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Assistance Banking Insurance Lifestyle

17 December 2021

Mohita Zaheed
Assistant Secretary
Treasury
Langton Cres
Parkes ACT 2600

Dear Ms Zaheed

The Royal Automobile Club of Queensland (RACQ) is pleased to provide the attached submission to the exposure draft legislation regarding the cyclone and related flood damage reinsurance pool.

Although our team has examined the exposure draft to the best of its ability, the short consultation period of 10 business days has made the task very difficult. We have sought to provide a comprehensive view of RACQ's perspective however we would like to reserve the right to provide supplementary comments in the new year should further consideration warrant them.

RACQ has provided input to the Insurance Council of Australia's submission but there are issues on which we differ or have more to say and these are apparent in the attached.

Despite the exposure draft providing more detail on the policy direction the Government proposed to take, there are a lot of factors we still do not know. For this reason, we are not yet able to assess how effective the pool will be in meeting the Government stated policy objective – improving the accessibility and affordability of insurance in cyclone prone areas.

We encourage the Treasury-led Cyclone Reinsurance Taskforce and the Australian Reinsurance Pool Corporation to heighten industry consultation next year to work through the finer detail and the unresolved issues.

I reiterate RACQ's commitment to work hand-in-hand with Government to ensure the pool works for everyone involved – the Government, industry, and most importantly policyholders in the north. For any queries related to our submission, the Taskforce can contact in the first instance

[Redacted contact information]

Yours sincerely

David Carter
Group CEO

[Redacted contact information]



CYCLONE REINSURANCE POOL

RACQ RESPONSE TO EXPOSURE DRAFT
LEGISLATION AND REGULATIONS

December 2021

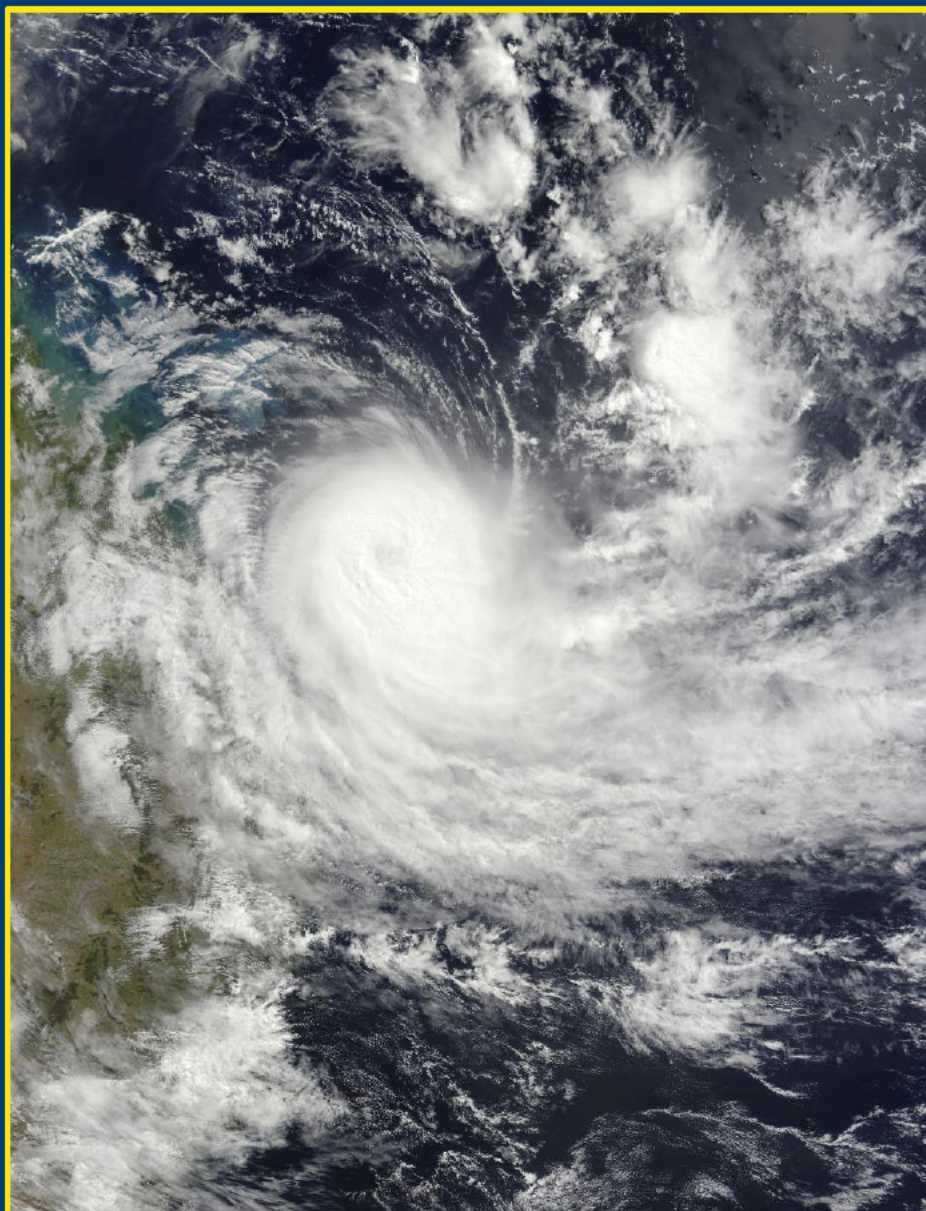


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EXECUTIVE SUMMARY

The Royal Automobile Club of Queensland (RACQ) exists solely for our members who are our only shareholders. Approximately 300,000 north Queenslanders are members of RACQ. We are proud of our history of being on the ground, helping tens of thousands of Queenslanders through some of the worst natural disasters this state has ever seen. Much of the devastation has occurred in north Queensland, a region synonymous with tropical cyclones.

RACQ strives to play our role in keeping general insurance accessible, affordable and sustainable, particularly for our members in high-risk areas.

We strongly advocate for greater mitigation investment, contribute to critical research to fill knowledge gaps, attend industry and Government forums, actively participate in inquiries and, importantly, embed resilience into our business practices.

We have also long acknowledged that insurance in the region is becoming unsustainable but there are well-documented reasons. Disaster risk is increasing, climate impacts are being felt, communities have been put in harm's way, significant resilience investment has been absent, the "double-tax" (GST and stamp duty) on insurance is exacerbating and, more recently COVID-related factors have added to these pressures.

Resilience must remain at the core of keeping insurance accessible and affordable. A cyclone reinsurance pool will work best when it is running alongside significant multi-year investment in resilience and mitigation.

RACQ has supported the Government's cyclone reinsurance policy as it has developed throughout the year.

However, draft legislation released on 3 December 2021 only tells half the picture. We are yet to know a number of factors that will decide the pool's effectiveness, particularly the catastrophe modelling and pricing structure. We also believe the draft legislation contains a number of issues that could run counter to the Government's policy objective of improving accessibility and affordability of insurance in cyclone prone areas.

We remain hopeful that a well thought-out, fit-for-purpose pool can be achieved next year and we look forward to working with the Government on the finer details and resolving several outstanding concerns and challenges.

RACQ was pleased that the Cyclone Reinsurance Taskforce (the Taskforce) adopted into the draft Bill a number of our policy recommendations made in June, specifically:

- 1. Mandatory national reinsurance pool**
- 2. Suitable transition period (at least one year)**
- 3. Includes cyclone related flooding and storm surge**
- 4. Property-level pricing**
- 5. Cover landlords (investment properties for both stand-alone dwellings and strata dwellings)**
- 6. Operate on a continuous basis with no exit date**
- 7. Flexible risk retention**

We also support other decisions taken in the development of the policy and draft legislation. The pool will pay for the entire value of eligible cyclone claims after the policyholder's excess amount. RACQ believes this is a decisive step towards delivering on the policy objective.

Aggregating the premium pool to re-distribute the benefits to those who are in greatest need of assistance is also a positive move. Meaningful benefits can be provided to a smaller cohort of higher risk policyholders by gathering and redistributing the very small gains on the more numerous lower risk policies.

However, there are several unresolved issues. The pool's effectiveness will be predicated on certainty and confidence. The reinsurance market will need certainty in exactly what risks they are writing and confidence that losses believed to be covered by the pool will not leak to them.

Primary insurers dealing with the pool now need certainty in exactly what they are seeking from the reinsurance market – the exposure gaps that are left by the pool – and confidence that the pool provides cover as intended with minimal friction costs.

Any lack of certainty or confidence from either industry will undermine the pool in its policy objective. Greater uncertainty in insurance almost always puts greater cost into the system.

RACQ has identified four key themes that best encapsulate our main concerns.

- **Cost** – The draft legislation was released without a pricing formula or schedule of premium rates so we are not yet able to assess the difference between the “pool rate” and the “market rate” and the associated benefits for our members. A pricing approach that is truly not-for-profit and free of unintended consequences will be critical to the pool’s success.
- **Capital** – APRA has not articulated its intended treatment of the \$10 billion guarantee so RACQ is not yet able to assess the pool’s effect on our prudential requirements, thus we cannot advise the extent to which this will flow through to our members’ premiums. RACQ plans to write to APRA to seek its guidance in this regard.
- **Coverage** – In seeking a “black and white” set of rules to govern the determination of recoverable losses, the pool has limitations that partly offset its strengths. The defined “claims period” is the most obvious example and will restrict the number of cyclone-related claims it covers as will the exclusion of motor. This will lead to only partial transfer of the cyclone and flood-related risk to the pool and require cover to continue to be purchased from the reinsurance market. Further, changes to risk modelling will be required to “carve” out the risk associated with the new definition. As the modelling is uncertain, it is likely to result in additional cost to offset. Other critical factors are uncertain, such as the treatment of product features and the Bureau of Meteorology’s (BoM) cyclone declarations in practice.
- **Claims Management** – The coverage issue can potentially lead to confusion and delay in the management of cyclone claims as well as a different kind of claims experience for RACQ members. Although absent in the proposed legislation, Treasury’s Factsheet states that insurers will continue to manage any claims. This is a sensible step to ensure the primary insurer manages the end-to-end relationship with the policyholder. However, RACQ is concerned certain policy settings related to the pool’s coverage may require additional processes, administration and cumbersome interactions with our members, culminating in extra costs borne by the insurer and frustration for those impacted by a cyclone.

RACQ notes that Government expects the pool to achieve premium savings in two distinct ways:

- 1) The pool will charge premiums to insurers without a commercial profit margin
- 2) The \$10 billion guarantee is available to be drawn down immediately if the premium pool is exhausted at any time.

The resolution of Cost and Capital will inform the effectiveness of each mechanism while questions relating to Coverage and Claims Management are necessary to determine how these factors will offset the benefits.

There are other considerations highlighted in the paper, including price monitoring, claims handling expenses, excess amount and systems change with the Australian Reinsurance Pool Corporation (ARPC).

RACQ commends the Government on moving the cyclone reinsurance pool policy closer to reality through draft legislation. However, we note there is still a lot of work to do on the finer detail, particularly modelling and pricing. The Government must next year heighten consultation that is inclusive of the broad industry.

We remain entirely committed to the interests and wellbeing of our members and the region and so we welcome a pool that will deliver downward pressure on premiums and keep insurance accessible well into the future.

A total of 15 recommendations are featured throughout the submission with explanations, however a full list is provided here.

1. **The Government's values should be adjusted so the legislation makes abundantly clear that the stated policy objective – improving insurance accessibility and affordability – is the overriding priority of the pool.**
2. **The pool's catastrophe modelling should be shared with all insurers as soon as possible.**
3. **The ARPC and the Taskforce should have due regard for reinsurers' current operating environment and underlying performance when determining a reasonable profit margin to be foregone.**
4. **The ARPC and the Taskforce should have due regard for insurers' current operating environment, including unprecedented cost pressures, when determining the catastrophe modelling and pricing formula.**
5. **APRA should advise insurers of its approach to recognising the \$10 billion guarantee in prudential capital requirements as soon as possible.**
6. **The ARPC and/or the Taskforce should further detail the approach to restoring the \$10 billion guarantee using future premiums. Any payback period should not occur over a short period.**
7. **The ARPC should clarify what "own resources" means in relation to meeting claims costs.**
8. **The definition of the claims period should be changed to align with standard reinsurance treaties and apply a "168 hours clause" (seven days). However, the seven-day period must overlap with a point in time when the weather event was a declared cyclone to meet the Government's policy objectives.**
9. **The pool's coverage should match the reinsurance market's treatment of product coverage, meaning it would cover features and entitlements above sum insured. The pool should also cover other forms of insurance that are impacted by cyclone, particularly motor, as per standard market practice. Clarification of any maximum sum insured limits for residential properties should also be given.**
10. **The full value of eligible claims should be recoverable from the pool if a portion of loss occurred during the claims period.**
11. **Assessing claims and costs for recovery should remain the responsibility of the insurer for the purposes of pool recoveries. The pool recovery process should include "cash calls" consistent with current reinsurance market practice.**
12. **The price monitoring regime should be simple and not become a costly investigation that dilutes premium benefits by increasing regulatory costs and therefore, runs counter to the Government's policy objective.**

13. The ARPC should share with the insurance industry any property-level cyclone and flood mitigation data it uses to provide discounts to policyholders. The ARPC could share this data with the Insurance Council of Australia to upload it onto the existing National Flood Information Database (NFID).
14. The pool should cover claims handling expenses associated with eligible cyclone-related losses.
15. The ARPC should consult with insurers in the design and implementation of systems to operate the pool.

INTRODUCTION

RACQ is Queensland's largest member-owned mutual with nearly 1.8 million members. RACQ provides motor vehicle roadside assistance across the state, together with insurance and banking. The Club has been operating for over 116 years and this year marks our 50th anniversary providing general insurance to Queensland homeowners and motorists. We have grown to become the state's largest motor insurer and second largest home insurer.

Unlike the majority of the market, we are not governed by the pursuit of profits. As a mutual, RACQ exists solely for our members who are our only shareholders. Approximately 300,000 north Queenslanders are members of RACQ, 20% of whom have home and/or contents insurance with us. Many of these homeowners have turned to RACQ in their greatest hour of need.

We maintain a strong daily presence in the region, particularly in the populated centres of Rockhampton, Mackay, Townsville and Cairns where we have more than 50 staff and contractors based, with RACQ branches in each location and we are pleased to be able to deliver face-to-face services to north Queenslanders on an ongoing basis. Everyone at RACQ is proud of our history of being on the ground, helping tens of thousands of Queenslanders through some of the worst natural disasters this state has ever seen. Much of the devastation has occurred in north Queensland, a region synonymous with tropical cyclones.

Eight of RACQ's 15 costliest weather events in the past decade have occurred in north Queensland and all of them, with the exception of Townsville floods (2019), have involved tropical cyclones.

RACQ is immensely proud of its record in putting our members' lives back on track after natural disasters. Our Assistance fleet is on the ground as our initial incident response and our Mobile Member Centre is often the first insurance vehicle in impacted regions. Our catastrophe response also features dedicated teams of assessors, claims managers and professionals as well as a vast network of builders, trades and other partners. This response activity often stretches far beyond insurance. The RACQ Foundation exists to help communities recover from adversity. For instance in the aftermath of the Townsville Floods, the Foundation gave more than \$780,000 to 22 impacted community groups such as sporting clubs and charitable organisations. We also sent 23 staff and skilled tradespeople to help 13 community groups and farms rebuild and repair their assets and properties after the floods.

RACQ has accumulated many insights and experiences to help Governments and communities build a more resilient north Queensland. We are passionate supporters of this wonderful part of Queensland and we want to see the region grow and prosper well into the future.

In this respect, our motivations go far beyond general insurance. We believe natural hazard resilience in north Queensland will improve quality of life, and in turn, create happier, safer communities. One cannot put a dollar figure on having greater peace of mind and confidence to make more certain decisions about family, home, and business. If we all act on this starting premise, then a stronger economy and more accessible insurance should fall into place.

Nevertheless, RACQ strives to play our role in keeping general insurance accessible, affordable and sustainable, particularly for our members in high-risk areas. RACQ advocates for greater mitigation investment, contributes to critical research to fill knowledge gaps, attends industry and Government forums, actively participates in inquiries and, importantly, embeds resilience into our business practices.

In 2016, we introduced a cyclone resilience discount which involves a premium reduction of up to 20% of a premium's cyclone component for members who implemented various resilience measures to their home including strengthening their roof and cyclone shutters.

RACQ has long acknowledged that the cost of insurance in north Queensland is too high and becoming unsustainable. It is well understood that north Queenslanders are paying double for their home insurance compared to southern Australia. However, through many inquiries, the causes are now well understood.

Disaster risk is increasing, climate impacts are being felt, communities have been put in harm's way, significant resilience investment has been absent, the "double-tax" (GST and stamp duty) on insurance is exacerbating

and, more recently COVID-related factors have added to these pressures. The main objective of our insurance pricing strategy is to collect enough premium from members to fully pay all projected claims costs.

Despite the cost disparity, the region has not been profitable for general insurers for a long time. The Australian Competition and Consumer Commission (ACCC) noted that over the 12-year period to 2018-19, insurers in northern Australia, including RACQ, have experienced an estimated aggregate gross loss across home, contents and strata insurance products of approximately \$856 million in real terms.

North Queensland needs a comprehensive plan for resilience and sustainable insurance agreed to by all levels of Government, one that leverages the expertise of insurers like RACQ to ensure it will result in tangible affordability outcomes.

There is no “silver bullet” to these complex challenges. However, the Commonwealth Government’s policy to introduce a cyclone reinsurance pool (the pool) could be an important part of a larger program of practical, evidence-based initiatives. Without projects to protect vulnerable communities along our coastline, the pool risks becoming nothing more than a “band-aid” solution. However, working in tandem with meaningful investment that progressively takes risk out of the system, as well as tax relief and disaster mitigation, a well-designed and efficient pool can provide much welcome relief to RACQ members and the broader north Queensland region while ensuring continued access to affordable insurance.

On that basis, RACQ expressed its support during Treasury’s initial consultation in June this year. The release of exposure draft legislation and regulations regarding the pool’s proposed structure, governance and operation on 3 December 2021 helps RACQ better understand the policy in practice and how it could help (or affect) our members.

However, it is only half the picture as there is still much we do not know and evidently, much that is yet to be developed. We need to know the pool’s catastrophe modelling, pricing structure, more detail on exclusions and capital implications as well as other rules and processes that will influence how we do business with other reinsurers and, ultimately, assist our members.

These issues are further explained in this submission.

Based on advice the Taskforce has provided to industry on timing of deliverables, it is difficult to see any pathway that would enable the pool to be operating and accessible to insurers on the proposed start date of 1 July 2022.

However, we remain hopeful that a well thought-out, fit-for-purpose pool can be finalised next year. We also believe the pool can make a difference in the north, but the industry is facing a number of issues, pressures and uncertainties that will limit the size of benefits for our members. We look forward to closely collaborating with the Taskforce, Treasury and the ARPC next year, as we have done throughout 2021, to ensure the pool is effective and works for Government, insurers and, most importantly, policyholders in northern Australia.

SECTION 1: THE POOL'S POTENTIAL

RACQ has always assessed and supported the pool with the Government's policy objective in mind, which is to improve the accessibility and affordability of insurance in cyclone prone areas of Australia. This focus will continue through legislation, pricing consultation and, ultimately, implementation.

During initial consultation, RACQ made a number of recommendations to Treasury for a well-designed pool that would meet the policy objective.

We are pleased to see a number of these recommendations partially or fully adopted in the exposure draft, as well as other decisions taken that will go some way towards setting up the pool for success.

RACQ'S RECOMMENDATIONS ADOPTED

1. Mandatory national reinsurance pool

Given the catastrophic nature of a cyclone, RACQ stated the pool should be mandatory for insurers to maximise efficiency, and therefore, benefits to be passed on to members. We believe such a pool can only work with scale and size so there are enough funds to build up over time to cover for liabilities. **Part 2A Section 8A** of the draft amendments detail the mandatory nature of the pool, specifically subsection 1 (a) & (b) specify contracts that:

*“(a) cover the insurer's liability, under all pool insurance contracts that it enters into, in respect of eligible cyclone losses; and
(b) insure against 100% of the insurer's liability, under each of those pool insurance contracts, in respect of eligible cyclone losses.” (Exposure draft legislation – page 5)*

The exposure draft regulations prescribe a threshold amount of \$10 million under which insurers with total gross written premiums (GWP) covering liability for cyclone losses are not required to participate (Exposure draft regulations – page 3).

This exclusion is appropriate to ensure only those insurers underwriting reasonable amounts of cyclone risks are contributing to the ARPC's premium pool and others with small exposures are not unnecessarily burdened with compliance and friction costs for little gain.

2. Suitable transition period (at least one year)

Recognising a mandatory pool involves a program of activity, including a period of allowing other reinsurance contracts to run so there are no “double-ups” of cover, RACQ recommended at least 12 months after the pool's commencement for insurers to participate.

This recommendation is now particularly pertinent given the number of uncertainties that remain and will not be clarified or known until next year, making participation on 1 July 2022 unachievable.

Part 2 Section 25 of the exposure draft legislation sets out those insurers who must commence by 2024 calendar year and the other smaller insurers (with total GWP less than \$300 million) who must commence by 2025 calendar year.

These periods should allow sufficient time for insurers to invest in necessary systems changes and restructure their reinsurance programs to accommodate the pool.

RACQ also understands the ARPC will allow insurers to join the pool at any time between 1 July 2022 and their respective commencement deadline. We support this decision as an insurer could use the allowance if it determines the full transition period is not needed to be ready, or if an insurer wants to see their policyholders benefit from the pool earlier than required.

3. Includes cyclone related flooding and storm surge

RACQ recommended all claims arising from a cyclone should be covered for certainty, confidence and clarity. We called for the pool to include claims relating to wind damage, water ingress, storm surge and flooding. We are pleased that the exposure draft legislation and regulations rely on the definition of a flood in subsection 34(1) of the *Insurance Contracts Regulations 2017* (Exposure draft regulations – page 3). There is now

universal application of this definition across general insurance and most home insurance policies now contain flood cover.

Section 5C of the exposure draft regulations state the definition of storm surge will be: “. . . an abnormal rise in sea level, over and above the normal astronomical tide levels.” (*Exposure draft regulations – page 3*)

Storm surge should be covered by the pool given that cyclones produce larger than normal tides. Storm surge has been defined by RACQ as “an increase in the sea level that is caused by a tropical cyclone or other intense storm” (*RACQ Household Insurance Policy PDS – page 113*).

While inclusion of flood and storm surge is to be commended, RACQ notes the exclusion of losses as set out in 8C & 8F of the exposure draft legislation regarding eligible cyclone loss and declarations about cyclone events respectively (*Exposure draft legislation – pages 8-10*). This effectively means the pool will only cover losses that occurred during a declared cyclone and 48 hours after it has been downgraded.

RACQ believes some of the certainty and clarity achieved through flood and storm surge inclusions could be clouded by the restrictions placed on claim eligibility. This issue is explored in greater detail in section 2.

4. Property-level pricing

RACQ recommended that the pool should price at the individual property level based on the risk profile of the property, to allow for accurate and fair pricing that takes into account a range of attributes. Keeping a price signal for risk is critical to incentivise mitigation and to discourage poor planning and construction of homes and communities.

While not explicit in the exposure draft legislation or regulations, the **Treasury Factsheet** states the pricing formula “will use property-level data such as: geography, building characteristics, and mitigation” (*Factsheet – page 2*).

RACQ welcomes this decision however the pricing formula is yet to be released for consultation. We note the Factsheet does not specify how cyclone peril will feature in the property-level pricing formula. A number of pricing issues to be resolved are detailed in section 2.

5. Cover landlords (investment properties for both stand-alone dwellings and strata dwellings)

RACQ felt it was important the pool covered landlord policies to enable tenants access to properties and affordable contents insurance. Landlords themselves are often “mum and dad” investors with the same insurance affordability pressures as residential homeowners.

An exclusion would have also unfairly penalised tenants who are often paying for growing property costs through rental increases. On this basis, RACQ supports 3B Definition of *pool insurance contract* in the exposure draft legislation which confirms the principal place of residence can be occupied by the insured or another person (*Exposure draft legislation – page 7*).

6. Operate on a continuous basis with no exit date

RACQ recommended against a pool exit date given the recurring nature of tropical cyclones in the north and climate science which indicates growing cyclone severity. The cost of cyclones will continue to rise and put upward pressure on insurance premiums.

Furthermore, RACQ is concerned that a foreseeable end to the pool will trigger insurers exiting the market, leaving a small number of Queensland-based insurers behind to pick up the poorer risks with no pool support. This would have been a perverse outcome, notwithstanding any disaster mitigation that was to occur for the duration of the pool. This is why RACQ is pleased to see no reference to an exit date in any of the materials released on 3 December 2021.

7. Flexible risk retention

RACQ has advocated for flexibility in the amount of insurers’ risk retention for a range of reasons. Principally, we recognise that each insurer is different with their own portfolio needs and challenges. If the pool becomes an unviable form of cover for insurers with sizeable programs, then it is fair for those insurers to be allowed to decide what, if any, risk they should cede to the pool.

While ambiguous in the draft legislation, the Explanatory Memorandum (EM) states that a risk-sharing agreement could be put in place between the ARPC and the insurer after the first three years, on the condition that the pool continue to cover a significant proportion of cyclone-related risk.

OTHER DECISIONS TAKEN

RACQ understands that in insuring against 100% of the insurer’s liability for eligible cyclone losses, the pool will pay for the entire value of eligible cyclone claims after the policyholder’s excess amount. While not entirely explicit in the draft legislation, the Explanatory Memorandum clearly states this intent on page 12.

RACQ believes this is a decisive step towards delivering on the policy objective.

RACQ pays proportionately more for reinsurance in north Queensland with a “rate on line” (ratio of reinsurance premium paid to maximum loss recoverable) nearly three times greater than south east Queensland, as the below figure shows.

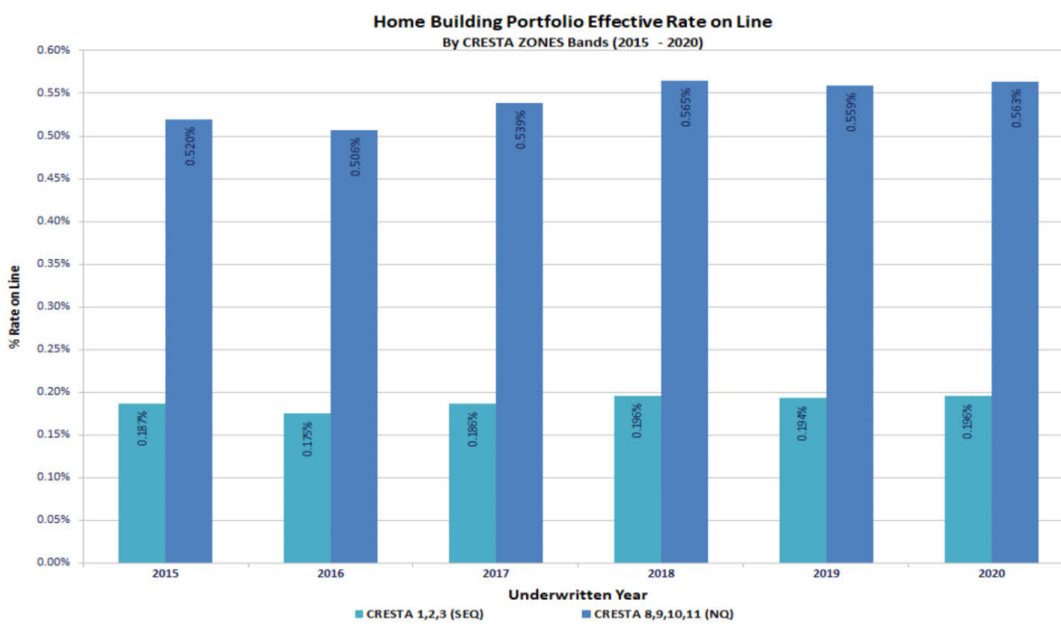


Figure 1: Home building portfolio effective rate on line
Source: RACQ Internal Analysis

Cyclone drives this higher rate due to past claims history and catastrophe models that point to increased risk. RACQ’s current catastrophe program costs \$125 million.

As mentioned above, eight of RACQ’s 15 costliest weather events in the past decade have occurred in north Queensland. The below graph tracks the costs of these weather events in today’s terms.

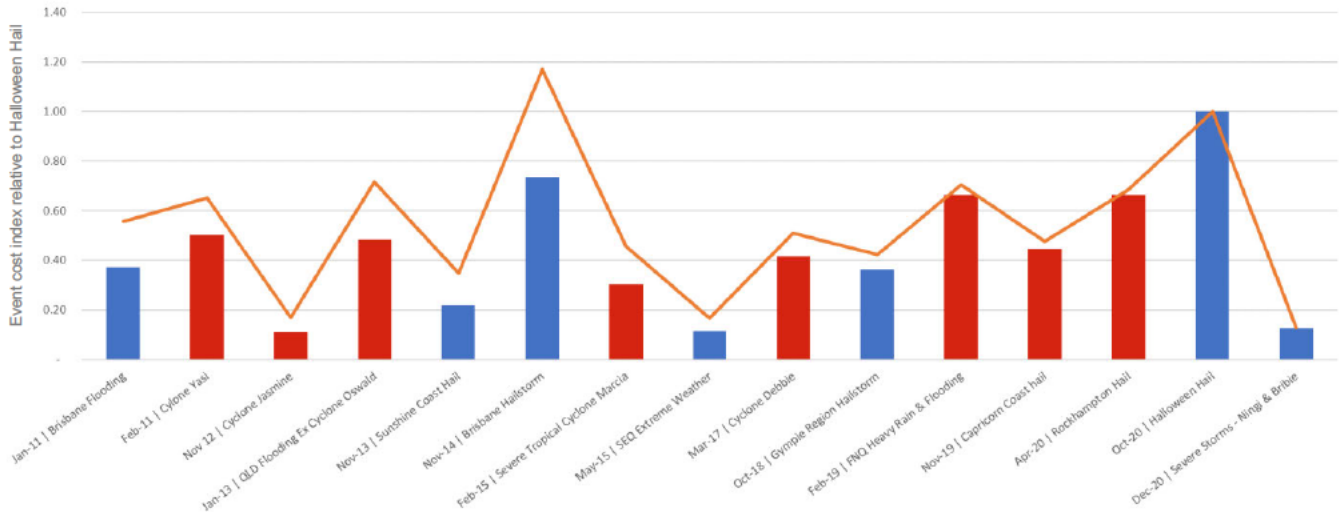


Figure 2: RACQ's top 15 events, with costs indexed against the October 2020 Halloween Hail event (RACQ's most costly event)
 Legend: Red column = Original cost northern Queensland; Blue column = Original cost other location; Orange line = Cost in today's terms
 Source: RACQ Internal Analysis

Given the cyclone peril constantly looms large in RACQ's catastrophe program, any measure that transfers as much of this exposure as possible from our portfolio and program to a "non-profit" pool is supported.

RACQ also supports the decision to maximise the benefits to medium and high cyclone risk policies by aggregating policies containing low cyclone risk as evident in **8D Setting reinsurance premiums** subsection (b) which states:

“ . . . to keep those premiums:
 (i) to the extent they are for reinsuring liability under pool insurance contracts that involve medium to high levels of exposure to eligible cyclone losses—as low as possible; and
 (ii) to the extent they are for reinsuring liability under pool insurance contracts that involve lower levels of exposure—comparable to what would be charged by other reinsurers; and
 (c) to maintain incentives to reduce and mitigate the risk of eligible cyclone losses.” (Exposure draft legislation – page 9)

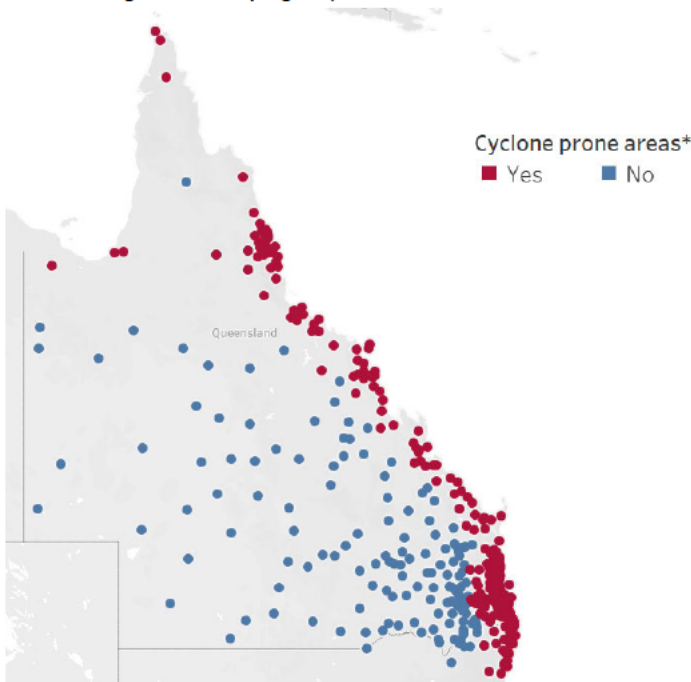


Figure 3: RACQ's home insurance portfolio footprint
 Source: RACQ Internal Analysis

Aggregating the premium pool to re-distribute the benefits to those who are in greatest need of assistance aligns with RACQ's preferred modelling provided to the Taskforce. Meaningful benefits can be provided to a smaller cohort of higher risk policyholders by gathering and redistributing the very small gains on the more numerous lower risk policies.

A basic geographic footprint of RACQ's home insurance portfolio by postcode and suburb is shown adjacent. A loose classification of cyclone prone areas is used to provide this footprint, i.e., postcodes and suburbs that are within 75 kilometres distance to the coast are classified as cyclone prone areas.

The map shows cyclone risk present in home insurance policies along Queensland's entire coastline. Approximately 110,000 RACQ building policies contain very low to low cyclone risk, which are predominantly located in the southern half of



Queensland and northern New South Wales. There are approximately 50,000 building policies with medium to high cyclone risk concentrated in north Queensland.

Under the Government's proposed approach, RACQ members in the lower risk regions would forego very marginal benefits to contribute to larger gains for members living in cyclone prone parts of the state.

RACQ reiterates its commitment to returning any financial benefit from the pool to its members to keep insurance accessible.

However, our support for the pool and certain policy settings is subject to several unresolved issues and reservations that are detailed in the following section.

SECTION 2: KEY ISSUES

The pool's effectiveness will be predicated on certainty and confidence. The reinsurance market will need certainty in exactly what risks they are writing and confidence that losses believed to be covered by the pool will not leak to them.

Primary insurers dealing with the pool now need certainty in exactly what they are seeking from the reinsurance market – the exposure gaps that are left by the pool – and confidence that the pool provides cover as intended with minimal friction costs.

Any lack of certainty or confidence from either industry will undermine the pool in its policy objective – improving the accessibility and affordability of insurance in cyclone prone areas. Greater uncertainty in insurance almost always puts greater cost into the system.

RACQ has identified four key themes that best encapsulate our main concerns.

- **Cost** – The draft legislation was released without a pricing formula or schedule of premium rates so RACQ is not yet able to assess the difference between the “pool rate” and the “market rate” and the associated benefits for our members. A pricing approach that is truly not-for-profit and free of unintended consequences will be critical to the pool's success.
- **Capital** – APRA has not articulated its intended treatment of the \$10 billion guarantee so RACQ is not yet able to assess the pool's effect on our prudential requirements, thus we cannot advise the extent to which this will flow through to our members' premiums.
- **Coverage** – In seeking a “black and white” set of rules to govern the determination of recoverable losses, the pool has limitations that partly offset its strengths. The defined “claims period” is the most obvious example and will restrict the number of cyclone-related claims it covers as will the exclusion of motor. This will lead to only partial transfer of the cyclone and flood-related risk to the pool and require cover to continue to be purchased from the reinsurance market. Further, changes to risk modelling will be required to “carve” out the risk associated with the new definition. As the modelling is uncertain, it is likely to result in additional cost to offset. Other critical factors are uncertain, such as the treatment of product features and the BoM's cyclone declarations in practice.
- **Claims Management** – The coverage issue can potentially lead to confusion and delay in the management of cyclone claims as well as a different kind of claims experience for RACQ members. Although absent in the proposed legislation, Treasury's Factsheet states that insurers will continue to manage any claims. This is a sensible step to ensure the primary insurer manages the end-to-end relationship with the policyholder. However, RACQ is concerned certain policy settings related to the pool's coverage may require additional processes, administration and cumbersome interactions with our members, culminating in extra costs borne by the insurer and frustration for those impacted by a cyclone.

RACQ notes that Government expects the pool to achieve premium savings in two distinct ways:

- 1) The pool will charge premiums to insurers without a commercial profit margin
- 2) The \$10 billion guarantee is available to be drawn down immediately if the premium pool is exhausted at any time.

The resolution of Cost and Capital will inform the effectiveness of each mechanism while questions relating to Coverage and Claims Management are necessary to determine how these factors will offset the benefits.

COST – PRICING FORMULA AND SCHEDULE ISSUES

Perhaps the most influential factor in determining the size of financial benefit possible for north Queenslanders is the reinsurance premium the ARPC will charge insurers.

With the policy objective in mind, there is a reference in the EM under **Premium Settings** suggesting improving insurance accessibility and affordability is a second order priority behind fiscal responsibility.

Specifically, it states:

“1.56 Specifically, the ARPC and reviewing actuary should first consider the requirement that the reinsurance pool is intended to be cost-neutral over time. The pool will be funded by the premiums that insurers would pay to participate in the scheme. The premiums charged would be expected to cover the long-term costs of insured risk in addition to the pool’s ongoing administration expenses. [Schedule C, item 8, section 8D(a) of the Act]

1.57 The ARPC and reviewing actuary must also have regard to the second requirement, which is that the reinsurance pool is designed to reduce reinsurance costs. The pool does not include a profit margin above cost as it does not seek to make a profit, thereby increasing savings available to policyholders and insurers. The pool would provide targeted reinsurance premium reductions based on each property’s risk profile, where higher risk properties receive higher discounts. [Schedule C, item 8, section 8D(b) of the Act].” (Explanatory Memorandum – page 12)

Ideally, cost-neutrality should be placed after affordability and accessibility as per the policy objective.

RACQ RECOMMENDATION: The Government’s values should be adjusted so the legislation makes abundantly clear that the stated policy objective – improving insurance accessibility and affordability – is the overriding priority of the pool.

Premium formula and catastrophe modelling

Theoretically, the pool will charge for the eligible exposures at a lower rate than what insurers and brokers would otherwise find in the open market.

As it stands, the Taskforce is yet to consult with industry on the formula it intends to use to set premiums, nor has it shared any catastrophe modelling that will inform the formula. RACQ understands the fully parametrised pricing formula at a property level will not be available to industry until April 2022.

Firstly, the timing means that RACQ will be unable to join the pool from 1 July 2022. RACQ has already begun work to place the next catastrophe reinsurance program which commences at the same time as the pool. The annual program protects our members’ capital from increasing disaster risk and needs to satisfy APRA’s prudential requirements. A number of factors influence the structure, components and costs of the program, but pool participation will require an exact understanding of the liabilities the pool is covering and what value the market will put on these liabilities. The market should then “credit” the insurer with a reduced cost in recognition of the losses that are expected to be recovered from the pool. Insurers will almost certainly require access to the Government’s catastrophe modelling to engage with brokers and the market for any program that runs in tandem with the pool. This process is likely to take several months.

In addition, any pricing adjustments triggered by the pool will need to be made months in advance. RACQ needs to reconfigure pricing, possibly add more information on renewals and send the first “pool” notices about two months before participating in the pool.

We are yet to understand how the pool’s catastrophe modelling will “inform” the pricing formula. Catastrophe models are useful on an aggregate portfolio level, but not ideal for property risk level pricing. It would be difficult to see how a risk-based pricing approach allowing for mitigation can meet a portfolio-wide view at the 1-in-200-year return period, based on catastrophe modelling when risk mitigation and detailed building characteristics are not often built into such models.

RACQ suggests if the modelling and the pricing formula was provided well before next April, RACQ would be in a stronger position to participate in the pool earlier.

RACQ RECOMMENDATION: The pool’s catastrophe modelling should be shared with all insurers as soon as possible.

Reinsurer margins

Thirdly, the commercial profit margin the ARPC and the Taskforce deem reasonably “forgone” as a result of the pool’s existence will be crucial. Such a margin that represents the entire market is arguably subjective on many fronts. How does one assess the current and prospective profitability of reinsurers to derive a “benefit” that insurers should pass on to a specific cohort of policyholders?

Presumably, the Taskforce modelling may involve an assessment of the reinsurance component in a north Queensland policy’s premium and apply a projection of future costs. It could then carve out a portion of that premium component representing the liability the pool would attain and add an estimated profit margin.

Estimating a profit margin assumes the reinsurance industry has achieved a degree of profit in recent years. A retrospective snapshot of recent underwriting years shows an industry barely “breaking even” as a result of significant natural disaster costs combined with the impacts of COVID-19.

Reinsurers’ Combined Ratio

Tier 1 & 2 Global Reinsurers

Reinsurers	2016	2017	2018	2019	2020	5-yr avg	5-yr SD
Tier 1 Global Reinsurer							
Munich Re Group	95.70%	114.10%	99.40%	101.00%	105.60%	103.2%	7.1%
Swiss Re	93.50%	111.50%	104.00%	107.80%	109.00%	105.2%	7.1%
SCOR Group	93.10%	103.70%	99.40%	99.00%	100.20%	99.1%	3.8%
Hannover Re Group	93.70%	99.80%	96.50%	98.20%	101.60%	98.0%	3.0%
Lloyd’s*	97.90%	114.00%	104.50%	102.10%	110.30%	101.7%	8.8%
Aspen Group	98.50%	125.70%	106.50%	108.50%	106.00%	109.0%	10.1%
XL Re	94.20%	108.30%	N/A	N/A	N/A	N/A	N/A
AXA XL			108.60%	101.50%	112.20%	107.4%	5.4%
Average	95.23%	111.01%	102.70%	102.59%	106.41%	103.4%	5.8%
Tier 2 Global Reinsurer							
Sompo International (former Endurance Specialty)*	90.96%	122.88%	97.10%	91.60%	96.70%	99.8%	13.2%
Everest Re Group	87.00%	103.50%	108.80%	95.50%	102.90%	99.5%	8.5%
Partner Re	93.60%	114.70%	108.70%	100.30%	106.00%	104.7%	8.1%
Renaissance Re Holdings	72.50%	137.90%	87.60%	92.30%	101.90%	98.4%	24.5%
Trans Re	95.50%	108.11%	105.40%	100.90%	103.60%	102.7%	4.8%
Argo Group	97.80%	108.10%	97.90%	109.10%	106.20%	103.8%	5.5%
Sirius International	94.00%	107.60%	103.10%	110.80%	110.30%	105.2%	6.9%
SiriusPoint							
Average	90.19%	114.68%	101.23%	100.07%	103.94%	102.0%	8.8%

Combined Ratios (losses plus expenses to premium revenue) for every Tier 1 Global Reinsurer exceeded 100% in 2020. All but two had five-year averages that exceeded 100%. Tier 2 reinsurers recorded very similar levels.

These results strongly suggest pressures exist for reinsurers to improve their financial performance and return on equity.

Without taking into account recent experiences and planning for a constrained market into the future, the ARPC and the Taskforce risk under-pricing cyclone risk, calling the sufficiency of the premium pool into question.

RACQ RECOMMENDATION: The ARPC and the Taskforce should have due regard for reinsurers’ current operating environment and underlying performance when determining a reasonable profit margin to be foregone.



Figure 4: Reinsurers’ combined ratio results
Source: Guy Carpenter (reproduced with permission)

Other cost pressures in general insurance

Finally, while RACQ agrees a pool can make a positive difference as part of a larger program of initiatives, community and Government expectations need to be managed in the context of the recent and current operating environment of general insurers in Australia.

Cost pressures have significantly increased, pushing up insurance premiums throughout Australia. They are expected to continue on an upward trajectory as a result of rising catastrophe losses and COVID-19 impacts, similar to the challenges experienced by reinsurers.

Globally, average annual losses are approaching \$100 billion, up from about \$20 billion just 30 years ago, as shown in the figure below. There have been more than 300 catastrophes every year since 1993.

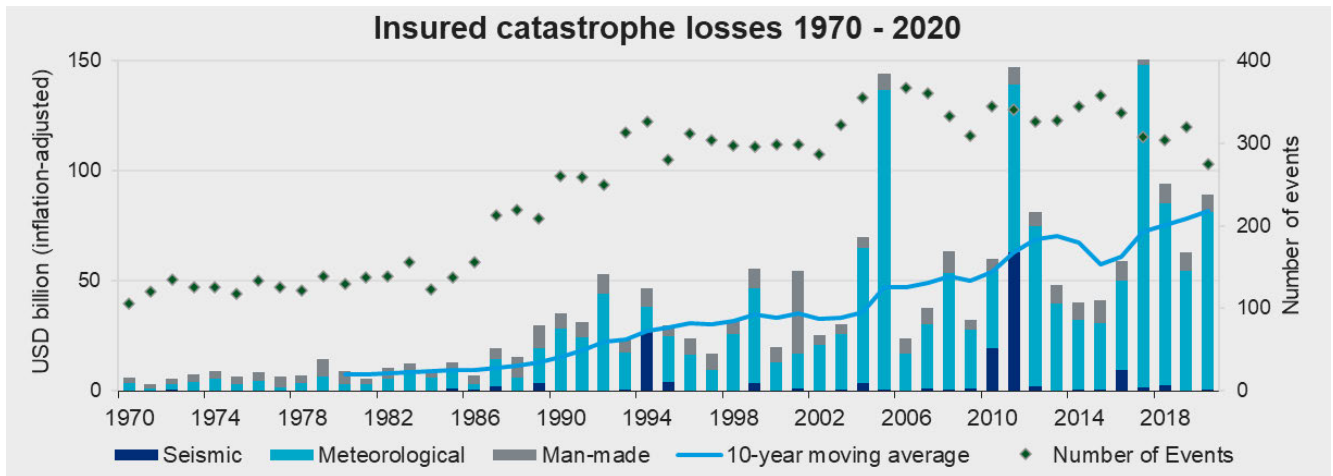


Figure 5: Global insured catastrophe losses from 1970 - 2020
Source: Guy Carpenter (reproduced with permission)

The global experience is reflected in RACQ’s recent history of catastrophe losses. The figure below shows the upward trajectory of reinsurance costs and natural hazard allowances.

RACQ’s reinsurance costs have increased from \$25 million in 2008 to \$99 million in 2020-21 while risk retention – used to offset these costs – has also significantly increased during the same period. Similarly, our actual natural hazard experience (net of reinsurance recoveries) has risen from \$33 million in 2008 to \$136 million in 2021. Climate change, alongside population and asset growth, will see insurers’ annual losses significantly increase across most perils including cyclone and storm surge, even under a 2° warming scenario.

These pressures are driving up the cost of insurance in Queensland, particularly in high-risk areas, which the pool can only partially address.

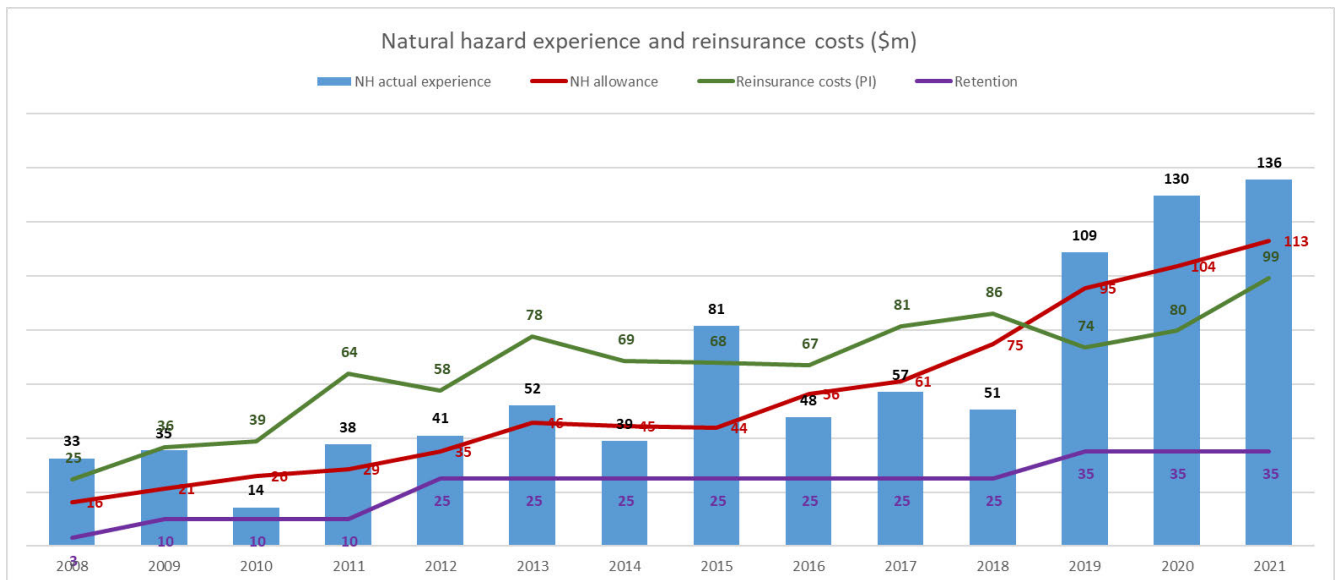


Figure 6: RACQ’s natural hazard claims experience and reinsurance costs by financial year
Source: RACQ Internal Analysis

COVID-19 is still causing unprecedented impacts on insurers’ claims operations. Supply chain and import disruptions, as well as border closures and uncertainty, have caused chronic trade and material shortages as well as logistical delays. Indirectly, Government stimulus packages for home builds and renovations, combined with persistent record-low interest rates, are exacerbating these shortfalls with insurers competing for in-

demand trades, such as roofers. This, in turn, is leading to premium increases to cover various demand surges and longer wait times. RACQ analysis shows an increasing trend in square-meterage rates across multiple categories but is most prominent in roofing which has almost doubled in price in the last 12 months. The average cost of a home claim from natural hazards has increased by 90% over the past two years.

RACQ is also currently experiencing similar issues in the motor insurance business, particularly a lack of new car imports that are driving up the cost of second-hand vehicles as well as a shortage of motor parts pushing up the cost of claims.

How quickly the pool will respond to increased cost pressures will be an important consideration as well as the agreed process the pool will follow to change price.

RACQ RECOMMENDATION: The ARPC and the Taskforce should have due regard for insurers' current operating environment, including unprecedented cost pressures, when determining the catastrophe modelling and pricing formula.

CAPITAL – PRUDENTIAL REQUIREMENT UNCERTAINTY

RACQ plans to write to APRA for guidance to help determine the extent to which the \$10 billion guarantee will be accepted towards our capital requirements. A reduction in capital required could also contribute towards benefits in insurance pricing to our members.

RACQ's current catastrophe program has a panel of around 50 reinsurers with coverage to a 1 in 200-year loss or \$1.5 billion as required by APRA. The entire program costs RACQ approximately \$125 million (2021-22), up from \$99 million last year.

Section 35A Commonwealth guarantee: payments under cyclone reinsurance contracts states:

“(1) The Commonwealth guarantees the due payment of money that may become payable by the Corporation to any person (other than the Commonwealth) in respect of a liability (a cyclone loss liability) of the Corporation as insurer under a contract of reinsurance it enters into under the cyclone reinsurance scheme.” (Exposure draft legislation – page 15)

Based on RACQ modelling, doubts remain as to whether the \$10 billion guarantee will be sufficient to cover losses from a 1 in 200-year cyclone under the ARPC's proposed definition.

This is a significant consideration for RACQ as the cyclone peril is the key driver of the Probable Maximum Loss (PML) that we are required to cover in any year. If the guarantee is deemed not sufficient, RACQ will likely be required to purchase additional reinsurance to make up the shortfall, thus diluting the pool's benefits.

In **Section 1.65** of the EM, the Treasurer has the mandate to increase the cap on the guarantee to “ensure that all cyclone liabilities offered under reinsurance contracts with the ARPC are met” (*Explanatory Memorandum – page 13*). The Taskforce expressed an expectation that the guarantee would serve to reduce insurers' 1 in 200-year event cover requirements, however RACQ will require a formal confirmation.

The EM explains the \$10 billion guarantee will “back” the pool and be reinstated each year.

There is no reference regarding prudential considerations except Treasury's **Factsheet** which states:

“... the Australian Prudential Regulation Authority (APRA) has indicated it would allow insurers to fully recognise the risk transfer provided by the reinsurance pool. Changes to APRA's prudential framework would occur after the passage of legislation.” (Factsheet – page 2)

The prudential timeframe is also likely to hamper insurers' ability to participate in the pool from 1 July 2022. Earlier advice from APRA about these considerations would be welcome in order to help insurers plan their catastrophe program.

In addition to the anticipated reduced PML liability, RACQ is also keen to understand how the guarantee may affect horizontal reinsurance requirements. In **Section 1.65** of the EM it states that the \$10b guarantee will be increased to meet the liability relating to “all claim costs in the event of one or series of large but rare cyclones in any annual period” (*Explanatory Memorandum – page 13*). RACQ would like clarification that the pool covers multiple cyclone events occurring within a year.

RACQ would expect APRA to treat the pool in a similar way it responds to Government loan guarantee schemes, giving banks the ability to shed risk and provide lower interest rates. We saw this, most recently, at the height of the COVID-19 pandemic last year during a string of Federal Government economic stimulus measures. However, clearing up the definition issues relating to the pool, so as not to cause duplication of either reinsurance cover or capital, will be critical in maximising the benefit of APRA's treatment.

APRA's advice on its approach would be based on draft legislation which is subject to amendments and timing of passage so we recognise that APRA may need to revisit this advice.

RACQ RECOMMENDATION: APRA should advise insurers of its approach to recognising the \$10 billion guarantee in prudential capital requirements as soon as possible.

In addition, RACQ notes that "cost-neutrality" has been a recurring theme throughout the development of the Government's policy.

While absent from the actual legislation, both the EM and the Factsheet make it clear that the pool is to be cost-neutral to Government "over time". RACQ understands this objective will also apply to the guarantee such that insurers are to repay any funds drawn through premiums paid over a period. On this basis, the guarantee is mainly in place for liquidity to ensure immediate access should the premium pool be exhausted. RACQ would welcome further explanation of this "payback period" as it could potentially impact on the policy objective.

RACQ RECOMMENDATION: The ARPC and/or the Taskforce should further detail the approach to restoring the \$10 billion guarantee using future premiums. Any payback period should not occur over a short period.

Finally, under **Commonwealth Guarantee**, the EM states: *"The Commonwealth guarantee will be drawn from if funds from the reinsurance pool and the ARPC's own resources are insufficient to meet claim costs."* (Explanatory Memorandum - page 13)

The reference to the ARPC's "own resources" suggests cyclone claims may be paid using sources other than the cyclone reinsurance premium pool.

To effectively plan our participation and assess the true extent of financial benefit to be achieved, RACQ would like to understand exactly what this reference means.

We would not expect the ARPC's terrorism reinsurance premium pool to be used for cyclone claims as the two pools should be managed separately to respond to very different perils.

The long-term sustainability of the cyclone reinsurance pool depends on the build-up of reserves in years with nil or benign cyclone experience.

RACQ RECOMMENDATION: The ARPC should clarify what "own resources" means in relation to meeting claims costs.

COVERAGE

The exact nature of losses to be recovered could perhaps be the most influential factor in the pool's effectiveness. The "devil will be in the detail" not yet fully known or understood across two key themes:

- Claims period
- Policy and Product

However, what is clear and what must be understood by the broader community is that the pool, as it stands now, will only cover some cyclone-related losses. In fact, depending on the nature and movement of the cyclone, the pool may cover only minimal losses incurred by a cyclone.

Given only part of the cyclone and flood related risk is being transferred to the pool, insurers will need to purchase additional reinsurance from the open market or price the risks directly into premiums to address these gaps. The definition is a new concept and requires established risk models to be adjusted which may create uncertainty. Any uncertainty will lead to reinsurers adding margin which will be passed onto RACQ and eventually passed onto members, reducing the benefits provided by the pool.

Claims period

Under **8F Declarations about cyclone events**, the draft amendments state:

“(1) If the Bureau notifies the Corporation that a cyclone exists or has reintensified, the Corporation must declare that a cyclone event has begun. The declaration must:

- (a) specify the day and time when the cyclone began or reintensified, as notified by the Bureau; and*
- (b) state that the claims period for the cyclone event began on that day at that time.*

Note: If a cyclone ends but then reintensifies, a new cyclone event is declared under this section in relation to the cyclone.

(2) If the Bureau notifies the Corporation that a cyclone has ended, the Corporation must declare that the cyclone event has ended that was previously declared under subsection (1) in relation to that cyclone. The declaration under this subsection must specify:

- (a) the previous declaration; and*
- (b) the day and time when the cyclone ended, as notified by the Bureau; and*
- (c) the day and time when the claims period for the cyclone event ended, or will end, as the case requires.*

(3) The day and time specified under paragraph (2)(c) must be the day and time when the period ends:

- (a) that began on the day, and at the time, specified under paragraph (2)(b); and*
- (b) whose duration is prescribed by the regulations for the purposes of this subsection.” (Exposure draft legislation, pages 10-11)*

The exposure draft regulations state the “duration” relating to 8F (3)(b) is 48 hours, meaning the claims period begins when the BoM declares a cyclone has begun and ends 48 hours after the BoM declares the same cyclone has ended. The claims period can impact on the policy objective in a number of ways.

Firstly, setting the 48-hour period limits the volume and, at times, severity of cyclone-related losses to be covered.

RACQ understands the Government’s policy rationale for proposing this period to be:

- 1) Achieving coverage clarity, to the greatest extent possible, so there is no reinsurance duplication in covers between the pool and the market.
- 2) Focusing coverage to ensure the pool’s benefits are directed at cyclone prone areas.

The second point may be achieved most of the time. RACQ undertook initial analysis of three major cyclones during the past decade to determine how the pool would have responded if it were in place at the time.

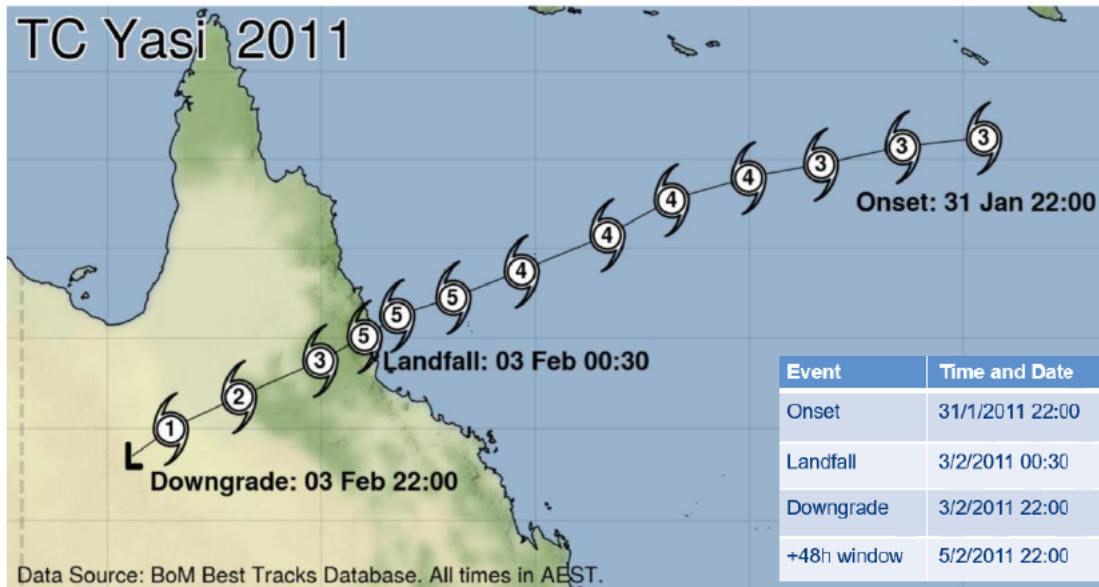


Figure 7: Tracking and timing of Tropical Cyclone Yasi
Source: BoM Best Tracks Database

Cyclone Yasi was category five cyclone in 2011 that cost around \$100 million in claims for RACQ, in today’s terms. TC Yasi was declared by the BoM on 31 January, made landfall at 12.30am on 3 February and was downgraded that night at 10pm. This means the pool’s claims period would have ended on 5 February at 10pm when Yasi continued south-westerly direction. TC Yasi is an example of the pool fulfilling the 48-hour objective as 98% of RACQ’s claims would have been covered.

Cyclone Debbie was a category four cyclone in 2017 that cost around \$75 million in claims for RACQ, in today’s terms. TC Debbie was declared on 25 March, made landfall at 12:40pm on 28 March and was downgraded at 10am on 29th March. This means the claims period would have ended at 10am on 31 March. In addition to wind damage, Debbie inflicted significant flood damage as an ex-TC however most of that damage occurred within the 48-hour period and so 89% of RACQ’s TC Debbie claims would have been covered by the pool.

However, Cyclone Oswald is a different case study. Oswald was only a category 1 cyclone in 2013. However, it was a slow-moving system that brought incredible storm-related damage costing RACQ approximately \$100 million, in today’s terms.

It was declared on 21 January, made landfall at 4am on 22 January but was quickly downgraded. The claims period would have ended at 4am on 24 January.

Because ex-TC Oswald caused most of its damage after the 48-hour period down Queensland’s coastline, the pool would have covered virtually none of RACQ’s claims.

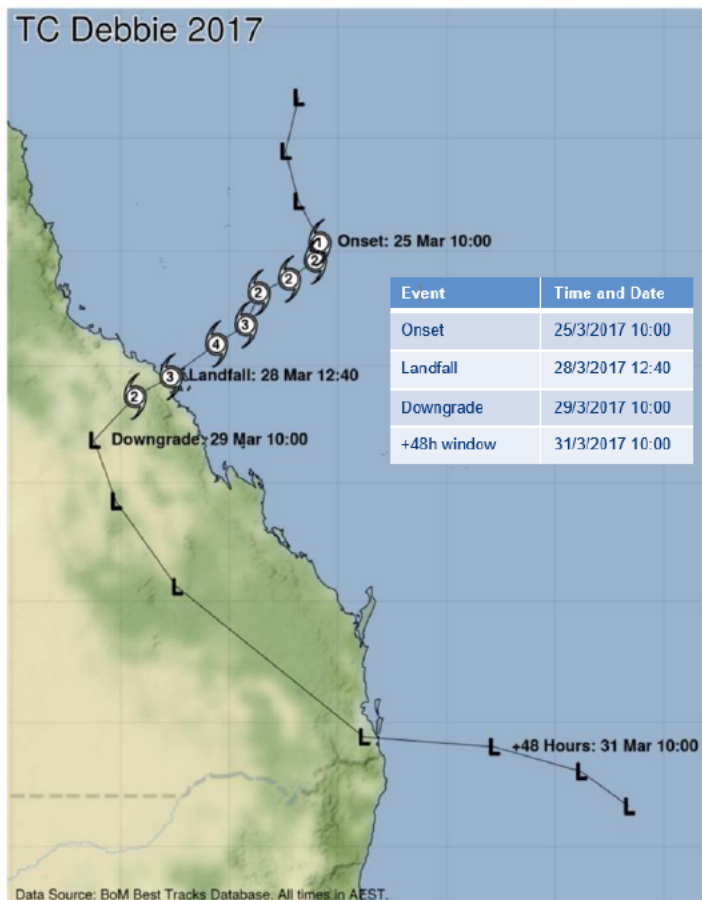


Figure 8: Tracking and Timing of Tropical Cyclone Debbie
Source: BoM Best Tracks Database

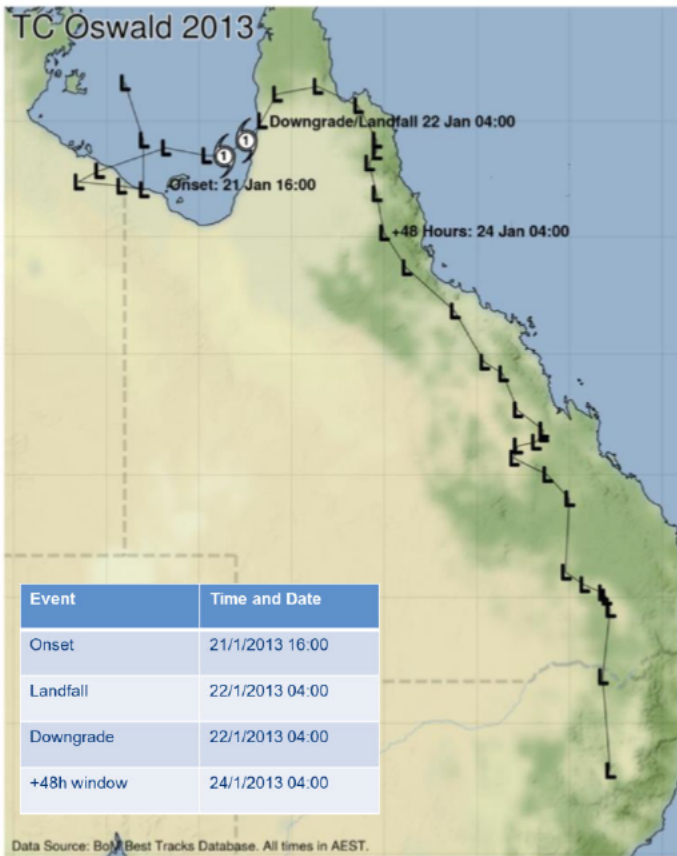


Figure 9: Tracking and Timing of Tropical Cyclone Oswald
Source: BoM Best Tracks Database

By allowing the BoM, via the ARPC, to make the start and end date determination, it is made purely on meteorological terms and the choice of date of loss is taken away from the insurer.

The claims period, as it is defined, is not an approach adopted by the global market and so its alignment with typical reinsurance treaties is yet to be properly tested. Any cover uncertainty or duplication will impact on member benefits.

Currently, an insurer chooses the start and end date of the catastrophe event for the purposes of making a reinsurance claim. Should the insured event last longer than 168 hours (seven days), the insurer is able to choose which seven-day window from which it wishes to recover claims. For example, Ex-TC Oswald, the claim period chosen for the reinsurance claim was 24 January to 30 January.

Interestingly, Oswald was not declared a cyclone when it first made landfall. It was a low-pressure system when it touched in the Gulf of Carpentaria, circled back east of the Northern Territory before intensifying to category one and hitting Queensland. In reading the legislation, the pool presumably would not cover losses caused by a system during the time between reaching landfall and being declared a cyclone.

These examples demonstrate there can be instances where the determination of the claims period can actually work against the policy objective of the pool. Setting seemingly “black and white” parameters for clarity could come at the expense of flexibility so the insurer cannot exercise judgement about when the pool can assist the most.

A “pre-cyclone” system could cause significant flooding or storm surge. Similarly, a slow-moving ex-TC could also cause these impacts after the claims period.

In addition, setting a narrow cyclone definition may be difficult when explaining to the broader community. Perhaps the Taskforce needs to ask itself “What is the community expectation of defining a cyclone?” A homeowner who is impacted by a system either shortly before a cyclone is declared, or after a cyclone is downgraded, is unlikely to appreciate such nuances and semantics and is likely to expect the pool to respond to their situation.

RACQ RECOMMENDATION: The definition of the claims period should be changed to align with standard reinsurance treaties and apply a “168 hours clause” (seven days). However, the seven-day period must overlap with a point in time when the weather event was a declared cyclone to meet the Government’s policy objectives.

The claims period is the leading cause of friction issues detailed in this paper. The closer the pool can move towards standard practice, the less uncertainty will be built into the system. RACQ recognises the Government’s objective to link the pool’s benefits to cyclone prone areas. Anchoring the seven-day period to any time when the event was a cyclone – even a category one – would ensure the pool covers the period when most losses are likely to occur. However, it would also allow for instances where a system is yet to become a cyclone (but making landfall) or has been downgraded and tracking through cyclone prone areas.

Policy and product

RACQ understands the pool will recognise different building policies that cover different perils. For instance, the pricing formula will include a cyclone-only rate for policies without flood or storm surge cover.

It will also provide for a combination of two or all three perils. This decision is supported as it ensures product coverage remains a decision of the insurer and there is consumer choice in the market.

Cover for flooding and storm surge is included in all policies written by RACQ.

However, RACQ is less clear about how, or whether, the pool will recognise different features in different products.

The pool should not hamper product innovation or product competition. If it does not recognise benefits that currently exist in the market it could risk setting off a “race to the bottom”, causing reduction in product covers.

Whether the pool’s coverage is restricted to the sum insured noted on the policy or inclusive of additional benefits can make a significant difference to recoveries. Typical reinsurance treaties cover losses against these features. RACQ provides a range of additional product features beyond the sum insured as detailed in the table below.

Benefit	Limit	Building	Contents
Temporary accommodation	Accommodation costs up to the market rental value of your home prior to the insured event happening.	We pay this benefit on top of your home sum insured.	
Storage costs after an event	Up to 10% of your contents sum insured shown on your Certificate of Insurance.		We pay this benefit on top of your contents sum insured
Lost rent	Up to 10% of your home sum insured or your contents sum insured shown on your Certificate of Insurance.	We pay this benefit on top of your home sum insured, or your contents sum insured or both sums insured depending on which part of your policy you claim under.	
Investigating leaks	Up to 10% of your home sum insured shown on your Certificate of Insurance.	We pay this benefit on top of your home sum insured.	
Gifts	Up to \$1,000 for each claim, or the general limits for your contents shown on page 23.		We pay this benefit on top of your contents sum insured.
Extra living expenses	Up to 10% of your contents sum insured shown on your Certificate of Insurance.		We pay this benefit on top of your contents sum insured
Design	Up to 10% of your home sum insured shown on your Certificate of Insurance in total	We pay this benefit on top of your home sum insured	
Demolition and removal of debris	Up to 20% of your home sum insured (for home debris) or 20% your contents sum insured (for contents debris) shown on your Certificate of Insurance.	We pay this benefit on top of your home sum insured, or your contents sum insured or both sums insured depending on which part of your policy you claim under.	

Counselling services	Up to 6 sessions, \$1,500 in total	We pay this benefit on top of your home sum insured, or your contents sum insured or both sums insured depending on which part of your policy you claim under
Clean up costs	Up to 10% of your home sum insured or your contents sum insured shown on your Certificate of Insurance	We pay this benefit on top of your home sum insured, or your contents sum insured or both sums insured depending on which part of your policy you claim under.

RACQ also notes that motor insurance is not included in the coverage. Its inclusion was recommended in our June submission. We estimate approximately 10% of the total claims cost from cyclones relates to non-home related risk, predominantly motor. RACQ has not been required to “carve out” motor claims from home claims to recover from reinsurers. The added complexity is likely to impose friction costs on the system and dilute member benefits.

In addition, RACQ notes there is no reference in the proposed legislation regarding a maximum sum insured limit for residential properties – only small business properties. Clarification of any sum insured limits for residential properties would be welcomed for clarity and certainty of coverage.

RACQ RECOMMENDATION: The pool’s coverage should match the reinsurance market’s treatment of product coverage, meaning it would cover features and entitlements above sum insured. The pool should also cover other forms of insurance that are impacted by cyclone, particularly motor, as per standard market practice. Clarification of any maximum sum insured limits for residential properties should also be given.

CLAIMS MANAGEMENT

RACQ supports the decision to have insurers continue to manage claims as stated in the Factsheet. This will ensure RACQ can serve, support and assist its members from “end to end”.

The Earthquake Commission’s (EQC) management of the Canterbury earthquakes of 2011 in New Zealand remains a poignant example of why such Government entities should not be involved in claims management.

The earthquakes’ magnitude (1,000+ year event) seriously tested EQC’s operational capabilities. At this time, policyholders were required to deal with both EQC and their private insurance company creating confusion and a lack of transparency for all parties. It was exacerbated with supply and demand issues, forcing serious delays and failures in the referral and assessment of claims, especially when the EQC limit had been, or was likely to be, exceeded.

From lessons learned, private insurers are now responsible for managing all claims from the ground up in order to improve efficiency and effectiveness of claim process as well as the customer experience. The EQC acts only as a reinsurer. Policyholders will only have to deal with their insurer who rely on their own built-in claims operational capabilities. RACQ commends the Taskforce for recognising this important feature of the insurer-policyholder relationship.

However, the pool, in its proposed form, will present challenges in the way RACQ manages claims and supports members impacted by cyclone. In addition, it will potentially lead to further friction costs that do not exist today.

Firstly, the coverage limitations will mean that RACQ will deal with more than one reinsurer after a cyclone event.

Secondly, depending on how the claims period is applied, RACQ could be splitting a claim in two parts to seek recoveries from two reinsurers.

Thirdly, the prescriptive timing of the claims period will change the way RACQ interacts with its members during lodgement, focussing on exact time of loss. This may not only introduce new claims processes but negatively impact the claims experience for members.

Fourthly, ongoing damage that starts during a cyclone and ends after a downgrade will present greater complexity in determining “ownership” of liabilities.

Current reinsurance event loss recovery process

Under current arrangements with a single reinsurance panel, the process to make a claim for recovery is a reasonably straightforward administrative exercise, based on data collected in the insurer’s claims systems.

After a natural hazard event occurs, the insurer monitors the volume and aggregates costs of the claims received within the scope of the event, and if the total cost (including claims handling expenses) is anticipated to exceed the applicable deductible for the reinsurance policy, the event is notified to the reinsurer.

If necessary, the insurer then nominates the appropriate seven-day period of loss “window” according to the standard “hours clause” that provides the maximum recovery opportunity, taking into consideration the distribution of claim lodgements, costs and other factors relevant to their portfolio and the event.

The insurer may make a request for recovery, or “cash call”, from the reinsurer multiple times in the weeks and months following the event, reducing in frequency as time passes. More payments are made and reserves are reduced as individual claims close, and the ultimate cost of the event loss becomes clearer. This iterative process helps in managing the cash flow over time as claims are lodged, assessed and settled.

Internal insurer reports utilise a unique event code to assign the aggregated costs of event driven claims. The amount requested to be recovered is equal to the total payments made on claims for that event in addition to claims handling expenses (CHE), less any ex-gratia and tax components, and less the relevant deductible.

Usually, around three months after the date of loss, the insurer’s reinsurance, finance, analytics and claims management teams form a view of the ultimate net loss (UNL) for the event. This represents an estimated total reinsurance recoverable cost of the event, which is subsequently communicated to the reinsurer, monitored regularly and updated if necessary as forecasts change.

Finally, once all claims have been lodged and settled (which can take many years if there is a prevalence of late lodgements), the final reinsurance recovery is completed and the event is “closed”.

Recovery from multiple reinsurance panels

Due to the specific scope and limitations of coverage provided under the pool, RACQ is likely to require additional reinsurance to manage risk from the exposure gaps that remain. This may result in a scenario where an insurer is making a reinsurance recovery claim from both the pool and a commercial panel of reinsurers for the same weather event.

For example, as described above, Cyclone Debbie (2017) was a severe cyclone when it made landfall at Bowen. If the pool’s timeframe definition is used, the claims period would have ended at 3am on 31 March.

The portion of the loss that incurred within the 48 hours after the cyclone was downgraded would include the cyclone wind damage plus the first 20cm of flooding that occurred.

Clarification is sought on whether the entire claim cost amount from properties that received any damage during the claims period will be recoverable from the pool. Alternatively, will the pool only accept costs from the wind and first 20cm of flooding and then leave the remaining damage (e.g. the next 80cm of flooding) with insurers to recover from their other commercial reinsurance arrangements? In this split example of losses straddling the 48 hours timeframe, there may be a need to engage hydrologists to determine loss allocation at specific points in time. RACQ anticipates this will lead to friction, delays in defining losses and administration in the various reinsurance recoveries. RACQ believes a much cleaner and simpler process is required.

RACQ RECOMMENDATION: The full value of eligible claims should be recoverable from the pool if a portion of loss occurred during the claims period.

In this same Cyclone Debbie example, the inundation that occurred in south east Queensland would be within the 48-hour timeframe, but any losses from flooding that occurred in Rockhampton some days later due to delayed rain flowing from inland catchments, would not be recoverable from the pool. The Rockhampton floods

were caused by the Cyclone Debbie weather system and depending on the seven-day claims period selected by the insurer, would be recoverable under exiting reinsurance arrangements.

This is a potential point of dispute and friction between insurers, the pool, and the other reinsurers. It opens the door to the additional cost and time burden of detailed interrogation and categorisation of individual claims, and potentially scope of works and cost line items, which are not required under current reinsurance arrangements. Any gaps in cover are likely to require reinsurance from the open market which will diminish the intended benefits of the pool.

The administration of multiple reinsurance arrangements for a single weather event will be another challenge that does not exist today. The insurer may need to raise two “event codes” (used for classifying claims for recovery – one for the pool, and others for the commercial reinsurer panels) for a weather event. This adds complexity for reinsurance, accounting and claims management personnel who will need to correctly identify the cause of loss, date and time of loss, validate these against the pool coverage parameters in order to correctly triage and code the claim (or cost line item) and report for reserving and recovery from the pool or other reinsurer panels.

The other option is to establish a single code for any loss related to the weather system and apply business rules and data filtering techniques over the data after the fact to identify which claims or cost line items fall within the scope of pool recovery. Investment in insurer system and reporting enhancements will be required to successfully execute this change.

In the scenario where losses to the same house may fall under two different reinsurance covers, there may be a requirement for the managing builders or restorers to prepare scopes of work and invoice in two parts – works within or without the scope of the pool. This will add effort and cost to the claim, ultimately being passed back to customers in premiums, and eroding benefits made possible through the pool.

Furthermore, secondary mould due to flooding can develop and be identified much later than the original water ingress from the cyclone. This was the case in the Townsville flood event (February 2019) where mould damage following the flood made up a significant portion of claim volumes and costs. If a similar scenario were to unfold with mould appearing more than 48 hours after the downgrading of the original cyclone, the remediation costs could be out of scope of the pool. Again, this relies on the critical time of loss question to be answered correctly by the homeowner, and if outside the pool’s coverage parameters, would result in a multi-reinsurer recovery process being required, with associated challenges as described above.

Regardless of the approach to coding the claims and costs, there will be twice the amount of reporting, monitoring and administration effort required from the insurer to manage the overall recovery process for this event than under current state arrangements with a single reinsurer.

Time of loss

The frictions outlined above relate to the specific time of loss involving the date and time the cyclone was downgraded. RACQ believes under a pool, insurers will be asked to rely on their customers to correctly pinpoint the time of loss, in order to identify whether it was eligible for recovery from the pool. Loss time is not currently a data point required for reinsurance due to the established practice of accepting any claim falling within the 7-day date of loss window nominated by the insurer.

In the interest of public safety, residents are often evacuated to another place of shelter well in advance of the cyclone reaching the area. Homeowners may not discover if their house has been damaged by the cyclone (or related flood or storm surge) until evacuation orders have been lifted and they’ve been able to return home, which can be many days later. It will not only be impossible in these situations to correctly identify the time of loss but could be perceived as an overly specific and insensitive question to ask a distressed RACQ member whose home has been destroyed.

(as above) RACQ RECOMMENDATION: The definition of the claims period should be changed to align with standard reinsurance treaties and apply a “168 hours clause” (seven days). However, the seven-day period must overlap with a point in time when the weather event was a declared cyclone to meet the Government’s policy objectives.

Primary insurer responsible for categorising losses

Under existing commercial reinsurance arrangements, the onus is on RACQ to receive and respond to member claims. We then categorise costs accurately for recovery from the reinsurer. It is widely accepted that the insurer is best placed to undertake this activity, as they have closer relationships to the insured and understand the operational processes that give rise to the recoverable costs.

While there is some monitoring undertaken by the reinsurer of the detailed claims data supplied through the recovery request, it is very rare for reinsurers to challenge the eligibility of claims submitted for recovery.

This practice should be adopted by the ARPC in managing the pool and leave the responsibility with the insurer to appropriately assess claims and costs for recovery. If the ARPC gets involved in specific recovery disputes at an individual claim level, this would likely lead to conflict and confusion between insurer, reinsurer and the pool, with associated time and cost added to the system.

RACQ RECOMMENDATION: Assessing claims and costs for recovery should remain the responsibility of the insurer for the purposes of pool recoveries. The pool recovery process should include “cash calls” consistent with current reinsurance market practice.

SECTION 3: OTHER CONSIDERATIONS

In addition to the key issues, RACQ would like to briefly raise other considerations that could impact on the pool's effectiveness and influence decisions.

PRICE MONITORING

RACQ notes plans to appoint the ACCC as the pool's price monitor as per the Factsheet. We understand the policy imperative to ensure insurers are passing on the full extent of premium benefits that can be attributed to the pool.

However, RACQ would urge the ARPC and the ACCC to design a price monitoring regime that is simple and does not become a costly, heavy-handed exercise that will run counter to the Government's policy objective.

The ACCC's recent Northern Australian Insurance Inquiry was an important investigation that gave the most broad, comprehensive analysis of what is driving high premiums in the region.

It was allocated \$50 million over three years to conduct the inquiry but significant "hidden" costs were borne by insurers participating in the inquiry.

RACQ allocated additional staff to assist the inquiry over its duration. This was equal to four full-time-equivalent staff over three years, costing more than \$500,000.

In addition, approximately \$750,000 was spent on software, systems and legal support to comply with the significant volume of information requests.

Every dollar spent validating premium benefits is a dollar not spent on actual benefits associated with the pool and so RACQ would urge simple audits rather than inquiry-like investigations.

RACQ RECOMMENDATION: The price monitoring regime should be simple and not become a costly investigation that dilutes premium benefits by increasing regulatory costs and therefore, runs counter to the Government's policy objective.

Secondly, RACQ notes the option for insurers to transfer their whole portfolio over to the pool, not just risks not yet written. How the price monitoring regime manages whole-of-portfolio transfers may influence insurers' decisions. Any requirement to retrospectively pass on pro-rata benefits to risks already written may require too much cost and effort as to make these transfers unviable.

Finally, RACQ notes the pool will eventually recognise and reward cyclone and flood mitigation in the home through discounts. This kind of property-level information is currently not available to the insurance industry but would be very useful to better understand policies being underwritten.

RACQ RECOMMENDATION: The ARPC should share with the insurance industry any property-level cyclone and flood mitigation data it uses to provide discounts to policyholders. The ARPC could share this data with the Insurance Council of Australia to upload it onto the existing National Flood Information Database (NFID).

CLAIMS HANDLING EXPENSES

Claims handling expenses (CHE) are a standard feature of overall reinsurance recoveries. CHE is not referenced in any legislative materials and if they are not covered by the pool this will be another friction cost borne by insurers. RACQ understands the ARPC plans to use virtually the same CHE-related clause in its existing terrorism reinsurance contracts. RACQ is still considering whether this clause is appropriate for cyclone claim recoveries.

RACQ RECOMMENDATION: The pool should cover claims handling expenses associated with eligible cyclone-related losses.

EXCESS AMOUNT

Under **Funding claims made under the cyclone reinsurance scheme**, the EM states: “All eligible claims are funded by the reinsurance pool above the policyholder’s excess for cyclone events for the first three years.” (Explanatory Memorandum – page 12)

Excess amounts are a common feature of general insurance policies and often used as an affordability mechanism by policyholders. However, with the pool receiving 100% of eligible cyclone liabilities beyond excess there could be a perverse incentive to dramatically reduce these amounts without checks or balances.

RACQ is interested to understand how the ARPC plans to mitigate the risk of excess amounts reducing en masse across northern Australia which would be an unintended consequence.

SYSTEMS CHANGE

Ill thought-out systems compatibility could impose further unnecessary friction cost on the system. RACQ understands this is top of mind as the ARPC develops its modelling, formula and pricing schedule. In addition to several months, there is likely to be significant cost involved in changing systems to accommodate the pool’s pricing and interact with the ARPC in recoveries and reconciliation.

RACQ would urge ease and efficiency as two key principles when designing pool systems.

RACQ RECOMMENDATION: The ARPC should consult with insurers in the design and implementation of systems to operate the pool.

CONCLUSION

RACQ commends the Government on moving the cyclone reinsurance pool policy closer to reality through the draft legislation. However, we note there is still a lot of work to do on the finer detail, particularly pricing and final design. The Government must next year heighten consultation that is inclusive of the broad industry.

RACQ joins with Government, local representatives and the broader community in wanting to see the pool achieve success and deliver on the policy objective. Our knowledge and experience in north Queensland can lead to meaningful engagement to help reach this outcome together.

We reiterate the need for the pool to run in tandem with significant disaster mitigation to reduce risk over the long term, The pool should be expanded to include motor and align its claims period closer to standard reinsurance practice to minimise gaps in cover.

We remain entirely committed to the interests and wellbeing of our members and the region and so we welcome a pool that will deliver downward pressure on premiums and keep insurance accessible and affordable well into the future.