

Notes on the Treasury Laws Amendment – Cyclone Reinsurance Draft Bill

17 December 2021

Disclosure and Disclaimer

Until 31 October 2021 I was the Chief Executive Officer of the National Insurance Brokers Association of Australia. In that capacity I made submissions to and participated in discussions with Federal Treasury in relation to the development of the Cyclone Reinsurance Pool.

These comments were prepared and are presented on my own behalf, and do not and are not intended to reflect or represent the views of the National Insurance Brokers Association or its members. The views expressed in this submission are my personal views on this important topic.

Thank you for the opportunity to provide some comments and observations on the draft legislation for the creation of a Cyclone and Cyclone Related Flood Reinsurance Pool in Australia.

Section 8A(1)

The Terrorism Insurance Scheme is a voluntary scheme. Insurers do not have to take out terrorism insurance cover with ARPC if they can get the cover elsewhere in the private reinsurance market. I believe this is very smart design element, as it allows insurers the opportunity to go elsewhere to get terrorism cover if that cover becomes available in the commercial market (my understanding is that this type of cover is still very limited and generally not available to insurers).

However, the cyclone scheme makes it mandatory for insurers to get cyclone cover from ARPC. I presume this is to force insurers providing cover in the area to transfer their cyclone reinsurance premiums to ARPC, and thereby increase the size of the reinsurance pool for cyclone damage. I also note the ARPC will reinsure 100% of the risk – the question arises as to whether it would be better for insurers to retain some risk, and to have some “skin in the game” so to speak. I do note (paragraph 1.59 of the Explanatory Memorandum) that after 3 years of operation there may be some risk sharing by the insurers.

I also note that while the intent is to encourage insurers to provide cover in cyclone prone areas at a lower cost than at present, the scheme seems to work on the presumption that if cyclone risks are taken into the pool, there might be a greater incentive for insurers to participate in northern Australia. I am not aware if Treasury has discussed this with individual insurers, and whether this will in fact eventuate. The cyclone pool provides cover for cyclone and cyclone related flood, but insurers will retain direct responsibility for all other major weather events including major storms that are not rated as cyclones, and major flood events.

Section 8A (4)

This is a drafting matter, but the Bill says the Corporation may enter into a reinsurance contract on and after 1 July 2022.

I presume the intent is to allow the parties to enter into reinsurance contracts that take effect on and after 1 July 2022. I presume the contracts would be entered into prior to them taking effect (ie prior to 1 July 2022) – all parties would presumably need legal certainty in relation to this.

Section 8A (7)

I note Lloyd's underwriters are excluded from the scheme. I am not sure why this would be the case.

Section 8B (2)

The pool will only protect property that is owned by the insured. This means that where a landlord requires the tenant to insure the buildings and related property against storm and tempest, the tenant will not have the benefit of protection from the Cyclone Reinsurance Pool.

I note that for business interruption and consequential loss, the damage can be to property owned or occupied by the insured. This provides extended cover. It is not clear why there is a distinction here.

Section 8B (3)

I have a couple of concerns here.

There is a reference to "a strata title or community title development". Both of these concepts describe property where there are a number of units and common property, normally under the one legal title. The insured would normally be the owner of the property – the owners corporation or the body corporate for the strata plan or community title plan.

I am concerned that this might not cover property that is owned by a corporation registered under the Corporations (Aboriginal and Torres Strait Islander) Act 2006. This corporation might or might not be regarded as a "community title development", as my understanding is that a corporation registered under the CATSI Act is quite different to the entity that owns a community title development. I strongly urge Treasury to check with the Office of the Registrar of Indigenous Corporations to ensure that property that is owned by a CATSI corporation and is used primarily as a place of residence would receive the benefit of the cyclone reinsurance scheme. My understanding is that the CATSI corporation takes out insurance cover for all property owned by the corporation, including residential and community resources, and in some cases commercial premises such as the supply store/supermarket for the community. Other commercial premises might provide medical and health related services, and the like. It would be extremely unfortunate if the reference to "strata title or community title development" means that a CATSI corporation would not be able to access the benefits of the Cyclone Reinsurance Pool.

The way the legislation approaches the provision of cyclone reinsurance cover for small businesses is interesting. Rather than defining what a small business is, the section simply includes policies covering sums insured that do not exceed a certain amount. The fact sheet published by Treasury says the cover will be available for commercial property policies with less than \$5 million total sum insured across the risks covered by the pool (property, contents and business interruption).

I am quite worried about this approach in the drafting. It may severely limit the available of the scheme to very small businesses only that do not own much property or contents. I am not sure that was the intent behind the Government's announcement. Any small business that satisfies the current definitions would have expected to be able to access the scheme.

It is important to note here that the SME owner ONLY gets protection from the scheme if the total sum insured is less than \$5 million. If the sum insured is, say, \$5.5 million, there is no coverage from the cyclone pool. The cyclone pool does not provide protection for the first \$5 million of loss, with the remainder of the loss being covered by the insurer and any other forms of reinsurance it may have. Again, this is most likely to be contrary to the expectations of most small business owners in northern Australia.

Section 8D

One goal for ARPC when setting premiums is “to maintain incentives to reduce and mitigate the risk of eligible cyclone losses”. This scheme has substantial moral hazard risks, and therefore it is important that incentives remain and are promoted that will encourage and support mitigation of risks and the building of community resilience in cyclone prone areas. The legislation requires ARPC to do this “as far as practicable”, but does not give any indication of how this can or should be done. It will be a challenge.

I would like to suggest that the Federal Government take active steps to promote strategies to make northern Australia more resilient in relation to severe weather events that regularly have an impact on our communities. Strong action also needs to be taken to mitigate the nature and extent of losses where existing buildings are likely to be affected. These actions should be undertaken as part of, and outside, the Cyclone Reinsurance Pool.

Section 41

I support the provision for a review of the Act as soon as practicable after 1 July 2025, and every 5 years thereafter.

General Comment

At the start of this process, I indicated a personal view that in order to be successful the Cyclone Pool would need to facilitate material reductions in property insurance premiums across northern Australia, and would need to encourage three or four insurers to enter or to be more active in the northern Australia insurance markets.

The legislation will remove cyclone and cyclone related flood risks from the liabilities of those insurers who chose to operate in northern Australia. At the same time, claims costs will be covered by ARPC, and will be funded by reinsurance premiums charged to insurance companies operating in the area.

I have strong doubts that the removal of reinsurer profit margins from this type of risk will be sufficient to achieve material reductions in premiums for the majority of property owners in northern Australia who will be seeking relief from this scheme. This is a high level conclusion, and has not followed detailed discussions with insurers or the ARPC. I hope I am wrong in relation to this observation.

I also have reservations that the proposed scheme will not encourage significant greater participation in the northern Australia insurance markets, primarily because of the residual risks that

insurers will continue to carry. Those risks will require reinsurance protection, and will therefore continue to remain a costly exposure for insurers thinking about operating in the area.

I again urge the Government to have confidential discussions with key individual insurers individually in order to ascertain their likely response to the draft Bill from a business/commercial perspective, prior to finalization and presentation to Parliament. It would be anti-competitive to have those discussions on a collective basis, or through the Insurance Council of Australia.

I would be pleased to discuss these matters with Treasury if that would be useful.

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