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Manager
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Dear Sir/Madam

Reinsurance Pool for Cyclones and Related Flood Damage

Allianz Australia (**Allianz**) welcomes the opportunity to comment on the *Reinsurance pool for cyclones and related flood damage* consultation paper (the **Consultation Paper**). For some time, Allianz has been of the view that there is a problem with the affordability of home insurance for some residential homeowners and small businesses vulnerable to cyclones and floods. Homeowners with both high flood and cyclone risks can face premiums of more than twenty times those of other Australians. At such extreme levels, premiums cease to act as an appropriate price signal and start to drive other behaviours and decisions which have a range of negative consequences. Some of these include non-insurance, intentional underinsurance, disincentives to invest in residential property, discouraging population growth in whole regions and lower overall levels of economic activity.

As such, Allianz is supportive of the Government's policy decision to establish a government-backed reinsurance facility. An appropriately designed reinsurance facility, in conjunction with measures to enhance the resilience of properties to extreme weather events, is the most efficient and effective way of addressing affordability of insurance in regions exposed to cyclone risk. While Allianz's submission is focused on the questions posed in the Consultation Paper regarding key design considerations for a reinsurance pool (the **Pool**), we would also like to note that the intention for the Pool to be revenue neutral to government over the longer term is likely to constrain the potential impact that it will have on reducing premiums.

We understand that Treasury intends to conduct detailed modelling prior to settling the design of the Pool, which will enable estimated premium savings to be projected. Allianz anticipates that this modelling will confirm that more substantial premium savings will require some element of government subsidisation, and we would welcome further discussions with Treasury when this work progresses.

Our submission provides feedback on each of the themes outlined in the Consultation Paper, specifically, on Pool coverage, classes of insurance to be covered by the Pool, product design and insurer participation, Pool governance and monitoring, and links to risk reduction.

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1. Reinsurance Pool Coverage

Consultation Paper questions:

1. *How should 'cyclone' and 'cyclone-related flooding' be defined for the purposes of defining the reinsurance pool's coverage?*
2. *Should storm surge be covered by the pool and included in a definition of 'cyclone-related flooding'?*
3. *Is it desirable for the use of standard definitions of 'cyclone' and 'cyclone-related flooding' to be required in policies covered by the pool?*

Defining cyclone and cyclone-related flooding

The first trigger for a potential Pool event should be a cyclone as currently defined by the Bureau of Meteorology (**BOM**) and used to initiate the naming of a cyclone. That definition should be set out in regulations to provide certainty but which can easily be updated should technical changes to the definition be required. The Pool should be triggered by a BOM declaration based on this regulated definition (rather than the BOM declaring a Named Cyclone) because it is important for certainty that the Pool be triggered independently by a known, predictable criteria as to whether a low-pressure weather system should be deemed a Cyclone for the purpose of triggering the Pool. It is also important that the technical definition to be used by the Pool remains constant for the period of reinsurance (despite any definition change by the BOM) because the definition regulated at any point in time would be the one used to define the scope of events that insurers would seek to have carved out of their private market natural catastrophe reinsurance treaties. Otherwise, there is the potential for gaps and/or overlaps to be created in insurers' overall reinsurance arrangements.

There is no need to define cyclone-related flooding because the Pool should cover all insured losses arising from a triggered cyclone event, whether caused by wind, rain, water inundation from any source (eg flash flooding, rainwater run-off, riverine flooding, storm surge), lightning strike, hail, impact (eg falling trees etc) that occurs during a defined loss period (eg a seven-day period chosen by the insurer – see below).

Industry loss threshold trigger

Whether the Pool is triggered should also be subject to claims from a cyclone exceeding a total industry loss threshold, say, $100M. To not have such a threshold trigger would see the Pool responding to small events where the losses fall well below the current natural catastrophe reinsurance retention of any participating insurers. Insurers, therefore, should also nominate a level of retention, below which they do not wish to call on the Pool. As insurers would take responsibility for the losses below that amount, the premium charged by the Pool would reflect an insurer's level of retention.

To not have an industry loss trigger with an insurer retention would effectively force insurers to purchase reinsurance they do not want, which would conflict with their assessment of their most efficient use of capital. The industry event size threshold figure would need to be modelled to arrive at a figure that provided for the most efficient use of insurers' and the Pool's capital. Insurers' current natural catastrophe retention levels indicate the event size they have determined that their capital management objectives are best met without recourse to reinsurance. This generally arises because, for smaller events, at a certain point, the cost of reinsurance cover for a dollar of loss becomes equal to what it would cost for the insurer to pay that loss itself. When their retention level gets to this point, insurers refer to the purchase of reinsurance as a 'dollar swapping' exercise that provides no benefit to the insurer.

Losses captured by the Pool

When the Pool is triggered, it should provide cover in respect of an insurer's losses that occur in a 168 hour (7 day) period chosen by the insurer, which is an industry norm. Alignment with industry practice in this regard would also provide consistency with the cover available to it if the Pool decided to buy retrocession from the private market.

Allianz agrees that storm surge should be covered by the Pool. As suggested above - that all damage arising from a cyclone be covered - there is no need to define particular causes of damage like cyclone-related flooding. For example, property insurance policies generally do not mention the word 'cyclone', with the resulting damage captured by reference to things like wind, storm, flash flooding etc.

As there is no need to define 'cyclone', there is equally no need to define 'cyclone-related flood'. Defining cyclone-related flood for the purposes of Pool coverage could lead to the need for an insurer to include a similar definition in its policies. However, apart from this being a breach of the current statutory standard definition of flood, it would also create a complexity in policy wordings that would be difficult for most retail customers to understand. Flood, however caused, depending on the policy type is currently covered, excluded or optional based on the standard definition of flood in the *Insurance Contracts Act 1984*. The same cover choice applies to storm surge, which is currently covered, excluded or optional depending on policy type. There would, however, be value in developing a standard definition of storm surge, similar to that which exists for flood. This would provide certainty and consistency for insurers in relation to the reinsurance coverage provided by the Pool, and certainty for the Pool in terms of its exposure.

2. Classes of Insurance Covered by the Pool

Consultation Paper questions:

4. *Are there any difficulties which may arise from including home building, home contents, or residential strata policies in the reinsurance pool and how should the scope of this coverage be clarified?*
5. *Are insurers able to separately price or estimate the value of the property component of business insurance packages?*
6. *Are insurers able to separately price or estimate the value of the residential and small business components of mixed-use strata title policies?*
7. *Are there any difficulties which may arise from including mixed-use strata title policies in the reinsurance pool and how should the scope of this coverage be clarified?*
8. *How should 'small business' be defined for the purposes of eligibility?*
9. *Are there any difficulties which may arise from including small business property insurance policies in the reinsurance pool and how should the scope of this coverage be clarified?*

Household property and strata policies

Capturing home building and contents insurance policies within the scope of the Pool is expected to be straightforward. There are existing longstanding and well understood legislative definitions of home building and home contents, which can be used to define the scope of the Pool's coverage[1]. In addition to residential strata policies, Allianz's view is that

[1] There are broadly comparable definitions of "home building" and "home contents" in the Corporations Act 2001 (Regulations 7.1.12 and 7.1.13) and Insurance Contracts Act 1984 (Regulation 4).

the Pool should also clearly capture landlord policies. We note that the existing legislative definitions of home building is sufficiently broad to capture both residential strata and investment properties.

The only potential complexity lies in mixed-use strata properties, where the building is partially used for commercial purposes and partially used for residential purposes. It is common for industry underwriting guidelines to define residential strata to include mixed-use buildings where less than 20 percent of the building is used for commercial purposes. This practice is consistent with the definition of what constitutes a “mainly residential building” under the *Terrorism Reinsurance Regulations 2003*. It would be important for the Pool to have definitional certainty, and Allianz would be supportive of building on these existing practices in relation to mixed-use properties.

We note that once a mixed-use strata building is within scope of the Pool (i.e. because the building is mainly used for residential purposes however defined), the whole policy including the commercial components will need to be captured by the Pool. In response to the question posed in the Consultation Paper, insurers are not able to separately price the value of residential/small business components from commercial components in mixed used strata policies. It is also not possible to reliably split components of strata claims into specific lots; for example, if a shared wall, floor or ceiling is damaged that separated a commercial lot from a residential lot or common property (landscaping).

Small business property policies

Allianz is supportive of the intent for small business property policies, including cover for loss or damage to the equipment, stock, inventory or premises of a small business, to be able to benefit from the Pool.

As noted in the Consultation Paper, there are currently many legislative definitions of small business in use. All of these definitions contain various degrees of complexity, which should be avoided in the design of the Pool. Ideally, it should be practically simple for an insurer to determine whether a small business policy is within scope of the Pool at the time the policy is being written, rather than being determined post loss.

Allianz’s view is that definitions of small business requiring the input of a business’ turnover and/or employee count are complex, and creates challenges for insurers being able to determine whether a policy is in or out at inception. All of the existing legislative definitions use one or both of these inputs to distinguish between small and large businesses[2]. Rather than a turnover or employee count, consideration should be given to whether the sum insured amount provides a better indication of a business’ size. The sum insured for a small business policy (including cover for property, equipment and stock) can be readily ascertained at the time the policy is being written and avoids the need to verify information about turnover or employee numbers supplied by the business.

In relation to the types of cover within small business policies which should be within scope, in addition to cover for property, equipment and stock, consideration should be given to also extending the Pool to cover for business interruption. Business interruption cover typically only responds when there is a property loss. Excluding business interruption claims arising from covered property loss will result in the Pool only partially responding to losses arising for small business customers. It is also not generally possible to obtain standalone reinsurance for business interruption. In practice, most small businesses do not purchase business interruption cover, so the financial impact of including business interruption cover would not be significant.

[2] Including the Insurance Contracts Act 1984, Corporations Act 2001 and ASIC Act 2001.

The Consultation Paper queries whether insurers are able to separately price or estimate the value of the property component of business insurance packages. Allianz confirms that the property component of cover can be easily separated from a pricing perspective to other covers where there is no intention for the Pool to cover, such as liability.

Drawing on the existing definition of small business used by the Australian Financial Complaints Authority (**AFCA**) and using the sum insured as an indication of size, Allianz provides the following example of what a definition of small business could look like.

> ***Small business policy*** *means a* ***small business insurance product*** *with a maximum sum insured of $15 million.*
>
> *Small business insurance product means:*
>
> *a policy or part of a policy that provides insurance cover (whether or not the cover is limited or restricted in any way) in respect of one of more of the following:*
>
> *(i) General property (excluding motor vehicles, boats);*
> *(ii) Stock*
> *(iii) Loss of Profits/Business Interruption;*
> *(iv) Glass; and*
> *(v) Money;*
>
> *but excluding cover in relation to any of the following:*
>
> *(vi) Contractors All Risks;*
> *(vii) Fidelity Guarantee;*
> *(viii) Legal Liability (including Public Liability and Products Liability);*
> *(ix) Professional Indemnity; and*
> *(x) Industrial Special Risks.*

3. Reinsurance Product Design and Insurer Participation

Consultation Paper questions:

10. *What is the current approach used by insurers to assess and measure cyclone, storm surge, and related flood damage risks, to what extent are individual policy level data available, and how are cyclone related risk premiums calculated in insurer pricing models?*
11. *How should the reinsurance pool design a risk rating system for cyclone and related flood damage risks, and what are the trade-offs associated with using risk tiering and with the level of granularity used?*
12. *How much risk exposure should primary insurers retain?*
13. *Would implementing a reinsurance pool have any effect on the claims management process, and how could this be addressed in the reinsurance pool's design?*
14. *What is the appropriate level of participation in the pool, and how should considerations of coverage and the amount of risk to be ceded be addressed?*
15. *How should industry transition be managed and what is the best format and timeframe for it to take place?*

The Pool should use a pricing mechanism to ensure that the Pool's capacity is focussed in the areas of most need from an affordability perspective in relation to impact of cyclone risk on property insurance premiums. Otherwise, its capacity would be less effectively used in areas where there is no property insurance affordability problem driven by cyclone risk, for example, areas south of northern Australia where the cyclone risk is low but the concentration risk is high (eg SE Qld).

This could be achieved by the Pool charging insurers a minimum premium based on a percentage of the property's sum insured. For example, at a rate of 0.1% of sum insured, the minimum reinsurance premium for a home building policy with a sum insured of $300K would be $300. Insurers could decide which properties they wanted to cede to the Pool based on the comparative price they effectively paid private reinsurers in respect of those properties. Under this approach, properties would not be ceded to the Pool where private market reinsurance for cyclone and cyclone-related flood was cheaper. As a result, insurers would not cede properties that were so far south that private market reinsurance was cheaper than that available from the Pool. This would also negate the need for the coverage of the Pool to be defined on geographical criteria such as latitude or postcode.

Under this suggested approach, there is a potential for anti-selection against the Pool. There are a few ways in which this could be addressed, including for example by requiring insurers to cede every risk in a portfolio (eg householders, small business) which lies north of the most southerly property which they wish to cede to the Pool.

To align with the non-linear relationship between claims costs and sums insured witnessed by insurers, the minimum reinsurance premium rate should decrease as the property sum insured increases. A simplified example of this is set out below.

Sum insured	**Reinsurance premium rate**	**Minimum reinsurance premium**
$300K	0.1%	$300
$600K	0.75%	$450
$3M	0.0332%	$1000

Modelling would be needed to arrive at an appropriate 'curve' for the relationship between the minimum premium and the sum insured in order to achieve the desired coverage in terms of the areas and/or policyholders where the Pool's capacity is best directed to maximise the amount of premium relief delivered to address affordability pressures. The shape of the curve could also be designed to achieve other objectives, for example, equity in relation to the coverage of very expensive homes.

The premium charged to an insurer wishing to access the Pool should be priced on a portfolio basis based on a combination of a top down and bottom up premium amount. The bottom up amount would be the total of all the minimum property level premiums arising out of the methodology proposed above. The top down premium amount would be the gap between the bottom up amount and the total amount of premium the Pool needs to collect from the insurer in question, based on the risk exposure it brings to the Pool. The total insurer premium would be the amount that that insurer needs to contribute to the Pool in order for the Pool to collect the total annual industry premium it needs to meet its premium revenue target, whether this is based on the Pool being revenue neutral to the government over the long-term, or some other target that more effectively addresses the problem of property insurance affordability in many areas of Northern Australia.

Given the way insurers currently price at the property level, any reinsurance cost saving from accessing the Pool would mean that higher risk properties would receive a higher premium discount than lower risk properties, particularly in areas where concentration risk also exists, that is, areas of high urban density (eg Cairns, Townsville, Mackay). It is not necessary, therefore, for the Pool to design a sophisticated property level risk rating system for the purpose of setting the reinsurance premium it offers to insurers. A basic system is required for the purpose of assessing risk exposure.

No changes to the management of claims is required as a result of the establishment of the Pool. Insurers would manage claims in the same way they do currently, the only difference after the establishment of the Pool being that their reinsurance for the relevant perils would be purchased from a different reinsurer.

4. Reinsurance Pool Governance and Monitoring

Consultation Paper questions:

16. *What should be the key goals for a regular review of the reinsurance pool and what would be the optimal timeframe?*
17. *Should the reinsurance pool have a planned exit date?*
18. *Which mechanisms will ensure the pass-through of reinsurance premium savings to insurance policyholders?*

Pool review and lifespan

Consistent with the Australian Reinsurance Pool Corporation's (**ARPC**) existing review arrangements for the terrorism pool, Allianz considers a triennial review timetable to be appropriate. Within the terms of reference for each review should be a consideration of the effectiveness of the Pool in reducing premiums and other objectives, including links to mitigation activities. This analysis is critical in considering any exit arrangements for the Pool. Allianz suggests that an exit date for the Pool is not determined at the outset, but a question that is considered in light of the outcomes of each triennial review.

Monitoring of premium savings

Allianz recognises the importance of robust price monitoring to give the Government sufficient comfort that the savings in reinsurance costs generated by the Pool are being passed through to customers. In determining how price monitoring will be conducted, consideration should be given to utilising existing data and governance arrangements to enable the Government to undertake price monitoring at least cost. A burdensome price monitoring mechanism will increase the administrative costs of maintaining the Pool, reducing the potential cost savings to end consumers and potentially disincentivising insurers from participating in the Pool. Given the critical role that the ARPC will play in administering the Pool, Allianz submits that it will be most efficient for the ARPC to undertake the required price monitoring.

Consideration should be given to using existing databases to draw insights on changes to premiums over time. For example, the Australian Securities and Investments Commission (**ASIC**) holds current and historical data on home insurance premiums through its administration of the North Queensland Home Insurance Comparison Website. While it is likely the scope of the Pool will be broader than the policy data captured by ASIC, the data is likely to be insightful in analysing premium trends over time.

One of the challenges in determining reinsurance savings once the Pool has been established is that insurers will no longer be accessing the private market for risks ceded to the Pool. As such, the amount paid to obtain reinsurance in the private market will no longer serve as a benchmark to measure the cost saving of obtaining reinsurance from the Pool. However going forward, the actual cost of reinsurance in the private market could be assessed by obtaining indicative quotes from private reinsurers to estimate the industry cost saving from participation in the Pool.

Allianz considers that transparency is better achieved through appropriate price monitoring as opposed to imposing consumer-facing disclosure requirements. Over the past few years, in consultation with ASIC, the industry has conducted comprehensive consumer research on aspects of disclosure that is effective and ineffective for consumers. Overwhelmingly, the evidence suggests that information is only useful to consumers if they can use it to inform decision-making. Requiring insurers to disclose reinsurance costs is unlikely to be meaningful to consumers, as it is not information they can use to make decisions on whether a policy is appropriate for them or to help them compare different policies.

5. Links to Risk Reduction

Consultation Paper questions:

19. *To what extent do insurers price in discounts into insurance premiums for mitigation action undertaken by or affecting policyholders?*
20. *How might mitigation be encouraged by the reinsurance pool's design?*
21. *How should the pool's design seek to discourage any increase in risky behaviour?*

Insurers currently use building age as the key factor in risk models to assess and price cyclone risk. More contemporary buildings attract a lower risk rating due to the requirements to build to standards that are more resilient to cyclone and wind damage. It is more difficult to price in discounts to reflect mitigation action to reduce cyclone risk because of the multitude of property-specific characteristics which could have an impact on the effectiveness of the mitigation action taken. This is different to flood risk, where raising the floor height is generally effective in mitigating against flood risk.

For this reason, Allianz believes that the Pool can and should play a significant role in encouraging mitigation and resilience by capturing quality data on the effectiveness of mitigation actions on reducing the impact of cyclone and flood risk. Property risk data is currently held individually by insurers, but the Pool could capture data on a more comprehensive pool of addresses which insurers can use to support more accurate risk-based pricing reflecting individual property level mitigation activities.

Allianz is of the view that individual households should not be penalised for new builds in high risk areas (eg by excluding them from the Pool), as long as they meet current building standards. The industry is seeking to work collaboratively with all levels of government to ensure that development decisions are supported by quality data to minimise the exposure of new builds to natural peril risks. However, it would be unfair to penalise households for purchasing new properties which have been built in accordance with development consent processes by excluding participation in the Pool.