Actuaries Institute.

4 April 2024

Insurance Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: standarddefinitions@treasury.gov.au

Dear Sir/Madam,

Consultation: Standardising natural hazard definitions and reviewing standard cover for insurance

The Actuaries Institute ('the Institute') welcomes the opportunity to make a submission to this consultation.

The Institute is the peak professional body for actuaries in Australia. Our members work in a wide range of fields including insurance, superannuation and retirement incomes, enterprise risk management, data analytics, climate change impacts and government services. The Institute has a longstanding commitment to contribute to public policy discussions where our members have relevant expertise. The comments made in this submission are guided by the Institute's 'Public Policy Principles' that any policy measures or changes should promote public wellbeing, consider potential impacts on equity, be evidenced-based and support effectively regulated systems.

We have not responded directly to each question listed in the consultation paper. Instead, this submission sets out our thoughts on the points raised in the paper under a few broad headings.

Summary

We agree that the introduction of standard definitions has merit and be limited to terms that cause or are expected to cause significant difficulty due to inconsistency. The perils identified in the consultation paper for standardisation (fire, storm and stormwater/rainwater run-off), are consistent with the Institute's research of current areas of concern. However, while some perils have not caused significant consumer confusion so far, they could cause misunderstanding in the future if the frequency and average costs of those perils increase. Two examples are storm surge and actions of the sea, due to the impact of climate change on these perils as sea levels are expected to rise.

Standard terms can help with the availability of some, but not all, insurance at an affordable price. Some accumulations of risk are not suitable for insurance (e.g., building in high-risk prone areas). Mitigation and increasing the resilience of Australian households in advance of any peril event are often the most efficient and effective ways of reducing the cost of natural hazards. Supporting homeowners who now find themselves in high-risk areas requires broader solutions than insurance and standard definitions. We note in the concluding remarks our support of the broad program of work being coordinated by the Commonwealth Government to mitigate losses from natural peril events.

Option 2 is preferred

The Institute supports, in principle, Option 2 of the consultation paper i.e., *Amend the standard cover regime to mandate insurers offer a baseline level of coverage for home building insurance only.* Fewer disputes should follow. This may, in turn, improve insurance affordability and availability for some households, through a baseline minimum level of cover.

If this option raises awareness among consumers and policymakers of the cost of different covers, it can reinforce the focus of the existing program of work to reduce catastrophe costs through risk reduction and mitigation. The Institute's research on home insurance affordability and the accompanying report on flood both outline a broad range of loss mitigation, resilience and adaptation policy initiatives which could be considered to complement the standard terms being considered in this consultation[1].

We note there will likely be significant issues in implementing this option; we have some specific comments on this topic later in this submission.

We agree with the removal of the current standard cover regime for the four classes noted in the consultation (Motor vehicle, Personal accident, Consumer credit and Travel).

A variation of Option 2

The Institute encourages the Government to consider a variation to Option 2. This continues to allow flexibility in the cover offered by insurers (in excess of or below the standard cover), however requires each insurer to articulate their cover's difference from standard definitions. The benefits of this approach would include:

- Increased transparency, enabling consumers to make informed decisions compared to the current regime. However, this approach would only work if insurers found a simple way of explaining this to customers. We acknowledge Product Disclosure Statements (PDSs) are already very long and may not be read by customers, hence this articulation would need to be short and simple.

- Providing choice to purchase additional coverage, while enabling insurers to innovate and offer terms consistent with their risk acceptance criteria. This will allow insurers to innovate as policyholder appetite and needs change, ensuring insurance products continue to support societal requirements at an effective cost.
- Providing more basic insurance products to provide a baseline level of cover e.g., for lower-socioeconomic consumers.
- Allowing for the dynamic nature of risks, e.g., due to changes in legislation, climate, technologies and building materials. Insurers will be able to adjust product offerings independently of needing changes to standard definitions. Recent examples include responding to the risks of flammable cladding and lithium batteries.

Reinsurance is a critical component of the insurance framework. This approach ensures product design could be matched by reinsurance terms and remove any coverage gaps. The framework would need to acknowledge the "global exclusions" applied by most reinsurers, so that insurers are not

[1] Refer Funding for Flood Costs: Affordability, Availability and Public Policy Options and Home Insurance Affordability Update (both August 2023)

exposed to risk that is unacceptable to insurers' Boards and/or APRA. This approach then eliminates the otherwise immediate need for reinsurers to adopt the standard definitions.

Standardised definitions

The causes of underinsurance are complex. While standardising definitions may improve transparency, it is unlikely to address issues such as affordability and availability, particularly in high-risk areas. In other words, standardising definitions does not reduce the expected cost of events. Even with standardised definitions, it is likely that some households will decide to continue not purchasing insurance, which may be a choice to self-insure, or an inability to find appropriate cover at an acceptable price for their risk profile.

A significant number of insurance disputes concern the interpretation of contracts, including the appropriate meaning of individual words and phrases. Every individual claim requires the application of the definition in the policy contract, which can be difficult even if the definition itself is clear. The industry's attention could usefully turn to protocols about how the definitions are applied and used, including potentially controversial claims scenarios.

Flood is a good example. The common definition has helped, but hydrology reports are still needed for individual properties in many borderline situations. One improvement could be a system whereby a single hydrology report is commissioned for a given area after an event, and that report is binding and used by all consumers, insurers and the dispute resolution systems when making decisions.

Affordability

It may be challenging to limit baseline standard cover to standard definitions which are both affordable while offering broad, meaningful cover to consumers. This is due to the wide range natural perils risk exposure across Australia, particularly high exposure in specific areas. The consultation paper includes an example of excluding natural water damage to improve affordability, but this may reduce the overall perceived value of insurance to consumers, creating broader economic and societal issues (i.e., increased levels of uninsurance or underinsurance).

Where insurance is unviable for some members of society, which may become clearer with a standardised definition, a government subsidy could be considered in limited situations (e.g., for consumers who did not know of an emerging risk at the time they purchased their home and, partly due to advances in technology which allow for address level pricing, now face significant affordability pressure). The subsidy could be managed with the aim of unwinding this over time as the underlying risk is reduced through, for example, community and/or household level mitigation and adaptation investments or, if required and acknowledging the significant resources involved, supported relocations. Crucially, the Institute would encourage subsidies to be limited to existing properties only so that further development is not encouraged in high-risk areas.[2]

Concerns around Option 3

The Institute does not support Option 3 with a vertically differentiated rating system, given it introduces further consumer complexity and may limit innovation.

---

[2] A further discussion of design consideration for a premium subsidy program was provided in s.3.5.1 of the Institute's 2020 Research Paper on Property Insurance Affordability: Challenges and Potential Solutions.

Education and financial literacy

We support initiatives to enhance or simplify policy documents such as PDS e.g., highlighting departures from standard covers or including plain-English examples of what is covered or what is not covered.

While we note it can be difficult for consumers to understand and compare insurance products, we encourage a continued focus on education and transparency of natural perils risks. This will better enable informed decision making by consumers in terms of location to purchase or rent a home, and insurance and the degree of risk acceptance (including the risk they retain through not insuring, underinsuring, choice of exclusions and/or levels of excess).

As noted in the Institute's recent Pre-Budget Submission (2024/25), we support the Government taking a proactive approach to help individuals understand and undertake financial planning and budgeting and bolster financial equity. We therefore support the Government considering further allocating funding and resources towards the 2022 National Financial Literacy Capability Strategy.

Other considerations for any final design

We also suggest the following additional considerations in any final design around standard definitions:

- The Australian regulatory insurance framework has undergone many changes in recent years, including the introduction of Design and Distribution Obligations, Anti Hawking, Claims as a Financial Service, Unfair Contract Terms and the formation of the Australian Financial Complaints Authority (AFCA). Introduction of standardised terms should be considered as part of this holistic framework, ensuring alignment of goals, and removing or reducing any conflict or unnecessary complexity. Complexity can create (or add to) confusion and additional costs for policyholders and society.
- A standard definition for Storm and Stormwater run-off is proposed. However, natural peril events often have overlapping damage from several perils in the one event (e.g., Riverine Flood, Stormwater run-off and Storm). This makes claim assessments more complex if an insurer excludes one of these perils. We note that AFCA has recently ruled partial losses in situations where flood cover was excluded, which complicates other benefits (e.g., living away from home allowances while the home is uninhabitable). Bundling these covers as discussed in Treasury's consultation paper would reduce this complexity. However, we note this may be challenging in some regions (e.g., where Riverine Flood risk is significant).
- Insurance coverage exclusions will continue to be required where the cost is likely to be significant and does not meet insurance principles such as excessive accumulations of risk, and this will need to be clearly communicated to customers. Such exclusions might include land remediation costs, pandemics, asbestos-related liabilities and public utilities.
- While the focus is on Home Buildings, extending the change to Home Contents cover may remove complexity. Buildings and Contents are often sold as part of a packaged policy.

While some perils have not caused significant consumer confusion so far, they could cause misunderstanding in the future if the frequency and costs of those perils increase and generate significant insured damages. Two examples are storm surge and actions of the sea, due to the impact of climate change on these perils as sea levels are expected to rise.

Reiterating the Institute's support for the broader context of reforms

The Commonwealth Government is currently coordinating a broad program of activity to adapt to a changing climate and to mitigate losses from natural perils events. This includes some elements still being considered and developed. This work program includes commitments and initiatives for decarbonising the economy, disaster risk resilience and risk reduction including the Disaster Ready Fund, National Climate Risk Assessments and National Adaptation Planning process. We reiterate our support for the Sustainable Finance Strategy and the climate risk and sustainability reporting and disclosure requirements, as well as the actions that these initiatives will drive. In our opinion it is critical that this broad program of work continues, and if. successful, will meaningfully and sustainably address both higher than otherwise insurance premiums and the increases in retained event costs borne by consumers.

The Institute would be willing to discuss this submission further with Treasury. If that would be of assistance, please contact the Institute via (02) 9239 6100 or public_policy@actuaries.asn.au.

Yours sincerely

(Signed) Elayne Grace

CEO