



SUPPLEMENTARY SUBMISSION

TO THE

PRODUCTIVITY COMMISSION

NATURAL DISASTER FUNDING ARRANGEMENTS IN AUSTRALIA

NATIONAL INSURANCE BROKERS ASSOCIATION OF AUSTRALIA

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INTRODUCTION

The National Insurance Brokers Association of Australia (NIBA) welcomes the opportunity to provide a Supplementary Submission in response to the Productivity Commission's Draft Report on Natural Disaster Funding Arrangements.

NIBA respectfully accepts and supports the Commission's key finding that current natural disaster funding arrangements are not efficient, equitable or sustainable.

NIBA also supports and agrees with the finding that governments generally overinvest in post-disaster reconstruction, and underinvest in mitigation that would limit the impact of natural disasters in the first place.

This distortion in government funding not only results in natural disaster costs that have become a growing, unfunded liability for governments, but also contributes to ongoing increases in the cost of insurance claims, and hence the cost of insurance premiums, in parts of Australia.

The insurance industry has played a very important role in recent years in helping Australians recover from the major natural disasters that have affected communities across the country. However, the impact on premiums that has resulted from the recent insured losses is now making property insurance unaffordable in some areas.

NIBA respectfully submits that greater emphasis needs to be given to the management of potential natural disaster risks, in order to ensure property insurance does not become unaffordable for large numbers of Australians.

EXECUTIVE SUMMARY

NIBA respectfully makes the following submissions in response to the Productivity Commission Draft Report on Natural Disaster Funding Arrangements in Australia.

The Management of Risk

In modern Australia, government action controls virtually every aspect of land use. Those regulations and controls, including building standards and building use controls, can and does have an impact on the nature and level of losses that arise following natural disasters.

NIBA respectfully calls for better coordination and action by all levels of government to ensure that, to the greatest extent possible, consistent with available levels of government funding, the nature and extent of losses arising from natural disasters are kept to a minimum.

If this occurs, the cost of insuring those losses will remain at levels the community will be able to afford to bear.

If this does not occur, insurance will become unavailable or unaffordable, and communities will be unable to rebuild and recover when major adverse weather or other events occur in the future.

The Financing of Risk

Risk is financed in three ways –

- When the individual or business carry the risk themselves, otherwise known as “self insurance”. This is also known as non-insurance or uninsured.
- When the risk is transferred to an insurance company via the insurance process and the risk is pooled with similar risks, on the basis that the premiums of the many fund the losses of the few.
- When risk is funded by government, with taxpayer support. This often occurs, to some degree, following natural disaster events.

It is highly desirable that privately owned risks are fully insured via the normal insurance process. This gives financial security and protection to the property owner, and minimises the need for public funding of the risk via government programs.

However, the normal insurance process is only effective when insurance premiums are at levels regarded as acceptable and affordable in the community.

Following the natural disasters of the past 5 years, insuring the risk of property damage arising from natural disasters in some parts of Australia is becoming unaffordable, with strong community concern being regularly expressed in local media.

Action is therefore needed to ensure that, to the greatest extent possible, coordinated government effort is undertaken to minimise and mitigate the cost of losses arising from natural disasters, in order to ensure property insurance can remain available and affordable to the majority of property owners.

Government Intervention in Property Insurance

Where the number of potential policyholders is unlikely to be able to fund a premium pool which would be required to meet losses likely to arise from a natural disaster in an area or region, some form of government intervention might be required.

This has occurred successfully in Australia when market failure for terrorism risk insurance led to the formation of the Australian Reinsurance Pool Corporation.

NIBA has called for further examination of the potential for some alternative form of pooling risk, as occurs in relation to terrorism risk, if property insurance in northern Australia continues to be regarded by many as unaffordable.

Any decision to preclude government intervention in the property insurance markets in northern Australia should only be taken when all potential consequences of a decision of this nature have been examined and understood. Overseas experience is not a valid basis for failing to deal with this most important community issue.

ABOUT NIBA

NIBA is the peak industry body for the insurance broking profession in Australia. NIBA represents around 400 member firms, and over 3,000 Qualified Practising Insurance Brokers (QPIBs) throughout Australia. In total, NIBA represents an estimated 90% of all insurance brokers in Australia.

NIBA –

- represents and speaks on behalf of its members to governments, Members of Parliament, regulators, the media and other interested stakeholders;
- promotes the professionalism of insurance broking through industry based training and professional qualifications (NIBA College) and through a strong, independently administered and monitored Code of Practice for members;
- communicates the importance of insurance and the role of insurance brokers to the community;
- provides a number of services to its members, including member communications and an annual industry Convention; and
- liaises with equivalent foreign associations through its membership of the World Federation of Insurance Intermediaries in order to help maintain high standards for its members on an international basis.

The 400 member firms all hold an Australian financial services (AFS) licence, issued by the Australian Securities and Investments Commission (ASIC) under the Corporations Act, which enables them to deal in and/or advise on risk insurance products and other facilities through which people may manage financial risk.

NIBA Members include large multinational insurance brokers, large Australian-owned insurance brokers, and around 380 small to medium sized insurance broker businesses located in the cities, towns and regions across Australia.

ABOUT INSURANCE BROKERS

As previously advised, the primary role of insurance brokers is to:

- assist customers to assess and manage their risks, and provide advice on what insurance is appropriate for the customer's personal or business needs;
- assist customers to arrange and acquire insurance; and
- assist the customer in relation to any claim that may be made by them under their insurance program.

In doing the above the insurance broker acts on behalf of the customer as their representative or agent.

Insurance brokers perform another critical function as part of the insurance process: they provide the distribution mechanism for intermediated insurance companies, and in the course of doing so they constitute and operate the “market” for intermediated insurance in Australia. This occurs because insurance brokers can and do access the range of available insurance products and services provided by intermediated insurance companies, on behalf of their clients.

This dual role played by insurance brokers – advising and assisting the client on risk and insurance issues; providing a distribution mechanism for intermediated insurance companies – may give the appearance of potential conflict, but in fact this model has operated successfully in Australia and internationally for over 200 years.

All insurance brokers in Australia must hold an Australian financial services (AFS) licence, issued by ASIC under the Corporations Act, which enables them to deal in and/or advise on risk insurance products.

THE MANAGEMENT OF RISK

There can be little doubt in relation to the statement in the Commission's Draft Report to the effect that households, businesses and governments are generally best placed to manage natural disaster risks to their own assets¹.

This statement is certainly correct when considering the risk of individual losses arising from events that affect only one or a very small number of individuals or businesses.

However there is a more challenging factor at play, which has received some, but ultimately only limited, consideration in the Draft Report.

In modern Australia, government action controls and determines –

- how land can be used
- what can (and sometimes cannot) be built on land
- what building standards apply to those buildings
- what activities can take place on that land and in those buildings
- what infrastructure should be built to support the community in its day to day operations.

When natural disasters occur, they invariably affect communities rather than individuals or small numbers of businesses. More importantly, the nature and extent of the damage that occurs is often directly linked to the decisions governments (at all levels) have made in relation to land use, building controls and standards, and community infrastructure.

For example, allowing urban development near to bushland areas raises questions regarding the potential for bush fire damage to those properties. Similarly, lack of flood control and mitigation works will most likely have an impact on the nature and extent of flooding in a community. Building standards will have a direct impact on the level of damage and hence the cost of repair in cases of cyclones.

Natural disasters are a major feature of living in Australia. Decisions taken by governments in the past 50 years are now having a significant influence on the nature and cost of those disasters.

NIBA therefore respectfully submits that the risk of damage and loss as a result of natural disasters needs to be managed in a more effective, nationally coordinated basis. This requires strong

¹ Draft Report, page 13

engagement by all levels of government, as all have a role in ensuring the built environment is able to remain resilient and survive the types of natural disasters which have occurred and which inevitably will continue to occur.

The types of government related activity include –

- land use planning and controls that take account of the types of natural disasters that may occur in the area, and mitigate the potential nature, scope and cost of those disasters;
- building standards and controls that ensure buildings are likely to be able to withstand the type of weather events that can be expected in the area; and
- community infrastructure initiatives to contribute to careful management of potential damage that may result from natural disasters, such as flood mitigation works, careful water management through dams and other control mechanisms, maintenance of electricity transmission systems to reduce the chance of fire, and so on.

Of course, the risks to individual properties should also be managed by the owners of those properties, to the extent they are able to do so. The insurance industry is increasingly able to determine the risks associated with individual properties according to their individual circumstances, rather than underwrite on the basis of localities or postcodes. This will place stronger incentives on property owners in the future to manage and minimise their risk of loss.

THE FINANCING OF RISK

NIBA wishes to reaffirm that very little growth and prosperity occurs unless the owners and financiers of that activity are able to obtain insurance, or insurance like products and services, on competitive terms. The insurance industry in Australia helps provide the security that allows individuals, businesses, large and multinational corporations and governments to undertake their normal activities.

Risk is faced by individuals in relation to the property they own, the liabilities they incur to others, and their financial security in being able to earn income, fund their lifestyle and fund their retirement.

Businesses face risk in their daily operations, whether it be the risk of property loss, business interruption, product liability, public liability, employer liability, directors and officers' liability, and so on.

Communities face risk through their exposure to natural disasters and catastrophes. These events often expose levels of uninsured risk in the community, with the very real potential for community disruption and permanent losses.

The growth and prosperity of Australia is therefore dependent on mechanisms by which risk is financed – whether by the transfer of risk via the insurance process, or other more sophisticated risk financing mechanisms adopted by larger corporations and governments.

Risk is financed in three ways:

- “self insurance”, whereby the individual, corporation or government (taxpayers) finance their own risks, thereby putting their own assets and income streams in jeopardy;
- risk transfer, whereby risks are transferred to an insurance pool, and the insurance pool and the insurer’s capital carry and finance the risk; and
- community funding of risk and loss, which often occurs in Australia at the present time in respect of uninsured losses following natural disasters and other major events which affect numbers of people at the same time. The NDRRA and the AGDRP are both examples of community funding of risk and loss.

A modern society with a mature economy such as Australia should be entitled to assume that risks are being properly managed and mitigated, and that the financing of risk is operating in an optimum manner, for the benefit of all.

In one sense, “self insurance” is not a form of insurance, as the risk of loss remains with the individual or business that carries the risk. There is no risk transfer mechanism.

Large corporations and governments often “self insure” risks when it is cost effective to do so, and when they have the capital or financial capacity to implement sophisticated risk financing mechanisms. Insurance brokers regularly advise and assist large corporate and government clients with their risk financing needs.

However, when an individual or small business is unable or unwilling to purchase insurance cover, they remain uninsured, often without the ability to withstand a major loss resulting from bushfire, cyclone, flood or other forms of natural disasters. One reason why sufficient cover is often not purchased is simply the cost of cover.

Risk transfer is the process of insurance. The risks of many are pooled, and the insurance pool is then available to fund the losses of the few.

Individuals and small businesses normally protect themselves by purchasing insurance, and thereby transfer the risk of loss to the insurer. However, this process starts to fall down when the cost of insurance is beyond the means of the property owner, and they then carry some or all of the risk themselves.

NIBA respectfully submits that the insurance process not only needs to operate in an economically efficient manner (with the cost of insurance reflecting the cost of risk being transferred), but that for individuals and small businesses the insurance process needs to remain affordable for those wishing to access the security and protection insurance affords.

As noted above, actions by governments at all levels can and does have an impact on the nature and extent of losses that arise as a result of natural disasters. It is imperative, therefore, that governments have a strongly coordinated process of natural disaster risk management, to ensure the residual risks faced by communities are reduced as far as possible. This will provide the best opportunity for ensuring insurance cover for individuals and small businesses remains affordable, and the insurance process can continue to play its role in protecting the community.

GOVERNMENT INTERVENTION IN PROPERTY INSURANCE

The Draft Report states international experience has shown that government intervention in property insurance markets is “overwhelmingly ineffective”².

The Australian Reinsurance Pool Corporation has operated a terrorism risk insurance pool for a number of years, following what was regarded as full market failure in the private insurance market for terrorism risk insurance. The terrorism pool has been regularly reviewed, and continues to provide protection to commercial property owners in Australia for terrorism risks.

The terrorism pool is an excellent example of a strong and positive government response to a very difficult market situation.

NIBA respectfully suggests that government intervention in property insurance markets should not be totally dismissed on the basis of overseas experience.

Northern Australia, and far north Queensland in particular, faces the ongoing threat of cyclones. However, northern Queensland remains an attractive place for the many thousands of Australians who live and work there.

Recent experience has shown that the insured cost of losses arising from cyclones is now billions. At the same time, the premiums that are available to fund those losses, and potential future losses in the future, are only millions. There is a developing disconnect between the potential level of insured losses, and the size of the premium pool available to fund those losses.

The NIBA submission to the Federal Government on the high cost of home and strata title insurance in North Queensland commented as follows:

If the voluntary insurance market is unable to provide the necessary level of cover at what the community regards as reasonable prices, some alternative form of pooling of risk, as occurs in relation to terrorism risk, may be worthy of further consideration.

NIBA has received anecdotal information from members in North Queensland to the effect that buildings erected prior to 1985 are now regarded as being effectively uninsurable, because of their inability to withstand potential cyclone damage. The cost of property insurance for many others is regarded as unaffordable.

² Draft Report, page 31.

NIBA is concerned that further cyclone activity in northern Queensland will result in significant uninsured losses, with a resultant negative impact on the people concerned and on their community. Any decision to preclude government intervention in the property insurance markets in northern Australia should only be taken when all potential consequences of a decision of this nature have been examined and understood. Overseas experience is not a valid basis for failing to deal with this most important community issue.

FURTHER INFORMATION AND CONTACT DETAILS

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