CONSULTATION

Date	12 July 2011
Subject	**Natural Disaster Insurance Review – Issue Paper – Inquiry into Flood Insurance and Related Matters**

Lloyd‟s would like to thank the Natural Disaster Insurance Review (“NDIR”) panel for the opportunity to comment on its Issue Paper on the inquiry into flood insurance and related matters. Lloyd‟s has also contributed to the Insurance Council of Australia‟s submission to the NDIR.

Lloyd’s

Lloyd‟s is the world‟s leading specialist insurance market, conducting business in over 200 countries and territories worldwide, placing 3rd in the latest ranking of global reinsurers[1]. Lloyd‟s has a well established reputation for paying billions of dollars in claims, and supporting economies in the most significant and disaster prone areas globally.

Lloyd's is not an insurance company but a society of members, both corporate and individual. Lloyd‟s underwriting members provide capital and underwriting capacity to over 80 syndicates in the Lloyd‟s market, on whose behalf professional underwriters accept insurance risk. Lloyd‟s underwriting members are formed by investment institutions, specialist investors, international insurance companies and individuals.

The risks placed with underwriters at Lloyd‟s originate from clients, brokers and intermediaries all over the world. Together, the members underwriting at Lloyd's form one of the world's leading commercial insurer and reinsurer, offering an unrivalled concentration of specialist underwriting expertise and risk management talent.

Lloyd’s and Catastrophe (Re)insurance

Lloyd‟s plays an important role in providing natural catastrophe (re)insurance coverage around the world, protecting individuals and businesses from natural disasters and helping companies and communities recover and rebuild after severe events. Indeed, Lloyd‟s has a long history of helping policyholders around the world recover from natural catastrophes stretching back to the San Francisco Earthquake in 1906, when prominent Lloyd‟s underwriter, Cuthbert Heath, famously instructed his San Francisco agent to „pay all claims‟.

Today Lloyd‟s continues helping people and communities to recover after major natural catastrophes. Most recently, Lloyd‟s has actively responded to the recent earthquakes in Chile, Japan and New Zealand[2], and the January 2011 floods in Australia, where our

[1] Ranked by 2009 Net Written Premiums, Lexis *Nexis*.
[2] Estimated net claims for Lloyd‟s are as follows for these events:

US$ 1.95bn - Japan earthquake and tsunami

US$ 1.4bn – Chile earthquake

estimated net claims will reach US$650m. As ever, Lloyd"s priority has been to settle valid claims as swiftly as we can to help these communities get back on their feet.

As Lloyd"s has extensive expertise in this area, we would be delighted to support the NDIR in finding appropriate solutions to improve the availability of flood coverage in the private insurance market, without the imposition of inappropriate constraints that would restrict its ability to provide valued risk protection.

Provision of Coverage by the Private Insurance Market

Lloyd"s firmly believes that the first step in protecting Australian property owners from flood losses is ensuring that there is a healthy private insurance market, appropriately supported by the international (re)insurance market, that is allowed to perform its natural role, in particular the risk-based pricing of premiums.

International (re)insurers already play a fundamental role in the Australian insurance market, providing capacity and expertise not always available domestically, playing a particularly important role in the natural catastrophe market. The development of sophisticated modelling technologies, and the continued emergence of specialist (re)insurance capacity in centres such as London and Bermuda has seen the international insurance industry take on an increasingly significant role in supporting economies recover from natural catastrophes, relieving the considerable burden exerted on governments following such events. Given that the trend appears to be towards more frequent severe weather events and therefore increased losses, the responsibility of international (re)insurers in this regard will continue escalating.

By accessing international (re)insurance markets, Australian policyholders spread some of the risk away from domestic markets and share the burden with overseas insurance markets. This means that even in the face of significant natural catastrophe losses, the domestic private market is more likely to remain healthy and robust and able to meet future claims. Furthermore, by holding capital collectively against a number of different risks, insurers are potentially able to offer policyholders lower premiums.

Given the right pricing environment and appropriate terms and conditions, the international (re)insurance market will maintain an appetite for natural catastrophe risk. Therefore, insurers must be able to reflect the variations between individual risks in order for a healthy market to operate.

As such, government intervention into private insurance markets should be kept to a minimum.

Negative Aspects of Government Intervention in Natural Catastrophe Insurance

Government involvement, e.g. through the creation of insurance programmes or pools can limit the effectiveness of the insurance industry by distorting competition and reducing rates

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US$ 1.2bn - New Zealand earthquake

to uneconomic levels. This in turn can result in government-run schemes expanding beyond their original remit, creating large liabilities for taxpayers both by expanding the number of policyholders and by increasing the implicit subsidy to each. Furthermore, it can have the unintended consequence of diminishing the insurance industry"s role in encouraging a responsible attitude to risk and risk mitigation by reflecting the nature and cost of behaviour, location and build quality, to name but a few examples of rating factors.

US FAIR, Beach and Windstorm Plans
For example, the NDIR paper refers to the FAIR plans in the United States. It should be noted that these plans, and the Beach and Windstorm plans, which cover mainly wind only risks in selected coastal areas of the US, have over the last forty years experienced considerable growth. Between 1990 and 2005, the total FAIR and Beach Plan policies in force rose from 780,000 to over 2 million. Their exposure to loss rose from US$40.2 billion in 1990 to US$380 billion in 2005. This shift has left some plans with huge concentrations of risk and the potential for severe financial difficulties.[3]

US National Flood Insurance Program
We would also point to the experience of the US National Flood Insurance Program ("NFIP"). The NFIP"s rates are below those the private market would offer to cover flood. It provides overall flood insurance at one-third of the true risk cost in higher risk areas owing to its rating methodology and is restricted by law in its ability to adjust existing rates and to offer risk-based pricing. According to a March 2011 report by the US Government Accountability Office, the NFIP owed the Treasury US$17.8 billion and was in serious need of financial reform.

As a result, in the US, the proper functioning of the private natural catastrophe insurance market is currently disrupted by the presence of government run insurance programs or pools, some of which offer insurance that is not actuarially sound. When insurance is not risk-based, the wrong price signals are sent and there is little or no incentive to mitigate risk. Insurance is not sustainable if it is offered at rates below what is required by sound, risk-based actuarial practices. In turn, this leads to wider adverse impacts on society, such as environmental degradation of vulnerable environments and a reliance on government emergency funds to help rebuild communities after catastrophic events.

Government Intervention Supporting the Private Insurance Market

Notwithstanding our misgivings about government intervention, Lloyd"s acknowledges that Government intervention can be justified where there is a social need for flood coverage amongst those who would be otherwise unable to afford it. However, rather than creating a central programme or pool, with the inherent potential shortcomings described above, Governments should instead consider selective, means-tested and carefully targeted subsidies for those affected. Such programmes should not be extended to commercial policyholders.

[3] Further information can be found in the Insurance Information Institute 2007 report "From Markets of Last Resort to Markets of First Choice".

By the same token, Lloyd"s supports government intervention where it leads to the establishment of improved building codes in areas at risk for natural catastrophes. The benefits of introducing advanced building codes and technologies were most recently demonstrated by the relatively small damages and losses incurred in Tokyo, despite the immense magnitude of the March 2011 Japanese earthquake.

We would also like to highlight the experience in the UK, where the problems surrounding the provision of flood insurance in high-risk areas is being addressed through a model which demonstrates how government can work with the private insurance market to improve the availability of flood insurance for homeowners. Under the UK initiative, instead of establishing a state pool, the government works to encourage and fund risk mitigation measures, and to encourage and incentivise the private insurance industry to offer flood insurance on a consistent basis to personal lines policyholders, whilst avoiding its involvement in the private insurance market. In return the British insurance industry has committed to continue offering flood cover to existing domestic property customers at significant flood risk, provided the Environment Agency reduces that risk to below significant within five years. Similarly, the government funds and publishes highly comprehensive, standardised and publicly available flood maps which enables insurers to offer some form of insurance to the maximum number of homes. Though the execution of this programme in the UK has faced problems, its principles are sound in promoting government led risk mitigation initiatives that will facilitate the private insurance market in continuing to offer flood risk cover where it is most needed.

Conclusion

In conclusion, Lloyd"s believes that there is no one solution to assessing and managing natural catastrophe risks. However, international markets and insurers can bring different perspectives and ideas from their own domestic markets which may help in the Australian market.

We believe that Governments have a vital part to play in conjunction with private (re)insurers in addressing and managing the costs of natural disasters. However, in doing so, they must avoid compromising the domestic private market and international (re)insurance market"s ability to function to maximum effect. Ultimately, if there is a healthy private insurance market, governments will be relieved of their financial exposure to natural disasters and be able to focus on offering assistance on the most needy. By thinking of alternatives, for example promoting risk mitigation initiatives, or supporting the private insurance market through the development of flood maps, governments can work in train with insurers to ensure that high flood risk areas can acquire adequate insurance coverage.

Lloyd"s would like to assure the panel that we remain committed to the Australian insurance market, and at your disposal should you wish to examine any of these points in greater detail.