



Northern Australia Insurance Inquiry

*Allianz submission in response to ACCC consultation
on measures to improve affordability and availability*

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TABLE OF CONTENTS

1. EXECUTIVE SUMMARY	3
2. CAUSES AND IMPACT OF AFFORDABILITY ISSUES.....	4
3. SOLUTIONS TO ADDRESS AFFORDABILITY	6
4. BENEFITS OF A REINSURANCE FACILITY	8
5. IMPACTS OF A REINSURANCE FACILITY	10
5.1. Impact on premiums.....	10
5.2. Impact on insurance availability and competition	11
5.3. Impact on incentives to reduce risk	12
6. DESIGN FEATURES OF A REINSURANCE FACILITY	13
6.1. Application to single peril or multiple perils.....	13
6.2. Scope of specific geographic area	13
6.3. Coverage restricted to loss levels.....	13
6.4. Funding the reinsurance facility.....	13

1. EXECUTIVE SUMMARY

Allianz welcomes the opportunity to provide a submission to the Australian Competition and Consumer Commission (**ACCC**) on measures to improve insurance affordability and availability as part of its Northern Australia Insurance Inquiry (the Inquiry). 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. Absent a comprehensive policy response, home insurance affordability issues will only increase over time. We believe that mitigation measures in conjunction with a government-backed reinsurance facility would be the most efficient and effective way of reducing extreme premiums faced by these households.

The insurance industry has long called for comprehensive measures to mitigate against the risk of extreme weather events. The cost of home insurance is directly related to the risk of loss faced by a property and in many cases, the cost and frequency of that loss comes down to how well the property is protected from the effects of damaging natural weather events. Mitigation can help to protect the property against damage in the first place (for example, a levy bank that prevents inundation of a property by flood waters) and make the property more structurally resilient to damage.

Therefore, the starting point in any discussion about the availability and affordability of insurance should focus on mitigation. In this regard, Allianz concurs with the submission from the Insurance Council of Australia (**ICA**) about the importance of mitigation. Mitigation, adaptation, land use planning development controls and robust building standards are all critical in ensuring that all Australians have access to affordable home insurance.

However, these measures will not result in affordable insurance for all consumers. For example, Australia has a significant legacy of properties built in flood zones and not all flood risk can be mitigated. Even where mitigation could be effective, there would need to be sustained and substantial investment over decades which would not provide relief in the short to medium term for those consumer facing extremely high premiums.

Allianz is of the view that an appropriately designed reinsurance facility would be an effective and efficient way of reducing the cost of insurance in a way that would not cause undue inconvenience to policyholders or disruption to insurance markets.

2. CAUSES AND IMPACT OF AFFORDABILITY ISSUES

The high cost of insurance for consumers in northern Australia is already well documented, including in the Inquiry's first interim report. However, it is worthwhile revisiting briefly the cause of high premiums in northern Australia; specifically, the region's exposure to high cyclone and flood risk.

The higher cost of home insurance in northern Australia reflects 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. 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 coast of Queensland, particularly north Queensland.

Insurance premiums for properties exposed to cyclone risk can be very expensive. In some circumstances, a north 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).

While all homeowners in the region face cyclone risk, Allianz has also been concerned about the affordability of residential home insurance for consumers subject to the risk of flood. The annual premium of a home building and contents policy for an 'average' property (i.e. a total sum insured of \$400,000) with a high flood risk can be as much as \$20,000. Homeowners with both high flood and cyclone risks can face premiums of more than twenty times those of other Australians.

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 and lower overall levels of economic activity.

Allianz provides consumers with the ability to choose to opt-out of flood cover, and our data provides some insights in understanding the levels of non-insurance for flood. Our analysis indicates that for consumers with a high exposure to flood risk, opt-out rates in Queensland exceeds 90%. For consumers with a medium exposure to flood, 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 customers who cannot afford flood cover because what is likely to be their largest and most prized asset is not insured against a peril they are particularly vulnerable to.

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.

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 and action should be taken to directly reduce premiums. The policy response needs to consider both flood and cyclone risk. 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 consumers. This is particularly the case for those subject to both flood and cyclone risk, resulting in extremely high home insurance premiums.

3. SOLUTIONS TO ADDRESS AFFORDABILITY

There are a range of measures that can be taken to reduce homeowners' vulnerability to loss from cyclones and floods. Important measures include:

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

While all of these measures are critical and should be part of a comprehensive policy response, not all properties can be assisted by these measures. Many homes in north Queensland were built before the current cyclone building standards were put in place and retrofitting improvements to bring them up to standard would be prohibitively expensive for many homeowners. Effective mitigation requires a sustained and substantial investment over decades, and will not provide a short to medium term solution for many homeowners. This is particularly the case for homes where the risk cannot be mitigated, for example, properties built on flood zones.

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.

The major part 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 related to cyclone and related perils (i.e. riverine flooding and storm surge). This reinsurance cost reflects insurers' exposure to property damage arising from the frequency and severity of cyclonic events impacting northern Australia. Therefore, the solution that would be most impactful in driving down premiums is a Government supported reinsurance facility to reduce the cost to insurers of reinsurance. The remainder of our submission explores further the reinsurance facility option.

Allianz does not support the establishment of a mutual insurer. The Inquiry has acknowledged that home insurance premiums offered by insurers have not produced sustainable returns. Allianz does not believe that a mutual insurer could offer financially sustainable cover at premiums below the cost of existing insurance policies, even in the absence of a need to produce a dividend to shareholders. For example, insurers generally target a profit margin of around 5% of premium on home insurance, so if all a mutual model did was negate the need for a shareholder return, the maximum reduction in premiums it could expect to deliver would be 5%.

Allianz notes comments by some stakeholders that government intervention to address home insurance affordability is not justified because there is no market failure in relation to the availability of insurance protection against flood and/or cyclone. On this, Allianz offers two observations. While an unavailability of needed insurance would meet a technical economic definition of market failure, Allianz suggests that an effective market failure arguably exists if such insurance is out of reach to those who need it because they cannot afford to purchase it. In addition, like a government backed reinsurance facility, government subsidies provided to

the owners of houses and residential apartments to undertake building resilience works are also a form of government intervention.

4. BENEFITS OF A REINSURANCE FACILITY

The key factor impacting the cost to insurers of providing cover for cyclone relates to the cumulative exposure to cyclone risk. This is comprised of the probable maximum loss from a cyclone event, which drives the maximum amount of reinsurance cover required, together with the exposure created by the frequency of events. Frequency also drives the cost of cyclone reinsurance but also creates what insurers call 'sideways' exposure, which relates to the cost retained by insurers from multiple events.

Natural catastrophe reinsurance treaties have an 'attachment point', that is, the cost of claims the insurer has to pay before reinsurance is triggered. The reinsurer pays (up to the limit of cover provided) the cost of claims above the insurer's retained limit. Depending on the frequency and severity of the claims cost associated with different natural catastrophe events and an insurer's risk appetite, when setting their retained limit, there is a minimum attachment point below which it is not commercial for an insurer to go. As this minimum point is approached, the cost of the additional reinsurance cover becomes what insurers describe as a 'dollar swapping exercise'. In simple terms, this describes the situation where the extra dollar of reinsurance cover (in terms of a lower attachment point) costs the insurer an extra dollar of premium.

This commercially efficient level of the attachment point impacts on an insurer's exposure to losses differently depending on the frequency and severity of different types of natural catastrophes. Losses up to the reinsurance attachment point have to be paid out of insurers' own annual natural catastrophe allowance. Events that trigger the reinsurance program require insurers to pay a reinstatement premium after a claim on a reinsured layer. As a result, even with reinsurance, the frequency and severity of events an insurer is exposed to will impact the premiums it needs to charge policyholders.

For a low frequency, high severity event, such as a large, destructive metropolitan earthquake, very little 'sideways' exposure exists. As a result, the level of the attachment point will have only a minor impact on the amount of a home insurance premium attributable to the cost of earthquake reinsurance. While Australia occasionally experiences smaller earthquake tremors that do very little damage, the last significant earthquake in Australia, and the first for which reliable insurance loss data is available, was the 1989 Newcastle earthquake.

For a high frequency, medium to high severity peril, such as cyclone risk in northern Australia, the commercially efficient attachment point results in significant 'sideways' exposure due to the cumulative cost to the insurer of a large number of events that produce losses up to the attachment point as well as the cost of reinstating reinsurance cover for the events that exceed the attachment point (even if only by a modest amount). Since 2005, Northern Australia experienced 38 cyclones, five of which (Larry, Yasi, Marcia, Debbie and Townsville Monsoon) resulted in insured losses in excess of \$5.7 billion.

An advantage of a Government supported reinsurance facility is that it would lower the cost of cyclone reinsurance to insurers, which is the main cost driving premium differentials between northern Australia and elsewhere. In addition, if the reinsurance facility provided cover to an insurer at a substantially lower attachment point than the commercially efficient one currently dictated by its existing reinsurance treaty (e.g. \$5 million), the reinsurance facility would also substantially reduce insurers' sideways exposure to cyclone risk. This would further reduce the cost to insurers associated with cyclones, which would flow through to lower premiums for relevant customers.

Another advantage of a reinsurance facility is that it would be able to build up a pool of funds over multiple years to fund claims arising from a large loss event or to increase its level of retrocession retention, hence, lowering the cost of retrocession. Insurers are not able to do this. Under accounting and taxation rules, insurers cannot create multi-year catastrophe

reserves to cushion the financial impact of future large events. Any excess funds insurers have allocated for natural catastrophe events in a given accounting year cannot be retained and held in reserve for future years, but must be recognised as a profit of that year.

Reinsurance facility arrangements are 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 facility, which commenced operation in 2015, was at that time funded by a modest levy (around £10) on all household insurance policies.

5. IMPACTS OF A REINSURANCE FACILITY

The following section of our submission provides feedback requested by the ACCC on the impact a reinsurance facility would have on premiums, insurance availability, competition and incentives to reduce risk.

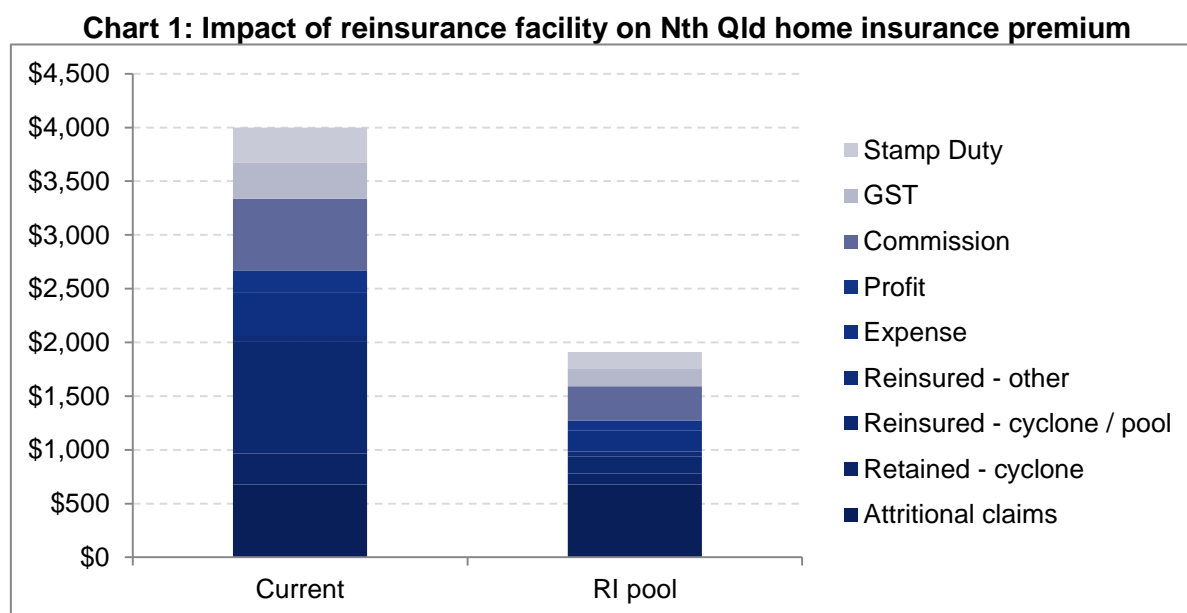
5.1. Impact on premiums

A previous Australian Government Actuary (AGA) report on home insurance prices in North Queensland found that catastrophe reinsurance could account for up to 40% of the premium in North Queensland and that the majority of claims costs (circa 60%) in this region were related to cyclone damage¹. Taken together, these figures suggest that the cost of cyclone reinsurance could account for around 24% of the premium.

Chart 1, provided in Allianz's submission to the Northern Australia Insurance Premiums Taskforce², 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, at \$1048, is 26% of the final premium (31.4% of the pre-tax premium). The reinsurance (RI) facility example in the chart shows the impact on the final premium of a cyclone facility reinsurance premium of 10% (\$159 in the example). This cost reduction (as with that related to the retained cyclone component of the premium) has a cascading, price-reducing impact on the final premium due to the 'grossing-up' effect on premiums of costs such as commissions 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.



¹ Australian Government Actuary (2014), *Report on Home and Contents Insurance Prices in North Queensland*, http://www.aga.gov.au/publications/home_contents_nth_qld/downloads/Home-Contents-North-QLD.pdf

² https://treasury.gov.au/sites/default/files/2019-03/R2015-002_Allianz.pdf

Table1: Figures underpinning Chart 1 (\$400k building sum insured example)
 RI premium (as % of insurance premium)
 10% (currently 31.406%)

	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 northern Australia Insurance Premiums Taskforce assessed the establishment of a cyclone reinsurance facility and had a number of design options assessed by Finity Consulting³. This assessment indicated that a cyclone reinsurance facility 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%. The risk premium is that charged by the insurer before the addition of taxes. As shown in **Table 1**, the premium reduction flowing from a lower cyclone reinsurance costs translates to around a 40% premium reduction in the hands of the consumer.

5.2. Impact on insurance availability and competition

The ACCC's report indicated that it had observed an unusual competitive dynamic in northern Australia, with insurers employing measures to manage their exposure in regions that are risky or volatile, rather than competing to maximise or even seek market share. This reflects the unique nature of insurance compared to many other products where a seller might aim to maximise its market share. This is evidenced by the North Queensland comparison website administered by ASIC, where in many postcodes covered by the site, consumers are limited to around half a dozen underwriters willing to sell home insurance online. This is substantially less than the number of insurers selling home insurance in southern areas of Australia.

Some insurers avoid northern Australia or are highly selective about the risks they will underwrite due to their limited appetite for exposure to cyclone risk. A reinsurance facility that substantially reduced insurers' exposure to cyclone risk would have a commensurate increase in the level of market participation and competition in northern Australia.

As an aside, the existence of the unique competitive market dynamic in some (if not most) insurance markets is why the ACCC and government should tread carefully in any consideration of an online comparator site for home insurance in north Queensland. Put simply, the last thing an insurer that is trying to manage its exposure to a certain natural peril like cyclone would like to discover is that it had the lowest price on a north Queensland home insurance comparison site. The obvious way to prevent an increase in exposure to levels above the insurer's risk appetite would be to raise premiums. Thus, the impact on prices by

³ Finity (October 2015), *Financial Impacts of Proposed Cyclone Schemes*, Northern Australia Insurance Premiums Taskforce report, Appendix 3, p. 11.

comparison sites for other goods and services may not be the same for property insurance given its unique competitive market dynamics, at least in areas where natural peril accumulation risk exists.

5.3. Impact on incentives to reduce risk

A reinsurance facility can be designed to ensure that premiums retain an appropriate price signal to homeowners and create appropriate incentives in relation to adaptation, mitigation and land use regulation, particularly in respect of new buildings.

Houses built prior to the introduction of improved cyclone resilience building standards, which were introduced in the early 1980s, are materially less resilient to cyclone damage than houses built to the revised standards. This is generally reflected in insurers' pricing which, all things equal will generally charge post-1980 houses a premium of around 20% less than older properties. This premium differential between older and new houses could be retained under a reinsurance facility so that owners of older properties would still have a price incentive to invest in property-level resilience.

6. DESIGN FEATURES OF A REINSURANCE FACILITY

The following section of our submission provides feedback requested by the ACCC on design features of a reinsurance facility.

6.1. Application to single peril or multiple perils

A reinsurance facility could be designed to only provide reinsurance for claims arising from the types of events that are driving lack of affordability, for example, 'named'⁴ cyclones and/or related floods. Insurers should continue to rely on their own claims reserves and reinsurance arrangements for all other claims they might receive in respect of a property that is eligible for support from the facility. 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 northern Australia.

6.2. Scope of specific geographic area

While the Inquiry's focus is on addressing insurance affordability in northern Australia, we note that access to affordable flood cover for consumers with a high exposure to this peril is a national issue. If a reinsurance facility were to be established, a comprehensive analysis should be conducted on the costs and benefits of a broader facility to cover flood risk in geographic areas outside of northern Australia.

6.3. Coverage restricted to loss levels

To bring about a reduction in insurers' exposure to the frequency and severity of losses from cyclones, the cover provided by a reinsurance facility would best be structured in a way that removed insurers' exposure to a large proportion of potential cyclone losses. For example, as at 2015, a facility that provided cover for named cyclones at an individual insurer attachment point of \$5 million up to a total industry insured loss event limit of \$1.5 billion would significantly reduce insurers' exposure to around 80% of the insured losses from cyclones that have impacted northern Australia since 1975.

While insurers would still have been exposed to losses associated with several small cyclone loss events over that period (i.e. cyclones that caused industry losses of up to \$30 - 40 million), a facility with the above insurer attachment point and limit would substantially reduce insurers' exposure to cyclones and consequently the cost of insurance for property owners in northern Australia.

6.4. Funding the reinsurance facility

Under a reinsurance facility, insurers would be charged a price for reinsurance. One option for setting the price for reinsurance would be to charge insurers a proportion (e.g. 10%) of the pre-tax premium associated with each property that has been ceded to the facility on a postcode basis. Under such a model, participation would be voluntary and insurers would only include postcodes where their reinsurance cost exceeded that being charged by the facility.

An important design consideration is that the price for access to the facility should be transparent. In some insurance markets, including health insurance and compulsory third-party (CTP) motor accident insurance, governments have used regulation to force insurers to introduce hidden cross subsidies into their pricing. Allianz's view is that such lack of transparency distorts insurer behaviour and has other negative impacts, and that premium cross subsidies should be explicit, for example, funded by separately identifiable levies.

⁴ That is, 'named' cyclones as determined by the Bureau of Meteorology and/or related floods.

The Australian Reinsurance Pool Corporation (ARPC), a government-backed reinsurance facility, could be a useful example to draw on. 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 commercial property insurance policies.

For the reinsurance facility to reduce reinsurance costs, this would most likely require a Government guarantee. The size of such a guarantee, at least in the early stages, would depend on:

- whether the facility purchased retrocession from the private reinsurance market, the price of that cover and the level of the attachment point that triggered the retrocession;
- what the attachment point was for insurers that purchased reinsurance protection from the facility;
- how much the facility charged insurers for its cover;
- the number of cyclone events that triggered payments by the facility (in any one year and over time) and the amount of those payments; and
- whether the cover provided is capped (e.g. on a per event and/or annual basis) and at what level.

One option for limiting the Government's exposure is to set a cap on the payout available. Setting a cap on the cover provided (e.g. on a per event basis) would be a practical way for the Government to limit its exposure. In addition, limiting payouts to insurers on an individual property claim basis through a per property cap could also be used to limit government exposure.

For example, a cap set at a building sum insured that covered the vast majority of properties in northern Australia (say \$400,000 for a standalone house) would focus the bulk of the cover (and any government subsidy) on 'average' homeowners. This would inject an 'equity' measure into the subsidy, which may also serve as a proxy for capacity to pay, as the owners of more expensive properties would be subject to normal insurance pricing for their risk of loss above the cap.