RACQ Insurance Submission:

Northern Australia Insurance Premiums Taskforce
Interim Report

Australian Government
Discussion Paper
17 August 2015

1. BACKGROUND

RACQ Insurance (RACQI) is pleased to provide this submission in response to the Australian Government's Northern Australia Insurance Premiums Taskforce (the Taskforce) Interim Report, released on 17 August 2015.

RACQI was established in 1971 and is wholly owned by The Royal Automobile Club of Queensland (RACQ) which was established in 1905 and is owned by more than 1.2 million Queensland members as a mutual organisation. It has a strong Queensland focus to its business, providing insurance cover to over 1.7 million policyholders throughout Queensland and northern New South Wales.

RACQI has an intimate understanding of the affordability pressures and challenges facing homeowners and the industry as a whole when it comes to the pricing of risk in Queensland, especially northern Queensland. RACQI advocates that the full range of factors be taken into consideration in calculating home building and home contents insurance premiums and that market conditions, underlying risk factors and underwriting considerations have ultimately driven premium prices.

This submission is a simple illustration of the commitment RACQI has to support the exploration of a number of alternatives to provide some relief to this pressure felt by homeowners.

The submission is geographically focused on the northern Queensland region, in line with RACQI's geographic boundaries; however the key considerations covered in the response are expandable to other regions that are subject to high natural peril risk.

1.1. RISK ASSESSMENT AND PREMIUM RATING

The sophistication and granularity of risk assessment and insurance premium rating has increased markedly in recent years as insurers such as RACQI have sought to gain a better understanding of the drivers and profiles of risk.

Despite this, there has been persistent dialogue in the media suggesting that insurers price household risk at postcode level in north Queensland. While this may be the case for some, RACQI operates a highly sophisticated pricing engine which allows natural peril risk such as flood and cyclone to be priced at property address level.

This approach not only allows for the accurate assessment of risk with all contributing factors taken into consideration, it also ensures that the consumer is paying a premium that is accurate and commensurate with the risk posed by their individual property. One outcome of this enhanced accuracy is that the pricing spread between different risks has grown.

1.2. INSURANCE COVERAGE

RACQI, unlike some market competitors, continues to provide insurance cover to the whole of Queensland, without imposing any generic new business embargoes on home insurance policy sales.

1.3. SUGGESTIONS OF MARKET FAILURE

Recent years have been some of the most volatile in the local insurance industry's history and this volatility, combined with major weather events and significant international financial instability, has created genuine home insurance affordability issues for some consumers in high risk areas like northern Queensland.

RACQI continues to reject assertions from a number of sources that there has been broad market failure in northern Queensland. To suggest so, is simply incorrect as northern Queensland householders are able to obtain insurance cover for home insurance from a number of existing insurance providers. RACQI also questions the need for Government intervention in what is a functioning insurance market. RACQI does however, acknowledge the price of home is an issue for some consumers in northern Queensland communities.

2. INSURANCE AFFORDABILITY IN NORTHERN AUSTRALIA

As outlined in the Interim Report, in recent years the insurance industry has reassessed the potential losses from cyclones in northern Australia, particularly northern Queensland. These reassessments were prompted by a number of factors including an increase in catastrophe reinsurance costs and the refinement of the insurance markets capability in respect to risk premium rating in order to more accurately assess and price risk.

RACQI recognises that there is an insurance policy affordability issue in northern Queensland, however maintains that the issue is not market wide. In RACQI's experience affordability concerns are restricted to certain demographics in the community who live in high risk areas and whose homes may not be compliant with modern building codes for wind resistance.

RACQI maintains that any action taken by the Government should be targeted to assist those demographics of the community who are most likely to be impacted by affordability issues and who are in high risk zones.

2.1. AUSTRALIAN GOVERNMENT ACTUARY STUDY

The recent Australian Government Actuary (AGA) reports into the cost of household and strata insurance in northern Queensland considered the causes of the premium increases and concluded that the business had not been profitable for the participating insurance companies.

Taking into account the losses made by the companies over the seven-year period 2005-06 to 2012-13, the AGA concluded that the insurance industry spent $1.40 on claims for home and contents insurance for every $1 of premium received in northern Queensland. Data from the Insurance Council shows that while Queensland contributed 15 per cent of national insurance premiums over 2005 to 2010, it represented 25 per cent of national claims (Insurance Council of Australia 2012).

3. KEY INSURANCE PREMIUM COST DRIVERS IN NORTH QUEENSLAND

In response to the AGA's study into strata insurance premiums in northern Queensland (May 2014), RACQI outlined four main insurance premium cost drivers. These were: individual risk pricing, cyclone risk, flood risk and taxes on insurance products.

These cost drivers align with and expand on the causes of premium increases identified by the Australian Government, recognised as stemming from: how insurance companies measure risk and price their policies, reassessment of the potential losses due to cyclones in northern Australia, prompted by losses caused by a number of cyclones and storms occurring in a short space of time, and increases in the cost of catastrophe reinsurance.

The re-evaluation of potential losses due to cyclones saw a range of insurers reprice their premiums sharply in northern Queensland from 2010. Some insurers have also reported that they stopped offering new policies in order to limit their exposure in the region.

3.1. PRICING ACCURACY

As highlighted, RACQI has developed the capability to price household insurance at the individual property level. RACQI operates a highly sophisticated pricing engine which allows this granularity in pricing natural peril risk, with all individual factors of risk being considered in the calculation. While the application of this approach resulted in dramatic premium increases to certain high risk sectors of the community which were previously ‘subsidised’ by other, lower risk premiums, other sectors of the community were not impacted by premium increases, while some premiums decreased.

In 2012, RACQI implemented automatically included cover for all household insurance policies across Queensland. This implementation was supported by the ability to price at property address level and according to the actual risk. While this did result in an increase in premiums for some property owners, the increase was reflective of the risk that those properties posed and in line with the findings of the AGA study that historically premiums charged in the region were not commensurate with or reflective of the risk faced.

In addition to developments in flood risk pricing, RACQI also further developed pricing capability for other natural perils. Of particular relevance in northern Queensland is the capability to determine cyclone risk at an individual property address and provide a premium that accurately reflects the risk faced by the individual property. As with flood, this has had varying impacts on premiums for policyholders.

3.2. CLAIMS MANAGEMENT

It has been surmised that excessive claims following cyclones in the northern Queensland region have contributed to increasing insurance costs. While it is not possible to comment on the internal processes of competitors, RACQI is a well-established brand that employs a robust claims management model, focused on managing and reducing claims costs.

4. TASKFORCE RECOMMENDED OPTIONS FOR EXPLORATION

Two main solution options assessed in detail by the Taskforce in the Interim Report are a mutual cyclone insurer and a cyclone reinsurance pool. This submission will provide RACQI’s views on both these options, but will also extend to comment on the alternative approaches being deliberated, including the more practical consideration of mitigation.

Key issues discussed in the following and relating to both approaches are the risk to the Government balance sheet, whether potential premium reductions will meet consumer expectation, sustainability of the proposed actions and the potential for the Government to exit the scheme without further disadvantaging consumers.

4.1. MUTUAL CYCLONE INSURER

Whilst acknowledging the specific details of the mutual insurer option have not yet been developed, RACQI is not confident in the long term success of the initial broad concept of introducing a mutual cyclone insurer for high risk areas such as northern Queensland.

In acknowledgement of the framework the Taskforce were initially provided to consider options - consumer impact, effect on the insurance industry and Commonwealth impact - the following considers the main impacts on both consumers and the Commonwealth.

4.1.1. CONSUMER IMPACT

The expected advantage of the mutual insurer is to provide peril focussed cyclone coverage to consumer in high risk areas at an attractive premium. This advantage, however, comes with the disclaimer of the need to purchase additional peril coverage from an alternative insurance provider.

At initial review, the concept of 'parametric cover', insurance for a particular region, demographic or peril, appears not to provide an ideal or thorough solution for consumers due to a number of practical considerations, including:

- the additional sales process the consumer will be required to engage in
- contract design intricacies
- possible gaps in cover
- possible confusion regarding coverage at claim time (i.e. gaps in cover, where does a cyclone start and stop, proximate cause e.g. a cyclone or flood from the rain that fell during a cyclone)
- adding an additional layer of complexity to the product
- potential difficulty in lodging and managing dual claims.

Of key concern is the additional layer of complexity for the consumer and potential confusion regarding coverage at claim time, both of which can further contribute to gaps in cover.

In the situation where a peril is taken out of the traditional insurance product and provided through another party, it will not be to the advantage of the consumer, particularly without clarity of coverage i.e. boundaries of cyclone impacts, what is classed as a cyclone and / or cyclone related damage (this may differ between the two insurance parties).

If there is damage such as flooding that impacts areas not directly covered by the cyclone related premium reductions, these consumers would be disadvantaged.

The potential inclusion of capped payouts, while limiting the Government's exposure, could further disadvantage consumers where the cost of damage is higher than the cap. Purchasing 'top up' cover would further increase complexity and negate premium benefits.

Additional benefits currently offered by RACQI across the policy may not be delivered by the Government owned mutual. Examples of these benefits include up to $1,000 cover for food spoilage, up to one year temporary accommodation while the home is repaired, counselling services and storage costs after an event, as examples. If the mutual did not provide similar benefits to the consumer under the cyclone specific cover, the consumer would be disadvantaged under the mutual cover.

The prominent question remains as to whether the segregation of insurance cover would provide the significant premium reductions anticipated by both the Government and consumers – from both the insurance companies providing coverage excluding cyclone and from the Government providing cyclone insurance through the mutual. The value of this proposal is negated unless this is delivered.

The proposed community rating as outlined in the Interim Report would see all individuals paying the same premium for cyclone risk. Questions remain around the impact of this on communities with greater risk, i.e. residents of QLD than in WA and NT. Community rating this would also mean the return of cross subsidised premiums, and an end to individual property risk pricing for risk and the associated advantages.

4.1.2. COMMONWEALTH IMPACT

Furthermore, the costs to establish a new insurance entity 'owned' by the people of northern Australia would be significant. Concerns remain regarding the sustainability of the funding pool into the future and its ability to pay out all claims as required in a catastrophe situation.

In addition to this, in order to deliver the advantage of reduced premiums, operating expenses must be kept at a minimum. This must be carefully balanced against the provision of robust sales, service and claim processes, that have the ability to be seamlessly scaled up in response to an event. Failure to do so will see a disparity in the claims experience of consumers insured by two providers.

Consideration of a potential exit strategy delivers further concerns as once the scheme was developed it would be difficult for the Government to exit. This has been shown in the case of mutuals such as Territory Insurance Office (TIO); as the only effective exit strategy is to sell the mutual to a retail insurer. Without Government backing the potential benefits to consumers could be at risk.

Until the modelling for this option is complete, illustrating in more detail the proposed benefits available to consumers, RACQI will reserve its final comments and views on the mutual cyclone insurer proposition until the final report is delivered. RACQI remain willing to engage in further consultation as required.

4.1.3. MUTUAL STRUCTURE

4.1.3.1. DISCRETIONARY MUTUAL

A discretionary mutual operates in a similar way to a mutual insurer, however the structure voids the need for the mutual to abide by regulations such as APRA standards that insurance companies in Australia must subscribe to and so reduces the amount of capital needed to set up and / or be held within the scheme.

From a consumer perspective, the discretionary mutual has the discretion to (or not to) make payments to its Members. RACQI holds the view that this would not be the most beneficial option for consumers, as this potentially may not provide the same level of insurance as a traditional policy. RACQI refers back to the intent of the Taskforce – to implement a solution in north Queensland to benefit consumers who the Government believes are currently being disadvantaged.

While this option is not supported as the optimal solution by RACQI, in the event this 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.

RACQI also holds that, to assist with sustainability of the scheme, it is critical to link consumer benefits with mitigation activities; incentivising proactive response to the cyclone risk faced for individual property levels.

4.1.3.2. APRA REGULATED ENTITY

Implementing an APRA regulated entity would be the preferred choice from a consumer point of view, as the issues associated with the discretionary mutual (outlined above) would be somewhat negated and the long term sustainability of the scheme improved. This would, however, impose additional cost to the Government in setting up the mutual and maintaining regulatory requirements such as minimum capital.

4.2. CYCLONE REINSURANCE POOL

The cyclone reinsurance pool option proposes the establishment of a Government supported reinsurance pool to offer reinsurance to insurers in a similar way to a catastrophe loss model, but only covering the loss caused by tropical cyclones.

Further modelling and clarification is needed in relation to the option, to understand if Government provided reinsurance prices will be comparable or lower than industry, if the scheme will in fact deliver the expected premium reductions and if the pool would be a viable option into the future.

There are a number of identified challenges and issues to consider in relation to this option including contract design, scope of cover, pricing, impact on premiums and risk to Government. Ultimately the overall measure that should drive considerations is which option maximises benefit to the consumer.

Currently there are a large number of variables and unknowns relating the scheme and the potential benefits available to the consumer; further exploration is needed before RACQI can provide a more thorough view on this proposed option, however an outline of key considerations is provided below.

4.2.1. CONSUMER IMPACT

While the Government may be able to deliver a subsidised reinsurance premium for cyclone cover, it does not mean that there will be an automatic impetus for reinsurers who provide the remaining cover for insurers to reflect this saving in the premiums delivered.

In addition, the definition of what is covered as ‘cyclone’ peril and what is not covered is difficult to be clear on, as there potentially will be impacts from cyclones on areas that are outside the parameters of the cover, e.g. flooding caused by the cyclone in areas not directly impacted. RACQI recommends the definition of cyclone should include impacts such as these to ensure consumers are adequately and fairly covered.

While the suggestion of limiting payments under the reinsurance pool would reduce the Government's exposure in the event of a large cyclone related claim, this would not ultimately benefit the consumer. Insurers in northern Queensland traditionally have low profit margins (evidenced by AGA statistics), meaning there is less opportunity for the insurer to absorb losses over and above the Government cap.

If there is not a substantially better reinsurance premium available through the Government scheme, to have a positive impact on the premiums offered to consumers, RACQI takes the stance that there is not sufficient reason to change the current situation, as the consumer would not see a benefit or may be disadvantaged through the application of a more complex process.

4.2.2. COMMONWEALTH IMPACT

In response to the requirement to deliver a future exit strategy for the Government, RACQI raises concerns regarding a viable exit strategy for a reinsurance pool due to international experience, such as the New Zealand. In examples such as this, schemes have not reached a scale where they are self-sustainable.

The result of this being that the Government must be committed to providing capital support to ensure longevity and sustainability.

5. MITIGATION

RACQI agrees with the Interim Report relating to the outlined role of mitigation. Mitigation should be an important component of any and all effort/s to reduce insurance premiums, as this can reduce the risk of damage and claims following an event, rather than simply transferring the cost of the risk to another entity.

5.1. IMPLEMENTATION

There appears to be a degree of willingness of north Queensland homeowners to take measures to cyclone proof their home if it resulted in a reduced premium. RACQI maintains it is critical to link mitigation with subsidies provided through the mutual, reinsurance pool or activities as outlined below i.e. reduced premiums provided through any of the subsidy models are available in conjunction with mitigation.

5.2. EXCESSES AND POLICY EXCLUSIONS

RACQI currently provides consumers across Queensland various voluntary excess options, and actively supports this approach to increase affordability. RACQI does not support the use of additional policy exclusions to reduce the number of small claims in high risk regions as this action carries the risk of consumers in the region being disadvantaged in comparison to other areas of the state.

6. TAXES AND DUTIES

In the Interim Report, the reduction of taxes and duties on insurance premiums in high risk regions is purported to provide direct savings to the consumer in the range of 19 per cent – 20 per cent. Recent market statistics from northern Queensland also supports these figures and the application of this approach.

6.1. CONSUMER IMPACT

RACQI advocates the reduction of taxes and duties on insurance premiums for areas of high risk, targeted to demographics experiencing home insurance affordability issues and potentially linked to mitigation activities (e.g. retrofitting) as outlined below. The approach provides an effective and simple premium reduction, without the added layer of complexity which could result from options such a mutual insurer or reinsurance pool. Incentives such as this could also be easily linked to mitigation activities to ultimately reduce the risk faced by the consumer.

6.2. GOVERNMENT IMPACT

Application of this approach also provides added flexibility for the Government, as it is not restricted specifically to cyclone risks and can be considered for other high risk areas, e.g. bushfire or flood, should insurance affordability become an issue. While there would be a small loss of revenue associated with tax and duty reductions, in comparison to a mutual insurer or reinsurance pool, the cost to Government would be minimal.

7. RACQI'S POSITION

RACQI's position is underpinned by our focus on implementing real benefits for the consumer, without undue Government intervention in a market that has not failed. RACQI acknowledges that high risk zones such as northern Queensland are difficult to insure and raises the concern that there may be repercussions from implementing measures to address affordability in this region which are not available to other high risk areas, such as regions at high risk of bushfire in New South Wales or Victoria. As such the following position is taken.

7.1. INDIVIDUAL ASSESSMENT AND RETROFITTING

RACQI supports the Insurance Council of Australia's proposed solution to reduce insurance premiums in northern Queensland. This option recognises that the vast majority of home buildings with premiums double the comparison cost of others are not believed to be compliant with the cyclone building code based on their year of construction. The solution recommended is individual assessment to confirm compliance, followed by retrofitting to make the buildings compliant if necessary.

RACQI considers, on a case by case basis, the actions of consumers where they advise they have introduced cyclone resilience measures to their homes, including the installation of new wind rated roofs, strengthened windows and other household resilience enhancements or improvements.

7.2. HIGH RISK SUBSIDY POOL

In addition to the implementation of the above, RACQI broadly supports the concept of a subsidy pool for high and extreme risk properties. The establishment of a pool will assist with affordability issues for those within the community that are most vulnerable to the risk of cyclone damage.

RACQI maintains that any system should be simple and equitable for all policy holders and that subsidies should be phased out to coincide with the material reduction of risk over time, for example when the insured completes recommended mitigation activities as recommended through initial assessments.

RACQI also maintains that these subsidies should be provided to those insureds that most need assistance, and so should be restricted by socioeconomic factors combined with the risks faced in the area where the property is located.

8. FINAL SUMMARY

The further exploration and detailed modelling of a number of alternatives in order to provide some relief to the insurance affordability pressures felt by a segment of homeowners in northern Queensland is fully supported by RACQI.

RACQI continues to reinforce that there has been no market failure, and that Government intervention in the form of a Government funded mutual cyclone reinsurer or cyclone reinsurance pool is not the ideal solution.

Key concerns relating to the option of a mutual cyclone insurer from a consumer point of view are the additional complexity added to the insurance process in both sales and claims, potential gaps in cover for consumers and whether significant premium reductions would result from the segregation of aspects of insurance cover.

Impacts to the Government relating to the development and operation of a mutual cyclone insurer relate to the amount of capital potentially required to establish and operate the mutual, taking into consideration international experience. In addition there is no simple exit strategy for this option once implemented.

Key concerns relating to a cyclone reinsurance pool relate to the reliance of the option on associated reductions from established reinsurers with the removal of one peril risk. If these savings were not realised, the consumer would not realise a significant benefit.

Impacts to the Government are similar to those of a mutual insurer, in that the reinsurance pool would require a large amount of capital to establish and maintain, and the exit for the Government is neither simple for effective.

Recent market statistics support the option of reducing taxes and duties, these results show promising direct savings to the consumer, with minimal cost to the Government and can easily be linked to mitigation activities by the consumer to further reduce their risk.

RACQI recommends the implementation of a solution that will reduce the actual risk faced by affected consumers, while concurrently providing them fiscal relief. The solution proposed is a two part solution, encompassing the introduction of building assessment and retrofitting combined with a subsidy pool restricted to certain demographics that are facing extreme insurance premium affordability issues. This approach is sustainable and effective, addressing the base cause of issues and provides maximum benefit to the consumer with minimised ongoing support by the Government.