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Northern Australia Insurance Premiums Taskforce
The Treasury
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Submission on Northern Australia Insurance Premiums Taskforce INTERIM REPORT 2015

The Actuaries Institute welcomes the opportunity to submit comments in respect of the INTERIM REPORT issued by the Northern Australia Insurance Premiums Taskforce.

Background

The Northern Australia Insurance Premiums Taskforce was set up by the Treasury to explore the feasibility of options that use the Commonwealth balance sheet to reduce home, contents and strata insurance premiums in those regions of Northern Australia that are reporting insurance affordability concerns due to cyclone risk.

The taskforce has released the INTERIM REPORT addressing the findings on:

- ➢ Current insurance affordability in Northern Australia
- ➢ Feasibility and issues of various options, in particular to:
  - Option 1: A mutual insurance company offering cyclone cover to householders
  - Option 2: A reinsurance pool for cyclone risk
  - Other approaches raised by stakeholders
- ➢ Roles and possible initiatives for mitigation efforts

Our recommendations

We have set out our recommendations at a high level into four themes below and we have set out some additional detailed comments on the INTERIM REPORT in the attached appendix.

1. The causes of the increase in premium and the “real issue”
2. Issues surrounding the mutual insurance company
3. Impact of reinsurance and the need for a reinsurance pool for cyclone
4. Role and benefits of mitigation programs

The causes of the Increase in premium and the “real issue”

In the INTERIM REPORT, the taskforce has discussed the possible causes contributing to the increase in insurance premiums in Northern Australia which is driven by a cyclone loading. The taskforce has provided several possible causes of the increase in premium in Northern Australia including:

- Losses caused by a number of cyclones and storms occurring in a short space of time;
- Increases in the cost of catastrophe reinsurance;
- Lack of competition

The Actuaries Institute supports the findings of the Australian Government Actuary (AGA) as referenced in the INTERIM REPORT, which concludes that “the business had not been profitable for the insurance companies”. Comments of the AGA suggest that the historical premium level is inadequate, nor in the long term sustainable. The correction to technical premium levels is one of the main drivers to the premium increases.

The Actuaries Institute wishes to point out that another factor, which has contributed to the increase, is technology advancement. During the past 8 – 10 years, catastrophe modelling techniques have improved significantly, both in terms of better understanding of the hazards and insurers’ ability to individually risk rate certain exposures.

The Actuaries Institute recommends the taskforce clarify the premium composition and contributions to the premium increase in the final report, to provide transparency and assist better understanding of the issues to be addressed.

The Actuaries Institute believes it is important to clarify the “real problem” before evaluating various options. Is the issue the overall cyclone loss cost (pure premium or technical premium); premium affordability for specific sub-group(s) of the community, such as low income families; or there is an insurance/reinsurance capacity shortage? Understanding the issue is an important overarching consideration in the discussion of potential government involvement and exit options.

Issues and consideration surrounding a mutual insurance company

The INTERIM REPORT discussed many aspects of a potential mutual insurance company offering cyclone cover to householders. The Actuaries Institute feels clarifications are required to first understand potential roles of the mutual insurer:

- A sole cyclone insurance provider for all residents in Northern Australia
- A limited cyclone insurance provider for specific sub-group(s), such as high risk customers or residents with affordability issues
- An alternative cyclone insurance provider operating (competing) with private insurers

The Actuaries Institute believes that the economic benefits of mutual funds are modest and arise due to lower, but non zero, expectations of the return on capital between shareholder and mutual insurance entities. Further, a premium subsidy or restrictions in rating factors/methodologies have no impact on the true cost of protection against the underlying hazards.

There are many complications involved in the setting up of a mutual insurance company such as coverage gaps, interaction with commercial insurers, difficulties in determining the appropriate premium, etc. The difficulty of managing insurance coverage provided by different structures and to ensure consumers are educated can not be underestimated.

For approaches involving significant premium subsidies, the Actuaries Institute believes that the potential cost to the government is high and long term. The premium subsidy will also distort the effectiveness of insurance premium acting as a price signal, reduce incentives for loss mitigation and may bring anti-selection concerns for the mutual insurer.

<u>Impact of reinsurance and the need of a reinsurance pool for cyclone</u>

The Actuaries Institute agrees with the taskforce that higher reinsurance cost allocation has contributed to the increase in premiums for home, contents and strata insurance premium in Northern Australia. However, these increases are due to previous under-pricing by the market and an ongoing reassessment of the true cost. Setting up a potential reinsurance pool may have little impact on the overall cyclone premium, if not subsidised by government funding.

<u>Role and Benefits of Mitigation programs</u>

The Actuaries Institute supports the taskforce's statement that "Mitigation should be an important component of any effort to reduce insurance premiums". Mitigation effort, if conducted appropriately reduce the actual risk and are therefore far more effective at reducing the overall technical premium compared to premium subsidy or a community rating approach.

The Attachment to this letter sets out the Actuaries Institute's thoughts on the INTERIM REPORT, and reasons for the recommendations.

The Actuaries Institute would be pleased to discuss this submission with the Taskforce. Please contact our CEO David Bell on (02)9239 6106 or via e-mail david.bell@actuaries.asn.au

Yours sincerely,

Estelle Pearson
President

Attachment

The causes of the increase in premium and the "real issue"

The INTERIM REPORT has illustrated the premium increases experienced by segments of the Home and Contents Insurance and for Strata Insurance markets in Northern Australia. It is also noted in page 9 – 10 of the INTERIM REPORT that there are several causes of the premium rate increases.

- Losses caused by a number of cyclones and storms occurring in a short space of time;
- Increases in the cost of catastrophe reinsurance;
- Lack of competition.

The Actuaries Institute recommends the taskforce clarifies the premium composition and contributions to the premium increase in the final report, to provide transparency and assist with better understanding of the issues to be addressed.

The Actuaries Institute finds it crucial to clarify the "real issue", e.g. the main driver(s) of the premium increase in the recent years. For each of the causes identified, corresponding solutions shall be listed; the merits and concerns can then be discussed and compared. The current approach in the INTERIM REPORT offers two main options and several other approaches, however, without sufficient clarification of the core issues some solutions may not be identified.

The Actuaries Institute supports the conclusion of the Australian Government Actuary (AGA) as noted in the INTERIM REPORT, which suggests that "the business had not been profitable for the insurance companies". The AGA concluded that the insurance industry spend $1.40 on claims on home and contents insurance for every $1 of premium in northern Queensland.

Based on the findings, the Actuaries Institute believes that the primary driver of the overall premium increase is the adjustment to long term sustainable technical premium levels. 140% loss ratio over an 8 years' period (2005/06 – 2012/13) is unlikely to be a sustainable level for any insurance business.

High loss cost is likely to be the main driver leading to an increase in the cost of catastrophe reinsurance over the same period. Poorly performing insurance markets also typically involve the exit of market players and discourage new players entering the market, which in term, creates capacity shortage and reduces competition.

The Actuaries Institute wishes to point out that another factor, which has contributed to the increase, is technology advancement. As mentioned in Appendix D of the INTERIM REPORT, insurers are increasingly moving towards individual risk rating from the community rating methodologies used in the past. Better catastrophe models enable better assessment of cyclone risks for the overall portfolio as well as individual risks. Better data and technology advancement such as GPS and NFID, enhance the ability of insurers to more accurately price cyclone hazards and use more complex rating factors. Insurers are now able to differentiate the differences in potential loss cost for various factors such as construction types, age of buildings (as a reflection of building code changes), occupancy type, and ground elevation for flood potentials.

The advancement of individual risk rating is a major contributor to premium increases of high risk exposures, compounding with the overall premium level increase as mentioned above.

Although reinsurance costs have contributed to the increase in premiums for northern Queensland, it is unlikely to be significant due to the low proportion reinsurance cost accounts for in the overall premium, and the softening of the reinsurance market cycle post 2011. Please refer to the later section for a detailed discussion.

Issues surrounding the mutual insurance company

The INTERIM REPORT has addressed many important aspects of a potential mutual insurance company offering cyclone cover to householders. The Actuaries Institute finds most relevant issues have been raised and are well discussed in the INTERIM REPORT.

The Actuaries Institute recommends further discussion of the level of government involvement and possible government exit options. Clarifications would be helpful to address different roles of the proposed mutual insurer:

- A sole cyclone insurance provider for all residents in Northern Australia;
- A limited cyclone insurance provider for specific sub-group(s), such as high risk customers or residents with affordability issues;
- An alternative cyclone insurance provider operating (competing) with private insurers, such as the Citizens model.

The Actuaries Institute wishes to raise a potential misinterpretation of the US issues with flood and hurricane. This could be also a good example of illustrating the complexity in setting the coverages for the mutual insurer / cyclone pool. The US Flood program covers riverine flood as well as coastal storm surge. There were relatively few claims issues with riverine flood and cyclone, other than down-stream flooding losses as discussed in the INTERIM REPORT. Much of the US issue with flood and hurricane was due a combination of the flood program covering coastal storm surge and significant coverage restrictions relative to private market hurricane (wind) coverage. For example, if the NFIP has a $300,000 coverage limit, the insured with a $500,000 loss after a hurricane has a strong incentive to claim against the hurricane coverage instead of the flood coverage (storm surge). To the extent that Australia does not offer coastal storm surge coverage or contemplate lower flood limits than for wind the US example cited may not be applicable.

On page 25 of the INTERIM REPORT, the possible crowding out effect of the private sector is mentioned using Citizens Property Insurance Corporation as an example. However, this example could be less applicable here because in the US rates are subject to strict regulation and some argue that Florida regulators suppressed premiums in high risk areas for private insurers. This may have led to insurance coverage availability problems when insurers no longer offer coverage at approved prices. To the extent that Australia does not regulate rates in the way the US does the example may not be directly applicable to Australia.

Insurance premium (risk premium) is a reflection of potential risk as determined by the insurance company. The INTERIM REPORT states that “An important role of the insurance market is to provide price signals about risks…”; “…insurance premium should provide an incentive for development in areas with lower risk of nature perils". The Actuaries Institute finds discussion is required to bring the awareness that mandatory suppressing of premium rates for the overall community or certain sub-groups may have the impact of distorting the effect of insurance premium as a price signal, reduce the incentives of risk mitigation and anti-selection.

In the possible case of a non-mandatory mutual insurer, the anti-selection issue could arise where many insureds with high risk choose the mutual insurer (it is assumed to be offering lower premiums rates than commercial insurers); while less exposed buyers remain with the current private insurance market.

The Actuaries Institute agrees with the taskforce that the potential confusion regarding coverage gaps, customer experience including design insurance contracts, policy distribution and claims management issues are complex and important considerations. Those issues not only create confusion to the customers, but also create uncertainty for the insurers in the pricing, distribution and settlement of the losses. A recent example of how the interaction of different risk coverage between two policies may not work that we would recommend investigating is the New Zealand earthquake e.g. the EQC cover and the related householder policy.

Impact of reinsurance and the need for a reinsurance pool for cyclone

The Actuaries Institute agrees with the taskforce that higher reinsurance cost allocation is one of the contributing factors for the premium increase in Northern Australia. However, we do not believe this is a key driver of the premium issue, or that there is any immediate issue that needs to be solved. Setting up a reinsurance pool may have little impact on the overall cyclone premium if not heavily subsidised by government funding.

The Actuaries Institute finds the method insurers use to allocate reinsurance cost to various geographical regions and policy types, as described in the INTERIM REPORT, is justified. Cyclone is one of the main drivers for required reinsurance purchase and hence will bear its proportion of reinsurance cost.

For catastrophe excess of loss reinsurance contracts typically purchased by the insurance companies in Australia, only the amount above the excess point is covered by reinsurers. Due to the high frequency nature of cyclone events in north Australia, as mentioned in Appendix E of the INTERIM REPORT, the insurance companies retain a significant proportion of the cyclone losses in each and every event, which is not dependent on the cost of reinsurance.

The Actuaries Institute finds there is no evidence suggest any shortage of reinsurance capacity in the current market, nor any indication of potential market failure in the current catastrophe reinsurance market for Australia or globally. In fact, the soft reinsurance market is operating at its lowest level since 2001. This is fundamentally different to the situation of terrorism reinsurance market when ARPC was established in 2003.

The Actuaries Institute supports the concerns as expressed by the taskforce that a number of challenges and issues exist regarding the feasibility of a cyclone reinsurance pool, including but not limited to: coverage specification, contract design, wording, structure design, pricing, retrocession, etc. The proposed reinsurance pool is heavily concentrated and little diversification benefit is available due to the single line single peril exposures involved.

The Actuaries Institute finds little additional benefits the proposed reinsurance pool can bring to the market, insurers or primary policyholders, and the potential challenges and issues clearly out-weight those benefits.

The Actuaries Institute recommends further studies to the experience and lessons learned in the Florida Cat Fund, if necessary, as many of the questions the taskforce is trying to address have been thoroughly discussed there for over twenty years.

Role and Benefits of Mitigation programs

The Actuaries Institute supports the taskforce's statement that "Mitigation should be an important component of any effort to reduce insurance premiums". Mitigation efforts, if conducted appropriately, reduces the actual risk and is a far more effective method to reduce the overall technical premium compared to premium subsidy or community rating approaches.

The main drivers of the recent increase in premium rates for northern Queensland include the correction from previous (undercharged) levels; and the impact of refinement of risk rating in the cyclone peril enabled by the advancement in technology.

Reverting back to community rating does not change the overall risk and premium level. It is a mechanism for sharing losses amongst the community. Government premium subsides would create immediate but only a short term effect. As soon as the subsidy is removed, the insurance premium would revert to the technical level.

In contrast, mitigation efforts have the flexibility of being applied to the whole community or a specific sub-group of the population. It brings a fundamental change to the underlying hazards, which will lead to a sustainable reduction in premium cost.

Effective (cyclone) loss mitigation will bring:

- True reduction in underlying exposures, and long term sustainable premium reductions;
- Flexibility in the target group so available funding levels can determine whether mitigation efforts can be focused on selected community groups or applied across the board to all residents in Northern Australia
- Community and social benefits. In addition to the insurance premium reductions, mitigation helps to raise the community awareness of cyclone hazards and improves the risk resilience. It will also bring additional social benefits in the terms of lower damage levels and less disruption to residents after a cyclone; and

Economic benefits – KPMG modelling [i] shows that, over 10 years, a $250 million annual investment in disaster mitigation could result in a $6.5 billion boost to GDP, while a pool approach reduces GDP over the same period.

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i Commissioned by Suncorp referenced in submission to the 2014 Productivity Commission for Natural Disaster Funding Arrangements http://www.pc.gov.au/inquiries/completed/disaster-funding/submissions/submissions-test2/submission-counter/subdr176-disaster-funding.pdf