

Natural Disaster Insurance Review

Inquiry into flood insurance and related matters

Executive Summary

September 2011

EXECUTIVE SUMMARY

PURPOSE AND NATURE OF THE REVIEW

Following the series of storms, floods and cyclones that affected many parts of Queensland and some parts of Victoria in late 2010 and early 2011, the Assistant Treasurer, the Hon Bill Shorten MP, announced on 4 March 2011 the Natural Disaster Insurance Review (the Review).

It was not these extreme weather events themselves that stimulated the Review, because the insurance industry has demonstrated, in events such as the Victorian bushfires in February 2009 and the hailstorms in Melbourne and Perth in March 2010, that it has the financial capacity and other resources needed to respond effectively to such events.

It was the absence of flood insurance for many policyholders, particularly in Brisbane and Ipswich, that was the primary stimulus for the Review.

For all natural disasters other than flood, insurance cover for homes has been widely available in Australia for many years. A high proportion of Australian homeowners have insurance cover for their homes and this provides cover for storms, earthquakes, bushfires and cyclones. Many homeowners and renters also have corresponding cover for the contents of their homes.

The fact that all home insurance policies cover storm damage including related water damage but many do not cover flood damage, which distinction is seen as arcane and artificial by many, led to a community backlash against insurers during 2011 and considerable distress, financial loss and disillusionment for many insured homeowners.

Hence the theme of the Review, arising from the flood coverage problem and the full Terms of Reference of the Review, is the availability and affordability of insurance offered by the private insurance market, with particular reference to flood but also including other natural disasters.

There are also other issues dealt with in this Review. There is evidence of under-insurance, which has become most apparent after total losses that have occurred in bushfires and are also seen after cyclones and floods. There are also some indications that affordability is emerging as a genuine problem for cyclone insurance in far north Queensland. There are issues around consumers' access to information and documentation in a form they can readily understand, given that insurance is a complex product increasingly transacted through direct sales and renewals by telephone and the internet under a 'no advice' model. There are also some questions about insurers' claims performance and the degree of independence of some of their internal dispute resolution processes.

The Terms of Reference also specifically asked the Review Panel to consider whether the existing Commonwealth and State arrangements for dealing with natural disaster recovery and resilience require supplementation.

The Review Panel published an Issues Paper on 2 June 2011 and received in response more than 100 submissions from both private individuals and organisations, including insurers, governments and government agencies, consumer groups and various experts. Panel members consulted directly, both individually and collectively, with representatives of insurers, local and state governments, consumer groups and community representatives including some affected by the floods and cyclone.

FLOOD INSURANCE

The underlying flood insurance problem for the community

There is a serious community issue around the availability and affordability of flood insurance. It is essentially a coverage issue. When floods occur, individuals and the community often suffer severe economic and social losses; these losses are exacerbated by the fact that many policyholders do not have flood cover, leading to financial hardship that impedes personal and community recovery. Further, any attempted resolution of the coverage problem leads directly to access problems: some policyholders cannot obtain flood cover and, among those who can, there will be some who do not purchase the cover, for various reasons, including in many cases its high price. Experience also shows that those most exposed to the risk of flood are the least likely to purchase it.

The coverage aspect of the flood insurance problem can be described as the *consumer's disaster insurance paradox*:

- all home and contents policies include, as a matter of course, cover for:
 - fire (including bushfire);
 - earthquake;
 - storm (including rain, wind and cyclone);

and the policyholder cannot opt-out

but

- many home and contents policies exclude cover for flood;
 - and*, if the cover is offered, in many cases the policyholder can and does opt-out.

Hence the absence of flood cover for many insured properties and the associated combination of uncertainty and disputes around insurance claims when floods do occur is the primary problem confronting the Review Panel.

There are approximately 6.6 million detached houses in Australia and around 1 to 2 million other dwellings, including terrace houses and home units.

Perhaps 5 per cent to 10 per cent of dwellings are subject to flood risk, or approximately 450,000 houses along with approximately 100,000 home units.

The constraints

The Review Panel is well aware that any steps taken to improve the availability of flood insurance need to take into account that:

- flood cover for those homes with a high flood risk can result in high insurance premiums leading to problems of affordability;
- to maintain a competitive insurance market, insurers need control over their flood risk exposures and accumulations, adequate information for pricing and underwriting, and the ability to seek commercial prices for any flood risks that they underwrite; and

- there has been sub-optimal risk management of flood-prone land and buildings in the past. Accordingly any new arrangements to facilitate improved insurance coverage should also encourage, either of themselves or in conjunction with separate initiatives, improved flood risk management (that is, improved flood risk measurement and mitigation).

Dealing with flood insurance — the key recommendations

The Review Panel is recommending an integrated solution to the availability and affordability of flood insurance and has been able to identify five essential requirements that would need to be met by such a solution:

1. All home insurance, home contents insurance and body corporate insurance products need to include flood cover.
2. Discounted insurance premiums are needed for homes, home contents and home units in areas of medium and high flood risk, so as to render flood insurance affordable.
3. National coordination of flood risk measurement and mitigation is needed, in order to improve flood risk management for the benefit of the community generally and to ensure the continuing development of a competitive market for flood insurance.
4. A mechanism is needed to fund the discounts that are to be offered for affordability purposes.
5. Insurers will need access to a government-sponsored reinsurance facility if they are to deliver flood insurance discounts without compromising their own commercial positions.

In designing a set of arrangements to meet these five requirements, it is important not to create perverse outcomes that encourage further residential development in areas subject to flood risk.

To meet these requirements, the Panel is making four pivotal recommendations. They are:

Pivotal Recommendation 1: Architecture

That an agency sponsored by the Commonwealth Government be created to manage the national coordination of flood risk management and to operate a system of premium discounts and a flood risk reinsurance facility, supported by a funding guarantee from the Commonwealth.

While this new agency would need to be established under Commonwealth legislation, to function effectively it would need to operate along the lines of a joint venture between the Commonwealth, the States and the insurance industry.

Given the right level of expertise and authority, the right kind of governance structure and accountability, and a brief to apply itself exclusively to these matters, a single agency of this kind would have the wherewithal to succeed where previous efforts of cooperation, in good faith, amongst a myriad of agencies and departments of government (Commonwealth, State and local) and insurers have yielded limited results.

Pivotal Recommendation 2: Availability

That all home insurance, home contents and home unit insurance policies include flood cover.

While acknowledging that many insurers are working hard to extend the availability of flood cover, their initiatives alone will not meet the community need.

Pivotal Recommendation 3: Affordability

That a system of premium discounts be introduced in order that most purchasers of home insurance, home contents and home unit insurance policies in areas subject to flood risk be eligible for discounts against the full cost of flood insurance.

The nature of flood risk, whereby flood prone land can be identified because it has a higher risk of flood than other land, can lead to high insurance premiums for flood cover in these locations with the result that flood cover, if available, will generally be seen as unaffordable.

Pivotal Recommendation 4: Funding

The Commonwealth Government guarantee the payment of claims by ensuring that, whenever a funding shortfall occurs in the reinsurance facility through claims exceeding the funds held in the facility, the Commonwealth would meet the shortfall *and* the Commonwealth would seek reimbursement of a portion of the shortfall from the State or Territory government in whose jurisdiction the flood occurred.

The existence of such a guarantee would ensure that discounts offered for affordability purposes do not increase the premiums for householders with no flood risk.

It is notable that these four pivotal recommendations represent an integrated system. A new government-sponsored agency charged with national coordination of flood risk management and with operating the system of premium discounts and the flood risk reinsurance facility, supported by a funding guarantee from the Commonwealth, would create the capacity to deliver flood insurance premium discounts, and also to influence flood risk mitigation and ensure the availability of flood insurance to all relevant policyholders. Flood insurance premium discounts are a prerequisite for homeowners to be able to afford to purchase flood cover, which in turn makes it possible to deliver on the Review Panel's conclusion that unequivocal insurance coverage for flood is central to addressing the community need.

It is important to note that, in recommending that flood cover be included in all home contents and home unit insurance policies, the Review Panel is not recommending that insurance itself be made compulsory. There need also be no increase in premiums for policyholders who have no flood risk and no cross subsidisation of insurance premiums among policyholders.

By way of further explanation of the recommended new national agency, it would have two key functions, national coordination of flood risk management and operating the flood risk reinsurance facility.

National coordination of flood risk management

Working with State and local governments and insurers, this new agency would be the focal point of activities and responsibilities such as:

- coordinating flood mapping across the country (while leaving responsibility for undertaking flood mapping in the hands of State governments and their councils);

- introducing national guidelines for flood risk mapping and classifications;
- acting as a national repository of or portal for flood risk information, primarily through collating and analysing information collected by others;
- continuing development of the Insurance Council's National Flood Insurance Database (NFID) or an equivalent developed by the new agency;
- monitoring the effectiveness of flood risk mitigation initiatives across the country and advising on priorities for flood risk mitigation;
- publishing and disseminating flood risk information in formats appropriate to the various user groups; and
- overseeing the quality of the flood risk information.

The flood risk reinsurance facility

The reinsurance facility would be operated by the agency in conjunction with flood risk measurement activities and would have three key attributes:

- insurers to be able to use the facility to give discounts on flood insurance for affordability purposes;
- insurers to be able to use the facility as a source of reinsurance capacity for flood cover more generally; and
- the discounts in particular and the facility in general to be funded if and when necessary by claim subsidies from the Commonwealth Government to the facility, under a Commonwealth Government guarantee, and supplemented by contributions from the government of the State in which the event causing the funding shortfall occurs.

Small business

The absence of flood cover for many insured businesses has similar consequences to the absence of flood cover for home and contents. The Review Panel also notes, however, that the recovery of small businesses after a natural disaster, whether flood or otherwise, is critical to the recovery of the local economy and hence the local community.

The Review Panel would have preferred to see flood cover offered as standard to small business with no opt-out as with homes. It accepts, however, that such a position could not reasonably be imposed at this time, especially as the Review Panel is not proposing to see discounts introduced for affordability purposes for small business or access by insurers to the reinsurance facility for small business flood insurance. Nevertheless there is still an important need for flood insurance to be made more widely available to small business and for some steps to be taken to encourage and promote a greater take-up of flood cover by small businesses.

Recommendation: Small business

That all insurers offering small business insurance be obliged to include flood cover on an opt-out basis, instead of opt in/opt-out as at present, in all of their small business package policies.

The Review Panel believes that the questions of flood cover as standard in small business policies and access to discounted premiums for small business policyholders should be revisited once the recommended arrangements for homes, home units and contents are in place.

OTHER ISSUES

Cyclones

Because cyclones are treated by insurers as storms, all insured homes and home units have full cyclone coverage. As a result, for example, policyholders with claims for loss or damage from Cyclone Yasi have, on the whole, been dealt with effectively by their insurers. As renewals occur of policies taken out before Cyclone Yasi, however, some very large premium increases, sometimes 300 per cent or more, are being sought by insurers, especially for home units.

Such extreme price increases can occur for several reasons but, irrespective of the reasons, they are presenting immediate affordability problems and can also cause continuing problems.

The Review Panel has not had the means or the time to investigate fully the causes of these price increases but it does accept that there is, *prima facie*, an affordability problem. The Panel is therefore making a two-stage recommendation:

Recommendation: Cyclones

- The Agency offer cover to insurers for cyclone risk, on the same basis as for flood risk, but with no affordability discounts (in the expectation that, when the Agency does its own pricing, it will offer a fair price to home and home unit owners; this price may be lower but is not guaranteed to be lower than the prices of commercial insurers); and
- an investigation be undertaken to ascertain whether there is a basis for granting affordability discounts for cyclone risk, along the lines of the recommended flood insurance discounts, for homes and home units in northern Australia.

Replacement value and sum insured

Most insurers limit their cover to a sum insured specified by the policyholder for both home building and contents. Some insurers, however, offer full replacement or reinstatement cover on the home itself in the event of a total loss. Generally neither the homeowner nor the insurer knows how closely the sum insured corresponds to the replacement value.

Whenever there are disasters that cause homes to be total losses, the level of under-insurance becomes visible. This phenomenon is most evident in bushfires. In both the 2003 Canberra bushfire and the 2009 Victorian bushfires the levels of under-insurance were severe, typically 30 per cent or more, except for homeowners whose policies offered replacement cover.

By contrast, most other claims, being partial losses only, are covered by insurers on a replacement or reinstatement basis, so long as the loss does not exceed the sum insured.

It is widely accepted, within and outside the insurance industry, that replacement cover is a superior product for the homeowner to cover for a specified maximum sum insured. Nevertheless there are complexities and competitive problems for insurers to make a transition to replacement cover. Further, there is an adverse cycle occurring where some owners deliberately under-insure, to reduce their premiums, causing cross subsidies from those who do not knowingly under-insure, leading to insurers having to increase premiums for the lower (inadequate) sums insured.

In order to address **under-insurance** and to break the cycle of chronic under-statement of sums insured, the Review Panel is recommending that insurers make the transition to offering full replacement cover, but that they be given some reasonable lead time to do so.

Recommendation: Replacement Value

All home building insurance policies offering sum insured cover be modified by the end of 2014 so as to offer full replacement cover in the event of total loss of the home.

Consumer matters

Claims and internal dispute resolution

The Review Panel is making a number of recommendations to improve policyholders claims handling and dispute resolution experience.

Recommendation: Claims and Dispute resolution

The Code of Practice be modified to provide for a maximum 4 months to claims determination (that is, a decision to accept or reject liability for a claim) subject to exceptional circumstances, for all claims including during natural disasters.

Internal dispute resolution processes be independent of the claims department, IDR complaints and disputes officers have the authority to overturn the original decisions and to accept claims, and a general fairness test be applied to claims and complaints handling.

The Code Compliance Committee members be appointed by the Financial Ombudsman Service Board, record all breaches of the Code reported to it, investigate breaches of the Code where appropriate, conduct regular audits of insurance companies for compliance with the Code, report serious or systemic breaches direct to ASIC and publicly release an annual report as to the Code compliance and breaches with insurers to be named in the report.

Insurers have shown themselves capable of resolving claims competently and promptly on the whole, during natural disasters as well as in normal times, with the single exception of flood claims. Once flood cover is a standard inclusion as recommended herein, the current problems will largely disappear. The Review Panel would then expect insurers generally to welcome the holding to account of any individual insurers who put at risk, through poor claims, the reputation of the industry.

Consumer awareness at time of purchase

The purchase of home insurance involves an initial agreement usually by telephone backed up the later mailing to the consumer of policy materials including premiums and policy coverage details and the PDS. This is proposed to be supplemented by another 'after sale' disclosure through the Key Fact Statement.

It is well recognised that policyholders have not been actively engaged in reading these often complex post-sale materials. These have little impact in informing consumers in a practical way of the terms and conditions of their policies.

The Review Panel believes that it is important consumers are made aware before they complete their purchase whether the policy has full flood cover and whether it has full replacement coverage. These are extremely important coverage decisions for consumers. It is recommended that consumers be given 'health warnings' if the policy proposed to be purchased does not include flood cover or replacement cover. These warnings should also be included in the Key Fact Statement. Once full flood cover and replacement cover are fully in place this warning at time of purchase may no longer be needed.

Recommendation: Policy coverage

A 'health warning' system be introduced in conjunction with the new Key Facts Statement, pending legislation to give effect to the recommendations above on flood coverage and replacement value for buildings. A 'health warning' would be added to the Key Fact Statement and be required to be provided to customers seeking to purchase a policy by telephone or the internet. The warning would state that 'This product does not provide (full) cover for flood' and 'This product does not provide (full) replacement cover for buildings, you may be under-insured in the event of a total loss.'

This system is designed to increase awareness and understanding of key product features and also to overcome an important component of the current advice problems that insurers have with telephone and internet sales, namely that the purchase is usually completed before the disclosure documents are received.

The system may not continue to be needed if and when full flood cover and replacement value cover become inclusions in all home policies.

Implementation and transition

Legislation will be needed to give effect to the Review Panel's key recommendations that flood cover be included in all home, contents and home unit insurance policies, establishing a national agency to coordinate flood risk management, introduce a system of flood premium discounts and operate a reinsurance facility.

In the interim, properties will continue to be exposed to flood risk and the Review Panel is therefore recommending that the Government give priority to introducing the necessary legislation.

Furthermore, the Review Panel is recommending that a number of intermediate steps be taken. They include the Government taking preparatory steps towards establishing the new disaster risk and insurance agency and introducing 'health warnings' for home and contents policies about flood cover and replacement value cover. They also include the Insurance Council making a series of amendments to the General Insurance Code of Practice in the interests of improved consumer awareness and consumer protection regarding the handling of home and contents insurance claims.