



Natural Disaster Insurance Review

Inquiry into flood insurance and related matters

Issues Paper

June 2011



Natural Disaster Insurance Review

Inquiry into flood insurance and related matters

June 2011

© Commonwealth of Australia

ISBN 978-0-642-74709-9

Ownership of intellectual property rights in this publication

Unless otherwise noted, copyright (and any other intellectual property rights, if any) in this publication is owned by the Commonwealth of Australia (referred to below as the Commonwealth).

Creative Commons licence

With the exception of the Coat of Arms (see below) this publication is licensed under a Creative Commons [Attribution 3.0 Australia](https://creativecommons.org/licenses/by/3.0/au/) Licence.



Creative Commons Attribution 3.0 Australia Licence is a standard form license agreement that allows you to copy, distribute, transmit and adapt this publication provided that you attribute the work. A summary of the licence terms is available from <http://creativecommons.org/licenses/by/3.0/au/deed.en>. The full licence terms are available from <http://creativecommons.org/licenses/by/3.0/au/legalcode>.

The Commonwealth's preference is that you attribute this publication (and any material sourced from it) using the following wording:

Source: Licensed from the Commonwealth of Australia under a Creative Commons [Attribution 3.0 Australia](https://creativecommons.org/licenses/by/3.0/au/) Licence.

The Commonwealth of Australia does not necessarily endorse the content of this publication.

Use of the Coat of Arms

The terms under which the Coat of Arms can be used are set out on the It's an Honour website.

CONTENTS

- Executive summary IV**
- Addendum to the Executive Summary: Questions contained in the Issues Paper IX**
- Chapter 1. Introduction..... 1**
- Chapter 2. Home insurance cover for flood 5**
- Chapter 3. Identifying the homes with high flood risk..... 13**
- Chapter 4. An insurance system for homes with high flood risk..... 19**
- Chapter 5. Flood cover for contents insurance..... 25**
- Chapter 6. Flood cover for strata title and other residential property..... 27**
- Chapter 7. Flood cover for small business insurance..... 30**
- Chapter 8. Natural disasters other than flood..... 33**
- Chapter 9. Measuring flood risk..... 35**
- Chapter 10. Risk mitigation and insurance 39**
- Chapter 11. Non-insurance of homes: should home insurance be compulsory? 43**
- Chapter 12. Under-insurance of homes 45**
- Chapter 13. Non-insurance and under-insurance of contents..... 49**
- Chapter 14. The role of lending institutions 51**
- Chapter 15. Consumer awareness of risk and insurance 53**
- Chapter 16. Processing of claims..... 58**
- Chapter 17. Resolution of claims disputes..... 60**
- Chapter 18. Funding public infrastructure..... 64**
- Chapter 19. International comparisons..... 69**
- Appendix 1 Terms of Reference 71**
- Appendix 2 Commonwealth Government natural disaster initiatives..... 74**
- Appendix 3 High flood-risk properties — a flood insurance Pool 76**
- Appendix 4 Natural disaster schemes in other countries..... 81**

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.

It was not these extreme weather events themselves that stimulated the Review, for the insurance industry has demonstrated, in these events and others 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.

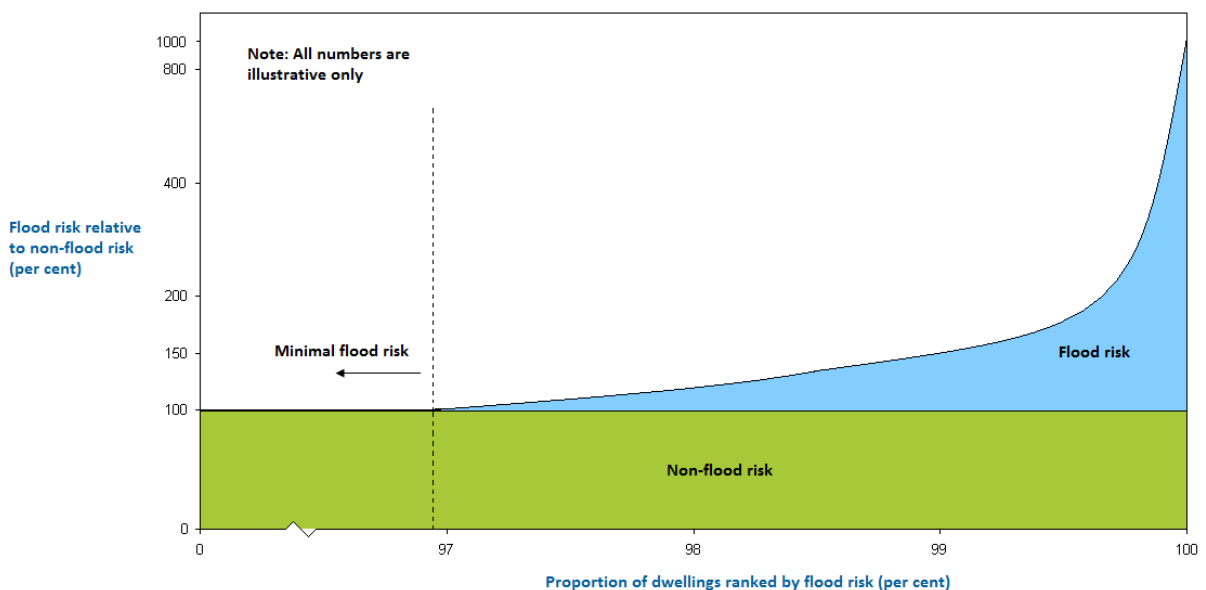
It was the absence of flood insurance for many policyholders, particularly in Brisbane and Ipswich, that was the primary stimulus to the Review.

The fact that all home insurance policies cover storm damage but many do not cover flood, allied with the insurance industry's distinction between the two, which is seen as arcane and confusing by many, has led to a community backlash against insurers and considerable distress, financial loss and disillusionment for many insured homeowners.

The theme of the Review, arising from the flood problem and the full terms of reference of the Review (see Appendix 1), is the availability and affordability of insurance offered by the private insurance market, with particular reference to flood and other natural disasters. This acknowledges that the insurance industry cannot solve the flood insurance problem on its own.

There is a good explanation as to why insurers have difficulty in offering flood cover. It is illustrated by the following figure.

Figure 1: What is the flood insurance problem?



There are probably only about 50,000 homes subject to high flood risk, less than one per cent of Australia's estimated 6.2 million homes, but if their insurance included flood cover, their

premiums would reflect the high risk indicated by the curve on the right of Figure 1. There are probably a further three to six per cent of properties subject to modest flood risk.

In undertaking the Review, the Panel has considered possible new arrangements for flood insurance for homes. It also explores whether any such arrangements ought to be extended to home contents, strata title and other residential properties, and small business.

The Panel has also looked at whether there are any insurance issues related to other natural disasters. They are bushfire, cyclone and earthquake (usually covered as standard in insurance policies) and also actions of the sea and landslide.

Other matters considered by the Review Panel, in the context of availability and affordability, include non-insurance and under-insurance, consumer understanding and dispute resolution, flood risk measurement and mitigation, and some aspects of government funding of natural disaster relief and recovery. The Issues Paper examines all of these matters, explains them in various levels of detail, and poses a set of questions about each of them.

FLOOD INSURANCE FOR HOMES — A WAY FORWARD

The Review Panel has identified two alternative models of flood insurance for the future: that flood cover be provided automatically as part of home insurance, just as it provides cover automatically for bushfire and storm; or that flood cover be provided automatically but that homeowners be able to 'opt out' and have home insurance that includes cover for other causes of damage but not flood. The other main possibility is to retain the status quo whereby insurers remain free to offer full, partial or nil flood cover for home insurance and homeowners are free to decide whether or not to include flood cover in their home insurance policies.

Under the first model, Automatic Flood Cover, all disputes about whether water damage is caused by flood or storm would be eliminated. Flood cover would then be in place at the same level as bushfire and storm cover for every insured home. Some homeowners, however, would face significant increases in insurance premiums under such a model unless these homeowners were given some form of assistance to enable them to continue to insure their homes. Such an arrangement would benefit the homeowners themselves, but the broader community would also benefit from extending flood cover to more homes.

Under the second model, Automatic Flood Cover with Opt Out, the take-up of flood insurance would undoubtedly be greater than under the status quo but would still remain limited. Disputes over whether water damage arose from flood or storm could also still occur for policyholders who opt out of flood cover.

Both models require three steps to give some form of assistance to owners of homes exposed to high flood risk so that their premiums become affordable:

- identifying the homes with high flood risk;
- providing discounts to some or all of these home owners; and
- funding these discounts.

Each of these steps requires careful and extensive consideration.

Distinguishing the homes with high flood risk from those with modest flood risk introduces the idea of a *high-risk threshold*. Two suggestions are put forward:

- an *engineering threshold*: the threshold is determined by flood mapping and related techniques, using for example a 1 in 100 annual return interval and perhaps also taking account of the design and construction of each house.

This approach relies on engineering techniques and the threshold is set independently of the insurance industry.

- a *price threshold*: the threshold is specified as an insurance premium relative to a non-flood insurance premium, for example 140 per cent or 150 per cent of the non-flood premium, and if no insurer is willing to offer a lower premium, the home owner would be eligible for a discounted premium.

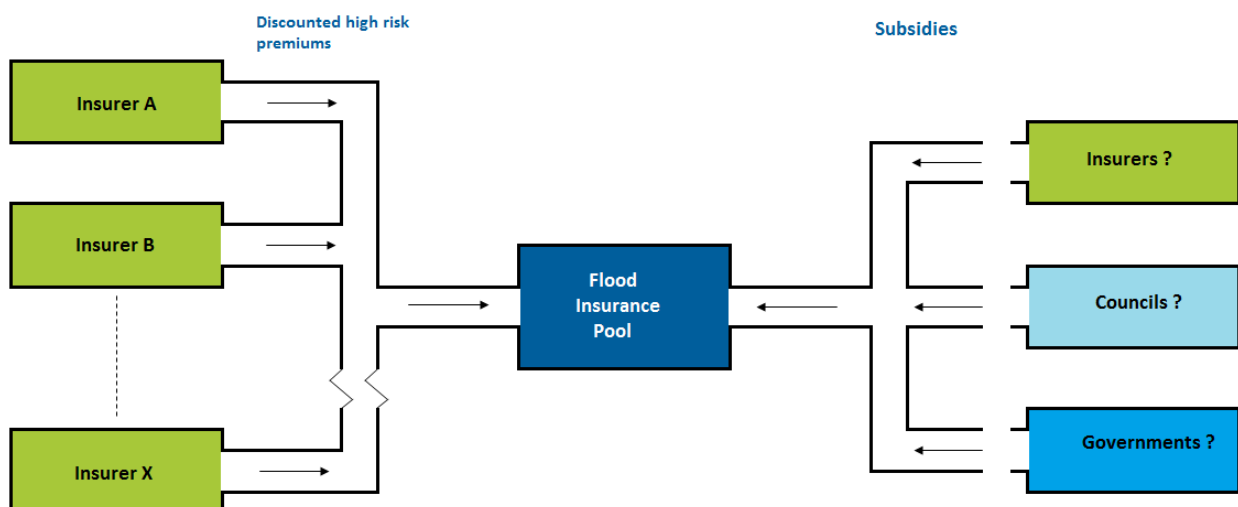
This kind of threshold could be referred to as an *insurance market solution* to the threshold question.

The essential argument for introducing subsidies is firstly the desirability and importance of solving the flood insurance availability and affordability problem, and secondly the benefit that can accrue to the broader community from a wide take-up of flood insurance. Insurance helps both individuals and communities recover from disasters, it encourages mitigation by the homeowner which also benefits the community, and it reduces the impost on charitable donors or taxpayers.

Under both systems, there is of course a need to maintain the integrity of the total system for the high-risk homes, that is, those where the flood risk is beyond the threshold. The key stakeholders (homeowners, insurers, councils and governments) all need to have a vested interest in order to avoid moral hazard and to maintain incentives for good risk management, including flood mitigation. The full details of the threshold mechanism and the associated premium discount and funding arrangements would need to meet the test of system integrity.

To devise a full insurance system for high flood risk homes requires not only a high-risk threshold mechanism but also:

- a *central vehicle* of some kind, referred to in the Paper as the Flood Insurance Pool. It is shown schematically below. The Pool itself could be a form of mutual with insurers as participants, or it could operate as a reinsurer.



- a *pricing regime*: for example the price could be set at say 150 per cent of the non-flood premium (as a flat rate for all homes beyond the threshold) or, on a more risk-oriented

basis, 150 per cent plus say 10 per cent or 20 per cent of the cost of flood cover beyond 150 per cent.

The discount is then the difference between the full risk-based price and the discounted price charged to the homeowner.

Note that the full risk-based price is assessed by the Flood Insurance Pool.

- *eligibility criteria*: which homes with high flood risk are eligible for premium discounts? It can be argued, for example, that future new homes with high flood risk should not be eligible for discounts.
- an *insurance underwriting* regime: for example under an engineering threshold, insurers would be obliged to accept homes beyond the high-risk threshold at the specified discounted price; under a price threshold, if no insurer were willing to offer a premium below the threshold price (of say 150 per cent), insurers would be obliged to accept homes at the specified discounted price.
- a mechanism for *funding* the discounts: there are several ways to deal with the discounted premiums. For example, the flood portion only of the risk could be transferred to the Pool or the whole risk could be transferred, with a suitable premium also transferred to the Pool. It is suggested that, for transfer of flood risk only, the whole flood premium plus 25 per cent of the non-flood premium would go to the Pool or, for transfer of the whole risk, 90 per cent of the whole premium would go to the Pool. The insurer shortfall implicit in the percentages, the 25 per cent and the 10 per cent respectively, are intended as incentives on insurers to accept as many homeowners as possible to their own account rather than cede them to the Flood Insurance Pool.

Another possible approach is for the whole risk to be retained by the insurer, with the insurer receiving a contribution or subsidy from the Pool to meet the cost of the discount.

- a source of *funding* for the discounts: the discounts have to be funded and therefore need to be subsidised by someone. The main possible sources of subsidies are governments, councils and insurers. In these cases, the subsidies would ultimately be met by, respectively, taxpayers, ratepayers or policyholders.

In considering an insurance system for high flood-risk homes, the reader's attention is drawn to the existence of 'residual market' schemes known as Fair Access to Insurance Requirements (FAIR) Plans in many states in the United States. These plans, which cater for various kinds of hard to place and high-risk homes, have a generic similarity to the type of insurance system for homes with high flood risk that is described in this Issues Paper. These plans are a rich source of ideas and experiences around pricing, funding, governance and risk mitigation. The Review Panel will be examining these systems further, including their successes and failures, as part of the next stage of this Review.

OTHER ISSUES

Structuring an insurance system for homes with high flood risk is the key focus of the Review. As is evident from the above, it is an undertaking that involves important and in some respects difficult conceptual, technical and practical matters. Their resolution will take extensive analysis, investigation and debate following release of the Issues Paper.

However, there is a range of related issues that also need to be worked through in order to enhance the role that insurance can play in mitigating the costs of natural disasters. The Issues Paper poses a series of questions around each of them.

These questions are recorded in the addendum to this Executive Summary, for convenience both in understanding the scope of the issues being considered by the Review Panel and in framing submissions in response to this Paper.

SUBMISSIONS

The Review Panel encourages all interested parties to examine the questions posed. Submissions are invited accordingly in response to this Issues Paper

The Natural Disaster Insurance Review Panel

Mr John Trowbridge (Chairman)
Mr John Berrill
Mr Jim Minto

Addendum to the Executive Summary

Questions contained in the Issues Paper

Chapter 2 — Home insurance cover for flood

Are there any other models besides Automatic Flood Cover and Automatic Flood Cover with Opt Out, supported in either case by a high flood-risk discount and funding arrangement, that could materially improve the availability and affordability of flood cover within home insurance policies?

Chapter 3 — Identifying the homes with high flood risk

How practical is the implementation of each of an engineering threshold and a price threshold?

What are the requirements for each to operate successfully?

What are the relative merits of these two approaches?

Are there any other concepts that might be applied to establish a high-risk threshold?

Chapter 4 — A high-risk flood insurance system

If the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model is introduced:

- what premium formulae and premium discounts would be appropriate for homes with high flood risk?
- what are the relative merits of the different possible ways of operating the Flood Insurance Pool in relation to transfer of risks and premiums from insurers to the Pool?

How might the Flood Insurance Pool be structured regarding its legal existence, capital, financial modus operandi and governance?

What resources and what level of access to flood mapping and related information would be needed by the Pool in order to carry out its full pricing responsibilities for the high flood-risk threshold and high flood-risk homes?

In the interests of a competitive market for home insurance with flood cover, how would the Pool need to operate in the field of flood risk measurement to maintain low barriers of entry to smaller insurers?

Which parts of the community (some or all taxpayers, ratepayers or policyholders) should ultimately fund the premium discounts and how should the subsidies be allocated?

What eligibility criteria would be the most equitable and the most effective for owners of high flood-risk homes?

Chapter 5 — Flood cover for contents insurance

If the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model is introduced for home insurance, to what extent should the flood cover in home policies be reflected in contents insurance, for each of owner occupiers and renters?

What practical issues could arise if home insurance policies were required to include Automatic Flood Cover but contents insurance policies were not required to include Automatic Flood Cover?

Chapter 6 — Flood cover for strata title and other residential property

If the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model is introduced for homes:

- How far should these arrangements apply to strata title properties?
- How far should these arrangements apply to company title properties?
- How far should these arrangements apply to mixed use strata properties (residential and commercial)?
- How far should these arrangements apply to retirement villages and aged care facilities?
- How far should these arrangements apply to caravans and mobile homes?

What would be the implications of these arrangements for bodies corporate, their members and insurers?

Chapter 7 — Flood cover for small business insurance

What, if any, are the impediments for the insurance industry in providing flood insurance for small business?

If new arrangements for flood cover for home insurance are introduced, is there a case for introducing similar arrangements for small business? And if not, what could be done to improve the affordability of flood insurance for small business?

What options are there to improve the take-up of flood insurance by small businesses?

Is there a case for any form of regulation or any other government intervention to reduce the current high levels of non-insurance by small business?

Is there a demand for insurers to extend the scope of cover for business interruption insurance? If so, what initiatives could be taken by the insurance industry and the small business community to meet this demand?

If no new arrangements are introduced for small business insurance or the Automatic Flood Cover with Opt Out model is introduced, should there be a standard definition of flood to apply to small business insurance?

Chapter 8 — Natural disasters other than flood

If new arrangements are put in place for flood cover by the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model, is there a case for extending the scope of cover to landslide and actions of the sea?

What, if any, are the impediments to the insurance industry in providing automatic cover for actions of the sea and landslide for home insurance policies?

How might these impediments be overcome?

Chapter 9 — Measuring flood risk

What are the merits of developing a single national standard for flood mapping in Australia?

What, if any, impediments are there in doing so?

Who would be best placed to develop such a standard?

Who should bear responsibility for producing and maintaining relevant flood maps? Who should fund this activity?

To what extent do land use decisions take flood risk into account?

What, if any, are the potential impediments to councils making flood maps publicly available in a way similar to the Brisbane City Council?

To what extent is the lack of consistency and availability of flood maps limiting the insurance industry's ability to offer flood insurance?

To what degree is not having a single source for flood maps an impediment to national consistency, both in terms of how maps are developed and how they are used?

Chapter 10 — Risk mitigation and insurance

How have the building codes that have been developed in response to cyclones affected the underwriting and pricing practices of insurers and reinsurers?

How much weight can be given by insurers to flood mitigation measures in areas subject to flood risk?

To what extent are responses to the recommendations of the Victorian Bushfires Royal Commission expected to reduce bushfire risk in Victoria? How are these responses being reflected by insurers in their pricing of home insurance?

To what extent are insurers able and willing to undertake repair and reconstruction of a home following a natural disaster so that it incorporates enhancements to improve resilience before formal changes to building standards?

To what extent should decisions on these matters require the agreement of the homeowner?

Chapter 11 — Non-insurance of homes: should home insurance be compulsory?

Given the high rates of voluntary take up of home insurance, the historical right not to insure and the significant changes to the legislative framework and administrative infrastructure that would be required, is there nevertheless a case for making home insurance compulsory?

Are the data that suggest four per cent of owner occupiers do not hold home insurance reflective of the overall level of non-insurance of homes across Australia, taking into account other classes of residential property owners such as strata title property owners, investors, and owners of holiday homes?

Chapter 12 — Under-insurance of homes

To what extent would the substitution of replacement cover for sum insured cover eliminate the under-insurance of homes?

To what extent does sum insured cover plus 'top up' address the under-insurance of homes?

What are the relative merits of replacement cover and sum insured cover with a 'top up'?

Whatever form(s) of cover is to be preferred, should insurers be encouraged to offer it or should it be mandated that they offer it?

If under-insurance of homes is to be minimised, should homeowners be able to purchase replacement cover only or sum insured cover with 'top up' only, or either? Or are there other possibilities?

In the event of total loss of a home, is there a case for changing the practices of insurers around cash settlements and other policies on rebuilding?

What arrangements could be put in place to minimise the possibility of disputes if a cash settlement is offered under a replacement cover policy?

What factors should be considered in determining whether homeowners should have the right to reject a cash settlement in favour of their insurer arranging rebuilding or repairing?

Chapter 13 — Non-insurance and under-insurance of contents

To what extent is the level of non-insurance for contents of concern to the community or to governments?

To what extent is the level of under-insurance for contents of concern to the community or to governments?

Should measures to improve affordability of contents insurance be considered?

What measures could be implemented to improve affordability?

If premium discounts are to be offered for homes with high flood risk should they also be offered for contents insurance?

Chapter 14 — The role of lending institutions

What level of responsibility do lending institutions have toward themselves and toward their home mortgage customers for:

- the purchase of insurance;
- the scope of insurance cover, and in particular whether it includes flood cover;
- the quantum of insurance; and
- the continuity of insurance during the life of the mortgage?

Chapter 15 — Consumer awareness of risk and insurance

What measures could improve consumer understanding of their insurance cover, particularly if purchased over the telephone?

How would consumers benefit from being provided with personal advice that takes account of the insurer's assessment of the consumer's risk?

What are the benefits for consumers being provided with scaled advice? What, if any, are the impediments for insurers and insurance brokers providing it?

Is there a particular need for unfair contracts laws to protect policyholders in natural disaster insurance?

Chapter 16 — Processing of Claims

What have been the causes of delays in processing claims other than delays caused by the need to determine whether damage was caused by storm or flood?

In cases of delayed claims processing and settlement:

- how adequate and appropriate is the nature of communication between insured and insurer?
- how adequate are the clarity and frequency of updates from insurers on the progress of the claims?
- should the insurer initiate the communication or should the onus rest with the claimant?

Should there be a time limit for decisions to be made on insurance claims arising from natural disasters? If so, how long should it be and should it be imposed by statute or under a voluntary code of practice?

Chapter 17 — Resolution of claims disputes

Should there be a mandatory time limit for insurers to respond to disputes following a natural disaster and, if so, how long should it be and should it be regulated through the industry Code of Practice or legislated?

Is there a case for improved monitoring and transparency of insurers' internal dispute resolution processes?

What, if any, changes are needed to the responsibilities of insurers and policyholders during the dispute resolution process?

How can policyholders' access to information during the dispute resolution process be improved with regard to reasons for decisions, documents relied upon in decision making and independent legal advice?

What can be done to improve the integrity of insurers' internal dispute resolution processes including full disclosure of any multi-tiered dispute resolution, adequate decision making powers for dispute resolution personnel and structural separation from claims personnel?

Should consumers have access to independent legal advice in rejected insurance claims, particularly in natural disasters? If so, from whom and how should it be funded?

When a claim is not resolved because of a dispute between broker and insurer, what legislative and other steps could be taken to protect the client's interests by obliging broker and insurer to act together in the first instance to resolve the client's claim, and then to embark separately on their own dispute over liability?

Chapter 18 — Funding public infrastructure

Would there be benefits to the States in equity and effectiveness if the NDRRA funding formula were to apply to expenditure gross of reinsurance recoveries rather than net of reinsurance recoveries?

What, if any, are the impediments to this approach?

Chapter 19 — International comparisons

Are there particular lessons to be learned from international schemes, whether featured in Appendix 4 or not, that should be considered in evaluating different models for application in Australia?

Chapter 1. Introduction

- 1.1. Insurance plays a key role in the recovery from natural disaster. It helps people deal with significant financial loss and provides help to rebuild, repair or replace damaged property.
- 1.2. In the wake of the series of recent natural disasters in Australia, the private insurance industry has in large part responded effectively and in line with community expectations. For example, the insurance response to the Hunter storms in 2007, the Black Saturday bushfires in Victoria in 2009, the Perth and Melbourne hailstorms in 2010, and more recently Cyclone Yasi has been commendable.
- 1.3. However, the reaction to the 2011 floods that affected Brisbane and Ipswich, and to a lesser extent the floods in northern Victoria and the storms and floods in Toowoomba and the Lockyer Valley, was different. There has been considerable community backlash against the insurance industry that has highlighted issues with the role and performance of private insurers in assisting the recovery from flood. The Insurance Council of Australia (the Insurance Council) has advised the Review Panel that around 15 per cent of home and contents insurance claims relating to the Brisbane floods have been denied and that the majority of these related to flood exclusions in home insurance policies.¹ The Financial Ombudsman Service has advised that, as at 24 May 2011, the number of insurance disputes referred to it from the Queensland floods was over eight times the number from Cyclone Yasi, despite the fact that significantly fewer insurance claims were made following the floods.²

BACKGROUND TO THE REVIEW

- 1.4. On 4 March 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation announced an independent review into natural disaster insurance in Australia. A copy of the Terms of Reference is at Appendix 1.
- 1.5. Underlying the Terms of Reference is the key theme of this Review, which is the availability and affordability of insurance with particular reference to flood and other natural disasters.
- 1.6. There is a matrix that underpins the Review Panel's consideration of this theme: the natural disasters in Australia; the assets over which insurance is sought for natural disasters; and other attributes of the operation of insurance that have been highlighted by recent natural disasters.
- 1.7. The natural disasters considered are:
 - flood, which is not always included in standard insurance policies;
 - bushfire, cyclone and earthquake, which are generally included in standard insurance policies; and

1 Unpublished data provided to the Review by the Insurance Council.

2 The Financial Ombudsman Service has reported that, as at 24 May 2011, 39 insurance disputes had been referred to it from Cyclone Yasi, 79 from the Victorian floods, and 306 from the Queensland floods.

- other natural disasters, such as landslide and actions of the sea, for which insurance is generally not available.
- 1.8. The assets considered are:
- homes;
 - home contents;
 - strata title and other types of residential properties; and
 - small business.
- 1.9. The other attributes of the insurance market that are considered are:
- non-insurance and under-insurance;
 - the effectiveness and limitations of the insurance market;
 - risk mitigation and flood risk measurement;
 - consumer awareness of the risk of natural disasters and of insurance policies;
 - insurance claims processing and the resolution of claims disputes; and
 - funding public infrastructure assets.
- 1.10. This Issues Paper focuses firstly on the availability and affordability of flood cover for homes. This has emerged as the key insurance problem from the events over the 2010-11 summer. It then considers the availability and affordability of flood cover for contents, strata title properties and small business.
- 1.11. The treatment of other natural disasters, particularly those for which insurance is generally not available (landslide and actions of the sea), is considered next, followed by a range of issues that arise not just during natural disasters but for insurance more generally: issues such as non-insurance and under-insurance, risk mitigation and the responsibilities of consumers and insurers.
- 1.12. The Review has also been asked to 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.

OTHER COMMONWEALTH GOVERNMENT INITIATIVES

- 1.13. This Review is one of a number of Government initiatives in response to the natural disasters that struck Australia over the summer of 2010-11. Examination of the issues and the options being tested in this Issues Paper is consistent with the overall direction of these initiatives, which are aimed at fostering greater individual and community resilience.
- 1.14. An outline of the other Government initiatives is at Appendix 2.

TERMINOLOGY

1.15. For the purposes of clarity in the Issues Paper the Review Panel takes the following terms to mean:

- **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 the localised flooding that can occur as a direct consequence of rainstorms, perhaps of high intensity, that is generally considered by insurers as rainfall run off or flash flooding. It is also distinct from flooding caused by rising coastal waters as a result of a storm event.
- **Home** refers to a detached house or other individual dwelling with a single property title. Other types of residential property include strata title and company title properties, mobile homes and caravans.
- **Homeowner** refers to the person or entity that owns a home, whether as an owner occupier or absentee owner (such as an investor or holiday home owner).

REVIEW PANEL

1.16. The Review Panel is chaired by Mr John Trowbridge, with Mr John Berrill and Mr Jim Minto as panel members. The Panel is assisted by the Australian Government Actuary, Mr Peter Martin.

1.17. The Review Panel is supported by a Secretariat from within the Treasury, with representation from the Australian Reinsurance Pool Corporation and the Australian Prudential Regulation Authority.

CONSULTATION

1.18. As part of the Review's initial investigations, the Review Panel and the Secretariat have met with a range of interested stakeholders. There have been meetings with individual insurers and the Insurance Council, and the Institute of Actuaries of Australia. The Review Panel has also spoken with representatives of consumer organisations and the Financial Ombudsman Service, and has met with the Queensland Floods Commission of Inquiry and the Queensland Reconstruction Authority, which are both dealing directly with the consequences of the recent natural disasters. We have met with the Local Government Association of Queensland, the Brisbane City Council and the Ipswich City Council, and the National Community Titles Institute about strata title properties.

1.19. All have been generous with their time and their information and the Review Panel appreciates their contributions.

SUBMISSIONS

1.20. The Review Panel is now seeking written submissions in response to this Issues Paper. The Issues Paper sets out a number of propositions, questions and options for a way forward. We are keen to hear reactions to these propositions and questions from all interested stakeholders.

- 1.21. The Review Panel may seek to undertake additional consultations following the receipt of submissions.

HOW TO MAKE A SUBMISSION

- 1.22. Submissions may be lodged via email to NDIR@treasury.gov.au or in hard copy form to:

Natural Disaster Insurance Review
C/- The Treasury
Langton Crescent
PARKES ACT 2600

- 1.23. Submissions close on 14 July 2011.

- 1.24. Submissions will be treated as public documents and published on the Natural Disaster Insurance Review website (www.ndir.gov.au) except where individual authors specify that their submissions are to be treated as confidential.

Chapter 2. Home insurance cover for flood

LIMITED FLOOD COVER FOR HOMES IS THE PRIMARY ISSUE

- 2.1. When natural disasters occur, there is often widespread dislocation, disruption and distress across whole communities, even where most financial losses are covered by insurance. Recent examples include Cyclone Yasi, the Victorian bushfires of 2009, the hailstorms in Melbourne and Perth in 2010 and the Christchurch earthquakes. The upheaval is even greater, and in some cases tragically so, when many homeowners do not have insurance.
- 2.2. In the aftermath of the recent floods in Brisbane and Ipswich it became clear that many homes that were damaged were not covered by insurance. Only some insurers offered cover for flood and some of these offered partial cover only. Some individuals had opted not to take flood cover where it was available. Some were unaware that their insurance did not cover flood or only covered it partially.
- 2.3. The absence of flood cover has left many in areas of moderate and high flood risk exposed to potentially heavy financial loss. Furthermore, since many homes are covered for some forms of water damage but not for others, the need for insurers to establish the nature of the water damage in these cases has caused prolonged delays in the resolution of some insurance claims. By contrast, the floods have not raised any concerns about comprehensive motor vehicle insurance because it automatically includes cover for flood.
- 2.4. The absence of flood cover for many homeowners is supported by some preliminary data from the Insurance Council of Australia covering around 90 per cent of the Australian general insurance market.³ These data indicate that, nationally, 54 per cent of all home insurance policies include full flood cover, 8 per cent include flood cover with a sub-limit (i.e. partial cover), and 38 per cent do not include flood cover. Flood insurance cover in Queensland closely tracks these national figures. These data do not indicate the proportion of homes in high flood-risk areas that are covered for flood.
- 2.5. Compared to other natural disasters (such as earthquakes, cyclones, and bushfires), flood presents a unique challenge. Flood usually affects homes located in fairly close proximity to a river or on a flood plain; each time a river floods, it is the same homes that are at risk of being affected. This is not true for other natural disasters; while there are areas predisposed to cyclones, for instance, the individual homes affected are more likely to be different from one event to the next.
- 2.6. Most natural disasters are covered as standard in home insurance policies. As a result, when these natural disasters occur, insured homes will be covered for the event and insurers will accept liability for the costs of damage relatively quickly. There will always be some claims denied, regardless of the cause of damage, for a range of valid reasons. As already noted earlier, however, since flood is excluded from many home insurance policies, floods result in a much larger proportion of denied claims. Also, as many policies will include cover for storm and not flood, there can be delays in insurers assessing claims while they determine whether the damage was caused by storm or flood. As a result, there can be delays before insurers accept liability for the claim. Table 1 demonstrates some of these factors.

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

Table 1: Home and contents claims data for selected natural disasters

Event	Year	Value of claims (\$millions)	Number of claims	Proportion of claims denied (Per cent)	Average time to liability acceptance (days)
Flood					
Brisbane	2010-2011	892	19,779	15.3	28
Regional Queensland	2010-2011	326	11,919	8.4	28
Regional Victoria	2011	75	5,355	4.2	21
Lockyer Valley	2010-2011	161	3,646	2.0	21
Storm					
Victoria	2011	218	34,451	0.2	7
Melbourne	2010	476	68,426	3.3	5
Perth	2010	499	91,191	1.0	5
Cyclone					
Yasi	2011	607	56,878	0.02	7

Source: Unpublished data provided to the Review Panel by the Insurance Council.

Notes: Data are for insurance policies covering home, contents or both. Data cover insurance policies issued by members of the Insurance Council.

- 2.7. Table 1 shows that the proportion of claims denied has been far higher for flood than for other natural disasters in recent events. It also shows that the time taken by insurers to accept liability for damage due to flood has been considerably longer on average than for other natural disasters. In events where the cause of damage was initially unclear but eventually treated by insurers as storm, such as in the Lockyer Valley in early 2011, far fewer claims were denied than in flood events. However, in these events the resolution of claims was still delayed considerably compared to other storm events. For other storm events as well as cyclone the table also illustrates that few claims were denied and claims were resolved relatively quickly.

WHAT IS THE FLOOD INSURANCE PROBLEM?

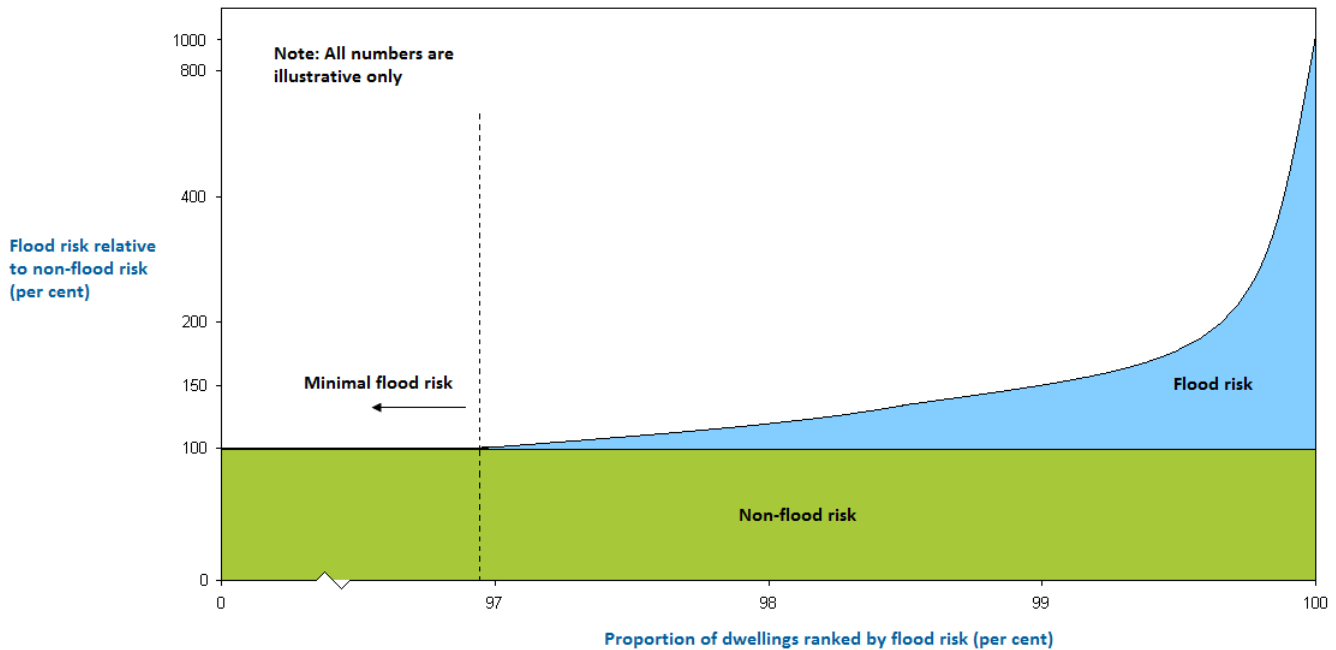
- 2.8. It is estimated that there are around 6.2 million homes⁴ in Australia, of which around 400,000, or 6 per cent, may be exposed to some risk of flood. Of these, around 250,000, or 4 per cent, are at low risk (less than once every 100 years on average), while around 150,000 are exposed to higher risk. Around 50,000, or 1 per cent, may be exposed to very high risk of flood (more than once every 20 years on average).⁵

4 Estimate of the number of separate houses in Australia using unpublished data from 2006 ABS Census of Population and Housing.

5 Proportions are based on a paper by Tim Andrews et al, 'The Insurance of Flood Risk', November 2008, p7. http://www.actuaries.asn.au/Library/GIS08_4a_Paper_Flood%20working%20group_The%20Insurance%20of%20Flood%20Risks%20-%20Flood%20Working%20Party%20-%20Final.pdf.

2.9. Figure 1 illustrates the problem of providing flood insurance by representing schematically the statistics on flood risk.

Figure 1: What is the flood insurance problem?



2.10. This figure makes it clear 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 (those at the far right in Figure 1). Insurance premiums based on these levels of risk will be correspondingly very high.

2.11. For homes exposed to minimal flood risk, the market has been developing over recent years and more insurers are now preparing to extend the availability of flood cover, partly as a result of the stimulus of the recent events in Queensland and Victoria. For homes exposed to a high level of flood risk, however, flood cover availability will always be problematic in a private insurance market, because insurers are likely to attempt to underwrite or price themselves out of this higher-risk business. Hence a competitive market is unlikely to exist.

2.12. The problem is exacerbated by the uncertainties associated with assessing flood risk in the high-risk areas. As a specific example, it might be difficult for insurers to determine realistic assumptions about the future flood mitigation outcomes of the Wivenhoe Dam, and hence a reasonable price for the cost of flood risk in the areas surrounding the Brisbane River. An insurer pricing such homes is almost certainly going to engage in 'defensive pricing': the business will be marginal at best and probably unattractive from an underwriting viewpoint, so the insurer will tend to take, justifiably, a pessimistic view of the risk.

THE COMMUNITY BENEFITS OF WIDER FLOOD INSURANCE COVERAGE FOR HOMES

2.13. As discussed in paragraph 2.3 there are clear costs to homeowners of limited home insurance for flood. They are exposed to potentially heavy financial losses and to disputes with insurers over the cause of the damage to their home that can lead to dislocation and delays in undertaking repairs to or rebuilding their homes.

- 2.14. However, there are also benefits to the community from supporting homeowners to protect themselves from loss through purchasing insurance. If they have insurance they bear some of the cost, through payment of a premium and perhaps an excess when a loss occurs. Having the homeowner bear some of the cost provides a signal about the level of flood risk the individual is facing. This provides an incentive to the homeowner to attempt to manage the risk, for example by undertaking mitigation or considering relocation.
- 2.15. The benefits of mitigation undertaken by a homeowner will also be shared across the broader community. Actions taken by the homeowner can have impacts on neighbours and on community facilities. Mitigation can also limit the non-financial costs of natural disasters, such as those to human life and social infrastructure. These non-financial social costs can be high and are uninsurable.
- 2.16. Having insurance for natural disasters does not reduce the immediate distress for individuals or communities that can be caused by a natural disaster but it can assist the speed and effectiveness with which the community can recover. By helping individuals to repair and rebuild their homes quickly after a natural disaster, insurance can help the community as a whole to recover and allow social and community life to resume.
- 2.17. In the absence of insurance, part or all of the costs of repairing or rebuilding a home after a flood are borne by the broader community. For example, the Queensland Premier's Fund is funded by donations. Under the Fund, homeowners whose homes have been destroyed as a result of the Queensland floods or Cyclone Yasi are eligible to receive up to \$150,000; homeowners whose homes have suffered structural damage are eligible for payments to meet the full costs of repairs, up to a maximum of \$80,000. The greater is the reliance of homeowners on insurance, the less is the reliance on the community through charitable donations. The Commonwealth Government also provides emergency payments to those affected by natural disasters, funded through taxation. The Australian Government Disaster Relief Payment (AGDRP) program administered by Centrelink has made 708,000 payments this year, totalling over \$816 million, and \$81 million has been paid to individuals, families, small businesses, primary producers, charities, and non-profit groups under the Natural Disaster Relief and Recovery Arrangements.⁶
- 2.18. Some homeowners will be aware before purchasing a home that it is in a flood risk area. Some of them have protected themselves financially through insurance and others will be prepared to absorb, from their own resources, the rebuilding and repair costs that will follow a flood. However, others will have purchased a home unaware that it is in a flood risk area. Past planning decisions may not have taken flood risk into account, the flood risk that is factored into planning decisions may not have been accurate or the flood risk may have changed as the result of new road works, drainage systems, etc. These considerations raise questions of fairness as to whether these homeowners alone should bear the costs of flood damage to their homes, including high insurance premiums, or whether the costs should be shared.

INCREASING THE AVAILABILITY OF HOME INSURANCE COVER FOR FLOOD

- 2.19. In view of the above, it is evident that the most important element of this Review is to investigate ways to extend the availability of flood cover and while doing so to

⁶ Queensland Reconstruction Authority, May Monthly Report, May 2011, <http://www.qldreconstruction.org.au/u/lib/QRA-Monthly-Report-May-2011.pdf>.

overcome the affordability problem for flood cover where flood risk is high. The Review Panel has identified three options or models that would each deal with availability to different degrees:

- **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.
- **The Status Quo** – Insurers are free to offer full, partial or nil flood cover in home insurance policies and homeowners are free to insure with or without flood cover.

2.20. In all three cases, affordability could only be catered for if there is some form of price discount offered for homes with high flood risk. This question is examined at some length below and in the next chapter.

2.21. The first model, Automatic Flood Cover, would ensure full availability for all homeowners who purchase insurance and would therefore overcome altogether the problem of disputes over whether water damage was caused by flood or storm.

2.22. The second model, Automatic Flood Cover with Opt Out, would extend availability and, depending on the details, may do so substantially. There would remain, however, some proportion of homeowners without flood cover (by election) and for whom therefore disputes could occur in the future over the cause of water damage (storm or flood).

2.23. The third model, the Status Quo, would likely result in higher flood coverage in the future than in the past, because of initiatives currently being undertaken by some insurers, but would make no fundamental difference to the current situation.

2.24. If we denote the combination of *availability* and *affordability* as representing *access* to flood cover, then Table 1 below summarises the potential outcomes of each of the three models in high flood-risk areas.

Table 2: Availability and affordability

Model	Availability	+	Affordability	=	Access	→	Coverage*
Automatic Flood Cover	Yes		With intervention		With intervention		All
Automatic Flood Cover with Opt Out	Yes		With intervention		With intervention		Many
The Status Quo	Maybe		No		Some		Some

*Among homeowners who purchase insurance.

2.25. Table 2 compares the three models according to their ability to address these criteria and thereby to influence the total level of insurance coverage for flood as measured by the proportion of insured properties that have flood cover (see last column in Table 2).

- 2.26. Only where flood cover is both available and affordable do homeowners have full access to flood cover. While the Automatic Flood Cover and Automatic Flood Cover with Opt Out models would require insurers to offer flood cover, on their own they would not affect affordability, hence the reference in the table to 'intervention', meaning some form of new arrangement to assist these owners with affordability. While addressing affordability under the Opt Out model would ensure access for all homeowners, it would not ensure all homeowners with home insurance had flood cover as some could opt out. Only the Automatic Flood Cover model would ensure all home insurance policyholders are covered for flood.
- 2.27. It is important to note here that *intervention* does not necessarily imply government funding or any other particular form of intervention. It does, however, imply some form of premium discount for some homes subject to high flood risk. This topic is covered in some detail in the next chapter.

Implications

Automatic Flood Cover

- 2.28. Under this model, all homeowners that have home insurance would be automatically covered for flood in the same way as for other perils. Application of the model would eliminate two major failures that have occurred in the 2011 floods in relation to home insurance. One failure is the absence altogether of flood cover for some homeowners (and exacerbated by a definition of flood which is not the same for all insurers) and the other is the inclusion of limited cover only, or 'sub limits', for flood cover (compared with full cover for other forms of water damage). The consequence of these failures, and one which has caused extensive owner and community outrage, is the need in many cases for the insurer to conduct an investigation into whether the water damage was caused by flood or storm. Such investigations can be time consuming and expensive to undertake while also yielding an outcome that is sometimes a matter of opinion. The owners are obliged to wait, in some cases for months, to know whether their insurance policy covers their damage.
- 2.29. Hence under this model the ambiguity that has led to disputes and delays in determining claims would be eliminated, as all policyholders would be covered for all forms of storm and flood damage. It may also generate more confidence in the insurance system and, in doing so, may give improved brand protection to insurers.
- 2.30. Without additional supporting measures, however, this model could cause considerable difficulties for the many insurers who do not offer flood cover, some of whom claim that they cannot satisfactorily price it or underwrite it in areas of material flood risk. Furthermore, risk-priced flood insurance would be very expensive for some homeowners in flood-prone areas, generating an affordability problem and potentially causing some owners to abandon insurance altogether.
- 2.31. In order to avoid such consequences, some further action would be required. Assistance would need to be provided for homes with high flood risk to enable the owners to continue to insure their homes. To do so would require three significant steps:
- identifying the homes with high flood risk;
 - providing discounts to some or all of these homeowners; and
 - funding these discounts.

- 2.32. Any options developed to provide and fund discounts would also need to ensure that homeowners, insurers and governments have the right incentives to mitigate flood risk. These issues are addressed in Chapter 4.

Automatic Flood Cover with Opt Out

- 2.33. Under this model, all owners purchasing home insurance would be obliged either to take flood cover or to decline explicitly to take it. Relative to the status quo, this model would clearly place more responsibility for not having flood cover on those owners who choose to opt out.
- 2.34. To be workable, however, it would need to overcome the same problems as for the Automatic Flood Cover model, being the difficulty for insurers in offering cover on high flood-risk homes and the high prices that some homeowners would be asked to pay.
- 2.35. In order to avoid these issues and maximise flood coverage through addressing affordability, a discount and funding mechanism would be required, in essentially the same way as for the Automatic Flood Cover model.
- 2.36. The two main disadvantages of this Opt Out model compared with the Automatic Flood Cover model are that:
- the take-up of flood cover will remain limited; and
 - disputes over the cause or source of water damage may occur when the homes of owners who have opted out are flooded.
- 2.37. Under this model, each insurer would have to define the flood cover being excluded. The Government is currently considering a standard definition of flood cover would apply to exclusions of cover.

The status quo

- 2.38. The Review Panel's consultations have indicated that, in light of recent events, some insurers that do not currently provide flood cover are preparing to do so. The considerable public backlash against those insurers not providing flood cover and the possible loss of business to those insurers who do not provide such cover offer an incentive for insurers to include flood cover in home insurance policies. Given the increased public awareness of flood risk following recent events, homeowners' take up of flood insurance could also be expected to rise, at least in the short term.
- 2.39. However, the ability of insurers to offer flood insurance for all flood risks depends in part on whether they are willing and able to meet the technical requirements and costs of access to flood mapping and other information necessary to offer the cover. These requirements can be an important barrier to market entry, especially for smaller insurers. As a result, some insurers may choose to continue to provide home insurance that excludes flood cover.
- 2.40. Although it is likely that flood cover will become more readily and more widely available from some insurers in the foreseeable future, the affordability problems that are clearly evident in many of the areas of higher flood risk will continue. Indeed in some respects affordability will be a greater problem because some insurers already offering flood cover have notified of increased prices in some areas, presumably because they now

believe they were under-pricing flood risk previously. The likely consequence is that some homeowners with flood cover today will opt out of the cover at next renewal.

2.41. While both the first and second models have their attractions, they can only be fairly evaluated by considering the types of discounts and funding arrangements that are needed for their successful implementation.

2.42. These matters and the models themselves are explained further in the next two chapters.

Questions:

Are there any other models besides Automatic Flood Cover and Automatic Flood Cover with Opt Out, supported in either case by a high flood-risk discount and funding arrangement, that could materially improve the availability and affordability of flood cover within home insurance policies?

Chapter 3. Identifying the homes with high flood risk

- 3.1. As noted in Chapter 2, any obligation on insurers to offer automatic flood cover, with or without the ability of the homeowner to opt out of the flood cover, leads to questions about the availability and affordability of insurance cover for homes with high flood risk.

Issue:

In high flood-risk areas, market determined insurance premiums that are risk based for cover that includes flood are likely to be at levels that many homeowners will be unwilling or unable to pay. As a result, if flood cover is to be made available to these homeowners on reasonable terms, some form of premium discount will be required.

- 3.2. Paragraph 2.8 gives some estimates of the numbers of homes in Australia that are subject to flood risk. The vast majority of homes (more than 90 per cent) are at no material risk of flood. The remainder can be thought of as being in two categories according to the extra level of flood risk relative to all other risks:
- modest flood risk — perhaps 10 per cent to 40 per cent additional risk; or
 - high flood risk — perhaps 50 per cent or more additional risk, and in some cases a multiple of the non-flood risk.

An affordability framework

The above two categories can be related to a reasonableness criterion by treating:

- *modest* as being insurance premiums with flood cover that all householders can reasonably be expected to pay, with no special funding arrangements or subsidies, and
- *high* as being insurance premiums with flood cover that are likely to be at levels that many homeowners will be unwilling or unable to pay unless some form of discount is available (while recognising that there may be some circumstances where the full cover premium should be payable by the owner).

The Review Panel has considered the concept of affordability by reference to the premiums that homeowners are already paying without flood cover. There is currently a well-functioning insurance market that appears to be delivering reasonable premiums for home insurance without flood cover. There is evidence of a high level of home insurance coverage, implying that such cover is affordable. Therefore, it makes sense to concentrate on reasonable premiums expressed by reference to premiums that exclude flood cover.

Alternative concepts of affordability rely on the ability and willingness of individuals to pay against a benchmark of their income or their assets. On that basis, there would not be a single 'reasonable' full flood cover premium, but a range of premiums taking account of an individual's circumstances including income or assets. In the context of insurance, affordability could also be related to an individual's risk preferences; those who are risk averse may regard a premium as affordable that would be regarded as too high by those with a stronger appetite for risk.

3.3. Insurers cannot be expected to offer insurance cover at prices that do not include the full costs of the risks they underwrite and nor can they apply identifiable cross subsidies in a competitive market (because competitors who do not cross-subsidise will have lower premiums for lower risk homes, all other things being equal). Homeowners, on the other hand, will not usually pay substantial additional premiums for flood cover over and above the premiums they need to pay for all other risks covered by their insurance policies.

3.4. If a system of premium discounts for homes with high flood risk is to be introduced, there are three questions to address:

- *High-risk threshold* – How are the high flood-risk homes to be identified; that is, how do we determine the high-risk threshold or boundary?

To deal with the distinction between homes with a modest flood risk and those with a high flood risk will require some means of identifying or establishing the threshold that divides them.

- *Pricing* – What pricing mechanism might be used to determine discounts for the high flood-risk homes?

Pricing relates to the premiums or the prices that insurers charge and policyholders pay for their insurance.

- *Funding* — What funding mechanism might be used to fund the aggregate discounts for the high flood-risk homes?

Funding relates to the financial mechanisms used to meet the costs of claims.

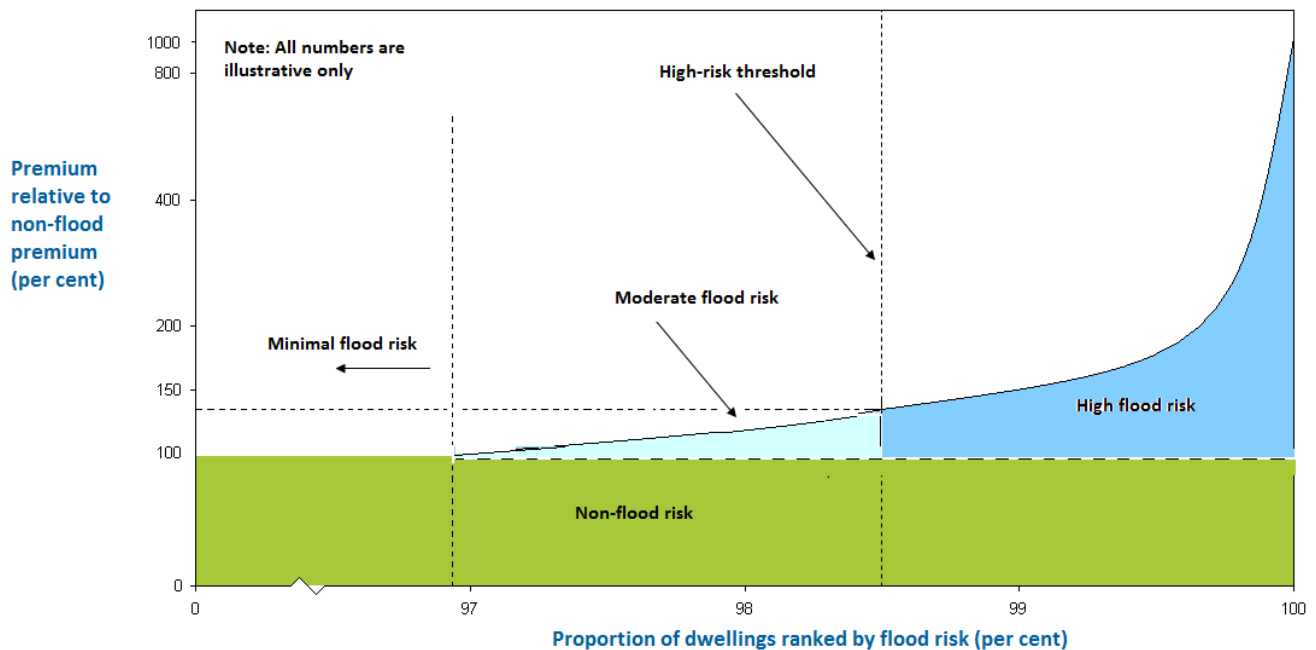
3.5. There is also an important subsidiary question to be considered, namely:

- *Discount eligibility* – Which high flood-risk homes, should be treated as eligible for premium discounts?

There are arguments for treating some categories of high flood-risk homes as eligible for discounts while treating some others as ineligible for discounts.

EXPLORING A HIGH-RISK THRESHOLD

Figure 2: How do we identify the high-risk homes?



- 3.6. Figure 2 illustrates the concept of a high-risk threshold. The light blue section indicates the flood risk below the threshold. The darker blue section indicates homes with high flood risk.
- 3.7. For homes where the flood risk is below the threshold, we assume that the insurance market will function effectively; that is, that flood cover will always be widely available from multiple insurers, and that the normal workings of a competitive market will act to make cover available. The threshold therefore needs to be set at a level where the competitive market is operative and prices are reasonable for homeowners (meaning not so high relative to the non-flood premium as to cause homeowners to go without insurance altogether rather than buying it with flood cover included).
- 3.8. As a result, we are looking for a suitable threshold beyond which there will be premium discounts for some homeowners.
- 3.9. The question is: where is a suitable threshold between homes with modest risk and those with high flood-risk homes? And how should the threshold be determined, by whom, and when and how should it be updated or modified?
- 3.10. The Review Panel has identified two kinds of solutions to this question:
- An engineering solution (*engineering threshold*).

Under this approach, the high-risk threshold is determined by flood mapping and related techniques and is set, for example, at an agreed level for the assessed probability of the occurrence of flood (for example, one in 100 years or one in

50 years estimated average return interval⁷). It could also be designed to take account of the individual characteristics of properties.

The threshold would therefore be set independently of the insurance industry and it would be based on data collection and analysis by hydrologists and related specialists. In its simplest version, it would comprise geographical areas or zones determined by flood mapping techniques.

An extension of this idea would be to apply a flood rating for each property within each flood risk zone. Another threshold would then be needed to distinguish between homes with a low risk of damage during a flood and those with a high flood risk. This second threshold would probably be a compound one that takes account simultaneously of the estimated frequency and severity of water inundation on the one hand and the building design and construction on the other.

- An insurance market solution (*price threshold*).

Under this approach, the high-risk threshold is imposed on the insurance system as a fixed price for full cover, including flood, relative to non-flood cover. Such a threshold might be something like 140 per cent or 150 per cent of the non-flood premium and could be regarded as the maximum reasonable premium that homeowners could be expected to pay without a premium discount.

In this system, if a homeowner were offered a premium by one or more insurers that is below the threshold, the homeowner would buy full cover in the open market but, if there was no insurer willing to offer full cover below the threshold, a discount would be applied. The threshold would therefore be set within a market pricing environment.

- To operate successfully, such a system would need to meet a number of design criteria. An example is outlined in Appendix 3 along with some further explanation of this concept.

3.11. Each approach is built around its own version of flood risk. Under the *engineering threshold*, flood risk is assessed directly by the relevant experts and without reference to insurance company assessments of risk. Under the *price threshold*, flood risk is assessed indirectly by reference to premiums that are established by a suitable *flood risk pricing vehicle*; this idea is explained further in Appendix 3. Note also that a *flood risk pricing vehicle* is relevant to the pricing of all homes insurance in high flood-risk areas under both types of threshold.

3.12. Under both systems, there is of course a need to maintain the integrity of the total system for the high flood-risk homes; that is, those where the flood risk is beyond the threshold. The key stakeholders (homeowners, insurers and councils) all need to have a vested interest ('skin in the game') in order to avoid moral hazard and to maintain incentives for good risk management including flood mitigation.

7 The average recurrence interval for a flood can be defined as the average time period between floods which reach or exceed a given depth.

3.13. If premium discounts are offered for homes with high flood risk, two issues emerge:

- *Moral hazard* can arise through under-charging for flood risk, by removing or even reversing the incentive for homeowners to attempt to mitigate their flood risk. Also councils are inevitably partners in the management of flood risk because of their role in land use and building requirements, so their interest in flood risk mitigation may also be reduced if local homeowners are not required to meet the full costs of flood risk.
- An *equity* issue arises between those who receive discounts and those who do not, and it exists whether the latter group subsidises the discounts or whether a third party, such as government, provides the subsidies.

There will also necessarily be some *intervention* in the private insurance market.

3.14. These problems are well recognised by the Review Panel. The moral hazard issue is discussed below and the equity issue is referred to in Chapter 4 in relation to both eligibility for premium discounts and the funding of the discounts.

3.15. There is, of course, one technique for avoiding the need for a threshold and that is to give some form of discount to every homeowner who has some flood risk. This approach is equivalent, however, to setting the threshold at a very low level and thereby building in discounts for every homeowner that has flood risk. Such an approach would represent, a major market intervention and would not take advantage of the ability of the insurance industry to price and underwrite a high proportion of homes with some flood risk, nor create incentives for action by stakeholders to mitigate their risks.

Questions:

How practical is the implementation of each of an engineering threshold and a price threshold?

What are the requirements for each to operate successfully?

What are the relative merits of these two approaches?

Are there any other concepts that might be applied to establish a high-risk threshold?

Moral hazard and risk management

There are costs in managing and mitigating flood risk and there are additional costs when flooding occurs. The optimal insurance solution for flood cover could be regarded as one where the interests of all parties, that is homeowners, councils and insurers, are aligned. Aligning these interests might mean, for example:

- homeowners paying insurance premiums for flood cover and insurers meeting the costs of claims when a flood event occurs;
- homeowners bearing some cost to carry out prescribed risk mitigation steps (for example, building design and land preparation) in addition to paying insurance premiums;
- councils taking relevant risk mitigation steps (for example, land zoning and use restrictions, watercourse management), along with disaster management plans; and
- data on flood risk being collected, analysed and presented in a manner that would assist all interested parties.

Under current arrangements and current insurance market conditions, those insurers offering the cover do bear costs through claims payments to policyholders if a flood occurs. There is not, however, any related obligation on homeowners or councils to undertake flood risk mitigation: the parties are essentially operating separately, whereby insurers make their own risk assessments in order to set prices, and they may take account of the actions of individual homeowners or councils, but there is no direct connection and no partnership between the parties aimed at both reducing flood risk and having insurers respond to the reductions.

There are of course flood risk mitigation efforts made by some homeowners and some councils, but they are not generally linked with insurer efforts to price and underwrite flood risk and there is certainly no established cycle of the parties working together and responding to the efforts of each other.

The existence of flood or natural disaster insurance schemes in many countries is testimony to the limitations generally of the ability of insurance markets to cover these risks satisfactorily. The flood insurance issues raised in Queensland in January 2011 illustrate this problem in Australia. While acknowledging that the insurance industry has made efforts to deal with flood insurance and has made progress, especially in the last decade, and will clearly make further progress stimulated by recent events, these efforts on their own are unlikely to be able to respond fully to the needs of the community.

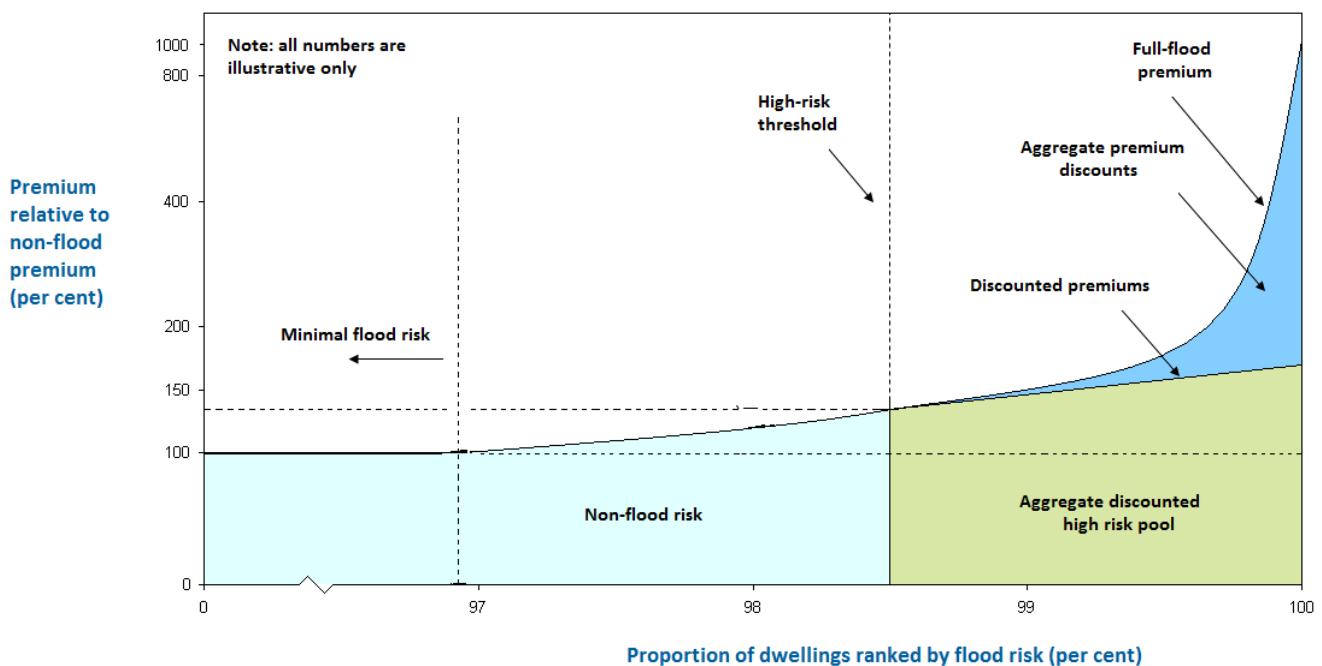
Chapter 4. An insurance system for homes with high flood risk

- 4.1. As noted in Chapter 2, the offering of premium discounts for homes that are subject to high flood risk would require a system for determining the discounted premiums, funding the discounts and managing the high flood-risk threshold.
- 4.2. In order to operate such a system, some form of central vehicle would be needed. For the purpose of this Paper, this vehicle will be called the Flood Insurance Pool. Among other things, this Pool would undertake the role of flood risk pricing.

DISCOUNTS FOR ELIGIBLE HIGH-RISK HOMES

- 4.3. It will be important to decide which homeowners, among those whose homes are subject to high flood risk, would be eligible for discounted premiums. Eligibility is considered later in this chapter.
- 4.4. Separately from eligibility is the question of how to determine the discounts for the homeowners who are eligible.

Figure 3: How do we give discounts to high flood-risk homes?



- 4.5. Figure 3 illustrates the premium discount concept under consideration. The line above the green section represents the discounted or actual premiums charged, while the line above the dark blue section represents the full flood premiums (without discounts).
- 4.6. There are several techniques that could be used to determine discounts or discounted premiums for eligible high-risk homes, under each of the engineering threshold and the price threshold. For example:
 - An *engineering threshold system* might operate along the following lines:

The homeowner is entitled to ask any insurer for full flood cover and the insurer is obliged to offer it, for a discounted premium of either perhaps 150 per cent of the non-flood premium (that is, the same premium for all high-risk homes irrespective of the level of risk) or, as a more risk-oriented approach, 150 per cent plus some amount, perhaps a proportion of 10 or 20 per cent, of the cost of flood cover beyond 150 per cent. These homeowners will therefore receive a discount against the full cover premium.

The pricing basis here, 150 per cent, would need to be a price that is not less than the highest price for full flood cover for homes that are outside the high-risk zone. Whether 150 per cent is the right level would depend on pricing assessments undertaken by the Flood Insurance Pool.

- A *price threshold system* might operate along the following lines:

A threshold is nominated as part of the system. It might be, say, 150 per cent, so that where full flood cover costs 150 per cent or less of the non-flood cover, the insurer retains the full premium and accepts the full risk.

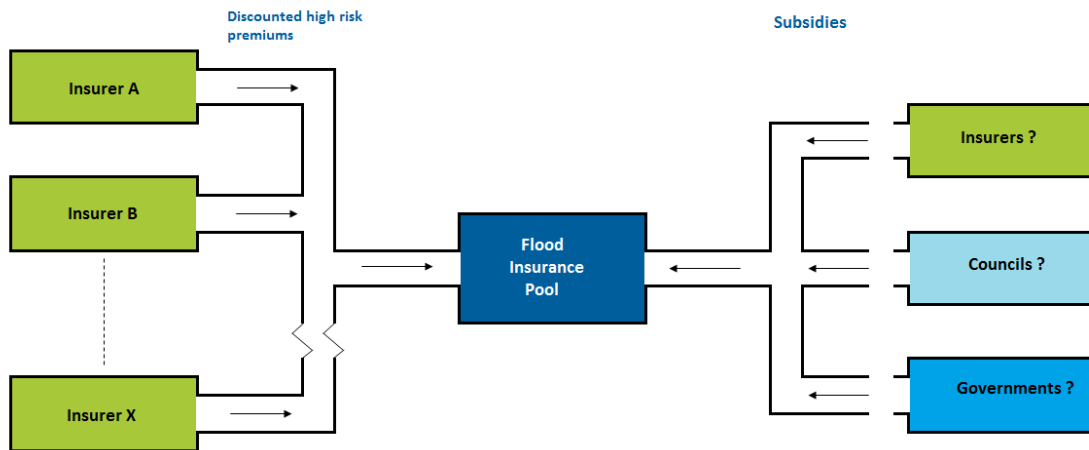
Each homeowner approaches an insurer for a price and, if the price is less than 150 per cent, the homeowner purchases a policy from the insurer in return for full flood cover.

If there is no quote available below 150 per cent, the homeowner is entitled to ask any insurer for full flood cover and the insurer is obliged to offer it for a discounted premium of either, say, 150 per cent (that is, the same premium for all high-risk homes, irrespective of the level of risk) or, as a more risk-oriented approach, 150 per cent plus some proportion, perhaps 10 or 20 per cent, of the cost of flood cover beyond 150 per cent.

FUNDING OF FLOOD DISCOUNTS - HOW IS IT DONE?

- 4.7. It is implicit in a discounted pricing system that insurers would need either to be exempted from meeting flood claims on the high-risk policies and could transfer the risk to the Flood Insurance Pool, or else would receive revenue from elsewhere to make up for the discounts given.
- 4.8. There are numerous ways that the funding of discounts might be arranged. This topic is relatively technical and is elaborated, with some ideas about possible solutions, in Appendix 3. Conceptually it would work as shown schematically in Figure 4.

Figure 4: Funding the discounts



- 4.9. In principle, some portion of the discounted premiums received by individual insurers is passed to the Flood Insurance Pool, and the corresponding risk is also transferred to the Pool. The Pool’s revenue is then supplemented through subsidies to a level that covers the aggregate premium discounts granted through the insurers. The obvious potential sources of the subsidies are one or more of insurers, councils and governments. Ultimately such subsidies would be paid for by others in the community, for example, by all policyholders, all ratepayers or all taxpayers or some combination.
- 4.10. In order to provide discounts to eligible policyholders, the Flood Insurance Pool would need to determine the premiums applicable for insurance with and without flood cover. These premiums would need to be set centrally by the Pool, rather than decided by individual insurers; prices would therefore be common across the industry. This is discussed in more detail in Appendix 3.
- 4.11. In order for the Flood Insurance Pool to determine premiums for high-risk homes, the operator of the Pool would need full access to the relevant flood risk information, which it could then make available to all interested parties, functioning in effect as a national flood risk information repository. The key benefit of this approach is the encouragement of a competitive insurance market for properties below the high-risk threshold by giving all insurers access to the information needed to properly price flood cover according to risk. Barriers to entry, that are currently high due to the large amount of information needed to do so, would be reduced.

FUNDING OF FLOOD DISCOUNTS – WHO PAYS?

- 4.12. The question of the appropriate source of funding will require considerable attention. As discussed in Chapter 3 alternative approaches need to be considered against the issues of moral hazard and equity.
- 4.13. Historically, each time a natural disaster occurs in Australia, the community has risen to the challenge and generously assisted those adversely affected, both physically and financially. Assistance is given through government agencies, volunteers and the not-for-profit sector.
- 4.14. The community could continue providing ad-hoc support to those who incur financial loss when there is a flood or other natural disaster. A key disadvantage of such an approach is the absence of incentives for those at risk of future flooding to take personal responsibility to mitigate those risks.

- 4.15. Moral hazard is addressed by ensuring an alignment between those who bear the costs of damage caused by natural disaster and those who have responsibility for mitigating the risks of damage. Under the current allocation of responsibilities, State governments and councils have the main responsibility for mitigation. Allocating the task of funding to State governments would provide an incentive to mitigate the damage. State governments would be expected to seek to pass on the cost to State taxpayers and so would face an added incentive to undertake mitigation expenditure aimed at reducing future imposts on taxpayers.
- 4.16. If funding was at the council level and based on the proportion of high flood-risk homes in the council area, the imposition of a funding obligation on councils would provide them with an incentive to mitigate their existing flood risks and to minimise the expansion of future flood risks. It would be expected that councils would seek to pass on the cost of the funding to ratepayers. However, this may just shift the high cost of the flood premium on to ratepayers, who are the same property owners to whom premium discounts are being offered. An alternative would be to share the costs of the subsidies across the whole nation's ratepayers, for example by a levy that is the same percentage of council rates for all ratepayers.
- 4.17. It could be considered equitable to spread the cost of the subsidy across as large a population as possible so that the cost borne by each individual participant would be minimised. If the Commonwealth Government bore the cost of the subsidy the cost would ultimately be borne by all taxpayers. Any impost on taxpayers could also be designed to be progressive. Costs passed to ratepayers or State taxpayers could similarly be designed to be progressive. However, any impost at the Commonwealth level may impose a cost on those who do not own a home and that may be regarded as inequitable.
- 4.18. Alternatively, allocating the funding task to insurers would mean the cost would be passed on only to those who have home insurance. A levy could be imposed on insurers according to their market share or the proportion of high flood risks that they insure. Imposing the cost of the subsidy on insurers, and hence on policyholders, would ensure that any scheme was self contained within the insurance industry and that government involvement was limited. However, this approach could have an impact on the operation of the insurance market by increasing premiums for all policyholders, potentially creating an incentive for under-insurance or non-insurance. State-based fire service levies have been shifted from an impost added to insurance premiums to a charge on homeowners in response to concerns about their impact on non-insurance and under-insurance. The extent of disincentive would be driven by the quantum of any increase in premium.

ELIGIBILITY FOR FLOOD DISCOUNTS

- 4.19. Equity in the face of discounts has two elements: who should pay for the discounts and who should receive the discounts?
- 4.20. It is not obvious that every owner of a high flood-risk home should be eligible for a discount. There are several possibilities and eligibility is a subject that should be fully explored if a flood discount system is to be introduced. The Review Panel would expect eligibility rules to be built around the considerations of equity, affordability and risk mitigation incentives.
- 4.21. By way of example, discounts could be:

- temporary (for example, there might be a partial or full phasing out of discounts, perhaps beginning after 5 years and extending for another 10 years) or permanent;
- conditional (for example, on risk mitigation initiatives and on rebuilding standards after a flood) or unconditional;
- applicable to existing properties only, with all new homes receiving no discounts; or
- limited so that higher value homes receive lower discounts than lower value homes.

APPLICATION TO THE AUTOMATIC FLOOD COVER AND AUTOMATIC FLOOD COVER WITH OPT OUT MODELS

- 4.22. A system of discounts and funding is needed to accommodate high flood-risk homes under both of these approaches. The potential arrangements described above could be applied equally to both. The primary difference is that the number of high-risk insurance policies subject to premium discounts is likely to be higher under the Automatic Flood Cover model than under the Automatic Flood Cover with Opt Out model, because there will be homeowners who opt out.

INDICATIVE NUMBERS

- 4.23. In order to illustrate the possible scale of subsidies, the following numbers suggest an order of magnitude, total annual premiums for home insurance are about \$3 billion and the total average annual cost of flood claims for homes with high flood risk is in the order of \$300 million, which is equivalent to about 10 per cent of one year's premiums.
- 4.24. It is important that these numbers be recognised as very approximate, for there are many details to be investigated and resolved before ascertaining whether the aggregate annual subsidy would ultimately emerge as a number higher or lower than \$300 million. The numbers are intended to give nothing more than a general appreciation of the scale of the subsidies that might be needed and will be affected by all the detailed design elements of any model that is adopted.

Questions:

If the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model is introduced:

- what premium formulae and premium discounts would be appropriate for homes with high flood risk?
- what are the relative merits of the different possible ways of operating the Flood Insurance Pool in relation to transfer of risks and premiums from insurers to the Pool?

How might the Flood Insurance Pool be structured regarding its legal existence, capital, financial modus operandi and governance?

What resources and what level of access to flood mapping and related information would be needed by the Pool in order to carry out its full pricing responsibilities for the high flood-risk threshold and high flood-risk homes?

In the interests of a competitive market for home insurance with flood cover, how would the Pool need to operate in the field of flood risk measurement to maintain low barriers of entry to smaller insurers?

Which parts of the community (some or all taxpayers, ratepayers or policyholders) should ultimately fund the premium discounts and how should the subsidies be allocated?

What eligibility criteria would be the most equitable and the most effective for owners of high flood-risk homes?

Chapter 5. Flood cover for contents insurance

- 5.1. Contents, as well as homes, can be damaged by flood. Both homeowners and renters may choose to insure their contents. Like home insurance policies, many contents policies currently do not cover flood.⁸ A number of insurers also offer combined home and contents cover.

Issue:

If new arrangements for flood insurance for homes are introduced, by either an Automatic Flood Cover model or Automatic Flood Cover with Opt Out model, the implications for contents insurance should be considered.

- 5.2. For homes where flood cover is included in the home insurance, under either the Automatic Flood Cover or the Automatic Flood Cover with Opt Out model, but flood cover does not extend to contents insurance, there will be confusion among homeowners and continuing difficulties in assessing whether damage was caused by flood or storm.
- 5.3. Where homeowners' contents are not fully covered by insurance in the event of a flood, it will be more difficult for homeowners to recover, particularly if they have also been involved in disputes and delays in the assessment of claims for damage because of the need to determine whether storm or flood was responsible.
- 5.4. However, the factors that underpin homeowners seeking home insurance do not all apply to contents. Contents generally do not represent as significant an asset as a home. For most people, their home is their largest financial asset so insuring it against loss is a key plank of protecting their financial position. As around one half of homeowners have a mortgage, loss of the asset could also leave them with negative equity or at the extreme they could face bankruptcy. Further, a home provides shelter and stability so its restoration following a natural disaster is a key part of recovery.
- 5.5. Contents do not provide such basic shelter so it may be easier to recover from their loss. Contents can usually be more readily replaced than a home if they are damaged or destroyed. Where there is some warning of an impending disaster, as may be the case for a flood, there is also the ability to mitigate losses by moving some contents away from inundation.
- 5.6. For low income tenants, however, their contents may be the only assets they have. In addition, if they are destroyed by flood it may be very difficult for low income individuals to replace them.

⁸ The Review Panel understands that insurers that currently offer flood cover on homes also offer it on contents. Similarly, insurers that do not cover flood in home policies do not cover flood in contents policies.

Questions:

If the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model is introduced for home insurance, to what extent should the flood cover in home policies be reflected in contents insurance, for each of owner occupiers and renters?

What practical issues could arise if home insurance policies were required to include Automatic Flood Cover but contents insurance policies were not required to include Automatic Flood Cover?

Chapter 6. Flood cover for strata title and other residential property

- 6.1. There are a number of types of properties other than homes that are used as residences, such as strata title and company title properties, caravans, mobile homes, retirement villages and aged care facilities.

Issue:

If new arrangements for flood insurance for homes are introduced, by either an Automatic Flood Cover model or an Automatic Flood Cover with Opt Out model, the implications for strata title and other residential property should also be considered.

- 6.2. A strata title property is a building or collection 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) in which ownership is shared.
- 6.3. Strata title properties comprise a number of scheme types including owners' corporations and community title. Many apartment blocks are strata title properties and there are also lateral housing developments, such as collections of detached homes, townhouses or terrace-style developments that have strata title for each dwelling. Further, there are mixed use developments that comprise both apartments and commercial premises. Each strata title property is managed by a body corporate, owners' corporation, strata company or other similar entity (collectively referred to below as 'bodies corporate'). Strata title is governed by State and Territory legislation which requires bodies corporate to take out insurance for their strata title properties. None of this legislation, however, explicitly require bodies corporate to take out insurance to cover flood damage.
- 6.4. A company title property is a building and land owned by a company registered under the *Corporations Act 2001*. 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 through governance processes where the onus is on the company directors to uphold their fiduciary duties to the shareholders.

STRATA TITLE

- 6.5. The National Community Titles Association has told the Review Panel that approximately 22.5 per cent of households nationally live in properties managed by bodies corporate, owners corporations, etc.⁹ This figure is likely to increase as Australia's population density increases, particularly in metropolitan areas.

9 National Community Titles Institute, Natural Disasters Insurance Review Submission, 2011, p1 <http://172.16.11.130/content/Content.aspx?doc=submissions.htm>.

- 6.6. Industry estimates¹⁰ indicate that around 400 properties managed by bodies corporate were directly affected by the recent Brisbane floods. Very few, if any, had flood insurance which means property damage will need to be covered by the bodies corporate's existing funds or by additional levies on its members. The implications of a lack of flood insurance for members of bodies corporate are therefore the same as for homeowners.
- 6.7. No insurers currently offer flood insurance as a standard inclusion for strata title properties. Should an individual body corporate request flood insurance, the insurer assesses this case by case. As for home insurance, however, strata title insurers provide insurance for all other natural disasters as standard, except actions of the sea. As for home and small business, insurers note that pricing of flood risk strata title properties is currently hampered by a lack of adequate data.
- 6.8. As some strata title properties combine residential and commercial use (that is, mixed use), insurance offerings for these properties combine elements of personal and commercial insurance.
- 6.9. 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-story ones have many of the characteristics of office blocks, with a range of construction features and requirements (stairs, lifts, plumbing, 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.
- 6.10. 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 located below ground (for example damage to electrical rooms and lifts). This risk needs to be factored into insurance premiums.
- 6.11. 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 it is usually recommended and arranged by strata property managers who are essentially being serviced by professional commercial insurers, either directly or through brokers.
- 6.12. There are fewer insurers who provide strata title insurance than home insurance and the two largest insurers have developed considerable specialist expertise in this field. This limited market can lead to limited competition in some areas, for example in far north Queensland, where cyclone risk limits the number of market participants. While strata title insurers provide insurance for cyclone risk as standard, some limit their exposure by not covering geographic areas of high cyclone risk. Further, the significant sums insured for some strata title properties can represent large accumulations of risk for insurers, leading to questions of insurance and reinsurance capacity.

10 National Community Titles Institute, Natural Disasters Insurance Review Submission, 2011, p1 <http://172.16.11.130/content/Content.aspx?doc=submissions.htm>.

CARAVANS, MOBILE HOMES, RETIREMENT VILLAGES AND AGED CARE FACILITIES

- 6.13. There are other types of residential buildings that, like homes, provide the fundamental services of shelter and comfort.
- 6.14. Caravans and mobile homes that are static are able to be covered by home insurance. The Review Panel has heard from a number of insurers of the difficulties involved in pricing flood risk, and indeed other natural disaster risks, for caravans and mobile homes. This is due to their construction, the fact that they are not fixed, the difficulty involved in locating their position on a caravan site, and the fact that many caravan sites are located in high-risk areas (for example, next to the ocean or a river).
- 6.15. Retirement villages and aged care facilities are another class of residential building exposed to the risk of natural disaster. State legislation regulating these facilities typically requires the facility to be insured, but the form of insurance depends on the ownership structure of the facility.¹¹ A number of insurers offer general insurance products tailored to this market. As with strata title properties and commercial properties generally, flood cover is only provided if the facility operator specifically seeks the cover. Many such facilities will not have flood cover.

Questions:

If the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model is introduced for homes:

- How far should these arrangements apply to strata title properties?
- How far should these arrangements apply to company title properties?
- How far should these arrangements apply to mixed use strata properties (residential and commercial)?
- How far should these arrangements apply to retirement villages and aged care facilities?
- How far should these arrangements apply to caravans and mobile homes?

What would be the implications of these arrangements for bodies corporate, their members and insurers?

¹¹ In Queensland, for example, the operator of a retirement village scheme must take out general insurance for the retirement village and residents are required to contribute towards the cost of that insurance. This insurance must cover both accommodation units and communal facilities, except in a freehold arrangement where the insurance of communal facilities is the responsibility of the body corporate and the insurance of accommodation units is the responsibility of the owner (where the building is freestanding) or the body corporate (where the building is not freestanding).

Chapter 7. Flood cover for small business insurance

- 7.1. Businesses purchase insurance products for a number of different reasons. In particular, businesses buy insurance to cover:
 - their public and product liability to others;
 - damage to their property, including stock and motor vehicles; and
 - interruption or disruption to their business caused by a range of events.
- 7.2. Larger businesses generally are able to apply adequate resources and expertise to assess their insurance risk management needs and to purchase insurance, sometimes including dedicated internal staff. Smaller businesses do not usually have this capability and may rely heavily on their insurance brokers for insurance advice.
- 7.3. Many small businesses purchase small business insurance 'packages' rather than separate commercial insurance policies as occurs for larger businesses. This is particularly so for sole traders (for example, many tradesmen, small retailers and small family businesses). Other small businesses, whether because of their scale or the nature of their business, will purchase individual policies designed for their own needs.

Issue:

If new arrangements for flood insurance for homes are introduced, by either an Automatic Flood Cover model or an Automatic Flood Cover with Opt Out model, then alterations to flood cover for small business may also need to be considered. In addition, there are aspects of non-insurance and under-insurance of small business insurance, including business interruption insurance, to be considered.

BUSINESS INSURANCE

- 7.4. Small business property insurance policies insure business owners against loss or damage caused by a range of perils including stormwater, fire, theft and fraud. However, the vast majority of small businesses do not have flood insurance.
- 7.5. There are some key differences between home and small business insurance.
 - The risks faced by small business owners tend to be less homogeneous than the risks faced by homeowners. As a consequence, small business insurance policies tend to be tailored to suit the individual needs of the business, unlike home insurance policies which are much more commoditised. For this reason, it is more likely that small business owners would use a broker to advise them as to the appropriateness of the insurance.
 - It has been argued that small business owners are more price sensitive than homeowners when it comes to purchasing insurance. Small business owners often treat insurance as an expense that needs to be minimised and, as such, they are less likely to purchase additional insurance such as flood insurance where they may perceive the risk of loss to be low.

- The market for small business insurance is more fragmented and the availability of insurance is limited in some areas.
 - Flood insurance for small businesses is rare and, when it is offered, it is usually individually underwritten based on a conscious decision by both the insurer to offer such insurance and the small business to accept. This mostly results in only businesses in low-risk areas obtaining flood insurance.
- 7.6. In the current market, there is limited availability of flood insurance for small businesses, for many of the same reasons that apply for homeowners; that is, the difficulty in adequately assessing and pricing the risk of flood. In addition, the fragmented nature of the small business insurance market results in a diseconomy of scale. When a low level of demand is combined with the high cost of developing a flood insurance offering, there is very little incentive for an insurer to offer flood insurance.
- 7.7. However, if the Automatic Flood Cover model or Automatic Flood Cover with Opt Out model were to be applied to small business, all insurers wishing to remain in the small business market would be obliged to include flood cover in relevant insurance policies. The Review Panel is only aware of one insurer in the current market who offers flood cover as standard on small business policies. Given that few insurers currently provide flood insurance widely, the Automatic Flood Cover model could lead some insurers to reassess their participation in the market.
- 7.8. Any diminution in market participation could reduce competition and push up the cost of insurance for small business.
- 7.9. As noted above, rates of under-insurance and non-insurance are quite high in the small business insurance market in comparison to the home insurance market. As an example, an Insurance Council study conducted in 2008¹² estimated that 26 per cent of all small to medium sized enterprises do not have any form of general insurance. This compares with around four per cent of owner occupiers who we understand do not hold home insurance.¹³ The issue of non-insurance for small businesses is even greater when it comes to flood insurance with only a very small fraction of small business owners taking out flood insurance.
- 7.10. Price sensitivity is a key factor in the level of under-insurance and non-insurance in small business policies. Over 80 per cent of businesses surveyed in the 2008 Insurance Council study that indicated they were inadequately insured cited the cost of insurance as a reason for not purchasing it. Business owners faced with even a modest increase in premiums associated with the introduction of flood insurance may choose to exit the insurance market altogether.
- 7.11. However, a decision by a small business to take out insurance is one of a number of business decisions that are made based on their overall business plans. Indeed the very low level of non-insurance of homes suggests that small business owners opt to insure their homes to a greater extent than their businesses. Many business premises may also be leased.

12 Insurance Council of Australia, 'Non insurance in the small to medium size enterprise sector', December 2008, p1. <http://www.insurancecouncil.com.au/Portals/24/Issues/SME%20Report%20Final%20231208.pdf>.

13 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.

- 7.12. By contrast, homes occupy a central place in the community. They provide basic shelter and for many people it is their main financial asset and a key component of their lifetime financial plans. This brief comparison suggests that it is less important to institute new or special flood arrangements for small business insurance than for home insurance.

BUSINESS INTERRUPTION INSURANCE

- 7.13. Insurance can also cover losses associated with a disruption to business due to a defined event (referred to as business interruption insurance). Information made available to the Review Panel suggests that only around 40 per cent of small businesses have business interruption insurance,¹⁴ and only a small fraction have business interruption insurance that responds to flood.
- 7.14. In events such as floods, business interruption insurance can play an important role. While the damage to the premises or stock may not be significant, disruptions to suppliers, customers or other services can lead to a need to shut down the business or trade in constrained circumstances for a period and may result in significant losses.
- 7.15. Business interruption insurance generally only provides cover for the direct impact on the business such as damage to the premises. For indirect effects, however, such as loss of access to the premises or to customers, or stock supply interruptions, the insurance may not be effective. This can be of particular significance following a natural disaster when business and community dislocation is widespread.
- 7.16. Experience of numerous businesses during and since the Queensland floods have emphasised some of these coverage limitations for business interruption insurance.

Questions:

What, if any, are the impediments for the insurance industry in providing flood insurance for small business?

If new arrangements for flood cover for home insurance are introduced, is there a case for introducing similar arrangements for small business? And if not, what could be done to improve the affordability of flood insurance for small business?

What options are there to improve the take-up of flood insurance by small businesses?

Is there a case for any form of regulation or any other government intervention to reduce the current high levels of non-insurance by small business?

Is there a demand for insurers to extend the scope of cover for business interruption insurance? If so, what initiatives could be taken by the insurance industry and the small business community to meet this demand?

If no new arrangements are introduced for small business insurance or the Automatic Flood Cover with Opt Out model is introduced, should there be a standard definition of flood to apply to small business insurance?

14 Dr Allan Manning, 'Business Interruption Insurance and Claims', August 2008, p1.

Chapter 8. Natural disasters other than flood

- 8.1. There are a number of natural disasters other than flood that have the potential to inflict significant damage on individuals and communities across Australia.

Issue:

Bushfires, cyclones and earthquakes, along with storms, are satisfactorily covered by the private insurance market but landslide and actions of the sea are not usually covered by home insurance policies.

- 8.2. In the current market for home insurance, bushfire, storm, cyclone and earthquake are currently covered as standard. The insurance industry has demonstrated the financial capacity and the willingness to offer this cover. It has also been able to deal successfully with the claims that have arisen in the major natural disasters of recent years (for example the Hunter floods in 2007, the Canberra and Victorian bushfires in 2003 and 2009 respectively, the hailstorms in Melbourne and Perth in 2010, Cyclone Yasi in 2011 and the storms in Toowoomba and the Lockyer Valley in 2011).
- 8.3. Bushfires often lead to total loss insurance claims which can highlight the issue of under-insurance discussed in Chapter 12.
- 8.4. In relation to cyclone, insurance cover is generally available thanks in part to the building standards in cyclone prone areas and the Review Panel is not aware of any affordability problems for home and contents insurance for cyclone cover. New building codes were introduced in 1982 after the earlier experiences of Cyclones Althea and Tracy. Cyclone Larry in 2006 and Cyclone Yasi this year have demonstrated the general effectiveness of improved building standards.
- 8.5. There are, however, some natural perils that are not universally covered. They are landslide and actions of the sea, including tsunami and coastal inundation. (Some insurers cover tsunami and landslide in limited circumstances, for example, if they are the result of an earthquake or other insured event). If one of these events were to occur, the extent to which insurance could play a role in assisting individuals and communities to recover would be limited as the level of insurance would be low or non-existent. A tsunami, for example, would likely highlight similar issues to those that are currently being addressed for flood.

LACK OF AVAILABILITY

- 8.6. In the Australian insurance market, landslide and actions of the sea are similar to flood: historically it has been industry practice to exclude these risks. Flood has received considerable attention, particularly in the last 10 to 15 years, because the absence of flood cover has provoked severe community reaction when flood has occurred. There is not, however, any record of significant property losses due to landslide or actions of the sea, and hence no real demand from homeowners for this type of cover.
- 8.7. It is the Review Panel's understanding that, because of the lack of demand, insurers and reinsurers have paid little attention to these risks. As a result, they have not sought to collect the type of information that would enable them to price these risks.

- 8.8. In view of concerns about future climate change and the potential for sea levels to rise, there has been growing interest in actions of the sea in recent times and more insurers have offered some limited cover for some of these risks.
- 8.9. The question that now arises, in light of the consideration being given to flood insurance, is whether the debate around flood insurance ought to be extended to include landslide and actions of the sea.

AUTOMATIC NATURAL DISASTER INSURANCE

- 8.10. Automatic natural disaster insurance would provide more certainty for home owners in terms of the events for which they are (and are not) covered. We already know that many homeowners do not understand the difference between water damage caused by an overflowing river (flood) and water damage caused by storm. By extension, if there is future water damage that could be caused by actions of the sea, for example an especially high tide, that are excluded from insurance policies, there is the potential for similar confusion and misunderstanding. Automatic natural disaster insurance that includes not only flood but also landslide and actions of the sea would eliminate the need to differentiate between actions of the sea and other forms of water damage.
- 8.11. Automatic natural disaster insurance would also increase the resilience of individuals and communities and their ability to recover from natural disasters. Under the current arrangements, if an event that is not well covered by insurance were to occur (for example, a tsunami or landslide), individuals and communities would be forced to look to sources other than insurance, such as the Government and not-for-profit, for help in recovery.

Questions:

If new arrangements are put in place for flood cover by the Automatic Flood Cover model or the Automatic Flood Cover with Opt Out model, is there a case for extending the scope of cover to landslide and actions of the sea?

What, if any, are the impediments to the insurance industry in providing automatic cover for actions of the sea and landslide for home insurance policies?

How might these impediments be overcome?

Chapter 9. Measuring flood risk

- 9.1. Measuring flood risk has been raised with the Review Panel in a number of contexts: by insurers as necessary input for their ability to assess and price flood risk; by homeowners seeking to assess their flood risk; and by councils as part of their planning and risk management.
- 9.2. Flood risk is a function of the likelihood of a flood occurring and the severity of damage caused by a flood. The likelihood of a flood is measured on a map referred to in Chapter 3 in reference to an engineering threshold. The likelihood of a flood occurring depends on the location of a property, the topography (natural and man-made) and weather systems. The severity of damage depends upon the height of the flood water, the velocity of the flood water, the house design and construction and the materials used in it.

Issue:

The existence, quality, scope and consistency of flood maps around Australia are variable. Consequently, flood maps can differ greatly in terms of resolution, format, reliability and information content, and differ in how they are used. Other relevant information about flood risk such as geocoding of individual properties and relevant construction information such as floor heights are also variable. Not all the information that exists is publicly available.

- 9.3. Measuring flood risk has been problematic in many parts of Australia due to inconsistent flood mapping and land use. Poor land use decisions by councils in the past have resulted in many homes being constructed in flood prone areas. Furthermore, homes are constructed without reference to a flood building code, although such a code is now being considered.
- 9.4. Insurers have been reluctant to provide flood insurance without the data that allows them to price flood risk at a property level.
- 9.5. In most States in Australia, flood mapping is currently the responsibility of councils. In some cases, it has been undertaken with some funding support from Commonwealth and State governments.

FLOOD MAP USERS

- 9.6. There are a number of user groups who could potentially benefit from the use of flood maps. In particular, these groups are:
 - 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 council 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 and pricing;
 - homeowners, renters and business owners: in making decisions around where to live or operate a business;
 - lending Institutions: to assist them to value properties that are subject to mortgage; and
 - public and private organisations providing road and rail infrastructure and other community infrastructure
- 9.7. The full nature of the information needed and the level of detail required by each group would vary to some degree.

CONSISTENCY AND COUNCIL USE OF FLOOD MAPS

- 9.8. The extent of mapping varies widely from State to State. There is also no national standard for flood maps and it is up to each individual council to decide on the level of detail included in each map. As a result of this, the level of consistency of flood maps between councils is limited.
- 9.9. The *Disaster Management Act 2003* requires councils to prepare a disaster management plan, which must provide for events that are likely to happen in an area, as well as strategies and priorities for disaster management. The *Queensland State Planning Policy 1/03 Guidelines* also require councils to, wherever practicable, identify natural hazard management areas through a comprehensive and detailed natural hazard assessment study. For flood, this is to be done by defining the areas at risk of a 1 in 100 year flood. While the implication is that these requirements cannot be met without flood maps or other studies, they are not compulsory.
- 9.10. The Review Panel notes that the Brisbane City Council, the largest council in Australia, has its own internal expertise to update flood maps and it makes its expertise available to other councils.
- 9.11. Mapping is generally undertaken by qualified hydrologists. Mapping is not only a complex science, it is also expensive to develop and maintain. The development of new roads and land developments can change the potential for flooding so maps need to be updated on a regular basis (approximately 5 to 10 years).
- 9.12. Australian Rainfall and Runoff is the current national guideline for determining the underlying flood risk. It was last published in 1987 and this is currently being updated.

AVAILABILITY OF FLOOD MAPS

- 9.13. Flood maps are publicly available to a varying degree. Some councils provide their maps free of charge on a public website while other councils are less forthcoming with their information. Most people only have access to this information when they buy a house. The Brisbane City Council makes flood maps freely available following the recommendations of a Flood Task Force completed in 2005.¹⁵

¹⁵ 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.

- 9.14. The Taskforce noted that the Brisbane City Council should *'endeavour to improve the general levels of flood awareness of Brisbane residents to enable them to better understand flooding issues in general ... and how to prepare and respond to significant rain events'*. The Taskforce proposed to do this by establishing a flood information database that was freely available to all.
- 9.15. The primary motivation for making flood risk information publicly available was that individuals and communities in flood-prone areas have a role to play in flood risk mitigation. It is through the provision of flood risk information that local councils can encourage an active contribution to risk management by individuals and communities that could potentially reduce the impact of flooding.
- 9.16. The Taskforce also acknowledged the important role that disaster insurance plays in risk management and recommended that the Brisbane City Council make available to the insurance industry *'flood risk data in an appropriate format to be used in the setting of insurance premiums'*.
- 9.17. There are clear benefits in making flood risk information publicly available in an electronic spatial format. Both the Insurance Council¹⁶ and a coalition of consumer advocacy and legal aid organisations¹⁷ have called for publicly available flood mapping. The OECD¹⁸ recently recommended that governments should seek to undertake public national disaster risk mapping, with updates every 5 years.

FLOOD RISK INFORMATION FOR INSURERS

- 9.18. Insurers need well maintained flood maps to assist them to price flood risk and provide cover. The maps required by insurers are digital elevation maps which are digital three dimensional models of the ground surface topography, constructed using remote sensing technologies such as photogrammetry, airborne radar and satellite imagery. Insurers then overlay the digital maps with a geo-coded national address file to identify particular addresses within the flood maps. Insurers also need to know the elevation of the principle floor level if they are going to accurately calculate the flood risk.
- 9.19. Once an insurer knows the likelihood of floods at a particular address, it can apply a statistical view of the cost of damage based on the height of the flood, expected water velocity and the building construction design and materials used in it. This results in an annual risk premium to which administrative overhead, taxes and profit are added to calculate the price paid by consumers.
- 9.20. Some insurers and their service providers have developed their own methodologies to determine flood risk, and it is possible they have different interpretations of it.

<http://www.brisbane.qld.gov.au/community-support/emergency-management/flooding/prepare/Taskforce-on-suburban-flooding/index.htm>.

16 Insurance Council of Australia, '10 Point Plan to Tackle Disasters', January 2011, p1-2.

<http://www.insurancecouncil.com.au/Portals/24/Media%20Centre/2011%20Media%20Releases/ICA%20Release%20-%20Ten%20Point%20Plan%2027th.pdf>.

17 Consumer Coalition, 'A Fair Go in Insurance (12 point plan)', January 2011, p5.

<http://consumeraction.org.au/downloads/AFairGoinInsurance-Recommendations-010211.pdf>.

18 Organisation for Economic Cooperation and Development, 'Good Practices for Mitigating and Financing Catastrophic Risks', 2010, p 2.

<http://www.oecd.org/dataoecd/18/13/44778679.pdf>.

- 9.21. The primary source of flood mapping information currently available to the insurance industry is the National Flood Information Database. The National Flood Information Database is maintained by the Insurance Council and currently covers around 5 million individual addresses across the country. However, the National Flood Information Database is not a complete data set and does not include every property or geographic location. In consultations with the insurance industry, it has been suggested to the Review Panel that this lack of completeness is one of the key factors limiting some insurers' ability to provide flood insurance in certain geographic areas. According to the Insurance Council, one of the primary reasons for the incomplete coverage of the National Flood Information Database is the lack of availability of consistent, reliable flood maps. There is also a long lag between the flood maps being produced as part of a flood study and the information being available on the database
- 9.22. Consistent, reliable, up-to-date flood maps are clearly an important component in the understanding and assessment of flood risk. However, the fact that many insurers currently offer flood insurance suggests that the existence of such maps, while desirable, is not a pre-requisite for providing cover.
- 9.23. Indeed, the Review Panel has heard that a number of prominent insurers are currently working on providing flood insurance, despite the inconsistencies evident in current flood maps. They are working toward premium pricing models that rely on modelling approximations. The Review Panel notes that some of the smaller insurance companies are pooling their resources to obtain the necessary data to also be able to provide such cover. The Review Panel recognises the differing interpolations of flood mapping data by insurers may lead to further confusion by the public.
- 9.24. The extent to which the current state of flood maps is limiting the availability of flood insurance is therefore unclear. However, better quality flood maps may assist insurers to improve the granularity of their risk assessments and as a result improve their pricing.

Questions:

What are the merits of developing a single national standard for flood mapping in Australia?

What, if any, impediments are there in doing so?

Who would be best placed to develop such a standard?

Who should bear responsibility for producing and maintaining relevant flood maps? Who should fund this activity?

To what extent do land use decisions take flood risk into account?

What, if any, are the potential impediments to councils making flood maps publicly available in a way similar to the Brisbane City Council?

To what extent is the lack of consistency and availability of flood maps limiting the insurance industry's ability to offer flood insurance?

To what degree is not having a single source for flood maps an impediment to national consistency, both in terms of how maps are developed and how they are used?

Chapter 10. Risk mitigation and insurance

- 10.1. The Terms of Reference ask the Review Panel to consider ‘the relationship between disaster mitigation measures taken by State governments and councils 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’.

Issue:

Risk mitigation measures undertaken for both existing homes and new homes can have a material effect on levels of risk. The reduced risk may influence insurance premiums over time although if they do, the premium reductions may not be directly observable.

- 10.2. The Australian continent is subjected to most natural disasters including earthquake, cyclone, bushfire, tsunami and flooding. Since 1974, there have been at least seven major catastrophes from natural perils where the insured loss was greater than \$1 billion (in 2011 dollars).
- 10.3. In response to these events, mitigation measures have been taken at all levels: by individual home owners when they have rebuilt or repaired their homes after natural disasters and both State governments and councils. For example, the Commonwealth’s Natural Disaster Resilience Program provides funding of \$110 million over four years commencing from the financial year 2009-10, for mitigation programs conducted by States and local governments. Funding is allocated between States and Territories broadly based on population. Commonwealth funding for individual projects is capped at 100 per cent of the contribution by the States. In some cases, councils are also required to contribute funding.¹⁹
- 10.4. Mitigation measures fall into two categories; namely those for existing homes and those for new homes.
- Mitigation measures for existing homes include the construction of flood basins, levees and dams, the raising of buildings and, in the case of bushfire, backburning and land clearing. Most existing flood risk to property is due to the legacy of poor planning and land use, along with a lack of adequate building codes in the past. Much of the expenditure on mitigation is for existing homes. Councils invest in flood maps and floodplain management studies and plans to better understand the flood risks in their area and to develop a long term strategy to mitigate existing risk and to make better planning and land use decisions. A recent report by the Brisbane City Council²⁰ found that 90 per cent of residential properties

¹⁹ Some states require that councils also contribute funding to projects, where those projects are not state-wide. For example:

- the Queensland Government requires that councils contribute one third to the total project cost with the State and Commonwealth contribution totalling two thirds; and
- the Victorian Government requires councils to fund the full 50 per cent of required state funding, except for state-wide projects which are covered by the State Government, and flood mitigation programs whose costs are split equally between councils, State and the Commonwealth Governments.

²⁰ Brisbane City Council. ‘Brisbane Flood January 2011: Independent Review of Brisbane City Council's Reponse. 9-22 January 2011’ p3.
http://www.brisbane.qld.gov.au/2010%20Library/2009%20PDF%20and%20Docs/5.Community%20Support/5.4%20Emergency%20management/Floods/emergency_management_Independent_Review_of_BCCs_Response_Final_Report_v4.pdf

affected by the recent floods were in areas predominantly developed prior to 1978, after which planning decisions in Brisbane were influenced to a significant degree by the Defined Flood Level of the 1974 flood.

- Mitigation measures for new homes which generally make up around two per cent of the building stock each year, include land use and management using flood and wind maps. Buildings codes and standards have also been designed and implemented to resist cyclones, bushfires and earthquakes. Cyclone (wind) building codes have been in place since the early 1980s and the bushfire building code was further improved after the 2009 Victorian bushfires. A flood building code is currently being developed. These measures are aimed at minimising the likely cost of natural disasters for newly constructed homes.
- 10.5. The effectiveness of mitigation measures will at times not be known until a natural disaster occurs. The effectiveness of, for instance, flood levees relies on their maintenance in the intervening years and the co-ordination of other levees that are built upstream or downstream of the protected area. As an example, the Brisbane City Council not only requires developments to be built above the 'defined flood level' but that it can be demonstrated that any earthworks undertaken are not exacerbating the flood risk of others.
- 10.6. There is an expectation that the resultant economic losses from subsequent natural disasters will be reduced by effective mitigation measures. Similarly, there is an expectation that insurance cover will become more available and premiums will over time reflect the reduced risk.
- 10.7. Any impact of mitigation measures on the availability and cost of insurance may not be directly observable. A range of other factors will affect insurance offerings and may mask any impact from mitigation. Nevertheless, mitigation can and has reduced the damage to property after natural disasters.

EXAMPLES OF MITIGATION IN RESPONSE TO NATURAL DISASTERS

- 10.8. One response to flooding has been to construct levees in the flood-prone regions. In 2005, after completing a \$19 million levee, Lismore experienced a one-in-ten year flood. It is estimated that the levee saved about \$15 million in recovery costs from that event.²¹
- 10.9. After Cyclone Tracy in 1974, a new wind loading standard was introduced. The new wind loading standard (AS 1170.2) has strengthened roof cladding which is now secured to the building frame and additional ceiling space ventilation has been provided to reduce the risk of roof damage under the external pressure of a cyclone. Geoscience Australia has analysed the new building standard, comparing damage sustained to buildings constructed under the pre-Tracy code to buildings constructed under the new standard. The study showed that only one tenth of the damage would result if a cyclone with the same intensity as Tracy passed over Darwin today.²²

21 The Hon Robert McClelland MP, Attorney-General 'Future of Emergency Management: Resilience and Recovery' speech to the Australian Strategic Policy Institute, Defence and Security Lunch, 25 March 2011.

22 Geoscience Australia report: 'What Would Happen If Cyclone Tracy Hit Darwin in 2008?' <http://www.ga.gov.au/hazards/our-capabilities/case-studies/what-would-happen-if-cyclone-tracy-hit-darwin-in-2008.html>.

10.10. A study by the Cyclone Testing Station at James Cook University following Cyclone Yasi found that buildings constructed or extensively modified post-1980s performed well.²³ Their report noted that less than three per cent of all post-1980s homes in the worst affected areas experienced significant roof damage, more than 12 per cent of the pre-1980s housing inspected had significant roof damage and more than 20 per cent of the pre-1980s housing in some towns had significant roof loss.

10.11. The highest insured loss experienced in Australia from the Newcastle earthquake of December 1989 when 13 people were killed and damage to the Newcastle central business district was extensive. Much of the damage and injuries caused by the earthquake occurred when cavity walls, parapets and chimneys of small buildings collapsed during the 'moderate' 5.6 magnitude, shallow (only 11km) earthquake.²⁴

10.12. As a result, the relevant building code, Earthquake Loading Standard (AS1170.4), was adjusted in 1993 to extend the earthquake prone zones and to increase the design earthquake loadings for new buildings. The new code also reduced the allowable size of unreinforced cantilever walls such as parapets and chimneys.

10.13. The 2009 'Black Saturday' Victorian bushfires highlighted the risk to property and lives for those who build within heavily forested regions. The Victorian Bushfires Royal Commission made several recommendations for mitigation.²⁵

- Bushfire-prone locations should be identified and mapped.
- The building development code of Victoria should take into account the threat of bushfire.
- Removal of native vegetation should be allowed to protect residential and commercial buildings.
- The building code AS 3959-2009 is to be adjusted to increase the resistance of structures in bushfire-prone areas.
- People in the highest bushfire area to be resettled on a voluntary basis.

10.14. These recommendations have been applied only recently so it may be premature to assess their effectiveness. Nevertheless their influence on bushfire risk and the associated responses from the insurance industry are matters of community interest.

BUILDING REPAIRS UNDERTAKEN ON A LIKE-FOR-LIKE BASIS

10.15. Currently, when rebuilding or repairing a damaged home, the insurer will rebuild to the current building standards, on a like-for-like basis.

10.16. However, the pattern of damage to homes caused by natural disasters can lead to the identification of features of the building that were unsatisfactory. For example, kitchen

²³ Cyclone Testing Centre, James Cook University 'Tropical Cyclone Yasi, Structural Damage to Buildings' CTS Technical Report No. 57 March 2011. Page (ii), paragraph 4.

²⁴ Swiss Re Earthquake Damage Study 'Newcastle — The Writing on the Wall' by Dr. H Tiedemann 1990 p20 and Geoscience Australia www.ga.gov.au, Earthquake Search — 1989 events.

²⁵ Victorian Bushfires Royal Commission _ Final Report July 2010, pp 23 to 37.

cupboards made of chipboard are easily damaged in floods and tile roofs and roller doors can fail during cyclones.

10.17. Such problems may well trigger a review of building standards but such a review will inevitably take time to conduct. In the meantime, insurers will repair and rebuild as soon as possible after the natural disaster event, doing so to the current building standards. That means that in the event of a recurrence of flooding or another cyclone, these repaired building features may fail again.

10.18. There are a number of possible approaches to dealing with unsatisfactory design and construction features and they can be identified by the insurers, relevant government authorities, building standards bodies and others. For example, the Queensland Reconstruction Authority provides guidance on how to improve structural resilience. It is being made available more quickly than changes can be made to building standards, so that homeowners can take the guidance into account as they are rebuilding or repairing their homes.

Questions:

How have the building codes that have been developed in response to cyclones affected the underwriting and pricing practices of insurers and reinsurers?

How much weight can be given by insurers to flood mitigation measures in areas subject to flood risk?

To what extent are responses to the recommendations of the Victorian Bushfires Royal Commission expected to reduce bushfire risk in Victoria? How are these responses being reflected by insurers in their pricing of home insurance?

To what extent are insurers able and willing to undertake repair and reconstruction of a home following a natural disaster so that it incorporates enhancements to improve resilience before formal changes to building standards?

To what extent should decisions on these matters require the agreement of the homeowner?

Chapter 11. Non-insurance of homes: should home insurance be compulsory?

- 11.1. The three models described in Chapter 2, namely Automatic Flood Cover, Automatic Flood Cover with Opt Out and Status Quo, contemplate freedom on the part of every homeowner to decide whether to take out home insurance. In all of these models, there will be homes uninsured and so a fourth model is possible, namely compulsory home insurance for all homeowners.
- 11.2. Not every home is insured. Australia currently has very high rates of home insurance. The proportion of owner-occupied homes with no insurance, while not high (estimated at four per cent by Tooth and Barker²⁶ and one per cent in the Canberra bushfires in 2003), are important when major property damage occurs. Furthermore, a major stimulus to the commissioning of this Review is the lack of flood insurance on many properties.
- 11.3. In the event of natural disasters, owners of uninsured homes have often received payments from governments and not-for-profit organisations. These payments can be substantial (\$100,000 or more).²⁷ They can therefore represent, to some homeowners, a disincentive to buy insurance.

Issue:

Making home insurance compulsory would ensure coverage for all homes in times of disaster but, if introduced, would require major changes to the legislative framework and private insurance market.

- 11.4. Making home insurance compulsory would be a very significant change to the operation of the private insurance market in Australia. It would require new legislation that would take away the right of the homeowner to decide whether or not to buy insurance and there would have to be a way to oblige insurers to provide cover to homeowners that they may decline in a voluntary market. It would also place greater onus on the governments to ensure affordability of insurance in order to protect owners from being obliged to pay premiums which exceed their ability to pay or their perception of the benefit the homeowner receives from having the home insured.
- 11.5. If home insurance were compulsory, it would also be essential to have a premium discount for homes with high flood risk as the option of not paying the premium and not having insurance would no longer be available to the homeowner.
- 11.6. Compulsory insurance already exists in Australia, for example for third party personal injuries in motor vehicles (*compulsory third party motor insurance*) and for injuries to

26 Tooth and Barker, op cit p 12.

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

27 A family of four who lost their home in the Victorian Bushfires may have been eligible to receive \$10,000 Initial Home Dislocation Payment, up to \$80,000 Destroyed Homes Payment and up to \$25,000 Financial Hardship and In Need of Permanent Accommodation Payment. Source: 2009 Victorian Bushfire Appeal Fund <http://www.dhs.vic.gov.au/bushfireappeal/Fund-Payments> . Payments of similar magnitudes are being made available in relation to the floods and storms in Queensland in January this year.

employees (*workers compensation insurance*). Both of these are examples of insurance that is intended to protect third parties, rather than first parties, so the rationale for making the insurance compulsory is clear. By contrast, homeowners bear their own losses when a home is destroyed (by natural disaster or other events) and it has always been their own decision as to whether to purchase insurance. Third parties and the broader community are not generally affected by the homeowner's decision to insure or not, particularly if most homeowners have insurance.

- 11.7. If compulsory insurance were introduced, significant administrative infrastructure would also be required. A compliance regime would need to be put in place. Responsibility for proving compliance could be imposed on homeowners or on insurers but, either way, an enforcement mechanism would also be needed.

Questions:

Given the high rates of voluntary take up of home insurance, the historical right not to insure and the significant changes to the legislative framework and administrative infrastructure that would be required, is there nevertheless a case for making home insurance compulsory?

Are the data that suggest four per cent of owner occupiers do not hold home insurance reflective of the overall level of non-insurance of homes across Australia, taking into account other classes of residential property owners such as strata title property owners, investors, and owners of holiday homes?

Chapter 12. Under-insurance of homes

- 12.1. Where a home is destroyed (that is, is a 'total loss') in an event such as a natural disaster and it had been insured under a policy providing sum insured cover, the value of the sum insured may be insufficient to meet the full costs of rebuilding the home to its original standard. This can cause financial hardship for the homeowners concerned and impede recovery. This issue of under-insurance arises most noticeably in bushfire events where there are significant numbers of homes destroyed and to a lesser extent during floods.

Issue:

Under-insurance, where the level of insurance cover is less than the replacement cost of the insured property, appears to occur widely on homes in Australia, sometimes causing great financial hardship in the event of total loss of the home.

- 12.2. The magnitude of under-insurance of homes is unclear because usually the adequacy of cover is only ever tested when a home is severely damaged and needs to be rebuilt. Of course, most homes never suffer this level of damage. 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.²⁸ The Insurance Council has noted that the average claim for homes that were total losses from the Victorian bushfires was \$132,000 compared with an average cost of building a home in Victoria of \$230,000.²⁹

TYPES OF HOME INSURANCE COVER

- 12.3. The majority of home insurance policies sold in Australia provide 'sum insured cover'. Under this type of cover, insurers provide cover up to a specified dollar amount (that is, the sum insured). Homeowners can be under-insured if they underestimate rebuilding costs and nominate an insufficient sum insured value or where they choose to insure their home to a lower value.
- 12.4. 'Replacement cover' is offered by some insurers who commit to rebuild damaged homes to their previous standard without a sum insured being nominated.
- 12.5. As an alternative to replacement cover, some insurers offering sum insured cover provide an automatic 'top up' to the sum insured. This 'top up' is an allowance, typically 25 per cent of the sum insured, to cover inadvertent understatement of the sum insured. It is intended to cover costs incurred in rebuilding a home above the value of the sum insured.

28 Australian Securities and Investments Commission (ASIC), 'Getting Home Insurance Right', Report 54, September 2005, p12.

[www.asic.gov.au/asic/pdfflib.nsf/LookupByFileName/underinsurance_report.pdf/\\$file/underinsurance_report.pdf](http://www.asic.gov.au/asic/pdfflib.nsf/LookupByFileName/underinsurance_report.pdf/$file/underinsurance_report.pdf)

29 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, p7.

<http://www.royalcommission.vic.gov.au/getdoc/7ddec9c7-6c3c-4902-b4d4-1fa543085835/Insurance-Council-of-Australia-Ltd>

- 12.6. Greater availability of replacement cover and sum insured cover that includes a 'top up' are likely to assist in addressing under-insurance of homes.

FACTORS CONTRIBUTING TO UNDER-INSURANCE

- 12.7. There are a number of factors that may contribute to homeowners underestimating the cost of rebuilding.

- Estimating replacement cost is a technical task and may require building industry expertise to do properly. It requires time and effort of homeowners and, although professional advice can be obtained, it may be at a cost that many are unable or unwilling to pay.
- Although insurers provide online valuation calculators to assist homeowners to identify an appropriate sum insured value, the Australian Securities and Investments Commission (ASIC) has found that different calculators can provide different valuations of the same building. Accordingly, ASIC recommends that homeowners try at least three different calculators before arriving at an appropriate sum.³⁰
- Homeowners may not always adjust the sum insured value after undertaking renovations and extensions.
- 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 may not keep pace fully with increases in labour and materials building costs and any additional costs associated with changes in building standards.
- 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.

- 12.8. Factors that increase premiums can affect levels of under-insurance. Current state taxes on insurance, including stamp duties and, in some States, fire services levies, may be contributing to under-insurance through their impact on premiums. The *Australia's Future Tax System* Review found that Australia has high taxes on insurance, both in comparison to other countries and to the way that other products and industries are taxed. It also found that specific taxes on insurance add to the cost of insurance premiums and can lead to under-insurance or non-insurance. The Review recommended that all specific taxes on insurance products, including the fire services levy, should be abolished.³¹

30 Centrelink, 'News for Seniors', Issue 84, 2011, p11.

[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)

31 Australia's future tax system, Report to the Treasurer, December 2009, Part Two Detailed analysis, Volume 2, p474. http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Chapter_E.pdf.

12.9. We note that the Victorian Government has announced that it will replace its long-standing Fire Services Levy on insurance with a property-based levy by 1 July 2013.³² The New South Wales Government also made a commitment in the 2011 State election to conduct a review of funding arrangements for emergency services.³³

SOME CONSIDERATIONS IN ADDRESSING UNDER-INSURANCE OF HOMES

12.10. Clearly it would be better for homeowners to have full replacement cover than to be under-insured. Some insurers argue, however, that a sum insured plus 'top up' is more effective than replacement cover for both insurer and insured. There can also be some shortcomings in applying replacement cover.

Replacement cover: some considerations

12.11. Moving to replacement cover would mean that an insured home would be rebuilt to its previous standard in the event that it is damaged or destroyed. In principle, replacement cover should eliminate under-insurance as it does not involve specification of a sum insured. Homeowners would face less possibility of financial hardship and would be better assisted in recovering from disaster.

12.12. Only a few insurers currently offer replacement cover. The Review Panel has received indications from some insurers that a switch from sum insured to replacement cover would require premium increases but that those increases are likely generally to be less than five per cent.

12.13. Most insurance policies offering replacement cover vest a discretion in the insurer to make or offer a cash payment rather than rebuilding or repairing a destroyed or damaged home. A view put to the Review Panel is that insurers generally like to be able to offer cash payments because it allows them to be divested of responsibility for the administration and quality control of rebuilding and repairing.

12.14. Some homeowners apparently also prefer cash payments as it provides them with an immediate cash injection and flexibility in how, when and where to conduct rebuilding or repairs.

12.15. Agreeing on a cash amount may involve some negotiation between the parties and can lead to disputation.

- Such disputation does not occur with sum insured cover as the amount of any cash payment is limited to the value of the sum insured, which is set by the homeowner.
- Policies providing replacement cover may require the homeowner to describe the building, its size, fittings and fixtures in some detail at the time the insurance policy is purchased and/or at the time a claim is made. Some supporting information may also need to be provided to the insurer to ascertain the value and condition of the property.

32 Media Release issued by The Hon Peter Ryan MP, Deputy Premier, and The Hon Kim Wells MP, Treasurer, '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>.

33 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>.

- There is the potential for disputes between insurer and homeowner following a natural disaster or any other event causing a total loss. The insurer may make a judgement as to what constitutes replacement that differs from that of the homeowner. Additionally, although the insurer may make every effort to match materials, it may sometimes decide to use what it considers to be reasonable alternatives. The interpretation of replacement may therefore differ between the homeowner and the insurer.

'TOP UP' COVER: SOME CONSIDERATIONS

12.16. 'Top up' is additional cover above the sum insured value, usually expressed as a proportion of the sum insured. Some insurers offer up to an additional 25 per cent.

12.17. The 'top up' is designed to address the inadvertent understatement of replacement cost and also the inflation in building materials and labour costs that can accompany repair and rebuilding work beyond that allowed for in the sum insured. Such inflation can be higher than normal following a natural disaster when shortages can push up prices.

12.18. By having the effect of increasing the sum insured value in the event of the total loss of an insured home, 'top up' cover can assist in addressing under-insurance.

Questions:

To what extent would the substitution of replacement cover for sum insured cover eliminate the under-insurance of homes?

To what extent does sum insured cover plus 'top up' address the under-insurance of homes?

What are the relative merits of replacement cover and sum insured cover with a 'top up'?

Whatever form(s) of cover is to be preferred, should insurers be encouraged to offer it or should it be mandated that they offer it?

If under-insurance of homes is to be minimised, should homeowners be able to purchase replacement cover only or sum insured cover with 'top up' only, or either? Or are there other possibilities?

In the event of total loss of a home, is there a case for changing the practices of insurers around cash settlements and other policies on rebuilding?

What arrangements could be put in place to minimise the possibility of disputes if a cash settlement is offered under a replacement cover policy?

What factors should be considered in determining whether homeowners should have the right to reject a cash settlement in favour of their insurer arranging rebuilding or repairing?

Chapter 13. Non-insurance and under-insurance of contents

NON-INSURANCE OF CONTENTS

- 13.1. If the Automatic Flood Cover model is applied to contents insurance, as well as home insurance, the price of contents insurance for high flood-risk homes may be much higher than for non-flood cover. Existing rates of non-insurance for contents are higher than for homes, so increasing the price of contents insurance could further increase rates of non-insurance.
- 13.2. According to research by Tooth and Barker³⁴, 28 per cent of households in their survey had no contents insurance (12 per cent of owner occupiers, 67 per cent of tenants). As discussed in Chapter 11, this is significantly higher than the four per cent of owner occupier homes in the survey who had no building insurance.
- 13.3. Tooth and Barker note that rates of non-insurance decline with higher incomes and that those with fewer savings are also more likely to be non-insured. They observe that 'non-insurance is also closely correlated with many demographic variables including life stage, age, location, education and country of birth. Many of these demographic characteristics are highly correlated with each other and with income and other measures of financial position. In summary, non-insurance tends to be associated with those: at earlier stages of life; living in cities and particular regions within cities; born in non-western countries; in particular (less risk averse) 'value' segments; with lower levels of education; and without full-time work'.³⁵
- 13.4. For occupants of homes, whether owner occupiers or tenants who do not have contents insurance, some will have made a rational choice not to pay contents insurance premiums (perhaps after balancing the cost of insurance with the quantum of potential losses and the probability of those losses) on the understanding that they will pay to replace contents as required in the event of loss.
- 13.5. Others will not have contents insurance because they cannot afford to pay the premiums. In the event of loss of contents, however, they may not be able to afford to replace them. Others yet will not have it because they don't understand, value or trust insurance.
- 13.6. For all these reasons, contents insurance tends to be far more price elastic than home insurance. As a result, if new arrangements for contents insurance are to follow the Automatic Flood Cover model, with consequential rises in premiums, the level of non-insurance for contents would inevitably rise. If the Automatic Flood Cover with Opt Out model is introduced, the level of opting out could be high in areas that have moderate or high flood risk.
- 13.7. At the same time, it would be much harder to justify including contents in a flood discount regime of the kind described in this Paper for home insurance. As discussed in

34 Tooth and Barker, op cit p 12.

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

35 Ibid p4.

Chapter 5, loss of contents in a natural disaster does not impose the same financial burden as loss of a home.

UNDER-INSURANCE OF CONTENTS

- 13.8. Qualitative feedback received from the general insurance industry during the Review Panel's initial investigation suggests that under-insurance is more acute for contents insurance than home insurance, with tenants being particularly prone to under-insurance in relation to their contents.
- 13.9. Many aspects of under-insurance are likely to be variations on the non-insurance phenomenon for contents insurance and the under-insurance phenomenon for home insurance (Chapter 12)

Questions:

To what extent is the level of non-insurance for contents of concern to the community or to governments?

To what extent is the level of under-insurance for contents of concern to the community or to governments?

Should measures to improve affordability of contents insurance be considered?

What measures could be implemented to improve affordability?

If premium discounts are to be offered for homes with high flood risk should they also be offered for contents insurance?

Chapter 14. The role of lending institutions

14.1. This chapter considers the role and responsibility of lending institutions in relation to home insurance.

Issue:

Lending institutions currently play a role in home insurance by requiring borrowers to purchase insurance when taking out a home loan, but the purpose of the insurance and the relationship between the loan and the insurance are unclear.

14.2. The effect of the insurance requirements of lenders on levels of home insurance is indicated by the fact that the proportion of uninsured properties is much lower for mortgaged properties than for unmortgaged properties. In one survey, only 2.2 per cent of mortgaged properties were uninsured, compared to 6 per cent for wholly owned properties.³⁶

14.3. The Review Panel has learned, through enquiries with several lending institutions, that:

- most or all lenders require insurance as a condition of the mortgage at its inception;
- many lenders do not specify the scope of coverage of that insurance;
- many lenders do not require a minimum sum insured for that insurance beyond being satisfied that it covers the amount borrowed; and
- many lenders do not monitor the continuing currency of insurance during the life of the mortgage, notwithstanding that it is a condition of the mortgage that the property remains insured.

14.4. These practices raise questions about:

- the purpose for which lenders require insurance with home lending;
- the level of responsibility that lenders may have in ensuring, in their own interests and in the interests of their borrowers, that mortgaged properties are adequately insured;
- why lenders might be satisfied with insurance that covers storm, earthquake, cyclone and bushfire (all of which are included as standard in all home insurance policies) but not flood; and
- how far the responsibility of lending institutions extends beyond the protection of their own financial exposure to that of their customers.

³⁶ Tooth and Barker, op cit p 13.

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

- 14.5. Some lending institutions are understood to be reviewing some of their practices following the experiences of the Brisbane and Ipswich floods, where some borrowers have suffered severe flood damage and were not insured for flood. Some lenders have also reduced the maximum loan to value ratios that they will accept for loans on properties subject to flood risk.
- 14.6. It is worth noting that some lending institutions have made ex gratia payments to some mortgagors who had inadequate insurance cover and suffered flood damage in Brisbane or Ipswich.
- 14.7. Some lending institutions have suggested to the Review Panel that the administrative impost of monitoring the currency and adequacy of insurance policies would be unduly burdensome. This can be contrasted with lending practices of times past when lenders were diligent in ensuring the continuing currency of insurance coverage. It is also notable that, in some countries, lending institutions require evidence of insurance each year.³⁷ In such cases, it is the Review Panel's understanding that electronic interaction between lenders and insurers facilitates the process.

Questions:

What level of responsibility do lending institutions have toward themselves and toward their home mortgage customers for:

- the purchase of insurance;
- the scope of insurance cover , and in particular whether it includes flood cover;
- the quantum of insurance; and
- the continuity of insurance during the life of the mortgage?

37 As an example, in the United States lending institutions confirm whether their home loan customers have obtained insurance and if they have not, the institutions purchase it on their customers' behalf and then recover the associated costs from them. In addition, for loans backed by the US Government, at origination, increase, extension or renewal, lenders must determine the flood zone status of a property and if it is located within a mandatory flood zone, the lender must require flood insurance for the life of the loan. If the borrower does not purchase flood insurance, the lender must purchase insurance on their behalf and charge the cost of the insurance back to the borrower. Private sector firms have been established to perform this function for the lending institutions.

Chapter 15. Consumer awareness of risk and insurance

- 15.1. The recent floods highlighted a number of issues around consumers' awareness of their risk of flood and of their insurance cover. Some consumers did not appreciate the risk that they faced from flood. Some policyholders were unaware that their insurance policy did not cover them for flood. This may reflect that they did not read or did not read fully the product disclosure statement, or confusion around what was covered as different policies used different terminology to describe events such as stormwater or flash flood.

Issue:

Consumers may not have sufficient access to pertinent risk information for insurance purposes. Where this information is available, they may not interpret it correctly. This can lead consumers to protect themselves insufficiently against risk.

In addition, insurance policyholders are in some cases not fully aware of the extent of their insurance coverage. This was a major concern in recent flood events where some policyholders became aware only after their homes had been flooded.

Information on flood and other natural disaster risk

- 15.2. Homeowners could potentially benefit from the use of flood risk information to understand whether their property is likely to be affected by future flooding. This issue is discussed in Chapter 9.
- 15.3. There is evidence to suggest that, even where information is available, consumers may not make optimal choices. Studies in behavioural economics suggest that when consumers are faced with complex or incomplete information, they often employ 'heuristics', or rules of thumb, in making decisions. For the most part heuristics work. They economise on search costs and allow consumers to make sound and efficient decisions most of the time. However, in some cases heuristic processes can result in poor decision making.
- 15.4. In particular, consumers tend to systematically underestimate the risk of low-probability, high-consequence events such as flood and other natural disasters.³⁸ A lower than warranted assessment of risk would tend to reduce incentives to purchase insurance for those events.

38 For example, see: Ganderton, P. 'Buying Insurance for Disaster-Type Risks: Experimental Evidence' *Journal of Risk and Uncertainty*, 20:3; pp.271-289, 2000. Kunreuther, H. 'Mitigating Disaster Losses through Insurance' *Journal of Risk and Uncertainty*, 12:4 pp.171-187. Kunreuther, H, Novemsky, N & Kahneman, D. 2001. 'Making Low Probabilities Useful'. *Journal of Risk and Uncertainty*, Springer, vol. 23(2), pages 103-20, September. Kunreuther, H & Pauly, M. 'Neglecting Disaster: Why Don't People Insure Against Large Losses?' *Journal of Risk and Uncertainty*, Springer, vol. 28(1), pp 5-21, January 2004.

- 15.5. The implication of heuristics is that consumers may not purchase insurance for natural disasters, even when there is a need.

Provision of advice

- 15.6. Given the difficulties for consumers in assessing their risk of flood or other natural disasters, access to advice can play an important role in their decision making.
- 15.7. Under the *Corporations Act 2001*, financial advice to consumers is categorised as either personal or general advice. Residential building insurance is generally sold under a no advice or general advice model, whereby only advice about the specific financial product can be given. It is designated as personal if advice specifically takes into account a consumer's objectives, financial situation or needs (or a reasonable person might expect them to have done so) and is subject to greater responsibility and regulatory burden on the provider of advice than general advice. The increased requirements of providing more customised personal advice means that insurers prefer to provide general advice only, which results in consumers not being provided with advice about the particular risks that they face in relation to home insurance.
- 15.8. Insurance brokers tend to provide personal advice about insurance products. Their main role is to sell business insurance. Insurance products sold through brokers are able to be tailored towards the individual business' needs, as discussed in Chapter 7. Personal insurance products tend to be more standardised and hence are more suited to the no advice or general advice model.
- 15.9. The Insurance Council has argued that the definition of general advice in the *Corporations Act 2001* should be broadened such that discussions between consumers and insurers on appropriate insurance do not fall under the category of personal advice.³⁹
- 15.10. These calls for greater ease for financial service providers to give advice to clients have been addressed as part of the Commonwealth Government's Future of Financial Advice package.⁴⁰ The reforms aim to facilitate 'scaled advice' about one area of a consumer's financial advice needs, for example insurance. The reforms also propose that the ASIC provide regulatory guidance about the extent to which general information and general advice can be provided to consumers without constituting personal financial product advice. The guidance will facilitate the provision of advice about single issues, such as insurance for those with simpler needs. ASIC will release a consultation paper in mid-2011 that will seek submissions about guidance that ASIC could usefully provide on how scaled advice can be provided.

Understanding flood cover

- 15.11. In the recent flooding in Queensland and Victoria, many policyholders claimed that they were unaware that their policies did not cover them for flood or that the distinctions between different forms of water damage contained in insurance policies were not clear. This could reflect the different definitions of storm, flood, and flash flood that are used in insurance policies and which can differ markedly between insurers.

39 Insurance Council of Australia '10 point plan to tackle disasters.' 27 January, 2011.
<http://www.insurancecouncil.com.au/Portals/24/Media%20Centre/2011%20Media%20Releases/ICA%20Release%20-%20Ten%20Point%20Plan%2027th.pdf>

40 Future of Financial Advice Information Pack. 28 April 2011. pp13-14
<http://ministers.treasury.gov.au/Ministers/brs/Content/pressreleases/2011/attachments/064/064.pdf>

- 15.12. Lack of awareness by policyholders of the extent of their cover for flood may also reflect a broader lack of understanding of their insurance cover. The rights and responsibilities of the insured and the insurer are set out in insurance policies or more likely as communicated in a Product Disclosure Statement (PDS) which includes the terms of the insurance policy. A PDS can be as long as 50 pages or more. Numerous studies have found that consumers routinely do not read PSD carefully, with many at best glancing at the documents they receive from their insurers.
- 15.13. The length and complexity of insurance PDS makes reading, understanding and comparing insurance policies problematic. Consumers tend to rely on price in deciding on which insurance to purchase. This is arguably a result of price being the easiest to comprehend and most readily available information regarding an insurance contract.
- 15.14. In addition, many insurance policies are purchased by phone. In these cases the PDS is invariably not provided by the insurer until after the policy has been purchased. The Review Panel understands that ASIC has been looking into the requirement on general insurers to give a PDS when providing a quote for the premium on a general insurance product during telephone calls.

Key Facts Statement in insurance contracts

- 15.15. The Assistant Treasurer and Minister for Financial Services and Superannuation recently released a consultation paper on issues around home flood insurance.⁴¹ The consultation paper proposes that all home insurance policy disclosure statements include a clear, one page summary of the key features of the policy. The objective of the proposal 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.
- 15.16. Section 35 of the *Insurance Contracts Act 1984* specifies that classes of insurance set out in the regulations must include minimum standards for insurance cover. Home buildings and contents insurance policies are prescribed classes of insurance under the regulations, and the minimum cover includes cover for natural disasters including fire, earthquake, storm, flood, actions of the sea and landslide.
- 15.17. Insurers offering such policies which exclude types of cover prescribed as minimum cover must 'clearly inform' the insured in writing that they are deviating from the cover before the contract is entered into. The Act states that an insurer may satisfy the obligation to 'clearly inform' by providing a copy of the insurance contract. The courts have confirmed that the provision of the insurance policy, in the form of a Product Disclosure Statement, will usually constitute compliance with section 35.⁴²
- 15.18. However, consumer groups have informed the Review Panel that in practice policyholders are rarely so informed because, firstly, they are not aware of what standard cover is and, secondly, either do not read policy documents or PDS or they cannot readily identify what is and is not a deviation from standard cover.
- 15.19. In this context, a separate single page key facts statement setting out deviations from standard cover would be a more effective vehicle to satisfy the requirement to clearly inform.

41 Commonwealth Treasury. 'Reforming flood insurance: Clearing the waters'. 2011. http://www.treasury.gov.au/documents/1995/PDF/Reforming_flood_insurance.pdf

42 See *Hams v CGU Insurance Ltd* [2002] NSWSC 273, paragraphs 242-243.

Standard definition of flood

15.20. The recent consultation paper referred to above also proposes a standard definition for flood to address the confusion among consumers around what constitutes a flood for insurance purposes. It is designed to provide greater clarity on whether or not policies provide cover for flood.

15.21. Under the Status Quo or the Automatic Flood Cover with an Opt Out model described in Chapter 2, a standard definition of flood would be integral to ensuring policyholders are aware of what their policies include and exclude.

15.22. Under the Automatic Flood Cover model, there would be no need for a standard definition. All forms of non-tidal water damage would be covered. Hence there would be no material difference to policyholders as to whether the cause of inundation was 'flood' or 'storm'.

15.23. The Review Panel supports the work currently being undertaken on the standard definition of flood.

Unfair contract terms

15.24. The unfair contract terms laws⁴³ came into force on 1 July 2010 and apply to certain financial products and financial services through the *Australian Securities and Investments Act 2001* (ASIC Act). Under the unfair contract terms laws, a term of a standard form consumer contract is unfair (and subject to avoidance) if:

- it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
- it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and
- it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

15.25. However, the main subject matter of a contract is expressly excluded from the scope of possible review on the basis of unfairness.

15.26. The unfair contract provisions do not apply to insurance contracts. However, there are provisions in the *Insurance Contracts Act 1984* that imposed a duty of utmost good faith on all parties.

15.27. A Senate Report recommended in September 2009⁴⁴ that the unfair contract provisions be extended to insurance contracts and the Parliamentary Secretary to the Treasurer convened a roundtable with industry and consumer representatives earlier this year to discuss options to address the issue.

43 Commonwealth of Australia. 'The Australian Consumer Law: An Introduction', November 2010
http://www.consumerlaw.gov.au/content/the_acl/downloads/ACL_an_introduction_November_2010.pdf

44 Senate Economics Legislation Committee. 'Trade Practices Amendment (Australian Consumer Law) Bill 2009'.
http://www.aph.gov.au/senate/committee/economics_ctte/tpa_consumer_law_09/report/report.pdf

Questions

What measures could improve consumer understanding of their insurance cover, particularly if purchased over the telephone?

How would consumers benefit from being provided with personal advice that takes account of the insurer's assessment of the consumer's risk?

What are the benefits for consumers being provided with scaled advice? What, if any, are the impediments for insurers and insurance brokers providing it?

Is there a particular need for unfair contracts laws to protect policyholders in natural disaster insurance?

Chapter 16. Processing of claims

- 16.1. An effective process to handle claims plays an important role in helping individuals and communities recover from natural disasters. Insurers have the expertise and the resources to assess damage and pay claims following disastrous events.

Issue:

While insurers are generally highly effective in handling insurance claims, for flood claims there have been significant delays resulting from the necessity to determine the cause of inundation.

There are some other residual issues relating to claims processing by insurers.

- 16.2. The Australian insurance industry is generally highly effective in responding to large claims events caused by natural disasters. Given Australia's susceptibility to extreme weather events, the industry has had considerable experience in dealing with claims over a wide variety of disasters such as bushfires, cyclone and hailstorms. Insurance industry innovations such as mobile claims processing vans that can be mobilised quickly in areas affected by a natural disaster have assisted response to natural disasters. Some insurers also have flexible access to assessing staff that can be quickly mobilised when natural disasters occur. The larger insurers are also able to call upon assessors and call centre staff across Australia.
- 16.3. However, during the Queensland and Victorian floods, in some cases claims processing times by insurers became an issue. The need to determine in some cases whether property damage was the result of storm or flood led to significant delays in processing claims and to significant delays in the commencement of repairs and rebuilding. As shown in Chapter 2, the average time it took to assess claims from the recent Queensland floods was 28 days, with 2.8 per cent of claims still to be determined. In comparison, claims from significant storm events in 2010 took between 5-7 days to be determined. According to the Financial Ombudsman Service there has been considerable consumer frustration over the delays in their claims being processed, which is reflected in the large number of claims disputes currently before it (see Chapter 17).
- 16.4. Under the Automatic Flood Cover with Opt Out model, the same problems with claims processing identified by the recent floods are likely to exist and will continue to be an issue to the extent that people do opt-out of flood cover. An Opt Out model where the default option is more costly than the opt-out option is likely to have a large proportion of consumers exercising the option. In comparison, costless Opt-Out schemes such as organ donation are likely to have higher rates of take up. Opting out is also more likely if consumers under-estimate their actual risk as discussed in Chapter 15.
- 16.5. By contrast, under the Automatic Flood Cover model the problem of significant delays caused by determining the cause of inundation would be eliminated.

RESIDUAL CAUSES OF DELAYS

- 16.6. While the main cause of delay in the recent assessment of claims in Brisbane and Ipswich was the need to identify the cause of water damage, there are some other

causes of delay and ineffectiveness in the claims handling processes that are also applicable across the range of natural disasters.

- 16.7. Many claimants have expressed concern they were not fully informed over how their claims were being processed and at what stage their claims were. Given the length of delays, communication became an important factor in maintaining good relationships between insurer and insureds. Communication problems are reported to be a significant cause of dispute between insurers and policyholders.

POST-DISASTER RECONSTRUCTION

- 16.8. Insurers not only make financial payments to those affected by natural disasters, they also oversee and warrant the repair and rebuilding work.
- 16.9. Some insurers have contracts with construction or similar firms that are responsible for arranging repairs and reconstruction on damaged homes. This is one of the ways that, in the event of a natural disaster, insurers are able to coordinate and call on a large pool of tradespeople to carry out repair work.
- 16.10. However, even with these arrangements in place, capacity constraints are often reached in large disasters for both labour and materials. This can lead to an increase in the price of labour and materials and lengthy waiting times for some claimants.

Questions:

What have been the causes of delays in processing claims other than delays caused by the need to determine whether damage was caused by storm or flood?

In cases of delayed claims processing and settlement:

- how adequate and appropriate is the nature of communication between insured and insurer?
- how adequate are the clarity and frequency of updates from insurers on the progress of the claims?
- should the insurer initiate the communication or should the onus rest with the claimant?

Should there be a time limit for decisions to be made on insurance claims arising from natural disasters? If so, how long should it be and should it be imposed by statute or under a voluntary code of practice?

Chapter 17. Resolution of claims disputes

- 17.1. Dispute resolution processes can emerge as an issue following a natural disaster because of the volume of claims being determined by insurers. The lack of flood cover has given rise to a number of disputes over whether damage to properties was caused by flood or storm and whether the policies were clear about the absence of flood cover.
- 17.2. As at 24 May 2011, the Financial Ombudsman Service had recorded 306 claims disputes resulting from the Queensland floods and 79 disputes from the Victorian floods.⁴⁵ The Financial Ombudsman Service has reported that flood events invariably have the highest proportion of disputes per claim than any other natural catastrophe. This is due to the absence of flood cover in many cases and the consequent need to distinguish between flood and storm damage.

Issue:

The summer's storms and floods have caused unusually large numbers of disputes between policyholders and insurers. The disputes mainly relate to flood coverage and its definition as an exclusion in insurance contracts. There are also some other causes of dispute and some questions around the many dispute resolution processes of some insurers.

- 17.3. The number of disputed claims arising from flood events is likely to remain relatively constant under the Status Quo model. Where some insurers offer flood cover and others do not, there will continue to be disputes as to the cause of inundation. Effective measures to educate consumers over what is covered under their policies may reduce the number of disputes to some extent.
- 17.4. The Automatic Flood Cover with Opt Out model is likely to continue to see some disputes, though arguably at a lower level. Where insurers continue to make a distinction between flood and other forms of water damage, disputes will remain.
- 17.5. Only under the Automatic Flood Cover model is the cause of the majority of disputes arising from flood claims likely to be resolved as it overcomes the need to determine whether the damage was caused by flood or storm.

RESIDUAL DISPUTE RESOLUTION ISSUES

- 17.6. The most common cause of disputes in insurance claims aside from flood have been reported to be policyholders proving losses, under-insurance (discussed in Chapter 12) and the lapsing of cover due to policyholders' non-payment of premiums or insurers not adequately informing policyholders of cover lapsing.

⁴⁵ These disputes data are higher than that for other natural disasters. For example, Cyclone Yasi had only 39 disputes out of 65,200 claims.

17.7. There are a number of issues that have arisen with the process of raising and settling disputes, separate from the issue of flood. The insurance industry Code of Practice⁴⁶ notes that, if a consumer requests a review of a decision the insurer will treat it as a dispute, notify the consumer of a contact and respond to the dispute within 15 working days if all necessary information is available. However, the Code also notes that, due to the large number of claims following a catastrophe or disaster, insurers may not be able to meet all standards of the code but that they will respond to catastrophes and disasters in a fast, professional and practical way and in a compassionate manner.

INTERNAL DISPUTE RESOLUTION ISSUES

17.8. It is important that internal dispute resolution processes are effective and have integrity. To deliver that, internal dispute resolution staff should be independent of the claims department and have the authority to overturn decisions made by the claims department.

17.9. Some claimants are understood to have faced multiple internal processes before the dispute is elevated to formal 'internal dispute resolution'. The insurer might initiate reviews hierarchically through various levels of the claims department or through parallel review processes within the claims department. When that happens, claimants are often not aware that their query or dispute has gone back to the same claims department that made the decision in question, and that it has not entered formal and independent internal dispute resolution. Some consumers have also been confused by internal review officers being given the title of 'ombudsman'.

17.10. Whilst there may be some utility in having more than one level of internal review, this 'multi-tier' dispute resolution should not result in delays in insurers meeting their code of practice obligations to determine disputes within the relevant time limits. And nor should claimants lack a clear understanding of the full dispute resolution framework and the progress of their claims through this framework.

17.11. Policyholders often have difficulty in testing the opinions of experts relied upon by insurers in decision-making (for example, hydrologists) due to lack of funds and lack of knowledge as to how to engage experts.

17.12. Under the general insurance code of practice, insurers are obliged to provide reasons for decisions, including at the internal complaints stage. However, consumer groups have informed the Review Panel that the reasons can vary in quality.

17.13. The code also requires insurers to give policyholders access to documents they relied upon in decision making. Consumer representatives have informed the Review Panel that this requirement is not always complied with.

17.14. Consumer representatives have argued to the Review Panel that consumers have limited access to no or low cost independent advice as to their insurance dispute resolution rights. The Review Panel's understanding is that only in New South Wales and Queensland are there permanent legal advice and advocacy to policyholders. In New South Wales this service is available on a means tested basis. Following specific

46 Insurance Council of Australia, 'General Insurance Code of Practice', May 2010, p9.
<http://www.codeofpractice.com.au/LinkClick.aspx?fileticket=-XTcCIWRFGo%3d&tabid=37>

catastrophes, some limited grants have been made by various State governments to provide short term advice and advocacy for policyholders. Furthermore consumer groups have argued that the existence of these services is not well known by consumers even where they are available.

CLAIM DISPUTES WITH INTERMEDIARIES

- 17.15. When a policyholder has purchased insurance through a broker, it is normal practice for the policyholder to lodge any claims through the broker. The broker will handle the claims on behalf of the policyholder.
- 17.16. When a claim is denied, it is sometimes because the insurance policy does not cover the incident or event that is the subject of the claim. The lack of cover can occur inadvertently on the part of the client but it can also occur if the client's instructions to the broker are not followed. In such cases, it can be a matter of dispute between the broker and the insurer as to why or how the client's instructions were not followed.
- 17.17. If such a dispute arises, it is possible for the client to be left waiting for resolution of the dispute between broker and insurer, with no action on the claim until the dispute is resolved. Further, if it is the broker who is at fault, the client may have to take legal action against the broker, whose role was to act for the client in the client's relationship with the insurer.
- 17.18. It seems entirely unsatisfactory if a claim is not resolved only because of a dispute between broker and insurer (as distinct from a dispute between the claimant and broker together on the one hand and the insurer on the other).
- 17.19. By analogy in car insurance, if two insured car owners have a collision and there is a dispute over which owner (and insurer) is liable, the two insurers accept liability for their own insureds, meet the claims on a 'knock for knock' basis and then resolve their own dispute separately and at arm's length from two policyholders.
- 17.20. A valuable step forward in broker-insurer claim disputes would occur if the broker and insurer were obliged jointly to resolve a client's claim irrespective of any dispute between broker and insurer, and then to settle liability between themselves separately.

Questions:

Should there be a mandatory time limit for insurers to respond to disputes following a natural disaster and, if so, how long should it be and should it be regulated through the industry Code of Practice or legislated?

Is there a case for improved monitoring and transparency of insurers' internal dispute resolution processes?

What, if any, changes are needed to the responsibilities of insurers and policyholders during the dispute resolution process?

How can policyholders' access to information during the dispute resolution process be improved with regard to reasons for decisions, documents relied upon in decision making and independent legal advice?

What can be done to improve the integrity of insurers' internal dispute resolution processes including full disclosure of any multi-tiered dispute resolution, adequate decision making powers for dispute resolution personnel and structural separation from claims personnel?

Should consumers have access to independent legal advice in rejected insurance claims, particularly in natural disasters? If so, from whom and how should it be funded?

When a claim is not resolved because of a dispute between broker and insurer, what legislative and other steps could be taken to protect the client's interests by obliging broker and insurer to act together in the first instance to resolve the client's claim, and then to embark separately on their own dispute over liability?

Chapter 18. Funding public infrastructure

- 18.1. Under paragraph 9 of the Terms of Reference the Review Panel has been asked to 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.

Issue:

Considerations around a national fund predominantly involve matters of government budgeting practices. Changing these practices in order to 'pre-fund' expenditure required to rebuild public infrastructure would not reduce the impact of a natural disaster on the Commonwealth budget bottom line. However some changes to the current arrangements between the Commonwealth and the States could be considered.

A NATIONAL PRE-FUNDING ARRANGEMENT

- 18.2. The consideration of a national fund mostly concerns government budgeting practices, that is, how the Government pays for its programs and projects.
- 18.3. There are two steps involved in paying for the Commonwealth's programs and projects.
- 18.4. One step is to include the program or project in the budget estimates. The budget estimates reflect expected revenues and expenditure in the years ahead for the Government's stated policies. The net financial impact of these revenues and expenditure gives the expected budget position in a given year. New lines of expenditure or revenue are included in the estimates of the budget when the Government takes a new decision.
- 18.5. The other step is to ensure that cash is on hand to make payments on a day-to-day basis for programs and projects included in the budget estimates. When the cash coming in from revenue sources is not sufficient to cover payments going out, the Government raises cash to meet its needs by borrowing from the financial markets.
- 18.6. Creating a fund to provide 'pre-event' funding could involve the Government either:
- committing to new expenditure for natural disaster response measures and thereby *including this expenditure in the budget estimates*; or
 - undertaking borrowing early to *have cash available on 'stand by'* that could be used to finance unexpected natural disaster spending.
- 18.7. *Including additional expenditure in the budget estimates now* for a new natural disaster program would reduce the budget impact of disasters in the future (that is, after the event). However, it would have an immediate up-front impact on the budget bottom line at the time the new expenditure was included in the budget estimates.
- 18.8. In the past, an estimate of around \$80 million of spending per year has been included in the budget for the Natural Disaster Relief and Recovery Arrangements (NDRRA). This has reflected the Government's best estimate of the expected year on year natural disaster spending under the NDRRA, based on historical trends and other relevant data.

- 18.9. Alternatively, the Government could pre-emptively *set aside cash on 'stand by'* which could be drawn down to finance future expenditure on natural disaster relief. This approach is similar to that taken with the Nation-building Funds — the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund.
- 18.10. This approach would mean that cash is available to pay for natural disaster response measures as an alternative to borrowing funds at the time the expenditure for the natural disaster response is undertaken.
- 18.11. In years when the budget is in headline deficit, that is, when some of the Government's activities are financed through borrowing, the cash to be put into the fund would need to be borrowed. In practice, this would involve bringing the borrowing forward from the time when the natural disaster response expenditure is undertaken.
- 18.12. While cash would be available on 'stand by', when the Government recognises a natural disaster or makes a decision to spend this cash on specific disaster recovery projects, this spending would still affect the budget bottom line at that time.
- 18.13. These two approaches would therefore make no difference to the impact of a natural disaster on the Commonwealth budget bottom line. It would continue to act as a 'funder of last resort' in the event of a natural disaster that imposed heavy costs to rebuild public infrastructure.
- 18.14. A fund could be established which sought *reinsurance* for natural disaster events. In the event of a natural disaster, the costs would be financed by payments from the reinsurers rather than cash reserves or borrowing. A fund could be Commonwealth only, but as the Commonwealth is already 'funder of last resort' following a natural disaster through the operation of NDRRA, this approach would also make little difference compared with the current arrangements.
- 18.15. A joint Commonwealth and State fund would effectively amalgamate the State-based insurance arrangements. However, such an arrangement appears unnecessary. The States are responsible for the management of state assets including decision making about how to mitigate risks associated with those assets. Any fund would not alter that. Nor would it alter the Commonwealth's role as a 'funder of last resort' through the operation of the NDRRA.

A SUGGESTED CHANGE TO NATURAL DISASTER RELIEF AND RECOVERY ARRANGEMENTS

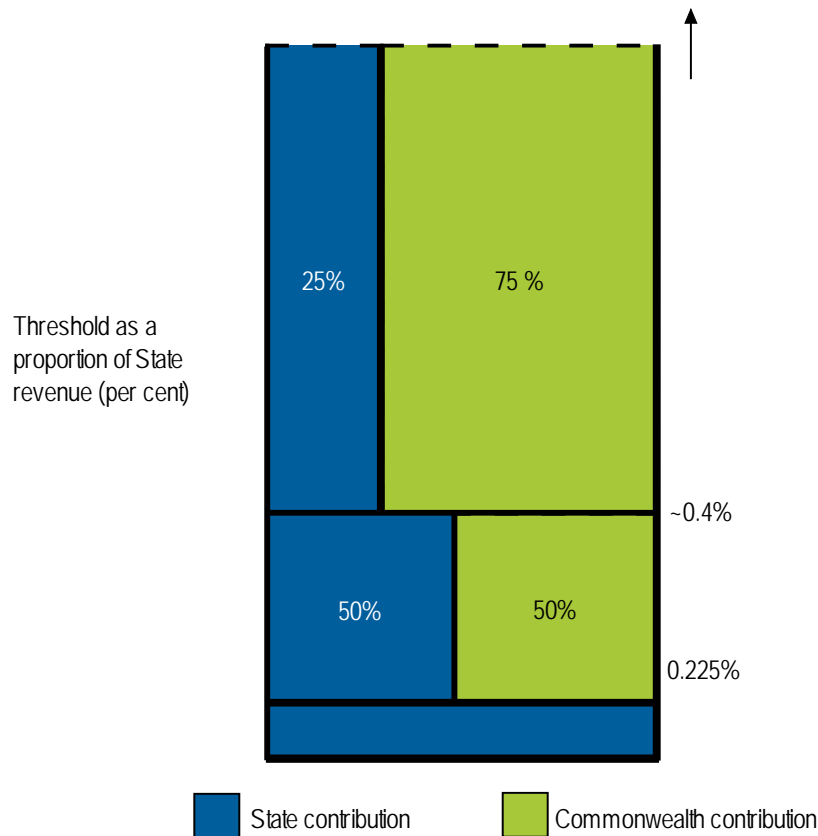
- 18.16. A change to one element of the NDRRA could improve the equity of treatment as amongst States.⁴⁷
- 18.17. The NDRRA provide for the Commonwealth and States to share the cost of reconstruction of State assets following natural disasters. Only reconstruction costs of essential public infrastructure (basically all Government assets such as non-toll roads and bridges, schools, libraries or Parliament Houses that are not operating businesses)

47 Attorney-General's Department. 'Natural Disaster Relief and Recovery Arrangements Determination 2011 Version 1'. 2011. [http://www.ema.gov.au/www/emaweb/rwpattach.nsf/VAP/\(689F2CCBD6DC263C912FB74B15BE8285\)~NDRRA+-+Determination+2011+-+Version+1+\(PDF\)+-+Web+update.pdf/\\$file/NDRRA+-+Determination+2011+-+Version+1+\(PDF\)+-+Web+update.pdf](http://www.ema.gov.au/www/emaweb/rwpattach.nsf/VAP/(689F2CCBD6DC263C912FB74B15BE8285)~NDRRA+-+Determination+2011+-+Version+1+(PDF)+-+Web+update.pdf/$file/NDRRA+-+Determination+2011+-+Version+1+(PDF)+-+Web+update.pdf)

are eligible for funding under the NDRRA, and eligible funding is net of costs recoverable from any other sources such as commercial insurance or reinsurance recoveries.⁴⁸

18.18. Figure 5 shows the operation of the thresholds under the NDRRA. Once a State's total costs of disaster recovery and reconstruction in any financial year has exceeded a specified threshold, the arrangements require that the NDRRA meet a portion of recovery costs on the specified types of assets. The thresholds are 50 per cent of costs above 0.225 per cent of State revenue and 75 per cent of costs above 1.75 times that threshold or approximately 0.4 per cent of State revenue, with the States covering the remainder.

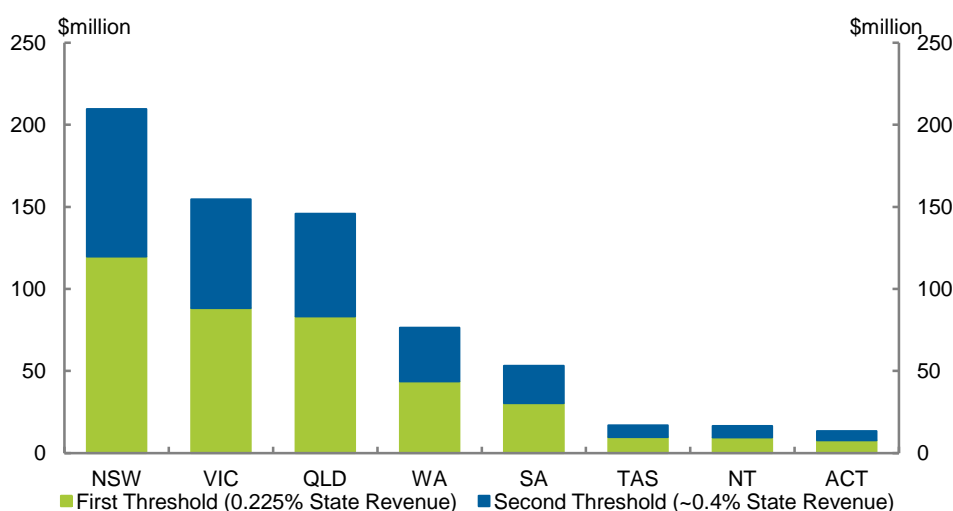
Figure 5: NDRRA Funding Structure



18.19. The 2010-11 thresholds for each State are shown as dollar amounts in Chart 1.

48 The NDRRA covers broader disaster recovery and reconstruction costs than for essential public infrastructure such as payments to small businesses, primary producers, not-for-profit groups, individuals and families, but it is only infrastructure costs that are being considered in this chapter.

Chart 1: NDRRA thresholds by State 2010-11



18.20. 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.

18.21. Assessing the NDRRA payments relative to each State's revenue provides 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. This could invite arbitrage. As a State does not receive all of the benefit of reinsurance recoveries, it could decide it is not in its interest to purchase reinsurance.

18.22. 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.

18.23. 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.

18.24. It is also notable that the existence of a self-insured 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. On this basis, 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.

18.25. This raises an issue of whether the NDRRA formula should be altered from one based on State government disaster costs *net* of reinsurance recoveries to one based on State Government *gross* costs. That is to say, the NDRRA funding threshold could be based on 100 percent losses and not take into account any commercial insurance or reinsurance arrangements. This approach would treat the States equally irrespective of the insurance or reinsurance arrangements that they have made.

Questions:

Would there be benefits to the States in equity and effectiveness if the NDRRA funding formula were to apply to expenditure gross of reinsurance recoveries rather than net of reinsurance recoveries?

What, if any, are the impediments to this approach?

Chapter 19. International comparisons

- 19.1. The issues around insurance for flood and other natural disasters identified in this Paper are not unique to Australia. All countries are subject to some degree of natural disaster risk, with the degree and type of risks differing across countries.
- 19.2. The history, design and experience of schemes from other countries demonstrate that many countries have natural disaster risks that either cannot be fully and suitably covered by the private insurance market or have not in the past been covered adequately by the insurance industry, leading to government intervention.
- 19.3. Consequently, many developed countries and some developing countries have implemented one or more types of schemes that complement the private insurance market in the provision of insurance for natural disaster. The schemes vary widely by design and are often a reflection of the climate and other specific characteristics of each country, such as the most common type and severity of natural disasters, insurance industry evolution, political and economic history, and level of community and government interest.
- 19.4. Catastrophe insurance schemes from five developed countries are summarised in Appendix 4, along with the 'residual market' schemes that are operated in many states of the United States. As indicated above, the design and operation of the schemes reflect the particular climatic, economic and political circumstances surrounding their establishment and history. As a result, no scheme can be directly translated to the Australian situation. Nevertheless, several observations of the schemes identified are worth noting:
 - not all schemes have direct government involvement, although the majority do;
 - there is no consistent blueprint for a natural disaster scheme;
 - schemes that deal directly with policyholders, instead of dealing through insurers, usually have difficulty dealing with the volume of claims that can occur during a major catastrophe; and
 - designing systems that are financially viable, adaptable and able to align the incentives of all stakeholders is crucial in maintaining their sustainability but difficult to achieve. As a result, some schemes are financially sound while some others are in a poor financial position.
- 19.5. Of all the schemes reviewed, it is the US state-based 'residual market' schemes known as Fair Access to Insurance Requirements (FAIR) Plans and their brethren Windstorm or Windstorm and Hurricane Plans, of which there are a few dozen across the country, that appear to have some similarity in operating requirements to the flood insurance problem in Australia. The Review Panel is in the course of examining these plans more deeply, for they are a rich source of ideas on techniques for pricing, funding, governance and risk mitigation, as to elements that are successful and elements that are unsuccessful.

Question:

Are there particular lessons to be learned from international schemes, whether featured in Appendix 4 or not, that should be considered in evaluating different models for application in Australia?

Appendix 1 Terms of Reference

The Terms of Reference for the Natural Disaster Insurance Review were announced by the Assistant Treasurer, The Hon Bill Shorten MP, on 4 March 2011 and are quoted below.

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 under-insurance 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 (MCPPEM-EM) for consideration in implementing the National Strategy for Disaster Resilience as agreed by COAG in February 2011.

Appendix 2 Commonwealth Government natural disaster initiatives

National Strategy for Disaster Resilience

- A2.1 The Government's National Strategy for Disaster Resilience was adopted by the Council of Australian Governments (COAG) on 13 February 2011.⁴⁹
- A2.2 The purpose of the Strategy is to provide high-level guidance on disaster management to federal, state, territory and local governments, business and community leaders and the not-for-profit sector. The Strategy includes steps to improve our understanding of the risks of natural disasters and educating people of these risks. It will also examine ways of reducing the impact of natural disasters through mitigation measures.
- A2.3 As part of the strategy, it has been agreed that Heads of Treasuries will report to the National Emergency Management Committee⁵⁰ on strategies for maximising the role of insurance in fostering greater community and individual resilience. The Assistant Treasurer and the Attorney-General will provide the outcome of this Review to the Heads of Treasuries for consideration in the context of their report to the National Emergency Management Committee.

Amendments to the National Disaster Relief and Reconstruction Arrangements (NDRRA)

- A2.4 On 3 March 2011, the Government passed amendments to the NDRRA. The changes require that States and Territories undergo regular assessments of their insurance and mitigation arrangements by an independent specialist, such as the state Auditor-General. The reports will be assessed and considered by the Department of Finance and the Attorney-General, who will make recommendations to the States regarding their insurance and/or mitigation strategies.
- A2.5 Should a State or Territory not undertake assessments or take appropriate action as a result of the Attorney-General's recommendations, the amount that the State or Territory would be reimbursed under the NDRRA may be reduced.
- A2.6 The amendments are to ensure that the States and Territories manage their insurance arrangements in the most appropriate way.

49 Attorney-General for Australia. 'COAG adopts National Disaster Resilience Strategy'.

http://www.ag.gov.au/www/ministers/mcclelland.nsf/Page/MediaReleases_2011_FirstQuarter_14February2011-COAGAdoptsnationaldisasterresiliancestrategy February, 2011

50 The National Emergency Management Committee provides advice and direction on national, strategic emergency management issues. Membership comprises two senior representatives from the Commonwealth, State and Territory governments and a representative from the Australian Local Government Association.

Standard Definition and Key Facts Statement

- A2.7 On 4 April 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation released for public comment two proposals relating to issues of more immediate concern.⁵¹
- A2.8 The first is for a standard definition for flood for use in insurance policies. This proposal stems from the confusion and uncertainty that many flood victims felt when trying to identify whether their insurance covered them for riverine flood.
- A2.9 The second proposal is for a one page Key Facts statement that summarises the terms of householders' insurance policies, as a preface to the Product Disclosure Statement (PDS). It is intended to assist consumers to quickly and easily check the basic terms of the policy, including the nature of cover and any key exclusions.

51 Department of Treasury. 'Reforming Flood Insurance: Clearing the Waters'.
http://www.treasury.gov.au/documents/1995/PDF/Reforming_flood_insurance.pdf 5 April 2011

Appendix 3 High flood-risk properties — a flood insurance Pool

- A3.1 To explain potential funding arrangements for a Flood Insurance Pool, some definitions are needed:

Full cover premium = competitive risk-based price including flood cover

Non-flood premium = competitive risk-based price excluding flood cover

Flood premium = competitive risk-based price for flood cover only

Hence: *Full cover premium* = *non-flood premium* + *flood premium*

PRICING

- A3.2 In the normal course of events in the insurance market place, the premiums that policyholders pay to an insurer are intended by the insurer to enable it to meet the full costs of claims, on a pooled or portfolio basis, and also to cover expenses, including a profit margin. Such premiums are referred to as the fully funded premiums and, in the market place, they are based on actuarially derived premiums, modified by the insurer according to its view from time to time of what kind of profit margins and other strategic business or competitive factors the insurer might wish to recognise in its premium rates.
- A3.3 In the case of flood insurance, it is the fully funded premiums for flood cover that may be too high in some cases for property owners to be prepared to pay. It is also the fully funded premiums that are used in this paper and the reference point against which premium discounts are measured.
- A3.4 It follows that, if an insurer were to accept discounted premiums on some properties exposed to high flood risk, the insurance portfolio would not be fully funded unless there were an additional source of revenue to meet the fully funded cost. The additional revenue would then represent a subsidy in respect of the discounted premiums.
- A3.5 Also, if there are to be some form of flood discounts for premiums on properties with high flood risk, then:

Flood discount = Difference between full cover premium and actual (discounted) premium payable.

POTENTIAL SOURCES OF FUNDING

- A3.6 By funding, we are referring to the mechanism used to ensure that all revenue sources (discounted premiums plus subsidies from other sources), taken together, will be sufficient to meet the costs of flood claims, that is to ensure that the claim costs are fully funded.
- A3.7 An additional funding issue to address is the source of the subsidies. That is, who should provide the funding needed to allow full flood cover to be provided to homeowners at high flood risk at reasonable premiums?

A3.8 Possible sources of funding are insurers, councils and Commonwealth and State governments. Chapter 4 assesses these sources of funding against the issues of moral hazard, equity and the degree of intervention in the insurance market.

Possible funding mechanisms

A3.9 If there are to be flood discounts for properties with high flood risk, there will also need to be a mechanism to fund the aggregate discounts granted in order to arrange for aggregate premiums in the system to be sufficient to meet the costs of flood risk.

A3.10 Two requirements emerge:

- a method of identifying or measuring the aggregate discounts; and
- a method of funding these aggregate discounts.

A3.11 The first requirement, measuring the discounts, leads to a need to assess the premiums for full flood cover for every property with a discounted premium in order to calculate the discount (which is the full flood cover premium less the actual or discounted premium paid).

A3.12 The second requirement, funding the discounts, leads to the need to establish some kind of central pool (the Flood Insurance Pool) that would receive, from whatever source or sources that are designated, additional funds to top up the aggregate discounted premiums and thereby to have the means to pay flood claims when they arise.

A3.13 Explained below are some funding possibilities that could be explored for a system that uses either an engineering threshold or a price threshold.

A3.14 Assuming there is a central Flood Insurance Pool established to deal with the funding of flood cover for high flood-risk properties, the key funding features might work along the following lines.

The insurer premium transaction

Option A: flood risk transferred to the Pool

A3.15 Assuming that maximum premiums for high flood-risk properties are 150 per cent of the non-flood risk premiums, each premium would be dealt with as follows: half the maximum premium; that is, 75 per cent of the non-flood premium, is retained by the insurer to cover all non-flood risks and the remaining 75 per cent is passed to the Pool and would represent a contribution to the cost of flood cover.

A3.16 One incentive operating here for the price threshold system is that insurers, by being offered only 75 per cent of the premium they would normally receive for the non-flood risks, will want to try to offer a price below the threshold if they can reasonably do so, in order to retain the whole premium. For risks that are assessed as having a flood premium up to around 50 per cent or so, this incentive should contribute to a competitive and honest market. In cases, however, where the full cover premium is materially above 150 per cent, there will not be a competitive market and insurers would still only retain 75 per cent of the premium.

A3.17 One disadvantage of this option is that, although the distinction between flood and other water damage is removed from the policyholder, the insurer and the Pool would still need to work with such a distinction.

Option B: full cover transferred to the Pool

A3.18 In this option, a portion of the premium, say 10 per cent, is retained by the insurer as a contribution towards costs. The remaining 90 per cent is passed to the Pool, along with transfer of the whole risk (flood and non-flood).

A3.19 In the price threshold system, the 10 per cent of premiums retained by the insurer would be lower than the insurer's costs, thereby representing an incentive to offer a price below the threshold so as to retain the whole risk.

A3.20 This option avoids altogether the need to distinguish between flood cover and non-flood cover. In doing so, however, it transfers more risk to the Pool than under Option A above.

The Pool premium transaction

Option A: flood risk transferred to the Pool

A3.21 The Pool receives all flood premiums for high flood-risk properties. This amount will fall short of the cost of full flood cover by the aggregate amount of the discounts plus the Pool's costs less the aggregate amount of the 25 per cent of non-flood premiums received by the Pool.

Option B: full cover transferred to the Pool

A3.22 As for Option A, but the Pool receives 90 per cent of the full cover premiums for high flood-risk properties. This amount will fall short of the costs of cover by the aggregate amount of the discounts plus the Pool's costs less the aggregate amount of the 10 per cent of full cover premiums received by the Pool.

Funding Version 1: the Pool funds the claims

A3.23 The Pool could operate as a quasi insurance company whose only portfolio is high flood-risk flood cover. It would have no capital but instead would operate as a form of mutual or insurance pool in which all home insurers participate. Alternatively, it could operate as a properly capitalised reinsurer. It may well take out reinsurance to cover its own catastrophe risk.

A3.24 Each year the Pool would declare a surplus or deficit which would be shared among the participating insurers in proportion to some measure of their participation in the Pool. The formula would be aimed at two things: maintaining equity among insurers, having regard to their contributions to the Pool and their risks underwritten, and maintaining incentives for the system to continue operating properly.

A3.25 Because the Pool would be under-funded on average, there would be a deficit in most years that would need to be met by funding contributions or revenue from another source. One possible source, as already indicated, is the participating insurers in which case the deficit would represent the aggregate subsidies that all insurers make towards the cost of flood risk. In this example it is the policyholders who would ultimately pay these costs because the insurers would cover their contributions to the deficits through additional premiums for all policyholders that would be in the nature of a levy on them to subsidise the high flood-risk properties.

A3.26 It may also be open to the Pool to operate on a pay-as-you-go basis rather than on a fully funded basis. That would mean not always funding deficits in the years that they arise, but rather funding part or all of the deficits in arrears, after floods have occurred.

Funding Version 2: the Pool subsidises insurers

A3.27 In Version 1 above, the Pool would be aggregating premiums and levies. It would then meet all claims from the Pool as the claims arise.

A3.28 An alternative is for the Pool to collect levies in much the same way as for Version 1 but, instead of paying claims, the Pool would pay premiums to insurers, perhaps on a quarterly basis. The premiums for each insurer would be equal to the aggregate discounts on high flood-risk policies written in the quarter by the insurer.

Assessing premiums and premium discounts

A3.29 An important practical issue relates to the establishment of premiums for flood cover and non-flood cover because both sets of premiums are needed to calculate the discounts and assess the subsidies or levies required to operate the Pool.

A3.30 These premiums would have to be set centrally, effectively decided by the Pool and not by individual insurers. The prices would therefore be common across the industry.

A3.31 Further, in order to measure the discounts, it would be essential that the flood premiums be transparent, that is, the non-flood premiums, the flood premiums and the discounts to the flood premiums would all need to be disclosed.

A3.32 To make all these risk and premium assessments, the Pool operator would need full access nationally to relevant flood mapping, elevation mapping and other underwriting information for all high flood-risk properties. The Pool operator would then also be in a position to make the information available to all insurers, councils, owners and other interested parties. It would be functioning in effect as a national flood risk information repository.

A3.33 There are several benefits of such an arrangement, not the least of which is encouragement of a competitive insurance market for properties below the high flood-risk threshold by giving all insurers, large and small, access to the information they need to undertake risk-based pricing for flood cover. Barriers to entry in offering flood insurance, which are currently high because of the large investment needed by insurers to obtain the requisite information and undertake the associated pricing work, would be reduced.

Governance

A3.34 A system of the kind described above, with centrally determined premium discounts and levies for properties with high flood risk, would need to maintain both adequacy of premiums for insurers from a prudential perspective and fairness of prices and levies for all insurers and policyholders.

A3.35 The governance model is therefore important. One could envisage, for example, an expert from the Flood Insurance Pool being overseen by a board that comprises representatives of the insurance industry and other bodies such as the Commonwealth Government, State governments, local governments, the property industry and the

water industry. There are several different board compositions that could be considered.

A3.36 The premium setting is clearly a critical function and would need to rely on the same types of flood risk information that insurers use in setting their own prices for properties with flood risk below the threshold. The prices would need to be set on an actuarial basis and would have to be seen by insurers and policyholders as fair. This premium setting process clearly has implications for the composition and role of the board and the effective functioning of the Pool.

A3.37 There will also be some prudential consequences of the operation of the Pool, depending on how the Pool is structured legally and financially, and what kinds of financial risks and liabilities, if any, that participating insurers carry.

A3.38 These pricing and financial issues are dealt with in some of the US FAIR plans by appointing an actuarial committee that consults with the Pool's appointed actuary. Something along these lines could be used for the Pool. Also, given the importance of flood risk assessment and building standards, there may be a case for adding other experts.

Appendix 4 Natural disaster schemes in other countries

- A4.1 A range of approaches to dealing with the insurance of natural disasters has been taken in developed countries. There are varying degrees of government involvement, ranging from the provision of natural catastrophe cover by a government direct insurer with a government guarantee such as the New Zealand Earthquake Commission, to the government's role being purely to mitigate risk to an acceptable, insurable level such as in the UK.
- A4.2 Many other countries have some form of natural disaster insurance scheme or system. There may be lessons from these schemes or systems that are useful in considering how to deal with natural disaster risks and insurance in Australia.
- A4.3 A sample is presented here to demonstrate the variety of approaches.

UNITED STATES

- A4.4 There are several dozen schemes for natural disaster insurance in the United States. One is a national scheme for flood and the others are all state-backed schemes that can be seen as variations on a common theme.

National Flood Insurance Program

- A4.5 Flood cover for residential and commercial buildings is available to homeowners if their community participates in the National Flood Insurance Program (NFIP). Participating communities must agree to adopt and enforce sound floodplain management regulations that meet or exceed the requirements of the Federal Emergency Management Agency. In return, the NFIP offers property damage insurance for flood and develops flood plain maps and management incentives.
- A4.6 Cover: Communities' involvement in the scheme is voluntary and they must apply to participate in the NFIP. As a requisite, they undertake to adopt appropriate preventative measures assigned individually by the NFIP. Communities that have opted for cover from the NFIP can obtain flood cover for individual homeowners, business owners and tenants. Owners who have received past benefit from the NFIP must continue to insure with the private market in order to retain cover from the NFIP. This program provides flood coverage up to \$250,000 for buildings and \$100,000 for personal property that may then be supplemented by cover from the private sector. The program also provides up to \$500,000 cover for commercial property.
- A4.7 Homes in communities covered by the NFIP can receive a statutorily subsidised premium for two reasons. First, homes that were built before a community receives cover under the NFIP are 'grandfathered' with lower premiums than for new properties. Second, homes in communities which undertake specific mitigation measures to lower the risk of flood may receive a discount on their premium.
- A4.8 Price: Rates are set by the NFIP and vary with the level of flood risk.
- A4.9 It has been argued that the NFIP has introduced a moral hazard for certain exposed properties. In the US, there are 71,000 properties, representing only 1.2 per cent of

premiums, which accounted for 16 per cent of claims between 1978 and 2008. Of these properties, 1 in 10 received a cumulative flood insurance reimbursement that exceeded the value of the property. But, on average, premiums for older, subsidised properties represented only around 40 per cent of the actuarially fair rate.

A4.10 Funding: Almost all flood insurance policies under the NFIP are provided through private insurance companies, though these companies bear none of that risk. As of 2010, 90 private insurance companies participate in the program. The NFIP benefits from the private insurance industry's marketing channels and the presence of insurers in flood-prone areas, and in return private insurers receive an 'expense allowance'.

A4.11 A report by the US Government Accountability Office in 2007⁵² found that, by design, the program is not actuarially sound because the premiums set do not allow the NFIP to build sufficient reserves to cover losses that exceed historic averages. The NFIP's financial insolvency has been attributed to its high administration costs and legislated inability to charge market rates, hold reserve funds, or purchase reinsurance. When NFIP funds are exhausted after large flood events, such as Hurricane Katrina in 2005 (with over US\$70 billion in insured losses, indexed to 2011), the NFIP must borrow funds from the US Treasury. The NFIP was forced to borrow around US\$18.6 billion from the US Treasury due to the 2005 disaster. Under its current structure, the NFIP will not be able to repay this debt.

US FAIR and Windstorm Plans

A4.12 The Fair Access to Insurance Requirements schemes are a series of US state-backed arrangements that provide limited insurance cover on assets deemed uninsurable by the commercial market. Otherwise known as FAIR Plans, the schemes are arranged by more than half the states as a form of mutual whereby 'hard to place' risks are offered limited coverage, mostly at above average premium levels.

A4.13 Several states also operate Windstorm or Windstorm and Hurricane Plans, the method of operation of which are generally similar to the FAIR Plans.

A4.14 The FAIR Plan system is designed as a 'residual' market mechanism for distressed assets and is not intended to serve the broader insurance needs of the general public. Property owners who are unable to purchase insurance or who find their insurance unaffordable can apply to the FAIR Plan to see if they are eligible for subsidised insurance. The property's insurance agent must first approach the commercial market before application can be made to the FAIR Plan.

A4.15 Properties that are eligible are offered twelve months basic insurance. The property owner is provided with written advice on short term risk management steps that are intended to make the property insurable in the commercial market.

A4.16 All insurers who operate in each state participate in a pool of the state's FAIR Plan risks. Each insurer's share is based on its proportion of annual gross property premium written

52 United States Government Accountability Office. 'Ongoing challenges facing the National Flood Insurance Program'. Statement of Orice Williams, Director, Financial Markets and Community Investments, Federal Emergency Management Agency before the Committee on Banking, Housing, and Urban Affairs, US Senate. 2007. <http://www.gao.gov/new.items/d08118t.pdf>

within the state. Administration costs, claims and premium are distributed to each insurer as per their proportional share. The higher administration costs are covered by the higher than normal insurance premiums.

A4.17 In general, residual market mechanisms have been designed to work as a complement to, rather than in competition with, the private market. Therefore, historically the rates charged by the residual plans have been higher than those in the voluntary market. The idea has been to charge a risk-based premium that is commensurate with the specific type of business being written.

A4.18 The schemes are funded out of premiums collected and in that respect are intended to be fully funded. However, the primary difference between FAIR Plan syndicates and insurers occurs when the premiums collected by the FAIR Plan are insufficient to pay for claims and operating expenses. In the event of a premium shortfall, insurers are asked (or mandated) to participate in that shortfall in the form of assessments.

A4.19 Many Plans also buy reinsurance or access the capital markets, providing them with additional layers of catastrophe coverage and ability to fund losses. However, in recent years some Plans have relied on government revenue to cover losses.

A4.20 FAIR Plans are administered by a board of directors that usually consists of representatives from supporting insurance companies and members of the public.

SPAIN

A4.21 The Consorcio de Compensacion de Seguros (CCS) is a government institution which was originally conceived in 1941 as the Riot Risks Compensation Consortium, a mechanism to pay compensation after the Spanish Civil War. CCS now provides cover for 'extraordinary risks' including both natural hazards such as floods, storms, tsunamis, earthquakes, volcanic eruptions, meteorites and political/social risks such as terrorism, sedition and civil commotion. Ninety three per cent of all natural disaster claims were for flood. Legal Statute stipulates a minimum cover for extraordinary risks that is to be provided by commercial insurers or CCS. If the commercial insurers exclude extraordinary risks, CCS must assume that risk and will receive premium. CCS will also cover losses if the insurer is unable to meet its payments due to bankruptcy. In practice, CCS is the sole institution that assumes the cover of the extraordinary risks in all circumstances.

A4.22 Cover: CCS cover is dependent on there being in existence an insurance policy covering material damage, life or personal accident. Once an insurance policy is purchased, cover from CCS for the extraordinary risks is compulsory and the payment of the premium includes a surcharge, based on the sum insured and type of property insured, in favour of CCS. Insurance companies collect the surcharge with their premiums, including a 5 per cent commission of the surcharge.

A4.23 Price: The premium is compulsory, levied at specified and fixed rates (that is, it is not risk rated), and applied to all insurance contracts. It thus contains a cross-subsidy between low and high risk groups. The premium rate for residential property in 2008 was €0.09 per €1000 insured.

A4.24 Funding: CCS is backed by an unlimited government guarantee. It has never been called upon despite having years of significant events (for example, 655.27 per cent loss ratio in 1983, 145.35 per cent loss ratio between 1981-1990).

A4.25 Claims are submitted to the insurer or CCS within 7 days of the loss and must be inspected and assessed by a CCS approved adjuster. Cover provided by CCS is in accordance with the sums insured on the original insurance policy and the averaging rule will apply for 'under-insurance'.

FRANCE

A4.26 In 1982, the French parliament established the Catastrophes Naturelles (CatNat) insurance system for natural disaster events such as earthquake, flood, drought, avalanche, tidal wave and landslide. Coverage for natural disasters (including flood) was made compulsory in all property and motor vehicle insurance policies funded by a compulsory levy on all property insurance contracts.

A4.27 Cover: When a state of natural catastrophe is declared by the government, policyholders and local communities can apply for damage compensation from the CatNat system.

A4.28 Price: Insurers charge an additional catastrophe premium rate, set by government decree, that is uniformly applied to all private insurance contracts. The levy is currently 12 per cent of the original policy premium and is used by the insurers to cover losses from significant catastrophic events.

A4.29 Funding: Insurance companies may protect themselves from insolvency under this plan by purchasing reinsurance from the commercial market or with the government owned company, Caisse Centrale de Reassurance (CCR). If the insurer decides to use CCR, the compulsory deductibles cannot be 'bought back'. The scheme is backed by an unlimited government guarantee which has been used only once.

A4.30 The scheme has in the past suffered from 'risk selection', whereby insurers have transferred exposure to high-risk policies to the CCR in full, but retained low-risk policies. For this reason, the CCR was unable to collect sufficient premiums to meet its claims. It used its government guarantee in 1999 when it needed a FF1 billion injection to remain solvent. Insurers collect an 8 per cent handling fee to cover their costs of collecting the premium.

A4.31 Claims and assessment are handled through insurance companies. In addition, government law requires that insurers indemnify victims of natural disasters within three months. While this is in practice not achievable after a large event, the scheme is widely regarded to be successful in the process of indemnification. For example:

- following insured losses of over \$300 million in 1988 due to floods in the city of Nimes, 95 per cent of victims were indemnified within three months; and
- in 1999 when storms Martin and Luther and associated flooding caused 80 per cent of French communities to be declared in a state of natural catastrophe and \$7.6 billion in damages, 28 per cent of the files were indemnified within three months and 80-90 per cent within twelve months after the event.

NEW ZEALAND

A4.32 The Earthquake Commission (EQC) was established by the Government in 1945 to provide earthquake and war damage cover for purchasers of fire insurance. Later, cover for other natural disasters was included and, later still, cover for war damage dropped. The modern EQC is a Government-owned Crown Entity.

A4.33 Cover: EQC pays claims from New Zealand residential property owners for damage caused by:

- earthquake, natural landslip, volcanic eruption, hydrothermal activity, tsunami;
- in the case of residential land, a storm or flood; and
- fire caused by any of these.

A4.34 Dwellings are insured up to a maximum of \$100,000 plus goods and services tax (GST) and personal effects are insured up to \$20,000 + GST. EQC pays the value of damaged land at the time of the earthquake or natural disaster, or the repair cost, whichever is lower.

A4.35 Consumers are able to top up their cover from the EQC by purchasing additional cover from the private market.

A4.36 Price: Premiums are calculated as a surcharge on the sum insured, currently 5 cents per \$100 insured per annum.

A4.37 As premiums are not risk rated and based explicitly on the sum insured, affordability is achieved through a cross-subsidy and at low universal premium rate (5 cents per \$100 insured). Given the maximum amounts payable (\$100,000 for building and \$20,000 for contents), the maximum premium is only \$67.50 per dwelling, including administration costs.

A4.38 Funding: For more than 60 years the EQC has been collecting premiums from insured homes and during that time a substantial fund of almost NZD6 billion which is backed up by reinsurance from overseas groups and a government guarantee.

A4.39 The fund was set up to ensure cover for all New Zealanders but also to limit fiscal exposure to earthquakes. The EQC had sufficient reserves and reinsurance cover to meet all claims from the Christchurch earthquakes of 2010 and 2011 however the fund has now been depleted.

A4.40 In a time of major disaster, such as a large earthquake, EQC works through its Catastrophe Response Programme (CRP). The CRP sets out how EQC will cope with the substantial increase in resources that will be required at such a time. The programme includes an alternative operations site and the provision of additional staff and equipment.

UNITED KINGDOM

A4.41 Flood cover is standard in the UK so the idea of adding flood cover, which is the question in Australia, has not arisen in the UK. Nevertheless, a series of floods in the 1980s and 1990s had led the insurance industry to query whether it could or would continue to provide flood cover universally.

A4.42 In 2000, the Association of British Insurers (ABI) and the UK Government established the Statement of Principles on the Provision of Flood Insurance. Under the Statement, insurers committed to continue to make flood cover as widely available as possible until 2013. In return, the Government was to ensure that flood risk was appropriately managed and that long-term flood risk management commitments were fulfilled. This

was intended to enable the competitive market to deliver affordable flood insurance for the vast majority of customers once the Statement of Principles ends in 2013.

- A4.43 However, some insurers placed a moratorium on flood coverage until 2002. They argued that they could not continue to subsidise losses and the market leaders gave the government two years to develop defences before they would cease covering high-risk areas. The industry also stated that premiums would be risk rated. The result was a rise in premiums for some insurance products.
- A4.44 In 2002, a new agreement between the government and insurance industry was signed. It left the original agreement untouched but formalised the state's role in land planning and mitigation and increased funding on mitigation.
- A4.45 Cover: The ABI committed to make available flood insurance for domestic properties and small businesses in standard home and small business policies if flood risk is not significant (no worse than a 1.3 per cent annual probability or 1 in 75 years).
- A4.46 The ABI also committed to continue to offer flood cover to existing domestic property and small business customers at significant flood risk provided the Environment Agency has notified ABI of its intention to reduce that risk to below significant within five years.
- A4.47 Price: The government funds and publishes highly comprehensive, standardised and publicly available flood maps which enables insurers to offer some form of insurance to the maximum number of homes and small businesses. It also implies that insurers are able to fully risk rate households, though they do not presently price accordingly. Implicit in the agreement is a high degree of cross-subsidisation.
- A4.48 Funding: In October 2010, the Government committed to invest £2 billion on flood and coastal defences over the next four years. However, the commitment of £2 billion represents a cut of 20-30 per cent in spending, which could lead to a withdrawal or lack of available flood insurance in the private market.
- A4.49 It is widely accepted that the arrangement cannot be continued beyond 2013 without a serious increase in government funding for mitigation.

SUMMARY OF INTERNATIONAL SCHEMES

Flood cover arrangements			
	Australia	NZ	Spain
Is flood cover readily available from insurance markets?	Limited	Limited	Mandated
Is there a state or market pool?	No	State - EQC	State — CCS
All perils or a flood specific pool?	N/A	All Perils	All perils
Is risk transferred to the state?	No	State	Yes
Who contracts with insured — insurer or pool?	Insurer	Pool	State
Is the pool private or state run?	N/A	State	State
How are premiums collected?	Direct	Direct	Levy on insurers
Who sets Premiums?	Market	State	State
Are premiums risk adjusted?	Yes	Surcharge on sum insured	Per cent of property premium
Does the state link mitigation and the provision of state cover?	N/A	No	No
	USA	France	Britain
Is flood cover readily available from insurance markets?	Limited	Mandated	Yes
Is there a state or market pool?	State	State Reinsurer - CatNat	No
All perils or a flood specific pool?	Flood	All Perils	N/A
Is risk transferred to the state?	Optional	Optional	No
Who contracts with insured — insurer or pool?	Pool	Insurer	Insurer
Is the pool private or state run?	State	State Reinsurer	N/A
How are premiums collected?	Direct with pool	Added to property premium	Direct
Who sets Premiums?	State	State	Market
Are premiums risk adjusted?	Yes	12 per cent of property premium	Yes
Does the state link mitigation and the provision of state cover?	Yes	Yes	Yes — agreement between insurers and state