Consumer Perspective

Natural Disaster Insurance Review

A consumer perspective on the
NDIR Issues Paper

September 2011

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1. Introduction

This document is a consumer perspective paper in response to the *Natural Disaster Insurance Review (NDIR) Issues Paper* circulated in June 2011 by the Natural Disaster Insurance Review Panel.

Chris Connolly has been commissioned by Treasury to assist the Panel by providing a consumer perspective on some of the key questions and recommendations in the Issues Paper.

The most contentious issue raised in the Issues Paper is the development of a new approach to providing flood insurance for homes in Australia. The Issues Paper provides an analysis of two core options for addressing this concern:

1. Automatic flood cover; and

2. Automatic flood cover with opt-out.

This document provides a consumer perspective on these options in Section 2.

In addition, the Issues Paper raises a series of specific concerns about broader aspects of natural disaster insurance. A consumer perspective on these broader issues is set out in Section 3.

A list of consumer representatives and consumer organisations consulted during the development of this document appears in Section 4. However, the conclusions and recommendations contained in this document are the views of the author.

2. Options for flood insurance for homes

2.1. Automatic flood cover

The Issues Paper notes that the lack of flood cover for many homes is a key challenge in the management of natural disaster insurance in Australia. The Issues Paper notes that cover for floods is increasing, and is likely to increase further even without intervention. However, the Panel believe that natural, market-led increases in cover will be slow and may not be sufficient. The Issues Paper therefore provides detailed information on potential options for reform of flood insurance for homes.

The following table provides some comments on those options from a consumer perspective:

Option	Summary	Consumer view
Status quo	The private insurance market would continue to offer a variety of home insurance products, including policies that exclude flood cover, and policies that provide either full or partial flood cover. Some minor changes could still be achieved within the status quo model – such as improved flood mapping, improved disclosure to consumers and a uniform definition of key terms such as flood and storm. Under this option, the overall level of flood cover should increase slowly over time.	Consumer representatives are concerned that the status quo model has been the cause of consumer detriment for specific policy-holders. The first key area of detriment is where consumers believe they have flood cover, but their policy excludes or limits flood cover. The second key area of detriment is where consumers without flood cover face difficulties and delays in making claims where the distinction between flood and storm damage is unclear. The third key area of detriment is where consumers are unaware that their property is in a flood prone area – many of these consumers would have considered flood insurance if they had known of the risks. These three problems would continue if the status quo option is adopted. Also, under this option there is no clear incentive for insurers to provide affordable flood cover to consumers in high risk areas. Consumer representatives believe that levels of flood coverage remain very low for home insurance and extremely low for home contents insurance.
Automatic flood cover	All home insurance policies would automatically provide flood cover. There would no longer be any disputes about the difference between flood and storm damage, and flood coverage would be available in all areas. The Issues Paper proposes several complex methods for funding a premium discount to ensure that flood cover is affordable for consumers in high risk areas.	This option has many positive aspects and has the support of consumer representatives. Consumer representatives believe that the key objective of any reforms in the natural disaster insurance sector should be to increase flood coverage. This option will boost the overall level of flood cover. This option will also lead to the removal of disputes about the difference between flood damage and storms, and make insurance products easier to understand for consumers. However, the funding models proposed in the Issues Paper are complex from the consumer's perspective, and need to be reviewed. Consumer representatives are concerned that this proposal may have a negative impact on affordability and lead to underinsurance for some low income and disadvantaged consumers, unless further steps are taken to improve affordability for these groups.

Option	Summary	Consumer view
Automatic flood cover with opt-out	All home insurance policies would automatically provide flood cover. However, consumers could opt-out of the flood cover, by making an active choice to exclude flood damage, presumably in exchange for a lower premium. Under this option there would still be disputes about the difference between flood and storm damage for those consumers who opt-out of flood cover. However, the overall number of people in this situation should be lower.	Consumer representatives acknowledge some positive aspects of this option. It shares many of the benefits of the automatic flood cover option, but it provides some consumers with the opportunity to reduce their costs by selecting alternative cover. However, in this option disputes about the difference between flood damage and storm damage will still occur for those consumers who opt out. Also, low income consumers are more likely to opt out because of affordability concerns, thereby reducing coverage levels amongst a group that is already vulnerable. The impact of opting out by consumers in low risk areas is also unclear – could this lead to an overall rise in premiums as the remaining consumers will have a higher risk profile? Overall, consumer representatives do not support this option as it will not lead to an appropriate level of flood coverage.

As can be seen from the summary table above, consumer representatives believe that automatic flood cover (with no opt out) will deliver the best outcome for consumers.

Support for the status quo is very limited. This is largely based on the existing market and the historical and recent behaviour of insurers. Some improvements could be achieved in the medium term if the industry and Government took serious steps to improve consumer disclosure around coverage, standardised definitions of flood and storm and other key terms, and increased disclosure of flood risk for each property. These improvements would require a new focus on compliance and enforcement, and there is no guarantee that these reforms will deliver the expected benefits. Consumer representatives are generally sceptical about the ability of the industry to make rapid improvements in these areas. Consumer representatives do not accept industry assertions that the current level of flood coverage is adequate.

Both of the automatic flood cover options have some support, but they raise some additional concerns around affordability. Support is significantly stronger for automatic flood cover without opt out.

Consumer recommendation

The Review Panel should pursue automatic flood cover as the preferred option for increasing flood cover. This option will require further work on solutions for those consumers facing affordability challenges.

The remainder of this Section discusses some of the more detailed issues raised within each of the proposed options for the two automatic flood insurance options.

2.2. Funding Models

The Issues Paper acknowledges that market intervention of some form is required in order to improve affordability for flood insurance in areas of high risk. This is the case under all the options considered in the Issues Paper.

The necessary steps identified in the Issues Paper are to identify houses that are at risk, provide a discount to some policy holders, and find a way to fund these discounts. However, these three steps could and should be complemented by some form of requirement to mitigate flood risks.

The identification of homes with a high flood risk is clearly in the interests of consumers, and there is strong support for industry and government measures that will provide information on risk directly to consumers.

Consumers require information on flood risk at key points, including some transactions which do not involve insurance. This includes during the purchase or leasing of property (and renewals). Regular information on flood risk could also be included in annual rates notices, and up to date information should be made available at key public sites and websites. In addition, information on flood risk should be included in insurance offers and renewals, even if flood cover is not currently being provided.

Risk could be disclosed in three to four “bands” – as long as this was done consistently across industry and government. The Issues Paper suggests that the bands or thresholds could be set through an engineering solution, independent from the insurance industry, and this is attractive to consumers.

The funding models considered in the Issues Paper are extremely complex and are based on numerous economic assumptions that remain untested. The proposed funding model includes the establishment of a central Flood Insurance Pool that would take on some of the risk, and associated infrastructure. Consumer representatives are concerned that this funding model has not been considered from a consumer perspective – it creates numerous complex obstacles for consumers to navigate. Simpler funding models may be worthy of consideration.

One alternative would be to pursue a funding model designed to focus only on the small number of homes in the extreme risk category. A model that concentrated on that category of houses might be able to deliver improvements in flood mitigation and more resilient buildings – and take some of the price pressure of flood insurance in the rest of the market. The establishment of a premium discount scheme linked to mitigation and remedial work could rely on the existing insurance and reinsurance market, rather than requiring the establishment of a new Pool that would have to take on some flood risk.

By concentrating on the highest risk band, the intervention may be able to be closely integrated with risk mitigation measures. There may be as few as 50,000 houses in the highest risk band, yet they represent a large proportion of the overall risk and potential cost to insurers. The goal should be to not only insure these properties, but to find ways to reduce the number of houses in this band. One option to achieve this might be to only provide a premium discount if certain conditions are met – such as a commitment by the local council to risk mitigation steps and appropriate zoning, a commitment by the homeowner (or strata) to make improvements to meet building standards, and specific rules for any re-building that occurs following a flood event. The Issues Paper suggests that eligibility criteria should be established for any discount, although it does not have a strong focus on a conditional discount.

The Issues Paper presents a number of highly technical options for calculating and funding the discount. The proposed model depends on the establishment of a Flood Insurance Pool that collects some portion of premiums and accepts some portion of risk. The Pool is accompanied by considerable infrastructure and even plays a role in determining premiums.

However, there may be ways to reduce the role of the Pool and remove some of the associated infrastructure. For example, if the insurance market is left to offer products and set premiums for consumers in the highest risk band, the new entity could play a more limited role.

A central body with a more limited role could set the conditions for premium discounts and collect subsidies from appropriate bodies – such as Governments and councils who will benefit from broader insurance coverage and risk mitigation. Obviously the insurance industry would also benefit from the risk mitigation steps, and they could be called to contribute to the subsidy. This is a very different approach to the model outlined in the Issues Paper, but it is simpler, requires less infrastructure, and has a clearer link with risk mitigation. The calculation of who should contribute to the subsidy could be calculated by an independent party, based on the fair share of the benefits of broader coverage and risk mitigation. The cost of the contributions would also provide a disincentive to councils when considering actions that might expand future flood risks (e.g. through zoning and planning decisions).

For consumers in the highest risk band, they would still pay more than consumers in the other bands – the discount would be partial, so that a price signal would still act as a warning about the risk level of the property. However, consumer representatives warn against any expectation that consumers in high risk areas can afford more than a moderate increase in insurance premiums. The “150%” premium model discussed in the Issues Paper might lead to significant non-insurance by low income consumers.

Ideally, the undiscounted premium should also be disclosed, so that consumers can see the benefit of meeting the discount conditions (even if the main conditions are being met by the local council). These factors lend support to the idea of the discount being expressed as a percentage discount, collected in practice by the insurer from the central body (similar to the administration of the private health insurance rebate).

If the Issues Paper funding model is pursued, there are concerns that consumers will find the process complex, confusing and frustrating. Under the Issues Paper model, consumers must first attempt to obtain full flood cover insurance at a total premium that is less than 150% of the non-flood cover premium. This calculation alone will be beyond the ability of many consumers. If the consumer cannot get a full flood cover insurance quote below this thresh-hold, they then have to know to specifically ask for a discounted premium. If they fall into this second category, then their risk will be transferred to the central Flood Insurance Pool, and any subsequent claims would be against the Pool rather than the insurer. However, the consumer would still be a customer of the insurance company. The complexity of this approach may act as a barrier to insurance take-up for many vulnerable and disadvantaged consumers. Consumers are much more likely to be able to understand and navigate a premium discount regime.

The Issues Paper also notes that under this model disputes may still arise between the insurance company and the Pool. For example, disputes over whether water damage was caused by a flood (the Pool’s responsibility) or by a storm (the insurer’s responsibility). Consumers are likely to be severely disadvantaged in any such dispute. Consumer representatives submit that if a Flood Pool takes on any of the risk, all payouts should be made immediately to the consumer, and any remaining dispute between private insurers and the Flood Pool should have no impact on the consumer.

Consumer recommendations

The Review Panel should consider alternative, simpler funding models for providing affordable flood cover for high risk homes. This should include consideration of a premium discount model, where the discount is conditional on risk mitigation steps.

The Review Panel should consider a more limited role for the central body, such as restricting its role to setting discount levels, establishing risk mitigation criteria, and calculating and collecting fair subsidies from organisations that will benefit from the increased insurance coverage and risk mitigation. Ideally, the central body should not need to take on any risk or play any role in setting premiums.

The Review Panel should avoid any funding models that will lead to confusion, complexity or delays for consumers.

3. Additional issues

3.1. Flood cover for contents insurance

Cover for contents involves lower insured sums and lower premiums. However, content cover is very important for low income and vulnerable consumers. In particular, consumer caseworkers are very concerned that low income consumers might face serious detriment if they can not afford contents insurance because of high flood premiums, as they would then likely be uninsured, and vulnerable to burglary and other risks.

Contents insurance is vital for low income consumers as the lump sum replacement costs cannot be met from a low fortnightly income and this group of consumers have limited access to credit and savings.

If automatic flood cover is provided for homes, the same model should be applied to home contents. Any inconsistencies between the two types of insurance will confuse consumers.

There will also be advantages to all parties from a requirement to disclose the relevant flood risk band to consumers who only have contents insurance – thus broadening the pool of people who are aware about flood risk.

However, consumer representatives note that the affordability and non-insurance concerns discussed in relation to home insurance are likely to be even stronger in relation to home contents insurance. It is essential that steps are taken to address affordability for low income and disadvantaged consumers.

Consumer recommendation

If automatic flood cover for homes is pursued, the same approach should extend to contents cover.

3.2. Flood cover for strata title property and other residences

The Issues Paper notes that home insurance for strata properties is very complex, requiring specialist assessment, often on a case by case basis. The market for strata insurance is also very concentrated.

However, strata properties are a large and growing segment of the homes in high flood risk areas. They should be included in the proposed automatic flood cover regime. Some strata properties may be able to mitigate their risk and qualify for premium discounts under the funding model discussed in section two above.

Consumers living in strata properties often have very little knowledge or control over the selection of insurance for the property. This sector may benefit from more detailed regulation and guidance, such as a requirement to establish appropriate flood cover.

Automatic flood cover should also be extended to other types of residences, including boarding houses, retirement accommodation and caravan parks.

Consumer recommendation

If automatic flood cover for homes is pursued, the same approach should extend to strata title property and other residences.

3.3. Under-insurance of homes

To date, insurers have offered a mix of agreed value, total replacement and buffer products. It seems unlikely that this mix of products will ever reduce under-insurance without some form of intervention or regulation.

Most individual consumers lack the information and expertise to insure their home for the correct amount to ensure full replacement following a natural disaster. Although some online calculators are available they can deliver inconsistent results, and not all consumers have easy access to the Internet. Consumers are also very price-sensitive when selecting insurance cover, which may result in under-valuing the level of cover in order to reduce premiums.

A better approach would be to insure homes on a total replacement cost basis. Many insurers already offer this type of cover.

Ideally, sum insured policies should be phased out quickly – even if this requires market intervention or regulation. This could be addressed by regulatory guidance, or it may require a specific test for all products (similar to the responsible lending test in credit).

Consumer representative support a mandatory requirement to offer insurance on a total replacement basis. They specifically reject suggestions that sum insured policies, or sum insured with a buffer policies, are suitable for consumers,

Consumer recommendation

The Review Panel should consider steps to phase-out sum insured policies for homes, in favour of total replacement policies.

3.4. Non insurance

Rates of home insurance in Australia are very high. However there are still gaps, and these gaps become noticeable during major natural disasters such as bushfires and floods. Some of the causes of non-insurance are:

Affordability
This could be partly addressed by allowing variable excesses, payment by instalments, and a premium discount model (matched to risk mitigation) as discussed in Section 2. However, affordability is likely to remain a significant concern for many low income and vulnerable consumers. The report *Reducing the Risks: Improving access to home contents and vehicle insurance for low income Australians* (Brotherhood of St Laurence, 2011), found that “cost is the greatest barrier to increased cover for low income Australians” (page 20).

Complexity, language and cultural reasons
The recent study *Measuring Financial Exclusion in Australia* (Centre for Social Impact UNSW, 2011) found that the level of general insurance coverage fell from a national average of 82.3% to a level of just 69.5% for consumers who were born outside Australia. No similar difference could be observed for ownership of transaction accounts or credit cards, leading the researchers to conclude that there must be some specific attributes of insurance that act as a barrier to people born overseas. The study will be repeated in 2012 and will explore whether the barriers are language or cultural, or whether other factors are involved, such as the complexity of insurance products.

Value
Some consumers may have doubts about the value of insurance, especially when compared to other expenditure choices. The insurance industry have a reputation for making the claims process lengthy and difficult, and rejecting claims for a wide variety of technical reasons. The value of premiums may be difficult to justify for many consumers when the payment of claims is not guaranteed.

The role of lenders
Lenders could play a more significant role in ensuring that the asset they hold as security for the loan is subject to appropriate insurance. This would not have an impact on home contents insurance, but it would improve coverage for home insurance. The link between lenders and insurers seems to work better in relation to car-loans, where the lender is notified automatically if the vehicle is no longer subject to comprehensive insurance. This system should be extended to home loans.

Consumer representatives urge the Government and industry to take steps to improve the affordability of all insurance. This could include bundling insurance with rent in some circumstances (e.g. social housing), allowing fortnightly payments at no extra charge, allowing Centrelink recipients to pay their insurance premiums by Centrepay, and allowing greater flexibility on setting the excess in home and home contents policies. Excesses for low income consumers should be arranged as 'deductibles' so that consumers do not need to make an up-front payment in order for their claim to be processed. See: *Reducing the Risks: Improving access to home contents and vehicle insurance for low income Australians* (Brotherhood of St Laurence, 2011) for a more detailed discussion of these measures.

There is no clear agreed definition of low income and disadvantaged consumers, however representatives had concerns about older consumers, especially those on fixed incomes, people relying on Centrelink benefits, and the working poor (people on or near the minimum wage and casual employees generally earning around $25-30k per annum).

Representatives believed that the insurance industry itself might have actuarial data on the price sensitivity amongst this group – i.e. the price points at which products can find a market. It was noted that many insurers offer a basic product and an enhanced product at very different premiums – presumably to address concerns over price sensitivity.

Consumer recommendation

Measures should be introduced to improve the affordability of insurance for low income consumers – these affordability measures are different from the conditional discount scheme outlined in earlier recommendations, and they should apply to all insurance. Levels of non-insurance could also be reduced by reducing the complexity of insurance products, and a greater focus on delivering a positive claims handling experience, to show consumers the value of insurance.

3.5. Consumer awareness of risk and insurance

Consumer awareness of risk would be improved by the publication of three to four consistent "bands" or categories that describe the flood risk for each house. It is essential that consumers in the highest band are aware of their level of risk. These bands could be set independently and used in all aspects of property purchase, management and insurance.

Consumers require information on flood risk at the following key points:

1. During the purchase or leasing of property (and renewals);

2. Annual and quarterly rates notices; and

3. Insurance offers and renewals, even if flood cover is not currently being provided.

In addition, up to date information on flood risk should be made available at key public sites and websites.

These disclosure requirements will need to backed up by an enforcement and compliance regime. The disclosure of risk will work best where there is still a price signal regarding risk (e.g. through the disclosure of higher base insurance premiums, even if a premium discount is also available).

Consumer recommendation

Level of risk should be disclosed in consistent bands or categories. Information should be provided to consumers at key times, not limited to insurance transactions.

3.6. Processing of claims

The processing of claims by the insurance industry is possibly the greatest area of consumer concern. Even if flood cover was universally available and affordable, consumers would still suffer detriment when lodging claims.

Key areas of concern in relation to claims handling are:

— **Time limits on claims processing**
Consumers accept that there may be some delay in processing claims following a natural disaster where a large number of claims are lodged at the same time. However, the delays experienced in processing claims during key natural disaster incidents in Australia have been unacceptable. Many of the delays relate to the provision of key information to consumers and their advisers. Consumer representatives are very concerned that the General Insurance Code of Practice has, in the past, been relied on to manage issues regarding timely claims processing. Oversight of the Code and compliance monitoring appear to have fallen in recent years, and the reputation of the Code amongst consumer advisers is currently poor. Time limits may need to be set in regulations, a claims handling standard or an ASIC Regulatory Guide. ASIC should also collect and publish data on the timeliness of claims handling by individual insurers.

— **Resolution of claims disputes – internal**
Consumer representatives are concerned that some insurers continue to make the internal dispute resolution (IDR) process as slow and complex as possible for consumers, and that many consumers no doubt give up on pursuing their claims in the face of these techniques. Common problems include telling a consumer over the phone that the damage is flood related and they are "not covered", the failure to provide evidence and documents that have been relied upon in refusing a claim (notably, hydrology reports), and the failure to provide sufficiently detailed grounds for refusal. Also, consumer rights to EDR are often not disclosed.

— **Resolution of claims disputes – external**
Consumers remain at a significant disadvantage in flood disputes, even when they reach the Financial Ombudsman Service. The disadvantage is caused by the inability of consumers to gain access to independent hydrology experts who can challenge the evidence of the experts hired by the insurers. This disadvantage should be addressed by the establishment of a panel of independent experts who can provide free and impartial advice in flood disputes. The establishment of a panel of independent hydrology experts available to provide consistent advice to all parties should represent a saving, rather than a new cost to industry. Currently, multiple experts represent multiple parties, often repeating and overlapping existing reports.

Consumer representatives are available to provide detailed input into the development of an appropriate standard – similar to their input to other codes and standards in other sectors. The standard should address the key issues identified above. A general fairness test in claims handling could also be useful.

Consumer recommendations

The Review Panel should propose improvements to the timeliness requirements for claims processing. These improvements should be contained in regulations, a claims handling standard or an ASIC Regulatory Guide. ASIC should also collect and publish data on the timeliness of claims handling by each insurer.

The Review Panel should pursue substantial improvements in insurance IDR processes, possibly through the introduction of new standards and greater compliance monitoring and enforcement regarding the Code and the relevant ASIC Regulatory Guides. Consumer representatives support the development of a mandatory claims handling standard.

The Review Panel should seek to create a level playing field for consumers taking flood disputes to the Financial Ombudsman Service by providing access to free and impartial expert hydrology advice for consumers.

4. Organisations and representatives consulted

The listed individuals and organisations have been consulted in the development of this document. Please note:

1. Where the listed individual is a consumer representative on an EDR scheme, they were speaking in their private capacity and not as a formal representative of the EDR scheme;
2. The views expressed in this document are those of the author, and do not necessarily reflect the views of all of the individuals listed below; and
3. Individual consumer organisations may choose to write to the NDIR Panel supporting all or part of this document, or suggest alternative views and options.

Organisations	Individuals
Brotherhood of St Laurence	Dominic Collins and others
CHOICE	Elizabeth McNess, Katrina Lee and Christopher Zinn
Consumer Action Law Centre	Gerard Brody and David Leemakers
Consumer Credit Legal Centre NSW / Insurance Law Service	Kat Lane and others
Family Care Shepparton	David Tennant
Financial Counselling Australia	Fiona Guthrie and some individual counsellors
Fitzroy Community Legal Centre	Denis Nelthorpe
Legal Aid NSW	David Coorey
Legal Aid QLD	Catherine Uhr and Loretta Kreet
Lifeline	Carolyn Joy
Salvation Army	Tony Devlin
	Stephen Duffield (FOS Panel)
	Paul O’Shea (FOS Panel)