
- for each option, undertake a thorough evaluation of:
  - the potential reduction in consumer premiums;
  - the likely cost and risks associated with using the Commonwealth balance sheet to lower the cost of insurance to consumers;
  - the potential effect on the operation of the insurance and reinsurance markets in northern Australia, particularly the likely effects on competition; and
  - how the role of the Government can be gradually reduced over time.

In conducting the review, the Taskforce will draw on a Reference Panel of stakeholder representatives and consult extensively, including with industry experts in insurance and reinsurance.

The Taskforce will provide an interim report providing policy options for consultation before providing recommended policies in a final report to the Government by November 2015.

## **APPENDIX B: REFERENCE PANEL MEMBERS**

Mr Dallas Booth, Chief Executive Officer, National Insurance Brokers Association

Mr Gerald Ewing, Chief Operating Officer, Regis Mutual Management

Ms Joan Fitzpatrick, Chair, Australian Reinsurance Pool Corporation

Ms Fiona Guthrie, Executive Director, Financial Counselling Australia

Ms Margaret Shaw, Northern Australia Consumer Representative

Mr Rob Whelan, Executive Director and CEO, Insurance Council of Australia

Mr Craig Wilson, Senior Executive Director, Department of the Premier and Cabinet, Queensland Government

The Reference Panel members have acted as advisers to the Taskforce. All findings and recommendations expressed in this report are those of the Taskforce.

## **APPENDIX C: REPORT BY FINITY CONSULTING**

[Refer to attached report entitled *Financial Impact of Proposed Cyclone Schemes*]

## APPENDIX D: ALPHABETICAL LIST OF SUBMISSIONS

Actuaries Institute  
Administrator, Indian Ocean Territories  
Allianz Australia Insurance Ltd  
Australian Reinsurance Pool Corporation  
Chamber of Commerce and Industry Queensland  
Christmas Island Tourism Association  
Cleeland, Mr Geoffrey  
Climate Institute  
Consumer Action Law Centre  
Council of Queensland Insurance Brokers Inc  
Cyclone Testing Station, James Cook University  
Financial Rights Legal Centre  
Graham, Mr Don  
Green Cross Australia  
Insurance Australia Group Limited  
Insurance Council of Australia  
Kennedy, Mr D M  
Kingspan Insulation  
Lloyd's Australia  
Lowe, Mr Barry  
Marshall, Mr Andrew  
McCourt, Mr Rory  
National Insurance Brokers Association of Australia  
Plowman, Mr Ross and Mr David Brooks  
QBE  
Queensland Government  
RACQ Insurance  
Regional Development Australia  
Regis Mutual Management  
Shaw, Mr A  
Shaw, Ms Margaret  
Stace, Mr Philip  
Suncorp General Insurance  
Whitsunday Moorings B&B

The Taskforce also received three confidential submissions.

## REFERENCES

- Australian Building Codes Board 2014 Resilience of Buildings to Extreme Weather Events — Final Report, accessed 17 November 2015, [www.abcb.gov.au/work-program/Natural%20Disaster%20Mitigation.aspx](http://www.abcb.gov.au/work-program/Natural%20Disaster%20Mitigation.aspx).
- Australian Geological Survey Organisation 1999, *Community Risk in Cairns, a multi-hazard risk assessment*, Geoscience Australia, accessed 29 June 2015, [www.ga.gov.au/corporate\\_data/33548/33548.pdf](http://www.ga.gov.au/corporate_data/33548/33548.pdf).
- Australian Government 2015, *Improving Australia's financial system: response to the Financial System Inquiry*, 20 October, Canberra.
- Australian Government Actuary 2012, *Report on Investigation into Strata Title Insurance Price Rises in North Queensland*, 19 October, Canberra.
- Australian Government Actuary 2014a, *Second Report on Investigation in Strata Title Insurance Prices Rises in North Queensland*, 6 June, Canberra.
- Australian Government Actuary 2014b, *Report on Home and Contents Insurance Prices in North Queensland*, 5 December, Canberra.
- Australian Treasury 2014, *Financial System Inquiry Final Report*, 7 December, Canberra.
- Boughton, G et al 2011, *Tropical Cyclone Yasi: Structural Damage to Buildings, Technical Report no 57*, Cyclone Testing Station, James Cook University, Queensland, April 2011.
- CGU 2014, *CGU Addresses Strata Insurance Affordability in North Queensland*, media release 1 April, <http://assets.cgu.com.au/getattachment/about-cgu/cgu-news/media-releases/cgu-addresses-strata-insurance-affordability-in-no/CGU-addresses-strata-insurance-affordability-in-North-Queensland.pdf.aspx>.
- CGU 2015, *CGU's Strata Resilience Project Delivers \$1.3 million in savings*, media release 26 March, Sydney, [http://assets.cgu.com.au/getattachment/about-cgu/cgu-news/media-releases-\(1\)/cgu's-strata-resilience-project-delivers-\\$1-3-mill/CGU-media-release-North-Queensland-strata-resilience-project-update-26-03-15.pdf.aspx](http://assets.cgu.com.au/getattachment/about-cgu/cgu-news/media-releases-(1)/cgu's-strata-resilience-project-delivers-$1-3-mill/CGU-media-release-North-Queensland-strata-resilience-project-update-26-03-15.pdf.aspx).
- Hanger 2014, *Report of the Royal Commission into the Home Insulation Program*, Commonwealth of Australia, Canberra, August 2014.
- Insurance Australia Group (IAG) 2015, *IAG Leads the Way Forward with New Insurance Trial in Queensland*, media release 16 July, [www.iag.com.au/iag-leads-way-forward-new-insurance-trial-queensland](http://www.iag.com.au/iag-leads-way-forward-new-insurance-trial-queensland).
- Insurance Council of Australia 2015a, *ICA launches Effective Disclosure Taskforce*, media release 2 July, [www.insurancecouncil.com.au](http://www.insurancecouncil.com.au).

Insurance Council of Australia 2015b, *Too Long; Didn't read: Enhancing General Insurance Disclosure*, Report on the Effective Disclosure Taskforce to the Insurance Council Board, November 2015.

Insurance Council of Australia 2012, Inquiry into Residential Strata Insurance: Insurance Council of Australia Submission, January 2012.

Johnstone 2015, New Zealand: Insurance risks drive robust legal activity, Monqad, accessed 12 November 2015, [www.mondaq.com/article.asp?articleid=425796&email\\_access=on](http://www.mondaq.com/article.asp?articleid=425796&email_access=on).

Northern Australia Insurance Premiums Taskforce (NAIP Taskforce) 2015, *Interim Report*, July 2015, Canberra.

Queensland Reconstruction Authority, *Planning for a stronger, more resilient North Queensland: Part 2 Wind resistant housing*, Queensland, 2011.

Productivity Commission 2014, *Natural Disaster Funding Arrangements*, Inquiry Report no. 74, Canberra.

Reference Group on Welfare Reform 2015, *A New System for Better Employment and Social Outcomes: Report of the Reference Group on Welfare Reform to the Minister for Social Services*, February 2015.

Smith and Henderson 2015a, *Report for Suncorp Group Limited: Insurance Claims Data Analysis for Cyclones Yasi and Larry*, Cyclone Testing Station, James Cook University, Queensland, July 2015.

Smith and Henderson 2015b, *Suncorp Group Limited Cyclone Resilience Research — Phase II*, Technical Report, Cyclone Testing Station, James Cook University, Queensland, 21 July 2015.

Standing Committee on Social Policy and Legal Affairs 2012, *In the Wake of Disasters: Volume Two — The affordability of residential strata title insurance*, March 2012.

Suncorp 2015a, *Initiative to better protect North Queensland from cyclone*, media release, 28 April 2015, Sydney.

Suncorp 2015b, Suncorp Strata: New Insurance Product to give cost relief and mitigation benefits, 29 April 2015, Sydney.

Urbis 2015, *Protecting the North: the benefits of cyclone mitigation*, Report commissioned by Suncorp Group Limited, 20 July 2015.