

July 13, 2011

Natural Disaster Insurance Review

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Ms Christine Barron


Natural Disaster Insurance Review Secretariat

Dear Christine

Please find attached a brief submission in response to the Issues Paper and following on from the Forum conducted on the topic by the Australian Centre for Financial Studies (ACFS) on Tuesday 12 July 2011.

ACFS would be happy to assist the Review in addressing various topics raised in the issues paper (and not covered in our brief submission) should such further assistance be required.

Yours sincerely



Professor Deborah Ralston

Director, ACFS



Professor Kevin Davis

Research Director, ACFS

Submission to the Natural Disaster Insurance Review

1. Natural disasters such as floods cause substantial private costs for individuals and for the communities they affect. Governments and societies will generally respond to such disasters by offering support for those affected, even though individuals may have been able to purchase insurance against such losses. Both insurance and government support are methods of sharing the cost arising from such disasters across the broader community. While it may be the case that government support reflects deficiencies in the availability of insurance, the consequences of such support on private incentives to take actions to avoid or mitigate future disaster costs need to be recognized. This is also the case in considering proposals which involve mandated changes to insurance arrangements (including government or community subsidization of insurance).
2. In thinking about costs of disasters and insurance arrangements it can be helpful to adopt a building block approach of the following form. First, there is the probability of a climatic event (eg high rainfall or cyclone) – which is essentially exogenous. Second, there is the probability of that climatic event creating costs (losses) for some individuals, and which can be affected by their location decisions and by government infrastructure expenditures. Third, there is the scale of the losses which are created, which can be affected by decisions about the type of construction or activity undertaken. Fourth, there is the possibility of affected individuals shifting some part of those losses to society through private insurance arrangements or through government compensation. Arrangements at that fourth stage have implications for the second and third stage. A high cost of insurance for certain locations may lead to individuals not locating in those areas thus reducing the probability of costs occurring, while differential insurance costs for particular building structures etc may lead to choices which reduce the loss incurred. Alternatively, belief that governments will compensate for loss, reduces such incentives and can increase social costs arising from the climatic events. That effect also arises if insurance is subsidized.

3. But there are other issues which are also critically important. Governments can take actions to reduce the probability of climatic events creating costs. This includes such activities as flood management schemes or restrictions on locating within flood prone areas. Restrictions on types of buildings allowed via building codes can also reduce the costs arising.
4. Those interventions by government may be justified on the grounds that individuals are unable to appropriately assess the risks and costs associated with location decisions. In principle, property values should be lower in high risk areas reflecting the higher risk of loss, and individuals may decide to locate in high risk areas because of willingness to bear that risk, or because they are able and willing to mitigate that risk through (higher cost) insurance for that location. However, it is arguable whether individuals have adequate information about the level of risks, and lower income individuals may be induced to take on such risks because of their inability to afford alternative locational choices. It may also be the case that affordable insurance is not available.
5. These comments point to the three issues which are particularly relevant for consideration of alternative policy strategies. First, availability of reliable information is important to ensure informed decisions. Second, to the extent that informed private decisions will not be made (or will involve spillover social costs), government authorities need to make appropriate decisions about restrictions on, or requirements for, construction decisions in high risk locations. Third, if adequate insurance is not available, what is the source of that market failure and how can it be corrected?
6. An absence of sufficient information about levels of risk is a potential source of market failure affecting both the availability of insurance (if insurers are unable to adequately assess risk) and the location and insurance decisions of individuals. Because there is a public good element to the creation of such information, there is an argument for government production of such information. However, while that can improve the supply-side of the insurance market, it is not apparent that all individuals will be able to fully assess the implications of that information for the risks they face.

Consequently there is likely to remain an important role for government restrictions on, or requirements for, construction and location decisions –and particularly so if those decisions involve spillover effects for society. These could arise if inadequate take up of insurance leads to government compensation for those suffering losses.

7. To the extent that some form of government intervention in the insurance market is required because of such spillover effects, there are several possible approaches. First, where low frequency, high cost events affect only a small proportion of the population, the ability of an insurance market to operate to spread risks widely is hampered by adverse selection issues. Those at high risk will tend to elect for insurance, but those with low risk will not, pushing up the premiums for cover. While this is consistent with an efficient market outcome, whereby the lower market value of properties with high risk is offset by higher insurance costs, and will inhibit new constructions in high risk locations, there is a legacy issue associated with existing high risk properties.
8. Any proposal to assist those in existing high risk situations to meet insurance costs needs to take account of two factors. First, subsidization of insurance costs will increase the market value of the properties involved – providing a once-off gain to the owners of those properties. There is no apparent reason for the granting of such a benefit. Consequently, *it would appear appropriate that any insurance subsidization should only apply to high risk properties until they are sold by the current owner (or heirs) to independent third parties (“sale-date termination”)*. That would prevent any arbitrary increase in the wealth of those receiving the subsidization, while enabling them to obtain affordable protection from risks. The second factor is that incentives for remaining in high risk areas should not remain in place over the long run. The suggestion made above of “sale-date termination” of insurance subsidy would be one way of achieving that.
9. Even where subsidization does occur, there is no guarantee that individuals in high risk situations will take up such insurance or may be underinsured. Compulsion to take on insurance is unlikely to be an acceptable proposition and is at variance with

the fact that individuals have different levels of risk aversion, or ability to cope with the consequences of particular risks – such that some individuals may not view (even subsidized) insurance as beneficial. However, to the extent that it is believed that (a) there are spillover costs for society from underinsurance (arising from political inability of governments not to provide compensation) or (b) some form of paternalism is warranted to prevent individuals making poor financial decisions, there may be a case for some form of “quasi-compulsion”. That could be effected (along lines similar to the situation with medical insurance) by schemes whereby individuals face some form of cost if insurance is not taken out – such as by higher council rates for those unable to produce evidence of adequate insurance.

10. A further issue concerns the appropriate design of insurance contracts, whereby insurance is provided in a single policy for loss against a range of risks (fire, cyclone, etc), and where the probability of such events varies across policy holders. The absence of, or uncertainties about inclusion of, flood cover in some policies is a particular concern given the perception that most individuals are not fully cognizant of what coverage is included. Given the informational problems, there would seem to be merit in government or industry specification of a standard range of risks to be available for cover in household policies written by registered insurers. In this regard, an important issue is whether policies should be designed and presented with “opt-in” or “opt-out” conditions for coverage against certain events. Behavioral finance suggests that specification of default options has significant effects on choice, with a tendency for individuals to be biased towards the default option. In that regard, if it is felt that potential non-insurance of flood cover is an important social problem, there is potential merit in requiring such cover to be part of the default insurance contract, but with an option for opt-out by individuals. To facilitate that, however, it is important that insurers have adequate information to be able to accurately price such cover.
11. There is a range of other issues raised by the Issues Paper which are not considered in this brief submission, but which the Australian Centre for Financial Studies would be happy to assist the Panel with in its deliberations if required.