13 June 2012

By email: climate-adaptation@pc.gov.au

Barriers to Effective Climate Change Adaptation
Productivity Commission
LB2 Collins Street East
Melbourne Vic 8003

Dear Sir or Madam

Barriers to Effective Climate Change Adaptation: The Role of Insurance

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Productivity Commission's (**the Commission**) Draft Report *Barriers to Effective Climate Change Adaptation* (**the draft report**). In particular, this submission refers to chapter 12 of the draft report, the role of insurance.

Briefly, we do not agree with the Commission's assessment that subsidising flood insurance will reduce the incentives for consumers to mitigate their flood risk and so create a barrier to climate change adaptation. On the contrary, we believe that consumers in high flood risk areas currently have little or no ability to mitigate their flood risk and the introduction of more affordable flood insurance will increase the likelihood of consumers doing so.

Our comments are detailed more fully below.

About Consumer Action

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.

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The Commission's position

In the draft report, the Commission recommended that

> Governments should not subsidise premiums for household or business property insurance, whether directly or by underwriting risks. This would impose a barrier to effective adaptation to climate change.[1]

The Commission's key reason for making this recommendation appears to be that:

> Subsidising insurance premiums means that the premiums paid by policyholders do not fully reflect the level of risk that they face. This would reduce their incentives to mitigate their risks and thereby impede effective adaptation to climate change.[2]

While the draft report notes existing concerns about the extent of non insurance and under-insurance,[3] it argues that this may simply reflect decisions of households about the value of insurance to them and which risks they prefer to bear, or the unwillingness of commercial insurers to provide cover.[4] Further to the first of these points, the Commission states that:

> ...provided that they are well informed of the level of risk they face, decisions by these households [at highest risk of flooding] not to purchase flood cover or otherwise reduce their exposure to flood risks would generally not warrant government intervention.
>
> ...a more appropriate initial policy response to concerns about the extent of flood cover... could include improved disclosure of risk information... or increased investment in flood mitigation infrastructure."[5]

The Commission concludes that the result of government subsidising insurance premiums will be to effectively make governments an 'insurer of last resort'.[6]

Our position

We disagree with the Commission's recommendation because it incorrectly assumes that consumers at high risk of flood have options to mitigate that risk. In particular, consumers in high risk flood areas:

- cannot easily insure against flood risk, either because flood cover for home building and contents policies is not available or is unaffordable;[7]

[1] Draft recommendation 12.3, page 244.
[2] Page 243.
[3] Page 231.
[4] Page 240.
[5] Page 242.
[6] Page 244.
[7] We note that 'conservative' estimates of the cost of flood cover 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. Cited in the Australian Government's discussion paper *Reforming Flood Insurance: A Proposal to Improve Availability and Transparency*, November 2011, page 6. Accessed from http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/Reforming-Flood-Insurance-A-Proposal-to-Improve-Availability-and-Transparency

- cannot necessarily move to a lower risk area: a shortage of housing and the high prices of housing available means many consumers (especially those on lowest incomes) will often have to take what they can get; and
- generally cannot reduce their risk by building flood mitigation infrastructure.

It is unlikely that consumers who have not purchased flood cover 'or otherwise reduced their exposure to flood risks' have failed to do so because they have made a conscious, rational decision. Rather, it is likely that they have not taken any steps to mitigate their risk because there are limited simple steps they can take—in many cases, mitigation requires action at the community level rather than the individual household level. It follows that subsidising flood insurance will not 'reduce [consumers'] incentives to mitigate their risks' as there is very limited ways consumers can individually respond to those incentives.

Further, 'improved disclosure of risk information' is not on its own an appropriate policy response as it will not give consumers any more options to respond to those incentives. In its review of consumer policy, the Productivity Commission acknowledged that consumer disclosure is not a panacea. In that report, the Commission stated "in situations where poor decisions can cause widespread, significant and/or irreversible damage, the use of more directive policies ... is often appropriate".[8] We think that the case of flood insurance represents such a situation.

It is for these reasons that the government is *currently* the 'insurer of last resort'—consumers in high risk areas have little or no affordable options to mitigate their risks so governments are left to fund relief and recovery after the event.

We support the recommendation of the Natural Disaster Insurance Review (**NDIR**) final report that:

- all home building and contents insurance policies should cover flood; and
- consumers would not be given the choice to opt out of flood cover; but
- governments would ensure that flood insurance is affordable through a system of premium discounts and a reinsurance facility.[9]

Rather than reducing the likelihood that individuals will mitigate their flood risk, this proposal will actually make consumers *more* likely to do so, by giving them a mitigation option. In addition, the reinsurance pool proposed by the NDIR has the potential to ensure that incentives to mitigate against flood risk are placed with governments—that is, those parties who can actually respond to them. Under the NDIR proposal, state, territory and local governments would be required to fund payouts by the reinsurance pool in some circumstances in recognition of their responsibility for land use planning, building standards and flood mitigation.[10]

The Commission's concerns that subsidised flood premiums may encourage development in hazard prone areas and lead to cross-subsidisation of high risk policies with low risk premiums[11] have been explicitly considered by the NDIR. Under the NDIR proposal, insurance premiums will

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[8] Productivity Commission, *Review of Australia's Consumer Policy Framework*, Inquiry Report Number 45, April 2008, volume 2, page 260.

[9] Natural Disaster Insurance Review Panel (2011) *Inquiry into Flood Insurance and Related Matters*, pages 3-4. Accessed from http://www.ndir.gov.au/content/report/downloads/NDIR_final.pdf

[10] Natural Disaster Insurance Review (2011), paragraph 7.54.

[11] Draft report, page 244.

still increase with flood risk and so will avoid creating incentives for development in high risk areas.[12] The possibility of having to meet the costs of future floods will also encourage state, territory and local governments to prevent development in these areas. The NDIR report was also clear that their proposal should not allow cross subsidisation between policy-holders.[13]

Further, it is important to note that the NDIR proposal involves adopting a system of premium discounts, which is quite different from the direct subsidies provided to industry. 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 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'.

We do not support the alternative scheme proposed by the Commonwealth Government in its consultation paper *Reforming Flood Insurance: A Proposal to Improve Availability and Transparency.* Briefly, this paper proposed that insurers should be required to offer flood insurance on all home building and contents policies but allow consumers to opt out of the flood cover. As the Commission notes,[14] the key problem with this proposal is that the people most in need of flood cover will be the most likely to opt out, and so this scheme will likely have little impact on the level of flood insurance in the community.[15] A copy of our submission to that consultation is attached for your information.

Please contact David Leermakers on 03 9670 5088 or at david@consumeraction.org.au if you have any questions about this submission.

Yours sincerely
CONSUMER ACTION LAW CENTRE

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[12] Natural Disaster Insurance Review (2011), recommendation 4, page 37.
[13] Natural Disaster Insurance Review (2011), recommendation 4, page 37.
[14] Draft report, page 242.
[15] Our response to this proposal is set out in more detail here: http://www.consumeraction.org.au/downloads/Jointsubmission-floodinsurance-availabilityandtransparency-March2012.pdf