



Australian Government

Reforming flood insurance A proposal to improve availability and transparency

Consultation paper
November 2011

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CONSULTATION PROCESS

Request for feedback and comments

The Government is seeking your feedback and comments on the proposal outlined in this consultation paper requiring all insurers to offer flood cover in home building and home contents insurance policies, while allowing consumers to 'opt out' of flood cover.

The meaning of flood used in this paper is consistent with the definition proposed in the consultation paper 'Reforming flood insurance: Clearing the waters', namely:

'Flood means the covering of normally dry land by water that has escaped or been released from the normal confines of:

- (a) any lake, or any river, creek or other natural water course, whether or not altered or modified; or
- (b) any reservoir, canal or dam'.¹

This proposal is part of a package of measures aimed at improving the availability and transparency of flood insurance. Other proposals that form part of this package are the flood risk information portal, the Key Facts Sheet and the standard definition of flood.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 30 March 2012

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¹ Department of the Treasury 'Reforming flood insurance: Clearing the waters', 2011.
http://www.treasury.gov.au/documents/1995/PDF/Reforming_flood_insurance.pdf

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FOREWORD



As a new Assistant Treasurer, last summer I asked myself: why does it take disaster to so consistently bring out the best in our nation?

In this great continent that we call home we are witness to the physics and chemistry of mother nature working their way across Australia in a way that makes you question that famous tag, 'lucky', attached to our country. But if we remain strong and resolute in the way that we pull together perhaps 'lucky' is still the best way to think, despite all that brutal water, wind and fire. In doing this though we should of course never take our communal good fortune for granted.

Perhaps in some unexpected, unsought and undesired way natural disasters do tend to help us in Australia to rediscover and remind us of our greatest strengths.

Australia rallied following the series of devastating storms, floods and cyclones in late 2010 and early 2011. But knowing system improvements were needed on 4 March the Australian Government commissioned the Natural Disaster Insurance Review (NDIR), an independent review of issues relating to natural disaster insurance in Australia. The Government has now released the final report of the NDIR and its response to that Review.

The Government is proposing a series of measures responding to the report's recommendations.

The Government will provide a single access point to existing flood mapping data — a portal to be hosted by Geoscience Australia. The portal will be complemented by the development of national guidelines that will cover the collection, comparability and reporting of flood risk information. The portal will provide a central point through which consumers and other interested parties will be able to obtain information about flood risk. It is intended that this initiative will, over time, result in a nationally consistent and improved understanding of flood risk in Australia for purposes such as land use planning, emergency management, mitigation, insurance and public education. Specifically, it will facilitate insurers providing flood cover.

The Review made a number of recommendations for changes to the General Insurance Code of Practice to improve insurers' handling of claims and disputes relating to natural disasters. The Government has commenced discussions with the industry on the merits of implementing these changes and has asked the industry to provide its views to the Government by the end of February 2012.

Through this consultation paper, the Government is seeking submissions on a proposal requiring all insurers to offer flood cover in home building and home contents insurance policies, while allowing consumers to 'opt out' of flood cover. This proposal means that consumers would always have the option of flood cover available to them, regardless of which insurer they choose, and would need to make a conscious choice about whether or not to purchase flood cover. The Government is seeking views from stakeholders as to whether this proposal could improve the availability and transparency of flood insurance and, ultimately, flood insurance penetration. The Government is also seeking to understand what costs are associated with implementing the proposal.

The intention of the proposal is for consumers to confront the flood risk they face by way of insurance premiums, and to be provided with information which they can use to make a considered choice about whether to purchase flood insurance. This consultation paper seeks to identify issues with the proposal and invites feedback from all stakeholders. The feedback provided will be used to inform the Government's considerations of this proposal.

This proposal would also complement several other recently announced measures aimed at increasing consumer awareness about flood risk and insurance in order to assist consumers to make informed decisions about how to manage their flood risk. These include a standard definition of flood and a one-page Key Facts Sheet. These measures have already been consulted on.

The Government has announced that it will introduce a standard definition of 'flood' which all insurers will be required to use if they offer flood cover to consumers in home building and home contents insurance policies, in a defined class of small business insurance policies, and in strata title insurance policies. Draft regulations, setting out a standard definition consistent with the form proposed in the 'Clearing the waters' consultation paper, will be released for consultation before the end of the year.

The Government will also require insurers to provide their customers with a Key Facts Sheet for all home building and home contents insurance policies. This will clearly set out, in a single page, all key information about the features of the policy. The Key Facts Sheet will complement the existing Product Disclosure Statement regime and was endorsed by the Review.

A further consultation will occur in 2012 on the recommendations in the Review's final report relating to the introduction of a system of premium discounts and reinsurance, once further design work has been undertaken.

It was without doubt a very Australian Christmas break last summer, albeit one to break the heart. We are warned in our national verse of the droughts and flooding rains, the far horizons and the beauty and terror which make up our national story. Yet it is comforting, in an odd way, when we recognise that a terrible beauty is born too. Australians were there for their friends and for strangers during all the anxiety — many risked their lives for the property and lives of others.

So in reaffirming this communitarian spirit nearly a year after the storms, I encourage all stakeholders to engage in the Government consultation processes, including by making a submission in relation to the substantial proposals outlined in this paper.

The Hon Bill Shorten MP
Assistant Treasurer and Minister for Financial Services and Superannuation

BACKGROUND

Following the flooding that occurred in many regions of Australia in late 2010 and early 2011, it became apparent that many policyholders did not have flood cover or had cover which only partially covered flood. Of these policyholders, many were unaware of this fact until making a claim. A significant proportion argued that they would have purchased a policy which included flood cover, if they had been aware that they were not covered.

For most natural disasters other than flood, insurance cover has been widely available in Australia for many years. This includes cover for storm damage, including related water damage. The distinction between water damage caused by storm and water damage caused by flood is confusing to many and has resulted in considerable distress and financial loss for those impacted by flood but without flood cover. This is particularly the case when policyholders only find out they do not have flood cover once their claim has been denied.

To address the issues of flood coverage, the Natural Disaster Insurance Review considered several options to increase the availability and affordability of flood insurance, one of which was to require all insurers to offer cover for flood, but with consumers being able to 'opt out' of this cover. The Review did not recommend this option, but noted that it would increase consumer awareness about whether their policies cover flood and that it may lead to some increase in the take-up of flood insurance.²

The Government has decided to consult at this time on the proposal because it would contribute to greater consumer awareness of flood risk and flood cover, and for a large proportion of households with low flood risk, it may contribute to increased rates of coverage for flood. Nevertheless, there may be costs and unintended consequences associated with this proposal which the Government wishes to fully understand before deciding on whether or not to progress this option.

The proposal requiring all insurers to offer flood cover in home building and home contents insurance policies, while allowing consumers to 'opt out' of flood cover, complements the Government's Key Facts Sheet and would ensure that consumers are aware of whether or not their policy includes cover for flood. The proposal also complements the initiative to introduce a standard definition for flood because all insurers would be required to offer flood cover which is consistently defined.

² Natural Disaster Insurance Review Issues Paper, pp 9-11.
<http://www.ndir.gov.au/content/issuespapers/NDIRIssuesPaper.pdf>

THE PROPOSAL AND THE OBJECTIVES

The proposal

The proposal for consultation is that all insurers be required to offer flood cover in home building and home contents insurance policies, based on a standard definition of flood. However, insurers would be able to choose whether to give consumers the option to 'opt out' of flood cover.

Specifically, some insurers may choose to allow consumers to 'opt out' of flood, while others may simply offer insurance which always includes flood cover. Where consumers with a flood risk are given the option to 'opt out' of flood cover, insurers must inform those consumers that they have a flood risk.

This would ensure that all consumers are given the option of purchasing flood cover at the point of sale and renewal.

The objectives

The proposal has been designed to meet two key objectives:

- to increase the availability of flood insurance by requiring insurers to offer flood cover in all home building and home contents insurance policies; and
- to focus consumer awareness on flood risk and whether their policy provides flood cover.

Achieving these objectives may lead to increased flood insurance penetration in the market, particularly for those at low to moderate risk of flood.

Discussion

The 2010-11 floods highlight several issues with the provision of flood insurance in Australia. Firstly, there are varied definitions of flood used by insurers, which has made it difficult for consumers to compare policies and understand exactly what cover for water damage is extended to them under their policy. Secondly, not all insurers provide full flood cover (for example, policies may specifically exclude flood damage or flood claims may be subject to sub-limits). Thirdly, where flood cover is excluded or limited, consumers may be unaware of this.

This proposal is being considered as part of a package of measures aimed at addressing the above concerns to resolve issues around the availability and transparency of flood insurance. The other proposals that form part of this package are the flood mapping data portal, the Key Facts Sheet and standard definition of flood.

Requiring all insurers to offer home building and home contents insurance policies which include flood cover would ensure that flood cover is universally available in all policies. Currently, insurers are able to exclude flood cover so long as they clearly inform the consumer of the exclusion in writing in the Product Disclosure Statement.

Requiring consumers to 'opt out' of cover rather than 'opt in' is preferred, as it forces consumers to confront their flood risk and explicitly make a choice about whether to purchase flood cover at every insurance purchase and renewal. It would therefore ensure that all consumers are aware on an ongoing basis about the flood coverage extended to them under their insurance policies, and that they potentially face a flood risk.

Roughly 93 per cent of Australian households have no flood risk. Under the proposal, it is anticipated that insurers would automatically cover these households for flood. If these households were offered the option of 'opting out' of flood cover, it is expected most would not do so.

For the remaining 7 per cent of homes which are subject to flood risk, there would be higher premiums if flood cover is provided. The flood risk premium for the majority of these homes is likely to be modest and most would be expected to take up flood cover. For the 2 per cent of homes at high and extreme risk of flooding, flood risk premiums are likely to be significant and this is expected to impede the take up of flood cover.

For high and extreme flood risk homes, various mitigation and adaptation measures may be a more cost effective method of managing risk than insurance.

The following issues associated with this proposal will be explored in further detail in this consultation paper and the views of stakeholders will be sought to assist the Government in determining whether this proposal would meet the objectives of increased flood insurance availability and transparency for consumers:

- likely increases in awareness (or transparency) about flood cover;
- likely increases in the availability of flood insurance;
- likely increases in the take-up of flood insurance, including as a result of increasing awareness about flood risk and flood cover, and availability of flood insurance;
- industry capacity to underwrite flood risk;
- the cost to the insurance industry, and ultimately consumers, of implementing the proposal;
- what an appropriate transitional period should be for such a proposal to be introduced;
- the nature of amendments required to relevant legislation;
- what assets should be covered; and
- appropriate sub-limits and/or excesses associated with policies providing flood cover.

The Government will release another consultation paper on the Natural Disaster Insurance Review's proposal for a flood reinsurance pool and system of discounts, once consultation on this proposal has been completed (this will be in 2012).

CONSULTATION QUESTIONS

OPERATION OF THE PROPOSAL IN PRACTICE

As previously stated, the proposal would require all insurers to include flood cover in home building and home contents policies which they offer to consumers. Including flood cover in these policies would be achieved through quoting a price for cover, inclusive of flood, at the initial point of sale and renewal.

This proposal is different from current practices, whereby insurers are not required to include flood cover in their policies so long as the exclusion is clearly stated in the Product Disclosure Statement.

In addition, flood would be defined consistently across all policies, being based on a standard definition of flood, for example, taking the form proposed in the consultation paper 'Reforming flood insurance: Clearing the waters':

'Flood means the covering of normally dry land by water that has escaped or been released from the normal confines of:

- (a) any lake, or any river, creek or other natural water course, whether or not altered or modified; or
- (b) any reservoir, canal or dam'.³

While the proposal would require insurers to offer flood cover in all home building and home contents policies, insurers would be able to choose whether to give consumers the option to 'opt out' of flood cover. If insurers chose to give consumers the option of opting out of flood cover, the way in which this would occur would be at the discretion of the insurer, provided that there is an initial offer of insurance which includes flood cover. For example, insurers might:

- initially provide two quotes to consumers, one inclusive of flood cover and one exclusive of flood cover; or
- provide one quote to consumers inclusive of flood cover, and require that the consumer contact the insurer for an additional quote without flood cover if they so choose.

As long as insurers provide consumers with the option of purchasing flood cover at the initial point of sale or renewal, they would comply with the requirements of the proposal. For example, insurers who include flood cover in their home building and home contents policies but do not give consumers the option of 'opting out' would comply.

Where consumers with a flood risk are given the option of 'opting out' of flood cover, insurers would also be required to inform those consumers that they have a flood risk. For example, for internet quotes of insurance a statement could be presented along the lines of:

³ Department of the Treasury 'Reforming flood insurance: Clearing the waters', 2011.
http://www.treasury.gov.au/documents/1995/PDF/Reforming_flood_insurance.pdf

'your home has been assessed as having a flood risk. We have automatically included flood cover in your quote. If you would like to exclude flood cover, you can do so by selecting the quote without flood cover/contacting us on ...'

A circumstance in which an insurer would not comply with the requirements of the proposal would be where it offered a quote for insurance which did not include flood cover but gave the consumer the option to contact the insurer in order to get a quote for insurance with flood cover. This circumstance would require the consumer to 'opt in', rather than 'opt out'.

Questions

What other ways could insurers implement the proposal?

What other ways could insurers inform consumers about flood risk? How could this be implemented?

What might be the most effective way for insurers to implement the proposal in terms of engaging consumers in electing to take insurance with or without flood?

How could the proposal to inform consumers of their flood risk be implemented?

INCREASING THE AWARENESS OF FLOOD RISK AND FLOOD COVER

Requiring all insurers to offer flood cover and consumers to explicitly 'opt out' of coverage each year may result in many policyholders purchasing flood cover where previously they were unaware that their policies did not cover flood.

Furthermore, requiring consumers to explicitly 'opt out' would force consumers to confront that they are subject to flood risk each time they purchase or renew their insurance.

The Government understands that flood risk information is increasingly becoming available to consumers, with several State and local governments implementing measures to make flood risk information publicly available. For example, the Brisbane City Council in 2008 released its flood risk information which is accessible by consumers on their website. Similarly, the Ipswich City Council recently published similar flood maps on its website indicating the flood level of both the 2011 and 1974 floods.

The Government's initiative to provide a single access point to existing flood mapping data — a portal to be hosted by Geoscience Australia — will enable consumers and other interested parties to obtain information about flood risk. The portal will be complemented by the development of national guidelines that will cover the collection, comparability and reporting of flood risk information. These measures will serve to improve access to available data and lead to a more consistent approach to data collection across the nation.

Questions

What benefits are there in offering flood cover to all consumers with an ‘opt out’ option? What benefits are there in using insurance premiums to provide an indication of flood risk to consumers?

What information would consumers require to make reasonable decisions as to whether or not to ‘opt out’ of flood cover? Is this information readily available? Are consumers able to adequately assess this information?

What initiatives would be required with respect to consumer education and financial literacy to assist consumers to make appropriate decisions with respect to ‘opting out’ of flood cover?

INCREASING THE AVAILABILITY OF FLOOD INSURANCE

The Insurance Council of Australia suggests the number of at-risk residential addresses, on a state by state basis, is as set out in the table below. Clearly properties in every state in Australia have some exposure to flood risk. Awareness of flood risk will better equip property owners to take measures to mitigate that risk, including assessing their insurance needs.

Distribution of residential property flood risk by State

Flood Risk Return Period (years)	Extreme >1:20	High 1:20 — 1:50	Medium 1:50 — 1:100	Low 1:100 — Probable Maximum Flood
NSW	68,913	24,929	16,874	3,860
QLD***	8,794	18,610	17,912	51,506
VIC	3,860	5,757	4,297	10,239
SA	1,927	787	7,848	49,576
WA	206	124	171	10,000
TAS	110	89	15	4,100

*** Only data for Brisbane, Gold Coast and several smaller catchments have been provided to ICA, QLD data is therefore under-quoted — modelling suggests that this is 60 per cent-70 per cent of exposed addresses.

Source: Insurance Council of Australia submission to the Natural Disaster Insurance Review, p8.

By increasing the availability of flood insurance, it is envisaged there could be increased take-up by consumers. For the 93 per cent of homes which are subject to no flood risk, the increase in take-up of flood insurance should be near universal as insurers would not need to collect additional premium to cover the risk.

For the remaining 7 per cent of existing homes who do face some flood risk, rates of take-up are likely to differ according to risk and the corresponding premium required to cover the risk. The following table illustrates the distribution of flood risk across Australia and estimates premiums for flood cover for home buildings. The premiums in the table are a conservative estimation of the cost of flood premiums, calculated simply as a product of the average claim size and probability of flooding. They do not include state taxes or take into account the distribution of costs at different flood levels, nor are they inclusive of contents.

Distribution of flood risk in Australia and estimated flood premium

Risk Band	Frequency of flooding (ARI)	Number of properties	Number of properties as percentage of total*	Probability of flooding pa	Average claim size (\$)	Flood risk premium (\$)	Annual cost of flood (\$m)
No flood risk	Nil	6,174,912	93.32%	0%			
Low	Greater than 111	276,277	4.18%	0.19%	40,242	77	21
	Total low	276,277	4.18%	0.19%	40,242	77	21
Medium	111 to 105	3,509	0.05%	0.93%	40,849	378	1
	105 to 100	3,081	0.05%	0.98%	40,895	399	1
	100 to 67	25,292	0.38%	1.25%	40,544	507	13
	67 to 50	18,483	0.28%	1.75%	41,475	726	13
	Total medium	50,366	0.76%	1.39%	40,928	572	29
High	50 to 40	14,092	0.21%	2.25%	42,333	952	13
	40 to 33	12,149	0.18%	2.75%	43,269	1,190	14
	33 to 29	8,160	0.12%	3.25%	43,557	1,416	12
	29 to 25	9,373	0.14%	3.75%	43,979	1,649	15
	25 to 22	8,073	0.12%	4.25%	45,220	1,922	16
	22 to 20	6,019	0.09%	4.75%	45,832	2,177	13
	Total high	57,867	0.87%	3.28%	43,736	1,443	84
Extreme	20 to 18	6,654	0.10%	5.25%	46,456	2,439	16
	18 to 17	3,610	0.05%	5.75%	46,514	2,675	10
	17 to 15	7,905	0.12%	6.25%	47,554	2,972	23
	Less than 15	39,410	0.60%	> 6.50%	58,880	6,777	267
	Total extreme	57,578	0.87%	9.70%	55,114	5,496	316
	All flood prone	442,088	6.68%			1,018	450

*figures based on data from number of properties column, total number of properties is assumed as the sum of those with no flood risk and all flood prone

Property numbers quoted in this table are conservative and based on 2006 estimates — this would need to be adjusted upwards to account for the number of properties now mapped in each risk band.

These are estimates of the risk related price only and do not include other costs that would add to the retail premium such as taxes or brokerage fees.

Source: Insurance Council of Australia submission to the Natural Disaster Insurance Review, p14 and Treasury calculations.

Around 7 per cent of existing Australian properties face some flood risk, with 4 per cent at low risk of flood. The indicative flood risk premium for these households is around \$77 per year. Similarly, indicative flood risk premiums for those households at moderate risk of flood are up to \$726 per year. This proposal could drive a higher rate of take-up among these households, who together comprise around 74 per cent of all homes with any flood risk.

For the remaining approximately 2 per cent of existing homes at high or extreme risk of flooding, it is likely that take-up of flood cover may be lower. For example, an indicative flood risk premium for a home with a flood risk average recurrence interval (ARI) of less than 1 in 15 years would be around \$6,777 per year.

By way of practical experience, NRMA offers flood cover on an 'opt out' basis for high risk properties in NSW. NRMA allows the 2 per cent of its policyholders in high flood risk areas to 'opt out' of cover, and has found that the majority do so. This experience suggests that take-up of flood cover under an 'opt out' option would be low for those with the highest flood risk.⁴

It is likely that for the relatively few homes at extreme risk of flood, insurance may not be a viable option for managing their flood risk and that alternative measures such as mitigation, land repurchases and adaptation strategies would be more effective, noting these strategies are the responsibility of State, Territory and local governments.

Any initial increases in the take up of flood insurance would need to be sustained over time. There is some evidence to suggest that rates may decline over time, particularly if a number of years pass without an event. To maintain the home owners' awareness of their flood risk, it is proposed that the 'opt out' decision be one which must be made annually.

Questions

To what extent would insurers offering flood cover to all consumers (including where an 'opt out' option is provided) increase the take-up of flood cover? Is it likely that there would be different take-up rates among groups exposed to different levels of flood risk? Please provide reasons.

How prevalent would the practice of offering an 'opt-out' option be? For insurers — would you envisage providing an 'opt-out' option? Why/why not? If you intend to offer an 'opt out' option, who would you intend to offer it to; for example: any consumer with any flood risk, or any consumer who has a flood risk premium above a certain value?

Would an annual decision on 'opt out' maintain coverage? If consumers elect to purchase flood cover, should they be provided with an 'opt out' option the following year or just offered a renewal of insurance including flood cover?

What would be the impact on actual insurance premiums for the different categories of flood risk?

THE STORM/FLOOD DISTINCTION

While requiring consumers to 'opt out' of flood cover would significantly reduce the confusion over whether the policyholder had flood cover, in reality many flood events occur in close proximity with storm events. In such weather events, there are normally properties which suffer from storm and stormwater runoff damage and properties which suffer flood damage. It is not uncommon for a property to be affected by both floodwater and stormwater runoff.

The Government's decision to legislate a standard definition of flood will lessen confusion about whether flooding has occurred because all insurers will use the same definition of flood.

However, disputes about whether damage was caused by flood or storm would still exist for those policyholders who do 'opt out' of flood cover, regardless of whether there is a standard definition. Determining the cause of water damage can be difficult when a policy covers storm but not flood. To

4 IAG submission to the Natural Disaster Insurance Review
[http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_\(IAG\).pdf](http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_(IAG).pdf) p3

the extent that policyholders 'opt out' of flood cover, the disputes which arise with every flood event about the cause of damage would remain.

Questions

What initiatives might assist to resolve, in a timely fashion, disputes about whether damage has been caused by storm or flood?

INDUSTRY CAPACITY TO UNDERWRITE FLOOD

The Insurance Council of Australia, in its submission to the Natural Disaster Insurance Review, argues that there is no market failure regarding flood cover because flood insurance has been widely available for every property in Australia since 2006. However, it has generally only been the larger insurers with risk appetite and financial capacity, who have invested in underwriting systems to increase the availability of flood insurance.

There are concerns that some insurers may be unable and/or unwilling to provide cover. Requiring all insurers to offer flood cover may result in some companies defensively pricing flood cover or simply 'redlining' flood prone areas. This could have a negative impact on competition in the insurance market, at least in areas exposed to flood risk.

The problems insurers face in covering flood risk are briefly summarised below.

Data Requirements

The provision of flood insurance requires a more complex data set for underwriting purposes than many other natural perils, as flood events tend to affect homes in close proximity to each other differently. For example, during the recent floods there were homes badly affected by flooding but neighbouring properties were not affected at all due to the property or floor level being higher.

Therefore, in order to successfully underwrite flood, insurers require property specific data such as the location of the land on which the property sits, the elevation and curvature of the land, and the exact location and floor height of the property on the land in order to correctly determine the flood risk. More property specific data may be required compared with other risks such as bushfire, cyclone and earthquake.

Flood data is produced by local and State governments, with the quality and availability differing significantly between jurisdictions. Some local government areas have highly detailed maps publicly available while others do not have the capacity to produce the data at all.

However, many insurers have already invested in the capacity to underwrite flood successfully with the availability of flood insurance increasing, and the industry continues to invest in the National Flood Information Database through the Insurance Council of Australia, which provides flood risk information for large parts of Australia.

The portal to be hosted by Geoscience Australia, along with the development of national guidelines that will cover the collection, comparability and reporting of flood risk information will, over time, result in a nationally consistent and improved understanding of flood risk in Australia for purposes

such as land use planning, emergency management, mitigation, insurance and public education. Specifically, it will facilitate insurers providing flood cover.

Systems Costs and Implications

Even where accurate flood data is available, underwriting flood cover requires investment in the underwriting systems which can convert the data into an insurance premium which accurately reflects the risk of flood on a property by property basis. The insurers who have offered flood cover to date have generally been the larger insurers who have the financial capacity and technical expertise required to invest in these systems.

The issue for the Government is to what extent (if any) would smaller insurers find it difficult to develop flood cover offerings.

Capital and Financial Strength

General insurers are prudentially regulated by Australian Prudential Regulation Authority (APRA). The key aim of APRA's supervision is to protect the interests of policyholders. APRA is charged with developing and enforcing a robust prudential framework of legislation and prudential standards, and also issues prudential guidance, that promotes prudent behaviour by the insurance companies it supervises.

Implementation of the proposal requiring all general insurers who offer home and content policies to also offer flood cover could potentially raise prudential issues. To maintain financial strength, it is important that insurers implement soundly based pricing for the flood risks they underwrite. Flood cover risks would be dealt with under the existing capital framework and insurers would need to hold capital against their liabilities, including for flood risk, based on appropriate actuarial valuations.

Questions

What particular issues need to be addressed before all insurers could be required to offer flood cover?

What is the likely impact on overall premiums of system costs?

Would insurers need to cross subsidise parts of their business to make this proposal workable? If so why?

Would affordable reinsurance protection be available for all insurers who take on flood risk? What factors would influence whether affordable reinsurance is available? Would there be any difference between the availability of affordable reinsurance for large and small insurers?

What other costs might insurers face as a result of the requirement to offer flood cover in all home building and home contents insurance policies? For example, costs of training call centre staff.

How will smaller insurers be affected by this proposal? Are they likely to engage in defensive pricing? Are they likely to exit the market entirely in certain areas?

TRANSITION PERIOD

Those insurers which do not currently offer flood cover would need time to build the capacity to offer flood cover. This includes technical capacity, but could also impact on reinsurance arrangements and prudential capital requirements.

The Government proposes that the transition to the new arrangements be two years from the commencement date of any required legislative change. The two year transitional period will give insurers one year to update their systems and pricing formulas such that they are able to price flood coverage in their insurance policies, and an additional year to transition existing and new policyholders into the new arrangements.

The Government would like submissions to focus on the interaction of a possible transition period associated with this proposal and the key facts sheet and the standard definition.

Questions

Is two years a sufficiently long transitional period to enable insurers to build the underwriting capacity required to offer flood cover on all home buildings and home contents insurance policies?

If the Government proceeds with implementing the proposed measure, is there a case for aligning the commencement date of the transitional period of the proposal measure with the commencement date of the Key Fact Sheet?

CHANGES NEEDED TO INSURANCE CONTRACTS ACT 1984

The *Insurance Contracts Act 1984* provides for a 'standard cover' scheme. The effect of the scheme is that prescribed contracts are required to include insurance for certain types of loss (prescribed events), and for minimum amounts.

Home buildings and home contents policies are prescribed contracts under the scheme. For both of these categories, prescribed events include:

‘storm, tempest, flood, the action of the sea, high water, tsunami, erosion or land slide or subsidence’

The result is that home buildings and home contents policies are required to provide cover for these prescribed events. However, insurers are able to differ their policies from standard cover if they can prove that they clearly informed the insured in writing before the contract was entered into (whether by providing the insured with a document containing the provisions, or the relevant provisions, of the proposed contract or otherwise) or the insured otherwise should have known that the cover was not included in the contract.

Introduction of the proposal requiring all insurers to offer flood cover in home building and home contents insurance policies they sell, while allowing consumers to 'opt out' of flood cover at their discretion when they purchase insurance, would require changes to the *Insurance Contracts Act 1984* and *Insurance Contracts Regulations 1985*. If the proposal being consulted on is adopted, insurers would not be able to exclude flood cover from home building and home contents insurance policies without the consumer opting to not purchase flood cover.

WHICH ASSETS SHOULD BE COVERED BY THE PROPOSED 'OPT OUT' REGIME?

The Government is proposing that the 'opt out' regime should apply to all home building and home contents policies. The Government is **not** proposing in this consultation that insurers be required to offer flood cover in small business policies.

Detached homes are the most common form of dwelling in Australia, and the insurance market for these homes is competitive and well served by many insurers offering a diverse range of products which are all tailored towards this type of dwelling. Applying 'opt out' to detached homes would thus be relatively straightforward and result in the majority of dwellings having the ability to choose to 'opt out'.

Home contents policies are quite often sold in conjunction with home building policies. Almost 80 per cent of home building policies are combined home and contents policies. It may therefore be difficult to apply 'opt out' only to home buildings and not to home contents.

Questions

Should insurers also be required to offer flood cover in relation to strata title insurance policies? What issues would this raise?

SUB-LIMITS AND EXCESSES

If 'opt out' is adopted, the question arises over whether insurers should be able to apply specific sub-limits and excesses on flood cover, as they currently do with some other events. Sub-limits and excesses are forms of co-insurance, whereby the insurer and insured share risk. They are a way to reduce premiums for consumers, but require that the insured meet a portion of costs out of their own pocket when the insured event occurs.

Particularly for the those households at highest risk of flood, whose full flood cover premiums could reach thousands of dollars, sub-limits and excesses could be a means of ensuring some cover against flood.

However, flexibility on sub-limits and excesses is not without issues. Depending on the size of any excesses and sub-limits, and the financial capacity of the insured to meet these costs, excesses and sub-limits might reduce the capacity of policyholders to recover in the event their property is affected by flooding. An inappropriate sub-limit or excess for a particular household can therefore be a cause of underinsurance. Often, consumers may not know how much coverage to seek and what would be most suitable for their needs.

Consideration would need to be given to the size of excesses and sub-limits for flood within which 'opt out' would be meaningful. For example, flood cover with a sub-limit of \$500 per event would not be a meaningful offer for flood cover by an insurer.

Questions

Should insurers have to offer flood cover without any flood specific excesses or sub limits as an option for consumers to consider?

Should flood specific excesses be permitted in policies which offer flood cover? If yes, should there be a maximum permitted excess? If yes, what should it be?

Should flood specific sub-limits be permitted in policies which offer flood cover? If yes, should there be a minimum permitted sub-limit? If yes, what should it be?

Should flood specific sub-limits and excesses only be allowed for high flood risk properties?

Are there any other issues raised with respect to sub-limits and excesses?