Australian Government
Australian Reinsurance Pool Corporation

Tuesday, 15 September 2015

Mr Mike Callaghan AM
Chair
Northern Australia Insurance Premiums Taskforce
The Treasury
Langton Crescent
Parkes ACT 2600

By email to NorthernAustraliaInsurancePremiumsTaskforce@treasury.gov.au

Dear Mr Callaghan

ARPC Submission to Northern Australia Insurance Premiums Taskforce – Response to Interim Report

I am writing in my capacity as Chair of Australian Reinsurance Pool Corporation (ARPC), and as a Member of the Taskforce Reference Panel. This letter provides ARPC comment on some of the issues raised in the Interim Report of the Taskforce. We have confined our comments to where ARPC has been referred to in the Interim Report as a potential cyclone reinsurance pool and to how a reinsurance pool could potentially operate.

Our comments are as follows:

- ARPC does not advocate for or against a pool – we are neutral if this occurs or not.
- ARPC exists to address market failure where there is insufficient insurance or reinsurance capacity or unaffordable insurance or reinsurance capacity.
- ARPC notes the Interim Report Table 2 which highlights that North Queensland and North Western Australia (with the exception of Darwin) has some of the highest participation rates in households having insurance in Australia; while Table 1 highlights that Northern Australia (North Queensland, Darwin, and North Western Australia) has a higher proportion of household income needed to purchase insurance.
- Should the government resolve to establish a pool, ARPC would work with insurers and reinsurers to structure it to be as efficient and effective as possible, involving as many participants in the market as possible. We would seek to support the market through subsidised reinsurance, and the use of retrocession reinsurance, and not replace the market.
- ARPC has a guarantee of solvency from the Government, this could be used for two purposes: terrorism and cyclones (both being extreme catastrophes). ARPC also has residual powers in our regulations for Functions of Corporation for insurance affordability. The existing infrastructure may make implementation relatively straightforward.
- ARPC has specialised property reinsurance skills and systems capability to extend to other reinsured perils for catastrophe.
- ARPC currently has reinsurance agreements with almost all Australian property insurers plus many foreign insurers. We have 231 insurer customers and 60 retrocession

reinsurers. This existing network is likely to enable high engagement with insurers and reinsurers on a cyclone reinsurance pool.

We wish to raise three concerns for the Taskforce to consider:

1) Losses to government would be expected to occur frequently, and we expect a scheme would not be self-funding for a number of years. Setting subsidised reinsurance rates lower than the technical rates that cover expected losses will exacerbate this.

2) Payments to government by ARPC of $0.8 billion over the period 2012-13 to 2017-18 are reducing ARPC's reserve for claims for terrorism which creates a medium term financial sustainability issue. It is important to ensure that our reserve for claims for terrorism be held separately to (or segregated from) the reserve for claims for cyclones.

3) ARPC is a voluntary scheme whereby insurers have the option to purchase reinsurance from ARPC or elsewhere. To maintain our excellent relationships with stakeholders and to be able to continue to deliver value for money we emphasise that any solution should remain voluntary.

We have attached two options explaining the operation of a reinsurance pool. These are an excess of loss reinsurance scheme (the terrorism reinsurance scheme is an excess of loss scheme); and a first loss reinsurance scheme where the scheme covers low value and high frequency losses (the New Zealand Earthquake Commission operates a first loss scheme although it operates as an insurer and not as a reinsurer).

We would be pleased to answer any questions raised by the Taskforce or by ARPC stakeholders and can be contacted at enquiries@arpc.gov.au.

Yours sincerely,

Joan Fitzpatrick

Joan Fitzpatrick BA(Hons), LLB, ANZIIF (Fellow), CIP, GAICD
Chair

Attachment: Options for reinsurance pools.

Option 1: Reinsurance Pool – Example Aggregate Excess of Loss Scheme, Voluntary Insurer Treaties

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Option
Reinsurance Pool pays claims in excess of a 1 in 10 year loss (to be calculated).
ARPC to purchase retrocession up to 1 in 20 years cover.
Commonwealth Guarantee sits above retrocession.
Annual aggregate retrocession cover to address reinstatement issues.
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Critical Inputs
• ARPC to develop a storm claim system and/or outsource claims payment capacity.
• Reduction percentage to apply to claim payments if the Commonwealth Guarantee is exceeded.
• Need to calculate size of retrocession program to, for example, 90% confidence of covering annual average loss. i.e. if annual average loss $500m, then retrocession is purchased for $1 billion.
• Retention for insurers: 5% indexed of total property gross written premiums.
• National coverage for named cyclones (defined by Bureau of Meteorology).
• ARPC to develop pricing by location.
• Purchase an Australian-focussed cyclone model.
• 10-20% of scheme premiums allocated to community risk mitigation initiatives e.g. through local councils.
• Reinsurance prices location based, but with a loss mitigation discount based on building code compliance (AS1170-2002).
• Discounts for mitigation should be reduced over a 10-15 year period to provide an incentive for home owners and allow Government to exit from scheme.
• Encourages both insurers and reinsurers to participate.
• Mandatory for policyholders; voluntary for insurers and retrocessionaires.
• A fee paid to Government for Guarantee.
• Scheme premiums are charged and collected; Government is compensated for Guarantee; Government is protected through use of retrocession.
• These three levers adjusted over time to enable orderly exit by Government.
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Considerations for ARPC
• Simplest model using ARPC’s existing infrastructure and processes.
• Consistent with ARPC Purpose ‘to protect Australia from economic losses caused by (terrorism) catastrophe”.
• Does not greatly disrupt market competition.
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Considerations for Government and Market
• Government: can produce required premium discounts through reinsurance prices being set lower than potential losses; Commonwealth Guarantee can be partially protected through retrocession program. Government directly controls scheme through Ministerial Direction.
• Market: facilitates industry-wide confidence in premium pricing for cyclones over time; encourages market participation; capital relief to insurers will also reduce prices.
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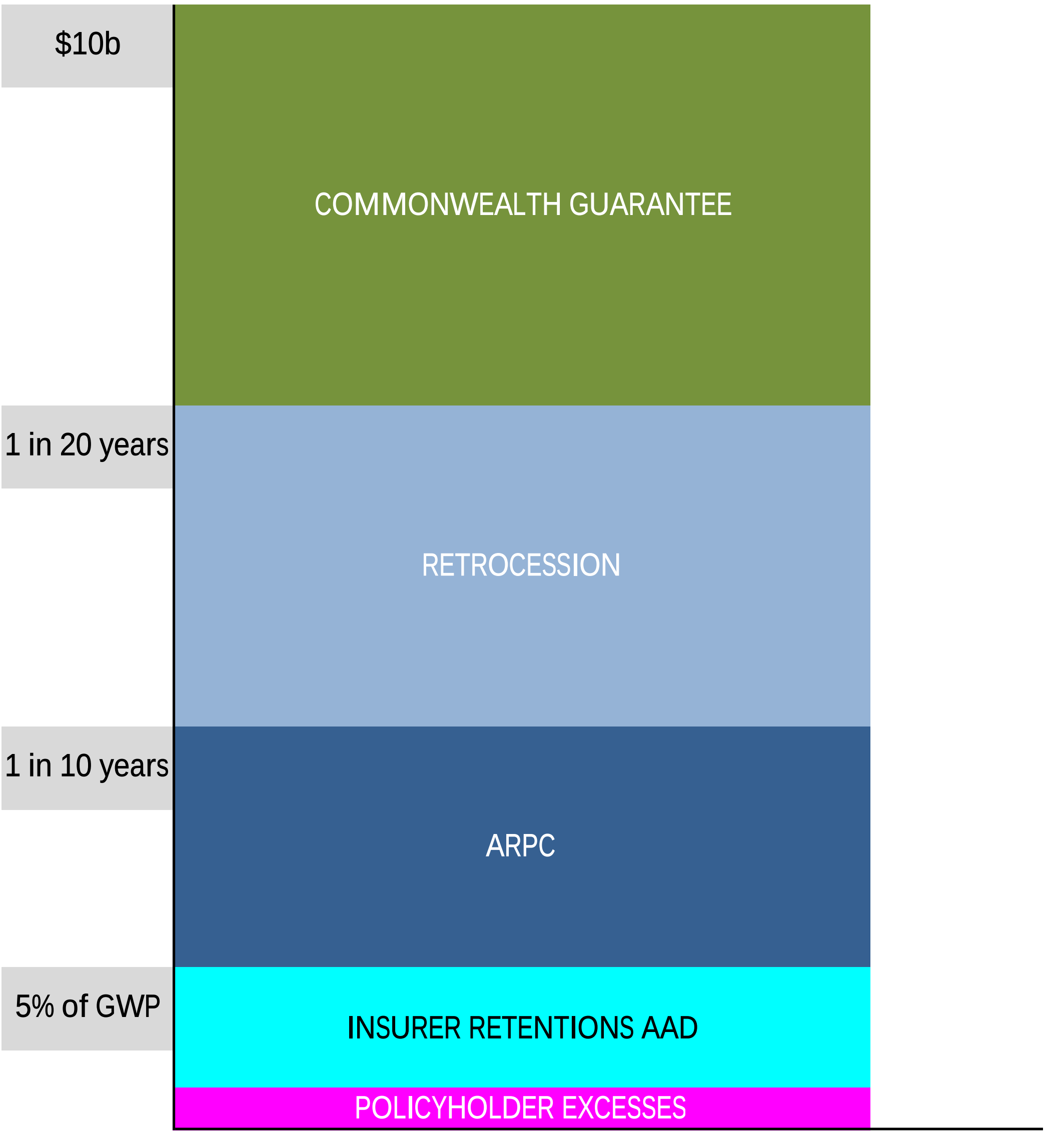
Advantages	Disadvantages
• Simplest approach using existing ARPC infrastructure. • Government can control its exposure. • Government is paid a Guarantee fee. • Enables subsidy to be delivered to insurers. • Mitigation is a key element. • Facilitates Government exit strategy. • Government protected through retrocession. • National coverage. • Defined cover for named cyclone only. • Participation by insurers and reinsurers. • Is a reinsurer and not an insurer, relies on insurers to manage claims so avoids New Zealand Earthquake Commission issues.	• Risk mitigation relies on local council commitment. • Pricing will require continuing updates due to ongoing mitigation works. • Accreditation of mitigation. • Voluntary, so may not have universal coverage. • Budgetary constraints (for both retrocession and mitigation initiatives) depending on available income. • Potential for large losses early in scheme – hence Commonwealth Guarantee would be drawn on early in scheme life. • No cover for non-insured households.

Option 1 – Cover Diagram



Option 2: Reinsurance Pool – Example First loss only (insurers pay balance of claims)

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Option

ARPC pays 95% of the first $20,000 to 30,000 of any household / strata claim for a named cyclone.

Insurers will pay above ARPC's cover.

ARPC will purchase retrocession above a 1 in 10 year scenario e.g. $300 million.

Commonwealth Guarantee sits above retrocession.

Insurers will sit above Commonwealth Guarantee.

Voluntary scheme.
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Critical Inputs
• ARPC develops storm claim system and/or outsource claims payment capacity.
• ARPC acts as the storm reinsurer offering subsidised pricing for first loss cover.
• Amount of cover to be set at a level that encourages insurers to discount premiums.
• No reduction percentage required.
• Need to maximise retrocession program to protect Commonwealth Guarantee.
• No reinsurance retention for insurers.
• National coverage for named cyclones (BoM definition).
• ARPC to develop pricing by location.
• Purchase an Australian-focused cyclone model.
• 10-20% of scheme premiums allocated to community risk mitigation initiatives e.g. through local councils.
• Reinsurance prices should be location based, but with a loss mitigation discount based on building code compliance (AS1170-2002).
• Discounts for mitigation should be reduced over a 10-15 year period to provide an incentive for home owners and allow Government to exit from scheme.
• Encourages both insurers and reinsurers to reduce pricing.
• Voluntary for insurers and retrocessionaires.
• A fee paid to Government for Guarantee.
• Scheme premiums are charged and collected; Government is compensated for Guarantee; Government is protected through use of retrocession.
• These three levers adjusted over time to enable orderly exit by Government.
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Considerations for ARPC
• ARPC will need to pay claims to insurers frequently – increased staffing and systems requirement.
• Consistent with ARPC Purpose 'to protect Australia from economic losses caused by (terrorism) catastrophe'.
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Considerations for Government and Market
• Government: acts as a reinsurer; clear incentive for insurers to reduce premiums; Commonwealth Guarantee can be protected through adequate retrocession program. Government retains direct control of scheme. Will minimise moral hazard by implementing 95% coverage only.
• Market: facilitates industry-wide increased confidence in premium pricing for storm over time; capital relief to insurers will reduce prices.
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Advantages	Disadvantages
• Use existing and proven ARPC infrastructure. • Government paid a Guarantee fee. • Subsidises cost of reinsurance, hence enables lower premiums. • Mitigation is a key element. • Facilitates Government exit strategy. • Government protected through retrocession. • National coverage. • Defined cover for named cyclone only. • Participation by insurers and reinsurers. • ARPC is a reinsurer and not an insurer; relies on insurers to manage claims so avoids New Zealand Earthquake Commission issues.	• Much higher frequency of claims. • Risk mitigation relies on local council commitment. • Less incentive for mitigation works (first loss always covered). • Pricing will require continuing updates due to ongoing mitigation works. • Accreditation of mitigation. • Budgetary constraints (for both retrocession and mitigation initiatives) depending on available income. • Potential for large losses early in scheme – hence Commonwealth Guarantee drawn on early in scheme life. • No cover for non-insured households yet higher exposure for under-insured households.

Option 2 – Cover Diagram