ACCC Northern Australia Insurance Inquiry

Response to Issues Paper by

Allianz Australia

Part 1 Introduction

Allianz notes the submission by the Insurance Council of Australia (ICA). Allianz supports the material in the ICA submission relating to the pricing and cost of insurance and the competitiveness of home insurance markets in Northern Australia and elsewhere in Australia.

The main focus of Allianz's submission is the affordability of home insurance in Northern Australia, particularly for the owners of older homes (ie those built before higher cyclone resilient building standards were introduced around 1982) and homeowners that face medium to high flood risks. Allianz is concerned that home insurance has become unaffordable for some Australians facing cyclone and/or flood risks. As a customer-focused organisation, this concerns us greatly.

Allianz's submission provides some background on how insurers set premiums and discusses some of the drivers of high home insurance premiums, particularly for properties vulnerable to cyclone and flood. Flood risk is not limited to Northern Australia, however, for affected property owners, it creates as much, and often more of a home insurance affordability issue as cyclone risk. As a result, any comprehensive discussion about home insurance affordability cannot be limited to cyclone risk or to Northern Australia. That said, affordability issues are most acute for homeowners that are vulnerable to both floods and cyclones.

In this context, Allianz submission focuses on how the industry and government could work together to practically, efficiently and comprehensively address the cost of insurance for those Northern Australian homeowners that cannot afford home insurance. Some of these reasons include the age of the property, its vulnerability to flood risk and household income. In relation to the Issues Paper, Allianz notes discussion about mitigation, disclosure and comparing quotes and switching insurers. However, it is Allianz's view that, while improvements can be made in all these areas, they would have limited if any impact on the high cost and, hence, affordability of home insurance in Northern Australia. Indeed, an initiative recently studied by the Senate Inquiry into General Insurance, that is, a mandatory home insurance comparison site, would likely exacerbate premiums in high risk areas and reduce competition. Allianz would be concerned about any government initiatives that had the unintended consequences of making home insurance even harder to obtain or afford for consumers.

If at some time in the future an Australian Government gave serious consideration to how the high cost of insurance facing some homeowners could be directly addressed, Allianz's submission discusses how this could be achieved through the establishment of a government supported reinsurance facility for cyclone and/or flood risk.

Other issues covered in this submission relate to the introduction of risk pricing following the purchase in 2014 by Allianz of TIO from the Northern Territory Government (Appendix A) and the role of strata managers in the arranging of insurance cover (Appendix B).

Part 2 Insurance: Principles, Premium Setting and Risk Selection

Principles of insurance

Pooling risk

Insurance is based on the principle of pooling risk. That is, a large number of policyholders pay a relatively modest premium into a 'pool', out of which is paid larger amounts of money to a relatively small number of policyholders that make a claim during the period of insurance, which is normally 12 months.

A basic, but complex, task of an insurer is to calculate the size of the premium pool that will be required to pay all claims received. To do this, insurers need to estimate how many claims might be received (the claims 'frequency') and what the cost of those claims will be (the claims 'severity').

For 'short tail' insurance[1], the objective is that, in each year, the premium pool collected by an insurer (eg home insurance) is sufficient to pay the claims made by policyholders, as well as to cover the operational and other costs of running the insurance company (eg commissions paid to intermediaries), including a reasonable profit, which after payment of company tax, provides a fair return to shareholders.

[1] 'Short tail' insurance refers to policies where the premiums received and related claims are generally paid within the same 12 month period (eg home and motor insurance). 'Long tail' insurance refers to policies where the claims are received and/or largely paid in the years after the period of insurance in which the premium was received (eg motor injury (CTP) and liability (public liability, professional indemnity) insurance).

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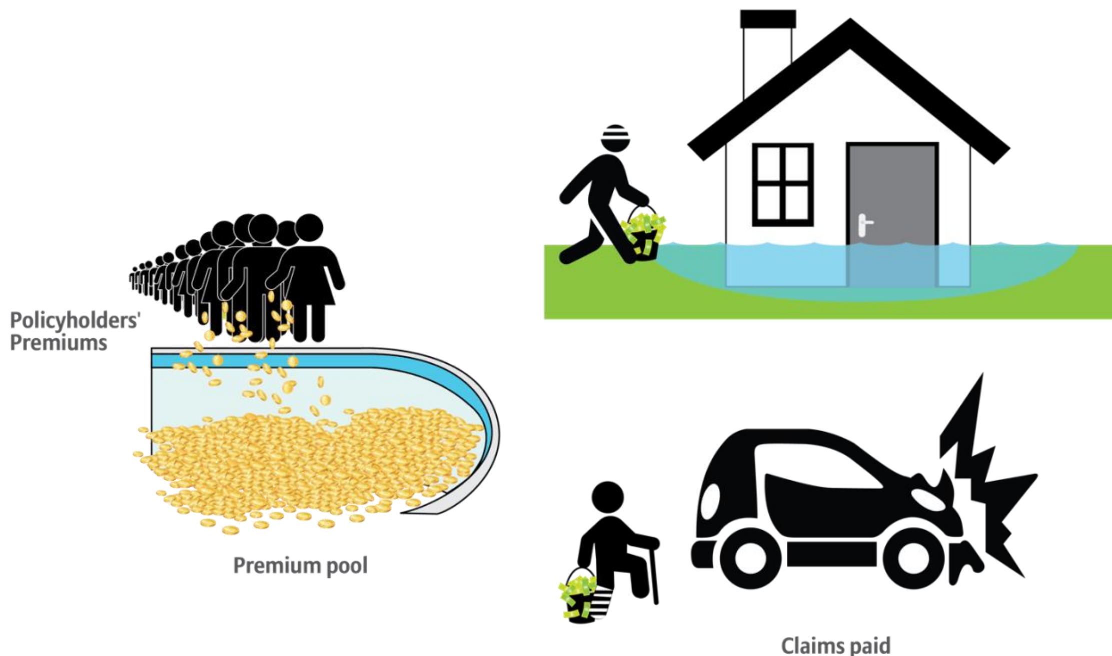
Figure 1: Insurers collect a 'pool' of premiums out of which claims are paid



Spreading risk

Insurance is also based on the principle of spreading risk across policyholders with different risk profiles. For example, insurers will seek to spread their risk geographically, for example, so they don't have a concentration of home insurance policyholders in areas particularly vulnerable to perils such as flood, cyclone or bushfire. For instance, no insurer would want to insure every house on the banks of the Hawksbury River (flood risk), in North Queensland (cyclone risk) or in the Adelaide Hills (bushfire risk). Insurers avoid such situations because they create what insurers call 'concentration risk'.

If an insurer is over-exposed in an area vulnerable to a particular natural peril, then it will be more adversely impacted than its competitors when an event occurs. To protect itself against such a risk an insurer would need to increase its level of reinsurance[2] protection. This would add to the insurer's costs[3] and necessitate an increase in its premiums to return its premium pool to its target level of profitability.

[2] Reinsurance is insurance that is purchased by one insurer from one or more other insurers and comes in many forms. A common one is 'catastrophe' reinsurance, which is used to protect an insurer against the impact of an unexpectedly large number of claims arising out of a catastrophic event (eg an earthquake).
[3] The Australian Prudential Regulatory Authority (APRA) also recognises this risk and applies an Insurance Concentration Risk Charge, which can increase the amount of capital an impacted insurer needs to hold, which will also increase the insurers cost base.

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Setting insurance premiums

Community rating – all policyholders pay the same or similar premium

One option for setting the premium to be paid by each policyholder is to divide the total amount of the required premium pool by the number of policyholders and, taking account of different levels of insurance cover, charge each policyholder the same 'rate' (ie cents per dollar of insurance cover)[4]. Put another way, charge each policyholder a 'weighted average' premium, where the weighting is based on the amount of insurance cover provided under each policy related to the different sums insured of customers' houses).

This approach is sometimes referred to as 'community rating'. In Australia, governments regulate some insurance markets to achieve, to a greater or lesser degree, a community rated premium, for example, private health insurance and compulsory third party (CTP) motor accident injury insurance.

Figure 2: Community rating – all policyholders pay a similar premium irrespective of risk

[4] Insurers call this the 'Rate on Line' (ROL), one version of which is a percentage derived by dividing the premium by the limit of the insurance cover. For example, a premium of $1000 for a car insured for $20,000 would have an ROL of 5%.

Community rating is not possible in an unregulated insurance market where policyholders have different risk profiles. That is, where some customers have a higher risk of making a claim than others. Charging all policyholders the same rate, irrespective of their risk profile, results in lower risk customers being overcharged and higher risk customers being undercharged, relative to the amount of ‘risk’ they bring into the insurance ‘pool’.

In an unregulated market like home insurance, an insurer that used the community rating approach would lose the lower risk customers that are being overcharged to other insurers who could offer a more competitive price, and be left with the higher risk customers that are being undercharged. The customers being undercharged would not contribute sufficient premiums to fund the claims they would be make, making the community rating insurer unprofitable.

Risk rating – different premiums for high and low risk policyholders

When premiums are ‘risk rated’, higher risk policyholders are charged a higher premium than lower risk policyholders. Principles of fairness and equity dictate that insurers should charge policyholders a premium that is commensurate with their risk. For example, why should older drivers pay a higher motor premium to subsidise the poor driving skill and behaviour of some young drivers?

Commercially, an insurer has no choice in the matter. If they don’t set premiums according to risk, competitors that do will be able to offer the lower risk policyholders of a community rating insurer a cheaper, more competitive premium. This would leave that insurer with both fewer customers in total and, more significantly, a larger proportion of higher risk customers in its premium pool. That insurer is said to be suffering from ‘anti-selection’ or being ‘selected against’. An insurer that suffers from anti-selection because it community rates its premiums (ie cross-subsidises between its high risk and low risk customers) will retain its less profitable (or loss making), higher risk customers and lose its more profitable, lower risk customers to its risk rating competitors. The combination of these effects will negatively impact a community rating insurer’s profitability.

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Figure 3: Risk rating – policyholders pay a premium that reflects their risk

Risk selection

Are there good and bad risks?

Just to complicate things further, low risk customers are not necessarily ‘good’ (ie profitable) risks and high risk customers are not necessarily ‘bad’ (ie unprofitable) risks. Any customer can be a ‘bad’ insurance risk and they become so if the premium they are charged is insufficient to cover the amount of risk they bring to the insurer’s premium pool. Alternatively, any customer, no matter how risky, can be a ‘good’ risk if they are charged a premium that reflects their risk. Indeed, some insurers specialise in providing insurance to customers that have high risks. Allianz Australia, for example, has a business unit, Allianz High Risk Solutions, that does just that.

Charging the ‘right’ premium to match the risk

The science and art in insurance, therefore, is to charge every customer the ‘correct’ premium to reflect their risk. If this occurred, all customers would be ‘good’ risks because they would contribute a premium commensurate with the risk they bring to the premium pool and, hence, the claim payouts they will take out of it. In doing so, they fairly contribute to the running of the insurance company and to the return on equity the insurer’s shareholders deserve.

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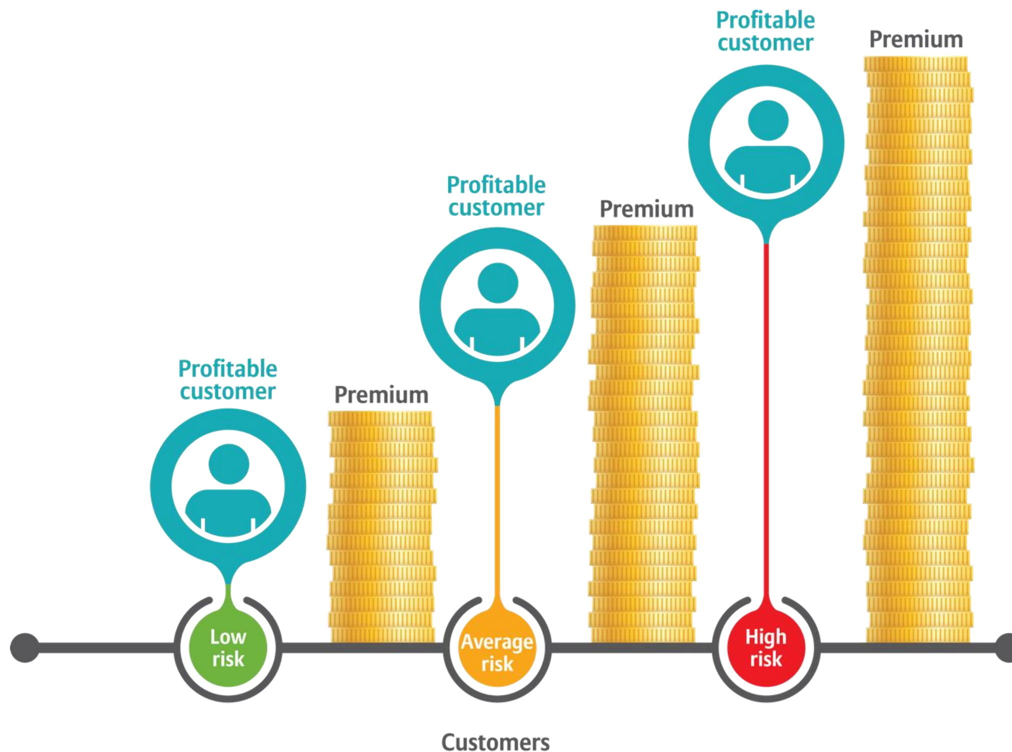
Figure 4: Calculating the right premium to reflect the risk



Selecting risks

To protect themselves against anti-selection, insurers use pricing and risk selection strategies to target ‘good’ (ie more profitable) risks in preference to ‘poor’ (ie less profitable) risks. Insurers also put in place strategies to ensure that they are not over represented in high risk areas and, as a consequence, accumulate an excessive market share of high risk customers (eg in cyclone, flood and bushfire zones). For example, if an insurer accumulates an excessive concentration of customers vulnerable to extreme natural events, its reinsurance costs will be higher relative to other insurers, causing its premiums to rise and making them less competitive compared to other insurers.

Setting the 'correct' premium

As suggested above, in an unregulated insurance market, no insurer will adopt a community rating pricing approach. All insurers will seek to risk rate all policyholders. Success then, depends on how accurately an insurer can do that. It is an insurer's premium setting ability, based on its risk pricing and risk selection capabilities, that will determine how well it can compete, whether it can generate adequate profits and, ultimately, whether it will survive.

Insurers invest heavily in expertise, information and technological capabilities to assess each customer's risk and try and calculate the 'correct' premium they should be charged. Insurers often refer to this as the 'technical' premium, which is a better description because, as discussed, uncertainties about future claims costs, imperfect information and information asymmetry, as well as technical limitations and other constraints, mean that it is in fact impossible to calculate the 'correct' premium for every customer. As a result, the premium setting and risk selection capabilities of home in the Australian market vary significantly.

Variations in insurers' prices

Even the premiums offered by insurers that have similar price setting capabilities can differ significantly. This arises because insurers will make different assumptions, for example, about the probability of a loss occurring and/or the cost of a resulting claim. Insurers will also sometimes use different rating factors, which will impact on their estimate of the 'correct' premium for a particular risk. For example, in cyclone areas an insurer might factor a house's roof material (eg, tiles, iron, Colorbond) into its premium calculations.

The range of factors, therefore, that can lead to insurers offering differing premiums for the same risk include, things such as:

- information from its past claims experience (eg the cost of repairing certain makes and models of motor vehicles);
- natural peril information (eg the risk of flooding at a particular address);
- 'rating factors' (eg the probability and damage severity of cyclones of different strengths); and
- modelling capabilities (eg the size and number of its multi-variate generalised linear models[5]).

Even if insurers used similar assumptions about which rating factors are relevant in pricing a particular risk, the weighting they place on their assumptions and rating factors when setting

[5] Multi-variate generalised linear models are statistical models used by insurers for a variety of purposes, including pricing.

prices may differ. All these factors will lead to insurers offering different premiums for the same customer.

Such premium differences can be found in the prices on the home insurance comparison site established by the Australian Securities and Investments Commission (http://www.nqhomeinsurance.gov.au). The ASIC comparison site shows 'indicative' premiums of insurers for home building and contents insurance policies in Nth Queensland. For example, for a home building policy for a pre-1980 built house in South Townsville (Postcode 4810) with a sum insured of $350,000, the 'medium' (ie average) premium among the represented insurers ranges from $2,521 to $7,618[6]. Across the full risk spectrum, that is, between the lower 10% and higher 10% of premiums, premiums ranged from $1,340 to $8,937. For the same house build after 1980 the premium quotes ranged from $1,475 to $6390.

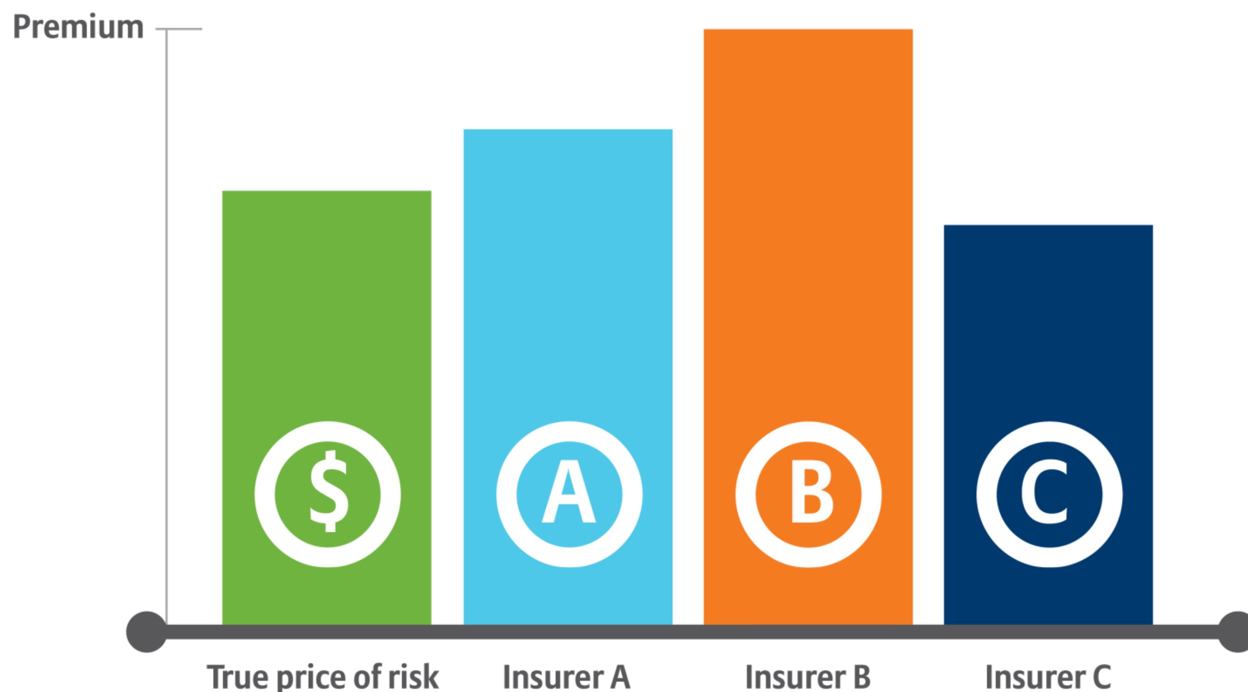
Thus, due to variations between insurers' pricing capabilities and/or their assumptions about risk, different insurers will offer the same customer a different premium. In a competitive market, this is normal and will always occur, for example, because the 'technical' price of the risk will differ between insurers depending on business cost factors (eg operational costs, cost of capital, cost of reinsurance etc) but, relevantly, due to the risk price the insurer has calculated for a particular customer.

For example, a particular house located in Townsville insured for $350,000 has the same risk of being destroyed by a cyclone, regardless of which insurer covers it. The 'true' cost[7] of that risk will be the same for every insurer and be driven by the actual frequency and severity of loss[8]. Despite this, the factors driving the setting of premiums mean that there is generally a range of prices offered in the market based on different insurers' estimates of their own 'technical' price and which can diverge widely from the 'true' price of the risk.

Thus, while all insurers' technical premium will not be exactly the same for legitimate reasons (eg underlying cost structures), and no insurer's 'technical' premium is likely to be exactly correct relative to the 'true' price of the risk, some are more inaccurate than others. As a result, because of the inaccuracy inherent in insurance pricing, even in a market where all insurers are seeking to set premiums according to risk, anti-selection is alive and well. Just as importantly, even among insurers that have similar risk pricing capabilities, different judgements about risk assumptions, will result in very different prices in the market for the same risk. These price differences also create the risk of anti-selection.

[6] As at 14 December 2017.
[7] Where the 'true' price is the 'theoretical' one that an insurer would calculate if it had perfect information and no other restrictions on their ability to calculate the precise premium that exactly matched the value (ie the frequency and severity) associated with the risk.
[8] The frequency of loss relates to the probability of a claim being received and the severity of loss relates to the cost of that claim. A single property can have a number of frequency and severity probabilities for the same type of event. For example, an insurer might estimate that a particular house has a risk of a $150,000 claim in a 1 in 100-year flood, a risk of a $80,000 claim in a 1 in 50-year flood and a risk of a $30,000 claim in a 1 in 20-year flood.

Figure 6: Variations in market prices for a risk



Impact of different pricing capabilities and risk assumptions on anti-selection

An insurer can be selected against if it (inadvertently, unknowingly or otherwise) mis-prices a risk, for example, if it under-prices a risk and, as a result, attracts unprofitable customers. However, due to differences in insurers' pricing and risk selection capabilities, some insurers will also be at risk of being selected against in relation to their lower risk customers.

For example, for customers that are regarded as having a high risk profile, an insurer would be extremely concerned if it discovered that it was the lowest price in the market. If an insurer was offering the cheapest home insurance in Nth Queensland it would potentially attract significant numbers of customers away from other insurers and risk accumulating an excessive exposure to cyclone risk. In such a circumstance, there can be two explanations as to why that insurer is cheaper than its competitors:

- first, because its pricing capability is superior to all other insurers, its price is the 'correct' one and all its competitors are unknowingly setting a wrong, higher price; or
- second, its pricing is wrong and all the other insurers' prices are closer to the 'true' risk price because they have superior pricing capabilities.

If an insurer came to the first conclusion, its cautious instincts would likely see it increase its price to protect itself against the risk of anti-selection. Even if did not believe it had mis-priced

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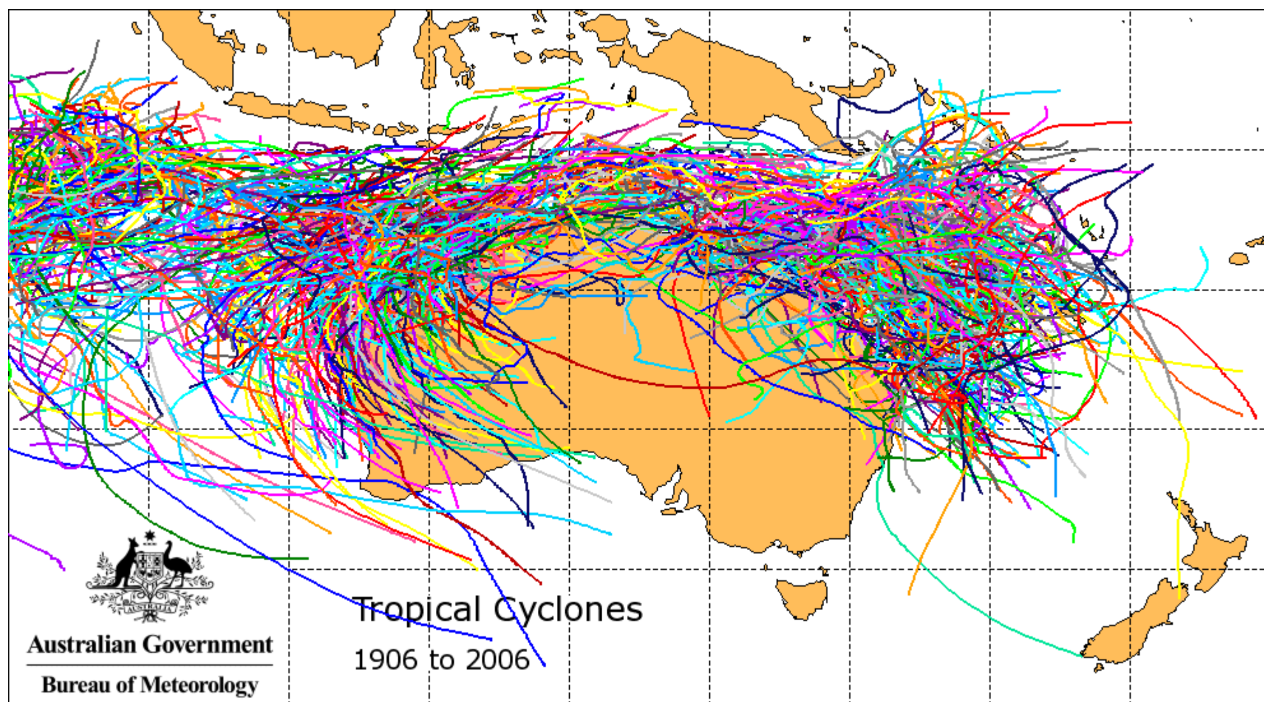
the risk, the risk of accumulating an excessive share of high risk customers would lead it to increase premiums, if only because a higher exposure to high risk customers would lead to higher reinsurance costs which would have to be passed on through higher premiums to policyholders.

If an insurer came to the second conclusion, it would increase its price, again, to protect itself against anti-selection and risk accumulation.

North Queensland cyclone risk and residential home and strata insurance premiums

The high prices of home insurance in Northern Australia reflect the risks associated with the extreme weather perils facing the area. In particular, Northern Australia is vulnerable to cyclones, which for the most part do not impact the southerly regions of the country – see pictures below. As at 2015, 214 reported tropical cyclones had crossed the East Coast of Australia in the last 155 years; an average of 1.4 per annum. The overwhelming majority of these cyclones crossed the cost of Queensland, particularly Nth Queensland.



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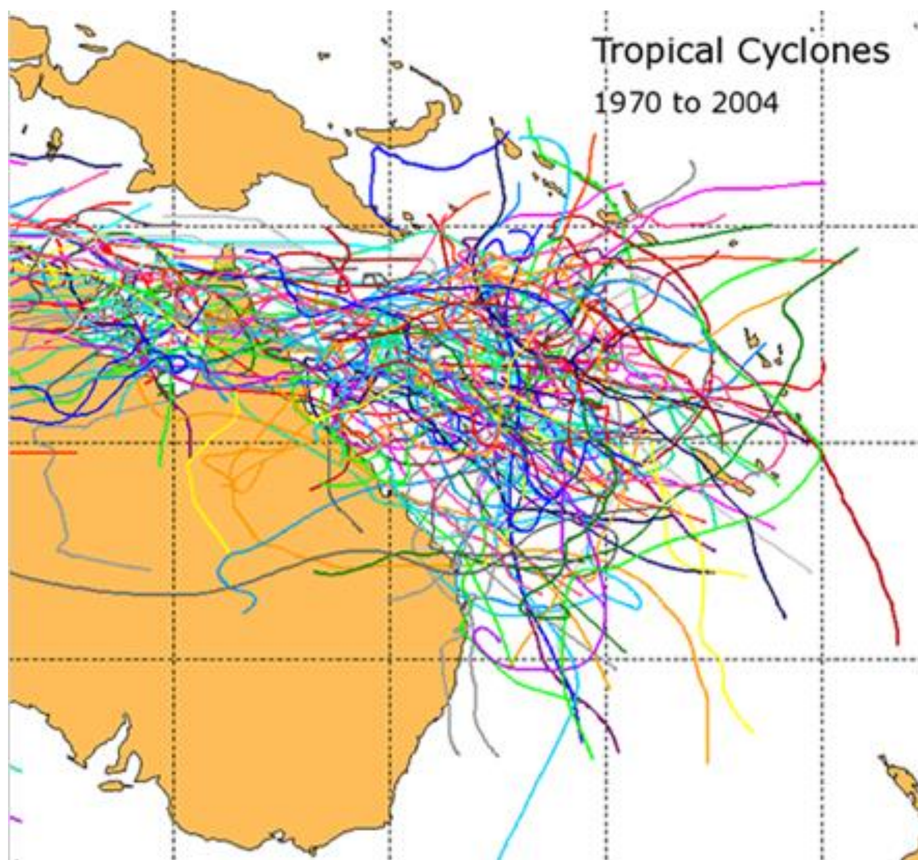

Allianz's submission focuses on residential home insurance. Many of the issues raised and solutions discussed apply equally to residential strata insurance. Prior to a recently established partnership with Strata Community Insurance Australia, Allianz did not generally provide residential strata insurance in Nth Qld. One reason for this was that, in Allianz's view, prior to premium corrections following Cyclone Yasi in 2011, cover for strata properties in Nth Qld had been under-priced and hence unprofitable for many years, if not decades. For example, in the eight years to 2012-13, Allianz's Gross Earned Premium from residential strata insurance was around $350,000. Over that period, Allianz's cumulative losses (inclusive of reinsurance recoveries) were around $1.15 million. In other words, Allianz incurred losses of more than three times the amount collected in premiums.

The responses to the ACCC's Issues Paper will understandably focus on the affordability of home insurance in Northern Australia in the context of cyclone risk because all homeowners in the region face this risk. However, Allianz has been concerned for many years about the lack of affordability of residential home insurance for those Australians that are subject to the risk of cyclones and floods (or both). Allianz's concern that the private market, charging premiums based on risk, is not able to provide affordable home insurance to all Australian homeowners, has prompted us to consider how this lack of affordability could be addressed. The potential

solution to this issue is therefore considered in the context of both cyclone and flood risk, the latter being relevant to the whole country, not just Northern Australia.

Allianz believes any discussion of home insurance affordability needs to consider both flood and cyclone risk because:

- while cyclone risk may be creating home insurance affordability issues in Northern Australia resulting in both non insurance and underinsurance, flood risk is creating more acute affordability issues for some homeowners all over Australia. The main reason high flood premiums have not led to large numbers (potentially some hundreds of thousands) of homeowners being forced out of home insurance altogether is that a small number of insurers, particularly Allianz, allow homeowners with a flood risk to opt out of flood cover. This, of course, is no solution to the problem of flood insurance affordability because it means that these homeowners do not have cover for the largest natural peril they face; and

- Northern Australian residents can be subject to both flood and cyclone risk, resulting in extremely high home insurance premiums that are unaffordable for most homeowners facing this twin peril.

Affordability of home insurance premiums

While home insurance premium rises have moderated over the last couple of years, premiums increased for all Australians, particularly those in Northern Australia, over the decade to 2015. One of the significant drivers of these increases was a large number of extreme weather events. This started with Cyclone Larry in 2006 and includes the:

- 2009 Victorian Black Saturday bushfires;
- 2010 Melbourne and Perth hailstorms;
- 2011 Queensland and Victorian floods, Cyclone Yasi and Melbourne's Christmas Day hail storm;
- 2013 Blue Mountains Bushfire;
- 2014 Brisbane hail storm; and
- 2015 NSW East Coast low and Cyclone Marcia;

The above is by no means all the extreme weather events that occurred over the period and since (eg Cyclone Debbie in 2017).

The impact of the earlier events, particularly the Queensland floods and Cyclone Yasi, on insurers' claims costs and the cost of catastrophe reinsurance flowed quickly through to higher premiums for all Australian homeowners, particularly over the period 2012-14. However, increases were even more pronounced for those vulnerable to flood and cyclone risk.

Affordability of insurance for cyclone risk

Insurance premiums for properties exposed to cyclone risk can be very expensive. Industry data suggests that average premiums for combined home and contents insurance in Nth Queensland are around 2.5 times those in Queensland's southern cities for properties with no or negligible flood risk. However, from its own experience, Allianz knows that underlying average insurance premium figures in Nth Queensland, there are wide variations in the prices faced by homeowners.

In some circumstances, a Nth Queensland property can face premiums of up to ten times that of a similar property not vulnerable to cyclone risk, if the property:

- was built before 1982, when higher cyclone building standards were introduced;
- is constructed of weatherboard, rather than brick;
- has had recent claims and is, for example, ineligible for no claims bonus discounts;
- is located on low lying land close to the coast and is thus also vulnerable to storm surge, which is often caused by cyclones or extreme low pressure storm events that cross the coast; and/or
- is located on the side or top of a hill (where windshear can result in wind speeds nearly twice that impacting adjoining flat areas).

The table below provides some examples of home building premiums currently being paid by Allianz policyholders in Nth Queensland and Western Australia. It is surprising to find that some of our customers can afford such premiums. No insurers, including Allianz, have reliable quantitative data on the number of homeowners what have decided to not insure or deliberately underinsure to avoid premiums at such levels.

Postcode	Policy Type	Sum Insured	Flood risk	Base premium excl. cyclone & flood risk	Total Premium
Qld 4817	Contents	$21,000	Yes	$508	$1,256
WA 6721	Building	$395,178	No	$3,523	$14,521
WA 6722	Building	$160,000	Yes	$866	$4,774
Qld 4750	Building	$224,700	No	$2,379	$6,568

As the table indicates, considering affordability issues based on a comparison of average premiums can be instructive, but it has limits in any broader discussion about home insurance affordability, the extent of the problem and the potential responses that might be considered to address community concerns about affordability.

If, all things being equal, home owners in Nth Queensland paid 2.5 times the amount (or 150% more) for home insurance than homeowners in non-cyclone risk areas Allianz suggests that such price differences reasonably reflect the different risks being faced and are consistent with

the desirability of retaining an appropriate risk signal to homeowners. In such circumstances, it is not clear that a case for any government intervention in the home insurance market is required. However, this conclusion becomes harder to sustain in light of the fact that some homeowners with both high flood and cyclone risks can, all other things equal, face premiums of more than twenty times those of other Australians, and where the cost of home insurance could be equivalent to the annual income of an aged pensioner that might own such a property. In the table above, just the cost of cyclone cover for the house in Postcode 6721 with no flood risk increases the base premium by more than 400%.

At such extreme levels, premiums cease to act as an appropriate price signal and start to drive other behaviours and decisions which have a range of negative consequences. Some of these include non-insurance, intentional underinsurance, disincentives to invest in residential property, discouraging population growth in whole regions (as opposed to on flood plains, which is desirable) and lower overall levels of economic activity. Sums insured such as that for house in postcode 6722 in the above table suggest that some homeowners are under-insuring in order to reduce premiums to manageable levels as it is very unlikely that a three bedroom house could be rebuilt in Nth WA for $160,000. We are concerned for our customers that find themselves in such an unenviable position.

A high level of underinsurance creates a vicious cycle for insurers because it reduces the efficient size of the premium pool. For example, all things being equal, underinsurance reduces the premium pool available to fund claims, increasing insurers' loss ratios. To maintain, or more closely reach target levels of return, insurers are likely to respond by increasing premiums. This only serves to exacerbate the underinsurance problem further, resulting in a vicious cycle of further premium rises.

Improvements in technology and the sophistication of insurance pricing will exacerbate these premium relativities. The ability of insurers to price at the address level (geocoding) rather than by postcode or suburb, has been a key driver of the ability for insurers to offer types of cover where pricing needs to vary geographically house-by-house. Flood is a classic example because flood risk between properties can vary dramatically over a matter of metres.

The cyclone maps above indicate that insurers have never required address-level pricing capabilities to determine which areas should be subject to premium loadings for cyclone risk. However, this capability now enables insurers to further refine pricing in cyclone areas to take into account factors such as proximity to the coast and storm surge risk, the direction a property faces and its elevation in relation to windshear risk.

The impact on premiums of this growing pricing sophistication will, all other things being equal, see premiums for some properties fall (maybe only by a modest degree) and premiums for some properties rise (possibly by a significant degree). Thus, while 'average' premiums could remain unchanged, the range of premiums, particularly at the upper end, will continue to

widen. As a result, ongoing improvements to risk pricing likely further exacerbate affordability issues.

Availability and affordability of flood insurance

Similar affordability issues arise in respect of flood cover for residential properties with medium to high flood risk.

Insurance cover for 'riverine' flood[9] damage is relatively new in the Australian market. Historically, residential insurance policies *excluded* cover for flooding. Widespread community awareness of this increased most recently in the aftermath of the 2011 Queensland floods. Over the last decade, the technology insurers need to 'price' flood risk and the availability of government flood risk data has improved. As a result, residential flood cover has been progressively introduced into Australia since around 2007 and, today, most Australian insurers offer flood cover. However, the price of cover in flood risk areas can be extremely high. For example, the annual premium of a home building and contents policy for an 'average' property (ie a total sum insured of $400,000) with a high flood risk can be as much as $20,000.

Premiums at such levels are likely to be unaffordable for most Australians. The annual premium for the relatively small number of homes that are subject to both high flood risk and cyclone risk can be in excess of $30,000. Thus, while only 3-5% of residential properties in Australia are exposed to riverine flood risks resulting in high premiums, it is arguable that the insurance market is unable to provide affordable home insurance to Australians facing flood risk. And while this proportion appears relatively small, if there are around 10 million residential dwellings in Australia, this issue effects between 300,000 and 500,000 Australian homeowners.

Allianz and affordability of flood cover

The impact on non-insurance and underinsurance of the high cost of flood cover differs compared to cyclone risk because of the ability, at least at this point in time, for homeowners who cannot afford flood cover to opt out of it. The introduction of riverine flood insurance has resulted in two approaches to the provision of residential flood cover currently being adopted by insurers:

- Mandatory flood cover – where inclusion of flood cover is standard in the policy, like other risks such as cyclone, fire, storm and earthquake; and
- Customer Choice – where flood cover is optional and the policyholder can choose whether or not to purchase it.

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[9] The term 'riverine' flood refers to flooding of the sort described in the Standard Definition of Flood in the Insurance Contracts Act.

Most insurers in the Australian market have adopted the mandatory flood cover approach. Allianz, on the other hand, offers Customer Choice of flood cover. In both cases, the premium charged will reflect the flood risk faced by the specific property, although the flood component of the premium may only be separately shown on policies that provide optional flood cover.

For insurers that provide mandatory flood cover, customers that do not wish to pay the additional premium for flood cover, or cannot afford to, are forced to seek insurance from another company if they wish to remain covered for other home insurance risks (eg hail, fire). If all insurers adopted the mandatory approach, home owners that could not afford flood cover would be forced out of the home insurance market altogether.

So that customers are not faced with this dilemma, Allianz currently adopts the Customer Choice approach. As a result, even if our policyholder cannot afford flood cover, they can still obtain insurance protection against other risks such as fire, storm, earthquake, burglary etc. Unfortunately, due to the high cost of flood cover for many properties with a flood risk, most customers opt out of flood cover. As a result, if their property is impacted by 'riverine' flooding, they are not covered.

It is true that, in terms of the number of insurers offering cover, there is wide availability of flood insurance compared to even a few years ago. However, this has not resolved the underlying problem of lack of insurance for properties vulnerable to flood. For example, industry data indicates that around 95% of home insurance policies cover flood, however, suggesting that the other 5% of properties are not covered. And this data does not include uninsured properties.

Allianz's optional approach to flood provides some data that can assist in understanding the levels of non-insurance for flood. For the purposes of analysis and discussion (as opposed to pricing, which is significantly more sophisticated), Allianz has established six flood risk categories where category 6 represents the highest flood risk and category 1 the lowest (zero or negligible flood risk). The table below shows the proportion of Allianz policyholders that currently opt out of flood cover for three highest flood risk categories.

Building flood cover opt-out rate

Category 6 ARI[10] 1-49yrs	Category 5 ARI 50-99yrs	Category 4 ARI 100-499yrs
94%	78%	57%

As the table indicates, in a flood risk category that extends to an Annual Return Interval (ARI) of up to 49 years, opt-out rates in NSW and Queensland exceeded 90%. While in Category 5,

[10] ARI – Annual Return Interval – The frequency in years of a flood occurring. Eg ARI 20 years means that, over the 'long term' a flood will occur 'on average' every 20 years. A corresponding measure is the Annual Exceedance Probability, for example, an ARI 20 translates to a 5% AEP, or for premium setting purposes, in any year, there is a 5% chance of a flood occurring.

which encompasses properties with an ARI of between 50 and 99 years, which could be described as a ‘medium’ flood risk, opt-out rates are still nearly 80%. These figures clearly indicate that the vast majority of homeowners that have a material flood risk are not covering themselves and, in almost all cases, the reason is likely to be because they cannot afford the flood premium. Allianz is deeply concerned for our customers that cannot afford flood cover because we know that what is likely to be their largest and most prized asset is not insured against a peril they are particularly vulnerable to.

Solutions to home insurance affordability issues

There is a range of measures that can be taken to reduce homeowners’ vulnerability to loss from cyclones and floods. Examples include:

- adaption (eg upgrading the resilience of buildings);
- mitigation (eg flood levies);
- land use planning (eg preventing development on flood prone land);
- development controls (eg building height standards in flood areas); and
- building standards (more cyclone resilient structures).

However, not all properties can be assisted by these measures. For example, Australia has a significant legacy of properties built in flood zones and not all flood risk can be mitigated. Even where mitigation would be effective, it would take tens of billions of dollars of investment over decades to undertake all the flood mitigation works that could be carried out in Australia. Even if governments had plans to undertake such mitigation, Allianz is concerned about the fate of flood affected home owners in the interim.

Many homes in Nth Queensland were built before the current cyclone building standards were put in place in around 1980 and retrofitting improvements to bring them up to standard would be prohibitively expensive for many homeowners. And even if such improvements were implemented, the premium savings are often fairly modest; about 20% being the maximum possible reduction. Even if governments paid for such upgrades, this would only solve cyclone risk affordability issues if there were no affordability problems for the owners of post-1980 built houses and that an at most 20% premium would resolve the affordability issues for owners of older houses. Allianz is not convinced that this is the case. For example, would the owner of the $395,000 sum insured house in postcode 6721 in the table above regard a 20% lower premium of $11,616 as reasonable?

Allianz is of the view that the upper range of premiums associated with properties subject to cyclone and flood risks has reached levels that are unaffordable for some affected homeowners. As a customer focussed business, this concerns us greatly. Concerns about a lack of affordability of home insurance are unlikely to be fully addressed unless action is taken that directly reduces the premiums faced by affected homeowners.

Allianz has concluded that, for many properties highly vulnerable to flood and cyclone, affordable home insurance can only be delivered through some form of subsidy arrangement. Such an arrangement should not eliminate the price signals insurance can provide about risk, but there is a need to strike a better balance between retaining an appropriate risk price signal, while at the same time making home insurance affordable for those for which it has become out of reach. Premiums do not provide an efficient price signal to customers that intentionally underinsure or drop insurance altogether.

There are other examples in Australia where private insurance markets are not able to provide affordable cover to individuals with high insurance risks, for example, private health insurance and compulsory third-party (CTP) motor accident insurance. In these instances, governments use regulation to force insurers to introduce hidden cross subsidies into their pricing. Allianz's view is that such lack of transparency distorts insurer behavior and has other negative impacts, and that premium cross subsidies should be explicit, for example, funded by separately identifiable levies.

Another example of government regulatory intervention which is instructive when considering responses to catastrophe risk is the scheme currently used to ensure affordable commercial property insurance in Australia. Following the 9/11 US terrorist attacks, the international reinsurance market ceased offering terrorism cover. In response, governments around the world intervened in their insurance markets to ensure the continued provision of affordable commercial property insurance that included cover for terrorism events.

In Australia, the Commonwealth Government established the Australian Reinsurance Pool Corporation (ARPC), a government-backed reinsurance facility. The ARPC manages a 'terrorism pool' which, in the event of an eligible terrorism event, can be drawn on to help pay insurance claims. The ARPC is funded by an explicit levy on non-residential commercial insurance policies.

Insurance pool arrangements are also used in other countries to assist in the provision of affordable flood insurance. For example, in the UK, the government and the insurance industry agreed to the establishment of a non-profit reinsurance pool, called Flood Re, to facilitate the provision of affordable flood cover to high-risk households. The pool, which commenced operation in 2015, is funded by a modest levy (around £10) on household insurance policies.

Following the 2011 Queensland floods, the Australian Government established the Natural Disaster Insurance Review (NDIR) in response to issues that arose in the aftermath of the event, such as the widespread lack of flood cover.

Allianz's submission[11] to the review suggested that flood insurance could be made more affordable through the establishment of a government-backed 'reinsurance pool' as a mechanism to provide a subsidy to homeowners facing unaffordable flood premiums. The NDIR made a number of recommendations relating to the affordability of insurance, including:

> *"That an agency…be created to…operate a system of premium discounts and a flood risk reinsurance facility." – (Pivotal Recommendation 1)*

> *"…an investigation be undertaken to ascertain whether there is a basis for granting affordability discounts for cyclone risk." – (Recommendation 27)*

The report acknowledged Allianz's contribution to the review, stating:

> *"The idea of…the reinsurance pool was originally inspired by the Allianz Australia submission to the Review. (p61)*

The NDIR's recommendations in relation to insurance affordability have not been adopted by the subsequent governments. However, Allianz remains of the view that a peril-specific, government-backed reinsurance pool could be used to address the lack of affordability of home insurance premiums for those Australians facing high flood and cyclone risks.

The design of such a pool is a complex exercise, as it would need to fit within the broader regulatory and market environment impacting on cyclone and flood risk. For example, it would need to ensure that premiums retain an appropriate price signal to homeowners and to ensure that access to the pool creates appropriate incentives in relation to adaption, mitigation and land use regulation, particularly in respect of new buildings.

A key design feature worth highlighting is that the pool would only provide reinsurance for claims arising from the events that are driving the lack of affordability, currently 'named' cyclones and floods. Insurers would continue to rely on their own claims reserves and reinsurance arrangements for all the other claims they might receive in respect of a property that is eligible for support from the pool. The provision of subsidised reinsurance for cyclones and floods would remove the high level of uncertainty associated with insurers' exposure to these events and the concentration risks that limit their appetite for business in areas such as Nth Queensland.

How a cyclone reinsurance facility would reduce premiums

Most of the difference between the premium charged to insure property in Northern Australia compared to southern and/or inland areas of Australia is driven by the additional cost to insurers of reinsurance for cyclone and related perils (ie riverine flooding and storm surge).

[11] http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Allianz_Australia_Insurance_Ltd.pdf

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This reinsurance cost reflects insurers' exposure to property damage arising from the frequency and severity of cyclonic events impacting Northern Australia.

A previous Australian Government Actuary (AGA) report on home insurance prices in Nth Queensland found that catastrophe reinsurance could account for up to 40% of the premium in Nth Qld and that the majority of claims costs (circa 60%) associated with Nth Qld home insurance were related to cyclone. Taken together, these figures suggest that the cost of cyclone reinsurance accounts for around 24% of premium.

The chart below, provided in Allianz submission to the Northern Australia Insurance Premiums Taskforce, used actual Allianz data for a notional house in Townsville with a building sum insured of $400,000. The premium in the example is $4,000, which is conservative because it is based on a post-1980 built brick house, when in fact many properties in the region are pre-1980 built weatherboard houses.

Largely consistent with the AGA report, Allianz's cost of cyclone reinsurance in the example below, at $1048, is 26% of the final premium (31.4% of the pre-tax premium). The reinsurance (RI) pool example in the chart shows the impact on the final premium of a cyclone pool reinsurance premium of 10% ($159 in the example). This cost reduction (as with that related to the retained cyclone component of the premium – see below) has a cascading price-reducing impact on the final premium due to the 'grossing-up' effect on premiums of costs such as commissions[12] and tax.

Therefore, while the cyclone reinsurance cost in the example falls from around $1,000 to around $200, the final premium in the hands of the homeowner falls from $4000 to around $1900.

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[12] This example contains a commission component, which is consistent with Allianz's current distribution strategy in Nth Qld, which focuses on financial institutions and brokers. Policies sold direct would likely have a fixed $ (rather than ad velorum) acquisition cost, which in an example like this, might be around 10% of premium.

Chart 1: Impact of reinsurance pool on Nth Qld home insurance premium

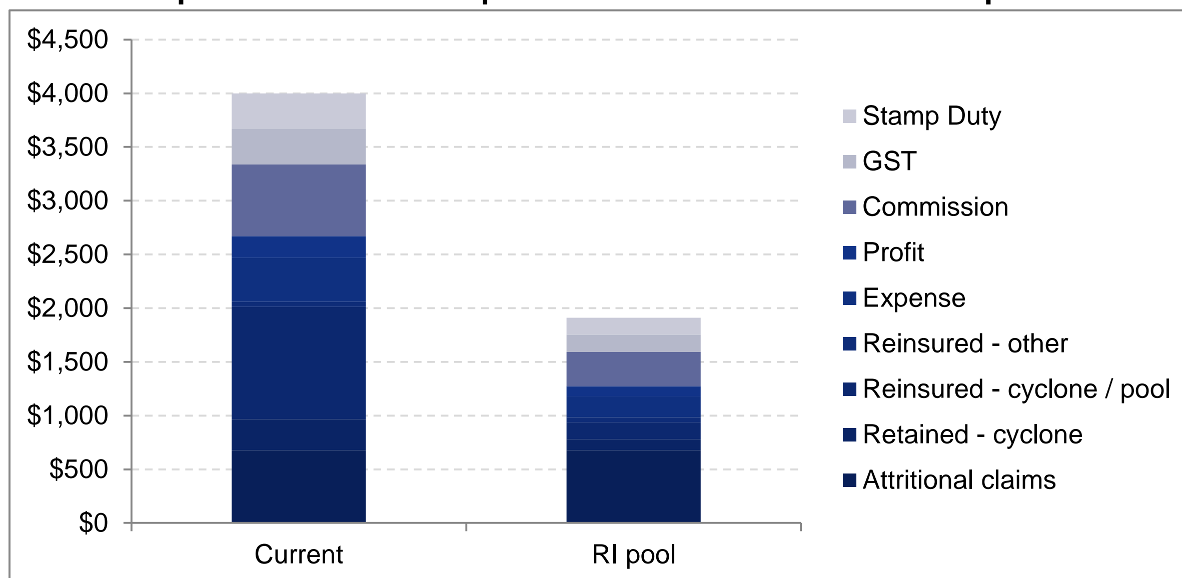

Table1: Figures underpinning Chart 1

RI pool charge (as % of insurance premium)

10% (currently 31.406%)

	$400k building example	
	Current	RI pool
Attritional claims	$678	$678
Retained - cyclone	$287	$100
Reinsured - cyclone / pool	$1,048	*$159*
Reinsured - other	$45	$45
Expense	$410	$196
Profit	$200	$96
Commission	$667	$319
GST	$334	$159
Stamp Duty	$330	$158
Total Premium	$4,000	$1,910
Insurance Premium	$3,336	$1,593
Customer Premium	$4,000	$1,910

The final report of the Northern Australia Insurance Premiums Taskforce assessed the establishment of a cyclone reinsurance pool. The report stated that:

> *A potential reinsurance pool scheme could operate through a statutory corporation owned by the Government that offered treaty (that is, whole of portfolio), excess-of-loss reinsurance for*

> *cyclone damage. An option is to expand the remit of the ARPC to offer cyclone reinsurance and build a cyclone reinsurance pool. The existing terrorism reinsurance pool would be completely segregated from any new scheme. (p*48)

The Taskforce also had a number of cyclone pool design options assessed by Finity Consulting. This assessment indicated that a cyclone reinsurance pool could reduce the cyclone risk component of the risk premium of a home insurance policy by 69%, which translated to a reduction in the total risk premium of up to 33%[13]. The risk premium is that charged by the insurer before the addition of taxes. As shown in the table above, the grossing up impact of taxes would result in a premium reduction of around 40% to the consumer.

Conclusion

In short, Allianz is of the view that there is a problem with the affordability of home insurance for some residential homeowners vulnerable to floods and cyclones. As a customer-focussed insurer, this concerns us greatly. Allianz also suggests that, in general[14], home insurance affordability issues for those vulnerable to these particular risks will only increase over time and, at some, point governments will need to give serious consideration to putting in place a sustainable solution to the problem. Allianz suggests that this is best done through a considered policy development process and a sober assessment of the alternatives, as opposed to a ‘knee jerk’ political reaction in response to a future large cyclone and/or flood event. We believe that a government-backed reinsurance facility would be the most efficient and effective way of reducing extreme premiums faced by homeowners with flood and cyclone risk.

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[13] Finity, Financial Impacts of Proposed Cyclone Schemes, Northern Australia Insurance Premiums Taskforce report, Appendix 3, October 2015, p11.

[14] The exception is areas where investment in flood mitigation can materially reduce flood risk and, hence, home insurance premiums.

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Appendix A

Introduction by TIO of risk pricing for home insurance

Allianz purchased TIO from the Northern Territory Government in 2014. TIO had traditionally 'community rated' its home insurance premiums for natural weather perils, in particular, cyclone, flood, bushfire and storm surge risk. In other words, the premiums of all Northern Territory policyholders contributed to the funding of these risks regardless of whether they faced them or not. In other words, Alice Springs residents were being charged for cyclone risk, and homeowners living on the tops of hills were being charged for riverine flood risk. Policyholders living hundreds of kilometres from the coast were being charged for storm surge risk.

Under community rating, low risk customers are overcharged to cross-subsidise high risk customers that are being under-charged. When an insurer that is community rating seeks to compete against insurers that are risk pricing, over time, customers with a low risk move to other insurers who are offering lower premiums because they are pricing according to an individual property's risk profile, while all the high-risk customers being undercharged stay with TIO.

For example, Katherine and Rapid Creek (in Darwin) are areas of high flood risk. TIO's average market share in the NT was around 60%. However, in these high flood risk areas, TIO had over 90% of the market. This is not sustainable, as eventually TIO carries all the high-risk properties but is not collecting sufficient premium to cover the risk.

This was recognised in a 2015 report by the Katherine Flood Mitigation Advisory Committee, established by the Government to assess flood mitigation options in the area. This report stated:

> "… a cross-subsidising insurer would retain or gain all the high flood risk property owners, but not generate an adequate level of premium to pay future flood claims. In such a situation, the solvency of an insurer applying a cross-subsidising approach may be threatened in a severe weather event."

TIO introduced new home and landlord insurance products in October 2015 and progressively migrated existing customers to the products from January 2016, as their policies renewed. The new products incorporated a risk address based pricing methodology that enabled TIO to price risks based on circumstances at the individual property level. The new pricing methodology

assesses the real risk of damage from a range of factors including cyclone, flood, storm surge, bushfire and other threats at each individual property.

The pricing methodology draws on flood mapping, meteorological data, and hydrological and cyclone modelling by independent specialists that assesses the risk of damage from perils such as cyclone, flood, storm surge and bushfire. We use the best available data from independent specialists to calculate premiums based on the circumstances at each individual address.

The impact on premiums differed from house to house. Our modelling of the change indicated that around half of TIO's customers would pay the same or less than they did previously and around 15 per cent of customers, particularly those in extreme flood areas, would see an increase in their total premium of over $500. For those customers who were impacted the most by risk address based pricing, the premium increases were phased in over three years.

TIO had been looking at this issue for a number of years and, under government ownership, had planned to introduce risk based pricing, where premiums are calculated on the specific risks faced. However, this was delayed due to the sale of TIO to Allianz. After the sale, TIO obtained access to Allianz's more sophisticated modelling and pricing capabilities. This enables it to examine risks at an individual address. This is not new technology and many of our competitors in the Territory have applied this same level of risk-based pricing for some years. This gave other insurers a competitive advantage over TIO, which was resulting in the loss of home insurance customers, adversely impacting TIO's market share. Without this movement to risk based pricing, TIO's competitiveness and financial sustainability would have continued to be eroded. While we understand that the removal of community rating had a material financial impact on some customers, all insurers need to collect sufficient premium to enable them to pay claims based on the probability that a claim will occur.

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Appendix B

The role of strata managers in arranging insurance cover

Introduction

This appendix seeks to shed light on:

- the nature of relationships between insurers, underwriting agencies, insurance brokers and strata managers;
- existing governance and transparency arrangements in the financial services and strata management industries with respect to remuneration arrangements; and
- the important functions, which are typically contractual obligations, that strata managers fulfil and which are compensated by way of commission.

On the issue of receiving insurance commission payments in their capacity as representatives of Australian Financial Services (AFS) Licensees, strata managers are subject to multiple layers of legislative and regulatory – as well as common law – obligations ensuring an appropriate degree of transparency, disclosure and accountability.

The role of strata managers

At the time of buying in to a strata or community title scheme, owners become members of a legal entity which is variously described as a ‘body corporate’, ‘owners corporation’, ‘strata company’, ‘community association’ or similar – depending on the legislation applicable in the particular state or territory. For simplicity, we will refer to these legal entities as ‘bodies corporate’.

The body corporate is responsible for management of the scheme, and as members of the body corporate, all owners share in both the assets and liabilities of the legal entity. The functions, duties and powers of bodies corporate – including those relating to management of statutory minimum insurances – are, in all but a minority of cases, outsourced to professional strata managing agents (strata managers), with such delegation being provided for in the relevant state or territory legislation.

Strata managers are professionals who are specially trained to deal with the everyday needs of strata and community title schemes, and whose activities are regulated by legislation in the relevant jurisdiction.

Bodies corporate appoint strata managers by entering into a strata management agency agreement, pursuant to which the strata manager is engaged to carry out some or all of the functions, duties and powers of the body corporate.

A snapshot of just some of these (legislated) functions, duties and powers includes:

- arranging periodic valuations and quotes for mandatory, and optional, insurances;
- renewal of insurances;

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- preparation and lodgement of insurance claims;
- ensuring the scheme fully complies with all relevant legislation and regulations;
- maintaining the trust account, all accounting records and common seal of the body corporate;
- storing and providing access to records and accounts;
- preparing and presenting annual financial budgets and statements;
- maintenance of the strata roll and the levy register, issuance of levy notices and the collection and deposit of levy contributions;
- arranging quotations for services, maintenance and remedial works, and coordinating repairs and maintenance of common property;
- engaging tradespeople, maintaining preferred trades lists and validating tradespeople licenses and insurances;
- preparing agendas and notices of all meetings, convening and holding all meetings including minute-taking;
- coordinating amendments to scheme by-laws;
- coordinating inspection of scheme records and provision of certificates as to financial and other matters for owners, mortgagees and covenant chargees; and
- assisting auditors and tax agents and liaising with the Australian Taxation Office.

Professional strata managers are invaluable for owners within strata and community title schemes. They are appointed on the basis of their knowledge and experience as trusted advisers carrying fiduciary obligations to the body corporate. They are entrusted with management of the scheme, are relied on to keep abreast of legislative and compliance requirements, and apply their professional experience and expertise in providing general counsel and guidance to the body corporate on a variety of matters.

Application of the financial services regime to strata managers

Insurance for bodies corporate is a type of general insurance product and as such is a regulated financial product for purposes of the *Corporations Act 2001* (Cth) (the 'Act'): ss763A, 764A(1)(d).

Pursuant to s766A of the Act, a person provides a 'financial service' if they:

(a) provide 'financial product advice'; or

(b) 'deal' in a financial product.

Dealing includes applying for or acquiring, issuing, varying or disposing of a financial product (whether as principal or agent) – or arranging for a person to engage in this conduct (that is, 'arranging' is a type of 'dealing'): s766C of the Act. The Australian Securities & Investments Commission (ASIC) takes the view that a person is likely to 'arrange' for another person to deal where there is a sufficient degree of connection between the person's actions and the

completion of a transaction in respect of a financial product: *ASIC Regulatory Guide 36: Licensing: Financial product advice and dealing*. Usually this will occur where:

- the person plays an important role for the consumer in relation to the financial product, and the transaction would likely have not proceeded without the person's involvement; and
- the person adds value for one or more of the parties to the transaction, for example, by negotiating the terms of the financial product.

There are other general indicators of 'arranging', such as:

- collection and remittance of money to a product issuer (or their agent);
- receipt of benefits (such as commission) based on sales of a product;
- assisting a client to fill in insurance proposals;
- guiding choices or suggesting suitable answers to insurance-related questions; and
- forwarding brochures or advertising material for another person's products.

Consistent with the above, numerous insurance-related services provided by strata managers to bodies corporate technically constitute – whether singly or collectively – provision of financial services, including but not limited to:

- arranging property valuations for insurance purposes;
- facilitating the insurance decision-making process by holding meetings or otherwise seeking instructions;
- completing insurance applications on behalf of the body corporate and communicating their insurance requirements to insurers, underwriting agencies and insurance brokers;
- acting on body corporate instructions to make arrangements with respect to issuance, variation, renewal and cancellation of insurance policies;
- providing the body corporate with copies of insurance policy wordings and disclosure documentation; and
- collecting and remitting insurance premiums on behalf of the body corporate.

Through exercising the above functions, strata managers are instrumental in negotiating and placing insurance for the body corporate and, as such, are seen as 'arranging' as defined in the Act.

Further, and where carrying the appropriate authorisation from one or more Licensees in exercising these functions, strata managers are expected to, and routinely do, in their capacity as trusted advisers make recommendations and statements of opinion that influence (or could reasonably be regarded as being intended to influence) insurance-related decisions of the body corporate. Where this occurs, the strata manager is providing 'financial product advice' as defined in the Act.

Generally speaking, in order to provide a financial service, a company or person must either hold an AFS Licence or be appointed as a representative of a Licensee (ss911A, 911B of the Act). The consequence is that strata managers must either obtain their own AFS Licence

(which is usually not practical) or be appointed as a representative of one or more Licensees in order to execute their delegated responsibilities.

Market practice has generally been for insurance companies to distribute products via either insurance brokers, or underwriting agencies specialising in the niche strata and community title insurance market. Those insurance brokers and underwriting agencies in turn generally operate under their own AFS Licences and in that capacity appoint strata managers as their representatives (either authorised representatives or distributors) to provide financial services to bodies corporate.

In terms of insurance commission payments, generally speaking, insurance brokers and underwriting agencies are paid a commission by the relevant insurer for placement of insurance business, and the insurance broker or underwriting agent may then pay part of that commission to the strata manager who assisted in placing that insurance business in the capacity as their representative – in accordance with the terms of the agency agreement between them.

Why are strata managers paid a commission?

Insurance companies have traditionally employed large teams of sales and distribution staff to distribute their product offerings. Over time, insurers have recognised that insurance intermediaries such as brokers and agents are often in a better position to distribute their products – whether owing to better relationships with customers, better understanding of particular risks, greater mobility and agility, or otherwise – and that authorising such intermediaries to distribute their offerings in return for a commission is often more commercially prudent (and cost-effective) than employing sales teams.

These advantages are even more pronounced in the case of strata managers, who have a closer relationship and direct connection with their body corporate clients and unparalleled knowledge of the risks associated with their schemes. The nature of this relationship makes distribution through strata managers particularly efficient for insurers and underwriting agencies.

Apart from these considerations and among other things, commission payments compensate for advocacy and administrative time in quoting, transacting and servicing an insurance contract for a scheme. It is also worth noting that strata managers will only be paid a commission where a contract is entered into, so there can be a lot of time dedicated to quoting and preparing an insurance contract for a scheme for no ultimate reward. For most schemes, the commission also covers time spent on managing claims which – if otherwise charged for separately by the strata manager as part of their management fees could be particularly costly owing to the many hours of work performed in managing unexpected claims.

Strata managers also save time and money by collecting, holding and presenting risk-specific data to insurance markets – whether via an insurance broker, or directly to insurers or specialist underwriting agencies, including:

- maintaining risk data and claims histories to negotiate best options;
- maintaining a schedule of business activities for commercial premises;
- organising and updating insurance valuations;

- completing and lodging insurance-related documentation;
- collecting and paying premiums;
- receiving and passing on insurance-related documentation; and
- coordinating repairs and administrative activities in the event of a claim.

Regulation of commission disclosure and other strata manager activity

Corporations Act 2001 (Cth)

Operating in the capacity as a representative of one or more AFS Licensees, strata managers are subject to the Act, which is regulated by ASIC. The financial services sector in Australia has a world class disclosure regime, with federal legislative requirements mandating disclosure of pricing information and remuneration arrangements through compulsory disclosure documentation including Product Disclosure Statements (PDSs) and Financial Services Guides (FSGs).

Strata managers appointed as authorised representatives of Licensees are required to provide their own FSG, pursuant to s942C of the Act which sets out the main content requirements for the document (with further content requirements being set out in *Corporation Regulations 2001* reg. 7.7.07). By way of summary, the relevant requirement is that the FSG provided by a strata manager to the customer must include:

(f) information about the remuneration (including commission) or other benefits that any of the following is to receive in respect of, or that is attributable to, the provision of any of the authorised services:

(i) the providing entity;

(ii) an employer of the providing entity;

(iii) the authorising licensee, or any of the authorising licensees;

(iv) an employer or director of the authorising licensee, or any of the authorising licensees;

(v) an associate of any of the above;

(vi) any other person in relation to whom the regulations require the information to be provided…

This same information must also be disclosed if the strata manager is acting as distributor representative of a Licensee.

Further information about product pricing and factors affecting premium must be disclosed in the PDS for the relevant insurance product.

An additional requirement is that strata managers, acting as representatives of Licensees, are obligated to disclose information about any associations or relationships that might reasonably be expected to be capable of influencing them in providing financial services.

The level of information that is required in the FSG is such as a person would reasonably require for the purpose of making a decision on whether to acquire financial services from the providing entity as a retail client.

The abovementioned documents and information must be provided to the insured (or intending insured) body corporate either by the strata manager or directly by the authorising Licensee.

Disclosure of commission on insurance quotations

It is also standard practice – in the case of underwriting agencies – to include details of commission amounts payable to strata managers on insurance quotations and other insurance schedule documentation, which is addressed to the body corporate.

However, there is still room for improvement in the industry in terms of disclosure. It may also account for some of the ongoing perceptions about lack of transparency on insurance commissions. A simple solution to this perception would be to enforce a requirement for *all* insurance intermediaries to provide “dollar-value” information on insurance quotations – that is, at or before the time the decision is made by the body corporate to select a particular insurer – not only *after* the decision has already been made. Ideally, this information would display each component of the total price payable by the body corporate as a separate line item – including amounts attributable to base premium, taxes and levies, commissions payable to strata managers and/or insurance brokers, and broker fees. Such a sensible, common-sense and targeted reform initiative should be easy for insurance intermediaries to implement and would immediately improve consumer outcomes in terms of disclosure and transparency around product pricing.

This reform proposal was picked up by the Senate Economics References Committee in their August 2017 report: *Australia’s general insurance industry: sapping consumers of the will to compare*, which stated:

> *“Recommendation 12*
>
> *The committee recommends that the government strongly consider introducing legislation to require all insurance intermediaries disclose component pricing, including commissions payable to strata managers, on strata insurance quotations.”*

The reference to component pricing in the above recommendation related to transparency of the premium, tax and commission components. This is not to be confused with other references in the Committee report to component pricing, which related to the risk-related components of the premium (eg for flood, bushfire, cyclone).

State and Territory legislation

Strata managers are in a unique position in the sense that, quite apart from federal financial services legislative requirements, in relation to disclosure of commissions and other remuneration arrangements, they are simultaneously bound by legislation in their state or territory jurisdiction(s). This provides an important additional layer of disclosure, transparency and accountability.

By way of example, it is noted that the recently implemented *Strata Schemes Management Act 2015* (NSW) (SSMA) requires a number of disclosures relating to commission arrangements to be made at the annual general meeting of the body corporate (in NSW termed the ‘owners corporation’). Particularly, s60 of the SSMA provides:

60 Disclosure of commissions and training services

(1) A strata managing agent for a strata scheme must report the following at the annual general meeting of the owners corporation for the scheme:

(a) whether any commissions... have been provided to or paid for the agent (other than by the owners corporation) in connection with the exercise by the agent of functions for the scheme during the preceding 12 months and particulars of any such commissions...,

(b) any such commissions... and the estimated amount or value of any such commissions... that the agent believes are likely to be provided to or paid for the agent in the following 12 months...

(2) *A strata managing agent must, as soon as practicable after becoming aware that commissions... provided to or paid for the agent (other than by the owners corporation) differ from the commissions... or any estimate of them disclosed at the annual general meeting, disclose to the strata committee the variation and give an explanation for the variation...*

It should also be noted that pursuant to s57 of the SSMA it is an offence for a strata manager to receive commissions that are not of a kind permitted by their terms of appointment (per their management agreement with the body corporate) or otherwise approved by the body corporate.

These provisions are reflected in other jurisdictions. In Queensland, particular insurance details are required to be disclosed at the annual general meeting of the body corporate, including the amount and type of any financial or other benefit given, or to be given, by the insurer to "a person engaged as a body corporate manager": *Body Corporate and Community Management (Standard Module) Regulation 2008* (Qld) (Standard Module) s177. Also, before entering into a management agreement with a strata manager, the body corporate must be provided a written notice disclosing any relevant commission, payment or other benefit arrangements the strata manager is entitled to receive from any other third party: Standard Module s135.

Codes of conduct

An additional layer of transparency and accountability is also provided by the fact that, in some jurisdictions, strata managers are also bound by codes of conduct enshrined in their relevant strata legislation.

In Queensland, strata managers (in Qld termed 'body corporate managers') are bound by the "Code of conduct for body corporate managers and caretaking service contractors" contained in Schedule 2 of the *Body Corporate and Community Management Act 1997* (Qld). This code of conduct obligates strata managers to, in performing their functions:

- Act honestly, fairly and professionally;
- Exercise reasonable skill, care and diligence;
- Act in the best interests of the body corporate unless it is unlawful to do so;
- Not engage in any misleading, deceptive or unconscionable conduct; and
- Take reasonable steps to ensure that goods and services being obtained for or supplied to the body corporate are obtained or supplied at competitive prices.

Template/pro forma strata management agreements

Lastly, template strata management agreements widely used throughout the industry transparently provide bodies corporate with the *option* of either permitting or excluding the payment of insurance commissions to strata managers.

For example, the template "Strata Management Agency Agreement" used in NSW, as provided by Strata Community Australia (NSW) – the peak industry body in that jurisdiction – provides consumers with upfront disclosure and choice. On its front page, the body corporate has the opportunity to elect one of three different remuneration models for their appointed strata manager:

- agreed services fee plus rebates, discounts and commissions detailed in the agreement (agent retains all commissions);
- agreed services fee plus rebates, discounts and commissions detailed in the agreement (agent retains some commissions); or
- agreed services fee only (agent not entitled to any commissions).

In other words, bodies corporate have the opportunity to stipulate, on the front page of the management agreement with their strata manager, that they are prohibited from the receipt of commissions. They have visibility as to the strata manager's proposed commission arrangements and fees payable, and the option to implement or negotiate alternatives if they prefer. If individual bodies corporate wish to remove commission-based revenue from arrangements with their strata manager, they have the choice to do so in accordance with their management agreement.

Such arrangements are not new and have been in place for some time. In practice, bodies corporate will make an appropriate election given their unique circumstances and requirements. For example, many smaller schemes will opt for a split fee/commission model, whereas a full fee-for-service model generally works better for larger schemes – and most large schemes have already chosen such arrangements.

Other considerations

Removing commissions will not necessarily reduce costs for consumers

It is important to note that insurance commissions paid to strata managers by Licensees, generally speaking, compensate strata managers for many functions they perform on behalf and for the benefit of the body corporate. In the absence of such commission payments, these functions would (contractually) still need to be performed by the strata manager. The effect is that where insurance commissions are reduced, strata managers' base management fees will generally increase commensurately to offset the difference. In a sense, bodies corporate are currently the beneficiaries of insurance commission payments to strata managers by way of strata managers discounting their base management fees in anticipation of insurance commissions as an alternative source of income.

Another consideration is that insurance premiums would not automatically reduce, but will fundamentally remain the same as insurers and underwriting agencies continue to utilise and remunerate intermediaries such as insurance brokers. As for strata managers, if forced into a position of replacing insurance commission income with increased management fees, bodies

corporate will inevitably either pay more for the same level of service or reduce the amount of professional services they receive from their contracted strata manager. Either way, such unintended outcomes are far from ideal.

Conflicts of interest

There is a persistent misperception that insurance commission payments to strata managers as distinct from any other form of remuneration arrangement with financial services intermediaries, represent a form of conflicted remuneration or otherwise unacceptable 'conflict of interest'. This may be considered from two perspectives.

Firstly, as representatives of Licensees, strata managers are subject to s912A(1)(aa) of the Act, which requires Licensees to have in place "adequate arrangements for management" of conflicts that may arise in relation to activities undertaken by them or their representatives. What is "adequate" is necessarily subject to case-by-case assessment based on a number of factors including the size, nature and complexity of the business and the nature of its activities.

The financial services regulator does not require that steps necessarily be taken to "avoid" conflicts – "avoidance" being only one of several suggested methods for managing conflicts: *ASIC Regulatory Guide 181 – Licensing: Managing Conflicts of Interest*. Specifically, ASIC discusses three mechanisms for managing conflicts: "controlling", "avoiding" and "disclosing". A combination of any or all of these may be appropriate depending on the circumstances.

In other words, there is nothing necessarily illegal or improper with being in a position of conflict of interest. It is common for professionals and those holding office, including, incidentally, property owners sitting on their body corporate executive committees. It is how any conflict is actually managed (disclosed or otherwise dealt with) that is important. In the case of insurance commission payments, if there is appropriate transparency and disclosure, any potential or perceived conflict can be understood and appropriately managed.

Secondly, the concept of "conflicted remuneration" now has a statutory definition, from which commission payments in connection with general insurance products are excluded. That is, insurance commission payments to strata managers are, by definition, *not* a form of conflicted remuneration.

The relevant provisions are found in the Act and formed part of the Federal Government's 2013 "Future of Financial Advice" reforms, which introduced (among a raft of other changes) a ban on "conflicted remuneration" as the government sought to strengthen retail investor protection and improve consumer confidence in the financial planning industry. The reforms were a response to an enquiry by the Parliamentary Joint Committee on Corporations and Financial Services in the wake of corporate collapses including Storm Financial and Opes Prime. In implementing the changes, government acknowledged that general insurance has significantly different features from investment products and specifically excluded it from consideration in discussions around banning of "conflicted remuneration".

The relevant provisions state:

963B Monetary benefit given in certain circumstances not conflicted remuneration

(1) Despite section 963A, a monetary benefit given to a financial services licensee, or a representative of a financial services licensee, who provides financial product advice to

persons as retail clients is not conflicted remuneration in the circumstances set out in any of the following paragraphs:

(a) the benefit is given to the licensee or representative solely in relation to a general insurance product;…

963C Non-monetary benefit given in certain circumstances not conflicted remuneration

(1) Despite section 963A, a non-monetary benefit given to a financial services licensee, or a representative of a financial services licensee, who provides financial product advice to persons as retail clients is not conflicted remuneration in the circumstances set out in any of the following paragraphs:

(a) the benefit is given to the licensee or representative solely in relation to a general insurance product;…