10 October 2019

ACCC Northern Australia Insurance Inquiry
GPO Box 520
MELBOURNE VIC 3001

Email: insurance@accc.gov.au

Dear Sir/Madam

Northern Australia Insurance Inquiry – Second Update Report

The Actuaries Institute ("the Institute") welcomes the opportunity to comment on this report. Although our comments are being provided after the consultation period, we hope they are of assistance to the ACCC's consideration of this complex topic. Our comments are restricted to 'Focus area 1: Measures to improve affordability and availability'.

Background

The Institute is the sole professional body for actuaries in Australia. The Institute is committed to promoting and maintaining a high standard of actuarial practice and contributing to public policy through submissions, thought leadership and expert analysis.

The Institute provides commentary on public policy issues where there is uncertainty of future financial outcomes. We strive to act in the public interest and our contributions to public policy issues are guided by the principles of transparency, a 'level playing field' and good regulation (proportional and the most appropriate regulatory tool/s).

This submission builds further on our submission of 21 December 2017 to this Inquiry.

General principles

The Institute offers advocates the following key principles guide development of any solutions to help address insurance affordability.

1. Solutions should, as much as possible, **target mitigation activity rather than disaster recovery** because this is likely to be most cost-effective in the long-term.
    - As noted by the Productivity Commission (2015) in Finding 2.6 "Mitigation expenditure across all levels of government is likely to be below the optimal level, given the biased incentives towards recovery under current budget treatments and funding arrangements."
    - Mitigation activity will become increasingly important as the physical risks of climate change increase. Consideration should be given to the current and future vulnerability of properties to a range of perils and appropriate building codes and town planning for new properties in high risk areas.

2. **Mitigation funding needs to be done at both the micro level** (individual households and businesses) **and macro level** (public spaces and infrastructure owned and managed by various levels of government).

Institute of Actuaries of Australia
ABN 69 000 423 656
Level 2, 50 Carrington Street, Sydney NSW Australia 2000
t +61 (0) 2 9239 6100 **f** +61 (0) 2 9239 6170
e actuaries@actuaries.asn.au **w** www.actuaries.asn.au

3. **Multiple stakeholders need to contribute** to both mitigation and recovery activity to maximise effectiveness.
    - Including, but not limited to, all levels of government, climate scientists, engineers, insurers, data providers, emergency responders and community leaders.
    - The contributions of individual members of the public are particularly relevant in effective micro mitigation activity.

4. As much as possible, the competitive market should be maintained because **market-based insurance price and/or benefits signals** provide incentives to individuals and businesses to prevent and mitigate risks. To the degree possible, such market-based pricing should quickly reflect mitigation actions in a way apparent to those who purchase insurance products.
    - As noted by the Productivity Commission (2015) in Finding 4.2 "International experience has shown that government intervention in property insurance markets through subsidies weakens the price signals that insurance premiums send to households and businesses about the level of risk faced. These schemes also create fiscal risks. Governments have had to bear significant costs following large natural disasters because their insurance schemes failed to accumulate adequate reserves."

5. However, where there is a market failure, measures can be considered – such as pools, mutuals, cross-subsidies, catastrophe reserving for insurers or other types. The Institute encourages **a deeper review of the examples available globally**.

6. Solutions should, as much as possible, be considered on **a national basis** because the insurance market itself is national.
    - Most natural and non-natural perils affect multiple regions. A solution to address any specific peril should therefore be available to all affected regions. Also, most insurers operate nationally.
    - Targeting of solutions and assistance to those most in need is likely to be most equitable, simple to understand and efficient to administer if done using Australia-wide data or agencies, such as Centrelink or the Australian Taxation Office.

Affordability Concerns

The Institute also provides the following specific comments about insurance affordability.

A key underlying driver of affordability concerns is a change in understanding of risk which has been triggered by:

- improved technology, including advances in catastrophe modelling;
- higher resolution data at an address level; and
- learnings from recent events, such as the Queensland Floods or Cyclone Yasi.

This has led to more refined rating better reflecting risk at the property level.

- Generally, this has a positive effect of sending appropriate economic signals about risk, providing incentives for risk mitigation, and thus lowering aggregate costs for all Australians over time.

- Better aligning price with risk benefits many policyholders who receive lower prices where risk is low, or mitigation actions have been taken.
- However, a limited cohort of policyholders may experience significant price increases when moving from a prior state of less refined rating to one focused on risk at the location level.

It is difficult to impossible for cross-subsidies to persist in a competitive market armed with high resolution pricing tools.

There are also socio-economic factors to consider in relation to affordability, such as wage and employment levels, level of debt and other household expenditure.

Addressing Affordability Concerns

In some cases, it is not practical or possible for existing policyholders to undertake mitigation activities that can sufficiently lower risk to render premiums "affordable".

- This can lead to undesirable outcomes, such as an increase in under- or non-insurance.
- This in turn can result in economic harm to individuals through reduced property values and/or inability to rebuild after a disaster, which can inhibit communities' resilience and recovery from disasters.
- Consequently, there can be an increased cost to government post-disaster recovery (e.g. through off-assistance, social security payments and reduced tax revenue).

Cross-subsidies through various mechanisms can be employed to address affordability issues. Since it is difficult to sustain cross-subsidies in competitive private markets, some type of government involvement is usually required to compel them, such as laws governing market behaviour.

- If not carefully controlled these can lead to adverse outcomes, including:
  - incentives for over-development in high risk areas and/or reduced incentives for mitigation, increasing long term costs to the system;
  - long term dependence on subsidies; and/or
  - an increased cost burden to those paying the subsidies.
- The Institute recommends the following "best practice" principles if cross-subsidies are employed to help with the transition to refined risk-based pricing.
  - They should be narrowly targeted to address demonstrated affordability issues.
  - Target those most affected by affordability issues, through mechanisms such as benefit limits or means testing.
  - They should only be made available to existing property; any new development/construction should be subject to full market pricing.
  - Private market participation should be maximised, and market disruption should be minimised.
  - Any cross-subsidies should be market neutral, in that they do not create advantages for one group of insurers over another.

Pools can be a mechanism for providing cross-subsidies but are not the only one.

- As with cross subsidies, if not carefully controlled these can lead to adverse outcomes, including:
  - large deficits that ultimately are paid by governments, taxpayers, or low risk policyholders;
  - cost inefficiencies through duplication, for example of claims handling; and
  - displacement of or disincentives to private insurers, which can reduce the service levels to policyholders.
- The Institute observes:
  - There are numerous examples of pools which have achieved a varying degree of success in promoting public policy goals such as addressing affordability, encouraging mitigation, limiting government exposure to deficits and maximising private market participation. Examples include:
    - EQC NZ (a program with significant cross-subsidies but which maintains a major role for private market to function);
    - Florida Hurricane Catastrophe Fund US (a reinsurance example focused on cyclones, similar to the Northern Australia 'problem');
    - Flood Re UK (an example of time limited pool tightly focused on problem properties); and
    - NFIP US (an example of a pool which has experienced enormous deficits and contributed to over-development in high risk areas).
  - Generally, public-private partnerships are desirable, should there be a market failure.
  - There are advantages and disadvantages to time-limited vs. long-term pools; in all cases periodic review of pools is necessary to ensure they remain fit for purpose as conditions change.
  - Pools can "play by different rules" than private insurers, which can create problems when the two interact.[1]
  - A detailed analysis of specific characteristics of pools is beyond the scope of this submission but has been done by other global actuarial associations and is an area of research for the Institute.[2]

There are other mechanisms globally to temper costs for high risk catastrophe markets, such as Claim Equalization reserves in Germany and Japan. These tax efficient reserves can support Insurers "saving" to manage catastrophe risk and ceding less through reinsurance. The potential benefits of lower reinsurance costs could improve affordability where it is cheaper for insurers to retain catastrophe risk diversified across financial years.

Affordability can also be addressed by reducing the vulnerability of homes through community infrastructure and/or measures to improve the resiliency of individual properties. In some cases, however, property locations may no longer be fit for residential purposes and a comprehensive solution should consider how this issue can be addressed.

[1] See Section 7.2, pages 46-49 in the International Actuarial Association Discussion Paper "Flood Risk", https://www.actuaries.org/IAA/Documents/Publications/Papers/REWG_Flood_Risk.pdf.

[2] See Sections 7.3 and 7.4, pages 49-53 of above-mentioned publication.

Climate change is likely to trigger further changes in risk understanding, which may mean the market disruption issue will be with us for some time. Long-term consideration of climate change is essential. In particular, the implications of climate change need to be considered in building code, land use and infrastructure investment decisions.

Other comments

The Institute would be happy to explore these or other ideas further if this would be of assistance to the ACCC. If you wish to do so, please contact Elayne Grace, Chief Executive Officer of the Actuaries Institute, on (02) 9239 6100 or elayne.grace@actuaries.asn.au.

Yours sincerely

Nicolette Rubinsztein
President