3 April 2011

By email: floodinsurance@treasury.gov.au

The General Manager
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir or Madam

Reforming Flood Insurance: A proposal to improve availability and transparency

The following is a joint submission to Treasury's consultation paper *Reforming Flood Insurance: A Proposal to Improve Availability and Transparency* (**'the consultation paper'**). The Consumer Action Law Centre, Financial Counselling Australia, Footscray Community Legal Centre, and the Insurance Law Service at the Consumer Credit Legal Centre (NSW) have all contributed to this submission. Information on the contributing organisations can be found in the appendix. We welcome the opportunity to comment on this consultation paper.

In summary, we do not support the model proposed in the consultation paper—that insurers would be required to offer flood cover in home building and home contents insurance policies and that insurers can allow consumers to 'opt out' from flood cover ('**the opt out model'**).

Instead, we recommend the Government adopt the model proposed by the Natural Disaster Insurance Review (**NDIR**) panel of automatic flood cover, without offering the choice of opting out, but with an affordability mechanism (a system of premium discounts and a reinsurance facility) to ensure that insurance remains accessible (**'the NDIR model'**).

We do not support the model proposed by the consultation paper because:

- if the opt-out model is adopted without affordability mechanisms it will have little if any impact on flood insurance coverage, and cannot be expected to increase levels of cover for many consumers living in high flood risk areas;

- even if the opt out model is supported by affordability mechanisms, it will be less effective at increasing the level of flood insurance in the community that the NDIR model;
- in either scenario, the opt out model is likely to create the perverse result that the consumers who need flood cover the most will be those most likely to opt out of cover;
- the opt out model does not resolve problems associated with the storm/flood distinction in insurance policies; and
- the problems with the opt out model cannot be corrected with better disclosure or awareness of risk.

Our comments are detailed more fully below.

Purpose and models for reform

The purpose of the current suite of reforms around flood insurance should, in our view, be to ensure that all Australians can access affordable flood insurance. As the NDIR said in their final report, the problem is essentially that not enough people have flood insurance. When floods occur, this lack of coverage exacerbates losses suffered and hinders recovery. However, in attempting to address the coverage problem (in this case by requiring automatic flood cover) there is a risk of making insurance unaffordable—of moving from a situation where most homeowners have insurance cover (but not for flood) to a situation where many homeowners have no insurance at all.[1]

This led the NDIR panel to recommend (among other things) that:

- all home building and contents insurance policies provide cover for flood (without allowing consumers to opt out); and
- the Government put in place affordability mechanisms (a system of premium discounts for consumers living in areas subject to flood risk, and a subsidised reinsurance facility for insurers, to ensure that the automatic inclusion of flood cover did not make insurance unaffordable).[2]

In our view, the NDIR model is the only model which will make flood insurance accessible and affordable for all Australians. We recommend that the Government adopt this model, for the reasons discussed later in the submission.

It should be noted that the NDIR proposal of adopting a system of premium discounts is quite different from the subsidy proposal suggested by the Insurance Council of Australia.[3] The discount approach does not require Government to fund amounts from the budget prior to a flood event occurring. Instead, the Government would provide a guarantee to the flood risk reinsurance pool entity to pay for claims above which could be borne by the industry (because insurers have only received a discounted premium). While it may be economically prudent and required for the Government to allocate funds to this guarantee, this is quite different to paying

[1] *Natural Disaster Insurance Review: Inquiry into Flood Insurance and Related Matters* (September 2011), The Treasury, page 2. Accessed 26 March 2012 from http://www.ndir.gov.au/content/Content.aspx?doc=report.htm.

[2] At pages 3-4.

[3] 'Insurers identify measures to address flood policy affordability', Media Release, Insurance Council of Australia, 11 January 2012. Accessed from http://www.insurancecouncil.com.au/media/73948/110112---insurers-identify-measures-to-address-flood-policy-affordability.pdf

subsidies directly to insurance companies without any assurance that they would pass these on in full to consumers. It also addresses industry concerns that they not be required to cover risks beyond their 'risk appetite'.

The opt out model set out in the consultation paper[4]:

- requires that all insurers offer flood cover in home building and home contents insurance policies, based on the standard definition of flood; but
- gives insurers the option of allowing consumers to 'opt out' of flood cover.

The proposal in the discussion paper also does not consider the affordability mechanisms recommended by the NDIR panel, though we understand that the Government intends to release a further discussion paper on this topic in the near future.

We do not support the opt-out model, whether or not it is supported by the NDIR panel's affordability measures, because we do not believe it can solve existing problems with affordability and accessibility of flood insurance.

Weaknesses of the opt out model

The opt out model will be almost completely ineffective if not supported by affordability mechanisms

If the opt out model is adopted without affordability mechanisms such as premium discounts or subsidies—and we understand the Government is unlikely to introduce subsidies[5]—the opt out model could only be expected to drive a small increase in flood cover in consumers as a whole, and will not increase levels of cover at all for low income consumers in high risk areas.

We note that 'conservative' estimates provided by the Insurance Council of Australia suggest that households with a moderate flood risk (a total of 18,483 homes, expected to experience flooding once in every 50-67 years) would pay a flood premium of up to $726 per year. For the homes in the extreme risk category (39,410 homes, expected to flood once in 15 years or less) the premium is predicted to be around $6,777.[6]

Even in the moderate risk category, the projected premiums will put a strain on many budgets. In the extreme category, most households would find flood insurance unaffordable whatever their income. In our view, a person on low income living with anything more than a low flood risk could not afford flood cover without subsidisation and so would opt out.

This is supported by the experience of NRMA in NSW. In Insurance Australia Group's (IAG) submission to the NDIR, it was reported that in NSW

[4] At page 3.
[5] 'Government subsidies for high flood risk properties unlikely', *Insurance News*, 26 March 2012. Accessed from: http://insurancenews.com.au/regulatory-government/government-subsidies-for-high-flood-risk-properties-unlikely.
[6] See page 8 of the consultation paper.

> ...NRMA Insurance provides flood cover automatically to 98% of its customers. The remaining 2% of customers in high risk areas have the ability to "opt-out" of flood cover. Only a minority of flood prone customers choose to take that cover.

IAG go on to say that

> The best way to make sure our customers have protection and to maximise the number of people covered is to automatically include flood cover in the premium.[7]

Although we and IAG take different views on how flood insurance availability problem should be solved,[8] we appear to agree that if consumers are offered full price flood insurance, very few will purchase it if given the choice to opt out. We encourage the Government to seek further data from IAG about the proportions of consumers that did opt-out and the price sensitivities that caused this. Based on the information available and our understanding of the price impacts of flood cover for householders living in high flood-risk areas, we are of the view that the opt-out model will have little if any impact on flood insurance coverage if affordability mechanisms are not also adopted.

We are aware that there is some suggestion from industry members who have offered the opt-out model that not as many consumers have opted out as expected, even when faced with premium increases. We have two comments to make in this regard:

- Firstly, in light of the existing data which suggests the contrary, it would be useful to see data in support of this claim; and
- Secondly, it is clearly early days in that it is only a little over a year since the series of significant flood events so it may be that, if established by the data, present consumer resilience to price increases diminishes over time.

Even if the opt out model were introduced along with affordability mechanisms[9], we believe it would be less effective than the NDIR model in increasing the rate of flood cover. This is because under the NDIR model consumers would be faced with a choice of either buying insurance including flood cover (including a modest premium increase) or going without insurance entirely. In this situation, we suggest few consumers would choose to go without cover entirely over paying a small premium increase.

However, under the opt-out model there is a real risk that consumers will decide to opt out of flood insurance rather than pay the additional premium—this is a much less daunting decision than deciding to do without insurance cover entirely. Consumers will be particularly likely to opt out of flood insurance if they have a low income, live in a high flood risk area, or both. That is, we believe the opt out model will actively encourage consumers who most need flood insurance to go without it.

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[7] Insurance Australia Group submission to Natural Disaster Insurance Review Inquiry into Flood Insurance and Related Matters, p 3. Accessed from http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Australia_Group_(IAG).pdf

[8] Among other differences, IAG are clear at page three of their NDIR submission that insurers should not be required to offer flood cover.

[9] As far as we know, this option has not been proposed.

This proposal does not solve the storm/flood problem

Following the 2011 floods, much of the confusion and disputes regarding coverage centred around whether the event causing loss for individual households should be classified under the contract as a 'storm' or a 'flood'.

Resolving this problem would prevent a considerable number of disputes from occurring and so create significant benefits. Legal Aid New South Wales estimated in a September 2011 submission that rejection rates of claims arising from the Queensland floods were approximately seven times the industry average[10]. This finding is supported by data reported by the Financial Ombudsman Service (FOS) in its submission to the Natural Disaster Insurance Review[11]. FOS data indicated that there were around nine times as many complaints to FOS arising from flood events than from other non-flood natural disasters.[12] Among other factors, FOS suggests that the high rate of complaints from flood events can be explained by:

- insurers excluding flood cover from their policies;
- denial of cover by insurers raising complex issues, including whether damage was caused by flood or storm; and
- insurers excluding flood cover needing to obtain hydrology reports before making a decision on claims, which causes delay and delay in turn causes disputes.

The increased number of disputes also increases demand on already stretched Legal Aid and Community Legal Centre resources. Statistics provided by the Combined Insurance Law Service shows that as at March 2012 - 14 months after the Queensland floods - legal services were still managing around half of their cases from that event. For example:

- The Insurance Law Service had 48% unresolved (22 out of 45 cases); and
- Caxton Legal Service (located in South Brisbane) had 53% unresolved (81 out of 152).

These figures would be far lower if disputes over whether damage was caused by flood or storm were removed. Having so many cases of this kind underway over so long a period limits the ability of these services to respond to other casework needs and other disasters as they emerge.

The NDIR model would eliminate this confusion by requiring all policies to provide flood cover—we understand that storm damage is covered as standard in home building and contents policies, and this is not expected to change. However, under the opt out model, consumers who choose to opt out will likely be affected by this problem if they experience water damage in circumstances involving a flood in future.

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[10] Legal Aid NSW found that around 15 per cent of claims from the 2011 Queensland floods had been rejected, compared to an average rejection rate across the industry of 2 per cent. *Submission on behalf of Legal Aid NSW to House of Representatives Standing Committee on Social Policy and Legal Affairs: Inquiry into the Operation of the Insurance Industry During Disaster Events,* September 2011, page 9. Accessed from http://www.legalaid.nsw.gov.au/__data/assets/pdf_file/0015/10824/Legal-Aid-NSW-Inquiry-into-Insurer-Response-to-natural-disasters.pdf

[11] The submission can be accessed from http://fos.org.au/public/download.jsp?id=17378.

[12] See page 13. The average percentage of complaints across two flood events (listed as 'Queensland Flooding' and 'Victorian Flooding' in the FOS table) is 0.621% compared to an average of 0.0675% for four non-flood events (Victorian Hail Storm, WA Hail Storm, Cyclone Yasi and Victorian Storms).

The introduction of a standard definition of flood for all insurance contracts and the provision of key facts sheets will relieve some issues related to the storm/flood distinction by making it easier for consumers to tell if their policy covers flood before they purchase. However these measures will not prevent uncertainty about whether a particular event should be classified as a flood or a storm. Experience from the 2011 floods shows that resolving these disputes can be highly complex, and even with free access to external dispute resolution services, consumers are at a disadvantage because they do not have access to expert hydrologists and will find it difficult to rebut evidence of hydrologists commissioned by insurers.

Improving disclosure and risk awareness will not overcome problems with the opt out model

As noted by the consultation paper, it is important to increase awareness of insurance policyholders of their flood risk to ensure they make informed choices about whether or not to buy flood cover. However, we stress that improving awareness of flood risk and improved disclosure (such as through Key Facts Sheets) will not overcome the problems with the opt-out model discussed above, for two reasons.

The first is that better risk awareness will not make flood cover any more affordable. The second is that, even for consumers who can afford cover, information about their flood risk may not override their original decision to opt out of cover. People may discount the likelihood of a flood ever affecting them, particularly if they have not experienced one before. People also tend to place a higher value on certain, immediate costs than on distant, uncertain ones (even when the distant costs have the potential to be much larger than the immediate ones).[13]

This means that, when faced with the choice of paying a large, specific amount of money for flood cover immediately or taking the risk that a vague, distant harm like a flood may affect them in future, many will choose to save the money and take the risk. For instance, we suspect that not an insubstantial number of people in an extreme flood risk would choose to remain uninsured for flood if the insurance premium was $6000 per year and the consumer was told that they could expect to be flooded once in every 15 years. As noted above, behavioural economics principles also tend to suggest that this effect will become more marked over time (that is, as the significance of the recent disasters is diminished, in particular for those consumers not directly impacted by them).

In addition to these problems, flood information will not be useful to people who do not understand the information being presented (perhaps because they speak English as a second language or otherwise have poor literacy) or who are too impatient to consider the information.[14]

[13] For example, see New Economics Foundation, *Behavioural Economics: Seven Principles for Policy Makers*, pages 10-11. Accessed from http://www.neweconomics.org/sites/neweconomics.org/files/Behavioural_Economics_1.pdf

[14] The Insurance Council of Australia has recently argued that if consumers may be disadvantaged by a requirement for insurers to provide Key Facts Sheets before entering a contract if they need cover urgently. It is reasonable to assume that someone in this much of a hurry will not pay attention to information on flood risk that is presented to them (or indeed read their PDS). 'Treasury to release discussion paper on Key Facts Sheets', *Insurance News*, 20 February 2012. Accessed from http://insurancenews.com.au/regulatory-government/treasury-to-release-discussion-paper-on-key-facts-sheets.

The NDIR model

We support the NDIR model because:

- it will create a greater increase in flood cover than the opt out model (for the reasons given above);
- it reduces the risk that consumers (and in particular consumers with low incomes and high flood risk) will opt out of cover;
- it resolves the problems associated with the storm/flood distinction.

We acknowledge that this solution is complex and creates cost for governments. While we understand that the Commonwealth may be reluctant to commit funding in the present budgetary environment, we do not think there will be any effective solution which does not involve government funding.[15] As experience with recent floods has shown, there is often call on the Government purse to support households after disasters through emergency relief and other support (and on insurers to offer ex-gratia payments). Further, adopting an ineffective solution (such as the opt out model) is in our view likely to be even more expensive as it will cost money to design and implement without creating any significant benefit.

The NDIR model was produced by an expert panel appointed by the Government after extensive consultation and consideration of the issues. It is our firm view that this model is the only solution yet proposed that can effectively address the lack of flood cover in Australia. We urge the Government to reconsider this proposal.

It has been said by members of the insurance industry[16] and recently by a spokesman for the Treasury[17] that particular forms of government intervention are not justified because a market failure has not been established. We disagree. We have no doubt that the insurance industry is not able to meet the demand for flood cover in the community, or at least is not able to supply it at a price consumers can afford—indeed, the insurance industry has called for subsidies to ensure households retain access.[18] This problem is particularly evident in some areas[19] and some policy types (for example, strata title) . However, as a general proposition we argue that without further regulation of the kind recommended by the NDIR, there will continue to be significant unmet demand for flood insurance.

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[15] For example, the alternative recommended by the Insurance Council of Australia would require governments to pay direct flood premium subsidies to consumers in high to extreme risk areas, as well as investment in mitigation. 'Insurers identify measures to address flood policy affordability', Media Release, Insurance Council of Australia, 11 January 2012. Accessed from http://www.insurancecouncil.com.au/media/73948/110112---insurers-identify-measures-to-address-flood-policy-affordability.pdf

[16] For example, see submissions to the NDIR by the Insurance Council of Australia (http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Insurance_Council_of_Australia.pdf, page 3) and IAG, page 3.

[17] 'Government subsidies for high flood risk properties unlikely', *Insurance News*, 26 March 2012. Accessed from: http://insurancenews.com.au/regulatory-government/government-subsidies-for-high-flood-risk-properties-unlikely.

[18] Insurance Council of Australia, *Press Release—Insurers identify measures to address flood policy affordability,* 11 January 2012, available at: http://www.insurancecouncil.com.au/media/73948/110112---insurers-identify-measures-to-address-flood-policy-affordability.pdf.

[19] For example, see 'Inland towns face insurance drought', *Australian Financial Review,* 9 February 2012.

Thank you for the opportunity to comment on this consultation paper. Please contact us if you have any questions. Our contact details are in the Appendix.

Yours sincerely

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Appendix - About the contributors

Consumer Action Law Centre

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action provides free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and is the largest specialist consumer legal practice in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

We also operate MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians experiencing financial difficulty.

Contact: David Leermakers, Senior Policy Officer, david@consumeraction.org.au, 03 9670 5088.

Financial Counselling Australia

Financial Counselling Australia is the peak body for financial counsellors. Financial counsellors help consumers in financial difficulty by providing information, support and advocacy. Their services are free, confidential and independent.

Contact: Fiona Guthrie, Executive Director, 0402 426 835 or fiona.guthrie@afccra.org

Footscray Community Legal Centre

Footscray Community Legal Centre and Financial Counselling Service is a non-profit, community managed incorporated association. The Centre has a Legal Service and a Financial Counselling Service. Our purpose is to address systemic injustice by providing free legal and financial counselling services on an individual level and more broadly through community education, law reform and advocacy. We assist people who live, work or study in the City or Maribyrnong. Our service gives priority to those who cannot afford a private lawyer and/or do not qualify for Legal Aid.

Contact: Denis Nelthorpe, Manager, 0414 545 290 or denis.nelthorpe@iinet.net.au

Insurance Law Service

The Consumer Credit Legal Centre is a community legal centre that also maintains a project called the Insurance Law Service ("ILS"). The ILS is funded by the Legal Aid Commission of NSW and the Commonwealth Attorney-General's Department through the Community Legal Services Program. The ILS is a national service and has provided telephone advice in the course of over 7,000 calls since its inception in mid 2007 and finalised more than 450 casework files. Advice is provided free of charge on a 1300 number available throughout Australia. 28% of calls in 2010/11 financial year to date came from Qld and 16% from Victoria, many involving consumers affected by recent storms and floods. ILS is actively involved in representing consumers affected by the Queensland floods and previously acted for a number of consumers affected by other natural disasters.

Contact: Katherine Lane, Principal Solicitor, 02 8204 1350 or kat.lane@cclcnsw.org.au