Insurance Council of Australia

18 June 2021

Manager
Cyclone Reinsurance Pool Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600
Email: ReinsurancePool@treasury.gov.au

Dear Sir/Madam

REINSURANCE POOL FOR CYCLONES AND RELATED FLOOD DAMAGE

The Insurance Council of Australia (the Insurance Council) appreciates the opportunity to respond to the Consultation Paper on the Reinsurance Pool for Cyclones and Related Flood Damage (the Consultation Paper). The Insurance Council welcomed the Roundtable which the Cyclone Reinsurance Pool Taskforce (the Taskforce) hosted for insurers and the Insurance Council on 4 June (the Roundtable).

Given the complex challenges in designing a reinsurance pool which successfully improves the accessibility and affordability of insurance for households, small businesses, and strata in cyclone prone areas, the Insurance Council and its members are keen to begin working through the issues with the Taskforce and other stakeholders as soon as possible.

The need to work through the issues

The Insurance Council has created a Working Group to specifically focus on design and operation of the Cyclone Reinsurance Pool. Through this dedicated Working Group, we have developed responses to the questions posed in the Consultation Paper and the outcomes reached so far are set out in the Attachment to this submission.

However, as recognised at the Roundtable, several key design issues such as the setting of reinsurance premium rates and the amount of risk to be ceded to the Pool, will be largely dependent on the results from financial modelling options for the Pool's operation. Consequently, for several consultation questions, we've indicated in the Attachment the issues which need to be considered when reaching a decision on the design feature concerned. The Insurance Council looks forward to being able to discuss these matters further with the Taskforce as its thinking develops.

The Insurance Council and its members respect the key features of the intended design set out on page 4 of the Consultation paper and will work with the Taskforce within those parameters. However, focusing on the goal of addressing insurance premium affordability, the industry would urge the Taskforce to keep an open mind on whether it may be necessary to recommend to the Government that it reconsider any particular aspect of the design.

The root cause of the affordability issue is the high level of cyclone risk and the average annual expected costs, of which reinsurance is only a small component to consumers. Looking at the ready availability of capital in the reinsurance market, at this stage it is not certain to insurers how the savings which the Pool is likely to be able to offer on the cost of reinsurance will be achieved without some element of Government subsidy. However, we look forward to obtaining a greater understanding of the Government's thinking on this important issue through the process established by the Government.

Insurance Council of Australia

Insurers are very conscious that Government support for the Pool through the annually restated guarantee of $10 billion must be robust enough to satisfy APRA's requirements in relation to reinsurance counterparties. In consideration of the vertical limits of reinsurance programs purchased by several members with cyclone exposure in northern Australia, the $10 billion may not be sufficient to address access to property insurance and affordability in all cyclone prone regions. Consequently, this will also need to be demonstrated through rigorous modelling of the Pool's operation. Furthermore, the modelling will need to show that the Pool can deliver significant premium reductions while remaining cost neutral to Government over time. Some eligibility criteria with which to assess insurance affordability may be required.

Risk mitigation and resilience

The Insurance Council was heartened by comments made by Taskforce members during the Roundtable which demonstrated that they and the Government were very aware of the need for the Pool not to stifle the risk signals given to policyholders through insurance pricing. While insurers support the Government's intention to ease affordability issues for Australians living in cyclone prone areas, it is crucial that policyholders remain aware of the level of risk they face and are encouraged to take mitigation action to lower that risk. Unless the Pool's settings allow these price signals to continue, ongoing affordability issues due to high cyclone risk will necessitate the continuation of the Pool.

The Pool can play a role in support of risk mitigation and resilience by rewarding resilience through the reinsurance premium benefit, through data and knowledge sharing with other Government bodies responsible for resilience, and through ensuring resilient rebuilding and repairs after cyclone events.

The Insurance Council welcomed the Government's announcement in the recent Budget of $600 million for new disaster preparation and mitigation programs as part of the establishment of the new National Recovery and Resilience Agency (NRRA). In order to maximise the Reinsurance Pool's likelihood of success, the Insurance Council urges the Government ensure a significant portion of this money is directed to measures to significantly reduce risks from cyclone and related flooding in northern Australia.

The Insurance Council also appreciates the recognition in the Consultation Paper of the wider need outside of the Pool's operation for all levels of government to undertake significant risk mitigation programs and strengthen Australia's resilience to natural perils. We are hopeful that awareness of the inter-related factors contributing to affordability issues will give further weight to the recommendation of numerous reviews that the burden of State and Territory taxation of insurance policies be lifted from policyholders.

Please contact [redacted] if you have any questions on the information and views in this submission.

Yours sincerely

Andrew Hall
Executive Director & CEO

Insurance Council of Australia

DESIGN OF CYCLONE REINSURANCE POOL: INSURANCE COUNCIL RESPONSES TO CONSULTATION QUESTIONS

QUESTIONS	INDUSTRY POSITION
Reinsurance pool coverage	
1. How should 'cyclone' and 'cyclone-related flooding' be defined for the purposes of defining the reinsurance pool's coverage?	The legislation establishing the Pool should define cyclone using the BoM definition. This would avoid difficulties if the legislation referred to a separate definition that was subsequently changed. Declaration of a cyclone should rest with an independent third party and the Insurance Council endorses the BoM as the appropriate body to assess a weather system as being a cyclone. 'Hours' clauses, often set at 7 days at the insurer's discretion, are common in reinsurance contracts to limit the damage to be covered from an individual weather event. The appropriate scope of cyclone-related flooding to be covered by the Pool needs to be considered in light of modelling of the Pool's operation. However, a broad definition of cyclone-related flooding would reduce complexity in pricing, facilitate separation of risk from other reinsurance treaties and minimise complexity at time of claim. A longer hours clause could support the declaration of the start of an event by allowing a reasonable period for its natural conclusion. This could reduce the potential for disputes and expensive claims management practices required to differentiate the cause of damage after an event. A definition of cyclone related flood will also enable policyholders, both residential and commercial, not to take cover for flood if they so wish.
2. Should storm surge be covered by the pool and included in a definition of 'cyclone-related flooding'?	Yes, as storm surge is closely related. A definition of storm surge would be required given that not all insurers include it in their cover.
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?	No. While reinsurance treaty definitions need to be clear and often flow through to policy wordings, inclusion of these definitions in an insurance policy may introduce unnecessary complexity and is unlikely to enhance consumer understanding. Some insurers also vary cover in their policies to meet different customer needs
4. Are there any difficulties which may arise from including home building, home contents, or residential strata policies in the	No in-principle issues have been identified at this stage. The Pool should be aware of differences between types of coverage and whether sub-limits on these are within the sum insured or in addition. An example is removal of debris.

reinsurance pool and how should the scope of this coverage be clarified?	Landlord policies should be explicitly included.
5. Are insurers able to separately price or estimate the value of the property component of business insurance packages?	It is possible to estimate the value of the property component of a business insurance package. However, it is noted that there may be difficulties in relation to the definition of small business and unbundling in practice the property from other elements of small business 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?	No, it is not feasible to separately price or estimate the value of residential and small business in mixed use strata policies. Rather than estimate the value of separate components for mixed use strata, it may be preferable to treat policies as either commercial or residential. For example, the ARPC considers buildings as commercial where 20% or more of mixed occupancy is commercial.
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?	Yes, there are difficulties with mixed use strata title properties in separating residential from commercial and separating small business lot owners from large business lot owners. As highlighted in the response to question 6, due to ARPC guidelines for terrorism coverage, buildings are treated as commercial where 20% or more of mixed occupancy is commercial, meaning strata buildings can be majority residential but classed as commercial. To exclude commercial strata in these instances would limit residential lot owners' access to the RI Pool discounts. Excluding commercial strata would also limit access to the discounts for small business lot owners.
8. How should 'small business' be defined for the purposes of eligibility?	Current definitions under the Corporations Act are difficult for insurers to administer because often the definitional characteristics are not collected by insurers for property insurance (e.g. employee numbers or turnover). Secondly, businesses close to the definition boundary may fall into and out of the category during normal business cycles. Rather than focus on the characteristics of the policyholder, having the Pool cover policies designed for small business usage would have the advantage of simplicity. Insurance Council members consider that the Pool should cover business interruption following material damage to the insured property due to the peril (but not to interruption due for example to damaged roads). This is ordinarily considered recoverable as property damage against reinsurance treaties following an event. There is limited appetite for this risk on a stand alone basis which could result in increased cost of business interruption insurance. Insurance Council has been a long term advocate of harmonising the various regulatory definitions of small business and if a definition approach is chosen, would favour adoption of a definition that could be a basis for

	harmonisation. In this regard, the definition in the Corporations Act is used in many solutions but remains problematic as noted above. It should be clear whether farms are to be considered small businesses. It can be difficult to separate out the residence or the business from a farm package policy.
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?	None identified at this stage but see answer to question 5 above.

Reinsurance product design and insurer participation	
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?	The basic methodology is made up of two components: the risk presented by the particular hazard and the risks associated with a specific property. Consequently, there is a base price associated with each hazard which is then modified for characteristics of the specific property. This is then adjusted by the insurer's underwriting considerations such as the type and level of coverage. Insurers have their own view of natural hazards risk developed through their own loss experience of how their products perform , as well as modelling tools available from third party vendors. Individual Insurance Council members may be able to provide further detail in confidence.
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?	This is a crucial but complex question, and Insurance Council members are keen to explore this with the Taskforce as it undertakes modelling of the Pool's operation. Although reducing premiums to improve affordability is the broader intention of the Pool, it is vital that the Pool's risk-rating system still effectively gives policyholders a clear signal of the severity of the cyclone risk they face. Removing price signals may otherwise exacerbate the risk. It has been suggested that there may be advantages in the Pool operating on the basis of transparent and publicly available reinsurance rates. These would be taken up by the insurer if it offered a better premium outcome for the policyholder. The cost of reinsurance would be simply passed through to policyholders in proportion to the amount of risk ceded to the Pool. This would obviate the burden of complex price monitoring.

	The Insurance Council notes that risk pricing is more complicated for wind damage compared to flood because more attention has to be given to the particular characteristics of the specific property. The Pool will need to know at a fine level of granularity the risks that it was taking on. The Pool may need to differentiate between the pricing for cyclone and cyclone-related flood damage. While too much complexity should be avoided, the industry had become increasingly sophisticated in its use of risk pricing and there is a danger that tiering may lead to a less granular approach. It would not be an ideal outcome if a rate structure were too flat to effectively transmit risk signals. This is important as we expect the success of the Pool will be contingent on measures focused on risk reduction. As with the ARPC, any risk-rating tiers should be differentiated by factual, not subjective, information.
12. How much risk exposure should primary insurers retain?	This is another important question that Insurance Council members are keen to explore with the Taskforce. The amount of an individual risk or policy to be ceded to the Pool should not be at the discretion of the ceding party. It would be important for the ARPC to have a view on the nature of the risks it was accepting and an appropriate pricing mechanism. Building on the suggested approach outlined above that the Pool have a published schedule of rates, it is suggested that the Pool should require a set level of cession per risk.
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?	We understand that policyholder claims will continue to be managed by the primary insurer. Therefore, we do not expect the Pool's establishment will, of itself, impact the extensive claims management obligations on insurers. As different insurers offer their own levels of cover and may settle claims to different rules, the Pool will either need to consider whether these differences are addressed through pricing or through standardisation . Claims handling costs related to claims recoverable from the Pool should also be recoverable from the Pool. It is suggested that the same cash call clauses as in current arrangements need to be provided by the Pool in order to avoid cash flow problems. It is also suggested that there should be a fixed methodology for allocation of claims processing costs (e.g. 5%).
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?	As with questions 11 and 12, the answers to the issues raised in this question need to be determined in light of the modelling of the Pool's expected operation.
15. How should industry transition be managed and what is the best	As has been widely acknowledged, there are a range of practical challenges in establishing the Pool and having it fully operational to provide reinsurance from 1 July 2022. In addition, insurers are keen to ensure a smooth transition with sufficient time to facilitate appropriate consumer disclosures, staff training, systems

Insurance Council of Australia

format and timeframe for it to take place?	implementation and other required steps. Transition will be relatively easier if the Pool operates as an additional reinsurer that insurers can utilise or not. Consistent with many other transitional provisions following legislative change, Insurance Council members suggest twelve months after passage of legislation is preferable. This takes account of essential implementation steps such as systems changes and policy document revision and the practice of sending policy renewals six weeks in advance. Given the above, it is realistic to expect that insurers may only be able to utilise the Pool some time after it becomes operational. At this stage, it is unclear how the Pool arrangement will interact with insurers' reinsurance programs. Transition issues may be clearer after further design of the Pool. However, a transitional period will also need to allow time for changes to programs to be worked through.

Reinsurance pool governance and monitoring	
16. What should be the key goals for a regular review of the reinsurance pool and what would be the optimal timeframe?	Insurance Council members suggest that Government may be best placed to identify the metrics for reviewing the Pool and its progress against the Government's goal of improving the accessibility and affordability of insurance for households and small businesses in cyclone prone areas. However, it would be important for the review to consider progress and effectiveness of mitigation actions, particularly if the Pool is designed to incentivize such action. Three yearly reviews as required for the Terrorism Reinsurance Pool would seem appropriate.
17. Should the reinsurance pool have a planned exit date?	Members commonly considered that an end date should be set in order to focus attention on the need to achieve a permanent reduction in the risk of cyclone related damage. The date set should be tied to an assessment of the time needed for meaningful progress in mitigation and risk reduction. There was another view however, that no end date should be set. Termination of the Pool under this approach would be contingent upon the outcome of a review of the Pool's efficacy in achieving its goal of lowering property insurance premiums in cyclone prone areas. As explained elsewhere in this submission, the lasting success of the Pool will be heavily dependent on the completion of a major program of mitigation works and improved practices to strengthen resilience. Depending on the design of the Pool, there may be benefits in progressively phasing out premium relief in order to prepare policyholders for the end of the scheme.

18. Which mechanisms will ensure the pass-through of reinsurance premium savings to insurance policyholders? For example: 18.1 Explicit price monitoring of insurance premiums? 18.2 Additional requirements to disclose the cost of reinsurance to policyholders? 18.3 Any additional mechanisms that may be appropriate?	<u>Price monitoring</u> Responsibility for monitoring the impact of the Pool's operation on premiums for relevant insurance may be best considered when Pool design is further progressed, given the design will have an impact on the nature of monitoring. It may be that the pass through of lower cost reinsurance is clearly apparent through the design of the Reinsurance Pool. Depending on the nature of monitoring considered appropriate, the function could be undertaken by the ARPC or the ACCC. The latter's recent three yearly review would have given it a good understanding of the complexity of insurance pricing. It will also be important to consider the additional costs associated with price monitoring – Insurance Council members would welcome the opportunity to assist in the development of an effective but minimal cost monitoring process. <u>Disclosure of reinsurance costs to policyholders</u> The Insurance Council supports disclosure of information to policyholders where it helps them understand their risks and their policy coverage. Provision of information should not be required if it cannot be used by the majority of policyholders to improve their decision making. Insurance Council members question whether disclosure of reinsurance costs will aid consumer understanding or whether this will be used as a basis for comparison across insurers. Considerations include: • Whether disclosure would be of the reinsurance cost component for cyclone risk alone? If the Pool charges the same reinsurance premium for equivalent risks, what is the benefit to the policyholder of this disclosure?; • the total reinsurance component? How will that help understand impact of the Pool?; • the cyclone and non-cyclone reinsurance components? Will consumers understand the difference? • Separate cyclone reinsurance components if an insurer requires cyclone reinsurance outside that offered by the Pool? The extent of disclosure requirements will also impact on the implementation time needed by insurers to ensure clarity for consumers.

Links to risk reduction	
19. To what extent do insurers price in discounts into insurance premiums for mitigation action undertaken by or affecting policyholders?	Previous inquiries have recommended that insurers provide discounts for mitigation action; that the pricing of discounts be clear; and policyholders be informed of the range of mitigation measures they may be able to undertake. Insurers have individual approaches to mitigation discounts and Insurance Council members may be able to provide further details in confidence. Insurers must respect the restrictions on providing information which may be considered personal financial advice.
20. How might mitigation be encouraged by the reinsurance	<u>Pool discounts for properties that undertake mitigation</u>

pool's design? For example: 20.1 Should the pool provide discounts for properties that undertake mitigation? 20.2 Should the pool have an explicit mandate to encourage mitigation?	We assume that mitigation undertaken will be factored into the Pool's risk rating of a particular property. Another matter relevant to promoting risk reduction and resilience is the need for the Pool to take account of the rebuild to modern building codes undertaken by an insurer when making good a damaged property. <u>Should the Pool have a specific mandate to encourage mitigation?</u> Our understanding is that the Pool will not be funded to undertake any ancillary roles outside of reinsurance. Even allowing for this, the Pool can play its part through: • Pricing which enables a premium reward to policyholders with appropriate resilient features; • Sharing data and risk information with other appropriate organisations such as the National Recovery and Resilience Agency (NRRA) to assist with mitigation; • Responsible rebuilding of properties after an event. Rebuilding or undertaking major repairs to a property substantially impacted by flood in the same location with the same floor height would be a poor outcome. A well-designed scheme to relocate property owners after an event could be supported by cash settlement and co-ordination with the NRRA. Should the Pool be given a direct mandate to encourage mitigation, then additional funding would need to be provided to enable this. Strong governance around the prioritisation of resilience and mitigation funding would also be necessary to ensure targeting of regions under the greatest affordability pressure.
21. How should the pool's design seek to discourage any increase in risky behaviour? For example: 21.1 Should there be a time-based cut-off to exempt new builds from the pool? 21.2 Should the pool only allow new builds that have been built to adequate standards and in suitable locations?	While all factors need to be considered carefully, a number of Insurance Council members do not favour any time-based restrictions on eligibility of properties for Pool reinsurance. Reasons include: • To do so may discourage property owners from voluntarily rebuilding to required higher standard. • Lower cost reinsurance through the Pool may act as a perverse disincentive if the reduction is greater than differential between insurance premiums on old and new, less risky housing stock. • Administrative inconvenience e.g. there may be situations where the policyholder claims their building is older than it is at the cut-off, how to deal with mitigation e.g. roof upgrades. Through flood and cyclone vulnerability studies undertaken through the Climate Change Action Committee on behalf of members, it is evident that considerable damage has arisen from events over the last decade to buildings constructed since 2000. As modern building codes are not sufficient to reduce the financial loss to property owners and insurers, it does not seem reasonable to exclude modern buildings. To ensure new builds occur in suitable locations to adequate design standards, better co-ordination with the NRRA, the Climate Science Agency and the National Construction Code and the Departments of Land Use and Planning is required. The insurance industry has much to contribute in respect of risk intelligence associated with an insurable bult environment.

	However, the Insurance Council emphasises that inclusion of all dwellings should depend on meaningful mitigation commitments, improved land use planning and an improved National Building Code taking local circumstances into account in implementation. Otherwise, there is a significant risk that buildings would continue to be built in high risk areas perpetuating the underlying problem and need for subsidisation.
22. To encourage further action by states and territories on insurance affordability: 22.1 What settings could be included in the design of the pool? 22.2 Which policy options could be introduced alongside the pool?	<u>Design of the Pool</u> Eligibility for pool coverage could be made dependent on the State/Territory where the property is situated having committed to rigorous building standards, risk sensitive land use planning, and risk mitigation. It is of course also important that local governments apply higher quality planning standards to ensure that no further development is allowed in areas of unacceptable risk. The regular reviews of the Pool's operation could call out where risk rating reflects a State's failure to take appropriate action. <u>Additional Policy Options</u> State Governments, supported by the Commonwealth, should commit to meaningful tax reform as recommended by numerous inquiries. This would require removal of stamp duties from insurance policies in all States and Territories (apart from the ACT) and the ESL in NSW. Apart from being poor public policy to tax a product which works to the community benefit, the premium increases due to taxation exacerbate affordability problems.
Interactions with the ARPC's existing functions	
23. What are the potential interactions between the terrorism reinsurance pool and the new cyclone and related flood reinsurance pool?	While perhaps obvious, the operation of the terrorism and cyclone pools should be kept substantially separate in order to safeguard their financial integrity.

About the Insurance Council of Australia

The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent approximately 95 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).