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APRA

6 September 2019

TO: THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

SUBMISSION – NORTHERN AUSTRALIA INSURANCE INQUIRY SECOND UPDATE REPORT

The Australian Prudential Regulation Authority (APRA) welcomes the Australian Competition and Consumer Commission's (ACCC's) Northern Australia Insurance Inquiry Second Update Report, released in July 2019 ('the Report'). APRA is grateful for the opportunity to provide a submission to this important inquiry.

Addressing concerns with affordability and availability of insurance is necessary to reduce detrimental impacts of underinsurance on individuals and the wider economy. Given APRA's prudential mandate, it has an interest in well-considered proposals that will reduce the associated risk to the insurance industry and ensure the resilience of the financial system. If the insurance market is not operating efficiently, the safety net it provides is less effective and risks are borne by the individuals affected.

Insurance availability and affordability challenges are a symptom of a more fundamental underlying problem: the increasing prevalence and financial impact of natural disasters in northern Australia. APRA's view is that meaningful change can only be brought about by focusing on the root cause – the high, rising and volatile costs of natural catastrophes. Focusing on premium affordability alone will not address the root cause.

To remain prudentially sound and financially viable, insurers need to set premiums that accurately reflect the risk and recoup costs over time. Pressure to reduce premiums, without a commensurate reduction in the underlying risk, will weaken the prudential strength of insurers and may see insurers choose not to offer insurance in high-risk areas or ultimately exit the market.

Improvements in data and technology enable insurers to price premiums to more accurately reflect risk. Such risk segmentation sends better price signals to policyholders but also exacerbates affordability challenges for higher risk policyholders. Measures which assist consumers to understand their risk exposure will provide better incentives for actions to lower their risk exposure and should thereby enable reduced premiums. However, measures which dampen price signals may deter risk mitigation efforts by all stakeholders – perpetuating the underlying challenge.

APRA considers that meaningful change requires a greater focus on risk reduction and public mitigation. Better information on the allocation of benefits and costs will enable an informed debate about risk mitigation financing. Attachment A outlines APRA's view on the underlying problem as well as options to respond.

APRA welcomes the opportunity to meet with the ACCC. If you have any questions, please contact either myself or Peter Kohlhagen (02 9210 3363 or peter.kohlhagen@apra.gov.au).

Yours sincerely,

Geoff Summerhayes
Executive Board Member

ATTACHMENT A

1. Introduction

This attachment provides context for APRA's submission, explains what APRA believes to be the core problem causing insurance availability and affordability challenges in northern Australia, and outlines APRA's view on options to respond.

2. Background

The Northern Australia Insurance Inquiry Second Update Report, released in July 2019 (the Report) notes that – having made 28 recommendations – 'the primary focus of our inquiry is now to consider and propose policy measures that could have the potential to achieve real and meaningful change'. This is outlined specifically in Focus Area 1 of the Report – 'Measures to improve affordability and availability'. The Report also notes that the measures proposed in the report 'are unlikely to address the acute affordability issues' and seeks further input from a range of stakeholders, including regulators.

APRA supports well-considered policy proposals that will have a lasting impact to improve the availability and affordability of insurance in northern Australia. APRA is conscious that the current, and possibly future, lack of access to affordable insurance cover may translate into further uninsured parts of society.

APRA has a strategic focus on addressing and mitigating underinsurance given the likely social and economic impacts which may have broader implications on the stability of the financial system. Reflecting APRA's prudential mandate, it is concerned that pressure for lower premiums without commensurate reductions in the risk may reduce the resilience of the insurance industry. If the private insurance market is not operating efficiently, the safety net it provides is less effective and risks are borne by the individuals affected. This is economically inefficient and can lead to significant hardship for individuals and place more burden on governments as the insurer of last resort – a cost that is ultimately borne by the taxpayer.

3. The core problem

APRA's view is that insurance affordability in northern Australia is a symptom of a more fundamental underlying cause, and that real and meaningful change can only be truly brought about by focusing on the root causes rather than the manifestation.

APRA believes that this is an opportune time to focus on the overall cost to the economy of natural peril events, i.e. the economic loss. This economic loss is felt broadly, not only by general insurers. It impacts households, businesses and the agriculture industry who experience losses and need to pay for repairs in circumstances of underinsurance and non-insurance. It also impacts others in the community as a result of disruption to economic activity (e.g. it could impact the short-term availability or the price of products or services, or alter economic activity and skills needs in affected regions), and – additionally – governments (through post-event remediation and the demand on government services).

In the general insurance industry, the gap between economic loss and insured loss (the protection gap) is rising, reflecting the high and variable underlying costs.[1] Costs are driven by urbanisation and population growth in risk-prone areas along with the longer-term impact of climate change, which is expected to increase the frequency and/or severity of weather-

[1] Swiss Re Institute, *Sigma No 2/2019: Natural catastrophes and man-made disasters in 2018: "secondary" perils on the frontline* (10 April 2019).

related events.[2] Climate change can be expected to amplify the underlying issues in terms of both increased uncertainty in areas which have historically experienced disaster events, and in exposing previously unaffected regions where building standards and land use planning do not adequately protect against the risks. Costs of remediation associated with such events often exceed the means of local governments and can fall on the broader community. The levy imposed after the 2011 South-East Queensland floods is an example of this.

The high and rising costs of natural disasters drive the high and rising general insurance premiums seen in northern Australia. The latest figures from the Insurance Council of Australia (ICA) show insurance losses for the three natural catastrophes declared by the ICA over the 2018-19 summer have passed $2.2 billion.[3] In order to ensure their financial viability, general insurers need to set a premium that is commensurate with the insured risk and recoup costs over time. In addition, the high volatility of insured losses from year to year means that capital and/or reinsurance needs of general insurers are high, necessitating significant scale and diversification (of risk types and geographic exposure) to remain prudentially sound.

APRA is also seeing an increasing trend towards more granular data-driven underwriting and pricing as general insurers gain access to better data and technology. This has resulted in pricing more accurately reflecting risk – good and poor - which has seen premiums for riskier policies increase significantly. Such risk segmentation sends better price signals to policyholders but also exacerbates affordability challenges for those policyholders in higher risk areas. Improved risk insights may also reduce insurers' willingness to provide policies in high risk parts of northern Australia.

Where the risk assessment is uncertain due to volatility, or where accurate pricing is unattainable due to market conditions, general insurers will either be more hesitant to provide cover or will charge a higher premium to reflect the uncertainty in the risk they are accepting. Measures that seek to reduce premiums without addressing the underlying risk may see insurers ultimately exit the market.

At present only 40 per cent of Australia's annual natural peril costs are insured.[4] In addition, as shown in figure 1, life and general insurance spending in Australia is already low and declining when compared to other OECD countries.[5] Typically, countries with lower insurance spending suffer more severe economic consequences, such as reduced output and increased debt levels, after a disaster.[6] There is clear potential over the medium and long-term for the protection gap to widen, which would be an indication that the general insurance industry is

2 A number of global attribution studies provide evidence that human activity is raising the risk of some types of extreme weather, especially those linked to heat, e.g. heatwaves, drought, heavy rainfall, hail, floods and extra-tropical cyclones. (The Climate Council, *Super-charged storms in Australia: The influence of climate change* (21 November 2016)).

3 Insurance Council of Australia, *Insurance bill for summer catastrophes passes $2.2 billion* (News Release, March 2019).

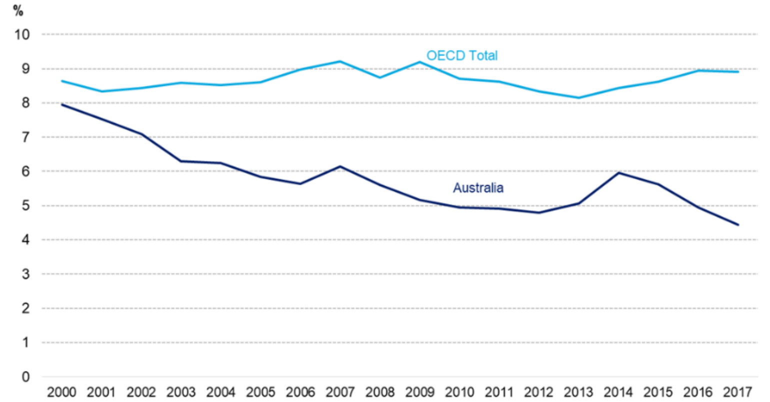
4 Actuaries Institute, Submission to The Treasury, *Pre-budget submission (2019-2020)* (1 February 2019) p. 2.

5 OECD, *OECD Data – Insurance Spending.* https://data.oecd.org/insurance/insurance-spending.htm.

6 The contribution of primary insurance markets to reducing economic disruption is usually assumed to be due to: (i) the ability of those affected to more quickly recover after an event based on their access to a (relatively) quick source of funds for reconstruction - reducing the disruption to economic activity and also the financial stress on households and business that would otherwise need to absorb those losses; and (ii) the more limited impact on public finances in countries with high-levels of insurance coverage for damages and losses as governments will often provide financial assistance to affected households and businesses without sufficient insurance coverage (OECD, *The Contribution of Reinsurance Markets to Managing Catastrophe Risk* (14 December 2018)).

not fully serving its broader economic purpose in risk management to support sustainable economic growth.

Figure 1: Non-life and life insurance spending as a percentage of GDP



Source: **OECD**

4. APRA's view on options to respond

APRA agrees with the ACCC's view that the measures already proposed in the Report 'are unlikely to address acute affordability issues'. Measures such as enhancing consumer choice through competition, redistribution of losses and government premium subsidies are not likely to have a lasting impact on affordability as they do not address the underlying causes of the risk.

In APRA's view, the only way to drive real and meaningful change is by reducing the underlying natural peril costs. This view was also expressed by the northern Australian Insurance Premiums Taskforce.[7] This can only be achieved through avoiding or mitigating the underlying natural peril risk: reducing the risk reduces the ongoing cost. Any other mechanism simply shifts who pays the costs, i.e. to the individual asset owner, other policyholders and taxpayers. APRA agrees with the Productivity Commission's view that paying for mitigation (pre-event) is far cheaper than paying for remediation (post-event).[8]

APRA notes that the Report acknowledges the importance of mitigation but it discusses this in the context of private mitigation measures.[9] APRA is strongly of the view that public mitigation offers the greatest potential to address the root cause of the risk and improve affordability. Examples of public mitigation include funding for pre-emptive infrastructure work, risk mapping, land use rezoning and robust building codes. Box 1 provides an example of how flood mitigation infrastructure can impact insurance premiums.

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7 The Treasury, *Northern Australian Insurance Premiums Taskforce Final Report* (November 2015).

8 Productivity Commission, *Natural Disaster Funding Arrangement, Productivity Commission Inquiry Report No. 74* (17 December 2014).

9 Section 3.4 of the Report acknowledges that mitigation is the most sustainable way to reduce premiums in Northern Australia, but the focus of the associated recommendations 12 and 13 is on private mitigation (i.e. customers improving the resilience of their properties) and how insurers can support this.

Box 1: The Roma example

Flood mitigation works in Roma and Ipswich were initiated and funded via the *Agreement for Implementation of the National Insurance Affordability Initiative* between the Commonwealth and Queensland governments. The example of Roma was included in a research study which reviewed the business case for flood mitigation investment.[10] This study estimated the net present value of economic benefits to the Roma community from flood mitigation works over a 50 year period to be $64.7 million. These benefits reflect avoided costs to physical assets for households, businesses and public infrastructure; as well as avoided losses from productivity disruptions to services and businesses and improved affordability of insurance.

Data from the ICA indicates a reduction in insurance premiums following flood mitigation works in Roma.[11] Public comments have estimated these reductions to be "exceeding 50 per cent, and in some cases 90 per cent".[12]

Money spent on prevention and mitigation generates greater sustainability as it makes homes and businesses more capable of withstanding natural perils, reduces the economic and insured losses when disasters do occur, and results in prolonged reductions in premium, thus improving affordability.

APRA considers meaningful change requires a greater focus on risk reduction and public mitigation, and better information on the allocation of benefits and costs will enable an informed debate about risk mitigation financing. Actions could include, but should not be limited to:

- further engagement between federal, state and local governments and the general insurance industry on mitigation options;
- encouraging insurers to think of how their capabilities and expertise – such as provision of loss data and data modelling – could be used to identify potential solutions;
- researching and detailing the benefits of pre-emptive mitigation in order to influence changes to the present imbalance between public mitigation and recovery funding (see box 2); and
- exploring mechanisms to finance public mitigation which consider how the benefits from investment in mitigation accrue to stakeholders.

10 Urbis Pty Limited, *Economic benefits of flood mitigation investments* (9 October 2014).

11 Insurance Council of Australia, *The dollar value of risk reduction: Roma & Insurance* (29 June 2018) https://disasters.org.au/news/2018/6/29/the-dollar-value-of-mitigation-roma-flood-mitigation-insurance.

12 Australian Financial Review, Senator Dean Smith, *Cut insurance costs by mitigating against disasters* (23 April 2017).

Box 2: Disaster management spending – recovery vs mitigation

As shown in the below figure, in Australia 97 per cent of disaster funding goes to clean-up and recovery, with only 3 per cent on prevention and mitigation.[13] A similar imbalance is seen globally with only 12 per cent of disaster management funding in mitigation and 88 per cent in response, repair and reconstruction.[14] As stated in the Report, the Productivity Commission has recommended that the Federal Government invest at least $200m per year in mitigation and resilience projects.

Finally, the ACCC has also stated that it is considering whether a reinsurance pool is a viable option to improve insurance affordability and availability in northern Australia. A range of literature has considered the effectiveness of international schemes which have been introduced in response to affordability concerns. Reinsurance pools operate by transferring risk from individuals and insurers to the government (either directly or indirectly). While they do not address the underlying causes or reduce the overall cost, reinsurance pools change the financing of the costs. Caution must be taken when designing reinsurance pools as they can give rise to a range of risks, including costs to the government, difficulty in unwinding the arrangement and blunting incentives to undertake mitigation. To assist with the ACCC's deliberations on this option, Box 3 contains some additional examples for consideration.

Box 3: Examples of publicly managed schemes

The ACCC Report identified international examples of publicly managed reinsurance pools that offer reinsurance to private insurers. In addition to the identified examples, APRA recommends that the ACCC also consider the following schemes.

Country	**Scheme**	**Description**
France	Caisse Centrale de Réassurance	Established 1982. Provides reinsurance to home insurers for natural catastrophes, including flood.
United States	National Flood Insurance Program	Established 1968. Provides flood insurance via insurers or brokers to home owners.
United States	California Earthquake Authority	Established 1996. Provides residential earthquake insurance via participating insurance companies.
Philippines	Philippine City Disaster Insurance Pool	An example of a parametric insurance pool designed to provide post-disaster financing to assist with early recovery.

[13] Insurance Council of Australia, *Statement on the 2019-20 Federal Budget* (News Release, 2 April 2019).

[14] Surminski, S. *The Insurance industry as "society's risk manager"? Reflections on the role of insurers in supporting climate resilience*, Presentation to Aon Hazards Conference (September 2017).