

Natural Disaster Insurance Review

Inquiry into flood insurance and related matters

September 2011

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Natural Disaster Insurance Review

Inquiry into flood insurance and related matters

30 September 2011

The Hon Bill Shorten MP
Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Assistant Treasurer

We are pleased to present our report on the Natural Disaster Insurance Review.

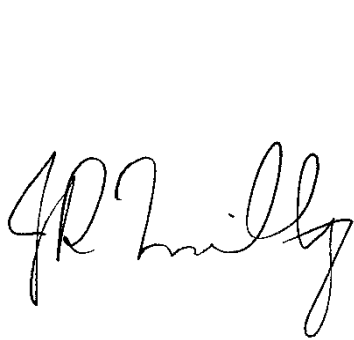
The Review has attracted wide public interest, evidenced by over 100 written submissions and considerable public debate amongst experts and other interested parties. The Review Panel has also undertaken many stakeholder meetings, with representatives of all levels of government, insurers, consumer groups, hydrological experts and others, and made numerous public speeches and presentations to diverse audiences following publication of our Issues Paper on 2 June 2011.

The Review Panel wants to express its gratitude to the many individuals and organisations that have contributed to the work of the Panel.

Our key recommendation is to establish an Agency that will, for the first time, bring together flood risk management and insurance in a manner designed to ensure the availability and affordability of flood insurance to all insured Australians.

We commend the Report to you.

Yours sincerely



John Trowbridge
Panel Chairman



Jim Minto
Panel Member



John Berrill
Panel Member

TERMS OF REFERENCE

Issued by the Hon Bill Shorten, Assistant Treasurer, on 4 March 2011.

BACKGROUND

- 1 Recent widespread flooding and other extreme weather events have caused devastating losses across the nation. These losses have been borne by individuals and businesses, State and local Government, community organisations, the Australian Government, private insurers, and reinsurers.
- 2 The Australian Government seeks to ensure that:
 - (a) Individuals and communities affected by the floods and other natural disasters are able to recover and rebuild as quickly as possible.
 - (b) People are able to choose where they live in an informed way.
 - (c) Individuals and communities at risk of future flooding or other extreme weather events are aware of the risks but are able to obtain suitable protection against those risks, both in terms of having access to insurance and benefiting from appropriate mitigation strategies.
- 3 The Australian Government is concerned to ensure that the appropriate national measures are in place to foster more complete sharing of risk and equitable sharing of the cost of damage and loss resulting from floods and other natural disasters throughout the nation. This Review is established to examine how best to achieve these objectives.
- 4 The National Strategy for Disaster Resilience adopted by COAG on 13 February 2011 outlines the shared responsibility of individuals, governments, businesses and communities in preparing for, and responding to, disasters.
- 5 As part of the National Strategy, the Commonwealth, States and Territories will be working together to support strategies to foster greater individual and community resilience, including having adequate and appropriate levels of insurance cover, and the Heads of Treasuries will provide a report to the National Emergency Management Committee (NEMC) on insurance by the end of 2011.
- 6 This Review provides an opportunity for an independent review of issues relating to insurance in light of the recent disasters, in the context of the long term funding of disaster relief. The Assistant Treasurer and the Attorney-General will provide the outcome of the Review to the Heads of Treasuries for consideration in the context of their report to the NEMC.

OBJECTIVE AND SCOPE

- 7 The Review should be guided by the following principles:

- (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 businesses should be encouraged to insure themselves where practicable.
- 8 The Review will consider the arrangements for the insurance of the assets of Australian individuals, small businesses and governments for damage and loss associated with flood and other natural disasters. In particular, the Review will consider:
- (a) The extent of, and reasons for, non-insurance and underinsurance for flood and other natural disasters in Australia.
 - (b) The ability of private insurance markets to offer adequate and affordable insurance cover for individuals, small businesses and governments for flood and other natural disasters.
 - (c) Factors that may impede the private insurance market in offering such cover.
 - (d) Measures that could improve the ability of the private insurance market to offer such cover and the take-up of such cover by individuals, small businesses and governments.
 - (e) The need for any further measures to enhance:
 - (i) consumer awareness and understanding of the scope and coverage of available insurance products.
 - (ii) claims management, dispute resolution and consumer assistance and advocacy services.
 - (f) The effect or likely effect of the recent floods and other natural disasters on future insurance premiums in respect of such cover.
 - (g) Whether there is a case for subsidising insurance premiums for individuals and small businesses in the areas of highest risk facing the highest premiums.
 - (h) Whether there is a role for the Commonwealth Government in providing disaster insurance or reinsurance to the private sector, through mechanisms such as a national disaster insurance program, and, if so, what are the best options?
 - (i) The impact or likely impact of any Commonwealth Government intervention in disaster insurance on the private insurance market.
 - (j) The relationship between disaster mitigation measures taken by State and local governments against flood risks, and the impact of such measures, or the lack of them, on the availability and affordability of flood and other disaster insurance.
- 9 The Review will also consider whether the existing Commonwealth and State arrangements for dealing with natural disaster recovery and resilience should be supplemented by the establishment of a national disaster fund to support the rebuilding of public infrastructure in the aftermath of events such as the recent floods.

COMPOSITION AND CONSULTATION

- 10 The Review Panel will be chaired by Mr John Trowbridge, with Mr John Berrill and Mr Jim Minto as members.
- (a) The Review Panel will be assisted by the Australian Government Actuary, Mr Peter Martin.
 - (b) The Review Panel will be supported by a working group from within the Treasury, with representation from the Department of Finance and Deregulation and the Attorney General's Department, and drawing on other government agencies as appropriate.
 - (c) The Chair may task members of the Review Panel to oversee programs of work related to their field of expertise.
 - (d) The Review Panel will consult with the public to allow for community and business input.
 - (e) The Review Panel will consult with State and Territory governments.
 - (f) The Review Panel will also, where necessary, draw on external expertise and comparative international best practice.
 - (g) The Review Panel should provide a final report setting out its recommendations to the Assistant Treasurer by no later than 30 September 2011.
 - (h) The final report will also be provided to the Commonwealth Attorney-General as chair of the Ministerial Council for Police and Emergency Management — Emergency Management (MCPem-EM) for consideration in implementing the National Strategy for Disaster Resilience as agreed by COAG in February 2011.

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EXECUTIVE SUMMARY

PURPOSE AND NATURE OF THE REVIEW

Following the series of storms, floods and cyclones that affected many parts of Queensland and some parts of Victoria in late 2010 and early 2011, the Assistant Treasurer, the Hon Bill Shorten MP, announced on 4 March 2011 the Natural Disaster Insurance Review (the Review).

It was not these extreme weather events themselves that stimulated the Review, because the insurance industry has demonstrated, in events such as the Victorian bushfires in February 2009 and the hailstorms in Melbourne and Perth in March 2010, that it has the financial capacity and other resources needed to respond effectively to such events.

It was the absence of flood insurance for many policyholders, particularly in Brisbane and Ipswich, that was the primary stimulus for the Review.

For all natural disasters other than flood, insurance cover for homes has been widely available in Australia for many years. A high proportion of Australian homeowners have insurance cover for their homes and this provides cover for storms, earthquakes, bushfires and cyclones. Many homeowners and renters also have corresponding cover for the contents of their homes.

The fact that all home insurance policies cover storm damage including related water damage but many do not cover flood damage, which distinction is seen as arcane and artificial by many, led to a community backlash against insurers during 2011 and considerable distress, financial loss and disillusionment for many insured homeowners.

Hence the theme of the Review, arising from the flood coverage problem and the full Terms of Reference of the Review, is the availability and affordability of insurance offered by the private insurance market, with particular reference to flood but also including other natural disasters.

There are also other issues dealt with in this Review. There is evidence of under insurance, which has become most apparent after total losses that have occurred in bushfires and are also seen after cyclones and floods. There are also some indications that affordability is emerging as a genuine problem for cyclone insurance in far north Queensland. There are issues around consumers' access to information and documentation in a form they can readily understand, given that insurance is a complex product increasingly transacted through direct sales and renewals by telephone and the internet under a 'no advice' model. There are also some questions about insurers' claims performance and the degree of independence of some of their internal dispute resolution processes.

The Terms of Reference also specifically asked the Review Panel to consider whether the existing Commonwealth and State arrangements for dealing with natural disaster recovery and resilience require supplementation.

The Review Panel published an Issues Paper on 2 June 2011 and received in response more than 100 submissions from both private individuals and organisations, including insurers, governments and government agencies, consumer groups and various experts. Panel members consulted directly, both individually and collectively, with representatives of insurers, local and state governments, consumer groups and community representatives including some affected by the floods and cyclone.

FLOOD INSURANCE

The underlying flood insurance problem for the community

There is a serious community issue around the availability and affordability of flood insurance. It is essentially a coverage issue. When floods occur, individuals and the community often suffer severe economic and social losses; these losses are exacerbated by the fact that many policyholders do not have flood cover, leading to financial hardship that impedes personal and community recovery. Further, any attempted resolution of the coverage problem leads directly to access problems: some policyholders cannot obtain flood cover and, among those who can, there will be some who do not purchase the cover, for various reasons, including in many cases its high price. Experience also shows that those most exposed to the risk of flood are the least likely to purchase it.

The coverage aspect of the flood insurance problem can be described as the *consumer's disaster insurance paradox*:

- all home and contents policies include, as a matter of course, cover for:
 - fire (including bushfire);
 - earthquake;
 - storm (including rain, wind and cyclone);

and the policyholder cannot opt-out

but

- many home and contents policies exclude cover for flood;

and, if the cover is offered, in many cases the policyholder can and does opt-out.

Hence the absence of flood cover for many insured properties and the associated combination of uncertainty and disputes around insurance claims when floods do occur is the primary problem confronting the Review Panel.

There are approximately 6.6 million detached houses in Australia and around 1 to 2 million other dwellings, including terrace houses and home units.

Perhaps 5 per cent to 10 per cent of dwellings are subject to flood risk, or approximately 450,000 houses along with approximately 100,000 home units.

The constraints

The Review Panel is well aware that any steps taken to improve the availability of flood insurance need to take into account that:

- flood cover for those homes with a high flood risk can result in high insurance premiums leading to problems of affordability;

- to maintain a competitive insurance market, insurers need control over their flood risk exposures and accumulations, adequate information for pricing and underwriting, and the ability to seek commercial prices for any flood risks that they underwrite; and
- there has been sub-optimal risk management of flood-prone land and buildings in the past. Accordingly any new arrangements to facilitate improved insurance coverage should also encourage, either of themselves or in conjunction with separate initiatives, improved flood risk management (that is, improved flood risk measurement and mitigation).

Dealing with flood insurance — the key recommendations

The Review Panel is recommending an integrated solution to the availability and affordability of flood insurance and has been able to identify five essential requirements that would need to be met by such a solution:

- 1 All home insurance, home contents insurance and body corporate insurance products need to include flood cover.
- 2 Discounted insurance premiums are needed for homes, home contents and home units in areas of medium and high flood risk, so as to render flood insurance affordable.
- 3 National coordination of flood risk measurement and mitigation is needed, in order to improve flood risk management for the benefit of the community generally and to ensure the continuing development of a competitive market for flood insurance.
- 4 A mechanism is needed to fund the discounts that are to be offered for affordability purposes.
- 5 Insurers will need access to a government-sponsored reinsurance facility if they are to deliver flood insurance discounts without compromising their own commercial positions.

In designing a set of arrangements to meet these five requirements, it is important not to create perverse outcomes that encourage further residential development in areas subject to flood risk.

To meet these requirements, the Panel is making four pivotal recommendations. They are:

Pivotal Recommendation 1: Architecture

That an agency sponsored by the Commonwealth Government be created to manage the national coordination of flood risk management and to operate a system of premium discounts and a flood risk reinsurance facility, supported by a funding guarantee from the Commonwealth.

While this new agency would need to be established under Commonwealth legislation, to function effectively it would need to operate along the lines of a joint venture between the Commonwealth, the States and the insurance industry.

Given the right level of expertise and authority, the right kind of governance structure and accountability, and a brief to apply itself exclusively to these matters, a single agency of this kind would have the wherewithal to succeed where previous efforts of cooperation, in good faith, amongst a myriad of agencies and departments of government (Commonwealth, State and local) and insurers have yielded limited results.

Pivotal Recommendation 2: Availability

That all home insurance, home contents and home unit insurance policies include flood cover.

While acknowledging that many insurers are working hard to extend the availability of flood cover, their initiatives alone will not meet the community need.

Pivotal Recommendation 3: Affordability

That a system of premium discounts be introduced in order that most purchasers of home insurance, home contents and home unit insurance policies in areas subject to flood risk be eligible for discounts against the full cost of flood insurance.

The nature of flood risk, whereby flood prone land can be identified because it has a higher risk of flood than other land, can lead to high insurance premiums for flood cover in these locations with the result that flood cover, if available, will generally be seen as unaffordable.

Pivotal Recommendation 4: Funding

The Commonwealth Government guarantee the payment of claims by ensuring that, whenever a funding shortfall occurs in the reinsurance facility through claims exceeding the funds held in the facility, the Commonwealth would meet the shortfall and the Commonwealth would seek reimbursement of a portion of the shortfall from the State or Territory government in whose jurisdiction the flood occurred.

The existence of such a guarantee would ensure that discounts offered for affordability purposes do not increase the premiums for householders with no flood risk.

It is notable that these four pivotal recommendations represent an integrated system. A new government-sponsored agency charged with national coordination of flood risk management and with operating the system of premium discounts and the flood risk reinsurance facility, supported by a funding guarantee from the Commonwealth, would create the capacity to deliver flood insurance premium discounts, and also to influence flood risk mitigation and ensure the availability of flood insurance to all relevant policyholders. Flood insurance premium discounts are a prerequisite for homeowners to be able to afford to purchase flood cover, which in turn makes it possible to deliver on the Review Panel's conclusion that unequivocal insurance coverage for flood is central to addressing the community need.

It is important to note that, in recommending that flood cover be included in all home contents and home unit insurance policies, the Review Panel is not recommending that insurance itself be made compulsory. There need also be no increase in premiums for policyholders who have no flood risk and no cross subsidisation of insurance premiums among policyholders.

By way of further explanation of the recommended new national agency, it would have two key functions, national coordination of flood risk management and operating the flood risk reinsurance facility.

National coordination of flood risk management

Working with State and local governments and insurers, this new agency would be the focal point of activities and responsibilities such as:

- coordinating flood mapping across the country (while leaving responsibility for undertaking flood mapping in the hands of State governments and their councils);
- introducing national guidelines for flood risk mapping and classifications;
- acting as a national repository of or portal for flood risk information, primarily through collating and analysing information collected by others;
- continuing development of the Insurance Council's National Flood Insurance Database (NFID) or an equivalent developed by the new agency;
- monitoring the effectiveness of flood risk mitigation initiatives across the country and advising on priorities for flood risk mitigation;
- publishing and disseminating flood risk information in formats appropriate to the various user groups; and
- overseeing the quality of the flood risk information.

The flood risk reinsurance facility

The reinsurance facility would be operated by the agency in conjunction with flood risk measurement activities and would have three key attributes:

- insurers to be able to use the facility to give discounts on flood insurance for affordability purposes;
- insurers to be able to use the facility as a source of reinsurance capacity for flood cover more generally; and
- the discounts in particular and the facility in general to be funded if and when necessary by claim subsidies from the Commonwealth Government to the facility, under a Commonwealth Government guarantee, and supplemented by contributions from the government of the State in which the event causing the funding shortfall occurs.

Small business

The absence of flood cover for many insured businesses has similar consequences to the absence of flood cover for home and contents. The Review Panel also notes, however, that the recovery of small businesses after a natural disaster, whether flood or otherwise, is critical to the recovery of the local economy and hence the local community.

The Review Panel would have preferred to see flood cover offered as standard to small business with no opt-out as with homes. It accepts, however, that such a position could not reasonably be imposed at this time, especially as the Review Panel is not proposing to see discounts introduced for affordability purposes for small business or access by insurers to the reinsurance facility for small business flood insurance. Nevertheless there is still an important need for flood insurance to be made more widely available to small business and for some steps to be taken to encourage and promote a greater take-up of flood cover by small businesses.

Recommendation: Small business

That all insurers offering small business insurance be obliged to include flood cover on an opt-out basis, instead of opt in/opt-out as at present, in all of their small business package policies.

The Review Panel believes that the questions of flood cover as standard in small business policies and access to discounted premiums for small business policyholders should be revisited once the recommended arrangements for homes, home units and contents are in place.

OTHER ISSUES**Cyclones**

Because cyclones are treated by insurers as storms, all insured homes and home units have full cyclone coverage. As a result, for example, policyholders with claims for loss or damage from Cyclone Yasi have, on the whole, been dealt with effectively by their insurers. As renewals occur of policies taken out before Cyclone Yasi, however, some very large premium increases, sometimes 300 per cent or more, are being sought by insurers, especially for home units.

Such extreme price increases can occur for several reasons but, irrespective of the reasons, they are presenting immediate affordability problems and can also cause continuing problems.

The Review Panel has not had the means or the time to investigate fully the causes of these price increases but it does accept that there is, prima facie, an affordability problem. The Panel is therefore making a two-stage recommendation:

Recommendation: Cyclones

- The Agency offer cover to insurers for cyclone risk, on the same basis as for flood risk, but with no affordability discounts (in the expectation that, when the Agency does its own pricing, it will offer a fair price to home and home unit owners; this price may be lower but is not guaranteed to be lower than the prices of commercial insurers); and
- an investigation be undertaken to ascertain whether there is a basis for granting affordability discounts for cyclone risk, along the lines of the recommended flood insurance discounts, for homes and home units in northern Australia.

Replacement value and sum insured

Most insurers limit their cover to a sum insured specified by the policyholder for both home building and contents. Some insurers, however, offer full replacement or reinstatement cover on the home itself in the event of a total loss. Generally neither the homeowner nor the insurer knows how closely the sum insured corresponds to the replacement value.

Whenever there are disasters that cause homes to be total losses, the level of under insurance becomes visible. This phenomenon is most evident in bushfires. In both the 2003 Canberra bushfire and the 2009 Victorian bushfires the levels of under insurance were severe, typically 30 per cent or more, except for homeowners whose policies offered replacement cover.

By contrast, most other claims, being partial losses only, are covered by insurers on a replacement or reinstatement basis, so long as the loss does not exceed the sum insured.

It is widely accepted, within and outside the insurance industry, that replacement cover is a superior product for the homeowner to cover for a specified maximum sum insured. Nevertheless there are complexities and competitive problems for insurers to make a transition to replacement cover. Further, there is an adverse cycle occurring where some owners deliberately under-insure, to reduce their premiums, causing cross subsidies from those who do not knowingly under-insure, leading to insurers having to increase premiums for the lower (inadequate) sums insured.

In order to address **under-insurance** and to break the cycle of chronic under-statement of sums insured, the Review Panel is recommending that insurers make the transition to offering full replacement cover, but that they be given some reasonable lead time to do so.

Recommendation: Replacement Value

All home building insurance policies offering sum insured cover be modified by the end of 2014 so as to offer full replacement cover in the event of total loss of the home.

Consumer matters

Claims and internal dispute resolution

The Review Panel is making a number of recommendations to improve policyholders' claims handling and dispute resolution experience.

Recommendation: Claims and Dispute resolution

The Code of Practice be modified to provide for a maximum 4 months to claims determination (that is, a decision to accept or reject liability for a claim) subject to exceptional circumstances, for all claims including during natural disasters.

Internal dispute resolution processes be independent of the claims department, IDR complaints and disputes officers have the authority to overturn the original decisions and to accept claims, and a general fairness test be applied to claims and complaints handling.

The Code Compliance Committee members be appointed by the Financial Ombudsman Service Board, record all breaches of the Code reported to it, investigate breaches of the Code where appropriate, conduct regular audits of insurance companies for compliance with the Code, report serious or systemic breaches direct to ASIC and publicly release an annual report as to the Code compliance and breaches with insurers to be named in the report.

Insurers have shown themselves capable of resolving claims competently and promptly on the whole, during natural disasters as well as in normal times, with the single exception of flood claims. Once flood cover is a standard inclusion as recommended herein, the current problems will largely disappear. The Review Panel would then expect insurers generally to welcome the holding to account of any individual insurers who put at risk, through poor claims, the reputation of the industry.

Consumer awareness at time of purchase

The purchase of home insurance involves an initial agreement usually by telephone backed up the later mailing to the consumer of policy materials including premiums and policy coverage details and the PDS. This is proposed to be supplemented by another 'after sale' disclosure through the Key Fact Statement.

It is well recognised that policyholders have not been actively engaged in reading these often complex post-sale materials. These have little impact in informing consumers in a practical way of the terms and conditions of their policies.

The Review Panel believes that it is important consumers are made aware before they complete their purchase whether the policy has full flood cover and whether it has full replacement coverage. These are extremely important coverage decisions for consumers. It is recommended that consumers be given 'health warnings' if the policy proposed to be purchased does not include flood cover or replacement cover. These warnings should also be included in the Key Fact Statement. Once full flood cover and replacement cover are fully in place this warning at time of purchase may no longer be needed.

Recommendation: Policy coverage

A 'health warning' system be introduced in conjunction with the new Key Facts Statement, pending legislation to give effect to the recommendations above on flood coverage and replacement value for buildings. A 'health warning' would be added to the Key Fact Statement and be required to be provided to customers seeking to purchase a policy by telephone or the internet. The warning would state that 'This product does not provide (full) cover for flood' and 'This product does not provide (full) replacement cover for buildings, you may be under-insured in the event of a total loss.'

This system is designed to increase awareness and understanding of key product features and also to overcome an important component of the current advice problems that insurers have with telephone and internet sales, namely that the purchase is usually completed before the disclosure documents are received.

The system may not continue to be needed if and when full flood cover and replacement value cover become inclusions in all home policies.

Implementation and transition

Legislation will be needed to give effect to the Review Panel's key recommendations that flood cover be included in all home, contents and home unit insurance policies, establishing a national agency to coordinate flood risk management, introduce a system of flood premium discounts and operate a reinsurance facility.

In the interim, properties will continue to be exposed to flood risk and the Review Panel is therefore recommending that the Government give priority to introducing the necessary legislation.

Furthermore, the Review Panel is recommending that a number of intermediate steps be taken. They include the Government taking preparatory steps towards establishing the new disaster risk and insurance agency and introducing 'health warnings' for home and contents policies about flood cover and replacement value cover. They also include the Insurance Council making a series of

amendments to the General Insurance Code of Practice in the interests of improved consumer awareness and consumer protection regarding the handling of home and contents insurance claims.

LIST OF RECOMMENDATIONS

The Review Panel makes four pivotal recommendations:

Pivotal Recommendation 1: Architecture

That an agency sponsored by the Commonwealth Government be created to manage the national coordination of flood risk management and to operate a system of premium discounts and a flood risk reinsurance facility, supported by a funding guarantee from the Commonwealth.

Pivotal Recommendation 2: Availability

That all home insurance, home contents and home unit insurance policies include flood cover.

Pivotal Recommendation 3: Affordability

That a system of premium discounts be introduced in order that most purchasers of home insurance, home contents and home unit insurance policies in areas subject to flood risk be eligible for discounts against the full cost of flood insurance.

Pivotal Recommendation 4: Funding

The Commonwealth Government guarantee the payment of claims by ensuring that, whenever a funding shortfall occurs in the reinsurance facility through claims exceeding the funds held in the facility, the Commonwealth would meet the shortfall and the Commonwealth would seek reimbursement of a portion of the shortfall from the State or Territory government in whose jurisdiction the flood occurred.

The recommendations in detail are:

Recommendation 1:

That all home building insurance policies include flood cover.

Recommendation 2:

That home building and home contents insurance should not be made compulsory.

Recommendation 3:

That whenever flood cover is included in home building insurance policies:

- flood-specific sub-limits not apply; and
- any excess that applies to flood cover be commensurate with that applicable to other insured perils.

Recommendation 4:

That the following five principles underpin the design of a system of premium discounts:

- premiums should rise with the level of flood risk;
- those whose homes do not face a flood risk should not pay a flood premium;
- there should be no cross subsidisation of premiums between policyholders;
- there should be some limitations on discounts to high-value homes; and
- the discount mechanism should be simple for policyholders and automated for insurers.

Recommendation 5:

That flood premium discounts be provided for home building insurance for eligible homes:

- the discounts be assessed by reference to an 'affordability threshold' for flood premiums;
- only existing homes would be eligible for discounts; and
- discounts would be phased out gradually over time.

Recommendation 6:

The levels of the discounts and the phasing out periods be reviewed from time to time.

Recommendation 7:

That there be limitations on the size of the discount available to high value homes.

Recommendation 8:

That all home unit insurance policies include flood cover, in the same manner as for homes.

Recommendation 9:

That flood premium discounts be provided, in the same manner as for homes, to the bodies corporate of eligible properties, and on the same basis as for detached homes.

Recommendation 10:

That the definition of a home for the purposes of flood cover and flood premium discounts be any building for which a homeowner purchases a home insurance policy.

- This definition ensures that the Review Panel's recommendations would apply to all 'non-standard' types of homes such as manufactured homes and mobile homes insured under a home buildings insurance policy.

Recommendation 11:

That all home contents insurance policies include flood cover.

Recommendation 12:

That discounts be provided, in the same manner as for homes, to home contents insurance policies for eligible properties.

Recommendation 13:

That all insurers offering small business insurance be obliged to include flood cover on an opt-out basis, instead of an opt in/opt-out basis as at present, in all of their small business package policies.

Recommendation 14:

That flood premium discounts not be provided to small businesses and that the reinsurance facility not offer reinsurance for small businesses.

Recommendation 15:

That the questions of flood cover as standard in small business policies and access to discounted premiums for small business policyholders should be revisited once the recommended arrangements for homes, home units and home contents are in place.

Recommendation 16:

That flood premium discounts be delivered through a model that requires insurers to retain and price a portion of the risk with the remainder to be ceded to the reinsurance facility at a discounted reinsurance premium.

Recommendation 17:

That for home building insurance policies receiving full discounts, policyholders pay for that portion of the risk retained by the insurer and pay nothing for the remainder of the risk up to \$500,000. For properties with a value greater than \$500,000 policyholders then pay the full cost of the portion of risk exceeding \$500,000.

Recommendation 18:

That for body corporate insurance policies receiving full discounts, policyholders pay for that portion of the risk retained by the insurer and pay nothing for the remainder of the risk up to \$500,000 times the number of units. For properties with a value greater than \$500,000 times the number of units policyholders then pay the full cost of the portion of risk exceeding \$500,000 times the number of units.

Recommendation 19:

That for home contents insurance policies, policyholders pay for that portion of the risk retained by the insurer and pay nothing for the remainder of the risk up to \$100,000. For contents with a value greater than \$100,000 policyholders then pay the full cost of the portion of risk exceeding \$100,000.

Recommendation 20:

That homes at high and extreme risk of flood be provided with discounts initially and that they be assessed regularly for mitigation work already undertaken and the potential for further mitigation.

Recommendation 21:

That a flood risk reinsurance facility, or reinsurance pool, be established which would have two primary functions:

- to deliver discounts to home, contents and home unit insurance policies for eligible properties; and
- to provide flood reinsurance capacity to the insurance market;

and two key design features:

- an excess of loss arrangement whereby insurers retain and price a 'first loss' portion of each policy on a commercial basis; and
- a 'facultative/obligatory' reinsurance treaty that would allow insurers to cede individual properties to the pool if they wish (facultative offer) but the pool would be obliged to accept them (obligatory acceptance).

Recommendation 22:

That the Commonwealth Government guarantee payment of claims from the reinsurance pool by ensuring that, whenever a funding shortfall occurs in the pool through claims exceeding the funds held in the pool, the Commonwealth would meet the shortfall.

Recommendation 23:

That the Commonwealth seek reimbursement of some portion of the shortfall from the State or Territory government in whose jurisdiction the flood occurred.

Recommendation 24:

That to facilitate flood risk information being made publicly available, Commonwealth, State and Territory governments grant indemnities to the providers of flood risk information if the information is obtained and provided in good faith and in the absence of any gross negligence.

Recommendation 25:

That a national agency sponsored by the Commonwealth Government be established to undertake national coordination of flood risk management and to operate the system of premium discounts and the flood risk reinsurance facility.

The Agency would:

- coordinate flood mapping across the country (while leaving responsibility for undertaking flood mapping in the hands of State and Territory governments and local authorities);
- introduce national guidelines for flood risk mapping and classifications, prepared in consultation with producers and users of flood risk information;
- act as a national repository of flood risk information, primarily through collating and analysing information collected by others;
- continue development of the Insurance Council of Australia's National Flood Information Database or an equivalent developed by the Agency;
- monitor the effectiveness of flood risk mitigation initiatives across the country and advise on priorities for flood risk mitigation;
- publish and disseminate flood risk information in forms appropriate to various groups of users; and
- oversee the quality of flood risk information.

Recommendation 26:

That the Agency charge insurers a small administrative fee for each policy ceded to the reinsurance facility.

Recommendation 27:

That:

- the Agency offer cover to insurers for cyclone risk, on the same basis as for flood risk, but with no affordability discounts (in the expectation that, when the Agency does its own pricing, it will offer a fair price to home and home unit owners. This price may be lower but is not guaranteed to be lower than the prices of commercial insurers); and
- an investigation be undertaken to ascertain whether there is a basis for granting affordability discounts for cyclone risk, along the lines of the recommended flood insurance discounts, for homes and home units in northern Australia.

Recommendation 28:

That all home, contents and home unit insurance policies cover the policyholder for storm surge, tsunami and landslide, where the storm surge, tsunami or landslide is the result of another event that is covered under the policy and regardless of whether the insured property directly suffers damage from the underlying insured event.

- This includes storm surge associated with a cyclone that does not cross the coastline.

Recommendation 29:

That the Commonwealth engage with the insurance industry and the States and Territories in planning for the future coordination of charitable and government payments to individuals to assist with recovery after future natural disasters.

Recommendation 30:

That access to insurance be enhanced through the development of alternative payment options, in particular:

- by the Commonwealth Government arranging for Centrelink customers to be able to pay insurance premiums fortnightly through Centrepay; and
- by State, Territory and/or local governments and community housing organisations arranging insurance premiums for contents to be able to be incorporated into rent for social and community housing tenants.

Recommendation 31:

That lending institutions remind mortgagors annually of their obligations to hold home insurance and of the risks of under-insurance in order to minimise non-insurance and under insurance of homes.

Recommendation 32:

That all home building insurance policies providing sum insured cover be modified by the end of 2014 so as to include replacement value cover in the event of total loss of the home.

That during the transition period insurers consider how the design features of home building replacement value policies should respond following a natural disaster, including the conditions under which cash settlements are to be offered and finalised.

Recommendation 33:

That subsection 35(2) of the Insurance Contracts Act 1984 be amended so that policyholders are not deemed to be clearly informed of a deviation from 'standard cover' by simply being provided a copy of the insurance policy or product disclosure statement.

Recommendation 34:

That, in endorsing the Government proposal for a Key Facts Statement, the Key Facts Statement list replacement cover and all natural disaster events, identified as 'standard cover' in the Insurance Contracts Regulations 1985.

That insurers issue a Key Facts Statement to policy holders with all new policies written and all policy renewals on an annual basis.

Recommendation 35:

That a 'health warning' be provided by insurers to the purchasers of home and contents policies that do not include full flood cover or full replacement cover. The health warning should be provided:

- in the Key Facts Statement;
- verbally at the time of telephone purchase; and
- in writing on internet quotation software for all online purchases.

Recommendation 36:

That the Commonwealth Government introduce a standard definition of flood in the form proposed in the 'Reforming flood insurance: Clearing the waters' consultation paper.

Recommendation 37:

That, in order to give general insurance policyholders the same legal remedies as other consumers, unfair contract terms laws be applied to general insurance.

Recommendation 38:

That every APRA-authorized general insurer adopt and comply with the General Insurance Code of Practice.

Recommendation 39:

That the Insurance Council of Australia amend the Code of Practice to impose a four month time limit (subject to exceptional circumstances) to make a determination as to liability and the nature of the loss or damage with respect to a claim.

That, should a claimant not receive a determination within the four month period, the claim be automatically escalated to an internal dispute resolution complaint and the insurer notify the Code Compliance Committee of the breach of the Code.

Recommendation 40:

That the Insurance Council of Australia repeal clauses 4.3 and 4.4 of the General Insurance Code of Practice, so that claims arising from natural disasters are subject to the same minimum standards as other claims — including the four month time limit for a determination on liability and the nature of the loss/damage with respect to the claim.

Recommendation 41:

That the Insurance Council of Australia amend clause 4.5 of the General Insurance Code of Practice to extend the time within which claimants in natural disasters have the right to make further claims or lodge reviews after the finalisation of an initial claim to seven months from the date of the relevant natural disaster, regardless of when the initial claim was finalised.

Recommendation 42:

That the Insurance Council of Australia amend the General Insurance Code of Practice to require that:

- internal dispute resolution processes be independent of the claims handling department and the internal dispute resolution officers have the authority to overturn the original decisions and to accept claims;
- internal dispute resolution complaints be finalised within an aggregate of 45 days and if this time limit is not met, the insurer to advise the claimant of his or her right to lodge an external dispute resolution complaint with the Financial Ombudsman Service (if applicable) and to seek independent legal advice;
- time limits on internal dispute resolution complaints commence immediately after a policyholder notifies the insurer of a complaint, whether verbally or in writing; and
- a general fairness test be applied to claims and complaints handling.

Recommendation 43:

That the Insurance Council of Australia amend the General Insurance Code of Practice such that the General Insurance Code Compliance Committee:

- be appointed in the same manner as FOS Panels, with the independent chair and the consumer and industry representatives to be appointed in the same manner as the ombudsman and panel members are appointed under the FOS rules;
- have the authority and resources to record all breaches of the Code reported to it, to investigate breaches of the Code where appropriate and to conduct regular audits of insurance companies for compliance with the Code;
- report serious or systemic breaches of the Code directly to ASIC; and
- publicly release annual reports as to Code compliance and breaches, with insurers to be identified in the reports.

Recommendation 44:

That ASIC conduct a review of the General Insurance Code of Practice three years after the amendments recommended to the Code in this Review are implemented, in order to assess the effectiveness of the Code with a view to determining whether an ASIC Regulatory Guide for claims handling should then be introduced.

Recommendation 45:

That the Commonwealth and State governments provide funding for legal advice and assistance with insurance disputes following natural disasters.

Recommendation 46:

That the current formula for the cost of rebuilding of State and Territory assets under the Natural Disaster Relief and Recovery Arrangements be changed to expenditure before any insurance recoveries by the State or Territory rather than net of any insurance recoveries.

Recommendation 47:

That the Government give priority to introducing legislation necessary to ensure that all home, contents and home unit insurance policies include flood cover and to establish a new national agency for flood risk management and flood reinsurance purposes.

Chapter 1. INTRODUCTION

1.1. Natural disasters, including bushfires, floods, storms, cyclones and earthquakes, are a feature of the Australian climate and landscape. Since the 1800s, European settlement in Australia has been adversely affected by natural disasters. Governor Macquarie, in 1819, pronounced:

'When the too fatal consequences of years has shown the Sufferers the inevitable consequences of their wilful and wayward habit of placing their Residences and Stock Yards within the reach of floods and whilst it must be still in their Remembrance, that many of the deplorable losses would have been in great Measure arrested had the Settlers paid due consideration of their own interests, and to the frequent Admonitions to remain within the flood marks of the townships assigned to them on the high lands.

Those, who notwithstanding shall perversely neglect the present admonition and Exhortation to their own Benefit, must be considered wilfully and obstinately blind to their own interests and undeserving any future Indulgences.¹

1.2. The average annual cost of the damage caused by floods and other natural disasters is estimated to be over \$1 billion,² with devastating losses experienced by individuals, communities and the economy. A range of research suggests that the number and severity of extreme weather events in Australia is set to rise.³

THE NATIONAL STRATEGY FOR DISASTER RESILIENCE

1.3. At its meeting on 13 February 2011, the Council of Australian Governments (COAG) adopted the National Strategy for Disaster Resilience to improve Australia's ability to withstand and recover from future disasters. The Strategy focuses on the shared responsibility of governments, business and communities in preparing for, and responding to, disasters. COAG agreed to take immediate steps to implement the Strategy. Key elements of the Strategy are understanding risks, communicating with and educating people about risks, empowering individuals and communities to exercise choice and take responsibility, and reducing risks in the built environment.

1.4. As part of the Strategy, the Commonwealth, State and Territory governments will be working together to support strategies to foster greater individual and community resilience, including having adequate and appropriate levels of insurance cover. The Terms of Reference for this Review, announced by the Assistant Treasurer on 4 March 2011, make clear that the Review is part of the National Strategy for Disaster Resilience.

1.5. The Review Panel responded to the Terms of Reference in the first instance by preparing and publishing, on 2 June 2011, an Issues Paper that sought public submissions. As a result, more than 100 submissions were received from both private individuals and organisations, including insurers,

1 Extract from Government and General Orders, Government House Sydney, 5 March 1817.

2 Bureau of Transport Economics, 'Economic Costs of Natural Disasters in Australia', Report 103, 2001. <http://www.btre.gov.au/info.aspx?ResourceId=199&NodeId=58> This report estimated that the average annual cost of natural disasters in Australia to be \$1.14 billion over the period 1967-1999.

3 Middelmann, Miriam H (Editor), 'Natural Hazards in Australia Identifying Risk Analysis Requirements' 2007 Geoscience Australia Canberra p iii. https://www.ga.gov.au/products/servlet/controller?event=GEOCAT_DETAILS&catno=65444

governments and government agencies, consumer groups and various experts. During the course of the Review, Panel members have also consulted directly, both individually and collectively, with representatives of insurers, local and state governments, consumer groups and community representatives including some affected by the floods and cyclone.

THE ROLE OF INSURANCE IN RECOVERING FROM NATURAL DISASTERS

1.6. Insurance is a key element in building community resilience to adverse weather events, including natural disasters. It provides financial protection in the event of loss through a process of aggregating premiums and spreading risk. All owners of property, including homeowners, renters and small businesses, are able to protect themselves financially from natural disasters by purchasing insurance. Over the last 5 years, Australian insurers have compensated consumers and businesses by paying over \$11 billion in claims for weather events.⁴

1.7. Having insurance for natural disasters does not reduce the number of deaths and injuries, physical damage and the disruption to normal life. However, it provides readily available funds, following loss, through the insurance industry's well-established delivery channels. Insurance, which is essentially risk transfer, allows the economy to manage risk more effectively, reducing financial uncertainty in the event of a disaster and allowing for a more efficient use of capital by individuals, business and government. Insurance assists individuals, business and the community more broadly to recover financially from disasters.

1.8. Insurance can also play a role in encouraging mitigation to reduce losses from future weather events. The price, or premium, for insurance provides signals about the level of risk from a range of hazards and gives some encouragement for risk mitigation and reduced vulnerability to loss.

1.9. Home insurance policies in Australia have traditionally provided cover for storms, earthquakes, bushfires and cyclones. This has resulted in the private insurance industry playing the role expected of it by the community in many recent natural disasters in Australia, including the Hunter Valley storms in 2007, the Black Saturday bushfires in Victoria in 2009, the Perth and Melbourne hailstorms in 2010 and Cyclone Yasi in 2011. In these events, insurance policies generally responded well to the losses suffered. Properties that were damaged were repaired or rebuilt and lost possessions were replaced, enabling communities to recover from the events. However, not all insurance policies provide cover for flood and in the floods of 2010 and 2011 many policyholders were not compensated for their losses.

HISTORY OF FLOOD INSURANCE IN AUSTRALIA

1.10. Historically, flood has not typically been part of home and contents insurance policies in Australia. Following flooding in Brisbane in January 1974 the then Queensland Insurance Commissioner noted that:

*'It seems likely that the properties of many of the victims of Queensland's flood are not covered by flood insurance. Unless building and contents policies carry a specific extension to include damage by flood, no flood cover exists. If any policyholder is in any doubt about his position, he should contact his insurer immediately'*⁵

4 Pearson, E 'Key Performance Trends for the Australian Insurance Market — slide 15' from Finity Consulting Presentation at Weathering the Future — The 18th Sunshine Seminar 20-21 July 2011.

5 Rutherford, JG in The Courier Mail, 31 January 1974.

1.11. Governments, the insurance industry and individual insurers have reviewed the flood insurance situation after almost every major flooding event since 1974 and have made several attempts to find solutions which would be acceptable to the community and insurers.

1.12. In October 1974, a Committee made up of members of the Australian Insurance Association, overseas reinsurers, brokers and loss adjusters presented a report to the Government entitled *Feasibility Study into the Introduction of a Natural Disaster Insurance Scheme for Australia*. It suggested that a scheme be established for the provision of insurance cover against flooding and several other natural hazards.

1.13. In March 1976, the Commonwealth Government announced that it agreed, in principle, to introduce a natural disaster insurance scheme and established a working party of officials and insurance executives to formulate a scheme. The working party recommended that insurers form a pool to offer natural disaster cover for households and small business.

1.14. The insurance industry had been strongly supportive of a scheme following the 1974 disasters. However, in the period 1976 to 1979 this strong commitment waned and a greater divergence of views within the industry emerged.

1.15. In January 1979, the then Treasurer announced that the Government had decided not to proceed with the implementation of a scheme of this kind. He suggested that such a scheme would be inappropriate on budgetary, technical and insurance policy grounds.⁶

1.16. Little changed with regard to the provision of flood cover once the proposal for a national disaster insurance scheme was rejected. Industry concerns about the magnitude of exposures, a lack of consistent and reliable flood maps, the absence of mitigation and concerns about the ability of policyholders to afford flood cover remained.

1.17. In the early 1980s, the Northern Territory state-owned insurer, the Territory Insurance Office, introduced cover for flood and storm surge from the sea as standard in household insurance policies to ensure that insurance for these events was available to residents of the Northern Territory. This cover has been a part of the Territory's own natural disaster strategy ever since. The premiums charged are designed to cover the costs of these risks (with some cross-subsidies).

1.18. Commencing 1 January 1986, the *Insurance Contracts Act 1984* introduced a statutory codification of general (and life) insurance contracts. Inter alia, the Act and the Insurance Contracts Regulations 1985 introduced standard terms and conditions for prescribed general insurance contracts, including home and contents insurance policies. The standard cover includes as perils flood as well as fire, storm, earthquake, cyclone and actions of the sea, and it also includes full replacement cover for lost or damaged items. However, insurance companies are permitted to vary or exclude any of these 'standard cover' items provided they 'clearly inform' policyholders of the exclusions. Insurers have largely continued to exclude flood.

1.19. In 1989, the insurance industry established the Claims Review Panel (today now part of the Financial Ombudsman Service). The Claims Review Panel had the power to review decisions on individual insurer members, including with respect to flood damage. Until the advent of the Claims Review Panel, very few insurer decisions on flood claims had been tested through the courts. The Claims Review Panel made determinations on the 1993 Benalla floods and the 1998 Townsville floods which brought more losses within the scope of the definitions of storm but did not lead to broad provision of flood cover.

6 Howard, The Hon John 'Natural Disaster Insurance: A Policy Information Paper issued by the Treasurer May 1979 p iii.

1.20. After the Wollongong floods in 1998, where community, government and media pressure led some insurers to make ex gratia payments, several insurers moved to extend their policies to include 'flash flooding' while others provided partial flood cover with sub limits. Westpac introduced flood cover at this time.⁷

1.21. Changes to the *Corporations Act 2001* introduced greater obligations on insurers in respect of disclosure, including Product Disclosure Statements. While these statements provide details of exclusions such as flood, they have had little impact on consumer confusion about what is covered by a policy and did not lead to flood cover being made more widely available.

1.22. 1.22. Other attempts by the insurance industry to find a solution to flood insurance issues followed. Initiatives using different models were tried in 1989-90, 1998 to 2000 and in 2004. Each industry attempt to resolve the problem collectively was unsuccessful because of one or more of the factors of competition, lack of adequate flood maps, lack of government support, affordability and trade practices concerns.⁸

1.23. The controversy resulting from the Newcastle and Hunter Valley floods in 2007 reportedly led the insurance industry to propose a common definition of flood.⁹ The Insurance Council drafted a flood definition and sought an exemption from the Australian Competition and Consumer Commission (ACCC) for what may otherwise have been anti-competitive behaviour among insurers. However, after complaints from consumer groups that the proposed definition was broader than the definition commonly used by insurers (and therefore likely to lead to more excluded flood losses), the ACCC ultimately rejected the proposed wording and the Insurance Council declined an invitation to put forward a modified flood definition.

1.24. Since 2006, offerings by individual insurers have made flood cover more widely available.¹⁰ For example, Suncorp introduced flood cover (on a no opt-out basis) on 1 July 2008 for home and contents policies issued by all its brands except AAMI, Zurich introduced flood cover as standard in September 2008 and IAG offered flood cover under its NRMA brand (allowing customers to opt-out) from June 2009 in NSW, Tasmania and the ACT.¹¹ The Insurance Council also created the National Flood Information Database in 2007 and the information it contains has assisted insurers to provide flood cover.

1.25. As the industry itself notes, however, the challenge is to ensure that the estimated 7 per cent of properties exposed to flood risk are covered by policies which include flood cover.¹² Clearly, there is no benefit in having the 93 per cent of Australian properties at no or minimal risk of flood covered for flood and the 7 per cent of properties with flood risk mostly without flood cover.

7 Mason, AJ, 'The History of Flood Insurance in Australia' p 9 found on <http://www.ndir.gov.au/content/Content.aspx?doc=home.htm>

8 Ibid p 8.

9 AAP 'Easy definition of 'flood' is yet to surface' in the Australian Financial Review, 26 January 2011 http://afr.com/p/national/easy_definition_of_flood_is_yet_H07VEJWagzfoGrE8Wnc5dL

10 In 2006, 3 per cent of policies purchased in Australia covered flood. In 2010, 54 per cent of policies purchased in Australia covered flood. The industry advises that by 2013, it is estimated that a further 30 percent of the market will potentially offer flood cover. Insurance Council of Australia submission p 8 http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Council_of_Australia.pdf .

11 Mason op cit pp 9-10.

12 Insurance Council of Australia submission p 8 <http://www.ndir.gov.au/content/Content.aspx?doc=submissions.htm>

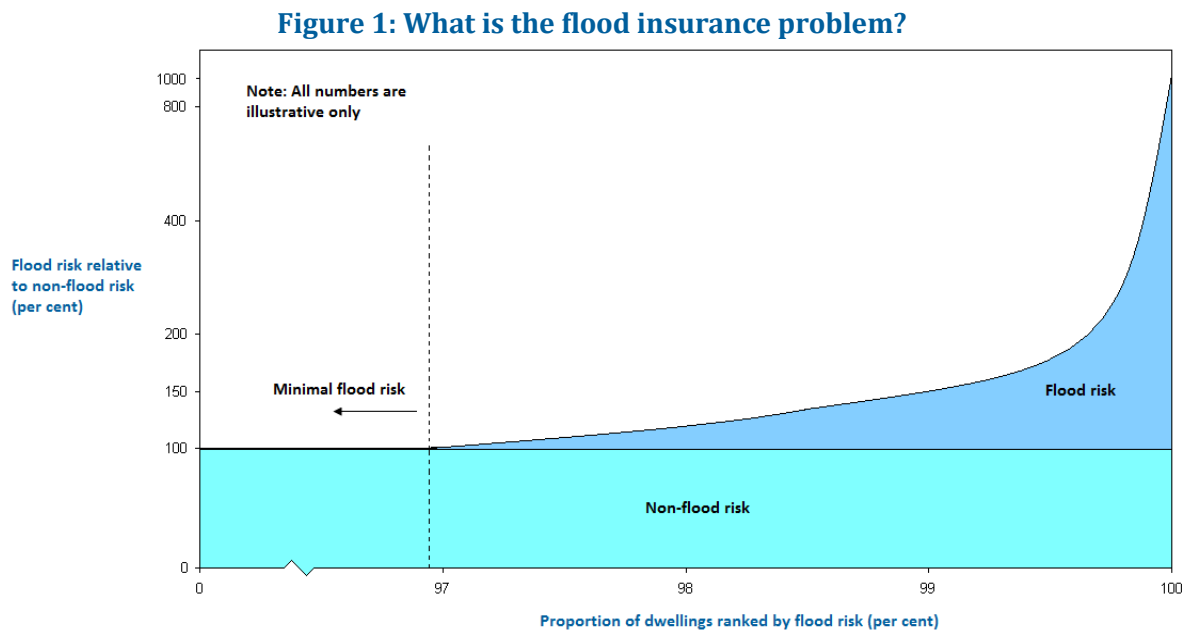
THE FLOOD INSURANCE PROBLEM

1.26. The limited extent of flood cover in home, contents and home unit insurance policies became apparent following the series of natural disasters in Australia over the summer of 2010-11, as has also been the case after previous floods.

1.27. Most natural disasters are covered by these insurance policies. The most common events of storm, cyclone and bushfire are included. Earthquake is also included. Some less common events such as landslide, tsunami and storm surge are sometimes included when they are connected to another insured event such as earthquake in the case of tsunami, storm or cyclone in the case of storm surge, and heavy rainfall in the case of landslide.

1.28. All natural disasters present a challenge for insurers. Since each event typically affects a large number of policyholders at once, a single natural disaster can have a very large impact on insurers exposed to the risk. This challenge, however, does not prevent insurers from offering cover for most natural disasters in all home insurance policies. And, in large part, insurers are able to cover these natural disasters at affordable premiums.

1.29. Flood, however, presents a unique challenge to insurers. Flood typically affects homes located close to a river or on a flood plain. As a result, the same homes are affected each time a river floods. Figure 1 demonstrates that, while the vast majority of homes are exposed to minimal flood risk, there is a small proportion of homes exposed to a high level of flood risk (shown at the far right in Figure 1.)



1.30. As a result of the very high premiums associated with high flood risk, insurers have often simply chosen to exclude flood cover from insurance policies.

1.31. The absence of flood cover leads to a paradox for consumers: home, contents and home unit insurance policies include protection for storm, cyclone, bushfire and earthquake and the policyholder cannot usually opt-out; but flood cover is often excluded for flood and, if flood is covered, the policyholder can usually opt-out.

1.32. Just as the same homes being affected each time a river floods limits the appetite of insurers to offer flood cover, leading to an availability problem, so will these homes face high insurance premiums, leading to an affordability problem. Some homeowners for whom flood cover is available

may choose not to purchase it. The experience of NRMA insurance in NSW, which offers flood cover on an opt out basis, shows that many policyholders exposed to high flood risk opt not to take-up flood cover.¹³

1.33. The implications of limited flood cover for consumers, insurers and the community played out in Brisbane, Ipswich and parts of Victoria over the summer of 2010-11. The insurance policies held by people affected by the storms or by Cyclone Yasi responded to those events, enabling policyholders to repair or rebuild with minimal delay and disputes. But some people who were flooded did not have flood cover as part of their insurance. This led to financial stress, delays and disputes.

1.34. Without flood cover, affected homeowners were left without the financial resources to repair or rebuild their homes. Some policies that included flood cover were subject to 'sub-limits' that restricted the claim payments to specified amounts that were significantly less than the value of the homes. Some policyholders who suffered total losses found that the sums insured specified in their insurance policies were insufficient to restore their homes or their contents, again leaving them with a financial burden.

1.35. While flood is not always covered in home insurance policies, storm damage is always covered. Where insurers were unsure as to the cause of the damage, insurers invariably needed to conduct hydrological assessments in order to determine whether the damage was caused by flood or storm before they could determine the claim. These assessments led to lengthy delays in many cases. The average number of days taken to accept liability was 28 days with respect to the Brisbane floods, compared with 7 days following Cyclone Yasi.¹⁴ The average also masks some very wide variations with some policyholders waiting 6 months or more to have their claims determined. These delays have left those with damaged homes in limbo and unable to undertake repairs or return to their homes. Delayed insurance claims also delayed payments from the Queensland Premier's Fund. Accompanying the delays, there were many complaints about a lack of communication from insurers while policyholders awaited answers. Some policyholders were also unsure about whether their insurance provided cover for flood.¹⁵

1.36. The 'flood versus storm' problem (see Appendix A for further explanation of flood versus storm) also led to more disputes following the floods than have followed other natural disasters. Table 1 (below) shows that the number of disputes as a proportion of insurance claims was much higher in the Queensland and Victorian floods than in Cyclone Yasi, the hail storms in Melbourne and Perth and the storms in Melbourne. Disputes lodged with the Financial Ombudsman Service as a proportion of claims from the Queensland and Victorian floods were nearly twenty times larger than disputes from the other events. Also many more policyholders sought legal advice: of the disputes taken to the Financial Ombudsman Service, 37 per cent of those with disputes arising from the Queensland floods had legal representation compared with 5 per cent of disputes from Cyclone Yasi.¹⁶

13 IAG submission, p 3
<http://www.ndir.gov.au/content/Content.aspx?doc=submissions.htm>

14 Unpublished data provided to the Review Panel by the Insurance Council of Australia.

15 The Legal Aid Queensland submission highlights the experience of clients across a wide variety of issues.
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Legal_Aid_Queensland.pdf

16 Financial Ombudsman Submission to the House of Representatives inquiry into the operation of the insurance industry during disaster events, 2011, p21
<http://www.aph.gov.au/house/committee/spla/insurance/submissions.htm>

Table 1: Disputes lodged with Financial Ombudsman Service¹⁷

Disaster Event	Number of Insurance claims as at 24/6/2011	Number of disputes lodged as at 30/6/2011	Lodgements per 1000 claims
SW/SE Queensland flooding — Roma and Charleville	7,056	21	3.0
Victorian Hail Storm — Melbourne	135,000	93	0.7
WA Hail Storm — Perth	165,000	43	0.3
Queensland Flooding — Brisbane, rural Queensland, Toowoomba, Lockyer Valley	56,200	479	8.5
Victorian flooding — rural Victoria	7,500	111	14.8
Cyclone Yasi — Cassowary Coast, North Queensland	68,300	49	0.7
Victorian Storms — Melbourne and suburbs	48,000	56	1.2
WA bushfires — Perth and surrounds	410	0	0

Source: See footnote.

1.37. The number of lodgements per 1,000 claims, as recorded in the right-hand column of this table, shows the clear difference between the frequency of disputes in floods (8.5 and 14.8 for the Queensland and Victorian floods, with much lower frequencies for the storms).

1.38. The delays and disputes also had an impact on insurers, who suffered considerable public backlash and some loss of the community's confidence. At a time when insurers' claims staffs were being asked to deal with large numbers of claims, there were incidents of staff being abused. Insurers have also borne the costs involved in determining the cause of the damage and in resolving the many disputes.

1.39. The financial stress, delays and disputes felt by individuals also inhibited the community's recovery. The greater the take-up of full home insurance cover for natural disasters, the greater the resilience and recovery of the community when a natural disaster occurs and the lower the reliance on community support.

1.40. When an individual suffers financial loss from a natural disaster, the impact is felt by the broader community; for example, such individuals might be forced to leave the community either temporarily or permanently, affecting social infrastructure such as local businesses and community groups. As flooding occurs in concentrated areas, many members of the community can suffer simultaneously. Any lack of flood insurance increases the burden on the community as it goes through the recovery phase.

1.41. The community also bears some of the financial impact through charitable funds and government relief payments. In Queensland in 2011, the Premier's Fund raised \$273 million to

17 Financial Ombudsman Service Submission to the House of Representatives Standing Committee on Social Policy and Legal Affairs Inquiry into operation of insurance industry during disaster events, 29 August 2011, p 19 <http://www.aph.gov.au/house/committee/spla/insurance/submissions.htm>

distribute to those affected by the floods and Cyclone Yasi.¹⁸ Spending by the State and Commonwealth governments on individuals and businesses has totalled approximately \$1.1 billion.¹⁹

1.42. Limited flood cover caused distress, delays and disputes for the individuals who were flooded. It also affected adversely the community's resilience and its ability to recover from the floods. That is why the key issue before the Review Panel is how to meet the community need for flood cover.

AN INTEGRATED SOLUTION

1.43. Addressing the availability of flood insurance on its own will not solve the coverage problem. There are a number of constraints that must be addressed to deliver improved flood cover.

1.44. Firstly, for homes at high risk of flood, the premium required by the insurer to offer them flood cover will be high. That could lead to an affordability problem for these policyholders who may respond by ceasing to use insurance altogether. Addressing availability without addressing affordability will therefore not deliver more flood cover. Both availability and affordability need to be dealt with together.

1.45. Secondly, to maintain a competitive insurance market, insurers need control over their flood risk exposures and accumulations, adequate information for pricing and underwriting and the ability to charge commercial premiums for the flood risks that they underwrite. A commercially sound insurance market is essential for delivering flood insurance.

1.46. Thirdly, any measures to improve flood insurance coverage should encourage improved flood risk management (measurement and mitigation), either on their own or in conjunction with other measures. If under-priced flood insurance is available, it can encourage further property development in areas exposed to flood risk. Clearly, therefore, any attempt to improve affordability by offering insurance at discounted prices needs to be done in such a way that adverse incentives of this kind do not arise.

1.47. In order to meet these three constraints the Review Panel has identified five requirements that are integral to a solution. Subsequent chapters of this Report discuss each of these requirements in turn and make associated recommendations before explaining the architecture that the Review Panel is recommending to bring them all together as an integrated solution.

- Chapter 2 considers the **availability of flood cover** for homes (buildings only).
- Chapter 3 addresses the **affordability of flood cover** for homes.
- Chapters 4 and 5 consider both the availability and the affordability of flood cover for home units and home contents.
- Chapter 7 explains how a **system of flood premium discounts** might operate in conjunction with a **government-sponsored reinsurance facility**, or reinsurance pool, to deliver discounted flood premiums through insurers in a manner that would be simple for policyholders and would not compromise the commercial positions of insurers while also providing them with new flood insurance capacity. Chapter 7 also discusses **funding** of the discounts.

18 Queensland Reconstruction Authority August Report, 2011, p36 <http://www.qldreconstruction.org.au/u/lib/CEO-Report---August-2011-Report---Public.pdf>

19 Queensland Reconstruction Authority, August Report pp34-35
<http://www.qldreconstruction.org.au/reports/august-2011-monthly-report>.

- The nature of flood risk measurement and how it might be improved in the future is explained in Chapter 8, which discusses the need for national co-ordination of flood risk **measurement and mitigation** that will, among other things, underpin the availability and affordability of flood cover.

1.48. Chapter 9 then explains the **architecture** that would be needed to bring together all these considerations into an integrated framework, in the form of a national disaster risk and insurance agency.

1.49. While the main focus of the Review is flood insurance, the Terms of Reference ask the Review Panel to consider natural disaster insurance more broadly. Chapter 10 is concerned with the availability and affordability of cyclone insurance, an issue that was specifically raised in submissions from residents of north Queensland. It also makes recommendations concerning actions of the sea and landslides.

1.50. The Terms of Reference also ask the Review Panel to consider a number of other insurance matters, some of which are not confined to natural disasters.

- The factors contributing to non-insurance and under-insurance are explained in Chapters 11 and 12 respectively, along with some associated recommendations.
- Chapters 13 and 14 recommend changes to improve consumer awareness of the scope and coverage of insurance and insurance products to assist consumers and also to improve claims management, dispute resolution and advocacy services.
- Chapter 15 recommends a change to the way that the Commonwealth Government and State governments share the cost of reconstruction of State assets following natural disasters.

1.51. Noting that some of the recommendations in the Report will require further development and legislation to be passed by the Parliament before they can take effect, Chapter 16 proposes that some recommendations be pursued immediately to ensure that insurance can respond more effectively to the next flood.

Chapter 2. THE AVAILABILITY OF FLOOD INSURANCE FOR HOMES

THE NEED

2.1. The absence of flood cover for many policyholders was the primary stimulus to the Review. As noted in Chapter 1, all home insurance policies include cover for bushfire, earthquake, cyclone and storm, but not flood. While home insurance cover for these other natural disasters has been widely available in Australia for many years, flood cover has traditionally been excluded from home insurance policies, and only over the last decade has flood cover been made available by a limited number of insurers. Where it is available, consumers are often able to opt-out of flood cover and evidence indicates that, when able to opt-out, many policyholders do so.

2.2. In summary, there is a serious community need around the availability and affordability of flood insurance in high risk areas. It is essentially a coverage issue. When floods occur, individuals and the community often suffer severe economic and social losses; these losses are exacerbated by the fact that many policyholders do not have flood cover, leading to financial hardship that impedes personal and community recovery. Addressing the limited availability and affordability of flood cover is the primary task before the Review Panel.

2.3. For some of those who lost their homes in the floods of 2010-11, or whose homes were significantly damaged, the lack of financial protection afforded by their insurance was a significant blow. The Review Panel's consideration of the issues therefore begins with flood insurance for the home.

THE OPTIONS

2.4. In its Issues Paper, the Review Panel identified three models that would each deal with availability to different degrees. The first model, termed 'Automatic Flood Cover', would oblige all insurers to offer flood cover in their home insurance policies and require all homeowners who purchase home insurance to purchase flood cover. The second model, 'Automatic Flood Cover with Opt-out', would oblige all insurers to offer flood cover in their home insurance policies, but homeowners would be able to opt-out of flood cover. Under the third model, the 'Status Quo', or 'Opt In / Opt-out', insurers would continue to be able to offer full, partial or nil flood cover in home insurance policies and homeowners would continue to be able to purchase insurance with or without flood cover. The Review Panel noted that, in all three cases, affordability could only be catered for through a system of premium discounts offered for homes with high flood risk.

THE CONCLUSION

2.5. After considering these three models and the wide range of input received through submissions and consultations, the Review Panel has concluded that there is only one model that would meet the needs of homeowners and the community, and that is 'Automatic Flood Cover', on the proviso that it can be offered in a way that meets three important constraints:

- Flood cover for those homes with a high risk of flood can result in high insurance premiums leading to problems of affordability.

- To maintain a commercially sound insurance market, insurers need control over their flood exposures and accumulations, adequate information for pricing and underwriting, and the ability to seek commercial prices for any flood risks that they underwrite.
- There has been sub-optimal risk management of flood-prone land and buildings in the past. Accordingly, any new arrangements to facilitate improved insurance coverage should also encourage, either of themselves or in conjunction with separate initiatives, improved flood risk management (that is, improved flood risk measurement and mitigation).

2.6. The reasons for having flood cover included in all home insurance policies, and thereby eliminating the ‘flood versus storm’ problem, are clear from the needs already explained in the previous Chapter. Because of the importance, however, of dealing meaningfully with the three constraints of affordability, the commercial soundness of insurers and effective flood risk management, the Review Panel has explored extensively all options for responding to these constraints.

2.7. Noting also that ideas that would respond to these constraints imply some major initiatives and changes, the Review Panel has considered carefully the implications of maintaining the current arrangements (opt in/opt-out) and flood cover with opt-out, in order to be fully satisfied that making a transition to flood cover in all home policies is justified.

2.8. The remainder of this Chapter explains the implications of all these models in order to clarify the problems and weaknesses of the two rejected models and to document the benefits of having flood cover in all home insurance policies.

CONSIDERING THE THREE OPTIONS

2.9. There is an expectation that the availability of flood insurance will improve in the period ahead. Some insurers already offer flood insurance, either nationally or in some parts of the country, and some others are making arrangements to do so in the near future.²⁰

2.10. The Insurance Council claims that in 18 months time flood insurance will be offered in more than 84 per cent of home insurance policies.²¹ However, this figure provides no indication of the extent of take-up of these offerings, particularly by the approximately 7 per cent of homes which are exposed to a risk of flood. For example, IAG notes that it currently provides NRMA policyholders an ability to opt-out of flood cover in New South Wales and that only a minority of customers in flood-prone areas choose to take-up flood cover.²² An expansion in the offering of flood cover will not solve the coverage problem unless policyholders take it up.

The ‘Status Quo’ or ‘Opt in/Opt-out’

2.11. If insurers continue to be able to choose whether to exclude flood cover from their home insurance policies, either by not offering or allowing policyholders not to buy flood cover, it will continue to be possible for a homeowner to purchase a home insurance policy without flood cover, and therefore to be exposed to an uninsured flood risk. Some homeowners may choose not to purchase flood cover and others may purchase a home insurance policy unaware that it does not cover them for flood. Some choosing not to purchase flood cover may subsequently suffer water

20 Suncorp submission, p 7; IAG submission, p 3.

21 Insurance Council of Australia submission, p 2.

22 Op cit, p 3.

damage that they expect to be covered by their insurance policy but which is not, due to technicalities associated with the definition of flood. As in the past, this will lead to disputes and delays in having liability for their claim determined. The initiatives of insurers alone, therefore, will not be adequate.

2.12. In summary, notwithstanding the extension of flood cover availability, the combination of affordability problems and lack of incentive to take-up flood cover will lead to a repeat, after the next flood, of the same problems that have caused so much distress and dissatisfaction as in past floods.

‘Automatic Flood Cover with Opt-out’

2.13. It is the view of the Review Panel that requiring insurers to include flood cover in their home insurance policies, but allowing policyholders to opt-out, would not represent an adequate improvement over the existing arrangements. Such an approach might lead to some increase in the take-up of flood insurance, since homeowners would need to explicitly decide not to accept the insurer’s offer of flood cover. Some may make a conscious choice to do so whilst others may not exercise a conscious choice and have cover by default.

2.14. However an opt-out provision is typically only effective, however, in driving take-up where the default option involves minimal perceived cost to the decision maker. For example, where the choice to become an organ donor has been changed from an opt-in to an opt-out decision, the number of registered organ donors has substantially increased.²³ Given then that the take-up of flood cover will come with a cost for some policyholders, and particularly for homes with material flood risk, an opt-out provision is unlikely to drive a significant take-up of flood insurance. The NRMA experience in New South Wales illustrates that it does not work effectively when there is a material cost involved.²⁴

2.15. The opt-out approach, therefore, would not provide the solution to the coverage problem needed by homeowners and the community. Allowing policyholders to opt-out would mean that there would continue to be financial and social costs imposed on the community as a result of homeowners facing financial stress following a flood. There would continue to be delays in determining the cause of damage, deferring the ability of homeowners to recover and resume normal lives. There would continue to be more disputes with insurers than after other natural disasters, creating costs and stress for homeowners and insurers. Insurers may also continue to face a backlash and brand damage from homeowners who believed that their insurance had not delivered to their expectations.

2.16. Accordingly, whilst the ‘opt-out’ option may lead to some increase in the take-up of flood insurance, Australians will still see a continuation of the problems that have plagued past flood events and it is therefore in the Review Panel’s opinion, an inadequate solution.

‘Automatic Flood Cover’

2.17. There are numerous consequences of the inclusion of flood cover in all home insurance policies, most of them beneficial. The more important ones as assessed by the Review Panel are described in the following paragraphs.

23 Johnson and Goldstein, ‘Do Defaults Save Lives?’, 2003, *Science*, Vol. 203.
<http://webs.wofford.edu/pechwj/Do%20Defaults%20Save%20Lives.pdf>

24 IAG submission, p 3
[http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_\(IAG\).pdf](http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_(IAG).pdf)

2.18. Flood cover in all home policies would provide all policyholders with the same financial protection for flood that they currently receive in the event of other natural disasters and would provide policyholders certainty of insurance coverage. The delays and uncertainty for policyholders that have resulted in assessing flood claims, where insurers have had to conduct detailed hydrological assessments to determine the source of water damage, would be eliminated in future, relieving many policyholders of considerable disruption and distress. Eliminating the need to distinguish between flood and storm would significantly reduce disputations following a flood.

2.19. The assessment that homeowners currently have to make in determining whether they need or should buy flood cover, and whether a particular insurance policy provides flood cover, would be eliminated. This assessment is often difficult. Insurance is a complex product; the disclosure statement that describes the product is a long and complicated legal document. The issues faced by consumers in dealing with complex decisions are well understood in the behavioural economics literature. Consumers have been observed to systematically make choices that are not in their own interests when payoffs are uncertain and infrequent.²⁵ Where insurers are able to exclude flood cover from their home insurance policies, a product already difficult to navigate is made even more difficult. It is no surprise, given this complexity, that many homeowners have found themselves with a home insurance policy that does not cover damage to their home caused by flood. The Review Panel's recommendation for flood to be included in all home insurance policies would overcome all of these issues.

2.20. The community would also benefit. The lower the financial impact of a natural disaster on the members of a community, the lower the impact on the community generally. The more quickly and ably members of the community can get back on their feet after a natural disaster, the more quickly community life can resume.

2.21. The inclusion of flood cover in all home insurance policies would reduce the reliance on charity and the financial burden on governments following a flood would be reduced, through reduced government support payments, making these funds available for other purposes.

2.22. This approach would also provide benefits to insurers. If all home insurance policies included cover for flood, the reputational damage that the insurance industry has suffered after floods would be all but eliminated. The confidence of the public in insurance generally would not be prejudiced, as policyholders could have confidence that their primary financial safety net will provide support when required. The costs incurred by insurers and the pressure on their staff due to the high number of disputes when floods occur would be eliminated.

2.23. Some submissions to the Review oppose the inclusion of flood cover in all home insurance policies as they claim it would reduce consumer choice.²⁶ It is true that homeowners would not be able to choose to have home insurance without cover for flood. It is worth noting, however, that a homeowner usually cannot choose to purchase home insurance without cover for storm, cyclone, bushfire or earthquake. General insurance necessarily involves the bundling of risks, many of which cannot be unbundled. The ability to choose not to be covered for certain forms of water damage and yet not having other coverage choices is, in the opinion of the Review Panel, of negligible value to homeowners.

2.24. As discussed in paragraph 2.5, in order for all home insurance policies to include flood cover, however, a number of constraints need to be met: affordability for homeowners with a high flood

25 For example, Kunreuther, Meyer & Michel-Kerjan, 'Overcoming Decision Biases to Reduce Losses from Natural Catastrophes', Wharton School of the University of Pennsylvania, <http://opim.wharton.upenn.edu/risk/library/C2009-HK,RIM,EMK.pdf>

26 Insurance Council of Australia submission, p 2; Suncorp submission, p 7; Allianz submission, p 2; Wesfarmers Insurance submission, p 10.

risk; the maintenance of a commercially sound insurance industry; and an improvement in flood risk management. The Review Panel believes that each of the constraints can be accommodated in a manner that justifies and supports the provision of flood cover in future in all home building insurance policies.

Recommendation 1:

That all home building insurance policies include flood cover.

2.25. The Review Panel has considered whether home insurance should be made compulsory for all homeowners, for all perils including flood. It is currently a matter for homeowners as to whether they choose to purchase insurance cover for their homes and it is a matter for insurance companies to decide whether to offer home insurance and, if so, to whom. In the opinion of the Review Panel, it would not be appropriate to change this situation and to compel homeowners to buy insurance for their homes. The Review Panel recommends, therefore, that insurance for neither home buildings nor home contents be made compulsory. This position is explained further in Chapter 11 and is of course distinct from the previous recommendation that, if a homeowner purchases home insurance, flood cover be part of the insurance policy.

Recommendation 2:

That home building and home contents insurance should not be made compulsory.

ITEMS INCLUDED IN FLOOD COVER

2.26. There are a number of items associated with the home, such as fences, sheds, pergolas, pools and jetties, that insurers sometimes exclude from their home insurance policies. If an insurer decides to exclude an item from cover under a home insurance policy, then that decision should be able to apply equally to flood cover provided by the insurer. If an insurer covers an item under its home insurance policy, however, then it should cover that item for flood.

2.27. Similarly, insurers typically exclude from cover under their home insurance policies any structures that are not approved by the local council. For example, in some parts of Queensland where it is common for the habitable floor level to be elevated, homeowners have built unapproved structures below the habitable floor level. Such structures can be particularly susceptible to flood damage where the home is in an area of flood risk. Where an insurer excludes such unapproved structures from its home insurance policies, then consequently, no flood cover would apply to those structures.

EXCESSES AND SUB-LIMITS FOR FLOOD COVER

2.28. Only where homeowners have full cover for flood damage, as distinct from partial cover, are they fully protected from the financial impacts and delays arising from flood. If insurers restrict the insurance cover they provide for flood, as some have done in the past, compared with that for other natural disasters, then there will continue to be issues of limited coverage, delays and disputes in the event of a flood.

2.29. One way that some insurers have sought to limit their flood coverage is via a sub-limit. Some insurance policies have included a sub-limit for flood damage which restricts the maximum payout in the event of flood damage to a level substantially below the replacement value or sum insured of the

home. While the provision of flood cover with a sub-limit may be better than no flood cover at all, the Review Panel considers that flood cover when included should be on the same basis as cover for other perils. The community expects insurance to provide the same protection for the policyholder in the event of a natural disaster, whether it be storm, bushfire, earthquake or flood.

2.30. Another way that some insurers limit their flood coverage is via an excess in the event of a flood claim. Whereas a sub-limit restricts an insurer's exposure to large claims and leaves them exposed only to smaller claims, a large excess has the opposite effect: it restricts an insurer's exposure to small losses and leaves them exposed only to larger losses. Just as with a low sub-limit, where a large excess is applied to flood claims, the policyholder remains exposed to a large financial shock in the event of flood.

2.31. Furthermore, where flood sub-limits or high flood excesses apply, when floods occur insurers need to conduct assessments to determine whether the damage was caused by flood or storm, potentially leading to the same kinds of delays as for policies with no flood cover.

2.32. Hence the use of flood sub-limits and high flood excesses generates many of the same difficulties as flood exclusions.

2.33. The Review Panel therefore recommends that insurers not be able to apply a flood specific sub-limit to flood cover, and any excess that applies to flood cover be commensurate with that applicable to other perils covered under the policy. This would ensure that the provision of flood cover by insurers would provide genuine, complete protection in the event of a flood. Policyholders would be fully protected from the financial shock, delays and disputes that would otherwise follow a flood.

Recommendation 3:

That whenever flood cover is included in home building insurance policies:

- flood-specific sub-limits not apply; and
- any excess that applies to flood cover be commensurate with that applicable to other insured perils.

Chapter 3. THE AFFORDABILITY OF FLOOD INSURANCE FOR HOMES

3.1. As noted in Chapter 2, the Review Panel considers that the inclusion of flood cover in all home insurance policies would meet the needs of homeowners and the community, provided that it can be offered in a way that meets the three important constraints of affordability, commercial soundness of insurers and risk considerations and effective flood risk management. This chapter considers the affordability question.

THE AFFORDABILITY PROBLEM

3.2. Table 2 provides some estimates submitted by the Insurance Council of the level of flood insurance premiums for homes exposed to differing levels of flood risk. They are not precise and have a number of caveats.²⁷ Nevertheless, they provide an indication of the distribution of homes by level of flood risk and of the extent of premium increases that might be required if all homeowners were obliged to meet the full costs of flood insurance.

Table 2: Insurance Council of Australia estimates of flood insurance premiums by flood risk

Risk Band	Frequency of Flooding (Annual Return Interval)	Number of properties	Annual Flood Risk Premium \$
No flood risk	Nil	6,174,912	0
Low	Greater than 111	276,277	77
Medium	111 to 50	50,366	378 — 572
High	50 to 20	57,867	952 — 2,1773
Extreme	20 to less than 15	57,578	2,439 — 6,777

Note: These are estimates of the risk rated price only and do not include other costs that would be added to a retail premium such as taxes or brokerage fees.

Source: Insurance Council of Australia submission, p 14.

3.3. On the basis of this table, the inclusion of flood cover in home insurance policies ought not to have any effect on the home insurance premiums for the 6.2 million homes without flood risk. For the 276,000 homes at a low risk of flood, the price impact would be low, at less than \$100 per annum. For the remaining 166,000 homes, the impact would be larger, ranging from the hundreds to thousands of dollars per annum. Note that the total number of homes according to this table is about 6.6 million.

3.4. It is clear from this table that, without additional measures, the inclusion of flood cover in all home insurance policies would result in high insurance premiums for homes with a medium, high and extreme risk of flood (to use the Insurance Council’s classifications), leading to an affordability problem. Affordability may be thought of in this context in two parts:

- Sharp price increases: irrespective of the value offered, purchasers of most products or services react against large or sharp increases in price and may decide not to purchase the product or service.

27 Insurance Council of Australia submission, p 14.

The perception of value and affordability in these cases is conditioned by the prices that have been paid in the past. Sharply higher prices are perceived as unfair or not worthwhile and so can be treated as unaffordable.

- High cost: high prices for products or services, as distinct from high price increases, naturally limit demand as potential purchasers weigh up their choices on what to spend their money on and what not to spend it on.

It is instructive here to compare typical home insurance premiums in cyclone-affected areas in north Queensland with premiums in other areas. In the north, homeowners pay premiums of \$1,500 to \$2,000 to insure homes that are worth \$300,000, whereas the same homes in other parts of the county might require premiums of just \$500 to \$600. The levels of non-insurance for homes in north Queensland are understood to be small, as they are in the rest of Australia but, in the north, homeowners have become accustomed to the higher prices, which of course reflect the higher risk of wind and storm damage in an area that is exposed to cyclones.

3.5. In current circumstances, it is the topic of potential sharp price increases for flood insurance which is of more interest, because it is price increases that will be relevant if a transition is to be made for many homeowners from no flood cover and no flood premium to full flood cover and some additional premium for that cover.

3.6. It is evident that, without measures to limit or alleviate premium increases on the introduction of flood cover in all home policies, a high flood premium could lead some homeowners to opt-out of insurance altogether. This would leave them exposed not only to the risk of flood but also to a range of other risks. This is the affordability constraint referred to above: the goals of this Review would be compromised if the introduction of flood cover in all home insurance policies had the effect, as the result of additional premiums for flood cover, of increasing the levels of non-insurance of homes. In other words, it is imperative that premium increases on the introduction of flood cover be limited in some way so that there is no material increase in levels of non-insurance during the transition.

3.7. The extent of any likely increase in non-insurance as a result of price increases is difficult to determine. Existing research indicates that policyholders are generally tolerant of some increases in their home insurance premiums and will absorb them rather than let their insurance lapse.²⁸ The home is the primary financial asset for many homeowners, who therefore value highly the financial protection afforded by home insurance. Also, for those who have mortgages, the lenders typically require the owners to maintain their insurance. Letting home insurance lapse altogether would be seen as undesirable by the typical homeowner. Nevertheless, there is a risk that, if faced with large increases in home insurance premiums, some homeowners would have little choice but to react by not renewing their insurance policies. Hence the need for a system of premium discounts of some kind for homes exposed to flood risk.

PREMIUM DISCOUNTS

3.8. For those 6.2 million homes without flood risk and for whom, therefore, there would be no increase in insurance premiums for flood cover, the introduction of flood cover will have no effect on levels of non insurance. For homes with a modest increase in insurance premiums, the inclusion of flood cover in their insurance policies would not be expected to lead to any material increase in non-insurance. It is for the homes with larger increases in insurance premiums where premium discounts against the full cost of flood cover need to be considered. While the demand for home insurance is not particularly price sensitive, the size of the premium for those with a high risk of flood

28 Dr Richard Tooth and Dr George Barker, 'The Non-Insured: Who, Why and Trends', Centre of Law and Economics, for the Insurance Council of Australia, May 2007, p 12.

could be so large as to influence their decision about whether or not to continue renewing their insurance.

3.9. The Review Panel recommends premium discounts for high-risk homes, subject to a number of eligibility criteria, in order to limit price increases and thereby prevent a material increase in non-insurance on the introduction of flood cover as an inclusion in all home insurance policies. These eligibility criteria are discussed below.

Recommendation 4:

That the following five principles underpin the design of a system of premium discounts:

- premiums should rise with the level of flood risk;
- those whose homes do not face a flood risk should not pay a flood premium;
- there should be no cross subsidisation of premiums between policyholders;
- there should be some limitations on discounts to high-value homes; and
- the discount mechanism should be simple for policyholders and automated for insurers.

'Affordability Threshold'

3.10. To determine the premium discounts required to prevent a material increase in non insurance, it is necessary to know what the full flood premium would be and the premium beyond which there is a risk of an increase in non insurance. A critical issue is therefore what might be called an 'affordability threshold': what is a reasonable maximum price to charge policyholders exposed to low and medium flood risk while ensuring there is no material increase in non insurance?

3.11. The premium discount would then be the difference between the full flood premium and the affordability threshold. The size of the premium discounts would therefore be small for those policyholders who have a full flood premium below the affordability threshold and would be higher for the homes with higher flood risk.

3.12. The Review Panel's consideration of what the affordability threshold should be is based on the weighing up of a number of criteria:

- the affordability threshold needs to be such that, as far as possible, all policyholders pay flood premiums that make a meaningful contribution to the cost of flood cover for their homes, in order that they accept some responsibility for their flood risk exposure;
- it should interfere as little as possible with the principle that the higher the flood risk, the higher should be the discounted flood insurance premium;
- it should restrict as little as possible the role that insurers play in providing both home insurance generally and flood cover; and
- it needs to be compatible with the means by which the discounts are to be provided (which is the reinsurance facility explained in Chapter 7).

3.13. The judgement of the Review Panel is that an affordability threshold that would balance these criteria, for a home at the average value of \$300,000 to \$400,000 that generally attracts a premium

without flood cover in the region of \$500 to \$600 per annum, is around \$200 per annum. The corresponding amount for contents (where the average sum insured is in the region of \$60,000 for which a typical premium is \$250 to \$300 per annum) would be around \$100 per annum.

3.14. The implications of an affordability threshold of \$200 of flood risk premium for homes with low to medium flood risk would be as follows:

- of the 6.6 million homes in Australia, nearly 6.2 million or all but 450,000 are not subject to flood risk and therefore their owners should expect to pay no additional premium to obtain flood cover;
- of the 450,000 homes subject to flood risk;
 - about 100,000 should have a full flood premium that is below the affordability threshold and so need no premium discounts;
 - about 200,000 should be asked to pay no more than about \$200 per annum for flood cover; and
 - the remaining 150,000 may need to be considered differently.

3.15. For these remaining 150,000 homes, there are likely to be some 100,000 where the flood risk is high but not extreme. If insurers were to underwrite them on the basis of a first loss of 3 per cent (see explanation in Chapter 7), flood premiums would probably range from around \$250 to perhaps \$1,000 per annum. The recommended approach for these homes is to include them initially in the system such that their home insurance would include flood cover and eligible homes would receive a premium discount. Including them in the system is important to allow them to be identified and to provide information on what their full flood premium would be. Once identified, they can be assessed for flood risk mitigation already in place and flood risk mitigation steps that might be taken.

3.16. The remaining estimated 50,000 homes are likely to have extreme flood risk that flood insurance premiums would be some thousands of dollars, even with a premium discount. For many of these homes the assessment may be that initiating risk mitigation measures is a more effective way to manage their flood risk than to continue to make premium discounts available for them. It is important that this assessment be undertaken as soon as possible to ensure that these homes can be made more resilient to flood, that any relevant State or local government initiatives can be identified, and to avoid unnecessarily exposing the reinsurance facility, given the size of the premium discounts that would be required to deliver an affordable premium for these homes.

No cross-subsidies

3.17. It is also important to note that the Review Panel believes that any discounts provided to those at risk of flood should not result in cross subsidies; that is, policyholders without a flood risk should not be obliged to pay higher insurance premiums to subsidise those at risk of flood.

Incentives to reduce flood risk

3.18. A key consideration in designing a system of premium discounts for homes exposed to high flood risk is to ensure that premium discounts do not provide a perverse incentive for more people to live in flood prone areas. A risk-based flood premium is a source of information on the extent of flood risk faced by a home. It can also provide an incentive for homeowners to seek to mitigate their flood risk. A high flood premium therefore provides an important signal to homeowners and potential homeowners about the flood risks that they face. The Review Panel considers it important

that, under a premium discount system, flood premiums still reflect, to some extent, relative flood risk exposure.

Eligibility for discounts — existing homes only

3.19. Ensuring that high flood risk results in high flood premiums can have a deterrent effect on homeowners moving into areas of high flood risk. Providing premium discounts for homes in high risk areas could, as a result, have the unintended consequence of weakening the deterrent. Limiting premium discounts to existing homes should, however, ensure that high flood premiums act as a disincentive for the building of new homes in areas of high flood risk. Further, if demand for homes in flood-prone areas falls, so may the demand from developers for further residential development in these areas.

3.20. The Review Panel therefore recommends that flood premium discounts be provided in respect of existing homes but not new homes.

3.21. There is also a 'legacy' issue of people who live in high flood risk areas but who moved there before information on the level of the flood risk was readily available. Information on flood risk has been available from the Brisbane City Council since 2005.²⁹ While flood insurance has also become more available since the mid 2000s, policyholders who have remained with insurers who do not offer flood cover may not have been made aware through higher insurance premiums that they had a high flood risk. There has also been extensive migration to south east Queensland in the past two decades and some people who moved there would have had little or no local knowledge of past floods. It is therefore not clear that those who live in high flood risk areas made an informed and deliberate decision to accept a high probability that they would be flooded.

3.22. As a result, a legacy remains of people who purchased properties in high flood risk areas when information on flood risk and insurance for flood risk was not available. It is fair that this legacy be acknowledged and that members of this group not be required to bear the full cost of ensuring that they can access flood insurance.

3.23. Limiting premium discounts to existing properties, as recommended above, would achieve this outcome.

Duration of flood premium discounts

3.24. An important question is whether flood premium discounts should persist indefinitely. The Review Panel sees the offering of premium discounts as being a necessary step in introducing flood cover in all home insurance policies. Once introduced, however, it becomes possible to contemplate an eventual move towards full 'user pays' for flood insurance, whereby the discounts are ultimately phased out.

3.25. Providing the maximum premium discount initially would dampen the financial impact of the introduction of flood premiums. Phasing out the premium discount gradually over time would allow homeowners time to adjust to meeting the full cost of their flood risk. While the Review Panel is not proposing a formula or scale for phasing out of premium discounts, it is likely that a period of up to 20 years may be needed for some of the larger premium discounts.

3.26. The Review Panel therefore recommends that premium discounts phase out gradually so that at the end of a period the full flood premium is payable. Some homeowners would be able to reduce their flood risk by making changes to their property or seeking to relocate to an area of lower flood risk; others would have time to make the necessary financial adjustments. This is consistent with the

29 Lord Mayor's Taskforce on Suburban Flooding, 'Strategies to reduce the effect of significant rain events on areas of Brisbane prone to flooding', August 2005.

principle enshrined by COAG in its National Disaster Resilience Statement, which states that ‘Disaster resilience is based on individuals taking their share of responsibility for preventing, preparing for, responding to and recovering from disasters’.³⁰

Recommendation 5:

That flood premium discounts be provided for home building insurance for eligible homes:

- the discounts be assessed by reference to an ‘affordability threshold’ for flood premiums;
- only existing homes would be eligible for discounts; and
- discounts would be phased out gradually over time.

3.27. The design of the phasing out of the flood premium discounts needs, however, to avoid undermining the affordability objective of the premium discounts that there be no material increase in levels of non-insurance. The phasing out therefore needs to have regard to the absolute size of premiums as well as the rates at which the premiums would increase from one year to the next. It is also important to ensure that the phasing out arrangements do not undermine incentives to take action to mitigate flood risk.

3.28. The factors that affect the affordability of flood cover and the incentive and ability to mitigate flood risk will also change during the phasing out period. For example, improved flood risk measurement and making more information public as recommended in Chapters 8 and 9 should improve flood risk awareness and influence mitigation. The insurance industry should also be able to improve its understanding of flood risk and its ability to offer more affordable flood cover.

3.29. The Review Panel therefore is of the opinion that it is not appropriate to propose any formula for the phasing out of discounts at this time. Instead, the Review Panel recommends that the size of the discounts and the length of the transition period be reviewed periodically by the Agency (recommended in Chapter 9). The review should assess the progress of the discount system overall, any discernible trends in non-insurance and progress in the awareness and management of flood risk. The review should make recommendations on whether the size of the discount and the transition period need to be reset.

Recommendation 6:

The levels of the discounts and the phasing out periods be reviewed from time to time.

Equity

3.30. The Review Panel’s view is that the provision of premium discounts needs to be limited in some way. In modern Australia, some older homes have relatively low replacement values of, say, \$100,000 and there are some that would cost \$5 million to replace. The average sum insured of all insured homes in Australia is about \$300,000 and the vast majority of homes would have a replacement cost of less than \$500,000. To ensure fairness and also to recognise that owners of higher-value properties generally have a higher capacity to pay insurance premiums, the Review Panel considers that there should be some limitations on premium discounts for eligible high-value

30 COAG, National Disaster Resilience Statement, p. iii., http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13/docs/national_strategy_disaster_resilience.pdf

homes. The delivery of this outcome is considered in more detail as part of the design of the system of discounts in Chapter 7.

Recommendation 7:

That there be limitations on the size of the discount available to high value homes.

Simplicity

3.31. It is important for a scheme providing discounts to operate as simply as possible and to take into account that purchasing or renewing insurance over the telephone or the internet is now the method preferred by many policyholders. This requires that the information necessary to determine the premium discount be available to the insurer as part of the process of initiating or renewing insurance cover. Similarly, policyholders would need to receive their premium discounts directly through the premiums they pay to their insurers. There should be no requirement to engage in separate processes or to involve other agencies.

3.32. The premium discount system recommended in Chapter 7 is designed to meet these simplicity criteria.

LOW-INCOME EARNERS

3.31. The Review Panel recognises that some households on low and fixed incomes may face cash flow and affordability difficulties in paying additional premiums for flood insurance and funding any flood mitigation measures.

The Review Panel considers in Chapter 11 some specific measures to address difficulties faced by policyholders in managing their cash flow to maintain insurance generally, not only flood insurance. The Review Panel has not otherwise considered the capacity to pay directly for those on low incomes. Any such affordability questions for those on low incomes could be considered, however, directly by the Government if it saw fit to do so outside the premium discount system being proposed by the Review Panel. Any additional support for those with low incomes would necessarily require information on income to be part of the eligibility criteria. To impose this on the recommended system of premium discounts would undermine its simplicity.

Chapter 4. FLOOD INSURANCE FOR OTHER DWELLINGS

4.1. There are numerous types of dwellings that function as homes beyond the conventional detached homes considered in Chapters 2 and 3. They include home units and other dwellings under a body corporate, company title or other similar arrangement. They also include manufactured and mobile homes.

Home units and other multiple-dwelling complexes

4.2. Home units and other dwellings under a body corporate or similar arrangement are buildings or collections of buildings where individuals each own a portion (a lot) but where there is also common property (for example, external walls, windows, roofs, driveways, etc.) of which ownership is shared. They can take a number of forms, from duplexes to gated communities to small and large apartment buildings. They can include mixed-use properties that contain both commercial and residential units. They can also include aged care facilities and retirement villages.

4.3. The National Community Titles Association has indicated to the Review Panel that, based on Census figures, 22.5 per cent of households live in properties managed by bodies corporate, owners' corporations, etc. and the proportion is growing.³¹ These properties are governed by State and Territory legislation which requires bodies corporate to take out insurance for their properties. None of this legislation, however, explicitly requires bodies corporate to take out insurance to cover flood damage.

4.4. A company title residential property is a building and land owned by a company registered under the *Corporations Act 2001*. Most of these properties are in the nature of apartment buildings. Through owning a set number of shares in the company, shareholders obtain the right to occupy a defined area in the company's building and to use common areas. The need for insurance follows the legislative obligation and is either mandated in the company's articles of association or occurs through governance processes where the onus is on the company directors to uphold their fiduciary duties to shareholders.

4.5. All of these arrangements — bodies corporate, owner's corporations and other similar arrangements — fulfil a similar purpose; that is, to assign property rights for residential purposes over what are essentially shared assets. Each of the individuals represented under the residential portions of these arrangements is the owner of a form of home and thus has a similar interest in protecting the property as the owners of traditional detached homes. These arrangements are therefore considered together for the purposes of the Review.

The body corporate insurance market

4.6. The insurance market for strata title properties is different from the market for home insurance. It is a specialist market because, while the owners of strata units have similar insurance needs to homeowners, the insurance characteristics of strata properties are different. For example, apartment buildings and particularly the larger multi-storey ones have many of the characteristics of office blocks, with a range of construction features and requirements (stairs, lifts, plumbing,

31 National Community Titles Institute submission,
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/National_Communities_Titles_Institute_sub.pdf

electrical, basements, etc.) that do not exist in most homes. There are also specialist requirements on fire safety and other matters arising from the legislative requirements.

4.7. The physical characteristics of some strata title properties are different to homes and small businesses, with the nature of flood damage likely to be different due to the risk exposure being located below ground (for example damage to electrical rooms and lifts). This risk needs to be factored into insurance premiums.

4.8. For these reasons, strata title insurance is something of a hybrid between commercial lines and personal lines insurance. The ultimate users of the insurance are the individual unit owners. However, the nature of the cover needed is essentially commercial insurance and, except for many duplexes and smaller apartment blocks, it is usually recommended and arranged by professional strata property managers who are being serviced by commercial insurers, either directly or through brokers.

4.9. There are fewer insurers who provide insurance for home units than for homes. Each of the two largest insurers in the field operates through an underwriting agency and both have developed considerable expertise in this field. This small field of just two strong players can lead to limited competition in some areas, for example in north Queensland, where cyclone risk limits the number of market participants. Further, the significant sums insured for some home unit properties can represent large accumulations and concentrations of risk for insurers, leading to questions of insurance and reinsurance capacity.

The availability of flood insurance

4.10. As with home insurance policies, policies covering home units typically do not include flood cover. No insurers currently offer flood insurance as standard for home units. Should an individual body corporate request flood insurance, the insurer assesses this case by case. As for home insurance, however, home unit insurers provide insurance for all other natural disasters as standard, except actions of the sea.

4.11. The lack of flood cover for home units had a significant impact during the floods of 2010-11, as explained in submissions to the Review by several affected residents of home units. Industry estimates indicate that around 400 properties managed by bodies corporate were directly affected by the floods and very few of these, if any, had flood insurance.³²

4.12. The implications of a lack of flood insurance for the owners of home units are the same as for the owners of detached homes. The owners of home units are financially exposed in the event of a flood. The determination of a claim can also be delayed where the cause of damage is uncertain, which leaves the owners of these home units in limbo, just as for homes. Since home units form such a large part of the housing stock, the lack of flood cover for home units affected the community substantially, as it did for detached homes.

4.13. Given that home units are peoples' homes, the arguments applicable to detached homes presented in Chapter 2 apply equally to home units, whether strata title or company title, and notwithstanding that the insurance industry treats body corporate insurance as commercial rather than personal insurance. The Review Panel considers, therefore, that insurance for these properties, where they are residents' homes and where the resident is responsible for any repairs or rebuilding following damage, should be treated equivalently to insurance for other homes. Unless they are treated equivalently, a significant part of the community will remain subject to the issues that arose

32 Ibid.

in the floods of 2010-11. In order to address these issues, all body corporate insurance policies should include flood cover.

4.14. Mixed-use properties in major cities are predominantly residential by floor area.³³ Therefore, mixed-use properties should be treated equivalently to home units and other dwellings under a body corporate arrangement.

4.15. As with homes, flood cover need only apply to those items covered by the body corporate insurance policy.

Recommendation 8:

That all home unit insurance policies include flood cover, in the same manner as for homes.

The affordability of flood insurance

4.16. As with homes, the inclusion of flood cover in all home unit insurance policies would result in an increase in insurance premiums for those at risk of flood. For those at high risk of flood, the impact could be substantial. In many apartment buildings, services essential to the whole building, such as electrical facilities and lift motors, are located at or below ground level, exposing them to the risk of damage due to flood. The risk of damage to these items due to flood would flow through to the insurance premium for the whole property, even though none of the residences themselves may be at risk of flooding.

4.17. Despite these potentially high premiums, the impact on non-insurance of the inclusion of flood insurance in all home unit insurance policies is likely to be offset by the compulsory nature of insurance for home units. Indeed, given that bodies corporate are required under State laws to have building insurance, there would appear to be little risk of non-insurance in the face of even significant rises in premiums.

4.18. Nevertheless, Strata Community Australia Ltd has advised that 'Non-compliance is also, anecdotally, a significant issue across Australia for smaller self-managed buildings' and that 'Enforcement is at best spasmodic and reactive'.³⁴ This suggests that non-insurance could still be an issue for many smaller bodies corporate if its owners were exposed to large premium increases to cover flood risk. It would also seem inequitable for owners of homes to receive affordability discounts but for owners of home units not to receive any such discounts.

4.19. The Review Panel considers, therefore, that discounts should be provided, in the same manner as for homes, to the bodies corporate of eligible home units.

4.20. Insurance policies for home units apply to, and are paid by, the body corporate as a whole. The discounts would therefore need to apply to the body corporate as a whole. In order to provide discounts on an equivalent basis to homes, discounts should be provided to the body corporate such that the discount per home unit is equal to the discount that would apply to an equivalent home. The same principles that apply to the Review Panel's recommendations for homes apply to those for home units.

33 Unpublished Finity Consulting report to the ARPC.

34 Strata Community Australia submission, p 5.

Recommendation 9:

That flood premium discounts be provided, in the same manner as for homes, to the bodies corporate of eligible properties, and on the same basis as for detached homes.

MANUFACTURED HOMES, MOBILE HOMES AND CARAVANS

4.21. For some people, a manufactured home, mobile home or caravan is their residence. Manufactured and mobile homes are built off-site and transported to the property, often within a caravan park or similar. The home is of course the property of the owner but the owner rents the site. The site owner provides various communal facilities for the use of the homeowners. Similar arrangements apply for caravans, though they are typically genuinely mobile whereas some mobile homes are commonly and more accurately described as 'stationary mobile homes'. Homeowners can, in some cases, take out home and contents insurance and in many instances they are required by the property owner to take out home building or contents insurance to have public liability insurance cover. The property owners usually take out insurance for the communal facilities. These properties are often located near rivers or low-lying areas, making them particularly susceptible to flood.

4.22. Notwithstanding ambiguities with regard to the definition of manufactured homes, mobile homes and caravans, as well as their susceptibility in many cases to flood risk, the Review Panel considers that, since they are a form of home, they should be treated equivalently to other homes. To apply the recommended arrangements, including flood cover and premium discounts, to detached homes and home units, but not to these other forms of homes would be inequitable. The issues that arose during the floods of 2010-11 for detached homes and home units applied equally to these other forms of homes.

4.23. The arguments in favour of both the inclusion of flood cover in insurance policies and the provision of discounts for more traditional detached homes therefore apply equally to manufactured and mobile homes. Given, however, the diverse nature of many of these 'non-standard' types of home and a need to minimise definitional problems, there is a simple practical solution: to define a home as a dwelling for which the owner can purchase a home insurance policy.

4.24. On this basis, the Review Panel's recommendations for homes give practical effect to this definition by being applicable to all dwellings for which an insurer will provide a home insurance policy. This approach ensures that these types of homes, if insured under a home insurance policy, will have flood cover and access to flood premium discounts. As such, provided that the owner of a manufactured home, mobile home, caravan, or any other form of home for that matter, purchases a home insurance policy, then the Review Panel's recommendations for homes would apply to them.

Recommendation 10:

That the definition of a home for the purposes of flood cover and flood premium discounts be any building for which a homeowner purchases a home insurance policy.

- This definition ensures that the Review Panel's recommendations would apply to all 'non-standard' types of homes such as manufactured homes and mobile homes insured under a home buildings insurance policy.

Chapter 5. FLOOD INSURANCE FOR HOME CONTENTS

5.1. Given the Review Panel's recommendations that flood cover be included in all home insurance policies and that discounts be provided for eligible homes, there is a question of whether these arrangements should be extended to cover home contents insurance policies. This question requires consideration of the community need for contents insurance cover for flood as well as its availability and affordability.

AVAILABILITY

5.2. It was recommended in Chapter 2 that all home insurance policies include flood cover in order to address the community need for flood insurance. The experience of the floods of 2010-11 was that limited flood cover for homes had resulted in financial stress, delays and disputes that had undermined the ability of individuals and the community to recover.

5.3. The logic that drew the Review Panel to conclude that flood cover needs to be included in all home insurance policies also holds for contents insurance, albeit to a lesser extent for many policyholders. The loss of contents does not, for all policyholders, entail the significant financial consequences that can arise from the loss of a home. While some low-value personal items such as basic clothing and food are vital to the immediate recovery from flood, these items are fairly readily replaceable and their loss is unlikely to have an impact on the individual's longer-term recovery. Higher-value personal items, which can include, furniture, white goods and electronics and a wide range of other personal and household items, may be less important to the immediate recovery but also less easily replaced without financial assistance. Nevertheless, the loss of even these higher-value items is unlikely to have the impact on the individual's longer-term recovery that the loss of the home would. By contrast, however, for those on low incomes, and tenants in particular, the contents can be their primary assets: without the financial resources to replace these assets in the event of a flood, they could face serious financial hardship akin to that faced by homeowners who have lost their homes.

5.4. Contents are also easier to protect in the event of a flood. Many items such as clothing, electronics and other small personal items are readily movable in the event of a flood. During a flood, those affected are often given sufficient notice to move these items out of harm's way. During the Queensland floods earlier this year, for example, it was common for people to move items of contents upstairs or out of the house to prevent them from being damaged. For larger items such as refrigerators the opportunities for this kind of mitigation are more limited. The financial costs of flood damage are likely, therefore, to be mostly concentrated on these less movable items. It is these items for which contents insurance is most important.

5.5. Both of these factors — the 'replaceability' and 'protectability' of contents — indicate that the need for insurance to protect these items from flood is less acute than for homes. The argument stands, however, that some level of financial protection is important to the immediate resilience of all individuals in the event of a flood.

5.6. There is another argument in favour of treating the home and contents consistently. Many homeowners who have home insurance also have contents insurance, either bundled into the same product or as a separate product. Around 60 per cent of residential insurance policies issued include

cover for both home and contents, while 20 per cent include cover for contents only and 20 per cent for the home only.³⁵

5.7. Given that so many homeowners are insured for both home and contents in the one policy, to require all home insurance policies to include flood cover but not to extend this requirement to bundled home and contents policies would be impractical. Also, in the event of a flood, while the claim for damage to a building could be determined readily, the claim for contents would require a determination of whether the event was a storm or a flood. The delays, disputes and financial stress in the event of a flood would continue.

5.8. A consistent approach to both the home and contents is endorsed by the Financial Ombudsman Service, which noted the following problems that could arise if flood cover is included in all home building policies but not extended to contents.³⁶

- 'Failure to include contents insurance as part of automatic flood cover will lead to confusion as to the extent of cover in bundled household building-contents policies.
- The level of disputation will remain high as most buildings affected by flood will suffer contents damage.
- Contents damage can be a significant loss to an individual and in particular for low income earners who are more likely to be tenants. The lack of flood cover covering contents could therefore disadvantage tenants and low income earners.
- Tenants are less likely to have knowledge of flood risks in a particular area. Without adequate knowledge, the risk of not having adequate insurance is increased.'

5.9. These observations indicate the importance of taking a consistent approach to both the home and contents. While the recommendations for homes would eliminate all of the issues that arose in the floods of 2010-11, many would recur if the arrangements were not extended to contents. The only way to resolve these issues fully is to take a consistent approach with both homes and contents.

5.10. Taking such a consistent approach for both homes and contents would have much the same benefits as for home buildings insurance. It would simplify the transaction of buying contents insurance, with one less decision for the consumer to make. It would make claims processing easier for insurers, who would have no need to differentiate between storm and flood. It would improve the overall efficiency of the product for both policyholders and insurers. It would also provide peace of mind for both tenants and homeowners, since they would know that their homes would be covered for flood for both building and contents.

5.11. The Review Panel recommends, therefore, that all contents insurance policies include flood cover. Treating home and contents policies consistently would ensure that the problems of financial damage, disputes and delays that occurred during the floods of 2010-11 would be eliminated for those with insurance cover for their home and their contents.

35 Insurance Statistics Australia data provided to the Review.

36 Financial Ombudsman submission to the Natural Disaster Insurance Review, p 6
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Financial_Ombudsman_Service_Limited.pdf

Recommendation 11:

That all home contents insurance policies include flood cover.

AFFORDABILITY

5.12. As for homes, there is a need to ensure that the inclusion of flood cover in all contents insurance policies will not create an affordability problem for policyholders. For homes at a high risk of flood, the full cost of flood cover for the contents insurance policy could be substantial, in the same way as for the building. There is a risk that, as a result, some policyholders could choose to opt-out of contents insurance altogether unless they have access to flood premium discounts.

5.13. Indeed, the level of non-insurance likely to result from a given increase in premiums is higher for contents than for homes. Studies indicate that policyholders have a lower tolerance for an increase in their contents insurance premiums than for their home insurance premiums.³⁷ There is also a significant existing level of non-insurance for contents, particularly for renters. It has been estimated that 67 per cent of tenants do not insure their contents, compared with 12 per cent of homeowners.³⁸ This compares to only 4 per cent of homes without home insurance. This might lead to a greater concern over affordability for contents than for homes.

5.14. The likely larger increases in non-insurance, as well as the existing relatively high levels of non insurance point, however, to a second important consideration. The lower tolerance by policyholders of a premium increase for the contents insurance policies indicates that contents insurance is less important for policyholders than home insurance. In effect, policyholders are making a judgment that financial protection of their contents is less important than financial protection of their home. This lower tolerance indicates that the consequences for policyholders of opting out of contents insurance are lower than for home insurance. The higher levels of non-insurance reflect, at least in part, the two factors discussed earlier, namely the relative high 'replaceability' and 'protectability' of contents, at least compared to the home.

5.15. The impact of the inclusion of flood cover in contents insurance policies can therefore be thought of in two parts:

- the impact of a price increase on the non-insurance of contents is likely to be higher than for homes, since the demand for contents insurance is more price responsive than for home insurance; but
- the consequences of non-insurance of contents are likely to be lower than that of homes, since the higher level of price responsiveness reflects both the more readily replaceable and more readily protectable nature of contents, compared with the home.

5.16. The impact of higher flood premiums for contents on tenants, particularly those on low incomes, also needs to be considered. As discussed above, the ability of those on low incomes to recover their assets following a loss is constrained, making insurance for contents a more important

37 A 2007 survey estimated that the demand for contents insurance is between 4 and 18 times more responsive to an increase in price than the demand for home insurance. Tooth and Barker, 'Insurance Law and Economics: An Analysis of the Demand for House and Contents Insurance in Australia', p 7
http://law.anu.edu.au/cle/Papers/Insurance_Demand_Home&Contents_Fina.pdf

38 Op cit p 38.

consideration in their recovery from a flood. An increase in the already high rates of non insurance for renters could further compromise the ability of this group to recover.

5.17. The Review Panel weighed the various considerations in determining its recommended approach. It considers that, while the consequences of an increase in non-insurance are not as significant as for homes, there is a need at least to preserve current rates of take-up of insurance and, in particular, not to exacerbate the non-insurance problem for those on low incomes.

5.18. As a result, the Review Panel recommends that discounts be provided to contents insurance policyholders, in a similar manner to homes and also that the principles underpinning the Review Panel's recommendation for discounts for home building insurance policies apply equally to that for home contents insurance policies. That is, higher discounted flood premiums should apply to homes with higher levels of flood risk, higher flood premiums should apply to higher sums insured and there should be some limitations on discounts for contents with high sums insured.

5.19. Discounts should also apply to contents insurance policies for existing homes only and not be extended to the contents of future new homes.

Recommendation 12:

That discounts be provided, in the same manner as for homes, to home contents insurance policies for eligible properties.

Chapter 6. FLOOD INSURANCE FOR SMALL BUSINESSES

6.1. The implications for small businesses of limited flood cover are similar to those for homeowners: in the event of flood damage, they face significant financial loss and potentially long delays in having their claims determined. Small businesses can also face the loss of income if their premises are damaged or their customers or suppliers cannot recover quickly after the flood.

WHAT IS A SMALL BUSINESS?

6.2. There is no single definition of small business that is applied consistently across the insurance industry. Some define a small business according to its assets and some according to its turnover; some insurers have multiple definitions across their different products. The Financial Ombudsman Service, the external dispute resolution service for the general insurance industry, uses a definition of small business as a business with less than 20 employees if it is a manufacturing business, or less than five employees for other industries.

6.3. For the purposes of this Review, small business is being defined by the policies that insurers sell: any small business package policies, whether issued direct by the insurer or through an intermediary, are the subject of this Chapter.

Small businesses losses can have wide community impact

6.4. The implications for the community and the local economy of limited flood cover for small business can be significant. Small businesses form the backbone of many local communities and, as such, play an important role in the community recovery following a natural disaster. They provide employment for local residents, they supply goods and services to homeowners and other businesses rebuilding and repairing their properties, and they support other local businesses by purchasing their products and services.

6.5. The Review Panel witnessed the importance of small business to the local community first hand when visiting the parts of Victoria affected by the 2009 Black Saturday bushfires. In the wake of physical devastation and the tragic loss of life, the community of Marysville has been severely disadvantaged subsequently through the loss of some significant local employers. These employers are understood to have been under-insured and, as a result, not in a position to rebuild and restart their businesses after the fires. Without these local businesses, the local economy is significantly diminished.

6.6. A greater take-up of flood insurance by small businesses would therefore address the needs of both the small businesses concerned as well as their local communities and economies.

Small businesses buy insurance differently from homeowners

6.7. There are important differences between small businesses and homeowners in their understanding of and approach to insurance. For small businesses, insurance is a business cost to be managed along with other aspects of financial and risk management of their business. Some small businesses buy insurance through an intermediary (an insurance broker), which allows them to obtain advice about their insurance needs and to tailor their insurances to their needs.

6.8. Other small businesses do not use an intermediary, but instead purchase insurance direct from insurers in the same way as homeowners. A number of insurers offer a direct product to sole practitioners, businesses operated from home and other micro businesses.

6.9. The issues facing buyers of these direct business insurance products can be similar to those facing homeowners. Indeed, it was submitted that small businesses are less likely to receive specialised advice and that 'this group would therefore benefit from automatic inclusion of flood within policies in the same way homeowners would — that is, they would be covered in the event of either storms or floods ...'.³⁹

Availability of flood cover for small businesses

6.10. For small businesses that buy insurance through brokers their insurance can be tailored to their needs. The absence of flood cover, however, for many small businesses in Brisbane and Ipswich suggest that flood cover is not given adequate attention by brokers or small businesses. The Review Panel is aware of only one insurer who offers flood cover as standard. For those buying small business insurance direct, as for homes, flood cover is not always offered.

6.11. There would be benefits to small businesses and to the local community and local economy within which small businesses operate if there was a greater take up of flood cover. However, the implications for affordability and non-insurance of making any changes to the current opt in/opt-out arrangements need to be considered carefully.

Affordability of flood cover for small businesses

6.12. An Insurance Council study on non insurance among small and medium sized enterprises (SMEs) undertaken in 2008 indicated that:

- 26 per cent of the sampled SMEs did not have any form of general insurance;
- of the SMEs sampled that had insurance, 94 per cent indicated they considered that they were adequately insured. Of those who indicated they were inadequately insured, 80 per cent indicated that the cost of insurance was a factor in this decision; and
- sole traders sampled had the highest rate of non insurance with 40% operating their businesses with no general insurance.⁴⁰

6.13. The study suggests that non insurance is more prevalent in the sole trader category where non insurance is estimated to be 40 per cent. Also, the cost of insurance is an important consideration for small businesses, partly reflecting that insurance can be regarded as one of a number of costs which need to be managed.

6.14. The Review Panel considers, therefore, that the risk in requiring flood to be included in all small business insurance policies is that the higher premiums that would be charged for flood cover could result in an increase in non-insurance in a market that already has significant levels of non-insurance and under-insurance.

6.15. For homes, contents and home unit insurance, the Review Panel has recommended that affordability be dealt with through providing flood premium discounts to eligible properties. The Review Panel has considered whether these discounts along with access to the recommended

39 IAG submission, pp 14-15.

40 Insurance Council submission, p 26.

reinsurance facility should be extended to small businesses. The Review Panel's conclusion is that, in addition to the technical and other difficulties that would arise if discounts were to be made available to small businesses, there is not a strong case in terms of business needs at this time for imposing flood cover as standard in small business insurance policies.

6.16. Nevertheless, there is a case for taking steps that will increase the availability and the likely take-up of flood cover.

6.17. For small businesses, the Review Panel's solution is to recommend that insurers be required to include flood cover in their small business policies, while allowing their small business customers to opt-out of flood cover if they so choose. This approach will ensure that they, make a clear decision about including flood cover in their insurance while minimising any increase in non-insurance by virtue of the right to opt-out of flood cover.

Recommendation 13:

That all insurers offering small business insurance be obliged to include flood cover on an opt-out basis, instead of an opt in/opt-out basis as at present, in all of their small business package policies.

Recommendation 14:

That flood premium discounts not be provided to small businesses and that the reinsurance facility not offer reinsurance for small businesses.

6.18. The Review Panel would have preferred to see flood cover offered as standard to small businesses with no opt-out as with homes. It accepts, however, that such a position could not reasonably be imposed at this time, especially as the Review Panel is not proposing to see discounts introduced for affordability purposes for small businesses or access by insurers to the reinsurance facility for small business flood insurance. Nevertheless, there is still an important need for flood insurance to be made more widely available to small businesses and for some steps to be taken to encourage and promote a greater take-up of flood cover by small businesses.

6.19. The Review Panel also considers that the questions of flood cover as standard (no opt-out) in small business policies and access to discounted premiums for small business policyholders should be revisited once the recommended arrangements for homes, home units and home contents are in place.

Recommendation 15:

That the questions of flood cover as standard in small business policies and access to discounted premiums for small business policyholders should be revisited once the recommended arrangements for homes, home units and home contents are in place.

Small business and business interruption insurance

6.20. In its Issues Paper, the Review Panel canvassed a range of issues regarding business interruption insurance. It noted that only around 40 per cent of small businesses have business

interruption insurance, and that only a small fraction have business interruption that responds to flood.⁴¹

6.21. In consultations since, the Review Panel has had confirmed the important role that business interruption insurance plays in the ability of businesses and local communities to recover after a natural disaster. Careful consideration has been given as to whether business interruption insurance should be made a standard part of small business insurance so that it would be more available to assist the recovery from floods and other natural disasters.

6.22. Business interruption insurance is a complex insurance product that is typically bought in addition to property cover. Cover tends to be triggered by damage to the building. Most businesses buy cover for a maximum period of 12 months from when the damage occurred (usually after a short waiting period), although some are covered for shorter periods of six months, and others for longer periods of two to three years. Premiums for business interruption cover tend to be significant and so businesses make careful assessments of their need for the product.

6.23. A key condition when making a claim on business interruption insurance is that the interruption must arise from damage to the business's property. Cover does not typically extend, for example, to a business being interrupted by failure of utilities or closure by a public authority. Also, such policies typically only provide benefits for the time it would take to restore the particular business, regardless of the surrounding community and whether transport links are restored, the rest of the street is operable, or the local population is back to normal.

6.24. As a result, business interruption insurance does not respond well to 'wide area damage', that is, disasters that impact a whole community. As a result, it does not respond well to natural disasters. Business interruption insurance may not therefore provide small businesses and the community with the support required to recover in the event of a natural disaster.

6.25. The 'wide area damage' problem is not really a problem that insurance can readily solve. Accordingly, the Review Panel is making no recommendations on business interruption insurance but wishes the Government to note the costs and disruption to businesses and their likely adverse effects on recovery and the subsequent health of small businesses in the areas affected by a natural disaster, with a view to small business recovery having priority within the National Strategy for Disaster Resilience.

41 NDIR Issues Paper, p 32 <http://www.ndir.gov.au/content/Content.aspx?doc=issuespaper.htm>

Chapter 7. A FLOOD PREMIUM DISCOUNT AND REINSURANCE SYSTEM

A SYSTEM OF FLOOD PREMIUM DISCOUNTS

7.1. As discussed in Chapter 3, the Review Panel has established five policyholder criteria for the design of a system of discounts:

- premiums should be higher where with the level of flood risk is higher;
- those whose homes do not face a flood risk should not face a flood premium;
- there should be no cross subsidisation of premiums between policyholders;
- there should be some limitations on discounts for high value homes; and
- the discount mechanism should be simple for policyholders and automated for insurers.

7.2. It is equally important that the system of discounts not undermine the competitive insurance market. To that end it is also desirable that it meet three insurer criteria:

- the system of discounts be compatible with the way the insurance market currently operates;
- insurers hold some part of the flood risk themselves; and
- insurers preserve their relationships with their policyholders for writing and renewing policies and for managing claims.

7.3. To meet both sets of criteria for flood premiums and discounts, one from a policyholder perspective and the other from an insurer perspective, the Review Panel has devised a model that integrates policyholder discounts with insurer participation. It functions through being supplemented by a government sponsored reinsurance facility, or reinsurance pool, that enables insurers to deliver the discounts to their policyholders without compromising the commercial soundness of insurers.

7.4. To meet these requirements, the Review Panel proposes a model that requires insurers to retain a portion of the flood risk and to underwrite and price that portion of the risk themselves. The portion of each risk not retained by the insurer would then be ceded to a disaster reinsurance facility, or reinsurance pool, established specially for the purpose. This model would apply to homes, home contents and home units.

7.5. Delivering discounts through this mechanism would effectively subsidise claims rather than premiums. This approach has a number of benefits over providing discounts through premium subsidies. Importantly, the recommended approach would maximise, in expectation, the level of premium discount that can be achieved for a given level of external funding support because the support is only called upon when a claim is made upon the pool, not each year as premiums are paid. A premium subsidy to insurers, on the other hand, would probably need to be paid according to the market price. That would include subsidising the return on capital and other components of the price that are in addition to an estimate of the risk. It would rely on each individual insurer's own pricing basis and would need to be supported by some form of compliance regime.

Recommendation 16:

That flood premium discounts be delivered through a model that requires insurers to retain and price a portion of the risk with the remainder to be ceded to the reinsurance facility at a discounted reinsurance premium.

7.6. This Chapter comprises five sections:

- eligibility for flood premium discounts;
- structuring the flood premium discounts;
- delivering flood premium discounts across the flood risk spectrum;
- designing the reinsurance pool; and
- access to the reinsurance pool.

ELIGIBILITY FOR FLOOD PREMIUM DISCOUNTS

7.7. The Review Panel has recommended in Chapter 3 that discounts be available to existing properties only but not for future new properties. This approach acknowledges that there is a legacy of homes that are exposed to flood risk while ensuring that owners of new properties meet the full cost of the flood risk they take on. It may also deter more homeowners from moving to high flood risk areas.

7.8. As noted in Chapter 3, for existing properties it is also recommended that the amount of the discount be limited for high value homes, high contents sums insured and high value body corporate properties. It is also proposed that all discounts be phased out gradually over time.

STRUCTURING THE FLOOD PREMIUM DISCOUNTS

7.9. The discounts would be provided to existing homes by the reinsurance pool offering the insurer a discounted premium for the portion of the risk covered by the pool. In the initial period of the operation of the pool, existing homes would be eligible for a full discount, that is, the discounts would not have begun to be phased out and the premium charged by the reinsurance pool to the insurer would be nil.

7.10. To limit the discounts available to high value homes, it is proposed that the risk for which the pool would offer the insurer a discounted premium be limited to the difference between the portion of the risk retained by the insurer and \$500,000.

7.11. For existing homes with an estimated replacement value less than or equal to \$500,000 and eligible for a full discount, the premium payable by the policyholder would be simply the premium charged by the insurer on the portion of the risk that it retains.

7.12. For existing homes with an estimated replacement value greater than \$500,000, the premium charged to the policyholder would be made up of two elements: the premium charged by the insurer on the portion retained by the insurer and the premium charged by the reinsurance pool to the insurer, or by the insurer on its own account, to cover the risk in excess of \$500,000.

Recommendation 17:

That for home building insurance policies receiving full discounts, policyholders pay for that portion of the risk retained by the insurer and pay nothing for the remainder of the risk up to \$500,000. For properties with a value greater than \$500,000 policyholders then pay the full cost of the portion of risk exceeding \$500,000.

7.13. For existing home units, the discount would operate in the same way for the whole complex, with the limit applying at \$500,000 times the number of units in the complex. (For example, in an apartment block of 20 units, full discounts would apply unless the value of the complex exceeded \$10 million.)

Recommendation 18:

That for body corporate insurance policies receiving full discounts, policyholders pay for that portion of the risk retained by the insurer and pay nothing for the remainder of the risk up to \$500,000 times the number of units. For properties with a value greater than \$500,000 times the number of units policyholders then pay the full cost of the portion of risk exceeding \$500,000 times the number of units.

7.14. For contents of existing homes and home units, discounts would be limited to the difference between the portion of the risk retained by the insurer and \$100,000.

Recommendation 19:

That for home contents insurance policies, policyholders pay for that portion of the risk retained by the insurer and pay nothing for the remainder of the risk up to \$100,000. For contents with a value greater than \$100,000 policyholders then pay the full cost of the portion of risk exceeding \$100,000.

7.15. The discounts would be phased out over time by means of the pool charging progressively higher premiums for the portion of the risk ceded to it by the insurer. The reinsurance premiums would continue to rise until policyholders eventually pay the full premium for flood cover.

DELIVERING FLOOD PREMIUM DISCOUNTS ACROSS THE FLOOD RISK SPECTRUM

7.16. To set discounts or, equivalently, maximum prices for flood cover that meet the criteria for affordability of premiums will be a matter of judgment. These criteria can be expressed as premiums that:

- represent reasonable or useful contributions to the cost of flood cover;
- are higher for higher flood risk; but
- are not so high as to cause a material increase in levels of non-insurance.

7.17. Because flood cover has not been widely offered by insurers in the past, there is limited claims experience on which to draw and therefore very limited data to assess the probability of floods occurring, probable height levels of inundation and likely levels of damage to houses at different

levels of inundation. Furthermore, floods are low frequency events, sometimes with high severity (as in January 2011), flood mapping is imprecise and the quality of flood mapping is uneven.

7.18. Taken together, these factors mean that estimating the costs of flood risk for insurance purposes is a very inexact and approximate exercise, whether considering the whole or only parts of the risk of flood damage.

An illustrative proposal for flood premium discounts

7.19. With these caveats about uncertainty, the Review Panel has attempted to prepare some ideas and to give some general guidance as to how discounted flood risk premiums might be assessed to take account of affordability considerations as explained in Chapter 3.

7.20. The starting point is considering the number of homes subject to flood risk, based on the table from the Insurance Council shown in Table 2 in Chapter 3, which subdivides homes exposed to flood risk into four risk classifications (low, medium, high and extreme).

7.21. Taking initially the homes subject to low to medium flood risk, this sub group of homes can be subdivided according to the 'first loss' proportions that might be used to set discounts and also to determine what size of 'first loss' the insurer would be expected to underwrite.

Explanation: if the 'first loss' proportion is 5% on a property with a value of \$300,000, the insurer would meet all claims up to \$15,000 annually claim costs above \$15,000 would be covered by reinsurance.

7.22. The 'affordability threshold' could then be set as the price point generated by the 'first loss' at the one per cent, or one in 100 year flood risk level, which can be taken generally as being within the medium flood risk band. This threshold is put forward because flood mapping exists at this level for most parts of Australia, albeit of differing quality.

7.23. If a benchmark is set as a general affordability threshold of about \$200 per annum of flood risk premium for homes with low to medium flood risk, as suggested in Chapter 3, and assuming all homes are of average value, the picture might be approximately as follows:

- of the 6.2 million homes in Australia, all but 450,000 (that is, more than 5.5 million) are not subject to flood risk and therefore their owners should expect to pay no additional premium to obtain flood cover;
- of the 450,000 homes subject to flood risk;
 - about 100,000 should be able to be underwritten fully by insurers with no need for the insurers to use the reinsurance pool and no need for the homeowners to be offered discounts for affordability purposes;
 - about 200,000 should be able to be insured with the assistance of flood premium discounts and use of the reinsurance pool such that no policyholder pays more than \$200 per annum for flood cover and the insurer accepts, depending on the level of flood risk, a first loss of 3 per cent, 5 per cent, 10 per cent or 20 per cent, depending on the level of flood risk for the home; and
 - for the estimated remaining 150,000 homes with flood risk that is higher than 1 per cent, that is, within the 1 in 100 year flood zones, there are some additional problems to be considered.

7.24. Looking further at these 150,000 homes with the higher levels of flood risk:

- for the 100,000 homes where flood risk is high but not extreme, if insurers were to underwrite them on the basis of a first loss of 3 per cent, flood premiums would probably range from around \$250 to perhaps \$1,000 per annum; and
- at the extreme risk end, it is likely that some 50,000 homes have such high flood risk that flood insurance premiums would be some thousands of dollars, even on a 3 per cent first loss basis. There will be homes with a high flood risk where the cost of flood damage to the home in the event of flood is low. This kind of situation can occur in homes which may take in water during a flood but where the habitable floor level is elevated above known flood levels or where the construction and fittings are such that, after flood waters recede, the home can be simply hosed down and washed out, with habitation quickly and easily re-established.

7.25. The Review Panel has no statistics on the composition of this population of homes at extreme risk of flood. In these cases the question arises whether requiring these homeowners to purchase flood insurance and pay a premium of many thousands of dollars is the optimal way to deal with their risk of flood from their own and the community's point of view.

7.26. Note, incidentally, that the \$200 'affordability threshold' used in this illustration should probably be moved up or down by about 15 per cent or \$30 for each \$100,000 of value of the home by which it exceeds or falls short of the average value.

7.27. It then becomes a matter of judgment as to whether in the first two to three years of the scheme, the owners of any or all of these homes should be asked to pay the premium required to meet a first loss of 3 per cent:

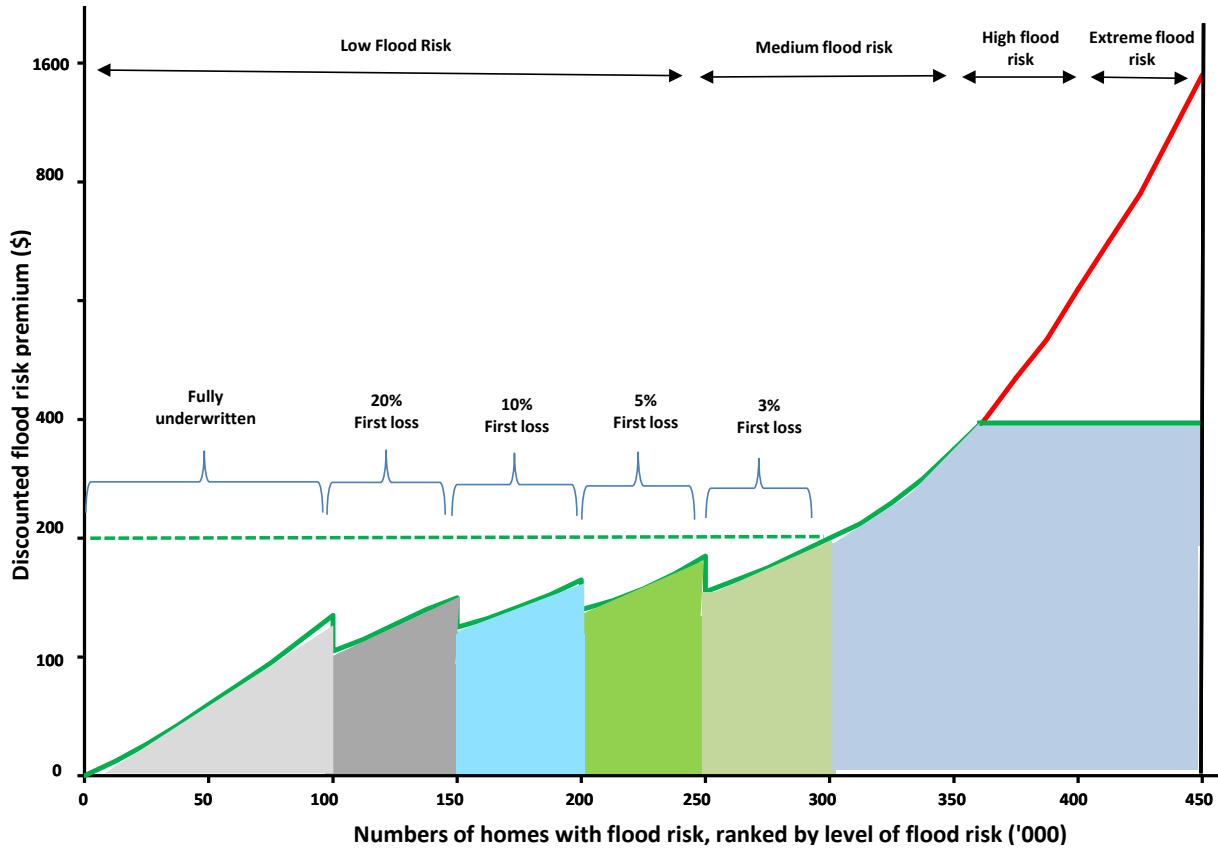
- in cases where the answer is yes, these properties would be treated in the same way as the other 300,000 homes where the flood risk is lower; and
- in cases where the answer is no, it would be open to the Agency to consider accepting the whole flood risk from the insurer, with the owner paying a capped premium for flood risk (for example \$300 or \$500) but subject to further investigation.

7.28. As already noted in Chapter 3, homes exposed to extreme flood risk should be assessed as soon as possible for flood mitigation purposes. In the meantime, these homes will need flood insurance but would not normally be risks acceptable to insurers, even for a 3 per cent first loss. The interim solution in these cases is the same as above for homes with high flood risk which are not paying for the full three per cent of cover but are paying a capped premium and where the whole of the flood risk is ceded to the pool.

7.29. Homes with a very high, but not extreme, risk of flood should also be assessed for flood risk mitigation work already undertaken and flood risk mitigation potential. The size of the required flood premium, however, is such that there is less urgency to assess these homes than those with extreme flood risk.

Diagrammatic representation

Figure 2: Discounted flood risk premiums and insurer risk retentions



7.30. Figure 2 is a pictorial representation of the illustrative proposal for discounts described above. It shows that, for those homes at low flood risk, the premium will be below the ‘affordability threshold’ of \$200 and so can be fully underwritten by insurers (the left-hand segment of the diagram). As the risk of flood rises, the proportion of the risk retained by the insurer falls to ensure that the premium paid by the policyholder does not exceed the threshold.

7.31. At extreme risk of flood, the premium could become unaffordable and may need to be capped. The horizontal line shown marked on the right hand side at \$400 demonstrates how the maximum flood premium would cut in. The red line (the curve) on the right-hand side shows where the discounted flood premiums would be for a 3 per cent first loss if there were no cap.

Recommendation 20:

That homes at high and extreme risk of flood be provided with discounts initially and that they be assessed regularly for mitigation work already undertaken and the potential for further mitigation.

DESIGNING THE REINSURANCE FACILITY

A 'first loss' model

7.32. As discussed earlier, the model proposed requires insurers to retain a portion of the flood risk and to underwrite and price that portion of the risk themselves. The portion of each risk not retained by the insurer would be ceded to the reinsurance pool.

7.33. The proposed reinsurance pool would operate on an 'excess of loss' basis. Insurers would carry the first part of any loss incurred following a flood and would charge a commercial premium to the policyholder in respect of the portion of the flood risk that they retained. The portion of the risk that the insurer did not retain would be reinsured by the pool. That is, the pool would pay any claims that exceeded the amount of the loss that the insurer retained and would charge a premium to the insurer for carrying this portion of the flood risk. The idea of using this 'first loss' or excess of loss approach for the purpose of operating the reinsurance pool was originally inspired by the Allianz Australia submission to the Review.

7.34. By retaining the first loss, insurers would fully cover all small flood claims. For example, if an insurer retained 5 per cent of the flood risk on a home with an estimated replacement value of \$300,000, it would cover all claims that were equal to or less than 5 per cent of \$300,000 which is \$15,000. Because many flood claims are small in amount and only some flood claims result in extensive rebuilding costs, a 5 per cent retention level by insurers would cover significant numbers of flood claims. Available statistics, while very approximate, suggest that if insurers retained five per cent of the flood risk, they would cover around half of all flood claims by number and would also cover around 30 per cent of the total cost of flood claims. Insurers are well able to underwrite this level of flood risk on a 'first loss' basis.

7.35. This 'first loss' approach therefore has a number of benefits. It leaves insurers to carry a portion of the risk that they can readily underwrite. The insurer would price the portion of the risk that it retains taking into account its own assessment of the risk and other commercial considerations. The premium for this portion of the risk would therefore reflect the insurer's assessment of risk and higher risks would result in higher premiums.

7.36. The insurer would also retain full responsibility for managing the policy and the policyholder would have no need to interact with the reinsurance pool nor to understand how it operates. The premium charged to the policyholder would be the sum of the insurer's own price for the portion of the risk it retains and the premium the insurer pays to the pool, plus taxes and charges (that is, fire services levy in those States where it applies, stamp duty and GST). The premium charged by the pool to the insurer would be transparent to the policyholder and, where the premium the insurer pays to the pool is discounted, the policyholder would be informed of the level of discount.

7.37. This approach also avoids the need for policyholders to provide any additional information to insurers or to involve other agencies in order to gain access to the discounts. The discount would be communicated when the policyholder purchases or renews the insurance policy. The policy documentation provided by the insurer would show the premium being charged and what the premium would be without the discount.

The reinsurance structure

7.38. The proposed reinsurance approach is in the nature of a 'facultative/obligatory treaty'; that is, one where insurers can cede risks to the pool if they wish (facultative offer) but the pool must accept all risks, at pre-agreed prices (obligatory acceptance). It is expected that the pool would be 'selected against'; that is, insurers would use it whenever they liked its prices but would not use it for good

risks that they could underwrite themselves at lower prices. In this way it would enable insurers to limit their own exposure to flood risks and thereby provide capacity to the insurance market.

7.39. This structure would therefore allow insurers to decide for each individual property whether to cede the portion of the risk above the 'first loss' to the pool or whether to retain the whole risk. Insurers would compare the price offered by the pool for the portion of the risk that the pool would accept with their own estimate of the price of the risk. If the insurer did not have data on the property to allow it to price the risk itself, it may cede it to the pool but if, on an underwriting basis, the insurer's price for the risk was less than the pool price, the insurer would normally retain the risk.

7.40. Note also, however, that in those cases where flood premium discounts are being offered through the pool, usually insurers would use the pool. Then, as the whole system matures, as is intended by the progressive diminution of the discounts over time, there should be progressively more risk retention by insurers and less reliance on the pool.

7.41. The pool pricing basis will be important to insurers. The reinsurance price could be based solely on flood risk probability for the property (that is, the land), assuming a standard damage curve for the building, that is, it would take account of property location but not building characteristics (design and construction). Under this approach, the pool would need only a limited pricing capability but insurers who chose to take a more detailed approach to flood risk assessment and pricing could take advantage of that approach for underwriting purposes. Alternatively it could take a rather more detailed approach, which would be more costly, more IT system intensive and also encroach more on the knowledge base of those insurers who have invested more themselves in flood insurance analysis. It is likely that the former basis, using standard damage curves, is the more appropriate basis for pool pricing.

7.42. This reinsurance arrangement can be thought of as a low intervention arrangement. Insurers continue to operate in a competitive insurance market and are required to assess, price and select the risks they want to underwrite. Insurers would receive commercial prices for any risks that they underwrite and retain full responsibility for dealing with policyholders.

7.43. Competition: By requiring insurers to price the risks that they retain and to decide whether or not to cede the risk to the pool, depending upon how their estimated price for the risk compares to that of the pool, competition is retained.

7.44. Claims: In line with Pivotal Recommendation 2, all home, home contents and home unit insurance policies would include flood cover. The portion of the risk retained by the insurer would therefore provide flood cover. No 'flood versus storm' issues would arise for claims that fall within the scope of the risk retained by the insurer. However, as the pool would only provide reinsurance for flood cover, for the portion of the risk ceded to the pool, the question of whether the damage was caused by flood or storm would arise. Importantly, these disputes would be between the insurer and the reinsurance pool, not between the insurer and the policyholder. Policyholders would have their claims determined without needing to know whether they were classified as flood or storm cases, and the settlements would not be delayed by any debate or possible disputes between the pool and the insurer.

ACCESS TO THE REINSURANCE POOL

7.45. Insurers would have access to the reinsurance pool for the flood risk within insurance policies that are eligible for a discount. They would also have access to the pool for the flood risk within insurance policies that are not subject to a discount.

7.46. In these latter cases, the reinsurance pool would offer cover to insurers at a price set by the pool on a property by property basis using information on the flood risk of the property. Providing access to the pool for policies not eligible for discounts is designed to ensure a fair price to the policyholder even though there is no discount, and also provide capacity to enable more insurers to offer flood cover, supporting a competitive market.

7.47. In summary, access to the pool for flood risk would be available to all insurers and for all home, home contents and home unit policies, irrespective of value, for cover excess of the insurers' first loss retentions, and the agency would offer its own actuarially assessed price on all of their risks. The price would be discounted only in those cases described in the earlier section 'Structuring the flood premium discounts'.

Recommendation 21:

That a flood risk reinsurance facility, or reinsurance pool, be established which would have two primary functions:

- to deliver discounts to home, contents and home unit insurance policies for eligible properties; and
- to provide flood reinsurance capacity to the insurance market;

and two key design features:

- an excess of loss arrangement whereby insurers retain and price a 'first loss' portion of each policy on a commercial basis; and
- a 'facultative/obligatory' reinsurance treaty that would allow insurers to cede individual properties to the pool if they wish (facultative offer) but the pool would be obliged to accept them (obligatory acceptance).

ESTABLISHING THE VALUE TO BE REINSURED

7.48. In order for the pool to apply its first loss and excess of loss structure when insurer retentions are based on property values, these values will need to be reasonable estimates of replacement value.

7.49. Home insurance policies in Australia are predominantly sold on a 'sum insured' basis where the policyholder nominates the sum insured. There is also evidence that most homes are under insured by reference to replacement values. In Chapter 12 the Review Panel recommends that insurers move to introduce replacement value to eliminate under insurance but that they be given some time to do so. In the interim, therefore, the reinsurance pool will need to take steps to ensure that the values of the properties for which it is providing reinsurance are adequate.

7.50. The Agency would expect insurers to be able to satisfy it that the sums insured are adequate or, alternatively, to increase them across the board by an estimate of the average level of under-insurance so that they do represent reasonable estimates of replacement value.

7.51. Where the insurer already offers cover on a replacement value basis, it would need to inform the pool of estimated replacement values, presumably by relying on the information it uses for pricing purposes or reinsurance purposes.

FUNDING THE REINSURANCE POOL

7.52. The reinsurance pool would be funded if and when necessary by the Commonwealth Government guaranteeing the payment of claims. It would ensure that, whenever a shortfall occurs in the pool through claims exceeding the funds held in the pool, the Commonwealth would fund the shortfall.

7.53. The Commonwealth has the financial capacity to deal with unforeseen and uncertain costs and does not normally engage in the pre-funding of its commitments but rather meets them on a 'pay-as-you-go' basis. Commonwealth funding would ensure the financial viability of the reinsurance pool.

Recommendation 22:

That the Commonwealth Government guarantee payment of claims from the reinsurance pool by ensuring that, whenever a funding shortfall occurs in the pool through claims exceeding the funds held in the pool, the Commonwealth would meet the shortfall.

7.54. State and Territory governments and their local government authorities have responsibility for land use planning, the regulation of building standards and flood mitigation initiatives. It is important that State and Territory governments retain an incentive to mitigate flood risk and maintain strong building standards. For this reason, while the Commonwealth would stand as guarantor for the funding of the pool, the Review Panel believes that, in the event of a funding shortfall, the State or Territory government in whose jurisdiction the flood occurred, should bear a proportion of the shortfall.

Recommendation 23:

That the Commonwealth seek reimbursement of some portion of the shortfall from the State or Territory government in whose jurisdiction the flood occurred.

7.55. The funding requirement for the reinsurance pool could be significant in years when there is widespread flooding, particularly if it occurred in the initial period of operation of the reinsurance pool when its premium income was small. Some indications of funding requirements are discussed further below.

7.56. The funding requirement needs to be considered against the cost that is already borne by Commonwealth and State and Territory governments in assisting private individuals to respond to floods and other natural disasters. For example, more than \$450 million has been paid under the Australian Government Disaster Recovery Payment scheme to those affected by the Queensland floods to provide short term financial assistance.⁴² The Queensland Government also provided assistance under the Queensland Personal Hardship Assistance Scheme.

7.57. Using these funds instead to support improved flood cover supports the principle underpinning the National Strategy for Disaster Resilience of encouraging individuals to take their share of responsibility for natural disasters. Rather than relying on government

42 Attorney-General's Department, Disaster Assist, 'Queensland Floods (November 2010 – February 2011)', http://www.disasterassist.gov.au/www/disasterassist/disasterassist.nsf/Page/Currentdisasters_QueenslandFloodingDecember2010.

assistance, individuals would take greater responsibility for recovery after a flood and would also have made a financial contribution through their payment of insurance premiums.

The funding requirement

- 7.58. In order to understand what the funding cost for the scheme might be from year to year, it is appropriate to start by considering the total annual costs of flood damage to residential property including contents.
- 7.59. The cost in any year will be highly variable and will often be small or even nil. There will be years when little flood damage occurs, if any, and other years when very significant flood damage occurs. Data are not available on the total cost of damage to homes from the significant flooding in Queensland and Victoria during 2011, partly because a significant portion of the damage was not insured. Data are available from the Insurance Council on the cost of damage that was claimed under insurance policies and, using that as a base, some estimates have been given of the total cost of damage based on a number of assumptions about denied claims and claims not submitted. These estimates suggest total claims from the recent floods of between \$1 billion and \$1.5 billion on the pool, had it been already in operation, net of claims costs paid by insurers and without taking account of any funds that might have (theoretically) accumulated in the pool.
- 7.60. An estimate of the total average annual cost of flood damage and an idea of the range of that cost are necessary inputs into any process of attempting to understand the possible funding needs for the reinsurance pool. However, it is impossible to estimate with any precision the amount of funding that will be needed in any one year.
- 7.61. What can be said is that the potential exposure would be greatest early in the discount period when the discounts would be greatest and pool premium income small. In subsequent years, the premium charged by the pool would rise, increasing the level of claims that could be met by the pool without drawing on funds from the Commonwealth.
- 7.62. The level of premium collected by the pool in this initial period would be small because no premium would be collected on existing properties with estimated replacement values up to \$500,000 and contents up to \$100,000 of sums insured, but some premium would be collected on homes, contents and home units of higher value.
- 7.63. In addition to collecting premiums, the reinsurance pool would charge a small administrative fee for each policy ceded to the pool, say \$20 per policy. This would support the funding of the reinsurance pool's expenses and create a financial transaction that would assist with the management of the pool and its interactions with insurers. Although it would be a cost to insurers who may seek to pass it on to policyholders its small size argues against its undermining the affordability aims of the pool.

Chapter 8. Improving flood risk management⁴³

- 8.1. Flood risk management comprises flood risk measurement and flood risk mitigation. Improved flood risk measurement and flood risk mitigation are important for both the future welfare of the community and the continued development of the market for flood insurance. Flood risk measurement, including flood mapping and flood modelling in their various forms, enables flood risk to be estimated and understood, which assists assessments and decisions regarding flood risk mitigation and flood insurance.
- 8.2. State and Territory governments have primary responsibility for managing flood risk. In many instances, responsibility for flood risk measurement and flood risk mitigation has been devolved to local governments or catchment management authorities. This has *often limited* measurement and mitigation priorities from being understood in a state-wide or national context and has caused existing measurement and mitigation activities to be fragmented.
- 8.3. The extent and quality of flood mapping varies widely within States and from State to State. Some of this variation is well justified, because of different floodplain characteristics, urbanisation and other factors. Nevertheless, there is no national standard or guideline for flood mapping and it is usually a matter for each individual local government authority to decide how the mapping is to be done and what form the output of the mapping activity might take. As a result, the nature of flood mapping across the country is inconsistent.
- 8.4. Flood risk information is publicly available to a varying degree. Some local governments provide their information free of charge on public websites whilst other councils place restrictions on and charge fees for access to information. The Brisbane City Council makes flood information freely available to the public following the recommendations of a Flood Task Force completed in 2005.⁴⁴

IMPROVING FLOOD RISK MEASUREMENT

- 8.5. There are many users and potential users of flood risk information who would benefit from improvements in flood risk measurement. These include:
 - councils: for land use planning and flood mitigation works;
 - property developers, their architects and planners: to make their own assessments of flood and other risks, and to ensure their designs comply with local government building rules and regulations;
 - the State Emergency Services: in order to plan for situations that may arise during a flood and to allocate resources;
 - insurers: as an input to risk assessment, underwriting and pricing;

43 The Panel's consideration of flood risk management issues has been informed by a workshop held on 26 August 2011, involving experts from the fields of hydrology and water engineering, flood plain management, State and local government, the insurance industry and the actuarial profession.

44 Lord Mayor's Taskforce on Suburban Flooding, 'Strategies to reduce the effect of significant rain events on areas of Brisbane prone to flooding', August 2005.
<http://www.brisbane.qld.gov.au/community-support/emergency-management/flooding/prepare/Taskforce-on-suburban-flooding/index.htm> .

- homeowners, renters and business owners: in making decisions on where to live or operate a business and how to manage their flood risk;
 - lending institutions: to assist them to understand the risks associated with properties that are subject to mortgages and the circumstances of their customers; and
 - public and private organisations providing road and rail infrastructure and other community infrastructure: for planning and risk management purposes.
- 8.6. The full nature of the information needed and the level of detail required by each group varies to some degree, according to the purposes for which it is used and the nature of its use.
- 8.7. Flooding results from a series of complex interactions between the natural and built environment.⁴⁵ Flood modelling estimates where rain water will run, given the location, intensity, frequency, duration and extent of rainfall, the topography and the various features of the built environment such as dams, levees and sealed surfaces. Topography details are incorporated into flood models using information from digital terrain models that show the height of the ground surface. The output from the flood modelling process is usually a series of flood maps which depict the extent of likely water flows and flooding for a range of probabilities and scenarios, given the assumptions used in the flood model used as the basis for the maps.

FLOOD RISK INFORMATION FOR INSURERS

- 8.8. Insurers are interested in having well maintained flood mapping information to assist them to price flood risk and provide cover. They would like to have a comprehensive set of detailed digital elevation maps. These digital three dimensional models of the ground surface topography can be constructed using remote sensing technologies such as Lidar (Light Detection and Ranging) and are supplemented with aerial photography and satellite imagery. Advancements in technology are lowering the costs and increasing the definition of these maps. Insurers can then complete the picture if they have access to an authoritative geo-coded national address file to link addresses to the areas on the flood maps, supported by details of the building at each address such as the elevation of the principal floor level and the nature of the building construction.
- 8.9. Insurers need to know not only the probability of a home being flooded but also the likely damage that will occur. Information on how high the water might go into a house is therefore important. Once an insurer knows the likelihood of flooding for a particular building, it can assess risk premiums by applying a statistical view of the cost of damage based on the heights of the floods, expected water velocities, the design and construction of the building and the materials used in it.
- 8.10. Better flood risk information for insurers would enable insurers to make more reliable and more confident assessments of flood risk for pricing purposes, thereby assisting insurers to offer flood cover more widely and at fairer prices.

45 Attorney-General's Department, Report on the Environmental Scan into a National Approach to Flood Modelling, p 4.

IMPROVING FLOOD RISK INFORMATION

- 8.11. Existing flood risk information has been produced over many years, for different purposes, in a variety of ways. When a local government commissions the collection of flood risk information, it may face technical and financial constraints. It therefore may choose to collect information in a way that meets its immediate needs, at a price it can afford. It also may choose not to update the information very often to take into account changes to the environment, as the financial cost of doing so may not be justified for its purposes. There may also be commercial constraints in place with respect to the local governments making the flood risk information available to others.
- 8.12. The consistency of flood risk information used for insurance and other purposes would be improved if measurements of flood risk collected from different sources conformed to national guidelines. Because of factors such as high variability of rainfall and stream flows and the range of different flood problems, including differences in requirements between urban and rural areas, a single uniform approach to flood mapping and modelling is not appropriate, in particular noting the rapidly improving technology in this field.
- 8.13. The Review Panel proposes that national guidelines for flood risk information be developed. The guidelines should specify the type of outputs required as well as technical formats. While the Australian Rainfall and Runoff⁴⁶ is the accepted national guideline on technical aspects of assessing flood risk, there is not a national guideline that specifies the types of output required from flood studies to meet the needs of different users. These outputs might include:
- terrain information;
 - probability maps (for a range of standard events including one per cent annual exceedance probability (AEP));
 - flood planning maps (including planning levels for the construction of habitable floors);
 - house information, including floor level and building construction;
 - maps that show where works have been carried out or houses removed or raised; and
 - meta-data including information relating to data quality, information on planning controls and when surfaces would be expected to change because of infrastructure which has been built in a floodplain.
- 8.14. *As part of the development process for such output-oriented guidelines, users should be consulted to ensure that guidelines meet their needs. Those who prepare the information should also be consulted.*

A central repository for flood risk information

- 8.15. Access to flood risk information would be improved if it was available in a central repository. The repository could include flood risk information currently held by numerous public sector agencies, information of the kind currently held in the insurance industry's National Flood Information Database (NFID), insurers' claims data and information provided by homeowners

46 Pilgrim, DH (ed), Australian Rainfall and Runoff — A Guide to Flood Estimation, Institution of Engineers, Australia, Barton ACT, 1987.

in relation to mitigation measures they have put in place. Information could be collected, analysed, disseminated and published nationally.

- 8.16. While the information would be held and managed in the central repository, flood risk management responsibilities, including undertaking flood risk measurement activities or mitigation, would continue to lie with State and Territory governments.

Access to information and legal liability

- 8.17. Submissions to the Review identified the potential liability of local government for the quality or accuracy of flood risk information as a major barrier that must be overcome before all existing flood risk information could be made available to all users.⁴⁷ Understandably, holders of information may be reluctant to release flood risk information publicly for use by others if they may be liable for any inaccuracies, particularly if they have been subject to technical, financial and commercial constraints when collecting the information.
- 8.18. The Review Panel acknowledges that liability concerns have inhibited the public availability of flood risk information, in some parts of Australia. In contrast, in New South Wales, where the Local Government Act 1993 (NSW) provides an immunity from civil liability for councils who provide flood risk information 'in good faith', information has been made more readily available than, for example, by some Queensland local government authorities.
- 8.19. The Review Panel considers that providers of information should ordinarily be responsible for the quality of the information they make available. However, given the constraints that holders of flood risk information may have faced in initially obtaining the information, and recognising the benefits that can flow from making as much flood risk information as possible widely available, the Review Panel recommends that, absent any gross negligence in obtaining and providing the information, and assuming it is provided in good faith, the provider should be immune from civil liability in respect of the information.

Recommendation 24:

That to facilitate flood risk information being made publicly available, Commonwealth, State and Territory governments grant indemnities to the providers of flood risk information if the information is obtained and provided in good faith and in the absence of any gross negligence.

Better flood risk information for the community

- 8.20. Better flood risk information for the community enables people to better manage the flood risks they face. For example, once individuals are aware that they live in a flood prone area they may be able to make decisions about how they wish to manage the risk, including by purchasing insurance, raising their house or moving out of the area. Flood risk information can also make people aware of risks before they purchase or rent a house and therefore enable them to avoid the risks altogether.

47 Australian Local Government Association submission, p 14; Local Government Association of Queensland submission, p 5.

- 8.21. It is also important that flood risk information being provided to the public is in a form that can be readily understood. Various studies⁴⁸ have revealed that consumers have difficulty interpreting information relating to events which are of low probability but high consequence, such as floods. This suggests that, in relation to such events, it is important that consumers are assisted as much as possible to interpret the relevant information. For example, portraying information in the form of maps may assist consumers to understand their risk.
- 8.22. A number of submissions pointed to the community's misunderstanding of the current terminology used to describe the probability of flood. For example, the Institute of Actuaries of Australia noted '(f)or an insurer, a 1 in 20 year event (for flood) is extremely risky. For an individual, this is likely to be longer than their expected dwelling duration at that location.'⁴⁹ Therefore to assist consumers to interpret a low probability, high consequence flood event, flood risk information provided to consumers could adopt classifications which are easy to understand. Submissions note that terms such as extreme, high, medium and low risk are easier for consumers to understand than risk quantifications.⁵⁰ These terms are also already familiar to many consumers as they are used to communicate bushfire risk.
- 8.23. To further improve consumers' understanding of risk, it is also important that any information provided to consumers, including in the form of maps, clearly distinguish between risk to personal safety and risk to the property. It may also be appropriate to classify flood risk both on the basis of how frequently flooding is expected to occur and how hazardous it would be if it occurred, for example how fast the water would be flowing and how fast the water would be rising.

FLOOD RISK MITIGATION

- 8.24. The goal of flood risk mitigation is to reduce flood risk. Once flood risk is properly understood, through analysis of available data and associated modelling, assessments and decisions of several kinds become possible.
- 8.25. Better access for governments to flood risk information would facilitate better mitigation decisions. Flood risk mitigation initiatives can be identified and cost/benefit studies can be done on a regional or floodplain basis, in local areas or for individual properties. Mitigation can involve, for example, land use planning decisions, the building of levees and dams and the adoption of building codes.
- 8.26. Mitigation can occur prior to the location of a home in a flood risk area, for example through controls that prevent the home from being built there in the first place. Alternatively mitigation can be undertaken to protect existing homes, for example by building a levee or raising an existing house.
- 8.27. Mitigation which reduces flood risk for individual homes should reduce insurance problems for those homes.

48 For example, Camerer, Colin. and Kunreuther, Howard (1989) 'Decision Processes for Low Probability Events: Policy Implications' *Journal of Policy Analysis and Management* 8:565-592.
<http://onlinelibrary.wiley.com/doi/10.2307/3325045/abstract>

49 Institute of Actuaries of Australia p 27.

50 *The Insurance Council of Australia and the Institute of Actuaries of Australia note in their submissions that it is important that consumers understand the flood risk that they face. They suggest that flood risk is better conveyed by descriptions such as extreme, high, moderate, low rather than quantifications such as a 1 in 100 year event.*

8.28. In summary, there is a strong case for several initiatives relating to flood risk management. These initiatives would include:

- national guidelines for flood risk measurement prepared in consultation with producers and users of flood risk information; and
- a central repository in which flood risk information is collected, collated, analysed and published.

Chapter 9. A national disaster risk and insurance agency

- 9.1. In order to address the problem of availability and affordability of flood insurance, the Review Panel has identified five requirements which are discussed in previous chapters.
- To address availability, Chapter 2 recommends that all home insurance policies include flood cover. Chapters 4 and 5 respectively recommend that all insurance policies for other dwellings, including home units, and for home contents, also include flood cover.
 - To address affordability, Chapters 3, 4 and 5 recommend that discounted insurance premiums for home insurance, home contents and home unit insurance policies be introduced in cases where there is exposure to flood risk.
 - Chapter 7 explains and recommends a system of flood premium discounts in conjunction with a government-sponsored reinsurance facility to deliver flood insurance discounts.
 - Chapter 7 also recommends a means of funding the discounts that are to be offered for affordability purposes.
 - Chapter 8 discusses national coordination of flood risk measurement and mitigation to improve flood risk management for the benefit of the community generally and to ensure the continuing development of a competitive market for flood insurance.
- 9.2. All of the five requirements are inter-dependent and so the right architecture is needed to bring them together as a solution to the problem of availability and affordability of flood insurance. The Review Panel has concluded that the centrepiece of this architecture should be a national agency sponsored by the Commonwealth Government and charged with national coordination of flood risk management and with operating the system of premium discounts and the flood risk reinsurance facility, supported by a funding guarantee from the Commonwealth.
- 9.3. A new agency, established exclusively to bring these functions together, including linking flood insurance and flood risk management, would possess a unity of purpose and focus that could not be achieved were the functions to be spread across various existing agencies. Given the national dimension involved in bringing together the elements of the new agency, it would need to be established under Commonwealth legislation. To function effectively, however, it would need to operate along the lines of a joint venture between the Commonwealth, the States and Territories, and the insurance industry.
- 9.4. Given the right level of expertise and authority, the right kind of governance structure and accountability, and a brief to apply itself exclusively to these matters, a single agency of this kind would have the wherewithal to succeed where previous efforts of cooperation, in good faith, amongst a myriad of agencies and departments of government (Commonwealth, State and local) and insurers have yielded limited results.

ROLES OF THE AGENCY

- 9.5. The Commonwealth legislation establishing the agency would set out its roles and functions. There are some functions that are essential. Once it exists, additional functions and services could be undertaken if that were advantageous to the community.
- 9.6. With respect to improving flood risk management, the agency would bring together the roles discussed in Chapter 8. For example, the agency would develop national guidelines for the collection of flood risk information. As part of the development process for these guidelines, the agency would consult all users of flood risk information to ensure that the guidelines meet their needs. The agency would also consult those who prepare flood risk information to determine how best to meet the requirements of users, given existing technology and prospective developments. The agency should encourage continuous improvement so that, as technology evolves and more information conforms to the guidelines, the guidelines are updated and, most importantly, the quality and scope of flood risk measurement and flood risk databases are continually extended and updated.
- 9.7. The agency would also coordinate flood mapping across the country. While responsibility for undertaking flood mapping would remain with State and Territory governments and local authorities, the agency would act as a national repository of flood risk information through collating and analysing information collected by others. The agency would also have a role in disseminating information to governments, insurers and the community and could establish a portal for that purpose. It could also play a valuable role in overseeing the quality of the flood risk information.
- 9.8. The Panel envisages that flood risk information currently held by numerous public sector agencies and others would be brought together within the agency. The Panel also envisages that flood risk information of the kind contained in the insurance industry's National Flood Information Database (NFID) would be included in the information held by the agency. This could occur either by the agency gaining access to the NFID, with the support of the insurance industry, and progressively enhancing it, or by the agency creating a similar database of its own. Insurers would also contribute data regularly to the agency on flood claims, for example the location, nature and costs of flood claims.
- 9.9. There would also be benefits in the agency collecting and storing information from homeowners about mitigation measures they have put in place that reduce their flood risk, such as raising the house or modifying its construction. In undertaking this function, the agency would, however, need to protect the privacy of individual homeowners.
- 9.10. As noted in Chapter 8, members of the public can benefit from flood risk information about individual homes, either their existing homes or homes they may be considering purchasing or renting. The agency would be responsible for determining the quantification of risks which would lie behind descriptors provided to consumers such as extreme, high, medium and low risk, in relation to both the probability of a flood and how hazardous the flood might be.
- 9.11. As there are a number of different users of flood risk information, with different requirements, it would be important for the agency to provide tiered access to the information it holds, by establishing a series of levels of data storage and accessibility. For example, the general public should be able to access information held in the first level, at no cost, but other users should be able to access more detailed information held in other levels, depending on their needs and perhaps paying fees.
- 9.12. The agency would also undertake reporting of progress made in flood risk measurement and mitigation activities, highlighting where measurement has been undertaken in accordance

with guidelines and where flood risk reduction has occurred as a result of mitigation actions. This reporting should enhance awareness of flood risk. The agency could also report where new homes have been built in flood prone areas, noting what mitigation measures, if any, have been incorporated into the construction.

- 9.13. The Review Panel also considers that the agency should have a role in advising governments with respect to flood risk measurement and mitigation priorities. Because the agency would collect, collate, analyse, disseminate and publish flood risk information and report progress made on governments' flood risk measurement and mitigation activities; it would be well placed to advise governments in relation to future priorities. For example, it could draw to a government's attention the areas that require updated flood modelling or where a particular mitigation program would be warranted. Undertaking mitigation would, however, remain the responsibility of State, Territory and local governments and mitigation funding and associated programmes, would continue to be considered in conjunction with the Commonwealth Government.⁵¹
- 9.14. Regarding building standards, the agency should maintain a relationship with the Australian Building Code Board in order to influence as many aspects of flood risk management as possible. For example, the agency may wish to influence the technical standards and non-regulatory guidance that the Australian Building Code Board puts in place.
- 9.15. The agency would also be responsible for operating the reinsurance facility in the manner set out in Chapter 7. This role would be a substantial one, covering setting prices and maintaining a system to notify prices to insurers, collecting reinsurance premiums and relevant insurer data, and generally maintaining the financial integrity and records of the facility.

51 The Commonwealth Government makes a contribution to mitigation through the Natural Disaster Resilience Program.

Recommendation 25

That a national agency sponsored by the Commonwealth Government be established to undertake national coordination of flood risk management and to operate the system of premium discounts and the flood risk reinsurance facility.

The Agency would:

- coordinate flood mapping across the country (while leaving responsibility for undertaking flood mapping in the hands of State and Territory governments and local authorities);
- introduce national guidelines for flood risk mapping and classifications, prepared in consultation with producers and users of flood risk information;
- act as a national repository of flood risk information, primarily through collating and analysing information collected by others;
- continue development of the Insurance Council of Australia's National Flood Information Database or an equivalent developed by the Agency;
- monitor the effectiveness of flood risk mitigation initiatives across the country and advise on priorities for flood risk mitigation;
- publish and disseminate flood risk information in forms appropriate to various groups of users; and
- oversee the quality of flood risk information.

POSSIBLE GOVERNANCE STRUCTURES OF THE AGENCY

9.16. The governance structures of the new agency are ultimately matters for the Commonwealth Government to determine having regard to existing laws and financial arrangements. The agency would, however, require a governance structure, accountability and a skills set that recognise its roles.

A governing board

9.17. To facilitate the active involvement of the Commonwealth, State and Territory and local governments and the insurance industry, the Review Panel envisages that the agency would be governed by a board that included nominees from each of these sectors.

9.18. The agency would need to draw on insurance industry expertise in operating the reinsurance facility and in its broader governance. States and Territories would also have a role in defining the priorities and activities of the agency. The agency's roles in relation to flood risk measurement and flood mitigation and in disseminating flood risk information mean that it would also be advantageous for local government to have a role.

Funding the administrative costs of the new agency

9.19. With respect to funding for the agency, Chapter 7 notes that in addition to collecting premiums, the reinsurance facility would charge a small administrative fee for each policy ceded to the facility, say \$20 per policy. It would support the funding of the reinsurance facility and create a financial transaction that would assist with the management of the facility and its

interactions with insurers. This would be a cost to insurers who may seek to pass it on to policyholders, but the small size of the impost argues against it undermining the affordability aims of the facility.

9.20. Other funding required by the agency, for example to undertake various flood risk management activities, may need to be met by the Commonwealth.

Recommendation 26:

That the Agency charge insurers a small administrative fee for each policy ceded to the reinsurance facility.

Administrative independence

9.21. The agency should be given independence from government and insurer influence in undertaking its roles relating to:

- coordination of flood risk mapping and information management;
- managing the reinsurance facility including setting premiums and discounts, interacting with insurers on prices and discounts, collecting premiums and making reinsurance payments to insurers; and
- employing staff and setting remuneration arrangements, noting that its staff would require specialised skills and employment experience.

Chapter 10. Other natural disasters

- 10.1. There is a range of natural disasters that have the potential to cause large scale property losses across Australia. Some of these are covered as a matter of course in all home, contents and home unit insurance policies and some are not.
- 10.2. Of those natural disasters that are always covered, the Review Panel is only aware of one possible issue in relation to availability and affordability of coverage. It concerns the home, contents and home unit insurance market for dwellings with high cyclone risk, particularly in north Queensland.
- 10.3. Apart from flood, the other natural disasters that are not currently universally covered in home, contents and home unit insurance policies are landslide and actions of the sea. These events are often, but not always, covered if they are the result of another event that is covered under the policy (for example, heavy rainfall in the case of a landslide).

CYCLONE

- 10.4. Damage from cyclone is currently included as standard in all home, contents and home unit insurance policies because cyclone is a category of storm and storm damage is covered. As such, cyclones do not typically lead to a high level of claim disputes.
- 10.5. However, a number of personal submissions to, and consultations undertaken by, the Review Panel have highlighted potential issues with both availability and affordability of insurance cover in areas exposed to cyclones, predominantly in north Queensland. Insurance cover has become difficult to source, particularly for strata title properties, because there are a limited number of insurers who will offer the cover, even when brokers are used. There have also been cases of bodies corporate being quoted premium increases of up to 400 per cent in 2010-11.⁵²
- 10.6. It is unclear whether the lack of affordability is being driven by a lack of competition in the market or the underlying risk profile in these areas. Insurance market capacity has been diminishing in north Queensland for several reasons, most of which are founded on the underlying risk profile of the area. Some insurers have withdrawn from the market perhaps because it is small or because they are over-exposed (which can occur when others withdraw, creating an adverse cycle for available capacity) or because their reinsurance arrangements make it uneconomic.
- 10.7. A parallel can be drawn between the Cyclone Yasi situation in north Queensland and the flood insurance situation in the Brisbane and Ipswich areas:
 - in Cyclone Yasi, all policyholders had storm cover so there have been few complaints about claims but, as insurance renewals occur following the cyclone, some very large premium increases have arisen; and

52 Submission to NDIR Issues Paper, Jo Anne Cracknell, '400 per cent increase in insurance premium for one bedroom units', p 1.
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Cracknell.pdf

- in the Brisbane and Ipswich floods many complaints occurred about claims because many policyholders were not covered; some of those policyholders now wishing to purchase flood cover are being asked to pay very high premiums (which is the parallel with Cyclone Yasi) but also they can opt-out of purchasing the cover if they choose.
- 10.8. The Review Panel has not had the means or the time to investigate fully the causes of the recent price increases in the north Queensland market. In particular, it is difficult to tell if the increases observed in some cyclone prone areas are being driven by a lack of competition in the insurance market or whether they reflect a reassessment of the underlying risk profiles in these areas. Either way they reflect a lack of market capacity and a limited appetite of insurers for exposures in these areas.
- 10.9. On the basis of the evidence outlined above, the Review Panel accepts that there is, prima facie, an affordability problem in some cyclone prone areas of Australia, regardless of the cause, and considers that a two stage approach is the best way to deal with this problem. The Review Panel recommends:
- firstly, that the reinsurance facility provide undiscounted reinsurance cover for cyclone risk to the insurance market on the same basis as recommended for flood insurance. That is, the reinsurance facility would allow insurers to reinsure a large proportion of their cyclone exposure with the facility, giving insurers capacity to write business in high cyclone risk areas without facing significant accumulations of exposure, as is currently the case;
 - this step should encourage more participation in this market which would in turn be expected to put downward pressure on premiums. The prices offered by the reinsurance facility may then be lower than the prices that insurers would otherwise charge for the risk and, if so, would further reduce premiums faced by policyholders; and
 - secondly that an investigation be undertaken as to whether there is a basis for providing reinsurance for cyclone risk on a discounted basis, in a similar manner to the discounts being recommended for flood cover, in order to further improve affordability.

Recommendation 27

That:

- the Agency offer cover to insurers for cyclone risk, on the same basis as for flood risk, but with no affordability discounts (in the expectation that, when the Agency does its own pricing, it will offer a fair price to home and home unit owners. This price may be lower but is not guaranteed to be lower than the prices of commercial insurers); and
- an investigation be undertaken to ascertain whether there is a basis for granting affordability discounts for cyclone risk, along the lines of the recommended flood insurance discounts, for homes and home units in northern Australia.[Box text paragraph]

ACTIONS OF THE SEA

10.10. Actions of the sea can be seen as comprising three types of peril: tsunami, storm surge and other tidal inundation.

Tsunami and Storm Surge

10.11. Tsunamis and storm surges are often, but not always, related to other events that would normally be covered in a home insurance policy. For example, tsunamis are often caused by undersea earthquakes and storm surges are typically associated with cyclones.

10.12. Cover for tsunami and storm surge is provided by some but not all insurers in the current market. In particular, cover is generally (but not always) provided where the underlying cause of the loss is an insured event. That is, some insurers cover tsunami where it is caused by an earthquake and storm surge where it is caused by a cyclone. Cover for tsunami is generally more widely available than for storm surge.

10.13. Some of the likely reasons for the lack of uniform cover for these events by insurers are similar to those for flood insurance, for example:

- insurers may not have access to adequate data for risk assessment and pricing;
- these perils only affect a limited part of the insurance market, limited the spreading of individual insurers;
- suitable reinsurance capacity may not be available to all insurers; and
- Increasing insurer exposure and accumulations due to increased population density in coastal areas.

10.14. However, given that a number of insurers currently cover tsunami and storm surge, in limited circumstances, it is arguable that the above issues are not insurmountable. They undoubtedly warrant technical investigation but the Review Panel understands that reinsurance capacity is generally available for these perils and that the additional premium associated with cover for tsunami and storm surge would generally be minimal.

10.15. The primary benefit of including cover for tsunami and storm surge in all home insurance policies is clear: it would eliminate potential disputes and misunderstandings over the causes of water damage, giving increased certainty for homeowners in terms of cover. It would therefore lead to increased resilience and ability to recover by communities in the case of such an event.

10.16. Therefore, given that it appears that the insurance industry is capable of providing cover for a seemingly modest additional premium, and given the additional benefits to homeowners of having cover, the Review Panel considers that all home, contents and home unit insurance policies should cover policyholders for tsunami and storm surge, where the underlying cause is an insured event and regardless of whether the insured property directly suffers damage from the underlying insured event.

10.17. This latter qualification relates particularly to storm surge associated with cyclones. Some insurers exclude storm surge if the cyclone does not cross the coastline. The Review Panel is recommending against the continuation by insurers of this kind of exclusion.

10.18. The Review Panel expects that the private insurance market would not require any additional support in order to provide this cover and therefore is not proposing that the reinsurance facility provide reinsurance for tsunami or storm surge risk.

OTHER COASTAL INUNDATION

10.19. Other coastal inundation relates to events such as king tides and rising sea levels. Cover for these types of events is generally not available in the current market. They are different from other weather events such as floods and cyclones because they appear more likely to be associated with possible climate change.

10.20. In any event, the Review Panel is not proposing that any changes be made by the insurance industry at this time in relation to coastal inundation.

LANDSLIDE

10.21. Landslides are not very common in Australia and are typically not very costly in comparison to other natural disasters. They are often, but not always, related to other events that would normally be covered in a home insurance policy such as heavy rainfall or an earthquake.

10.22. Cover for landslides in the current market is similar to cover for tsunamis and storm surge in that cover is sometimes, but not always, provided where the landslide is a result of an insured event.

10.23. Given that landslides have not resulted in significant economic loss very often in the past, the lack of consistent cover for landslide has not led to a many claims or many disputes. However, there remains the possibility that a large landslide in a heavily populated area could lead to confusion and disputes around insurance coverage, similar to that witnessed in the aftermath of the January floods.

10.24. Also, the relative infrequency and randomness of landslides means that the additional premium required to cover landslide should be modest.

10.25. The Review Panel therefore recommends that all home, contents and home unit insurance policies cover the policyholder for landslide where the landslide is a result of an insured event, such as heavy rainfall, and regardless of whether that event directly causes damage to the insured property.

10.26. The Review Panel expects the private insurance market not to require any additional support in order to provide this cover and therefore is not proposing that the reinsurance facility provide reinsurance for landslide risk.

Recommendation 28:

That all home, contents and home unit insurance policies cover the policyholder for storm surge, tsunami and landslide, where the storm surge, tsunami or landslide is the result of another event that is covered under the policy and regardless of whether the insured property directly suffers damage from the underlying insured event.

- This includes storm surge associated with a cyclone that does not cross the coastline.

Chapter 11. Addressing non-insurance

EXTENT OF NON-INSURANCE

- 11.1. Data on non-insurance is limited but suggest the rate of non-insurance of homes in Australia is relatively low. Tooth and Barker estimated the proportion of owner-occupied homes with no insurance at 4 per cent.⁵³
- 11.2. Existing rates of non-insurance for contents are higher than for homes. It is estimated that 28 per cent of households in Australia had no contents insurance (12 per cent of owner occupiers, 67 per cent of tenants).⁵⁴ A 2011 study by the Brotherhood of St Laurence found, similarly, that 32 per cent of low income Australians do not hold home contents insurance.⁵⁵
- 11.3. These rates of non-insurance appear broadly consistent with those of comparable countries.
- In the United States, a 2006 Insurance Research Council poll found that 96 per cent of home owners had home insurance but that only 43 per cent of renters had renters insurance, which covers possessions.⁵⁶
 - The Insurance Council of New Zealand noted in 2008 that around 10 per cent of homes in that country were not insured and that 10 per cent to 20 per cent of New Zealanders do not have home contents insurance.⁵⁷

CONTRIBUTORS TO NON-INSURANCE

Government and other natural disaster aid and assistance to households

- 11.4. Charities and governments in Australia provide significant amounts of assistance to households and communities who have been adversely affected by natural disasters. While this assistance provides much needed relief necessary in reconstruction and recovery, its provision presents some issues of moral hazard, equity and efficiency.
- 11.5. The Queensland Premier's Relief Fund received \$273 million in donations.⁵⁸ Payments have been made in three rounds. In the first round, any adult whose home was affected by flood or

53 Dr Richard Tooth and Dr George Barker, 'The Non-Insured: Who, Why and Trends', Centre of Law and Economics, for the Insurance Council of Australia, May 2007, p 12.

<http://www.insurancecouncil.com.au/Portals/24/Issues/The%20Non%20Insured%20-%20Report.pdf>

54 Ibid, p 12.

55 Dominic Collins, Brotherhood of St Laurence, 'Reducing the risks', 2011, p v.

http://www.bsl.org.au/pdfs/Collins_Reducing_the_risks_insurance_2011.pdf

56 Quoted by the Insurance Information Institute, 'Homeowners Insurance'.

http://www.iii.org/facts_statistics/homeowners-insurance.html

57 Terry Jordan, Insurance Council of New Zealand, quoted in 'Kiwis see need for insurance too late', The Dominion Post, 17 June 2008. <http://www.stuff.co.nz/business/492518/Kiwis-see-need-for-insurance-too-late>

58 As at 1 September 2011, Media Release issued by the Honourable Anna Bligh, Premier and Minister for Reconstruction of Queensland, 'Premier thanks Australia as she announces Disaster Relief Fund Wrap Up', 1 September 2011. <http://www.cabinet.qld.gov.au/MMS/StatementDisplaySingle.aspx?id=76351>

Cyclone Yasi was entitled to be paid \$2,000. In the second round, people whose homes had been totally destroyed or needed to be demolished and who had household income of less than \$150,000 were entitled to be paid up to \$280,000. In round three, people whose homes had suffered structural damage were entitled to be paid up to \$80,000. Payments of up to \$30,000 for damaged or destroyed contents have also been made. Under Round 2 and Round 3, any insurance payments, ex gratia payments and any assistance provided under the Commonwealth Government NDRRA Community Recovery Structural Assistance Grants were deducted when determining the amount of assistance provided from the Relief Fund.⁵⁹

- 11.6. The 2009 Victorian Bushfire Appeal raised \$395 million. Where homes had been destroyed, payments of \$35,000 were made to assist with rehousing, with an additional \$40,000 payment available based on need. Where homes had been damaged, payments of \$15,000 and up to an additional \$20,000 based on need were made available. \$15,000 was made available for contents replacement, with an additional \$20,000 also available based on need. Insurance payments did not affect eligibility for these payments.⁶⁰
- 11.7. The Australian Government Disaster Recovery Payment provides short term financial assistance to individuals affected by major or widespread disasters. A non means tested payment of \$1,000 for adults is available. As of the beginning of September 2011, a total of \$466 million had been paid under the scheme to those affected by the Queensland floods.⁶¹
- 11.8. State government payments such as the Queensland Personal Hardship Assistance Scheme and the Victorian temporary living expense grant and reestablishment grant also provided assistance in the order of up to several thousand dollars.
- 11.9. Charitable and government assistance following natural disasters can also be seen as a premium-free insurance against natural disasters. If a catastrophe occurs, individuals without insurance are the beneficiaries of the financial support they can obtain without having to pay premiums.⁶² Providing assistance after a natural disaster also reduces individual incentives to manage risk before the next natural disaster. If households expect to receive relief payments after a loss, they have less economic incentive to invest in mitigation measures or insurance before the next event. This may increase the uninsured losses experienced in the next disaster.

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- 59 Queensland Reconstruction Authority, Monthly Report, July 2011, Dashboard 3, <http://www.qldreconstruction.org.au/reports/july-2011-monthly-report>; Queensland Government, 'Application for Assistance Structural Damage Assistance – Destroyed Home'. <http://www.communityservices.qld.gov.au/community/community-recovery/support-assistance/documents/structural-damage-assistance.pdf>
Queensland Government, 'Premier's Disaster Relief Appeal Fund – Round 2 Frequently asked questions Structural Damage Assistance – Destroyed Homes'. <http://www.communityservices.qld.gov.au/community/community-recovery/support-assistance/documents/structural-damage-assistance-faq.pdf>
Media Release issued by, the Honourable Anna Bligh, Premier and Minister for Reconstruction of Queensland, 'Round Three of Premier's Disaster Relief Fund offers up to \$80,000', 7 April 2011. <http://www.cabinet.qld.gov.au/mms/StatementDisplaySingle.aspx?id=74304>
- 60 State Government of Victoria, Department of Human Services, 'Victorian Bushfire Appeal Fund'. <http://www.dhs.vic.gov.au/bushfireappeal>
- 61 Attorney-General's Department, Disaster Assist, 'Queensland Floods (November 2010 – February 2011)'. http://www.disasterassist.gov.au/www/disasterassist/disasterassist.nsf/Page/Currentdisasters_QueenslandFloodingDecember2010
- 62 Paul A. Raschky, Reimund Schwarze, Manijeh Schwindt and Ferdinand Zahn, 'Uncertainty of Governmental Relief and the Crowding out of Insurance', Working Papers 2010-03, Faculty of Economics and Statistics, University of Innsbruck, 2010, pp 3-6. <http://ideas.repec.org/p/inn/wpaper/2010-03.html>

- 11.10. Charitable and government payments are often reduced according to the amount of insurance payments. There are several natural disaster relief programs for individuals, families and small businesses administered by the States and partially reimbursable by the Commonwealth through the NDRRA which are all reduced in the presence of insurance.⁶³ Larger natural disaster events in the recent past have seen temporary charitable funds being set up.⁶⁴ The Review Panel is only aware of one instance (the Victorian Bushfire Appeal) where payments were not reduced at all for disaster victims that were uninsured.
- 11.11. Reducing charity and government payments to disaster victims according to their insurance payouts can be seen as penalising those who insure and creating or exacerbating problems of ‘charity hazard’. Nevertheless, the purpose of government and charitable relief is to assist households to recover financially from natural disasters. Not taking insurance payments into account might result in those in less need receiving as much as those in greater need and may result in those affected by natural disasters profiting financially; that is, receiving payments in excess of losses.
- 11.12. To balance these two needs, the Review Panel recommends that the principle that should guide charitable and government payments is that they should not replace or displace insurance. That is, payments should not penalise those who insure.
- 11.13. Accordingly, while the presence of insurance should be taken into account in determining the extent of any payments, it should not be the single determining factor. It should instead be considered alongside other indicators of the need for assistance such as assets, liabilities, income and damages.
- 11.14. This approach could also assist to overcome the issue of delayed payments. For example, there were delays in disbursing funds from the Queensland Premier’s Disaster Relief Fund due to delays in insurance claims being assessed or finally determined.⁶⁵
- 11.15. To implement this proposed coordinated approach between insurance claim payments and other sources of funds that provide relief and support after natural disasters would require a level of financial coordination that has not occurred in the past. It would require the insurance industry to become a party to Commonwealth and State payment arrangements commencing immediately after the disaster. The Review Panel therefore recommends that the Commonwealth engage with the insurance industry and the States in planning for the future coordination of charitable and government payments to individuals to assist with recovery from a natural disaster and to do so in a way that does not discourage homeowners from holding home and home contents insurance.

63 For example, the Queensland Government Personal Hardship Assistance Scheme, the Victorian Government Temporary Living Expenses Grant and the Victorian Government Re-establishment Grant.

64 For example, the Queensland Premier’s Disaster Relief Appeal and the Victorian Bushfire Appeal.

65 On 2 August 2011 RACQ Insurance announced that it would pay the claims of customers in the Ipswich region who initially had been declined flash flood and stormwater run-off payouts after the January 2011 floods. This followed the receipt by RACQ of new hydrological information. Under the arrangements governing assistance payments from the Queensland Premier’s Fund, RACQ customers may have had to repay any charitable funds received. However, the Queensland Premier subsequently announced that people who received an insurance payout after having received assistance from the Premier’s Fund would not have to repay the assistance.

(Sources: Media Release issued by RACQ Insurance, ‘RACQ Insurance announces claims re-assessment’, 2 August 2011. http://www.racq.com.au/about_us/news_and_media/stories/racq_insurance_announces_claims_re-assessment

Media Release issued by, the Honourable Anna Bligh, Premier and Minister for Reconstruction of Queensland, ‘Premier Pledge on Appeal Fund Recipients’, 4 August 2011. <http://www.cabinet.qld.gov.au/MMS/StatementDisplaySingle.aspx?id=75944>)

Recommendation 29:

That the Commonwealth engage with the insurance industry and the States and Territories in planning for the future coordination of charitable and government payments to individuals to assist with recovery after future natural disasters.

Insurance take-up by those on low incomes

11.16. The affordability of insurance has two dimensions: the size of the premium and the policyholder's ability to fund the premium, or 'cash flow'.

11.17. Discounts have been recommended to reduce the high price of some premiums for flood cover. However, some consumers would continue to face a cash flow impediment to taking up insurance.

11.18. While those on low incomes are less likely to take-up insurance generally, they can have a greater need for insurance if they do not have the financial resources to restore any assets or belongings that were damaged or destroyed.

11.19. The Brotherhood of St Laurence has identified several 'barriers' that low-income earners experience in regard to insurance, including:

- lack of affordability of premiums and the use of excesses;
- negative past experiences with claims;
- individuals' attitudes toward risk;
- difficulty estimating the actual value of their assets and, consequently, the potential financial impact of losses;
- self-exclusion, often due to perceptions about insurers' housing security requirements; and
- misunderstanding and feeling overwhelmed by contract terms.⁶⁶

11.20. The Brotherhood of St Laurence conducted a survey of 200 low-income earners and found that 68 per cent of respondents desired higher insurance cover, of which 34 per cent desired higher contents cover and 9 per cent desired higher home cover.⁶⁷ While most low-income earners would prefer to hold more insurance cover, some hold a preference for life and funeral insurance.⁶⁸

11.21. A May 2011 report into financial exclusion provided statistics on take-up of contents insurance according to the degree of financial inclusion that are summarised in Table 3 (below).⁶⁹ It

66 Dominic Collins (Brotherhood of St Laurence), op cit, p 5.

67 Brotherhood of St Laurence submission, p 5.
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Brotherhood_of_St_Laurence.pdf

68 Dominic Collins (Brotherhood of St Laurence), op cit, p 29.

69 The Centre for Social Impact, 'Measuring financial exclusion in Australia', prepared for the National Australia Bank, May 2011, p 28.
http://www.csi.edu.au/assets/assetdoc/3c1698bd3334ed55/NAB-Financial-Exclusion-Report_Final.pdf

shows that around 15 per cent of the general population (the ‘included’) do not hold contents insurance and that rates of non-insurance rise dramatically as the degree of financial exclusion worsens.

Table 3: Take-up of home contents insurance by degree of financial inclusion

Degree of financial inclusion	Have home contents insurance (%)
Included	85.3
Marginally excluded	75.1
Severely excluded	46.4
Fully excluded	0.0

Notes: ‘Included’ persons are defined as those persons having a transaction account and credit card and home contents or motor vehicle insurance (43.4 per cent of the adult population); ‘marginally excluded’ refers to persons holding two of these financial products (41.0 per cent); ‘severely excluded’ persons hold only one of these types of products (14.8 per cent) and ‘fully excluded’ persons hold none of these products (0.8 per cent).

Additional assistance for low-income earners

11.22. It is beyond the scope of this Review to consider whether specific concessions should be provided to those on low incomes to enable them to purchase insurance. It is open to the Government to consider providing concessions to certain groups for insurance against the other priorities facing this group.

11.23. However, the Review Panel considers that there is scope to improve low income earners’ access to insurance products through addressing the cash flow issues that can limit their ability to make ‘lumpy’ payments. Centrepay provides Centrelink customers with a voluntary, free bill-paying service by deducting amounts for regular expenses from Centrelink payments prior to depositing payments in customers’ bank accounts.

11.24. In the discussion paper ‘Reforming Flood Insurance — Clearing the Waters’ the Government noted that it had agreed to include home and contents and motor vehicle insurance premiums among the kinds of expenses that can be paid using Centrepay.⁷⁰ The Review Panel understands that the insurance industry has responded and approached Centrelink.

11.25. There may well be issues which arise from fortnightly Centrepay insurance premium payments such as:

- the level of fees charged to insurers who use Centrepay to receive premiums, given the low level of fortnightly payments that would be needed for many insurance policies;
- whether premiums should be remitted to insurers fortnightly or perhaps held in trust and paid monthly;
- potential levels of defalcations such as for Centrelink benefit recipients whose payments are suspended for breaches; and
- compliance difficulties for insurers who would need to cancel policies when non-payment of fortnightly premiums occurs.

70 Australian Government, ‘Reforming Flood Insurance: Clearing the Waters’, April 2011, p 20.
<http://www.treasury.gov.au/contentitem.asp?ContentID=1995&NavID=037>

- 11.26. Nevertheless, the Review Panel considers that this is a worthwhile initiative that should be actively pursued by the Commonwealth Government. In the time available, the Review Panel has not been able to undertake the analysis necessary to make concrete recommendations on how to proceed, but urges the Government to arrange for the development and implementation of a facility to allow Centrelink customers to pay insurance premiums fortnightly through Centrepay.
- 11.27. Similarly, there is considerable merit in pursuing options to allow insurance premiums to be paid as part of rent for social or community housing tenants. In the United Kingdom two approaches are taken to improve access to contents insurance for social housing tenants. Under ‘affinity’ schemes the landlord introduces the tenant to the insurer with all administration carried out by the insurer. Under ‘insurance with rent’ schemes the landlord promotes and administers the schemes including handling proposal forms, collecting premiums, issuing policies, setting up accounts and sending out renewal reminders. The landlords receive a commission from the insurer to cover costs.⁷¹
- 11.28. Such schemes may address cash flow affordability issues for low income earners and provide for cheaper insurance with economies of scale and collective or group purchasing.
- 11.29. A survey undertaken by the Brotherhood of St Laurence suggests that these approaches would encourage more of those on low incomes to purchase insurance. For example, 39 per cent of respondents indicated high or some interest in being able to pay for insurance through Centrepay and 37 per cent of respondents indicated high or some interest in being able to pay for insurance with rent.⁷²
- 11.30. In Australia, both State and Commonwealth governments as well as charities and not-for-profit organisations are involved in the provision of social and community housing. The Review Panel does not have a direct recommendation to make to these different levels of government on how to implement arrangements that would allow insurance premiums for contents to be paid as part of rent. However, the Review Panel considers schemes of this kind could facilitate access to insurance.

Recommendation 30:

That access to insurance be enhanced through the development of alternative payment options, in particular:

- by the Commonwealth Government arranging for Centrelink customers to be able to pay insurance premiums fortnightly through Centrepay; and
- by State, Territory and/or local governments and community housing organisations arranging insurance premiums for contents to be able to be incorporated into rent for social and community housing tenants.

Role of lending institutions

- 11.31. The Review Panel has examined the viability of mandating a role for lending institutions to reduce non-insurance and rectify under-insurance. Currently, lenders impose contractual

71 Association of British Insurers, ‘How schemes work’.
http://www.abi.org.uk/Access_to_Insurance/Financial_Inclusion_Champions/How_schemes_work.aspx

72 Brotherhood of St Laurence submission, p 7.
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Brotherhood_of_St_Laurence.pdf

obligations on mortgagors to insure their homes⁷³ even though there is no legislative requirement for them to do so. However, many lending institutions choose not to undertake checks of mortgagors' insurance arrangements nor do they specify the breadth of coverage that should be included in the policy.⁷⁴

11.32. Lenders argue that from their business perspective, it is not worthwhile for them to check insurance details such as the adequacy of sums insured, scope of insurance cover (for example whether flood cover is included) or even whether an insurance policy is in place. They contend that any financial exposure to them arising from non-insurance and under-insurance of homes is limited while the administrative costs of following up details of borrowers' insurance would be significant.

11.33. The Australian Bankers' Association (ABA) notes that banks' lending books have not been adversely affected by the recent floods and that lending losses in relation to non-insurance and under-insurance have been negligible.⁷⁵ Limited financial exposure of lending institutions is due to a variety of factors, including:

- much of the total property value being vested in the land, rather than the home;
- lenders' mortgage insurance being in place for some loans; and
- provision of government grants and charitable donations to affected homeowners following some natural disasters.

11.34. More broadly, the ABA argues that banks have many options to assess and manage risks besides home insurance. They can deny a loan, adjust the loan-to-value ratio, impose additional requirements such as purchase of lenders' mortgage insurance, increase capital holdings in respect of a particular financial exposure and adopt specific risk mitigation measures.⁷⁶ The ABA advises that some banks have reduced their maximum loan-to-value ratios in 2011 for loans on properties in flood risk areas.⁷⁷

11.35. The implementation of a comprehensive insurance compliance checking regime would entail significant administrative costs for lenders and insurers and pose enforcement difficulties such as whether a default should trigger a mortgagee sale of the property. Including flood cover and replacement value cover in all home insurance policies in line with the Review Panel's recommendation would also reduce the number of borrowers who have insufficient insurance. The benefits of introducing a compulsory insurance compliance regime do not, therefore, appear to be justified.

11.36. Nevertheless, lenders can play an important role in encouraging insurance among the estimated 50 per cent of homeowners who have a mortgage. The lenders' contractual requirements that the mortgaged property be insured act as an impetus for homeowners to take out insurance initially. Lenders can also play a useful role in reminding homeowners

73 Australian Bankers' Association submission, p 5.

http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Australian_Bankers_Association_Inc.pdf
ABACUS — Australian Mutuals submission, p 2.

http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Abacus_Australian_Mutuals.pdf

74 Small non-bank lenders (with only a few hundred loans) do undertake annual checks to ensure insurance continuity. Banks and large non-bank lenders do not.

(Sources: ABACUS Australian Mutuals submission, p 3, Australian Bankers' Association submission, p 5.)

75 Australian Bankers' Association submission, p 6.

76 *ibid*, p 5.

77 *ibid*, p 6.

periodically of the need to maintain or review existing insurance and of the risks of under-insurance. Providing reminders on, for example, an annual basis, would not impose significant administrative costs on lenders and may result in more comprehensive insurance cover which is consistent with the policy aim in requiring lenders to have some assurance that the assets are protected.

11.37. Lenders are also a source of information on the value of the property that could be used by homeowners as part of the information they bring to the estimation of the replacement value of the property.

Recommendation 31:

That lending institutions remind mortgagors annually of their obligations to hold home insurance and of the risks of under-insurance in order to minimise non-insurance and under-insurance of homes.

Abolishing State insurance taxes

11.38. Submissions from insurers argue for the removal of State taxes on insurance as an efficient method for governments to improve the affordability of insurance.⁷⁸ A number of submissions to the Review from individuals also called for the removal of insurance taxes.

11.39. The Review Panel has not undertaken independent analysis of the impact of the Fire Services Levy or insurance taxes on non-insurance and under-insurance. However, the analysis undertaken by others, including the Australia's Future Tax System Review (AFTS),⁷⁹ argues that the imposition of insurance specific taxes has a harmful effect on the levels of non-insurance and under-insurance.

11.40. Insurance premiums currently attract stamp duty imposed by State and Territory governments at rates of between 7.5 per cent and 11 per cent, a fire service levy on insurers in Victoria, NSW and Tasmania that is recouped through higher premiums, and GST.⁸⁰

11.41. The Victorian Bushfires Royal Commission calculated that in metropolitan areas, for every \$100 in premium, the Victorian Fire Services Levy added \$20 to the final cost of home insurance and State government stamp duty added a further \$13.20. For businesses located in

78 Allianz submission, p 2.

http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Allianz_Australia_Insurance_Ltd.pdf
IAG submission, p 21.

[http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_\(IAG\).pdf](http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_(IAG).pdf)
Insurance Council of Australia submission, p 2, pp 27-28.

http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Council_of_Australia.pdf
Suncorp submission, p 6. http://www.ndir.gov.au/content/submissions/issues_paper_submissions/suncorp.pdf

79 Australia's Future Tax System, Report to the Treasurer, Part Two, Detailed Analysis, Volume 2 of 2, December 2009, pp 472-474.
http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_2_Conso_lidated.pdf

80 Australia's Future Tax System, op cit, Table E8-1: Insurance taxes in each State, 2008-09, p 471.

metropolitan areas, for every \$100 in premium, the Fire Services Levy added \$50 and stamp duty added a further \$16.50.⁸¹

11.42. It was put to the Review that Federal and State Government taxes and charges on insurance premiums increased an insurance premium in metropolitan areas by up to 78 per cent for business insurance, and up to 44 per cent for home insurance.⁸²

11.43. These are significant imposts on insurance. As discussed in the AFTS Report, insurance taxes mean that insureds pay more to achieve the same level of risk reduction, potentially deterring some people and businesses from entering the insurance market or purchasing an adequate level of insurance.⁸³ Modelling conducted by Tooth and Barker in 2008 estimated that State insurance premium based taxes are the cause of around 300,000 households being without home contents insurance and 69,000 households being without home insurance.⁸⁴

11.44. The purchase of insurance by consumers represents a conscious attempt by them to take responsibility for the management of the risks that they bear. This form of financial self-reliance should be encouraged. However, the imposition by State governments of taxes and levies on insurance imposes additional costs on consumers for doing so.

11.45. Action is being taken by State governments to reduce the impost on insurers. The Victorian Government has announced that it will replace the Fire Services Levy with a property based payment. Abolition of the levy was also an election commitment of the NSW Government.⁸⁵ This would significantly reduce the cost of insurance policies in these States.

11.46. The Review Panel endorses the conclusions of the AFTS Review and others who argue that taxes on insurance are inefficient. However, these taxes are a significant source of revenue for State and Territory governments, and any consideration of their removal would need to be made in the context of broader State level fiscal reform efforts.

Compulsory insurance for homes and contents

11.47. Some submissions to the Review argue in favour of compulsory insurance because insurance enhances resilience and so insurance coverage for all would be advantageous. Compulsory insurance would also prevent those who have purchased insurance being asked to contribute to the provision of assistance to those who have not following a natural disaster.

81 2009 Victorian Bushfires Royal Commission, 'The Fire Services Levy and Insurance', Discussion Paper, November 2009, p 3, (stamp duty is levied on the total of the insurance premium, Fire Services Levy and GST).
<http://www.royalcommission.vic.gov.au/getdoc/7b5203e0-7d74-47d5-b30a-fb47f233d38d/Fire-Services-Levy-and-Insurance-Discussion-Paper>

82 Insurance Australia Group, op cit, p 21.

83 Australia's Future Tax System, op cit, p 473.

84 Dr George Barker and Dr Richard Tooth, 'An Analysis of the Demand for House and Contents Insurance in Australia', Centre for Law and Economics, 2008, p 4.
http://law.anu.edu.au/cle/Papers/Insurance_Demand_Home&Contents_Fina.pdf

85 Media Release issued by The Hon Peter Ryan MP, Deputy Premier of Victoria, and The Hon Kim Wells MP, Treasurer of Victoria, 'Coalition Government announces timetable for introduction of new fire services funding model', 14 May 2011.

<http://www.premier.vic.gov.au/media-centre/media-releases/947-coalition-government-announces-timetable-for-introduction-of-new-fire-services-funding-model-.html>

Media Release issued by the Hon Melinda Pavey MLC, 'Labor's bushfire levy bungle', 19 January 2011.

<http://nsw.nationals.org.au/Latest-News/labors-bushfire-levy-bungle.html>

- 11.48. However, as noted in the Issues Paper, making insurance compulsory would be a very significant change to the operation of the private insurance market in Australia.⁸⁶ Although forms of compulsory insurance do exist, they are intended to protect third parties such as third party insurance for motor vehicles. While there is an impact on the broader community if homeowners do not insure, it is not a direct third party implication.
- 11.49. Simply making insurance compulsory without also addressing underlying causes of non-insurance, such as affordability and financial exclusion, may have unintended and adverse consequences, potentially requiring additional measures to address them.
- 11.50. Problems also arise if the purchase of insurance is compulsory but insurers do not offer suitable products. Therefore if insurance were made compulsory it may also be necessary to institute a requirement on insurers to offer cover to everyone. It would also require substantial market intervention, in both compliance terms and commercial terms, if insurers were required to offer insurance to homeowners and all owners were required to purchase cover irrespective of risk and other characteristics. Finally, there would be substantial enforcement difficulties such as whether a failure by an existing homeowner to purchase insurance cover would trigger a sale of the property.
- 11.51. On balance, the Review Panel does not consider that the benefits of making insurance compulsory are justified, particularly given the current low levels of non-insurance of homes and the range of reasons for non-insurance of contents. See the Review Panel's Recommendation 2 in Chapter 2.

86 Natural Disaster Insurance Review, Issues Paper, Jun 2011, p 43.
<http://www.ndir.gov.au/content/Content.aspx?doc=issuespaper.htm>

Chapter 12. REDUCING UNDER-INSURANCE OF HOMES

THE MAIN TYPES OF HOME BUILDING INSURANCE COVER

- 12.1. There are two main types of home building insurance cover offered by insurers in the Australian market. The first is often referred to as 'sum insured cover' under which insurers provide cover up to a specified dollar amount (that is, the sum insured). This amount represents the maximum liability of the insurer for damage to the home. The second is 'replacement value cover' under which a sum insured amount does not apply. Instead, the insurer commits to rebuild a damaged or destroyed home to its original size and standard, regardless of the cost involved.
- 12.2. The majority of home building insurance policies sold in Australia provide sum insured cover. Only a small number of insurers currently offer replacement value cover. This is despite the fact that replacement value cover is standard for home building insurance under Division 2 of the Insurance Contracts Regulations 1985 that is, most insurers choose to deviate from this aspect of standard cover as defined in subsection 35(2) of the *Insurance Contracts Act 1984*.

UNDER-INSURANCE OF HOMES IS LINKED TO SUM INSURED COVER

- 12.3. Under sum insured cover, generally neither the homeowner nor the insurer knows how closely the sum insured corresponds to the replacement value. This creates the possibility that when a home insured under a sum insured policy is destroyed (that is, becomes a 'total loss' for insurance purposes) and needs to be rebuilt, the sum insured amount may be insufficient to fully fund replacement of the home. In that scenario, the homeowner is under-insured. If the home is to be rebuilt to its original size and standard, the homeowner will have to fund the shortfall between the sum insured and the rebuilding costs.
- 12.4. Under-insurance has the potential to cause significant financial hardship for homeowners who experience the total loss of their home.
- 12.5. The existence of under-insurance is generally not readily apparent because most insurance claims are partial losses, rather than total losses, and the sum insured is usually adequate in such cases. As long as the replacement cost of the partial loss is less than its sum insured, the homeowner is generally covered for full replacement. However, whenever there are natural disasters that cause homes to be total losses, the level of under-insurance becomes visible. This phenomenon is most evident in bushfires. Indications following both the 2003 Canberra bushfires and the 2009 Victorian bushfires were that a substantial proportion of homeowners were under-insured to some degree. Following the Canberra bushfires, it was estimated that structures were under-insured, on average, by 40 per cent of their replacement cost.⁸⁷ The Insurance Council has noted that the average claim for homes that were total losses from the

87 Australian Securities and Investments Commission (ASIC), 'Getting Home Insurance Right', Report 54, September 2005, p 12.
[www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/underinsurance_report.pdf/\\$file/underinsurance_report.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/underinsurance_report.pdf/$file/underinsurance_report.pdf)

Victorian bushfires was \$132,000 compared with an average cost of building a home in Victoria of \$230,000, indicating here also an average level of under-insurance of around 40 per cent.⁸⁸

CAUSES OF UNDER-INSURANCE OF HOMES

12.6. Under-insurance can occur for two main reasons.

- Firstly, the homeowner can deliberately choose a sum insured that is insufficient to cover rebuilding costs in the event of a total loss. This practice is usually engaged in to obtain a lower premium. It actually gives rise to cross-subsidies from those who are careful to avoid under-insurance to those who do under-insure. The reason is that insurers' aggregate claims costs are not heavily influenced by the sum insured but their premiums do vary by sum insured; under-statement of sum insured therefore leads to the average premium per unit sum insured having to rise, adversely affecting those who have not under-stated their sum insured.
- Secondly, the homeowner can underestimate rebuilding costs, resulting in inadvertent under-insurance. There are a number of factors that may contribute to homeowners inadvertently underestimating the cost of rebuilding.

12.7. Estimating replacement cost is a technical task and may require building industry expertise to be done properly. It requires time and effort by homeowners and, although professional advice can be obtained, it is not a practice that homeowners would see as worthwhile.

12.8. Although insurers provide online valuation calculators to assist homeowners to assess an appropriate sum insured value, the calculators have their limitations. The Australian Securities and Investments Commission (ASIC) has found that the calculators can vary in quality. Accordingly, ASIC recommends that homeowners try at least three different calculators before arriving at an appropriate sum.⁸⁹

12.9. Most insurers automatically increase the sum insured each year, in an effort to counter building cost inflation, but this indexation of the sum insured value, while a useful step, is something of a 'hit and miss' approach because the results depend on both the adequacy of the original sum insured and the appropriateness of the indexation rates used.

A 'TOP-UP' TO THE SUM INSURED

12.10. Rebuilding costs following events where a large number of homes have been destroyed, such as natural disasters, may be higher than normal due to greater demand for labour and materials that inevitably follows such an event. Accurately estimating how much higher costs could be in such circumstances is difficult.

12.11. Some insurers provide a 'top-up' of the sum insured in the event of a natural disaster to account for higher than normal buildings costs. The 'top-up' is additional cover above the sum

88 Insurance Council of Australia, Submission to the 2009 Victorian Bushfires Royal Commission responding to the Royal Commission's discussion paper entitled 'The Fire Services Levy and Insurance', January 2010, p 7. <http://www.royalcommission.vic.gov.au/getdoc/7ddec9c7-6c3c-4902-b4d4-1fa543085835/Insurance-Council-of-Australia-Ltd>

89 Centrelink, 'News for Seniors', Issue 84, 2011, p 11. [http://www.centrelink.gov.au/internet/internet.nsf/filestores/rt010_1104/\\$file/rt010_1104en.pdf](http://www.centrelink.gov.au/internet/internet.nsf/filestores/rt010_1104/$file/rt010_1104en.pdf)

insured value, usually expressed as a proportion of the sum insured. For example, some insurers offer up to an additional 25 per cent.

12.12. Although a 'top-up' can assist to reduce under-insurance, it does not represent a complete solution to the problem. It generally only applies following a natural disaster, rather than for all events that can cause a total loss and is only intended to address inflation of building costs following a natural disaster, rather than underlying under-insurance. It is capped at a percentage of the sum insured such that, even with the top-up, the sum insured may remain less than the replacement value. It could, perversely, also cause policyholders to reduce their sum insured, so as to lower their premium, knowing that a top-up to the sum insured will be provided by the insurer in certain circumstances. The restriction of the 'top-up' cover to natural disasters, however, is likely to avoid this possible 'arbitraging' of the sum insured.

INSURERS' PREFERENCE FOR SUM INSURED COVER OVER REPLACEMENT VALUE COVER

12.13. Under-insurance of homes is likely to remain a problem as long as sum insured cover continues to be the type of home insurance cover offered by most insurers. However, a switch to replacement value cover would eliminate under-insurance. This is because replacement value cover does not specify a sum insured but instead commits the insurer to reinstate the home in the event of a total loss regardless of the cost of doing so.

12.14. Insurers nevertheless have a preference to offer sum insured cover rather than replacement value cover. There are a number of factors underpinning this preference.

12.15. The key reason is that the sum insured clearly specifies the insurer's exposure in respect of an individual home whilst at the same time also limiting that exposure. The sum insured may also be used by the insurer in a number of other ways, for example, in premium calculations, to understand the insurer's aggregate risk exposure and to identify reinsurance requirements. Identification of a sum insured amount also facilitates cash settlement in the event of a loss. For some insurers, their computer systems are designed around having a sum insured.

12.16. Sum insured cover also places the responsibility for nominating the sum insured and for bearing the risk of under-estimating it squarely on the homeowner. The insurer, while perhaps trying to encourage a higher or more suitable sum insured, nevertheless usually accepts no responsibility for its adequacy.

12.17. In discussions with the Review Panel, several insurers expressed their dissatisfaction with the under-insurance phenomenon and the difficulties of breaking the cycle of chronic under-statement of sums insured. They also referred to efforts they had made to improve the adequacy of the sum insured as an estimate of the replacement value of the home, including 'top-ups' and improving the calculators made available to assist homeowners to estimate sums insured. None of the insurers that the Review Panel consulted considered that their efforts had been successful, particularly knowing that the sum-insured 'culture' including deliberate under-insurance seems well entrenched among the insuring community. Some of these efforts have been substantial but the problem persists.

12.18. Many home building insurance policies used to include 'averaging' or 'co-insurance' clauses which allowed an insurer to reduce the benefits payable at claims stage in proportion to the extent of under-insurance of the value of the property. However, section 44 of the *Insurance Contracts Act 1984* limited the practice by requiring an insurer to 'clearly inform' the insured of the clause and specified that an averaging clause was of no effect if the sum insured was at least 80 per cent of the value of the property. After the introduction of the Act

averaging has largely disappeared with regard to home building (and contents policies), although it is still used in some small business and commercial policies.

INSURERS' CONCERNS WITH OFFERING REPLACEMENT VALUE COVER

- 12.19. In contrast to a sum insured policy, under replacement value cover the responsibility for adequacy of cover is borne by the insurer rather than the homeowner.
- 12.20. There is uncertainty for the insurer as to the maximum exposure under replacement value. This uncertainty in respect of individual homes translates into a broader uncertainty as to the aggregate exposure and it may prove difficult for insurers to quantify this exposure with any degree of accuracy. This may also create difficulties for insurers in managing their reinsurance programmes, including satisfying reinsurers about their exposures.
- 12.21. The absence of a sum insured may also cause difficulties in insurers' relationships with some of their policyholders. Some homeowners are used to knowing their sum insured amount. Without it, there is also the potential for disputation over the amount of a cash settlement in the event of a total loss.
- 12.22. There are also administrative costs and quality control burdens on insurers associated with being responsible for rebuilding a home in the event of a total loss, as opposed to simply writing a cheque for the sum insured amount.

TRANSITION TO REPLACEMENT VALUE COVER

- 12.23. Notwithstanding insurers' preference for sum insured cover and the problems they may encounter in offering replacement value cover, the problem of under-insurance appears to be intractable and it is also contrary to the interests of policyholders who suffer total losses in natural disasters or otherwise.
- 12.24. Nevertheless, replacement value cover is acknowledged by many in the insurance industry to be superior for the homeowner to sum insured cover. It eliminates under-insurance of homes and is, therefore, significantly more effective for the recovery of individuals and the community following a natural disaster that results in total losses.
- 12.25. Despite the potential attraction of eliminating under-insurance, there does not appear to be any impetus from within the insurance industry to move to replacement value cover. Individual insurers who have contemplated it are discouraged from making such a move, partly by potentially adverse competitive consequences as a result of the transition. To the extent that replacement value cover exposes the insurers to greater uncertainty, they are loathe to offer it when their competitors do not. Insurers are effectively caught in the present system, which is perpetuating the chronic problem of under-insurance. Were all insurers to switch simultaneously, however, adverse competitive consequences would be avoided.
- 12.26. For these reasons, a transition to replacement value cover, with its acknowledged benefits for policyholders, is unlikely to emanate spontaneously from the insurance industry. The Review Panel also understands that a range of internal changes would need to be made by insurers as part of a move to replacement value cover. A move to replacement value cover is not, as a result, something that insurers could adopt quickly. However, given time to make the transition, they would be able to do so.

12.27. The Review Panel has concluded that the overall benefits of all insurers offering replacement cover justify the transition. The Review Panel therefore recommends that the *Insurance Contracts Act 1984* be amended to require insurers to offer replacement value cover for home buildings without the choice to opt-out but that a reasonable transition period should apply. Such a period, which should not be less than three years, would give insurers an opportunity to undertake necessary changes such as developing a capability to estimate replacement value for individual homes, reworking pricing systems as needed, making appropriate reinsurance arrangements, revising insurance policies and product disclosure statements and training both sales staff and claims staff.

REPLACEMENT VALUE COVER AND CASH SETTLEMENTS

12.28. The Review Panel recommends that as part of this transition to replacement value cover, insurers address a number of issues to ensure that replacement value cover meets the needs of homeowners following a natural disaster.

12.29. Cash settlements can facilitate a quick resolution of a claim and allow the homeowner more quickly to repair or rebuild their home. Some homeowners may choose this option given the delays that follow a natural disaster when there can be a very large number of properties that require rebuilding or repair.

12.30. A cash settlement can also allow a homeowner to relocate following a natural disaster. This can be an important part of mitigation and reduce the number of dwellings located in at-risk locations. Finally, cash settlements give homeowners the option of selecting their own builder and/or rebuilding their home to a different design.

12.31. Currently however, replacement value policies only give an insurer the discretion to offer cash settlements and a cash settlement can be imposed upon a policyholder. Whilst the Review Panel is of the view that cash settlements can enhance replacement value cover, it is important that they be provided with the full consent of the policyholder.

12.32. The Review Panel therefore recommends that the design of home building replacement value cover include that policyholders be able to apply for cash settlements following a total loss but that any cash settlement be by agreement. It would be advantageous if insurers were able to advise policyholders of the estimated replacement value of the home at the time the policy is purchased and renewed. This would give both parties greater certainty when considering whether to initiate or accept a cash settlement in the event of a total loss.

12.33. Further, it is important that a decision by a policyholder to rebuild at a new location or to rebuild incorporating mitigation measures should not automatically trigger a cash settlement.

12.34. Policyholders should be able to apply for cash settlements under replacement value policies following a total loss, but any cash settlement must be by agreement.

Recommendation 32:

That all home building insurance policies providing sum insured cover be modified by the end of 2014 so as to include replacement value cover in the event of total loss of the home.

That during the transition period insurers consider how the design features of home building replacement value policies should respond following a natural disaster, including the conditions under which cash settlements are to be offered and finalised.

Chapter 13. Consumer awareness

- 13.1. Including flood cover in home, contents and home unit policies will address the issue that arose during the recent floods of policyholders not being aware of whether they had insurance cover for flood and/or storm.
- 13.2. However, this change will take some time and consumer awareness of other aspects of insurance policies is also poor.
- 13.3. Insurance is a complex product with terms and conditions set out in lengthy policy documents and Product Disclosure Statements (PDS), which many consumers either don't read or don't understand. Further, the move towards more direct sales of general insurance policies by telephone under a no advice model means that consumers may not have access to information and documentation in a form they can readily understand before entering into a general insurance contract.
- 13.4. The Review Panel is concerned that the combination of the complexity of insurance policies and PDS and standard cover under section 35 of the *Insurance Contracts Act 1984* (the Act) does not accord with consumer behaviour and has not met consumer expectations and the need for relevant and understandable information and documentation.

CONSUMER UNDERSTANDING OF POLICY TERMS AND CONDITIONS

- 13.5. From a community perspective, consumer confidence in and understanding of general insurance is vital especially as insurance plays a key role in protecting their assets. However, there is ample evidence, as discussed in the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services in Australia⁹⁰ and the Future of Financial Advice⁹¹ (FoFA) reforms, that the disclosure regime with extensive documentation has failed consumers.
- 13.6. General insurance documents consist of written policies and schedules which may be anywhere between 20 to 80 pages in length. They are 'summarised' in a PDS which may be of a similar length. The terms and conditions of the product are set out in the documents. They include details of who is insured, the insured events, exclusions and limitations of cover, claims and complaints processes, the duty of disclosure, general policy conditions (such as renewals, cancellations and payments), general duties of the parties and a glossary. The documents are often generic in that they include a range of bundled insurance products, only some of which may be applicable to the insured.
- 13.7. Once the policy has been purchased, the consumer will usually receive a confirming letter together with the schedule to the policy which sets out particulars relevant to the purchaser and the general policy or PDS. If the policy is purchased by telephone, this is often the first time the purchaser will have the opportunity to see all the terms and conditions of the policy — although general insurance policies do include a cooling off period in which purchasers may cancel the policy.

90 Parliamentary Joint Committee on Corporations and Financial Services: Inquiry into financial products and services in Australia, November 2009 http://www.aph.gov.au/senate/committee/corporations_ctte/fps/report/report.pdf

91 Future of Financial Advice Information Pack, April 2011
<http://ministers.treasury.gov.au/Ministers/brs/Content/pressreleases/2011/attachments/064/064.pdf>

- 13.8. Until the early 1990s most residential insurance policies were purchased through agents, brokers or branches. However, from the 1990s there has been a dramatic shift towards telephone sales and more recently internet sales. The majority of home insurance is now purchased directly and telephone sales is the preferred model.⁹⁵ A recent survey of policyholders who made flood claims found that over 60 per cent had taken out their policies by telephone.⁹⁶
- 13.9. Direct sales are done on a 'no advice' model, in which consumers are not informed as to the suitability of the coverage for their specific needs and circumstances. Telephone sales, and to a lesser extent internet sales, are not well suited to complex insurance products with multiple coverage options. As one insurer's submission to the Review stated when referring to telephone sales, 'customers are already suffering information overload and are likely to "tune out" if faced with long-winded oral scripts'.⁹⁷
- 13.10. Motor vehicle insurance is a relatively straightforward product. The value of a motor vehicle, no claim bonuses, nominated drivers and choice of excess are well understood concepts. Price is a key driver, the coverage is similar between companies and the policy documents tend to be standard. In contrast, home insurance is complex and the cover can vary widely between insurers — no better illustrated than with storm/flood cover. The task of informing a consumer about the terms and conditions of a home insurance policy can be challenging when sold by telephone with a subsequent PDS or policy. Evidence presented to the Review is that the communication process is very problematic.
- 13.11. Consumers rely heavily on what is explained to them on the telephone. A recent survey of 126 policyholders assisted by the Caxton Legal Service after the 2011 floods showed that 32 per cent had only briefly read the policy documents because they had relied upon what was said to be important by the telephone sales staff.
- 13.12. However, there have been many instances reported to the Review of policyholders being misinformed or misunderstanding home insurance policy details, with significant differences between what they believed they were covered for following the purchase of insurance over the telephone and the actual policy wording as set out in the PDS. For example, the Financial Ombudsman Service (FOS) has determined a claim in favour of a policyholder where they were told over the phone that their policy covered flood but the PDS in fact excluded flood cover.
- 13.13. The oral misrepresentations or misunderstandings in telephone sales are often not rectified by the written documents. Indeed, some policyholders allege that they have never received the policy documents. A survey of 214 policyholders flooded in 2010-2011 indicated that only one policyholder had been sent a PDS prior to taking out the policy, 87 had received it after paying for the policy, and 54 reported that they did not receive it at all.⁹²
- 13.14. Regarding those consumers who did receive their policy documents, evidence to the Review is that many policyholders do not read their policies thoroughly or at all, finding them too lengthy and difficult to read. A survey of policyholders who were assisted by various independent legal services in Queensland in 2011 found that around half did not read their policy (or PDS) prior to having to make a claim and 37 per cent did read the policy but misunderstood important exclusions and limitations, such as flood cover.⁹³

92 Insurance Law Service Submission to the House of Representatives Inquiry into the insurance industry during disaster events, Appendix 1. <http://www.apf.gov.au/house/committee/spla/insurance/submissions.htm>

93 Insurance Law Service Submission to the House of Representatives Inquiry into the insurance industry during disaster events, Appendix 1. <http://www.apf.gov.au/house/committee/spla/insurance/submissions.htm>
Submission no.54

13.15. Having read many insurance policies and PDS and having received many submissions from policyholders and consumer representatives, it is clear to the Review Panel that there are substantial problems with consumer understanding of insurance policy terms and conditions, particularly with more complex insurance policies such as home, contents and home unit policies.

THE *INSURANCE CONTRACTS ACT 1984* AND STANDARD COVER

13.16. Certain laws prescribe minimum standards on insurers in communicating with their clients.

13.17. The *Corporations Act 2001* requires that the terms and conditions of a general insurance policy must be presented in a 'clear, concise and effective manner'.⁹⁴

13.18. The *Insurance Contracts Act 1984* (the Act) introduced a statutory framework for insurance contracts and imposes a number of statutory obligations on insurers to inform clients of policy details.

13.19. The most important of these is section 35 of the Act, pursuant to which insurers must offer consumers 'standard cover' for general insurance policies prescribed under *the Insurance Contracts Regulations 1985* (the Regulations). Divisions 2 and 3 of the Regulations set out prescribed events which are included under standard cover. Essentially all natural disasters, including flood, are required to be included as 'standard cover'. Also to be included as 'standard cover' are policies that provide replacement cover.

13.20. The requirement for 'standard cover' applies to home building and contents policies.

13.21. Insurers wishing to limit or exclude standard cover can only do so if:

*'the insurer proves that, before the contract was entered into, the insurer **clearly informed the insured in writing** (whether by providing the insured with a document containing the provisions, or the relevant provisions, of the proposed contract or otherwise) or the insured knew, or a reasonable person in the circumstances could be expected to have known ... that the contract would not provide insurance cover in respect of the happening of that event' (emphasis added) — section 35(2), Insurance Contracts Act 1984.*

13.22. The provision of the insurance policy or a PDS will satisfy the obligations to 'clearly inform' the policyholder if the wording of the limitation or exclusion can be proven by the insurer to be understood by a 'reasonable person in the circumstances'. This was confirmed in *Hams vs CGU Insurance Ltd (2002)*⁹⁵ in which the Supreme Court of NSW determined that the flood exclusion in that case was sufficient to clearly inform the policyholders that their policy did not include cover for flood damage. It is noteworthy that the flood exclusion was to be found on one page of a forty plus page document.

13.23. The Act thereby purports to ensure that when terms and conditions a policyholder would usually expect to find in a policy are excluded, they are brought to the policyholder's attention. However, the law as it stands does not reflect the reality of consumer behaviour which, as has been noted earlier in this Chapter, is that policyholders do not read insurance policies or PDS in detail. Accordingly, all too often consumers will simply not be sufficiently 'clearly informed' of deviations from standard cover by the provision of a PDS. This is no better reflected than in confusion about whether policies include or exclude flood cover.

94 *Corporations Act 2001*, Section 715A.

95 *Hams v CGU Insurance Ltd*, [2002] NSWSC 273 per Einstein J.

13.24. It is the Review Panel's view that subsection 35(2) of the Act needs to be amended to reflect current consumer behaviour so as to give practical effect to the notion of clearly informing consumers of deviations from standard cover.

Recommendation 33:

That subsection 35(2) of the *Insurance Contracts Act 1984* be amended so that policyholders are not deemed to be clearly informed of a deviation from 'standard cover' by simply being provided a copy of the insurance policy or product disclosure statement.

ADVICE TO CONSUMERS AT TIME OF PURCHASE

13.25. There are two forms of financial advice which financial service providers are able to provide: general and personal advice. General advice only gives guidance on the features of the financial product being considered, while personal advice relates the product to the consumer's specific circumstances. The general insurance industry does not, in general, provide personal advice to their customers at the point of sale.

13.26. Insurers have argued that the increased compliance obligations and other costs associated with the provision of personal advice make it difficult for insurers offering direct sale policies to provide cost effective personal advice. They cite barriers to providing advice as being onerous training obligations for sales staff, additional compliance documentation and obligations, potential liability and confusion around insurer obligations when providing advice.⁹⁶ Potential liability is one of the biggest concerns.

13.27. The FoFA reforms⁹⁷ currently being undertaken by the Assistant Treasurer are expanding a form of advice called 'scaled advice', which may provide insurers with a cost-effective and less onerous regime by which they are able to provide personal advice. Scaled advice requires that when financial service providers provide personal advice on one specific financial product in isolation (for example, general insurance) they need not take into account as much personal information as would be the case for other forms of personal advice.

13.28. The proposed reform is based on the principle that advice is valuable to consumers and that more consumers should have access to it. For superannuation and life insurance products the personal advice model already exists and introducing scaled advice allows it to be more effective. However, for home insurance there is today no broadly available personal advice model. Most consumers buy home insurance directly by telephone and can only be given product or general advice. There is a general insurance broker community but today brokers tend to work with business customers and those with larger insurance needs.

13.29. With a global trend towards direct purchasing of home insurance it is logical not to look to rebuild an intermediated model for consumers but to look to simplify the home insurance offer so it is better understood by consumers. The Review Panel considers that the inclusion of flood and replacement cover which has been previously recommended in this Report, in addition to the Key Facts Statement, will significantly reduce the complexity faced by consumers.

96 Suncorp submission to the Natural Disaster Insurance Review, p 15
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/suncorp.pdf

97 Australian Government The Treasury, Future of Financial Advice Information Pack, 28 April 2011
<http://ministers.treasury.gov.au/Ministers/brs/Content/pressreleases/2011/attachments/064/064.pdf>

Key Facts Statement

- 13.30. That the disclosure regime has failed to sufficiently inform consumers of the relevant terms and conditions of insurance policies was evidenced after the natural disaster events of 2010-2011 when many policyholders discovered, allegedly for the first time, that their home policies would not fully cover them for flood damage.
- 13.31. In response, the Government moved to propose a simplified one page Key Facts Statement to be provided to the purchasers of home building and contents insurance policies as part of the 'Reforming Flood Insurance: Clearing the Waters' consultation paper.⁹⁸ The objective of the Key Facts Statement is to 'allow consumers to quickly and easily check the basic terms of the insurance policy, including the nature of cover and any key exclusions. The proposal has been generally supported by the insurance industry and consumer groups. Given the problems with consumer awareness of cover for some natural disaster events, the Review Panel endorses the proposal.
- 13.32. Whilst the design of the Key Facts Statement is still to be completed, it would be important to include in the Key Facts Statement the natural disaster prescribed events and replacement cover set out in Divisions 2 and 3 of the Regulations. It would also be important that the information be provided upon policy renewals.

Recommendation 33:

That, in endorsing the Government proposal for a Key Facts Statement, the Key Facts Statement list replacement cover and all natural disaster events, identified as 'standard cover' in the Insurance Contracts Regulations 1985.

That insurers issue a Key Facts Statement to policy holders with all new policies written and all policy renewals on an annual basis.

HEALTH WARNING

- 13.33. Whilst a Key Facts Statement will contribute to a greater level of consumer understanding, as it will usually be received by a consumer after a telephone sale process has been completed, the reality will still be that some consumers will not read the Key Facts Statement.
- 13.34. One option to further enhance consumer understanding would be to provide consumers with a simple 'health warning' if the insurance policy they are purchasing does not include certain key features.
- 13.35. Such a health warning would be similar to that used with the purchase of tobacco products and could be provided verbally at the time of a telephone purchase or in writing on internet quotation software for an online purchase.
- 13.36. The Review Panel believes that it would be appropriate to provide the purchasers of home and contents policies with a health warning if their policies do not include full flood or full replacement cover. The warning would specify that the policy does not include full flood or replacement cover and in respect of the latter, should warn the purchaser that they may be under-insured. For example:

98 Commonwealth Department of the Treasury, 'Clearing the Waters: Reforming Flood Insurance' Consultation Paper, 2011 http://www.treasury.gov.au/documents/1995/PDF/Reforming_flood_insurance.pdf

- ‘this product does not provide (full) cover for flood’;
- ‘this product does not provide (full) replacement cover for buildings. You may be under-insured in the event of a total loss’.

Recommendation 34:

That a ‘health warning’ be provided by insurers to the purchasers of home and contents policies that do not include full flood cover or full replacement cover. The health warning should be provided:

- in the Key Facts Statement;
- verbally at the time of telephone purchase; and
- in writing on internet quotation software for all online purchases.

STANDARD DEFINITION OF FLOOD

13.37. The Government has recognised the confusion around the various definitions of flood by proposing an amendment to the Act which would introduce a standard definition of flood for home building and contents insurance policies.⁹⁹

13.38. Unlike the existing standard cover provision under section 35 of the Act, the standard definition of flood would be mandatory with no ability to opt-out or vary the definition.

13.39. The Government’s Consultation Paper ‘Reforming flood insurance: Clearing the waters’ (April 2011)¹⁰⁰, proposed the definition:

‘Flood means the covering of normally dry land by water that has escaped or been released from the normal confines of:

- (a) Any lake, or any river, creek or other natural water course, whether or not altered or modified or*
- (b) Any reservoir, canal or dam.’*

13.40. The definition has the features of most flood definitions, namely the escape or release of water from the normal confines of a natural water course or body of water, including those that have been modified. However, the one element of controversy is the absence of water escaping from non-natural water courses such as storm water channels.

13.41. Storm water channels are not commonly defined in insurance policies. However, they would usually consist of man-made, uncovered water courses, not including gutters and storm water drains.

99 Reforming Flood Insurance: Clearing the Waters Consultation Paper, p 3, 2011
http://www.treasury.gov.au/documents/1995/PDF/Reforming_flood_insurance.pdf

100 Reforming Flood Insurance: Clearing the Waters Consultation Paper, p 5, 2011
http://www.treasury.gov.au/documents/1995/PDF/Reforming_flood_insurance.pdf

13.42. The Insurance Council of Australia in its response to the consultation paper asserted that storm water channels are commonly constructed within natural water courses and followed the natural drainage lines of the terrain. Accordingly, they submitted that storm water channels should be included within the standard definition and proposed an amendment to part (b) of the definition as follows:

'(b) any reservoir, canal, dam or other water channel or water way whether altered, modified or purpose-built.'

13.43. Whilst many storm water channels may be constructed within the confines of natural water courses, this is not always the case and in any event, water escaping from such a channel could be classified as flood because it could still be said to be escaping from a modified natural water course.

13.44. Further, the proposed amendment appears to be too broad as it may encompass gutters and storm water drains, the escape of water from which usually falls within the definition of storm water and not flood water. To exclude water from storm water drains and gutters would be a major departure from current insurance practice.

13.45. The key to a standard definition is that it is narrow enough to be meaningful to consumers and such that when it is excluded it does not take away cover that policyholders already have. The Insurance Council of Australia proposed definition introduces the concept of a water way which is not commonly used in insurance policy wording and proffers three descriptions of water channels/ways which may confuse consumers.

13.46. The importance of the standard definition to the consumer is reduced with the introduction of flood cover as a standard inclusion in home, contents and home units policies; however it will still be of crucial importance to insurers, the reinsurance facility and small businesses.

Recommendation 35:

That the Commonwealth Government introduce a standard definition of flood in the form proposed in the 'Reforming flood insurance: Clearing the waters' consultation paper.

Unfair contract terms

13.47. Consumer contracts in Australia are governed by the *Australian Securities and Investments Act 2001* (the ASIC Act). The ASIC Act applies unfair contract terms laws to consumer contracts, with penalties applicable to contracts which breach these laws. Since 1 July 2010, ASIC has administered a new law to deal with unfair terms in consumer contracts for financial products and financial services.

13.48. The unfair contract terms law are part of the broader new national Australian consumer law which was fully implemented as of 1 January 2011.¹⁰¹

13.49. General insurance is currently exempt from unfair contract terms laws as it was argued that general insurance was sufficiently different from other financial products to demand different

101 The Australian consumer law was passed as the *Trade Practices Amendment (Australian Consumer Law) Act (No.1) 2010* which amends the *Australian Securities and Investments Commission Act 2001*. See 'Australian consumer law — unfair contract terms' Australian Securities and Investments Commission, 2011 <http://www.asic.gov.au/asic/asic.nsf/byHeadline/Unfair-contract-terms-law?opendocument>.

treatment under the law.¹⁰² The general insurance industry has resisted unfair contract terms legislation being applied to general insurance contracts, arguing that the duty of utmost good faith under section 13 of the *Insurance Contracts Act 1984* (the Act) provides consumer protection equivalent to or better than that provided by the unfair contract terms laws.¹⁰³ In addition, it is argued that insurance contracts are already subject to review both under the Act and the Terms of Reference for the Financial Ombudsman Service (FOS).¹⁰⁴

13.50. However, consumer groups have argued that the duty of utmost good faith in the Act is not equivalent to unfair contract terms laws as reliance by an insurer upon a term of an insurance contract (such as an exclusion clause) is not, as a matter of law, a breach of the duty of utmost good faith and, in any event, there are no penalties applicable to a breach of the duty.¹⁰⁵

13.51. One frequently cited example of consumer detriment arising from unfair terms in insurance contracts was a claim for stolen luggage denied after the insured left his baggage 'unattended' where the stolen baggage was within reach, but the insured was distracted at the time of the theft, asking for directions. Consumer groups argue that such an unfair exclusion clause for unattended baggage can only be dealt with under unfair contract terms laws and not the Act.¹⁰⁶

13.52. A Senate report recommended in September 2009 that the unfair contract provisions be extended to insurance contracts, stating that consumers are not provided with adequate protection in insurance contracts under existing law.¹⁰⁷

13.53. The Treasury released an options paper on the issue which canvasses the extension of unfair contract terms laws to insurance contracts in July 2011 and is consulting with stakeholders on its proposals.¹⁰⁸

13.54. Unfair contract terms legislation is based on notions of efficiency, fairness and equity and the ability to excise unfair terms which are not the main subject matter of a contract whilst taking into account the legitimate interests of the contracting parties. It appears to the Review Panel that these principles are consistent with general insurance contracts and may assist in fairly resolving disputes which arise out of natural disaster insurance claims.

13.55. General insurers concerns include that they will be forced to pay for risks that were not priced and premiums not collected, for example for flood damage when a policy excluded flood cover. This scenario, it is argued, could very quickly destabilise the insurers' prudential base,

102 National Legal Aid Submission to Unfair Terms in Insurance Contracts: Options Paper, p 2, 2010
http://icareview.treasury.gov.au/content/_download/submissions_options_paper/NLA_Submission.pdf

103 Senate Economics Legislation Committee : Trade Practices Amendment (Australian Consumer Law) Bill 2009 [Provisions], pp 50-51, September 2009
http://www.aph.gov.au/senate/committee/economics_ctte/tpa_consumer_law_09/report/report.pdf

104 Insurance Council of Australia submission to the Natural Disaster Insurance Review, pp 31-32, 2011
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Council_of_Australia.pdf

105 National Legal Aid Submission to Unfair Terms in Insurance Contracts: Options Paper, 2010, pp 11-12
http://icareview.treasury.gov.au/content/_download/submissions_options_paper/NLA_Submission.pdf

106 Commonwealth Government the Treasury, 'Unfair Contract Terms Options Paper', p 2, 2010
http://www.treasury.gov.au/documents/1756/PDF/Options_Paper_Unfair_terms_in_insurance_contracts.pdf

107 Senate Economics Legislation Committee : Trade Practices Amendment (Australian Consumer Law) Bill 2009 [Provisions], p 68, September 2009
http://www.aph.gov.au/senate/committee/economics_ctte/tpa_consumer_law_09/report/report.pdf

108 Commonwealth Government the Treasury, 'Unfair Contract Terms Options Paper', 2010
http://www.treasury.gov.au/documents/1756/PDF/Options_Paper_Unfair_terms_in_insurance_contracts.pdf

particularly in the case of flood.¹⁰⁹ However, it appears to the Review Panel that these fears are unfounded as unfair contract terms laws would not operate to excise, for example, insurance policy exclusions which were legitimate deviations from standard cover under section 35 of the *Act*, and which still kept intact a home building or contents insurance policy consistent with the *Insurance Contracts Regulations 1985*. Further, it appears that unfair contract terms legislation will provide consumer protection over and above that provided by the duty of utmost good faith under section 13 of the *Act* and the general fairness test under the FOS Terms of Reference.

Recommendation 37:

That, in order to give general insurance policyholders the same legal remedies as other consumers, unfair contract terms laws be applied to general insurance.

109 Suncorp Submission to the Natural Disaster Insurance Review, p 16
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/suncorp.pdf

Chapter 14. CLAIMS HANDLING AND DISPUTE RESOLUTION

CLAIMS AND DISPUTES PROCESSES

- 14.1. If a policyholder wishes to make a claim under a general insurance policy for a natural disaster or otherwise, they will contact the insurer to make a claim.
- 14.2. The insurer will normally then log the claim and forward the policyholder claim forms for completion — although in some natural disasters the necessity for written claims forms is dispensed with.
- 14.3. The policyholder will then usually complete, sign and return the claims forms together with any other information/documentation to support a claim such as an inventory of damaged or lost items in a home contents claim, proof of loss etc.
- 14.4. The insurer will allocate a claims officer who may engage an assessor, investigator and/or expert to assist in the assessment of the claim. In the case of a flood, an hydrologist may be appointed if the policy excludes or limits flood cover. A building expert may be appointed in the event of a home building claim.
- 14.5. Further information and documentation may be requested from the policyholder and third parties. The insurer will then make decisions on a claim as to liability (that is, whether the claimant's policy was current at the relevant time, what loss/damage was suffered, and whether the loss/damage claimed was because of an insured event.)
- 14.6. These decisions will be communicated to the claimant and if the claim is rejected (wholly or in part) the claimant should be informed of their right to lodge an internal dispute resolution (IDR) complaint against the decision(s). A rejection must be accompanied by written reasons.
- 14.7. If liability is accepted, the insurer will then assess the quantum of the loss/damage and proceed to arrange for payment, replacement or repairs. This process may involve a number of decisions; which items claimed are to be paid and in what sums, what repairs are to be undertaken, what items are to be replaced and with what, or what cash settlement is to be offered. Again, if any particular part of the claim is rejected, or if offers are made, the claimant should be advised of their right to lodge an IDR complaint.
- 14.8. An IDR complaint can be made verbally or in writing. When the claimant disputes the claim, the insurer should elevate the claim to a complaints officer who will assess and decide the complaint. This process may involve further investigations and requests for further information/documentation. A decision on the complaint should be made in writing with reasons within a total of 45 days — or such further period agreed between the parties. The claimant must be advised of their right to lodge an external dispute resolution (EDR) complaint or to seek legal advice if the IDR complaint is not dealt with to their satisfaction within 45 days.
- 14.9. The EDR complaints scheme for general insurance is the Financial Ombudsman Service (FOS) which has, subject to its Terms of Reference, the power to overturn or vary an insurers decision and order (or recommend) that a policyholder's claim be paid. FOS currently has a monetary limit for binding determinations on general insurance disputes of \$280,000. The determinations are binding on insurers but policy holders are free not to accept decisions and take their cases to court.

14.10. Standards for claims handling and IDR processes for general insurers are set out in the General Insurance Code of Practice¹¹⁰ (the Code), an industry self-regulated code administered by the Insurance Council and FOS that the majority of Australian general insurers and other industry participants have adopted. The Code provides standards on how participating insurers are to sell policies, handle claims and complaints, and respond to natural disasters. Since 2010 the Code is subject to review every three years.

14.11. Insurers' adherence to the Code is monitored by the Code Compliance Committee, a three person committee comprising of a representative from the insurance industry, a consumer representative and an independent chair appointed jointly by the FOS board and the Insurance Council.

CLAIMS HANDLING ISSUES IDENTIFIED IN THE 2011 DISASTERS

14.12. A Consumer Perspective Paper¹¹¹ prepared for the Review Panel identified problems with insurers' claims handling including:

- insurers failures to process claims in a timely manner;
- poor practices with regard to the collection and use of evidence;
- failure to communicate refusal of claims in a timely manner, including failure to provide proper reasons and evidence for refusals; and
- failure to adequately inform consumers of their rights to IDR and EDR in relation to refused claims or claims-related complaints.

14.13. Two of the biggest areas of client frustration identified from the 2011 floods were the failure of insurers' customer service staff to meet the immediate needs of claimants and the delays associated with the decisions about claims. These delays were often due to shortages in hydrologists to assess whether damage to property was due to flood or storm.

14.14. Consumer representatives have also submitted to this Review and the House of Representatives inquiry into the operation of the insurance industry during disaster events,¹¹² instances where insurers have failed to comply with the Code following the natural disasters in 2010-2011 in a number of key ways;

- discouraging policyholders from making claims and informing them that they would not be covered,¹¹³

110 General Insurance Code of Practice, 2010. <http://www.codeofpractice.com.au/LinkClick.aspx?fileticket=-XTcCIWRFGo%3d&tabid=37>

111 Connolly, Chris A consumer perspective on the NDIR Issues Paper, p 11
http://www.ndir.gov.au/content/commissionedpapers/2011/consumer_perspective_sept_11.pdf

112 <http://www.aph.gov.au/house/committee/spla/insurance/index.htm>

113 The Caxton Legal Service reported 26 instances (out of 126 surveyed) where this occurred, but the insured disregarded this advice and made a claim. The number of people who followed the advice of the claims staff and did not make a claim is unknown. See Caxton Legal Service submission to the House of Representatives inquiry into the operation of the insurance industry during disaster events, p 23, 2011
<http://www.aph.gov.au/house/committee/spla/insurance/submissions.htm>

- failing to use all necessary information needed to assess a claim. For example, there were reports of several insurers using aerial photos from the internet to assess claims; some which were taken many hours after the water had receded;
- failing to inform policyholders within 20 business days of the progress of their claims;¹¹⁴;
- sending out pro-forma rejection letters which did not sufficiently inform policyholders of the reasons for rejection or provide evidence on which the rejection was based (such as hydrology reports); and
- failing to notify policyholders of their rights to complain or dispute.¹¹⁵

14.15. The insurance industry, on the other hand, has defended its handling of claims arising from the 2010 and 2011 natural disasters pointing to the fact that the industry received over 57,000 claims from the floods in south-east Queensland, 97 per cent of which were determined within four months.¹¹⁶

14.16. However, insurers have conceded that they could do better and there have been some delays, particularly as a result of shortages in tradespersons to conduct repairs and in sourcing hydrologists to conduct investigations into whether the damage to property was caused by floodwater or stormwater or a combination of both.¹¹⁷

14.17. The Consumer Perspective Paper urges the development of a mandatory claims handling standard that goes further than the current Code and further proposes that a general fairness test be applied to claims handling.¹¹⁸ It further argues that oversight of the Code and compliance monitoring appear to have fallen in recent years, and the reputation of the Code amongst consumer advisers is currently poor. A submission by the FOS endorses the development of a claims handling standard, in particular with respect to the exchange of information and proof of loss where there is a natural disaster.¹¹⁹

114 The overwhelming majority of claimants surveyed by various Legal Aid Services (between 70-85 per cent) indicated that they had never been advised by their insurer on the progress of their claim. See Caxton Legal Aid Service submission to the House of Representatives inquiry into the operation of the insurance industry during disaster events, 2011 and Legal Aid NSW submission to the House of Representatives inquiry into the operation of the insurance industry during disaster events, 2011, for example.

<http://www.aph.gov.au/house/committee/spla/insurance/submissions.htm>

115 The Collaborative Insurance Law Services (CILS), a coalition of independent insurance law services established in March 2011, reports that of the 642 insurance claims in dispute as at 14 June, 2011, 550 were being represented by them. A survey of 214 policyholders assisted by Legal Aid services showed that 65 per cent did not feel they had been given accurate and useful information by the insurer about their right to EDR, and 46 per cent were not advised about their rights to EDR at all.

116 Insurance Council of Australia 'QLD insurance claims assessments near completion'

http://www.insurancecouncil.com.au/Portals/24/Media%20Centre/2011%20Media%20Releases/110510%20MR%20ICA%20payout%20update_F.pdf

117 Suncorp submission to the Natural Disaster Insurance Review, p 18

http://www.ndir.gov.au/content/submissions/issues_paper_submissions/suncorp.pdf

118 Connolly, Chris. A consumer perspective on the NDIR Issues Paper, p 11

http://www.ndir.gov.au/content/commissionedpapers/2011/consumer_perspective_sept_11.pdf

119 Financial Ombudsman Service submission to the Natural Disaster Insurance Review, p 14

http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Financial_Ombudsman_Service_Limited.pdf

GENERAL INSURANCE CODE OF PRACTICE

14.18. The Code¹²⁰ prescribes minimum standards for the provision of insurance services to consumers from the sale of policies, claims handling and dispute resolution procedures. It was first introduced in 1994 by the Insurance Council, and membership is voluntary although the majority of the general insurers are signatories to the Code.

14.19. It provides minimum standards for the way in which general insurance products are sold, such as circumstances for refusal of cover, correcting errors, cancellation and sales conduct.

14.20. In relation to claims handling, it requires that insurers:

- within 10 business days of receiving a claim;
 - notify the policyholder of the information needed to determine the claim;
 - appoint a loss assessor;
 - provide an initial assessment on the time needed to make decision on the claim
- keep the policyholder informed every 20 business days on the claims progress;
- respond to routine requests from the policyholder for information every 10 business days; and
- make a decision on the claim within 10 business days of receiving all necessary information;

14.21. If the time frames listed above are not practical due to the complex nature of a claim, insurers are to agree to reasonable alternative time frames with the policyholder. If agreement cannot be reached, the insurer is to notify of complaints handling procedures.

14.22. For denied claims, insurers are to provide:

- written reasons for the decision;
- information about complaints handling procedures; and
- copies of reports from service providers relied on in assessing the claim, if requested.

14.23. In relation to claims resulting from natural disasters, the Code:

- allows for insurers to not meet the above timelines and standards due to the large number of claims and to establish their own processes for responding to the disaster(s) (clauses 4.3 and 4.4 of the Code); and
- allows a claimant whose claim was finalised within one month of the natural disaster to request a review of their claim up to six months after the claim has been finalised. Insurers are required to notify the claimant of this entitlement and of their complaints handling procedures (clause 4.5 of the Code).

120 General Insurance Code of Practice, 2010. <http://www.codeofpractice.com.au/LinkClick.aspx?fileticket=-XTcCIWRFGo%3d&tabid=37>

14.24. For internal disputes, the Code requires that insurers:

- respond to the dispute within 15 business days if all necessary information has been received;
- keep the policyholder informed of the progress of the dispute at least every 10 business days;
- give the policyholder access to information relied upon in assessing the claims/complaint (unless they reasonably decline to do so);
- respond to the dispute giving;
 - reasons for the decision;
 - information on how to access the EDR schemes (FOS) and the timeframe within which the policyholder must register the dispute with FOS;
- advise the policyholder of their rights lodge a complaint to FOS if the complaint has not been resolved within 45 days.

14.25. Insurers' adherence of the Code is monitored by the Code Compliance Committee (CCC), a three person committee comprising a representative from industry (appointed by the Insurance Council), a consumer representative (appointed by the FOS Board) and a chairperson (appointed jointly by the FOS Board and the Insurance Council).

14.26. The Code requires the CCC to:

- monitor Code compliance through reports it receives from FOS and its own investigations;
- report its findings to FOS and the Insurance Council and seek corrective action in the event of a breach;
- impose sanctions because of failures by insurers to correct Code breaches. The sanctions available to the Committee include:
 - a requirement that steps be taken to rectify a breach within a specified time frame;
 - a compliance audit be undertaken;
 - corrective advertising be undertaken; and
 - the non-compliance be published.

AMENDMENTS TO THE CODE OF PRACTICE

14.27. Having reviewed the Code and the various submissions, the Review Panel considers that a stronger Code would address the concerns highlighted in the submissions to this and other reviews in relation to claims and complaint handling, particularly if accompanied by enhanced sanctions.

Membership of the Code

14.28. The Review Panel notes that while most general insurers are signatories to the Code, there are several insurers who are not. This contrasts with FOS, of which currently all general insurers are members.

14.29. The Review Panel considers that as a condition of their membership of FOS, all general insurers should be required to adopt and comply with the Code.

Recommendation 38:

That every APRA-authorised general insurer adopt and comply with the General Insurance Code of Practice.

Time limits on claim determination

14.30. The Code includes certain time limits for claims handling, but these time-frames are subject to extension if not practical due to the complex nature of a claim. In these circumstances, insurers are to agree to reasonable time frames with the policyholder.

14.31. While the Code does include several 5, 10 and 20 business day time periods within which an insurer must meet certain claims obligations, there is no concrete aggregate time limit within which an insurer must make a decision on a claim.

14.32. The 10 business day time periods to make decisions only run from when an insurer has been provided with what it considers to be all relevant information and documentation, and even that time period can be varied. As such, a decision can be delayed for a lengthy period of time without necessarily violating the Code.

14.33. The Review Panel is of the opinion that to provide consumers with a level of comfort that their claims will be handled in a timely manner and as a goal as to ensure that insurers will process claims expeditiously and not unduly delay claims, an aggregate time limit subject to exceptional circumstances is warranted.

14.34. However, mandating time limits on claims may have adverse consequences, notably that insurers may reject claims they might otherwise have accepted if they had more time to fully assess them. For example, in some claims where it was necessary to determine whether the cause of inundation was storm or flood, insurers sought individual hydrology reports which took considerable time but they argued these were obtained as second opinions to more general hydrology reports which were unfavourable to claimants. In some cases, the obtaining of the further hydrology reports led to claims being accepted. For example, on the 2 August, one insurer paid 246 claims which it had initially rejected based on new hydrology reports which it had commissioned.¹²¹

121 The Australian 'Insurance firm RACQ approves 246 Queensland flood claims' 02/08/11
<http://www.theaustralian.com.au/news/breaking-news/insurance-firm-racq-approves-246-queensland-flood-claims/story-fn3dxity-1226106639062>

14.35. Insurers have also stated in their submissions to the Review that it would be uneconomical for them to meet set time limits and this would be reflected in higher premiums,¹²² and that the timelines in the Code already meet reasonable consumer expectations.¹²³

14.36. The Review Panel notes insurers' concerns with time limits but considers that given the large number of claims arising from the 2010-2011 Queensland natural disasters and the fact that 97 per cent were determined within 4 months,¹²⁴ a uniform four month time limit on claims determinations as to liability subject to exceptional circumstances would not be too onerous. This is particularly so, given that the introduction of flood cover in home building, contents and home unit policies would resolve the bulk of the delays caused by insurers needing to determine the cause of water damage.

14.37. The Review Panel acknowledges that a claim can involve a number of decisions to be made by the insurer — what loss/damage was suffered, acceptance of liability, the quantum of losses, payments or repairs. Decisions with respect to quantum and repairs may have to be made many months after the event and it would not be practical to impose the time limits on such decisions. However, at least with respect to decisions on the nature and the extent of damage and liability, the Review Panel believes that insurers should comfortably be able to make decisions within the proposed four month time limit. Decisions regarding quantum, payments and repairs would remain subject to the more general requirement to make decisions as expeditiously as possible and within the existing time periods in the Code.

14.38. If a claim is not determined within the relevant period, the question is what consequences should apply. Options include:

- notifying the policyholder of their right to lodge an IDR complaint;
- automatic elevation of a claim to an IDR complaint/external dispute level;
- notification to FOS or the CCC of the breach;
- reporting of breaches to ASIC;
- a monetary penalty; and
- the claim be determined in favour of the claimant.

14.39. In the circumstances, the Review Panel recommends that a claim should automatically be elevated by the insurer to an IDR complaint and the insurer must self report the breach to the CCC.

122 Suncorp submission to the Natural Disaster Insurance Review, p 18, 2011
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/suncorp.pdf

123 IAG submission to the Natural Disaster Insurance Review, p 24, 2011
[http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_\(IAG\).pdf](http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_(IAG).pdf)

124 Insurance Council of Australia, 2011. 'QLD Insurance Claims Assessments Near Completion' Media Release
http://www.insurancecouncil.com.au/Portals/24/Media%20Centre/2011%20Media%20Releases/110510%20MR%20ICA%20payout%20update_F.pdf

Recommendation 39:

That the Insurance Council of Australia amend the Code of Practice to impose a four month time limit (subject to exceptional circumstances) to make a determination as to liability and the nature of the loss or damage with respect to a claim.

That, should a claimant not receive a determination within the four month period, the claim be automatically escalated to an internal dispute resolution complaint and the insurer notify the Code Compliance Committee of the breach of the Code.

Claims handling after natural disasters

14.40. Clauses 4.3 and 4.4 of the Code relieve insurers of the need to meet the minimum claims standards set out in the Code following natural disasters.

14.41. As a result, there are no uniform claims handling minimum standards for insurers in the event of a natural disaster, and therefore no set standards by which the industry's performance can be assessed by the CCC.

14.42. The Review Panel acknowledges that insurers' claims handling systems come under pressure following natural disasters. However, by far the most pressure comes from having to determine whether the damage to properties was due to storm or flood — which, if the recommendations elsewhere in this report are accepted and implemented, will largely disappear. Further, it is arguable that after natural disasters, consumers are more vulnerable, stressed and in need of greater protection in having their insurance claims assessed.

14.43. Accordingly, in the Review Panel's opinion, the usual claims handling standards should apply following a natural disaster and that the four month time limit set out in Recommendation 39 should also apply following natural disasters.

Recommendation 40:

That the Insurance Council of Australia repeal clauses 4.3 and 4.4 of the General Insurance Code of Practice, so that claims arising from natural disasters are subject to the same minimum standards as other claims — including the four month time limit for a determination on liability and the nature of the loss/damage with respect to the claim.

Review of natural disaster claims

14.44. Pursuant to clause 4.5 of the Code, in the event of a natural disaster, should a claim be finalised within one month of the natural disaster, a policyholder can seek a review of a claim within a further 6 months — even if the policyholder has signed a release.

14.45. At first glance it may appear strange that a six month time limit is placed on a policyholder requesting a review of a decision by the insurer, as this appears to circumvent the IDR complaints handling procedures. However, what the provision is in fact designed to achieve is to provide a policyholder whose claim arising out of a natural disaster was finalised quickly (by consent) with the opportunity to make further claims for lost or damaged items which they later discover — even if they have signed a release to finalise the claim.

- 14.46. This provision is poorly worded and needs to be amended to ensure that it does not in fact restrict a consumer's right to lodge IDR and EDR complaints.
- 14.47. Further, the limitation of its application to claims finalised within one month of a natural disaster is too limited given that many natural disaster claims will not be finalised within such a short period of time. Whilst the risk of not accurately assessing losses is greater the shorter the claim finalisation period, natural disasters by their nature often lead to dislocation and disorientation for policyholders over a significant period of time.
- 14.48. The Review Panel therefore considers that the right of review should be available regardless of the period within which the claim was finalised, as long as the aggregate time frame of seven months from when the natural disaster occurred is maintained.
- 14.49. It is also noteworthy that the Code requires insurers to inform policyholders of their right of review where their claim is finalised within one month. Five insurers have failed to notify policyholders of their right to review under this clause after the 2010-2011 disasters, resulting in 3,549 consumers not being notified of their rights.¹²⁵ Clearly, this important requirement has not been fully complied with and insurer compliance is in need of regular audits.

Recommendation 41:

That the Insurance Council of Australia amend clause 4.5 of the General Insurance Code of Practice to extend the time within which claimants in natural disasters have the right to make further claims or lodge reviews after the finalisation of an initial claim to seven months from the date of the relevant natural disaster, regardless of when the initial claim was finalised.

Dispute Resolution

- 14.50. The Code sets procedures for policyholders to lodge complaints as to claims handling and disputes with respect to insurers' decisions and responses to complaints.¹²⁶
- 14.51. The Code sets an overarching 45 day time limit for resolution of complaints, failing which the policyholder is to be notified of their right to lodge a complaint to FOS or to seek legal advice.
- 14.52. The major problems expressed with insurers' IDR processes by consumer representatives to the Review and other forums has been uncertainty about the point of entry to IDR and delays in having IDR complaints allocated and decided without informing policyholders of their right to lodge complaints with FOS.¹²⁷
- 14.53. Some insurers have multi-tiered review/complaints mechanisms which result in significant delays beyond 45 days in having complaints finalised from when a policyholder indicates their intention to challenge an original decision on a claim. This, it is argued, has led to consumer fatigue and significant number of policyholders not pursuing legitimate claims.

125 Financial Ombudsman Submission to the House of Representatives Inquiry into the operation of the insurance industry during disaster events, p 10, 2011

<http://www.aph.gov.au/house/committee/spla/insurance/submissions.htm>

126 General Insurance Code of Practice, pp 10-11, 2010 <http://www.codeofpractice.com.au/LinkClick.aspx?fileticket=-XTcClWRFG0%3d&tabid=37>

127 Insurance Law Service Submission to the Review of the General Insurance Code of Practice, 2009. <http://codeofpracticereview.com.au/LinkClick.aspx?fileticket=kvEdrelirSw%3d&tabid=97&mid=483>

- 14.54. The other problem identified by consumer representatives is that IDR complaints officers are not sufficiently independent of the original claims handlers and do not necessarily have the authority to pay claims, thereby undermining the integrity of the dispute resolution process. Some insurers have defended multi-tiered IDR processes on the basis that they provide consumers with further opportunities to have claims that would otherwise be denied to be reviewed and paid after being considered by 'a fresh set of eyes'.
- 14.55. Whilst there is some merit in this suggestion, it is the Review Panel's opinion that any such reviews should be encompassed within an aggregate 45 day complaints process to avoid consumers being lost in a maze.
- 14.56. It is the Review Panel's opinion that the claims and IDR complaints processes should be robust, timely, transparent and easy to navigate.
- 14.57. The Consumer Perspective Paper proposes that a general fairness test be applied to claims handling.
- 14.58. Section 13 of the Act imposes a duty of the utmost good faith on the parties to an insurance contract and the FOS rules include that FOS 'will do what in its opinion is fair in all the circumstances ...' (rule 8.2). Further, the Code also imposes obligations on participating insurers to act fairly (clauses 1.2 and 3.6).
- 14.59. Nevertheless, given the concerns expressed after the recent natural disasters by some policyholders and their representatives of difficulties they have experienced in having claims and complaints dealt with, it is the Review Panel's view that a general fairness test in claims and complaints handling should be inserted into the Code. This could enhance consumers' claims experience and the industry's reputation.

Recommendation 42

That the Insurance Council of Australia amend the General Insurance Code of Practice to require that:

- internal dispute resolution processes be independent of the claims handling department and the internal dispute resolution officers have the authority to overturn the original decisions and to accept claims;
- internal dispute resolution complaints be finalised within an aggregate of 45 days and if this time limit is not met, the insurer to advise the claimant of his or her right to lodge an external dispute resolution complaint with the Financial Ombudsman Service (if applicable) and to seek independent legal advice;
- time limits on internal dispute resolution complaints commence immediately after a policyholder notifies the insurer of a complaint, whether verbally or in writing; and
- a general fairness test be applied to claims and complaints handling.

Code Compliance Committee

- 14.60. The CCC monitors alleged breaches of the Code and conducts audits of insurers participating in the Code.

- 14.61. The CCC is currently appointed by a combination of the FOS Board and the Insurance Council and is housed within FOS. This appointment regime has been in place for many years and is not consistent with the appointment process adopted by FOS itself for the appointment of the members of its Panels — a consumer representative, an industry representative and an ombudsman.
- 14.62. The FOS Panel appointment process was adopted in the early 2000s by two of its predecessor schemes, the Financial Industry Complaints Service and the Insurance Ombudsman Service following a review. Under that process, the consumer and industry representatives are appointed by a committee appointed by the FOS Board following a merits selection process that includes input by relevant consumer and industry groups respectively. The relevant ombudsman is also appointed by a selection committee appointed by the FOS Board after a merits selection process.
- 14.63. It appears to the Review Panel that the above FOS appointments process is superior to that under the Code as it has a greater level of independence, transparency and quality control. In contrast, the chair of the CCC, for example, whilst appointed by the FOS Board, is nominated solely by the Insurance Council. Accordingly, the Review Panel recommends that section 7.13 of the Code be amended to alter the appointment for all of the CCC members to align with that for the appointment of an ombudsman and of Panel members under the FOS rules.
- 14.64. Under the current Code, the CCC receives reports of Code breaches from FOS and conducts audits of insurers. Its role could be expanded to receive, record and investigate self-reported breaches from insurers, and reports from policyholders, the general public and ASIC. Serious or systemic breaches could also be reported directly to ASIC.
- 14.65. It could also publicly release breaches of the Code. As a matter of practice, the CCC currently compiles an annual report which is made available to FOS and the Insurance Council to only. The report provides aggregate statistics on a de-identified basis.
- 14.66. The Review Panel is of the opinion that the role of the CCC should be to closely monitor compliance of the Code by insurers, investigate breaches where appropriate and publicly publish breaches and outcomes, identifying all relevant insurers.
- 14.67. Public transparency of compliance and non-compliance with the Code by individual insurance companies would provide a reference point for comparative performance and drive improved behaviour.

Recommendation 43

That the Insurance Council of Australia amend the General Insurance Code of Practice such that the General Insurance Code Compliance Committee:

- be appointed in the same manner as FOS Panels, with the independent chair and the consumer and industry representatives to be appointed in the same manner as the ombudsman and panel members are appointed under the FOS rules;
- have the authority and resources to record all breaches of the Code reported to it, to investigate breaches of the Code where appropriate and to conduct regular audits of insurance companies for compliance with the Code;
- report serious or systemic breaches of the Code directly to ASIC; and
- publicly release annual reports as to Code compliance and breaches, with insurers to be identified in the reports.

Review of the Code

14.68. Some consumer representatives have argued that a claims handling standard must go further than the Code and that the best mechanism would be through regulation, such as an ASIC Regulatory Guide.¹²⁸ Whilst there is a Regulatory Guide for dispute resolution (RG165), there is no Regulatory Guide which applies to claims handling practices. Instead, insurers' claims handling is regulated by a combination of the Code, the *Insurance Contracts Act 1984* and FOS.

14.69. Having reviewed the processes, the Review Panel considers that the Code should be first strengthened, implemented and then reviewed as to its' effectiveness before any moves towards government regulation.

14.70. The Review Panel considers that strengthening the Code should provide sufficient consumer protection and that it would be appropriate to allow time for the measures outlined above to work. A review of the Code should then be conducted after three years to assess the effectiveness of self-regulation. If the review finds that the Code does not meet the expectations and needs of consumers, a claims handling Regulatory Guide should be implemented.

Recommendation 43

That ASIC conduct a review of the General Insurance Code of Practice three years after the amendments recommended to the Code in this Review are implemented, in order to assess the effectiveness of the Code with a view to determining whether an ASIC Regulatory Guide for claims handling should then be introduced.

128 Connolly, Chris, September 2011. 'A Consumer Perspective on the NDIR Issues Paper'
http://www.ndir.gov.au/content/commissionedpapers/2011/consumer_perspective_sept_11.pdf

INDEPENDENT LEGAL ADVICE

- 14.71. While independent legal services provided much needed assistance to consumers in the 2010-2011 floods, there is evidence to suggest that not enough consumers were able to access these services. While there were significant contributions to Queensland Legal Aid services from the Insurance Council of Australia¹²⁹ and Commonwealth Attorney Generals Department¹³⁰, who contributed \$250,000 and \$200,000 respectively in January-February 2011, some consumers were unable or did not know how to access the services of Legal Aid.
- 14.72. FOS stated that the majority of complaints lodged with it from the 2010-2011 Queensland floods were as a result of the insurers' final decision letters informing policyholders of their right to external dispute. Only 15 per cent were referred to it from Legal Aid services.¹³¹ It argues in a submission to another review that it has concerns as to how effective it can be in resolving insurance disputes where a consumer is not supported by an advocate, as insurance is an extremely complex area of law and insurance cases are challenging even for solicitors.¹³²
- 14.73. Historically, following natural disasters, Governments tend to provide additional funding for legal services and the relevant State Legal Aid Commission, community legal centres, and the private legal profession respond to the crises — as occurred in the 2009 Victorian bushfires and the 2010-2011 Queensland floods and cyclone.
- 14.74. However, the Review Panel has heard that some of the legal aid services and community legal centres have struggled to deal with the volume of inquiries and requests for assistance in relation to rejected insurance claims following natural disasters. Some of the issues are a lack of resources and expertise, and difficulties in co-ordination between service providers, particularly in rural areas.
- 14.75. The Review Panel believes that due to the vital role these services play in providing advice and lodging disputes in natural disaster insurance claims, it is important that Commonwealth and State government funding for legal services be provided in the event of natural disasters.

Recommendation 45:

That the Commonwealth and State governments provide funding for legal advice and assistance with insurance disputes following natural disasters.

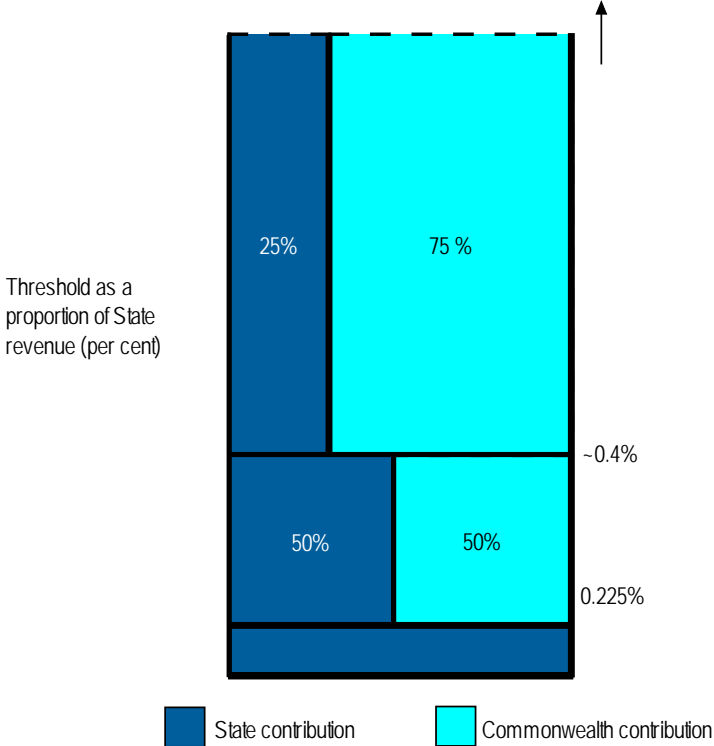
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- 129 Insurance Council of Australia, Media Release 'General Insurance Industry Supports QLD Legal Aid' 18/02/11
<http://www.insurancecouncil.com.au/Portals/24/Media%20Centre/2011%20Media%20Releases/ICA%20Media%20Release%20QLD%20Legal%20AID%20180211.pdf>
- 130 Attorney-General for Australia 'More funding for Queensland flood legal help'
http://www.ag.gov.au/www/ministers/mcclelland.nsf/Page/MediaReleases_2011_FirstQuarter_31January2010-MorefundingforQueenslandfloodlegalhelp
- 131 Financial Ombudsman Service submission to the Natural Disaster Insurance Review, p 16
http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Financial_Ombudsman_Service_Limited.pdf
- 132 Financial Ombudsman Service submission to the House of Representatives Inquiry into the operation of the insurance industry during disaster events, p 7, 2011

Chapter 15. Funding the rebuilding of public infrastructure

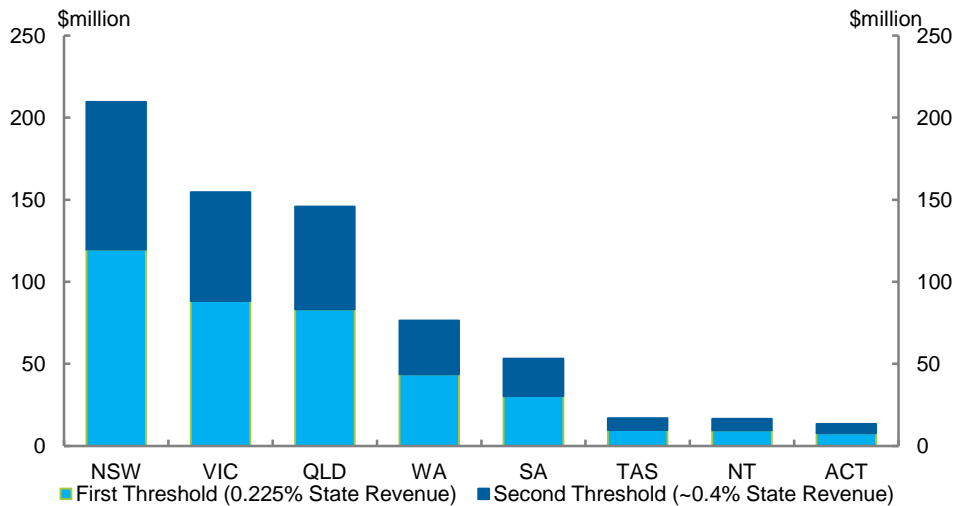
15.1. The Natural Disaster Relief and Recovery Arrangements (NDRRA) provide for the Commonwealth and States to share the costs of reconstruction of State assets following natural disasters. States are able to recover part of the cost of rebuilding State government assets from the Commonwealth. Recoveries are calculated net of costs recoverable from any other source, such as commercial insurance. Government business enterprises are not eligible.

15.2. Figure 3 shows the structure of cost sharing between States and the Commonwealth. Once a State’s costs of disaster recovery and reconstruction in any financial year have exceeded a certain threshold, the arrangements require that the Commonwealth co-fund a portion of the recovery costs on the eligible assets. The arrangements require that the Commonwealth fund 50 per cent of costs above 0.225 per cent of State revenue and 75 per cent of costs above 1.75 times the first threshold (approximately 0.4 per cent). The States cover the remainder.

Figure 3: Cost Sharing between States and the Commonwealth



15.3. The 2010-11 thresholds for each State are shown as dollar amounts in Chart 1.

Chart 1: NDRRA thresholds by State 2010-11

- 15.4. Hence New South Wales, for example, will bear the first \$120 million of natural disaster costs in 2010-11, 50 per cent of natural disaster costs up to \$210 million (a maximum of \$45 million) and 25 per cent of costs exceeding \$210 million.
- 15.5. Assessing Commonwealth contributions relative to each State's revenue is accepted by the Review Panel as a reasonable basis for delivering equity amongst the States. However, the contributions from the Commonwealth and each State are based on expenditure net of insurance or reinsurance recoveries, which could invite arbitrage and do not seem equitable. Under the current structure, a State would receive greater NDRRA recoveries if it did not insure at all. On this basis, NDRRA recoveries calculated net of insurance recoveries can be thought of as a penalty on those States who choose to take out insurance for large losses.
- 15.6. Each State has some form of managed fund, captive insurer or self-insurance fund that insures some State assets. The range of assets covered by each State fund, along with the level of cover provided and the charges for the cover, reflect judgements made within each State about how State assets are to be managed. There is no reason why those judgements need be the same in each State and, as a result, the insurance and reinsurance arrangements within each State fund vary greatly.
- 15.7. It is a clear objective of some or all of the States' funds that their existence and operation are designed to generate accountability for good risk management and to foster initiatives to manage State asset risk. In this respect, the NDRRA recoveries are incidental, and of course only occur in the event of relatively large losses.
- 15.8. It is also notable that the existence of a self-insurance fund or captive insurer into which premiums are paid each year represents a level of pre-funding for claims or losses, including losses from natural disasters. Reinsurance taken out by those funds is similarly a form of pre-funding. As already noted, NDRRA recoveries calculated net of reinsurance recoveries can be thought of as a penalty on those States that choose to take out insurance for large losses.
- 15.9. The Review Panel recommends that, to address this inequity, the NDRRA formula for cost sharing be altered from one based on costs net of insurance recoveries to one based on gross costs. That is, the NDRRA funding threshold could be based on 100 per cent of losses irrespective of any commercial insurance or reinsurance arrangements. This approach would treat the States equally regardless of the insurance or reinsurance arrangements that they have made.

15.10. Such a change would require the thresholds and rates of reimbursement to also be altered. What those changes should be is appropriately a matter for the Commonwealth and State Governments, having regard to overall fiscal constraints. The Review Panel therefore does not offer a view on what they should be.

Recommendation 46:

That the current formula for the cost of rebuilding of State and Territory assets under the Natural Disaster Relief and Recovery Arrangements be changed to expenditure before any insurance recoveries by the State or Territory rather than net of any insurance recoveries.

Chapter 16. Implementation and transition

- 16.1. The Review Panel's recommendation that all home, contents and home unit insurance policies include flood cover is supported by the recommendation to establish a new agency that coordinates flood risk management nationally, operates the recommended system of premium discounts and manages the associated reinsurance facility. These recommendations taken together are designed to deal comprehensively with the issues of availability and affordability of flood insurance for homes, contents and home units.
- 16.2. The Review Panel is mindful that, during the implementation period, many insurance policyholders will remain exposed to the risks of the current system whereby flood is often excluded from home, contents and home unit insurance policies. Those in high flood risk areas will continue to be subject to high premiums for flood cover. Many will not have flood cover and therefore will continue to be at risk of a 'flood v storm' problem. The implication is a repeat of the financial distress, delays and disputes that followed the floods in 2010-11 should a major flood occur during this period.

Recommendation 47:

That the Government give priority to introducing legislation necessary to ensure that all home, contents and home unit insurance policies include flood cover and to establish a new national agency for flood risk management and flood reinsurance purposes.

- 16.3. Implementing the recommendations will require, among other things, legislation to be developed reflecting detailed specifications of the reinsurance facility. To do so effectively will require consultation with the insurance industry and other stakeholders on numerous aspects. In addition, the Commonwealth will need to consult with State and Territory governments on various aspects of establishing the national agency, particularly regarding flood mapping and other aspects of flood risk management, and also regarding the funding of potential future shortfalls experienced by the reinsurance facility.
- 16.4. While preparations are being made for implementation, including legislative initiatives, there are some interim measures that would alleviate, to some extent, the risks that consumers will continue to be subject to until the Review Panel's recommendations are fully implemented.
- 16.5. Accordingly the Review Panel recommends that, as pre-cursors to legislative changes and to the establishment of the new national agency, the following be undertaken immediately:
- by the Government:
 - take preparatory steps towards establishing and operating the new Agency including its flood risk management role and designing the system of flood premium discounts and the reinsurance facility;
 - an investigation be undertaken to ascertain whether there is a basis for granting premium discounts for cyclone risk, along the lines of the recommendation for flood insurance premium discounts for homes, contents and home unit insurance policies (Recommendation 27);
 - amend the *Insurance Contracts Act 1984* (the Act) to deal with the 'clearly inform' problem (Recommendation 33), the application of the Key Facts Statement

- (Recommendation 34), the introduction of a 'health warning' (Recommendation 35) and the introduction of the standard definition of flood in the form proposed in the 'Reforming flood insurance: Clearing the waters' consultation paper. (Recommendation 36);
- amend the *Australian Securities and Investment Commission Act 2001* so that the unfair contract terms provisions apply to general insurance (Recommendation 47); and
 - by the Insurance Council:
 - implement the recommended amendments to the General Insurance Code of Practice (Recommendations 38, 39, 40, 41, 42, 43).
 - by lending institutions
 - implement the recommendation to remind mortgagors annually of their home insurance obligations (Recommendation 31).

APPENDIX A: FLOOD VERSUS STORM EXPLANATION

INTRODUCTION

1. General insurance policies provide cover for, inter alia, loss or damage to defined property or goods. Sometimes policies provide cover for defined events.
2. Policies also include exclusions which limit or exclude cover for loss or damage that would otherwise be claimable.
3. Many insurance policies distinguish between flood and storm damage in setting out what events they will cover in home building, contents and home unit insurance policies and small business insurance policies.
4. Typically a policy will include terms that the insured items are covered against loss or damage caused by an accident except for specified exclusions.
5. Many general insurance policies don't actually specify that storm damage is covered and hence don't define 'storm'. However, some policies do exclude flood damage and define 'flood'. Others exclude flood damage but include flash flooding.

FLOOD, STORM AND FLASH FLOODING DEFINITIONS

6. There are a range of definitions of 'flood' in the Australian market place including:
 - The escape or release of water from the normal confines of a pond, lake, reservoir, canal, dam or uncovered water course.
 - The covering of normally dry land by water escaping or released from the normal confines of a water course or lake, whether or not it is altered or modified. Flood also includes water escaping from the confines of any reservoir, channel, canal or dam.
 - The inundation of normally dry land by water escaping, or being released from, the normal confines of a reservoir, natural water course or lake (whether or not they have been altered or modified). Flood also includes water discharged from any sewerage or waste water systems due to pressure induced by flood water.
 - The inundation or covering of normally dry land by water which:
 - (a) escapes or overflowsor

(b) cannot enter, because it is full or has overflowed, or is prevented from entering because other water has already escaped or been released

from the normal confines of any water course or lake, including any that may have been modified by human intervention, or reservoir, canal, dam or storm water canal.

- When water that is normally contained in a water catchment system increases because of rain fall or snow melt (whether in the immediate region or elsewhere) or is deliberately released by an authority, and the water overflows onto land that is not normally covered by water into your home.
7. The common requirement for the flood definitions is the escape/overflow of water from the normal confines of a natural water course or body of water. This can extend to modified or artificial water courses such as redirected rivers or creeks and storm water channels. The definitions also sometimes include water released from dams and water which cannot enter a watercourse or body of water because it is already full or overflowing.
 8. Flood water damage, which is sometimes referred to as 'water rising', 'fluvial damage', or 'riverine flooding', contrasts with storm water damage which usually includes:
 - wind and hail damage,
 - damage caused by water flowing through a hole in premises made by a wind or storm,
 - damage from water inundation from run off from local streets, roads or surrounding areas, gutters or storm water drains.
 9. Water damage is sometimes referred to as 'local run off', 'water falling' or 'pluvial damage'.
 10. Some insurance policies which exclude flood damage do nevertheless cover damage caused by flash flooding. This is usually defined as flood damage (as per the definition of flood) occurring within a limited period of time after the storm or rain event which caused the flood. The period is usually 24, 48 or 72 hours.
 11. Therefore, if the water which inundates an insured's premises is from the overflow of a river, creek or dam etc and occurs within say, 72 hours of the downpour which led to the overflow, the policy will respond.
 12. For example, in relation to the recent South East Queensland natural disaster, it could be said that:
 - The event in Toowoomba could be classified as a storm event given that the inundation was primarily local run off immediately following the downpour event with water running down and off the main streets and roads.
 - The event in Lockyer Valley could be classified as flash flooding given that the local rivers overflowed very soon after the severe downpour and inundated the surrounding areas.
 - The event in Brisbane could be classified as flooding given that the storm event that led to the overflow of the Brisbane River occurred a number of days after the downpour originally occurred in the catchment areas — although there may have been some local inundation in some suburbs and the release of water from the Wivenhoe Dam may not fall within some flood definitions.

13. The distinctions between flood, storm and flash flooding can be very technical, involve the expert opinions of hydrologists, the interpretation of satellite imaging and eyewitness accounts as to the sequence of events, the time of inundation of a property, the colouration of water and nature of the debris which inundated the property.
14. The distinctions could be seen as very artificial and beyond the comprehension of most consumers. This is no more so than when the cause of the inundation is not clear and could be a 'mixed event' requiring the invocation of the legal doctrine of proximate cause — which most consumers know nothing about.

FLOOD v STORM

Onus of Proof

15. As a matter of law, the onus is on a policyholder to prove, on the balance of probabilities, that an insured event has occurred entitling them to claim under the policy for particular loss or damage.
16. The onus then shifts to an insurer to prove, on the balance of probabilities, that an exclusion applies.

Storm/Flood Cover

17. Home buildings, contents and home unit insurance policies usually cover storm loss or damage but many exclude flood damage. Accordingly, the policyholder must establish that the inundation of and loss or damage to their home or contents was caused by storm water damage. If the policy excludes flood damage, the insurer must then prove that the cause of the loss or damage was flood water (as defined).
18. If a policy excludes flood damage but includes flash flooding, the onus then shifts again to the policyholder to prove, on the balance of probabilities, that the inundation which caused the loss or damage occurred within the time limit specified in the policy of the storm or rain event.

Doctrine of proximate cause

19. If there are two or more proximate or effective causes of loss or damage, one of which is excluded under the terms of the policy, the excluded event prevails and the policy does not respond.
20. Called the doctrine of proximate cause or the Wayne Tank principle (*Wayne Tank & Pump Co Ltd v Employers Liability Assurance Corporation Limited* (1974) QB 57), it means that if the loss or damage to the home or contents was caused by inundation from a mixture of flood and storm waters (for example, water overflowing from a river, and local run off from streets and storm water drains), the insurer is not liable if the policy has a flood exclusion.
21. However, if the policyholder can prove, on the balance of probabilities, that some of the loss or damage was caused by storm water before the flood water arrived, the policy will cover this loss or damage.

CASE STUDIES: 'FLOOD' VERSUS 'STORM'

1. HAMS VS CGU LIMITED

22. Mr and Mrs Hams leased a 25,000 hectare property in North West New South Wales. The property included a homestead, shearer's quarters, sheds and a hangar situated in a large natural depression (4 km x 700 m). The depression was surrounded by lakes and a creek, (approximately 10 km to 25 km away) which were normally dry.
23. They held a 'rural pack' insurance policy which insured the buildings against accidental loss and damage. However, the policy excluded damage caused by flood, which was defined as:

'Inundation following the escape of water from the normal confines of any lake, reservoir, dam, river, creek or navigable canal, as a result of a natural phenomenon which has some element of violence, suddenness or largeness about it, but does not mean inundation by water from fixed apparatus, fixed tanks, fixed pipes or run-off of surface water from surrounding areas'.
24. In February 2000, the area was subject to a one in 200 years plus downpour. The depression was inundated with water which ran off from the surrounding areas. The homestead, shearer's quarters, hanger and sheds were inundated to a level of approximately 500 to 750 mm.
25. The depression was also inundated by water from the overflowing surrounding lakes and a 'wall of water' from the overflowing creek. The timing of the arrival of these waters was in dispute. However what was not in dispute is that within 24 hours, the depression was filled with water which had inundated the homestead, shearer's quarters, sheds and hangar up to roof level. The buildings remained under water for nine months.
26. The Hams claimed under the policy and the claim was rejected with the insurer asserting that the damage to the buildings was caused in part by the escape of water from the lakes and rivers and thereby under the doctrine of proximate cause, the policy did not respond.
27. The Hams sued the insurer for breach of contract and the actions ran to trial for two weeks in the New South Wales Supreme Court (the dispute was well beyond the monetary limit of the Insurance Ombudsman Service (now called the Financial Ombudsman Service (FOS)).
28. Much of the trial was taken up with competing expert evidence from hydrologists, building expert evidence and eye witness evidence as to the sequence of events, the timing of the overflows and the inundation of the buildings, and when the damage would have been done.
29. The Court found that the insurer had clearly informed the Hams of the effect of the flood exclusion by providing them with the insurance policy, a 40 plus page document with subsections offering multiple coverage options.
30. The Court also found that the doctrine of proximate cause applied (referred to as the Wayne Tank Principle) whereby if the cause of damage was a combination of flood and storm water, the exclusion would prevail. They found that the Hams were unaware of the doctrine of proximate cause but that the insurer's obligation to clearly inform of the flood exclusion did not extend to informing the Hams of the operation of the Wayne Tank Principle.

31. The Court concluded that the homestead, shearer's quarters and sheds were damaged by the initial inundation from the local surface run off before the flood waters arrived and ordered the insurer to pay for the damages.
32. However, they found that the damage to the hangar, which was made of steel, required prolonged inundation and was therefore damaged by a combination of storm and flood waters. They applied the doctrine of proximate cause and found that the policy did not respond to that damage.
33. The costs associated with the dispute far exceeded the amount claimed under the insurance policy.

2. FOS DETERMINATION CASE NUMBER 223789

34. The Applicant's home was inundated with water following intensive rainfall in March 2010.
35. The Applicant held a home building and contents insurance policy which insured against accidental and defined events loss and damage. However, the policy excluded damage caused by flood which was defined as:

'... the inundation of normally dry land by water escaping, or being released from, the normal confines of a reservoir, natural water course or lake (whether or not they have been altered or modified). Flood also includes water discharge from any sewage or waste water systems due to pressure induced by Flood water'.
36. The Applicant lodged a claim under the policy which was rejected on the basis of a hydrologist's opinion that the damage was caused by flood water as defined.
37. The Applicant lodged a complaint to FOS on the basis that the water damage was due to local run-off and not water escaping from the river. Alternatively, it was asserted that the insurer had not complied with the obligation to clearly inform the insured of the flood exclusion under Section 35 of the Insurance Contracts Act.
38. The classification of the water which inundated the Applicant's property was essentially an assessment of the time, location and severity of the downpour, the topography of the area, the position of the river and height of the Applicant's building, the timing of the overflow of the river and the inundation of the home and the colour of and the debris in the inundating water.
39. The insurer's hydrologist provided a general report with respect to the likely cause of inundation of properties in the area and more specific reports relevant to the Applicant's property. The conclusion was that the water which inundated the Applicant's building and contents was water which had overflowed from the local river.
40. The Applicant submitted a general report from a hydrologist commissioned by the local council which said that much of the relevant area was inundated by local storm water before the river overflowed (he was not able to pay for an hydrologist report specific to his property). He also lodged eyewitness statements as to the timing of the inundation.
41. The FOS Panel found that the balance of the evidence supported that the water which entered the Applicant's home was flood water from the river. They specifically noted that the only site-specific expert evidence was from the hydrologist engaged by the insurer.
42. With respect to the Applicant's assertion that the policy document did not clearly inform the Applicant of the flood exclusion, the FOS Panel found that the insurer had discharged the onus of proving that it had clearly informed the Applicant of the flood exclusion.
43. The Applicant noted that the flood exclusion was found on one page of a 73 page policy document and had to be read with a definition of flood found on a different page. However, the Panel found that the policy index directed the Applicant to the relevant pages of the policy and the renewal notice schedule also alluded to the flood exclusion.
44. The FOS complaint was therefore not upheld.

3. FOS DETERMINATION CASE NUMBER 217468

45. The Applicant held a commercial business insurance policy for a golf driving range which covered his buildings for a sum insured of \$400,000.00 and contents for \$80,000.00.
46. The netting, supporting poles and lighting on the driving range were damaged following a storm in 2007. The lower quote for repairs/replacement was \$278,000.00.
47. The Applicant lodged a claim which was denied on the basis that the damage was not caused by the storm event but was due to gradual deterioration which was not covered under the policy. The Applicant lodged a complaint and the FOS Panel overturned the decision on liability.
48. However, in relation to the quantum of the loss, the insurer asserted that the building and contents were substantially under insured and purported to rely upon a 'co-insurance' clause in the policy to reduce the quantum of the damages payable.
49. The 'co-insurance condition' stated:

'... we shall be liable for no greater proportion of the loss or damage than the sum insured at the location bears to 80 per cent of the replacement cost of the property insured at the commencement of the period of insurance ...'
50. The FOS Panel found that whilst the value of the buildings was close to the sum insured, the full value of the netting had not been factored into the total sum insured.
51. Accordingly, the Panel found that the co-insurance clause did apply to the calculation of the loss and reduced the benefit payable from \$278,000.00 to \$200,000.00.

CASE STUDIES — SUMMARY

52. The above case studies highlight the artificiality of the distinction between flood and storm water, the complexities and expense involved in determining the source of water damage and the potential difficulties faced by insureds in establishing entitlements under their policies.

LIST OF SUBMISSIONS

Following the publication of the Review Panel's Issues Paper on 2 June 2011, a total of 121 Submissions were received and 12 that were confidential. The remaining 109 are listed below.

Abacus Australian Mutuals	Fisk, Reg
Ajilon	Fleming Pastoral Company
Allianz Australia Insurance Ltd	Floodplain Management Association
Applegarth Insurance and Trade Consultants	FM Global
Arnold, Michael	Frazer, Frank
Australian Bankers Association	Gillies, Peter
Australian Centre for Financial Studies	Glazebrook, John
Australian Finance Conference	Gordon, Angus
Australian Local Government Association	Green, Kathy
Australian Red Cross	Hassall, Mike
Baird, Helga and William	Hastings, Marilyn
Bartlett, John	Hayes, Andrew (sub 1)
Beadsmoore, D	Hayes, Andrew (sub 2)
Bonifant, Lisa	Hollis, Linda & Mark
Brisbane City Council	Humphries, Joe and Carol
Bristed, Nicola	Hutchison, Bob
Brotherhood of St Laurence	Institute of Actuaries of Australia
Bruce, Bob	Insurance Australia Group
Bull, Ken	Insurance Council Australia
Byrnes, Alan	Insurance Law Service
Canegrowers	Jaques, Barry
Cantwell, Michael	Jones, Nathan
Carruthers, Ian	Jupp, Carolyn
Carter, Rachel Anne	Kennedy, John R
Cassowary Coast Regional Council	Kopittke, Michael
Chamberlin, Dr Merryll	Legal Aid Queensland
CHU Underwriting Agencies Pty Ltd	Lloyd, Geoff
Coleman, Tony	Lloyd's General
Consumer Action Law Centre	LMI Group
Cracknell, Jo Anne	Local Government Association of QLD

Financial Ombudsman Service Ltd	Logan, Chris
Fischer, Tom	Lunn, John G
Lustig, Terry	Sargeant, David
Lustig, Terry (supplementary)	Sentinel Pty Ltd
MacKenzie, Trudy	Smart Publishing
McAuley, Ian	Smith, Lee
McCabe, Karlene	Smith, Vic
McCormack, John	Stegman, Greg
McWilliam, Doug & Julie	Strata Community Australia
Mahon, Judy and Vincent	Suncorp
Majumdar JP, Dr Som	Tait, John
Manuel, William	Talbot, Lorraine and Richard
Martin, Heather	Tasmanian Government
Miller, Pamela	Taylor, John
Mills, Terry	Tilbury, S
National Community Titles Institute	Tindall, Dave
National Insurance Brokers Association	Tod, Susan
National Legal Aid	Trimblett, John
O'Brien, Tony	Vinson, Peter
Professional Finance Solutions	Vinson, Peter (supplementary)
Queensland Government	WMAwater
Queensland Insurance Commissioner	Wesfarmers General Insurance
Römcke, Ben	Wimmera Catchment Management Authority
Roney, Warren	Zhoa, Dr Zhengtang
Risk Frontiers	

BIOGRAPHIES OF REVIEW PANEL MEMBERS

JOHN TROWBRIDGE — CHAIRMAN

John Trowbridge completed in 2010 a four year term as one of three Government-appointed executive members of the Australian Prudential Regulation Authority (APRA), Australia's national prudential regulator for banking, insurance and superannuation. He had carriage at APRA of life and general insurance and also executive remuneration. During this time he was also a member of the Executive Committee of the International Association of Insurance Supervisors and a member of Australia's Financial Reporting Council.

Before joining APRA, John had spent the larger part of his career as a consultant, having founded Trowbridge Consulting in 1981, a firm which was known as an insurance specialist and became a leading actuarial and management consulting firm in Australia and Asia during the next 20 years. It merged with Deloitte in 2000. He had previously worked with Commonwealth Treasury in the Government Actuary's Office and had also held senior executive positions with QBE Insurance. After completing his consulting career in 2002, he led Suncorp's insurance business for a period and was subsequently a local director of Munich Reinsurance.

He has undertaken a very wide range of consulting assignments in his time and has developed a reputation as one of Australia's foremost experts in general insurance.

He was President of the Institute of Actuaries of Australia in 1998, served as a member of the Australian Treasurer's Financial Sector Advisory Council from 1998 to 2004, was awarded a Centenary Medal in 2001 and was named Actuary of the Year in 2006.

JIM MINTO — PANEL MEMBER

Jim Minto joined TOWER in New Zealand in 1988 as Managing Director of the Group's Trust business.

He went on to run several of the other TOWER Limited businesses — Managed Funds, Health Insurance, Life Insurance and General Insurance — before taking on the role of Group Managing Director of the trans-Tasman TOWER Limited Group.

When the TOWER Limited Group demerged in 2006 Jim was appointed Managing Director of TOWER Australia, (now known as TAL) which is now the third largest Life Insurer in Australia by premiums.

A Chartered Accountant, Jim holds a number of other directorships and has been active in industry bodies throughout his career. He is currently on the Board of ASFA.

Jim Minto is a strong public advocate for the social importance of the Life Insurance industry to the people of Australia.

JOHN BERRILL — PANEL MEMBER

John Berrill is a Principal at Maurice Blackburn and is the head of the largest national plaintiff Superannuation and Insurance Claims practice in Australia.

John has more than 15 years experience in insurance, superannuation and financial services law and is an accredited personal injuries specialist.

He was a consumer representative on the Financial Industry Complaints Service Panel from 1995 to 2001 and from 2004 to 2005 and the FICS Board from 2005 to 2009. He was also a member of the Stronger Super Peak Consultative Group in 2011 and the FOS Life Insurance Advisory Committee from 2009 to 2011. He is a consumer representative on the Travel Compensation Fund Board.

John was a founding member of the HIV/Aids Legal Centre and is also a member of the Consumers Federation of Australia, the Chronic Illness Alliance and the Australian Lawyers Alliance.

John provides legal insurance and superannuation advice and advocacy to many disability support groups, unions and consumer groups, and acts for workers and people with chronic illnesses and disabilities.

SECRETARIAT

Assistance was provided to the Review by the Australian Government Actuary, Mr Peter Martin.

A secretariat was established in the Treasury to assist the Review Panel. It consisted of 9 staff drawn from within Treasury, the Australian Reinsurance Pool Corporation, and the Australian Prudential Regulation Authority.

CONSULTANTS

The Review Panel was also assisted by Mr Graeme Adams (General Advisory Pty Limited), Mr Mark Babister (WMAwater) and Mr Geoff Atkins (Finity).

Communication support was provided by Armon Hicks (Kreab & Gavin Anderson)

PAPERS PRODUCED FOR THE REVIEW

Mr Chris Connolly (Transia Pty Ltd) — A consumer perspective on the NDIR Issues Paper.

Alan Mason (Melzan Pty Ltd) — A History of Flood Insurance in Australia.

SPEECHES/PRESENTATIONS

Biennial Conference — 12 April 2011

Flood Seminar — 16 May 2011

FSAA — 23 May 2011

Law Institute Seminar — June 2011

IAA Seminar — 6 July 2011

Australian Centre for Financial Studies Seminar — 12 July 2011

University of Queensland Seminar — 15 July 2011

ESA — Australian Economic Forum — 23 September 2011

GLOSSARY

Term	Definition
Actuarially fair rate	The price that would cover the expected claims cost determined using sound actuarial principles along with a margin for expenses and profit.
Australian Consumer Law	The Australian Consumer Law was passed as the <i>Trade Practices Amendment (Australian Consumer Law) Act (No. 1) 2101</i> which amends the <i>Australian Securities and Investments Commission Act 2001</i> .
Automatic Flood Cover	All insurers are obliged to offer flood cover in their home insurance policies and all homeowners who purchase home insurance must purchase flood cover.
Automatic Flood Cover with Opt-out	All insurers are obliged to offer flood cover in their home insurance policies but homeowners can choose to purchase home insurance that does not include flood cover; that is, they can opt-out of flood cover.
Body corporate	A separate legal entity created to manage the issues of necessary and mutual interest associated with the ownership of strata title property, including owners' corporations, strata companies or other entities.
Captive insurance company	An insurance company that is dedicated to insuring one entity, such as the owner and financier of the Captive.
Company title property	Buildings and land owned by a company. Through owning a set number of shares in the company, shareholders obtain the right to occupy a defined area in the company's building.
Contents	In this Report, refers to home contents.
Councils	In the context of the Issues Paper, the term Council generally refers to a local government authority, that is, the governing body of a local government area.
Cyclone	A violent disturbance of the atmosphere associated with sustained gale force winds.
Ex gratia payment	A payment made where no liability or obligation exists on the payer to make the payment.
Excess	In the context of an insurance policy, an excess is the amount for which a policyholder is liable in the event of a claim.
External dispute resolution	An alternative mechanism to the Court process to enable a dispute between two parties to be resolved by an independent umpire. In Australia, the mechanism used to resolve general insurance disputes is the Financial Ombudsman Service (FOS).

Term	Definition
Facultative-obligatory	<p>Facultative-obligatory reinsurance is an arrangement where the ceding insurer can elect to assign certain risks to the reinsurer, which is then required to accept them.</p> <p>By way of contrast, facultative reinsurance imposes no obligations on either party. The ceding insurer can seek to assign certain risks to the reinsurer, but the reinsurer is free to decide whether or not to accept them.</p> <p>On the other hand, obligatory reinsurance imposes obligations on both parties. The ceding insurer is obliged to assign certain risks to the reinsurer, which is then required to accept them.</p>
Flash flood	<p>The rapid inundation of normally dry and low lying land due to intense storms. Often involves the failure of local drainage systems, either natural or man-made, to the extent that the volume of water is more than they can accommodate.</p>
Flood	<p>In the context of this Report, flood is used in the same way as generally used by insurance companies and sometimes referred to as riverine flooding. It refers to flooding that typically occurs as a result of overflow from rivers and creeks following long duration rainfall over large catchment areas. It can also be through water rising up from flooding rivers, in contrast to water coming down from rain and storm. It is distinct from flash flooding or flooding caused by rising coastal waters as a result of a storm event.</p>
Flood risk management	<p>Involves reducing the impact of floods on people and infrastructure by reducing either the frequency of flooding, or its consequences, or both.</p>
General advice	<p>Financial product advice (intended to influence a person in making a decision in relation to a financial product or class of products) where the advice is of a general nature focussing on the product rather than the suitability of the product to the person's individual circumstances. General advice is subject to less regulatory requirements than personal advice.</p> <p>The term is defined in section 766B of the <i>Corporations Act 2001</i></p>
Home	<p>Detached house or other individual dwelling with a single property title. Does not include strata title properties, company title properties, mobile homes or caravans.</p>
Home unit	<p>In this Report, refers to dwellings under a body corporate or similar arrangement that are buildings or collections of buildings where individuals each own a portion (a lot), but where there is also common property (for example, external walls, windows, roofs, driveways, etc.) of which ownership is shared. They can take a number of forms, from duplexes to gated communities to small and large apartment buildings. They can include mixed-use properties that contain both commercial and residential units. They can also include aged care facilities and retirement villages.</p>

Term	Definition
Hydrologist	A hydrologist studies the science of water movement, distribution and quality.
Internal dispute resolution	Internal dispute resolution refers to a mechanism or process within a company to deal with and resolve complaints. All licensed general insurers in Australia are required to have an internal dispute resolution process that conforms with the General Insurance Code of Practice and ASIC Regulatory Guide 165
King tide	A term used to describe an especially high tide.
Lending institution	An institution providing home financing, principally including banks, credit unions and building societies.
Loss ratio	A measure of an insurer's financial performance, calculated by dividing total claims cost over the period by total premiums over the period.
Mitigation	Mitigation refers to the elimination or reduction in the frequency, magnitude, or severity of exposure to risks, and associated losses. The action of clearing trees around a property in a bushfire prone area is an example of mitigation.
Mixed use property	Property which combines areas used for both commercial and residential purposes.
Non-insurance	Non-insurance refers to the circumstance where an individual does not purchase insurance cover for a certain peril.
Personal advice	<p>Financial product advice (which is intended to influence a person in making a decision in relation to a financial product or class of products) where the provider has considered, or should have considered, one or more of a person's objectives, financial situation or needs.</p> <p>The term is defined in section 766B of the <i>Corporations Act 2001</i>.</p>
Premium	<p>A premium is the amount charged by an insurer to the policyholder enable them to cover an agreed risk. It includes the expected cost of claims; administration processes and insurer profit, and usually includes taxes and levies.</p> <p>An actuarially derived premium is one which is based on the expected cost of claims, taking into account the severity and likelihood of an event.</p> <p>A fully funded premium is an actuarially derived premium which also includes other costs such as insurer's claims handling, distribution, administrative costs and profit.</p> <p>A discounted premium is the amount charged after deducting a discount from a fully funded premium.</p>

Term	Definition
Premium (continued)	<p>A premium discount amount applied to an actuarially derived competitively priced premium to lower the cost to a policyholder. It is the difference between a full cover premium and the actual premium payable by a policyholder. It can also be referred to as a price break or flood discount.</p> <p>Full cover premium is an actuarially derived competitively priced amount charged by an insurer to provide cover for the events defined in an insurance policy, including flood cover.</p> <p>Non flood premium is the amount charged by an insurer to cover the risks defined in an insurance policy, other than flood risks. Typically, this would include non-weather risks, such as burglary, as well as weather risks, such as bushfire and earthquake.</p> <p>Full flood premium is an actuarially derived competitively priced amount required to fully fund the costs of flood.</p>
Reinsurance	Reinsurance is insurance purchased by insurers and is used as a way to transfer risk from the insurer to the reinsurer.
Replacement value cover	Replacement value cover provides for the full reinstatement of a damaged home to its original size and standard regardless of depreciation or age and in accordance with prevailing building standards. Replacement value cover usually includes the removal of debris and re-building fees in the event of a total loss claim.
Resilience	In the context of the Issues Paper, resilience refers to the ability to withstand a natural disaster. Resilience to natural disasters is improved through the use of mitigation works, measures and related activities that contribute to safer, sustainable communities.
Scaled advice	A form of personal advice which does not require financial advisors to consider all of a person's circumstances in providing advice. Rather, it allows financial advisors to consider a subset of a person's personal circumstances in providing advice on a specific product, such as insurance. It is subject to less regulatory requirements than personal advice.
Standard cover	A list of events prescribed under the <i>Insurance Contracts Act 1984</i> , which in prescribed contracts must either be covered, or excluded with the consumer clearly informed of the exclusion(s) by the insurer.
Strata title property	A building or collection of buildings, in which individuals and/or businesses each own a small portion (a lot) but where there is also common property (for example, external walls, windows, roof, driveways etc) in which ownership is shared.
Sub-limit	A sub-limit in an insurance policy refers to the maximum amount of cover applied to a particular section of the policy. For example, a \$10,000 sub-limit for flood would mean that the maximum amount payable in the event of a claim for flood damage would be \$10,000.

Term	Definition
Sum insured	A sum insured refers to the amount of cover, expressed in dollars, that is provided by an insurance policy. It is the maximum amount payable on each claim under the policy.
Top-up cover	Top-up cover provides additional cover over and above the sum insured value in the event of a total loss. The top-up amount is usually expressed as a proportion of the sum insured.
Total loss	A loss of sufficient size that the home cannot be economically repaired or there is no residual value.
Under-insurance	Under-insurance exists where the full replacement value of an insured home exceeds the actual amount of insurance (the sum insured) purchased by the policyholder.
Underwriting	Underwriting refers to the process undertaken by an insurer in order to assess, price and decide whether or not to accept a particular risk.
Unfair Contracts Laws	Laws that protect consumers and investors against unfairness in contractual dealings, for example, by prohibiting unconscionable or misleading and deceptive conduct. The laws apply to 'standard form consumer contracts'. Standard form contracts are commonly used across a range of industries including telecommunications, utilities, domestic building and finance. Contracts for home loans, credit cards and client or broker agreements for example, are almost certainly standard form contracts. Individually negotiated contracts and contracts between businesses are not covered. ¹³³

133 ASIC, Australian Consumer Law — unfair contract terms, 2010. <http://www.asic.gov.au/asic/asic.nsf/byHeadline/Unfair-contract-terms-law?opendocument>.

ACRONYMS

ABA	Australian Bankers' Association
ACCC	Australian Competition and Consumer Commission
AFTS	Australia's Future Tax System Review
APRA	Australian Prudential Regulation Authority
ARPC	Australian Reinsurance Pool Corporation
ASIC	Australian Securities and Investment Commission
CCC	Code Compliance Committee
COAG	Council of Australian Governments
FoFA	Future of Financial Advice
FOS	Financial Ombudsman Service
GST	Goods and Services Tax
IAG	Insurance Australia Group
NDRRA	Natural Disaster Relief and Recovery Arrangements
NEMC	National Emergency Management Committee
NFID	National flood Information Database
PDS	Product Disclosure Statement

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