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**Reinsurance pool for Cyclones and related flood damage**

Insurance Australia Group Limited (**IAG**) is pleased to have the opportunity to comment on the exposure draft legislative framework and supporting regulations for the establishment of the Cyclone and related flood damage reinsurance pool (the reinsurance pool) including.

- Exposure Draft Treasury Laws Amendment (measures for a later sitting) Bill 2021: Cyclone reinsurance (Exposure Draft)
- Terrorism Insurance Amendment (Cyclone and Related Flood Damage Reinsurance Pool) Regulations 2022 (the Regulations).

IAG is the parent company of a general insurance group with controlled operations in Australia and New Zealand. Our businesses underwrite over \$12 billion of premium per annum, selling insurance under leading brands, including: (a) NRMA Insurance, CGU, SGIO, SGIC, Swann Insurance and WFI (in Australia); and (b) NZI, State, AMI, and Lumley (in New Zealand).

At IAG we have been working to understand insurance affordability concerns across northern Australia. We welcome the establishment of the reinsurance pool as an important step in helping to ensure the availability and affordability of insurance for communities at high risk of cyclones and related flood damage.

IAG is broadly supportive of the Exposure Draft and the Regulations, however we are conscious that these are one part of the framework for establishing the reinsurance pool. Key to our support of the reinsurance pool is ensuring that,

- Risk Mitigation is prioritised.
- Australian Reinsurance Pool Corporation (ARPC) risk modelling aligns with modelling approaches commonly taken in the insurance industry.

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- The ARPC prices their cyclone and flood reinsurance lower than commercially available reinsurance such that material savings are created for policyholders.
- Definitions around hazard and policy coverage are clear in the legislation and applied fairly to all participants.
- Transition time is sufficient to allow insurers to enter the scheme.
- There is certainty for all parties around decision making on future risk sharing when the reinsurance Pool becomes a co-insurance arrangement.

## Mitigation and Risk management

We agree and support section 8D(c) of the Exposure Draft, that the ARPC needs to consider discounts that could be offered to incentivise risk reduction and encourage cyclone and flood mitigation over time. However, it is important that the insurance industry is consulted on these discounts and involved in shaping proposed mitigation measures to ensure the mitigation reduces risk to life as well as risk to property, the main driver of risk in the technical price of a premium.

At IAG we have long advocated that investing in mitigation reduces the impact of natural perils. Our organisation has a great deal of expertise, research, and evidence identifying those mitigants that are most effective at protecting property and reduce insurance premiums. We recommend ARPC and the Treasury work with IAG and the broader insurance industry to create a guideline on what mitigations measures could result in premium reductions.

In addition to incentives as part of the reinsurance pool, there also need to be mechanisms to,

- a) Improve land use planning to limit development approvals in high-risk cyclone, flooding and storm surge zones.
- b) Disincentivise future creation of high-risk properties. Known gaps in the national construction code, responsible for driving higher risk, should be addressed before the commencement of the reinsurance pool. Specifically, the elements of the building envelope responsible for wind driven rainwater ingress. We recommend that ARPC and the Treasury work with insurers on a program of work to ensure new buildings in these high-risk areas are built to withstand the risk. This would involve collaboration between Australian Standards, related industry bodies (e.g., glazing, roof cladding), insurers and research institutions such as the James Cook University Cyclone Testing Station.

## Risk modelling and pricing

It is important that the ARPC and the Treasury appreciate that the risk modelling and subsequent reinsurance pricing is key to the expected savings being realised. We understand the ARPC will provide details of the pricing philosophy and premium rates in early 2022, which will then allow us to determine the premium impact. This may require further discussions with Government if the savings are not deemed to be material.

IAG believes to achieve savings, the ARPC must base their premium on common definitions of risk using industry accepted models and modelling techniques. The Treasury and the ARPC should consult with the industry to agree on the use of known and commonly used vendor modelling (not bespoke) and seek agreement from insurers on the modelling approach the ARPC will take. Not using a common risk definition and industry accepted modelling could result in the ARPC, insurers and commercially available reinsurers having significantly different risk assessment and price for the same policy. Where there is disparity in risk modelling and price there is potential the scheme will not achieve expected savings and, in fact, could result in significantly higher pricing for some customers.

Any potential disparity could also affect mitigation discounts. If the technical premium supplied by the ARPC doesn't reflect the true risk before an appropriate discount is offered, then the pool may collect an insufficient premium to remain cost neutral over time. It may also materially underestimate the pools exposure.

Due to the importance of the above in realising savings, we suggest that Schedule C, item 8, section 8D of the Act is amended to include a part (d) as below. A suggested wording for your consideration is,

***8D(d) a premium that relies on common definition and modelling of risk that is agreed to by insurers in a manner stipulated by the Regulations.***

If the above is adopted then the regulations would also need to set out a mechanism by which the insurers are required to agree and how agreement is achieved (i.e., 50% agree, 75% agree, unanimously agree) is determined. This proposed amendment would require consultation with IAG and the insurance industry. IAG would be happy to work with the Treasury and ARPC to assist in the drafting required.

#### **Narrow eligibility may impact savings from the reinsurance pool**

IAG supports the reinsurance pool as a step to reducing insurance premiums for those in high-risk cyclone areas of Australia, but ultimately the expected savings will depend on the ARPC offering a lower price for reinsurance of the whole cyclone risk in our portfolios.

Although we understand and support the Treasury placing boundaries around eligibility for the reinsurance pool, it's important to note that the narrower the eligibility is to access the pool the more insurers will have to pay for commercially available reinsurance cover of any gaps. This will impact the expected savings of the scheme.

#### **Policy differences may impact success of the reinsurance pool**

Insurers offer different policy coverages across their products. This can include policy extensions across all products or full replacement cover in some home/contents products. The pool must recognise different policy coverages could change the sum insured and create an unfunded liability for the reinsurance pool or require insures to seek commercially available reinsurance to cover this, both impacting on the pools success. Similarly, failing to recognise and appropriately price for extensions would mean a customer receives very different prices for what is the same risk.

For example,

- 1) **Replacement cover** – If open ended cover is not priced correctly by the ARPC, the pool could be exposed to losses above what is calculated by the premium. Or if capped at a certain value and full replacement isn't offered, insurers would need to purchase reinsurance for this gap adding to the complexity and costs of the premium for the customer.
- 2) **Policy extensions** – If a percentage buffer in a policy on top of the agreed value is not priced correctly by the ARPC, the pool may again be exposed to losses above what has been calculated by the premium or require insurers to take additional commercial reinsurance to cover the buffer. This could be particularly difficult for SME policies where there is an eligibility cap of \$5million. This policy extension could result in a change in eligibility for the scheme.

We propose the Treasury and ARPC in conjunction with the insurance industry consider how these policy difference will be covered in the pool we would welcome the opportunity to discuss this further.

## Coverage

### Hazard coverage:

IAG supports the Exposure Draft and the Regulations containing clear information about when a cyclone is declared covered by the pool, when a cyclone has ended and when it has re-intensified. We also support the definitions of storm surge and flood defined in 5C of the regulations and BoM having the authority to make a declaration of the hazard with immediate effect.

However, we do have concerns around hazard coverage including,

1. **The hazard definitions being placed in the regulations** - While we agree it is important that definitions remain flexible, being able to easily change the definition of a hazard, creates the possibility of reinsurance coverage gaps occurring. For example, if the Pool definition of when a cyclone ends or when it re-intensifies changes midterm, the traditional reinsurance the insurer has contracted into may not cover the additional risk created by the changed definition, thereby increasing the retained insurer risk. Alternatively, if the insurer has cover for the increased risk under their traditional reinsurance arrangements, that may result in a doubling up of reinsurance premiums for that risk which would lead to higher premiums that need to be passed through to the customer.

The ability for the Regulations to change the definition of 'cyclone' means that the predominant purpose of the whole legislation could be entirely changed by changes to the regulations. IAG propose one solution could be to specify in the Regulations that any changes to the definition of 3A, 5C and 5D of the Regulations must allow a lead time of at least 12 months for these changes to take effect. This would allow insurers an appropriate amount of time to ensure that their commercially available reinsurance arrangements appropriately reflect the cover being provided for by the Pool. If the change is material, then, the viability of the Pool should be considered through appropriate additional consultation.

2. **Different coverage of storm surge and flooding in the pool** - The explanatory materials note, (clause 1.12, p14) that

***'Storm surge and flooding are included where these hazards are covered under the policyholder's choice of insurance cover'***

The pool pricing will reflect that in that there will be differential pricing for reinsurance which covers cyclone related flood and/or storm surge and that which does not. However, this is not reflected in the legislation or regulations. Sections 8A (1) (a) and (b) deal with the policyholder's choice of cover, as these clauses state that the reinsurance contracts must '**cover the insurer's liability**' under all pool contracts in respect of eligible cyclone losses. The insurer's liability would be nil where the policyholder chose not to take out flood (or other) cover. We suggest making this explicitly clear, the legislation could be amended to include 8A (1) (c).

***'Where storm surge or flooding is not included as part of the insurers liability, this will not be covered by the reinsurance pool'***

3. **Cyclone Definition** – We appreciate the Treasury aligning with the current Bureau of Meteorology (BoM) definition of Cyclone. However, in our experience the following wording in the Regulations 3A (2) (b)

***“That extends more than half-way around near the centre of the system”***

introduces a great deal of uncertainty on coverage. This information is not available on most of the historical event database from which the risk models are built. It could be the case that a customer experiences very strong cyclonic strength winds and significant damage but as the winds did not extend more than halfway around the cyclone, they are not covered by the pool, and we have significant retained risk. It would be our preference to remove this or have further information about how this will be applied for the purposes of the pool. We would be happy to discuss this further and provide further information about how this has been difficult to apply in recent cyclones.

4. **The unintended consequences of a 48-hour coverage after cyclone end** – We appreciate the Treasury and ARPC need to provide clear boundaries on eligibility for the scheme and are committed to working together to design the eligibility criteria that best meets the objectives of the scheme.

However, we have concerns that the proposed 48-hour (from cyclone end) coverage may not achieve the desired premium reduction goals as,

- **Primary insurers would retain or have to purchase additional reinsurance cover** for most of the cyclone-related flood risk in long-response catchments and cede most of the risk in short-response catchments, with proportional impacts to ARPC’s ability to influence flood insurance premiums.
- **Without access to the pricing and risk modelling information, it’s difficult to know how we will achieve expected savings** and whether the flood eligibility criteria should be more restrictive or, alternatively, provide coverage for a longer duration and which option will result in the expected savings of the pool. We propose Treasury consider amending 5D of the regulations to

***‘For the purposes of subsection 8F (3) of the Act, the prescribed duration and special limitations is to be determined after the pricing model is finalised.’***

If it is necessary to stipulate a timeframe in the legislation, we propose the 48hours clause is amended to 7 days if the intention is to cover a reasonable level of cyclone related flooding. However, if the primary intention is to cover cyclone wind and rain damage then 48 hours is appropriate, but flood should then be explicitly excluded. We propose the above, provided there is scope to review and amend this time period after we assess the risk modelling and pricing information.

- **It’s not clear if all risks are covered in the 48-hour period** – it is our understanding that the intent of the pool is if a property suffers any damage within the timeframe of the declared event (cyclone + 48 hours), then all damage to that property will be covered by the Pool regardless of whether further damage occurs after the 48 hours. It is important we work towards clarity around this, as doing so would reduce the need for insurers to obtain hydrology reports to determine what portion of the damage is covered under the pool. The need for hydrology reports adds time to the claims process, and adds significant cost and complexity in handling accepted flood claims. Further, the outcome is that claims along the same watercourse having very different recoveries. IAG would be happy to work with Treasury on amendments to the Exposure Draft or the Regulations to make this clearer.

## **Policy Coverage**

IAG supports the Exposure Draft clearly defining what policy coverage is provided and what is excluded in section 8B of the Act. However, we have a few concerns with how the inclusion and exclusion of some policies could create a need for insurers to seek additional commercially available reinsurance that interferes with the ability to provide cost saving with the pool, including,

1. **Farm business exclusion** – Generally we sell farm insurance packages that cover all the insurance requirements of the customer. This commonly includes cover for both a residence (or multiple residences) as well as the small business of the farm including business interruption and business property (sheds machinery etc). We understand all residences on a farm property would be covered by the pool but are not sure of the rationale as to why the farm SME business has been excluded.

We suggest small to medium farms are treated the same as any other SME business and are eligible to be in the pool if the total sums insured (covering building, contents, and business interruption) is \$5 million or less. We agree with the exclusions listed in 8B (8)(b) including crops, and livestock but would also exclude fencing as these are standard exclusions across most insurance products for farm.

## 2. SME

**Further clarity around the \$5million threshold-** It is our understanding; that the pool will provide cover for policies based on their eligibility at the time their cover commences. If the sum insured increases to greater than \$5m during the period of insurance they should remain covered by the pool until policy expiry. This should be clarified in section 8B (3)(d) with words similar to

***‘Those businesses whose sum insured increases to greater than \$5m within the year of reinsurance, will remain in the pool and eligibility will be reviewed at renewal time’***

In addition, it is our understanding that the sum insured test is based on the sum insured per “policy” rather than per “risk/location”. We suggest that the sum insured test could apply to the location of the asset allowing multiple assets less than \$5m to be insured under the one policy. Consideration should be given making this explicitly clear. We would be happy to assist Treasury in drafting words to this affect.

Lastly the exposure draft and regulations need to provide a definition on sum insured for the purpose of assessing the \$5m threshold. Is it:

- a) the declared values for property damage and business interruption values, excluding coverage extensions? or
- b) the declared values for property damage and business interruption inclusive of coverage extensions (this could be open to interpretation and introduce complexity)? or
- c) the policy limit?

One solution could be to amend the regulations (5B, p3) to specify a declared property and business interruption value of \$5million.

## 3. Strata

**Include commercial strata with same \$5m threshold-** IAG believes the simplest way to cover strata is to include all residential and commercial strata in the reinsurance pool. The reasons for this are:

- Applying an 80/20 (or other split) test introduces additional complexity which requires consideration on a case-by-case basis (manual underwriting). For example, a strata scheme comprising a total of 20 lots, may include 18 residential apartments and 2 commercial lots. The 2 commercial lots may comprise greater than 20% of the floor space due to design. This would mean 90% of lot owners which are residential are unfairly disadvantaged and do not get access to the scheme

- Allocating the floor space may be ambiguous and open to interpretation. For example, when considering common areas such as gyms and pools. Are these for residential or commercial use?
- Owners of commercial strata units are generally small investor customers in many cases the asset may be owned by their self-managed super fund who should be afforded cyclone protection in the same way as both residential and SME customers. In our experience larger business owners are more likely to own/rent an entire property rather than a strata titled unit.

**Recognise that a \$5m threshold causes inequity across strata owners** - Many commercial strata buildings have building sum insured values that exceed \$5m. However, the average sum insured value of any lot within the strata envelope is more than likely to fall below \$ 5m. This asset is generally owned by small investor customers who would be disadvantaged by not getting access to the scheme purely by having investing into a building that has a higher number of lots and therefore higher overall sum insured value.

For example, a mixed strata with a value of \$10m with 50% commercial i.e., \$5m in 2 Lots owned by 2 businesses with an individual value of \$2.5m would be covered by the Pool. Compared to a 100% commercial Strata with a value of \$6m with 10 Lots each with a value of \$600k would not be covered. This creates an inequitable result with wealthier commercial unitholders gaining from Pool compared with modest commercial owners, which does not align with the intention of the reinsurance pool.

**Clearer definitions of eligibility in the strata space-** If our suggestion above of including strata with the same \$5m threshold is not accepted, we suggest the Treasury clearly define a few terms to ensure the intended risk is eligible for the reinsurance pool including,

- **'Residential purposes'** – in 8B(3)(c)(iii) strata is included if 80% of the total floor space is used wholly or mainly for residential purposes. There needs to be further clarity on what defines residential purposes to ensure the. For example, how would complexes that have gyms, pools, conference facilities, restaurants, retail etc be classified? It could be argued these facilities exist for resident's use.
- **>80% floor space-** does this consider common areas. How and what is included in percentage floor space.

## Reinsurance agreement

It is our understanding that some of the specifics around claims handling costs and definitions of sum insured would be included in the reinsurance agreement with the ARPC.

It is therefore important that we receive a copy of the proposed reinsurance wording at the time the ARPC provides their proposed pricing to have sufficient opportunity to review and agree changes as required. The contract and the pricing need to be developed jointly as we will be unable to appropriately evaluate the pricing properly if we don't have a full understanding of the coverage and terms and conditions provided by the reinsurance contract.

We understand there will likely be a standard industry contract, but reiterate insurers must have the opportunity to view and negotiate the terms of this contract so that no protection gaps are created between the pool contract and the commercial reinsurance contract



## Transition complexities

It is not clear from the legislation whether there will be an option for portfolio transfer arrangements and, if so, how this would operate. We are unable to provide a definitive answer on whether we want to pursue portfolio transfer arrangements at this time, as this depends on the pricing modelling not yet released and our ability to renegotiate exiting long term reinsurance contracts. We would, however, like to explore with Treasury how this could operate.

We also have some concerns around the timeframe for transitioning all risks into the reinsurance pool. Adopting new pricing from ARPC will require significant system changes within IAG. Although we appreciate the need for this pool to be in place quickly, we suggest there may not be sufficient lead time for IAG to ensure all agreements, pricing, and system changes are in place. The proposed start date of 31 Dec 2023 for large insurers will depend on the method of transition of policies to the Pool. This should be subject to further consultation with insurers.

## Risk sharing

The Exposure Draft provides for a Ministerial decision to set the level of risk retention in the scheme after the first three years. While it does include a requirement for consultation with the insurance industry. We suggest the following is added to Section 38 (2) (e) of the act.

***'The insurance industry must be consulted on the extent of risk retention and have the ability to provide written submissions to the minister on the matter. The Minister should also consider the level of profitability in insurance policies covering cyclone damage, as evidenced by the ACCC monitoring of premiums'***

IAG remains committed to the reinsurance pool and working to achieve the Government's objective in reducing premiums. We appreciate the consultative approach the Treasury has taken to date, and we look forward to ongoing work with the Treasury and the ARPC on the consultation. [REDACTED]

Sincerely,



Darren Maher

Group Chief Underwriting Officer

IAG

c.c. Julie Batch Group Executive, Direct Insurance IAG.