

Natural Disaster Insurance Review Response to Issues Paper

Introduction

Australian domestic policyholders are in the fortunate position that most major natural perils, with the exception of flood, are covered by their insurance policies. The availability and affordability of flood insurance remains an extremely controversial issue for insurers, policy holders and government. The recent Queensland and Victorian floods brought this to a head when there was widespread concern and community anger over the performance of the insurance industry.

The Federal Government has responded with a number of initiatives, including;

- a) Releasing a discussion paper on a proposed standard definition of flood; and
- b) Establishing the Natural Disaster Insurance Review (NDIR).

The National Disaster Insurance Review Issues Paper.

The NDIR released an issues paper outlining three options for resolving this issue. These involve;

1. Insurers obliged to automatically include flood insurance as part of home insurance and homeowners purchasing insurance obliged to purchase flood cover, with some form of discounting or subsidy of the premium for high risk properties;
2. Insurers obliged to automatically include flood insurance as part of home insurance with homeowners having an opt out provision for those who do not want the cover; and
3. Continuing with the status quo.

For all options, affordability can only be addressed for those in high risk areas by introducing some form of discount or subsidy.

The NDIR rejects Option 3, the status quo, as it would make no fundamental difference to the current situation. As well, this issue has been around too long and doing nothing is unacceptable to consumers and the government. The issues paper notes that Option 2 would most likely extend availability but provides no incentive for people to accept cover, and leaves open the possibility for home owners who opt out, to dispute the cause of future water damage by storm or flood.

The NDIR concludes Option 1, automatic inclusion of flood insurance in all home insurance, is the preferred way forward and would overcome the problem of disputes over the cause of water damage by storm or flood. Fundamental to Option 1 is the creation of a **Flood Insurance Pool** for properties with a high risk of flood. The NDIR also notes that in order to provide discounts to eligible (high risk) policyholders, premiums for all flood risks would need to be set centrally by the Flood Insurance Pool and not by individual insurers. The Review suggests the pool could be subsidised by Insurers, Councils and Government or a combination of these.

The Review notes the *“essential reason for introducing subsidies is firstly the desirability and importance of solving the flood insurance availability and affordability problem, and secondly the benefit that can accrue to the broader community from a wide take-up of flood insurance.”*

PFS Comments

While we agree that some subsidies are necessary to address the availability and affordability issues, we note that introducing subsidies raises serious economic questions and discourages the development of an efficient flood insurance market. Subsidies dampen price signals that would otherwise encourage changes in behaviour, and result in cost shifting from less efficient to more efficient sections of the economy. In many instances, the real cost of subsidies are not transparent and ultimately result in the whole community paying for poor decisions made by others.

The introduction of unrestricted subsidised flood insurance would be no different. Those making decisions about land use and where to purchase and/or develop properties would have no real incentive to change or modify their behaviour because they know their decisions will be subsidised by the wider community one way or another. We therefore suggest the extent of subsidies be very restricted.

The guiding principles in the terms of reference for the NDIR states;

- a) *“Government intervention in private insurance markets is justifiable only where, and to the extent that there is clear failure by those private markets to offer appropriate cover at affordable premiums.*
- b) *The appropriate mitigation of risk by individuals and governments at all levels is a key objective.*
- c) *Individuals and business should be encouraged to insure themselves where practicable.”*

Government and consumer advocates agree there is a market failure around the availability and affordability of flood insurance that justifies government intervention in the market. However Option 1, introducing automatic flood cover with subsidised premiums for high risk properties, without limitation on the sums insured, will not address key aspects of the terms of reference. Instead, homeowners in high risk areas have a perverse incentive to purchase subsidised flood cover without taking appropriate flood mitigation measures or recognising the true risk rate of the cover they are purchasing.

We suggest that in addition to meeting these guiding principles, any solution to address the availability and affordability of flood insurance should:

- Be fully transparent to the community and policyholders;
- Be easy to administer and audit compliance; and
- Have low compliance costs

Appendix 3 of the Issues Paper outlines how Option 1 could be funded. This appears to be overly complicated and potentially costly to administer. The paper does not address who should be responsible for meeting these costs, but if it is the Flood Insurance Pool then they will ultimately fall back to the consumer.

PFS Proposal

The NDIR has asked if there are other models that could materially improve the availability and affordability of flood cover within home insurance policies.

PFS suggests there is an alternative and less costly approach for the NDIR to consider, and if they agree to recommend to government. This involves:

- Introducing a standard definition of flood, which is already under consideration; and
- Mandating an automatic but very restricted level of cover against flood in all domestic dwelling and contents insurance policies. This level of cover should be sufficient to constitute a safety net which

would ensure people have the ability pick up their lives following a major flood event. However, the level of cover should be low enough that insureds with high flood risk exposure recognise the need for additional cover, which would be available on a risk rated basis from their insurer.

We suggest the premium for this cover should be community rated, and transparent to policy holders. Insurers would be obliged to include this automatic level of cover in all home and contents policies, and would collect the premium and pass it on to the Flood Insurance Pool. The Pool would provide the first layer of flood cover up to this level, on a non-proportional basis. The Pool would operate as an insurer, manage claims, and purchase reinsurance. It could apply an appropriate excess to limit small claims.

For the purposes of this submission we suggest a mandated level of automatic flood cover of \$25,000 for houses and \$15,000 for contents, at a premium rate of \$0.10c/\$100 sum insured. The appropriate level of mandated automatic cover and premiums will have to be decided by Government and the proposed Flood Insurance Pool after actuarial analysis of available data. On our illustrative basis the cost of this cover would be:

Type of Cover	Level of Cover	Cost pa /\$100 sum insured	Total Cost pa
Home dwelling	\$25,000	0.10cents	\$25.00
Domestic contents	\$15,000	0.10cents	\$15.00
Total Annual Cost			\$40.00

The Insurance Council of Australia has previously commented that its research indicates that policy holders would be willing to pay a maximum of \$4.00 per month (\$48.00 pa) to support those in high risk flood regions. We propose the cover provided be set at a level that requires a premium a little below this, say \$40.00 pa.

Using unpublished data from the ABS Census of Population and Housing, the NDIR notes that in 2006 there were around 6.2 million homes in Australia. At a recent Insurance Council of Australia/ Institute of Actuaries of Australia Seminar¹ the Chairman of the NDIR John Trowbridge commented that around 95% of these, or 5.89 million households, are insured.

Our suggested total cost of cover of \$40.00 pa would therefore yield a total annual premium pool of around \$235 million. The Flood Insurance Pool would use this to purchase reinsurance and pay any claims that might arise.

Information in Table 1 of the Issues Paper suggests the average cost of home and contents claims for the recent Queensland and Victorian floods was around \$35,700, with total claims costs in the vicinity of \$1.454 billion. The paper does not differentiate between house and contents claims. If arrangements along the lines we propose had been in place, claims on the Pool would have been capped, and the Pool would have paid considerably less in respect of those claims admitted. On the other hand, the Pool would have admitted many claims that were in fact declined. Further analysis of historical data is required to establish the likely costs to be borne by the Pool under various levels of cover.

Clearly the cost of claims on the Pool in a year of poor experience could be some multiple of the Pool's premium income, and Government would need to think about the Pool buying reinsurance or catastrophe bonds in order to limit its exposure as the ultimate guarantor of the Pool.

We expect insurers will respond by making available additional cover in excess of that mandated, on a risk rated basis. Given a large number of small claims would be fully covered by the Pool, we expect the

¹ Insurance Council of Australia/ Institute of Actuaries of Australia Seminar, Natural Disaster Insurance Review, Discussion of Options, Wednesday July 6th.

insurance rates would be significantly less than if the Pool did not exist. Consequently cover for those living in high risk areas would be more affordable, provided appropriate mitigation and risk management measures are taken by either property owners or local authorities.

Flood mapping is essential

The extent to which private insurers can price the additional cover in high risk flood areas will depend on local authorities providing data to improve flood mapping. Both the NDIR and the Insurance Council of Australia note this and we fully support flood mapping being publically available. Without this, insurers are unlikely to be able to adequately risk rate the true flood exposure.

Advantages of this Proposal

A mix of community and risk-rated flood insurance has many advantages and addresses all the guiding principles outlined in the NDIR's terms of reference including;

- a) All policy holders regardless of risk would have access to an affordable minimum level of cover against flood.
- b) People in lower risk areas would only be required to purchase a very limited amount of cover.
- c) People in higher risk areas are free to purchase additional cover from their insurer at an appropriate risk-rated premium.
- d) Development of a competitive flood insurance market with insurers providing additional cover at an appropriate but more affordable risk rate, because of the substantial deductible provided by the mandatory cover.
- e) Property owners in high risk areas have strong incentives to implement their own flood mitigation measures and/or pressure their local and regional authorities to do so.
- f) Local authorities have incentives to implement appropriate land use planning measures to reduce flood risk and reduce the need for costly flood mitigation measures.
- g) The Flood Insurance Pool is contributed to by all policy holders in a transparent way and not through an unknown subsidy from taxpayers or consumers.
- h) The proposal is relatively simple to administer compared to the complicated funding measures outlined in Appendix 3 of the Issues paper.
- i) The Flood Insurance Pool can operate as an insurance business and purchase reinsurance in the same way insurers' reinsure risk.
- j) Low compliance costs for insurers to amend their policies to automatically include the mandatory cover, collecting the premium and passing it onto the Flood Insurance Pool in return for an administration fee to cover costs.
- k) The role of the Australian Reinsurance Pool Corporation could be expanded to manage and administer the Flood Insurance Pool.
- l) The Flood Insurance Pool would be in a strong position to encourage local authorities to complete mitigation works, improve and release up-to-date flood mapping information and, provide improved consumer information.
- m) A reduced need for federal, state and local government to direct resources to support individual flood victims thereby allowing resources to be directed towards local infrastructure recovery.
- n) Less obligation on individuals to support flood relief campaigns as they are already contributing through their premiums to the Flood Insurance Pool.

Insurance Cover for Small to Mid-Size Business

In this proposal we have not addressed the issue of insurance cover for small to mid-size business. We consider that commercial insurance arrangements are essentially a matter for business owners and insurers to decide on. However, we acknowledge the ability of a community to fully recover after a major event largely depends on businesses being able to resume quickly and people to return to work.

It may be possible to extend the concept we have outlined in this paper for covering domestic dwellings and contents to businesses also. However, the ability for many businesses to resume activities after any major loss is often dependent on having adequate business interruption insurance in place to carry them over the period their commercial activities are disrupted. We consider this should be a matter for business owners to decide in consultation with their insurance broker and/or insurance company.

Underinsurance and Non Insurance

The NDIR highlighted the high level of underinsurance in Australia for both home and contents and the high level of non-insurance of contents, particularly for tenants. These issues are relevant for all insurance, not only disaster or flood risk, and we suggest warrant substantial consideration in their own right.

The Insurance Council of Australia has mentioned the high level of State government imposts on home and contents policies, which add substantially to the cost, as a factor in underinsurance. In Victoria and New South Wales the fire service levy (FSL) results in insurance premiums being increased by over 60% in some cases before adding stamp duty and GST. In Victoria it has been announced that the FSL will be replaced with a property based levy by 2013. The removal of the FSL in NSW would substantially increase the affordability of home and contents insurance in that State.

Conclusion

Finding a long term workable solution to providing flood cover for those in high risk areas inevitably involves trade-offs between the insurance industry and all levels of government. An insurance based solution can only work effectively and efficiently if there is proper risk mitigation and readily available flood mapping. This work must be supported and carried out by government. There are broad social policy implications involved in finding a workable solution to this issue and this can only be achieved with the appropriate mix of public and private sector involvement.

We would be very pleased to discuss this with the Review Panel if we can be of further assistance.

Yours sincerely



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14th July 2011