

# Submission to Natural Disaster Insurance Review

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## Introduction

Firstly I should like to congratulate the panel on the outstanding quality of the issues paper. It is very clear and comprehensive. The issues have been very well presented and have been carefully thought through. Suggestions for the future are very clever and will solve most of the current problems. They will provide good incentives for mitigation, which everyone agrees is very important.

## Overall Objectives of Future System

1. Availability of affordable full natural disaster cover for everyone.
2. Protection of the weaker members of the community.
3. Elimination of the potential for disputes.
4. Incentives for authorities to (a) carry out mitigation activities, and (b) not add to the current pool of high risk properties.

## Models for the Future

1. Compulsion

I still believe very strongly that natural disaster insurance should be compulsory.

Australia is a relatively rich developed country. It has established institutions with sophisticated mechanisms. Protection of peoples' physical and financial well-being through a multitude of legislative instruments is embedded in our social fabric. We have universal health care, social security, and retirement income through the taxation system. Other protections are provided by the private sector but subject to legislative requirements.

The paper identifies that, in the field of insurance, compulsion only exists for the protection of third parties (CTP and workers compensation). I would argue that a homeowner is a type of third-party -- the other parties being the local council which gives approvals and the State government which manages the environment. The risk rating of particular properties is mainly dependent on the actions of both those two bodies. **The reality is that most homeowners in flood prone areas are innocent victims of past unfortunate decisions of councils.**

Couple that with the fact that the majority of tragic financial problems which are suffered in natural disasters occur to the less advantaged members of the community. Those people are simply unable to properly protect themselves in a voluntary system.

I believe that the community has an interest and a duty to ensure that their weaker members do protect themselves by accepting the need for a compulsory system.

The paper identifies that 96% of homeowners have home insurance by choice. My guess is that the majority of less advantaged people are in the other 4%. I suspect that would remain the case if either of the models suggested by the panel come into being. Those people simply do not have the necessary skills to benefit from a voluntary system. Compulsion would create no disadvantage to the 96%. The only people disadvantaged by compulsion will be a small number of people in the 4% who are not "less advantaged" and who are sophisticated enough to prefer to self-insure. I do not believe it is unreasonable to expect that small number of people to accept compulsion as the cost of looking after the weaker members of the community.

Having said that I recognise that compulsion is outside the terms of reference of the panel. I also seriously doubt that the Commonwealth government would have the courage to impose compulsion. On the other hand it is more politically possible that the Queensland government could impose compulsion on the residents of Queensland because most of that state suffers natural disasters on a very regular basis.

In a compulsory system the issue of monitoring compliance arises. Monitoring would be relatively easy through the council rating system. Every homeowner has to pay rates to the local council and could be required to provide a yearly certificate from the insurance company and confirmation. The future is increasingly electronic and there could be direct linkage between councils and insurance companies to obtain confirmation electronically.

## 2. Automatic Cover in Voluntary Home Insurance

Since compulsion is very unlikely, then this model is actually very clever and does solve a lot of the problems (although it still leaves the weaker members of the community exposed).

I believe that the cover which should be included should cover all types of natural disaster -- not just floods. The paper suggests that sea incursion is a problem for insurers. However, I believe that in the context of this model the insurance industry is capable of solving those problems. When a river breaks its banks it can be caused by a combination of upstream heavy rain coupled with a king tide and offshore severe storms. If sea incursion is not automatically included in such a situation there will be arguments about the actual cause and bitterness, emotion, and negative publicity when claims against riverine flood are denied. I believe that the elimination of disputes in future should be a priority objective.

## 3. Automatic Cover with Opt Out

I am opposed to this model for more or less the same reasons as I favour compulsion. It will be the weaker members of the community who tend to opt out and hence this model leaves the weaker members of the community exposed.

Also, as the paper identified, the potential for disputes will remain and their elimination should be a priority.

## **Subsidy**

In my submission to the Queensland Commission I expressed strong objection to the idea of subsidy. However, I was thinking of this in the context of a universal premium, or community rating, for flood insurance (i.e. not risk related). This would have involved owners of low-risk properties subsidising the high risk. I am still strongly opposed to low-risk owners contributing to a subsidy through their insurance premiums.

Having read the issues paper I have changed my mind and I now fully support the principle of subsidy for high risk homes.

All existing homes in flood prone areas were approved by the local council. As a result the council is at least partly (and in many cases mainly) responsible for the high risk rating of the property. They should be accountable and should contribute significantly to the subsidy. The State government is responsible for land allocation and the overall environment and, in particular, the level of flood mitigation which exists. They, along with the council, have a responsibility to progressively improve flood mitigation in the future. They should contribute to the subsidy to give them an incentive in this regard to reduce risk ratings in the future and thereby reduce the amount of subsidy required. As the paper says, the owner, the council, and the State government should have "skin in the game".

Of course this means that ratepayers and tax payers will be contributing to the subsidies. However, councils and State governments are answerable to them through the ballot box.

To enable councils to understand the consequences of their decisions I suggest that it is imperative that the administrative process established should provide councils with a listing of the properties on which they are paying a subsidy and the amount of that subsidy. This will require an extra processing effort compared with an overall averaging approach but in view of the small numbers of properties involved I do not think that should be an impediment. It will also give councils the opportunity and incentive to consider whether it would be more sensible to resume clearly uneconomic properties.

The issues paper suggested that future homes should not be eligible for a subsidy. I disagree with that. Councils remain responsible for building approvals and they should have an incentive to act responsibly. Similarly State governments have the ongoing incentive for future flood mitigation works. I suggest future homes should be eligible for a subsidy but at a lower level than existing homes -- possibly 50%.

I believe the less advantaged, and hence weaker, members of the community should have stronger protection than the more advantaged. I believe there should be some form of regressive discount scale which gives lower value homes a greater relative discount than higher value homes. I realise this will add a level of complexity. However it is important in the interest of social justice. I have not given a great deal of thought as to how this can be achieved in practice. There will be two known values for each property -- rateable value and insured value. Either or both of these could be

used to develop a sliding scale. The rateable value does of course apply to the land, not the home which is being insured. However, it may well reflect where the owner sits on a scale of advantage. Rateable values are, of course, affected by location. For example Sydney values are much higher than Bendigo values. Construction costs are much less variable by location which tends to suggest that insured values should be used for this purpose.

### **Subsidy Funding**

I believe the funding of the subsidy should be shared between councils and the State governments. I believe it should be directly related to the high risk properties in their area of responsibility. I have not been able to form an opinion about their relative shares. I think this can only be done by looking at estimates derived from modelling.

I do not believe the Commonwealth government should be directly involved in funding the subsidies. It will always be there as "banker of last resort" and this should be done through the overall financial arrangements between the Commonwealth and the States which are reviewed yearly.

### **Flood Insurance Pool**

I strongly support the principle of an independent body being created to carry out the types of functions suggested in the paper. However, I do have preferences about a number of these functions.

Firstly I believe the body should deal with all natural disasters in the same way -- i.e. including bushfires, cyclones, etc. As a result it should be renamed **Natural Disaster Insurance Authority** (or something similar). For the rest of this submission I will simply use the term "The Pool".

Philosophically I believe that market forces, or private enterprise, should drive as many functions as possible. Government run institutions do not have a good track record for being well-run and as much as possible should be done by the competitive insurance industry. However, there are clearly issues of efficiency (avoiding duplication), integrity, equity, etc which would be better centralised in The Pool. In the process The Pool should operate to facilitate a competitive market.

I would prefer the functions of The Pool to be :-

1. Act as a reinsurer of natural disaster risks -- i.e. the insurance companies will retain the risks and will handle and pay all claims. They will reinsure risks above their retention level with The Pool. The financial arrangements for this will have to be structurally sound. I am confident that experts can work out the details.
2. Act as the central agency for collecting subsidies from councils and State governments and passing them to insurance companies. In the process provide the detailed information to councils about the high risk properties in their area.
3. As suggested in the paper -- function as a national disaster risk information repository. It should make all such information freely available.
4. Identifying properties which are classified as at high risk from natural disasters and set the " assessed risk rating" for each. The ratings should be compound -- i.e. take into account both the probability of the event and the construction of the property

which will affect likely repair costs. These ratings should be available to all insurers. The ratings should be subject to review and reassessment when changes such as mitigation works are carried out. Insurers can still compete by adjusting ratings if they want to.

5. Set the subsidy threshold and other parameters needed for the whole system to work properly (e.g. rebuilding cost factors needed for preventing under insurance -- see my comments below).

### **Subsidy Threshold**

I cannot fully grasp the implications of the differences between the engineering system and the pricing system suggested. However, for reasons stated above, I have a philosophical preference for a market-based system which leads me to favour the pricing system.

### **Preventing Under Insurance**

I believe it is as important to prevent under insurance as it is to ensure that the whole population has insurance against natural disasters. Even if insurance itself is not compulsory (i.e. one of the panel models prevails) I believe there should be a statutory requirement that insurance taken is "adequate".

Ideally I would favour a "replacement cost" system. However, as the paper identifies, this can lead to disputes. I believe that creating a system which eliminates disputes is a high priority of this whole exercise. As a result I support a "sum insured" system.

I suggest that insurance bought must be for a minimum sum insured based on factors set by The Pool. The Pool should set replacement cost factors based on location, construction type, construction materials, etc. This will eliminate the current variation between advisory models used by different insurance companies. There should also be a specified margin to cover inflation during the insurance period and relocation costs during reconstruction. Insurance companies can ensure that at least the minimum is taken based on size, etc. Individual owners can insure for higher amounts than the minimum based on factors such as above-average quality levels.

### **Shared Ownership**

In principle the same rules should apply to properties involving shared ownership such as strata title and the like. I acknowledge that there are additional complexities and their solution will require additional effort. Possibly implementation for these types of properties could occur as a second stage to give time to solve the additional complexities.

### **Small Business**

During the dramatic TV pictures in the Brisbane flood I could not avoid sharing the suffering of the "corner shop" which was fully flooded as much as the suffering of the "battler" homeowner. Although I accept the points made in the paper that business owners should have business plans, professional advisers, etc the reality is that people who run convenience stores in flood prone areas are generally just as unsophisticated

and battlers as the residents around them. I believe they should have the same opportunity for protection and insurance subsidy as those residents and the same principles should apply -- i.e. natural disasters should be standard inclusions and they should be entitled to the same level of subsidy based on the level of cover they take but without the requirement for a minimum sum insured. This will at least give them an incentive to insure for full cover.

### **Contents**

I believe that the same principles should apply to contents cover -- i.e. eligibility for subsidy -- based on the amount of cover bought and without the requirement for a minimum sum insured which would be impractical. Again this will, at least, give an incentive to ensure. Further, the whole proposed framework will make people more aware of the need.

### **Flood Mapping**

I believe that flood mapping should be completed at public expense within a reasonably short time frame. There should be a national standard and regular updates. There should be a process for feedback of mitigation steps taken. The process should be extended to other forms of natural disaster. The information should be freely available. I have no sympathy with those homeowner's objecting to this information becoming public because it "might damage the perceived value of their home". In effect they are really trying to defraud possible future purchasers. However, with a system of compulsory subsidised insurance it seems to me that values should not be affected except possibly marginally.