

Cyclone and related flooding reinsurance pool

Regulation Impact Statement
Department of the Treasury

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1. What is the problem?

Background

Insurance affordability has been a long-running concern in northern Australia, particularly in natural disaster-prone areas. Numerous reviews have highlighted this issue in recent years, including the 2011 Natural Disaster Insurance Review, the 2015 Northern Australia Insurance Premiums Taskforce Report, the 2020 Royal Commission into Natural Disaster Arrangements, and the Australian Competition and Consumer Commission's (ACCC) Northern Australia Insurance Inquiry.

On 4 May 2021, the Government announced that it intends to establish a reinsurance pool covering the risk of property damage caused by cyclones and cyclone-related flood damage across Australia. The pool would seek to improve the accessibility and affordability of insurance for households and small businesses in cyclone-prone areas, which are mainly located in northern Australia.

The Australian Reinsurance Pool Corporation (ARPC) would administer the pool, which would operate from 1 July 2022. A Treasury-led Taskforce consulted with industry and community representatives to inform a decision on the reinsurance pool's final design.

Insurance affordability in northern Australia

Higher risk of natural disasters is driving significant insurance affordability and access pressures in northern Australia. Northern Australia is more exposed to extreme weather events than other areas of Australia. The damage to residential and business property caused by extreme weather events is often severe, and on a scale that leads to the displacement of people from their homes and disruption to business activity.

Due to the greater risk of extreme weather events, including cyclones, insurance premiums are significantly more expensive in northern Australia. While there are legitimate reasons for this, including the greater cost to insurers to provide property insurance in northern Australia, this has led to cover becoming less affordable and accessible for consumers and small businesses in the region.

The ACCC found that, in 2018-19, the average premium for combined home and contents insurance across northern Australia was about \$2,500, almost double the average premium for the rest of Australia at about \$1,400.¹ Some areas within the region have higher risk of natural peril than the average risk for the region and, within these areas, a substantial proportion of consumers pay significantly above the average premium. A particularly stark example is the case of Port Hedland, where around one quarter of households pay more than \$6,200 for combined home and contents insurance, over four times the average premium for the rest of Australia.²

In their inquiry, the ACCC identified that access and affordability pressures are similarly acute for strata properties. In 2018-19, strata insurance premiums in northern Australia remained higher than in the rest of Australia. In northern Australia, there are more than 9,000 strata policies in insurance. The average premium was highest in north Western Australia, at \$13,400, over four times the average for the rest of Australia at \$3,300.³

Average premiums have also increased at a faster rate than in the rest of Australia, with average combined home and contents insurance premiums rising by 122 per cent between 2007-08 and 2018-19 in real terms, compared with a 71 per cent increase

¹ Australian Competition and Consumer Commission (2020) *Northern Australia Insurance Inquiry – Final Report*, November 2020, p. vii. available at: www.accc.gov.au/publications/northern-australia-insurance-inquiry-final-report.

² Ibid, p. viii.

³ Ibid, p. 22.

for the rest of Australia.⁴ More recently, there are indications the rate of premium increases is slowing. However, the ACCC note this may be in part due to higher-risk properties leaving insurance markets altogether in response to high premiums and therefore may not reflect an improvement in affordability.

Consumers in northern Australia have responded to higher premiums by selecting higher excess levels, as policies with higher excesses have lower premiums. However, the higher the excess level, the greater the dollar value that consumers must contribute when submitting a claim. For this reason, excess levels impact the affordability of insurance products for consumers, including the ability and likelihood of a consumer making a claim in the event of an extreme weather event. Average excess levels selected by consumers in north Queensland and north Western Australia are higher than the rest of Australia, at \$1,100 for buildings compared with \$700.⁵ Claim frequency for home insurance products in northern Australia is lower for higher excess brackets, as higher brackets deter smaller claims by consumers, who may find it more cost effective to fund their own repairs.

Technology and greater granularity in the pricing of cyclone and flood risk is also contributing to rising insurance premiums in northern Australia. Since 2013, insurers have moved towards address level pricing for cyclone risk, which makes up a large part of premiums. The use of these technologies has led to premium increases in far north Queensland and the Northern Territory, while average premiums did not experience large changes at a national level. Address level pricing allows insurers to more directly align premiums paid to the level of risk and minimise potential overpricing of low-risk policies — reducing the extent of risk pooling through insurance. However, in some cases, this change has resulted in very large increases to premiums for consumers most vulnerable to cyclone risk, exacerbating affordability issues. For example, a consumer's target premium increased by 70 per cent, from about \$3,000 to \$5,000, following the adoption by the insurer of address level pricing for cyclone risks leading to cyclone component changes across the insurer's portfolio.⁶

In addition to these factors affecting affordability in northern Australia, higher premiums mean higher state and territory stamp duty on home, contents and strata insurance. In northern Australia, stamp duty adds between 9 and 10 per cent to premiums, on top of the GST-inclusive amount.⁷ Stamp duty is not a cost to insurers but is added to the cost incurred by consumers. Between 2007-08 and 2018-19, the average tax (including GST) paid by consumers in northern Australia grew from \$204 to \$413, in real terms.⁸ As at 2018-19, the average dollar value of stamp duty in northern Australia was almost double that in the rest of Australia (\$256).⁹ As taxes are proportional to premiums, growth in stamp duty has had a compounding effect on insurance affordability in northern Australia. Other reviews have noted that state and territory insurance taxes (in the form of stamp duties in northern Australia, and stamp duties and levies elsewhere) increase the cost of insurance and thereby reduce insurance coverage.

Higher incidence of underinsurance or non-insurance in northern Australia

Insurance affordability pressures have contributed to under and non-insurance in northern Australia. High premiums mean there are likely a considerable number of uninsured homes in northern Australia, as some households choose to opt out of or decrease their level of insurance coverage due to affordability constraints. Using 2016 Census data, the ACCC estimated the rate of home building non-insurance in northern Australia to be about 20 per cent (or about 86,000 properties) in 2016, compared with 11 per cent for the rest of Australia.¹⁰

⁴ Ibid, p. viii.

⁵ Ibid, p. 22.

⁶ Ibid, p. 65.

⁷ Ibid, p. ix.

⁸ Ibid, p. 55.

⁹ Ibid.

¹⁰ Ibid, p. 155.

Insurance is an important tool for households and businesses to manage financial risks, including those associated with natural disasters. It communicates the level of risk associated with living in a particular region or building and renovating in a particular way via price signals, and therefore influences the behaviour of households and businesses. Insurance also helps communities to fund their recovery from natural disasters. The report of the Royal Commission into National Natural Disaster Arrangements (Royal Commission) highlighted that uninsured or underinsured households have reduced financial capability to recover from a natural disaster.¹¹ This can increase costs and pressures for communities and for governments, through increased pressure on health, emergency, and welfare systems. It can also slow the economic recovery of a region following a disaster. Therefore, reducing the levels of underinsurance and non-insurance improves the resilience of households, businesses, and communities.

Poor profitability of insurers

Insurance markets are more concentrated in northern Australia. Eight insurers supply majority of home, contents and strata insurance in the region, compared with over 20 insurers for the rest of Australia.¹² Insurer costs are also higher in northern Australia. Claims are on average larger and more frequent in northern Australia compared with the rest of Australia. Higher claim costs are due primarily to the frequency and scale of natural disasters experienced in northern Australia.

Larger and more frequent claims have resulted in poor profitability of insurers in northern Australia. While northern Australia comprised about 5 per cent of all home, contents, and combined home and contents insurance policies supplied in Australia on average between 2007-08 and 2018-19, it accounted for about 9 per cent of gross written premium and 11 per cent of total claims costs over the same period.¹³ For the 12 years to 30 June 2019, insurers in northern Australia are estimated to have experienced an aggregate loss across home, contents and strata insurance products of approximately \$856 million in real terms.¹⁴ From 2010, including the 2010-11 Queensland floods, insurers have paid out almost \$28 billion in claims Australia wide.¹⁵ In response to profitability challenges, insurers are seeking to manage exposure to higher risks, including by reducing their exposure to regions with these risks. The ACCC found that risk is the largest deterrent of new insurers from entering northern Australia.¹⁶

Current government measures to address affordability

Current government measures to improve the natural disaster resilience of households, strata properties and small businesses will contribute to the longer-term improvement in the affordability of premiums for consumers where insurers acknowledge mitigation activities.

In the 2021-22 Budget, the Government provided \$1.2 billion to improve Australia's capability to better prepare, respond, and recover from natural disasters, including by establishing a new National Recovery and Resilience Agency (NRRRA) to lead resilience to, and recovery from, hazards and disasters. The NRRRA will be assisted by the Australian Climate Service, which is a partnership of the Bureau of Meteorology, Geoscience Australia, CSIRO and the Australian Bureau of Statistics to better understand how natural hazards impact our society, economy, and built environment.

¹¹ Royal Commission into National Natural Disaster Arrangements (2020) *Final Report*, October 2020, available at: <https://naturaldisaster.royalcommission.gov.au/publications/html-report>.

¹² Australian Competition and Consumer Commission (2020) *Northern Australia Insurance Inquiry – Final Report*, November 2020, p. 155.

¹³ *Ibid*, p. 12.

¹⁴ *Ibid*, p. 103.

¹⁵ *Ibid*.

¹⁶ *Ibid*, p. 260.

As part of these measures, the Government:

- provided \$615.5 million for the Preparing Australia program to provide grants for projects that support public and private disaster risk reduction and resilience; and
- announced a plan to specifically reduce insurance costs for strata properties, by committing \$40 million for the North Queensland Strata Title Resilience Pilot Program, to start in 2022.

The Queensland Government delivered the Queensland Household Resilience Program, which included \$10 million funding from the Australian Government. The program allows owner-occupiers who live in a house built before 1984 in identified high-risk areas to receive a grant of 75 per cent of the cost of improvements to improve the resilience of homes against cyclones.

Moreover, in its 2021-22 Budget, the Queensland Government made \$10 million available for the North Queensland Natural Disasters Mitigation Program. The program will support physical mitigation projects that reduce disaster risk works, as well as studies or investigations to support a better understanding of a community's risk.¹⁷

Current government resilience and mitigation measures should result in some premium relief in the long term but not in the short term. Further action beyond these current government measures is needed to address the immediate insurance access and affordability pressures in northern Australia.

¹⁷ Queensland Government, *North Queensland Natural Disasters Mitigation Program*, available at: <https://www.qra.qld.gov.au/funding-programs/resilience-funding/north-queensland-natural-disasters-mitigation-program>.

2. The need for Government action

There is an opportunity for the Government to assist in reducing the cost of high-risk insurance premiums, which is the largest barrier to adequate insurance coverage. Without action, increasing levels of underinsurance and non-insurance may lead to decreased resilience to natural disasters and a deterioration in households' ability to financially recover from disasters. This in turn can increase costs to governments through increased pressure on health, emergency services, and welfare systems.¹⁸ It may also jeopardise progress made towards the economic development, and the improved liveability and prosperity, of northern Australia.

A lack of effective insurance coverage in a region can have long-term economic consequences, particularly in regional areas with a narrow economic base. Following the initial shock of a natural disaster, insurance can provide an economic stimulus through claims, increasing the speed of communities' efforts to rebuild and providing a boost to business activity.

By addressing both acute and longer-term insurance affordability pressures, the Government can:

- improve insurance access and affordability in northern Australia;
- strengthen northern Australia's resilience to natural disasters;
- build the financial capability of people and businesses to support a disaster resilient Australia; and
- reduce costs to governments due to pressure on health, emergency services, and welfare systems.

In pursuing these objectives, the Government can also promote increased competition in insurance markets in northern Australia, improving consumers' ability to access affordable insurance.

The Government has the capacity, and is well-placed, to address insurance affordability and access pressures in northern Australia, through leveraging:

- the Government's balance sheet, while minimising risk and cost to the Government; and
- the existing expertise of the ARPC in running a reinsurance pool.

Without further action from the Government, insurance accessibility and affordability pressures for households and small businesses in northern Australia will continue. In the short to medium-term, the insurance market is unlikely to unilaterally assist with these pressures, given that higher premiums reflect the level of natural disaster risk in northern Australia.

A range of options have been considered previously

Government insurer

One method of government intervention is for the government to act as an insurer. For certain events, the government can act as an insurer and hold the risk of the event occurring instead of a private insurer. While this model is like a government reinsurance pool, the government's interaction with the market is greater and, in this respect, may represent a more intrusive market intervention than establishing a government reinsurance pool. Although the level of competitive pressure in the northern Australian insurance market is weakening (with some insurers seeking to reduce their exposure in high-risk areas), private insurers continue to service this market, and the introduction of a government insurer for cyclone risk would likely crowd out private cyclone cover.

¹⁸ See, e.g., Royal Commission into National Natural Disaster Arrangements (2020) *Final Report*, p. 420.

Government insurers in the past have proved to be problematic and very costly for governments. One of the main examples of a government insurer internationally is the National Flood Insurance Program (NFIP) in the United States. NFIP has required additional funding on several occasions and since 2004 has borrowed \$US39.4 billion from the federal government to pay out claims. Other schemes such as New Zealand’s Earthquake Commission and the California Earthquake Authority have both required additional funding from levies to provide subsidised premiums, and also limit the total amount that can be paid in claims. Further concerns include a complex and costly establishment process.

The Northern Australia Insurance Premiums Taskforce (NAIPT) also investigated the feasibility of a reinsurance pool in its report in 2015 as compared to an insurer subsidised by the government.¹⁹ It found a reinsurance pool to be the more feasible option, with the potential to deliver premium reductions and promote competition through new entrants to the northern Australia market.

Direct subsidies

Direct government subsidies involve government subsidising part of the cost of insurance premiums that are currently sold in the market. Schemes may vary in terms of duration, scope and size and could be used as a measure to address the most acute affordability issues facing consumers in northern Australia. Subsidies come at a fiscal cost each year, are often unsustainable as a long-term solution, and are difficult to withdraw.

In its report, the ACCC recommended direct subsidies as a means of providing immediate relief to consumers facing acute affordability pressures.²⁰ They noted that several risks exist when implementing subsidies. Depending on the design of a subsidy, future price increases would either reduce the effectiveness of the subsidy or increase its cost to government. Direct subsidies are also only likely to temporarily reduce the issues of affordability, without making any lasting improvements to insurance affordability because the underlying issues will remain unchanged and, unless designed carefully, subsidies could facilitate inappropriate development in high-risk areas.

The Productivity Commission, in their 2013 report *Barriers to Effective Climate Change Adaption*,²¹ opposed government-funded subsidies to address high insurance premiums. They considered that subsidies would dull incentives to manage risks and would be a short term and potentially costly solution. The then Government accepted the view of the Productivity Commission and decided against proceeding with the proposal.

Mitigation

Mitigation of natural disaster risk is an important part of long-term risk reduction. Investing in public and private mitigation actions, such as the building of levees and dams, as well as household level interventions, increases properties’ resilience.

The ACCC has identified that there is a key role for the insurance industry to play in identifying possible mitigation measures and resulting premium reductions for consumers.²² This sentiment was echoed by the Royal Commission who recommended that the insurance industry and state and territory governments should work together to provide and circulate to consumers clear guidance on individual-level mitigation actions that will be recognised by insurers when setting premiums.²³

The NAIPT also made a similar recommendation noting that one way to sustainably reduce premiums is through mitigation activities that reduce the risk of damage from cyclones. It recommended that the insurance industry develop insurance

¹⁹ The Australian Government the Treasury (2015) *Northern Australia Insurance Premiums Taskforce Final Report*, November 2015, available at: <https://treasury.gov.au/publication/northern-australia-insurance-premiums-taskforce-final-report>.

²⁰ Australian Competition and Consumer Commission (2020) *Northern Australia Insurance Inquiry – Final Report*, November 2020, p. xxiv.

²¹ Productivity Commission (2013) *Barriers to Effective Climate Change Adaption*, March 2013, available at: www.pc.gov.au/inquiries/completed/climate-change-adaptation/report.

²² Australian Competition and Consumer Commission (2020) *Northern Australia Insurance Inquiry – Final Report*, November 2020, p. xxi.

²³ Royal Commission into National Natural Disaster Arrangements (2020) *Final Report*, p. 43.

pricing systems that provide greater recognition of mitigation action and that, where mitigation actions are unaffordable for consumers, the Government may subsidise the cost.²⁴

Following the NAIPT's report recommendation that the insurance industry develops insurance pricing systems that provide greater recognition of mitigation action, the ACCC found an increased level of mitigation recognition in the market. The insurance industry calculates premiums based on individual risk profile of properties and can provide discounts for mitigation that is quantifiable and verifiable. The ACCC Report indicates that Suncorp, Sure Insurance and RACQ explicitly offer premium discounts to properties where activity has been undertaken to improve the property's cyclone resilience.²⁵

As noted above, the Government has established the National Recovery and Resilience Agency following the 2020 Royal Commission into Natural Disaster Arrangements. In establishing the new agency, the Government provided \$615.5 million for the Preparing Australia program to provide grants for projects that support public and private disaster risk reduction and resilience. The Government also established the Australian Climate Service, which is a partnership of the Bureau of Meteorology, Geoscience Australia, CSIRO and the Australian Bureau of Statistics to better understand how natural hazards impact our society, economy, and built environment.

Removal of stamp duty

In its report, the ACCC recommended that the governments of Western Australia, the Northern Territory and Queensland abolish stamp duty on home, contents and strata insurance products.

The 2020 NSW Review of Federal Financial Relations considered the efficiency of insurance taxes.²⁶ The review found that 'insurance taxes are unfair, inefficient, and shift risk on to those least able to bear it'.²⁷ The review recommended that all specific taxes on insurance products should be removed and replaced by more efficient and broad tax bases (such as a levy on property owners, combined with a future broad-based land tax), to improve the affordability and uptake of insurance (see review recommendations 10 and 11).

Removing or reducing insurance taxes would be one of the most direct, immediate, and effective state government levers to improve insurance affordability. State insurance taxes are also economically inefficient as they change consumer behaviour by increasing the cost of insurance above what it would otherwise be, leading to under- and non-insurance.

²⁴ The Australian Government the Treasury (2015) *Northern Australia Insurance Premiums Taskforce Final Report*, November 2015, p. xvii.

²⁵ Australian Competition and Consumer Commission (2020) *Northern Australia Insurance Inquiry – Final Report*, November 2020, p 304

²⁶ NSW Treasury (2020) *NSW Review of Federal Financial Relations Final Report*, October 2020, available at: www.treasury.nsw.gov.au/four-pillars/federal-financial-relations-review/federal-financial-relations-review-final-report.

²⁷ *Ibid*, p. 67.

3. Policy options

3.1 Option 1 – Status quo

Under Option 1, no policy action would be implemented.

Under this option, no additional measures or a reinsurance pool would be introduced to support insurance affordability. High and rising insurance premiums in cyclone-prone areas in northern Australia is a long-running issue, leading to greater levels of underinsurance in the community. It is likely that, without government action, insurance affordability and access conditions in northern Australia would continue to deteriorate. Should a natural disaster occur, households and small businesses with no or reduced insurance may have limited financial capability to recover from the natural disaster event. They could then face challenges to their economic and personal wellbeing, which in turn can cause wider impacts in their communities and increase the fiscal burden on public health, emergency services and welfare systems.

The current work the Commonwealth government is undertaking to improve disaster resilience through the National Recovery and Resilience Agency, including the Preparing Australia Program, along with the state and local government efforts would continue. This should result in some premium relief in the long term but not in the short term.

3.2 Option 2 – Establishing a reinsurance pool with mandatory participation

Under this option, it is proposed that the Government would establish a reinsurance pool for cyclones and flooding related to cyclones, to improve the accessibility and affordability of insurance for high-risk properties.

Reinsurance is insurance for insurers; it is purchased by insurers to manage their exposure to large losses resulting from insurance claims made in response to a major event, such as a severe natural disaster.

Reinsurance can take different forms and there exists a global private reinsurance market that provides reinsurance in Australia for natural hazard risks. Private reinsurers diversify their exposure across many regions globally and, like any commercial business, ensure that the prices they charge will allow them to remain solvent and profitable.

Internationally, there are many examples of government-supported reinsurance pools for natural disaster risks, such as the French government's national catastrophe reinsurer Caisse Centrale de Reassurance, Flood Re in the United Kingdom (UK), and the Florida Hurricane Catastrophe Fund in the United States of America. International experience shows that such pools can be successful at improving insurance access and affordability.²⁸

Establishing a Government reinsurance pool for cyclones and related flood damage in Australia would allow insurers to reinsure the risk of losses from claims at a lower cost than in the private reinsurance market, as the pool would:

- forgo a commercial profit margin and charge premiums that correspond to the long term expected cost of cyclone and related flood damage events and administration of the reinsurance pool; and
- be backed by a government guarantee, so the reinsurance pool would not have to charge higher premiums to ensure it has enough liquidity (that is, cash on hand) to cover the cost of rare and catastrophic events.

²⁸ For example, the 2019 quinquennial review of the Flood Re scheme found that the scheme had been successful and made significant progress on its access and affordability objectives. See *Flood Re (2019) Regulation 27: The Quinquennial Review*, July 2019, p. 20, available at: www.floodre.co.uk/wp-content/uploads/QQR_FINAL.pdf

A reinsurance pool would lower insurance premiums for households and small businesses by decreasing the cost of reinsurance, which is a significant cost component of premiums for policies with high cyclone and related flood damage risk. Insurers would be expected to benefit from lower reinsurance costs but would face some disruption to their existing reinsurance arrangements. Reinsurers would also face disruption and lose access to the reinsurance business that would be covered by the pool.

A lower cost of reinsurance paid by insurers would lead to a lower cost that is passed through to the consumer in lower premiums. Pass through would be ensured through monitoring undertaken by the ACCC. Downward pressure on premiums may also arise from the pool encouraging increased insurer competition in cyclone-prone areas and, over time, from the pool providing a stronger financial incentive for natural hazard risk mitigation through its pricing of premiums (including discounts for mitigation actions).

Reductions in the cost of high-risk insurance premiums would contribute to the Government's priorities of developing northern Australia, increasing access to more affordable insurance, and – in conjunction with mitigation proposals – reducing the expected harm of natural disasters to individuals and communities.

Administration

The ARPC would operate the reinsurance pool. The ARPC is a public financial corporation established by the *Terrorism Insurance Act 2003* (TI Act) to administer the terrorism reinsurance scheme, which provides primary insurers with reinsurance for commercial property and associated business interruption losses arising from a declared terrorist incident.

Coverage

The pool would offer reinsurance for eligible risks, including household, strata, and small business property insurance policies. This would also include charities and not-for profits.

The pool would cover mainland Australia, coastal islands that are part of Australia and extra-territorial jurisdictions, such as Christmas Island and the Cocos (Keeling) Islands.

The pool would cover cyclone and cyclone-related flood damage. This refers to all wind, rain, rainwater, rainwater run-off, and storm surge and riverine flood damage caused by a cyclone. The definition of 'cyclone' would be defined in law based on the current definition of tropical cyclone given by the Bureau of Meteorology.

Guarantee

The pool would be backed by a Government guarantee and the ARPC would charge premiums only to cover expected administration and claims costs (that is, be cost-neutral to Government over time).

Participation

Under this option, insurers must obtain reinsurance for all eligible cyclone and related flood risks and must obtain it from the ARPC.²⁹ Insurers would still be able to obtain additional reinsurance alongside that offered by the pool, and would do so to manage their exposures in line with their risk appetites.

Mandatory participation maximises participation in the scheme and enables the greatest potential premium reductions. It negates the risk that insurers only pass on their 'worst' risks to the pool or that only insurers with the riskiest portfolios participate, thereby undermining the pool's ability to offer premium reductions. It would allow for the greatest diversification of risk for the reinsurance pool.

²⁹ Note: no obligation to take part for insurers that do not hold eligible risks.

Transition period

Under this option, the reinsurance pool would include an initial transitional period to allow insurers sufficient time to transition their existing reinsurance contracts, upgrade their IT systems, update their capital management, underwriting and pricing processes, and communicate any changes to policyholders.

Insurers would be able to sign up any time between the pool's commencement on 1 July 2022 and the end of 2023, with an additional year for small insurers. There would be an incentive for insurers to transition early to the pool to access cheaper reinsurance.

Once signed up, new and renewing insurance policies from that date would be ceded to the pool. As most insurance policies renew on an annual basis, most eligible policies would be covered by the pool within 12 months of the insurer signing up for coverage. Existing policies could be covered from the sign-up date by agreement between the pool and the insurer.

Monitoring

A monitoring program to ensure there is a pass-through of premium savings to consumers would be undertaken by the ACCC. The objectives of the monitoring program would be to monitor the impact of the pool in improving the affordability of property insurance for households and small business and monitoring the pass through of insurer savings to policyholders.

The ACCC would publish an annual report on its monitoring activities that would identify any insurers that are not passing on savings to policyholders. The ACCC's analysis would also inform future evaluations of the reinsurance pool as well as any subsequent adjustments to its design.

3.3 Option 3 – Establishing a reinsurance pool with voluntary participation

As for Option 2, except in relation to participation and transition arrangements.

Participation

It would be optional for insurers to purchase insurance for cyclone related flood risk from the ARPC. However, if insurers choose to participate in the pool, they must reinsure all eligible cyclone risks in their portfolio with the ARPC.³⁰ As with Option 2, insurers would still be able to obtain additional reinsurance alongside that offered by the pool.

Insurers would be likely to take part in the pool if the reinsurance pool offers a rate that is less than what is available in the market. This would reduce costs for insurers and participating in the pool would be a financial incentive that would then allow them to pass on savings to consumers and better compete against other insurers.

Transition

Under this option, the reinsurance pool is voluntary and no special transition arrangements are required. Insurers would be able to sign up any time from the pool's commencement.

Once signed up, new and renewing insurance policies from that date would be passed on to the pool. As most renew on an annual basis, most eligible policies would be covered by the pool within 12 months of the insurer signing up for coverage. Existing policies could be covered from the sign-up date by agreement between the pool and the insurer.

³⁰ Note: eligible risks would be the same as under Option 2.

4. The likely net benefit of each option

4.1 Option 1 – Status quo

Who is affected and what is the impact?

Policyholders – households and businesses

In the absence of further government action, acute property insurance affordability issues for households and businesses in high cyclone risk areas are likely to continue to worsen. This would weaken northern Australia’s resilience to natural disasters and increase costs to governments due to pressure on health, emergency services, and welfare systems.

The current work the Government is undertaking to improve disaster resilience through the National Recovery and Resilience Agency, including the Preparing Australia Program, along with the state and local government efforts would continue. This should result in some premium relief in the long term but not in the short term.

Insurers and reinsurers

No direct impact on insurers and reinsurers, although insurers may face pressure to further reduce their exposure to high-risk regions, particularly in northern Australia.

Government

Governments would continue to bear increased costs after cyclones for communities where there are high levels of underinsurance and no insurance. This would be through increased pressure on health, emergency services, and welfare systems.

Estimate of regulatory impact

There is no regulatory impact imposed under the status quo.

Regulatory burden estimate (RBE) table

Average annual regulatory costs				
Change in costs (\$ million)	Individuals	Business	Community organisations	Total change in cost
Total, by sector	\$0	\$0	\$0	\$0

4.2 Option 2 – Establishing a reinsurance pool with mandatory participation

Who is affected and what is the impact?

Policyholders (individuals, households and small businesses)

Individual, households and small businesses in cyclone risk areas would be expected to benefit from reduced property insurance premiums and improved access to home, contents, strata and commercial property insurance. Charities and not-for-profits would also be eligible and therefore expected to benefit.

Modelling indicates that the pool could generate annual total premium savings of about \$290 million for eligible insurance policies across Australia, with a higher proportion of savings going to household policies.³¹ Premium reductions would be targeted to high-risk areas, which are largely located in northern Australia. The pool would not be expected to significantly affect average premiums outside of cyclone-risk areas.

The savings arise from the elimination of commercial profit margins through the mandatory participation of insurers and is also supported by the Government guarantee. The discounts available to consumers are greatest under a reinsurance pool with mandatory participation.

Policyholders would not experience any regulatory burden impact from the adoption of Option 2 as they do not have direct interaction with reinsurers or reinsurance, which is handled by insurers instead.

Insurers

The ACCC found that there are eight insurers who underwrite the vast majority of home, contents and strata insurance in the high-risk region of northern Australia. There are also others who supply a small number of policies in northern Australia. The commercial property insurance market is similarly concentrated. These insurers would be expected to benefit from reduced reinsurance costs.

Insurers may experience some disruption in transitioning from their existing reinsurance arrangements to reinsuring with the pool. Local reinsurance cover renews at various points in the year, with the majority on 1 July or 1 January, but with a few at various other points in the year. While most reinsurance contracts are estimated to renew on an annual basis, some insurers enter into multi-year agreements which run up to three years (or longer, in rare instances).

Many insurers will already have a relationship with the administering organisation, ARPC, through its existing provision of reinsurance for commercial property and associated business interruption losses arising from a declared terrorist incident. But the contracts with the ARPC and their other reinsurance providers would need to be negotiated and signed. Insurers would need to update their systems to allow for the premium calculations and payments to the ARPC.

The proposed transitional arrangements would reduce transition costs as insurers would either be able to sign up as their current reinsurance contracts cease (without needing to renegotiate or exit existing contracts) or would have sufficient time to renegotiate longer-term multi-year contracts on favourable terms. As noted in section 3, insurers would have the option of ceding only new or renewing policies from the date they sign up for coverage, which they could choose to do if it reduces disruption to their existing reinsurance arrangements. Otherwise, they could agree to pass all eligible policies to the pool.

In addition, by reducing reinsurance costs and sharing the risk of meeting cyclone damage claims in northern Australia, the pool would be expected to encourage additional insurers to enter the northern Australian market. As high natural peril reinsurance costs are a barrier to entry into this market, the new pool would provide a stable and lower cost means for insurers

³¹ The modelling does not explicitly account for the effect of new entrants and increased competition.

to manage their cyclone risk exposure. The entry of additional insurers would be expected to increase competition and place downward pressure on insurance premiums.

Insurers would also face one-off implementation costs to educate themselves on the new pool and implement any changes to their processes to ensure they are compatible with the reinsurance pool's legislation, regulations and consequential changes to Australian Prudential Regulation of Australia (APRA) standards. Insurers would likely need to upgrade their IT systems, update their capital management, underwriting and pricing processes, and communicate any changes to policy holders. This would involve modelling based on the pool design, subsequent marketing, determination of their reinsurance contract structure, which is to then be approved by their board. However, this would not be expected to be a significant cost as it is normal business practice for insurers to annually obtain reinsurance for natural disaster risks, so there would be little additional costs for 'normally efficient' insurers.³²

Insurers would need to collect and share data to comply with the ACCC monitoring program. The monitoring program would request data from insurers, which would impose an additional cost on insurers.

Insurance brokers

The implementation of a reinsurance pool for cyclone and cyclone-related flood risks would have a minor administrative impact on insurance brokers. Reinsurance and insurance brokers would have to be briefed by insurers and like insurers would face one-off implementations costs to educate themselves on the new pool and implement any changes to their processes to ensure they are compatible with the reinsurance pool.

Reinsurers

The implementation of a reinsurance pool for cyclone and cyclone-related flood risks would result in reinsurers losing some of the risks they currently cover to the pool. This would result in lost revenue for reinsurers depending on the amount of business lost to the pool.

Modelling indicates that, under Option 2, the pool would take on cyclone risks that would otherwise sit, collectively, with insurers and reinsurers and amount to about \$1 billion per year in insurance costs.³³ The modelling also suggests that the majority of these premiums are attributable to the expected annual average loss from cyclones and related flooding.

Reinsurance is considered to be a competitive market, with reinsurers writing global portfolios and managing their portfolios in this context.³⁴ Australia acts as a diversification market for natural disaster insurance exposure globally, so reducing the demand for reinsurance here would have some effect (though relatively marginal in the context of a global reinsurance market estimated to have a capital base of over US\$650 billion).³⁵ However, insurers do not purchase reinsurance just for cyclone and related flood risk. Typical natural catastrophe reinsurance covers several natural disaster perils (including earthquake risks, all bushfire risk, non-cyclone related flood risk, and severe convective storm risk). Limiting the coverage of the pool to cyclone and cyclone-related flood risks would leave a material proportion of the total natural disaster loss exposure in the private reinsurance market.

³² Consistent with Office of Best Practice Regulation guidelines, a 'normally efficient' business is defined as a regulated entity that handles its regulatory tasks no better or worse than another.

³³ The modelling was based on current market conditions, which included specialised natural catastrophe modelling to inform estimates of natural catastrophe risk, and was informed by confidential insurer and industry data to estimate the impacts of a reinsurance pool. The methodology and assumptions underlying the modelling were tested with the Australian Government Actuary and with an Industry Expert Panel. Their feedback was incorporated and helped refine the outputs of the model.

³⁴ Australian Competition and Consumer Commission (2020) *Northern Australia Insurance Inquiry – Final Report*, November 2020, p. 159. available at: www.accc.gov.au/publications/northern-australia-insurance-inquiry-final-report.

³⁵ Willis Towers Watson (2021) *Willis Re Reinsurance Market Report – Half Year 2021*, September 2021, available at: www.willistowerswatson.com/en-AU/Insights/2021/09/willis-re-reinsurance-market-report-september-2021-results-for-half-year.

A key factor in determining the impact of the pool on reinsurance pricing is the effect on the amount (or 'top limit') of reinsurance bought by insurers, which is determined by insurers based on their 'probable maximum loss' (or 'PML'). The PML is defined by the APRA as the largest loss that would arise with a probability of 0.5 per cent over one year (referred to as a '1-in-200-year' return period), even though such an event does not occur every 200 years. Some insurers decide to buy more cover than needed for the PML, which is a commercial decision based on their risk appetite.

For most insurers, the PML is not determined solely by their cyclone exposure (that is, cyclone is not the largest catastrophe risk they face). For many insurers, the risk determining the PML is earthquake in Melbourne or Sydney. For many insurers, therefore, the pool would not reduce the amount of private reinsurance cover bought but it should, all else being equal, reduce the price because there is less likelihood of claims. There may be a smaller number of insurers that have cyclone as their largest risk, and for these insurers the amount of reinsurance cover they purchase may well reduce as well as the price. Given the global scale and competitive nature of the reinsurance market, as well as the material proportion of Australian natural disaster loss exposure that the reinsurance pool would leave unaffected, it is not expected that reinsurers would attempt to 'penalise' Australian insurers to any significant degree for any loss of profit margins due to the transfer of cyclone risk to the reinsurance pool. In addition, the reinsurance pool may in future transfer some of the risk back to private reinsurers through a retrocession program, similar to that in place for the terrorism reinsurance pool.

Reinsurers would also face one-off implementation costs to educate themselves on the new pool and implement any changes to their processes to ensure they are compatible with the reinsurance pool. Primarily, reinsurers would need to adjust their systems to separate the risks that are passed to the reinsurance pool. However, this is not expected to be a significant cost for the normally efficient reinsurer. Many reinsurers have existing relationships with the ARPC through the terrorism reinsurance pool retrocession program (that is, the ARPC purchasing reinsurance itself for the terrorism risks that insurers have transferred to the pool). There are about 70 participants in the ARPC's terrorism retrocession program.³⁶

Reinsurers would also incur the cost of renegotiating reinsurance treaties with insurers (as discussed in the insurer section).

Community and environmental

By increasing the availability and affordability of home, contents, strata and small business property insurance in cyclone risk areas, the pool would be expected to have some effect on the decisions of individuals, households and small businesses on where to locate over time, with more people and businesses choosing to move to or stay in northern Australia than there otherwise would be. All else being equal, this would be expected to have a flow-on effect on the locational decisions of community and government organisations. Longer term, this may be expected to result in greater development in northern Australia.

However, it is important to note that the cost and availability of insurance is just one of many factors that informs locational decisions and likely plays a relatively minor role in informing locational decision. For example, other government policy actions contemplated by the ACCC in its report, such as raising building standards and changing planning regulations may raise apparent living costs in disaster prone areas in northern Australia and have a corresponding impact on decisions to move to or stay in these areas.

Government

The ARPC would need to expand its capabilities to deal with the increased demands of running a natural hazard reinsurance pool. Currently, it manages Australia's national terrorism reinsurance scheme.

The reinsurance pool would be expected to be cost-neutral to administer and cost-neutral to Government over time but would have budget impacts in instances where the cost of a cyclone event exceeds available funds accumulated in the reinsurance pool, causing the Commonwealth's guarantee to be called upon.

³⁶ Australian Reinsurance Pool Corporation (2020) *2019-20 Annual Report*, September 2020, p. 43, available at: www.arpc.gov.au/publications/annual-report/.

As a historical point of reference, Cyclone Tracy was Australia’s costliest cyclone – it hit Darwin in late 1974 and resulted in damage worth about \$6.5 billion (adjusted to current value).

The ACCC would require additional resourcing to undertake a monitoring role in relation to the reinsurance pool.

Estimate of regulatory impact

There would be an estimated \$0.44 million average annual regulatory cost on the insurance industry to support a benefit for properties in high-risk cyclone areas.

The regulatory costing assumes:

- full participation of insurers holding eligible risks under the mandatory model;
- that most reinsurers active in the market would be affected;
- that about a fifth of insurance brokers or other intermediaries would both:
 - deal in eligible risks (household, SME property and strata); and
 - deal in policies with sufficient cyclone risk that they need to adjust processes for the cyclone reinsurance pool.
- that there is no regulatory impact on policyholders (including individuals and businesses), as they do not have any direct interaction with reinsurers; and
- to simplify the calculation, that the regulatory impact is identical within cohorts (i.e. same impact for all insurers, same impact for all reinsurers).

While the regulatory costing was not directly tested with stakeholders, the assumptions and costs underpinning it were informed by stakeholder consultation as well as analysis from past reviews, including the 2011 Natural Disaster Insurance Review, the 2015 Northern Australia Insurance Premiums Taskforce Report, the 2020 Royal Commission into Natural Disaster Arrangements, and the Australian Competition and Consumer Commission’s Northern Australia Insurance Inquiry.

A mandatory reinsurance pool would address the policy objectives to:

- improve insurance access and affordability in northern Australia;
- strengthen northern Australia’s resilience to natural disasters; and
- build the financial capability of people and businesses to support a disaster resilient Australia.

Regulatory burden estimate (RBE) table

This table can be used to present quantifiable impacts using the Regulatory Burden Measurement Framework. For further information, please consult the Regulatory Burden Measure Guidance Note.

Average annual regulatory costs				
Change in costs (\$ million)	Individuals	Business	Community organisations	Total change in cost
Total, by sector	-	\$0.44	-	\$0.44

International comparison

Internationally, at least five countries have established natural disaster reinsurance pools to promote insurance affordability and smooth risk across regions. These include Japan, France, the United Kingdom and Indonesia.

There are several different ways in which a reinsurance pool can be designed, including how they are structured, how they are funded and how they approach setting premiums and paying claims. For example:

- Most reinsurance pools do not set premiums at the true technical rate corresponding to the underlying risk. Most charge a flat rate fee, receive a levy from all insurers, set risk-based but discounted premiums, or a combination of these.
- Reinsurance pools are often backed by some form of government guarantee which can be called on if claims exceed reserves. Where this is not the case, or where the guarantee is limited, the pool generally limits the claims it will pay in some way.
- Some reinsurance pools contain measures which are intended to maintain risk signals. For example, Flood Re in the United Kingdom only provides cover to buildings built before 2009 when flood insurance issues began to arise.
- Some pools are seen as temporary solutions, and contain mechanisms to be phased out. For example, Flood Re has a limited life of 25 years.

Options 2 and 3 adopt some of their high-level design from the Florida Hurricane Catastrophe Fund, which is a mandatory reinsurance pool that is self-supported. The Florida Hurricane Catastrophe fund was established after Hurricane Andrew in 1992. It provides a stabilising force for the reinsurance market and the level of insurer retention is set statutorily.

Similarly, the Indonesian Earthquake Reinsurance Pool began operations in 2003 and participation in the Earthquake Reinsurance Pool (now called MAIPARK) was made compulsory for all general insurers and reinsurers.

The Flood Re in the United Kingdom, which is a voluntary reinsurance pool supported by a national levy, was also considered during the policy design process. Flood Re was established in 2016 to improve affordability for those households at highest risk of flooding and increase availability and choice of insurers for customers. Flood Re provides reinsurance cover at a subsidised rate, which is funded through a £180 million levy on household insurers in the UK. However, a levy is not being considered.

4.3 Option 3 – Establishing a reinsurance pool with voluntary participation

Policyholders (individuals, households and small businesses)

As for Option 2. However, the level of savings would be reduced and fewer individuals, households and small businesses would benefit due to the reduced participation of insurers in the reinsurance pool as well as a less balanced portfolio of risks for the reinsurance pool.

With voluntary participation, the nature and extent of insurer participation in the pool would have a significant impact on the possible premium reductions.

- The more insurers take part and the more cyclone and related flood risk that they pass on to the pool, the greater the influence the pool can have on the cost of cyclone cover.
- In the absence of a direct government subsidy, the pool would only be able to provide meaningful premium relief to medium-to-high cyclone risk properties if it takes on a balanced portfolio of risks from insurers.

The ‘one-in-all-in’ approach reduces adverse selection at the individual insurer level as insurers would not be ceding only the highest risk properties in their portfolios to the pool. However, this would not address the adverse selection of insurers with higher-risk portfolios (see discussion below under ‘insurers’ heading).

An estimate informed by modelling is that about half of the premium reductions in high-risk areas would be available, as compared to Option 2.³⁷ This indicative estimate assumes that the highest risk household policies are ceded to the pool, and about half of the remaining policies are with insurers that choose not to participate in the pool.

³⁷ See footnote 33.

Insurers

As participation for insurers is voluntary, insurers would be able to minimise any disruption to their existing reinsurance arrangements (for example, by either choosing not to reinsure with the pool at all, or timing their switch to the pool to coincide with their reinsurance contract coming up for renewal). Individual insurers would only participate if the benefits to them outweigh the costs.

As noted earlier, the nature and extent of insurer participation in the pool would have a significant impact on the premium reductions that it could achieve.

- The more insurers participate and the more cyclone and related flood risk that they pass on to the pool, the greater the influence the pool can have on the cost of cyclone cover.
- In the absence of a direct government subsidy, the pool would only be able to provide meaningful premium relief to medium-to-high cyclone risk properties if it takes on a balanced portfolio of risks from insurers.

Under this option, there would be significant uncertainty about the extent to which insurers would choose to participate in the pool. This uncertainty arises because of the adverse selection risk discussed above, which could give rise to a 'vicious cycle'. Initially, there may not be sufficient take-up for the pool to offer sufficiently discounted rates to attract insurers with lower-risk portfolios. The levels of savings could be further reduced by a lack of diversification of risk within the pool as insurers with higher-risk portfolios would cede to the pool, while insurers with lower-risk portfolios may not. Consequently, the reduced savings offered by the pool would lead to less participation by insurers with lower-risk portfolios and the pool carrying a portfolio more heavily weighted towards high cyclone risks. However, the extent of adverse selection and its impact on available savings depends on market behaviours that are difficult to predict, let alone rigorously model.

Some insurers have indicated that market dynamics alone might be sufficient to incentivise participation (that is, if the pool offers cheaper reinsurance than the commercial market, then insurers would use the pool as a matter of sound business decision-making). However, given the transitional costs of transferring existing reinsurance arrangements to the pool as well as the uncertainty around adverse selection and the impact on available savings, there may not be sufficient take-up for the pool to offer sufficiently discounted rates. As acknowledged during stakeholder consultations, the greater the level of participation in the pool, and the more diverse the portfolio of risks the pool holds, the more benefit there will be for insurers to participate in the pool, including insurers with lower-risk portfolios.

Otherwise, the benefits and impacts otherwise would be the same as for Option 2.

Reinsurers

As for Option 2, however the level of insurer participation in the reinsurance pool would be lower, which would result in less of a reduction of revenue and diversification for reinsurers.

Community and environmental

As for Option 2. However, as the improvement in affordability would be reduced and more narrowly distributed, there would be less effect on the decisions of individuals, households and small businesses on where to locate, and so there would be fewer people and businesses choosing to move to or stay in disaster prone areas of northern Australia than there would be under Option 2 (but still more than under Option 1).

As with Option 2, however, it is important to note that the cost and availability of insurance is just one of many factors that informs locational decisions and likely plays a relatively minor role in informing locational decision.

Government

As for Option 2, the APRC would need to expand its capabilities to deal with the increased demands of running a natural hazard reinsurance pool.

As the extent of insurer participation would be expected to be lower than under Option 2, there would be fewer reinsurance claims for the ARPC to process and fewer agreements to negotiate with insurers. While the ARPC would still need to expand its capabilities, it may be able to implement this option with less resourcing than under Option 2.

As with Option 2, the reinsurance pool would be expected to be cost-neutral to administer and cost-neutral to Government over time but would have budget impacts in instances where the cost of a cyclone event exceeds available funds accumulated in the reinsurance pool, causing the Commonwealth’s guarantee to be called upon.

As a historical point of reference, Cyclone Tracy was Australia’s costliest cyclone – it hit Darwin in late 1974 and resulted in damage worth about \$6.5 billion (adjusted to current value).

As for Option 2, the ACCC would require additional resourcing to undertake a monitoring role in relation to the reinsurance pool.

Estimate of regulatory impact

There would be an estimated \$0.25 million average annual regulatory cost on the insurance industry to support a benefit for properties in high-risk cyclone areas.

The regulatory costing makes the same assumptions as the costing under Option 2, except it assumes that:

- half as many insurers holding eligible risks would participate under the voluntary model; and
- half as many reinsurers would be affected.

While the regulatory costing was not directly tested with stakeholders, the assumptions and costs underpinning it were informed by stakeholder consultation as well as analysis from past reviews, including the 2011 Natural Disaster Insurance Review, the 2015 Northern Australia Insurance Premiums Taskforce Report, the 2020 Royal Commission into Natural Disaster Arrangements, and the Australian Competition and Consumer Commission’s Northern Australia Insurance Inquiry.

A voluntary reinsurance pool would address the policy objectives to:

- improve insurance access and affordability in northern Australia;
- strengthen northern Australia’s resilience to natural disasters; and
- build the financial capability of people and businesses to support a disaster resilient Australia.

Regulatory burden estimate (RBE) table

This table can be used to present quantifiable impacts using the Regulatory Burden Measurement Framework. For further information, please consult the Regulatory Burden Measure Guidance Note.

Average annual regulatory costs				
Change in costs (\$ million)	Individuals	Business	Community organisations	Total change in cost
Total, by sector	-	\$0.25	-	\$0.25

5. Consultation

Significant stakeholder consultation was undertaken during policy development. The purpose of consultation was to:

- seek industry and other stakeholder views on key features of the reinsurance pool to guide the design process;
- ensure Treasury has sufficient information to form views on key risks associated with a reinsurance pool, across short-, medium- and long-term time horizons, and be able to advise the Government on these risks;
- understand industry transition risks and consider appropriate transition arrangements; and
- understand the regulatory impact on businesses, community organisations and individuals to inform decision making.

Policy development also relied on analysis from past reviews, including the 2011 Natural Disaster Insurance Review, the 2015 Northern Australia Insurance Premiums Taskforce Report, the 2020 Royal Commission into Natural Disaster Arrangements, and the Australian Competition and Consumer Commission's Northern Australia Insurance Inquiry.

Consultation process

Phase one of consultation occurred prior to the 2021-22 Budget. Treasury undertook consultation across Government to test initial responses and draw out any fundamental drawbacks in the broad proposal. The purpose of this consultation was to gauge the potential impact of a reinsurance pool and to better understand the state of the market. This initial consultation phase also relied on in-depth analysis of past reports, reviews and inquiries on issues related to insurance affordability in northern Australia and the establishment of a reinsurance pool (noted above).

Feedback from these meetings and reports was used to inform our understanding of the insurance market in northern Australia, the problems facing the market, options for reform, and approaches to implement these options.

Phase two of consultation commenced following the Government's 4 May 2021 announcement. This phase ran from May until September 2021, and consisted of three main methods of engagement:

- consultation via invitation to submit a response to a public consultation paper;
- establishment of two standing roundtables; and
- continuous, targeted, bi-lateral consultation with community, business and consumer advocacy organisations, key industry actors and groups, and other interested stakeholders.

Public consultation

A consultation paper was published on the Treasury website on 21 May 2021 and was open for comment until 18 June 2021. Subject to the Government's discretion, submissions would also be published on the Treasury website in due course. The objectives of the consultation paper were primarily to seek broad, exploratory feedback from stakeholders to assist the Taskforce to:

- design a reinsurance pool scheme that improves the availability and affordability of insurance in cyclone-prone areas;
- understand risks associated with the establishment of a reinsurance pool to be mitigated across short-, medium-, and long-term horizons;
- guide the industry transition to reinsuring with the pool, by ensuring that the industry is informed adequately and in a timely manner to undertake the relevant actions; and

- minimise any adverse or unintended impacts arising from the establishment of the reinsurance pool.

The paper sought comments on a wide range of design features of a reinsurance pool, including the pool coverage ('how should cyclone and related flooding be defined' and 'which insurance policies should be eligible to be covered'), the reinsurance pool product design and insurer participation ('how should the reinsurance product be designed and priced' and 'how should insurer participation be managed'), as well as how a reinsurance pool should be governed and monitored over time.

The paper received strong interest and engagement, with Treasury receiving 64 submissions from a broad range of relevant industry and community stakeholders. This included 38 consumer and community advocacy submissions from individuals and organisations, 15 submissions from insurance industry stakeholders (comprising insurers, reinsurers, brokers, and industry expert bodies and peaks), and 8 government bodies.

Accompanying the release of a public consultation paper, the Taskforce hosted two industry roundtables, with insurers and strata insurance stakeholders respectively, in June 2021. A range of insurers and other stakeholders were invited to attend, and the roundtable sought feedback on the technical design questions outlined in the consultation paper. Due to COVID-19 health and travel restrictions, three further roundtables were held virtually in the Whitsundays, Cairns and Townsville in July 2021, where the Taskforce met with leaders and advocates from communities affected by the issue of insurance affordability in northern Australia.

Both the submissions and discussions at the roundtables reaffirmed the challenges of insurance affordability and access in northern Australia. Submissions from consumer, business and community organisations shared data, case studies and anecdotes demonstrating the impact of insurance affordability issues of the lived experience of northern Australia residents and the resilience of their communities. The complexity of designing a pool that would address these issues was also a key theme arising from the submissions and discussions. Through this consultation process, the Taskforce had a greater understanding of the potential complications associated with some design features and where additional attention should be focussed during the design phase.

Standing roundtables

In parallel to consultation through the public consultation paper, two standing roundtables were established to provide industry expertise and advice during the design of the reinsurance pool:

- **Industry Advisory Panel:** This panel consisted of members with significant, deep experience in actuarial practice, insurance and reinsurance industries, as well as insurance broking. The Panel provided technical advice on the impact of different models of reinsurance on the broader insurance and reinsurance market, and the implications for pricing of premiums (including the generation of any savings). The Panel met regularly from mid-July and provided information and feedback out of session on materials prepared by the Taskforce.
- **North Queensland Consultant Panel:** The North Queensland Consultant Panel was established to draw on the experience and knowledge of key local community stakeholders and insurance affordability advocates during the development of a pool design. The North Queensland Consultant Panel was met from mid-July and provided advice on a range of topics, including on the policy coverage, hazard coverage, and type of reinsurance. Members of the panel provided information and feedback out of session on material prepared by the Taskforce.

Targeted consultation

In addition to testing positions through the standing roundtables, the Taskforce undertook a significant level of targeted, bi-lateral consultation with over 40 organisations. This targeted consultation was used to:

- seek advice from specialist organisations including existing Government reinsurance pool operators, catastrophe modellers, scientific experts, and meteorologists;
- explore responses to the consultation paper in further detail with respondents;

- provide an opportunity for a broad range of stakeholders, especially community organisations and industry groups, who were not panel members to provide their views to the Taskforce during the design development phase; and
- address any remaining gaps in the Taskforce’s understanding of reinsurance product design and market mechanisms.

Targeted meetings, presentations, and discussions provided robust input to policy development and the specification of the pool’s design parameters. These parameters would be tested through the standing roundtables, and further advice would be sought through targeted consultation, in a cyclical process of refining positions through gathering additional information.

Incorporating consultation outcomes

Feedback from stakeholders was continuously incorporated into the policy development of the reinsurance pool at every stage of the design process. As outlined above, the consultation program was conducted across a variety of formats to ensure that feedback could be sought via the most appropriate means for the specific stage of the design process and consultation objective.

Overview of stakeholder feedback by stakeholder group and subject area

The below table outlines the feedback received by the Taskforce through the consultation process (comprising the public consultation, roundtables, and standing panels) by stakeholder group and subject area.

Topic	Consumer, business and community advocacy	Insurance industry and subject matter experts	Government agencies and bodies
Reinsurance pool coverage	<ul style="list-style-type: none"> • Almost all submissions supported the use of the Bureau of Meteorology’s (BoM) definition of a cyclone as the basis for defining a cyclone. • There was also broad support to include storm surge in the hazard coverage of the reinsurance pool. <p>Stakeholders supported a broad definition of ‘small business’ (such as less than \$10 million turnover or less than 100 employees). Some stakeholders advocated for no thresholds on the size of businesses covered by the pool.</p>	<ul style="list-style-type: none"> • Stakeholders noted the importance of developing definitions of ‘cyclone’ that provide adequate clarity and contract certainty to the insurance industry. • Stakeholders had concerns that using a definition of ‘small business’ that is impractical or costly for insurers or the reinsurance pool to implement poses a risk to the pool’s success as well as compliance burdens on small businesses. • Stakeholders suggested an eligibility threshold based on maximum property sum insured. 	<ul style="list-style-type: none"> • Stakeholders emphasised the importance of establishing clear hazard definitions and clarity around the policy coverage scope of the pool. • Stakeholders noted that coverage should extend to Australia’s external territories. • Stakeholders considered that more flexible definitions of ‘small business’ were preferable.
Reinsurance product design and insurer participation	<ul style="list-style-type: none"> • Stakeholders noted a general need for the pool to take on a significant proportion of cyclone risk from insurers to deliver premium savings. 	<ul style="list-style-type: none"> • Stakeholders recognised that the pool would need to take on a significant proportion of cyclone risk to generate material premium savings. 	<ul style="list-style-type: none"> • Stakeholders emphasised the importance of ensuring premium savings are delivered promptly and passed on to consumers in full. They preferred models of

Topic	Consumer, business and community advocacy	Insurance industry and subject matter experts	Government agencies and bodies
Reinsurance product design and insurer participation (cont.)		<ul style="list-style-type: none"> • There was also support for a reinsurance model that provided the ability for premium pricing at a per property level to target savings. • Stakeholder feedback on participation models was mixed. Some stakeholders suggested that participation should be mandatory. Other stakeholders preferred a voluntary participation model, suggesting market dynamics alone are sufficient to incentivise participation. • Stakeholders emphasised that appropriate transitional arrangements would be important to minimise disruptions to the market and transition costs for insurers that may incur. 	reinsurance that resulted in the greatest benefit to residents in northern Australia (such as a mandatory participation model).
Reinsurance pool governance	<ul style="list-style-type: none"> • Stakeholders emphasised the importance of monitoring to ensure savings generated by the pool are passed on to policyholders. • Almost all stakeholders supported a regular ongoing review of the reinsurance pool. Views differed over the ideal period for reviews. 	<ul style="list-style-type: none"> • Stakeholders also supported an ongoing review of the pool, and reviews could consider changes in competition and analysis of past claims events. 	<ul style="list-style-type: none"> • Where stakeholders commented, they supported a regular review of the reinsurance pool. • Stakeholders broadly supported monitoring of pass through of premium savings.

Overview of how consultation outcomes have been incorporated

The Taskforce used the feedback received through the consultation process to develop preliminary positions on key elements of the design of a reinsurance pool. These positions, and the consultation feedback that informed them, were tested with the two standing roundtables – the Industry Advisory Panel and the North Queensland Consultant Panel – and through targeted consultation with relevant experts. Through this process, stakeholders were able to validate or qualify the advice received through consultation.

The table below provides an overview of how feedback received through the consultation process has been used to inform the development of options for a design of a reinsurance pool and the impact analysis presented in this regulatory impact statement.

Topic	
Reinsurance pool coverage	<ul style="list-style-type: none"> In line with stakeholder feedback, options developed reflect an understanding of ‘cyclone-related flooding’ that includes cyclone, as well as inland (riverine) flooding, and flooding from the sea via storm-surge. Additionally, ‘cyclone’ and ‘storm surge’ would be defined in law, with the legal definition based on the current BoM definition. This approach was tested with industry experts through the Industry Advisory Panel as well as targeted consultation with Australian scientific and meteorological bodies. The outcomes from the consultation process supported the use of sum insured test for small business property eligibility (see <i>Case study: defining small business</i>) and testing with industry experts validated this approach.
Reinsurance product design and insurer participation	<ul style="list-style-type: none"> Strong stakeholder feedback emphasised the importance of ensuring premium saving generated from the pool would be material. This has been reflected in the scoping and assessment of options for a model of reinsurance that would maximise the pool’s ability to improve the affordability of insurance for household, strata and small business property policies in northern Australia (options discussed further in sections 3 and 4). Feedback also guided the development of options for insurers’ participation in the scheme, and the criteria of assessing how a mandatory model compares with a voluntary model of participation (see section 6). In response to insurers’ feedback on transitional risks, particularly for small insurers, transitional arrangements have been developed for each option with a focus on reducing transition costs. They include an initial transition period to allow insurers sufficient time to transition their existing reinsurance contracts and update operations, with additional time for small insurers. Options for reinsurance product design and insurer participation were refined through testing with the Industry Advisory Panel and North Queensland Consultant Panel.
Reinsurance pool governance	<ul style="list-style-type: none"> Reflecting stakeholders’ broad support of regular ongoing review arrangements, the implementation and evaluation plan for a reinsurance pool (see section 7) includes the establishment of a formal review process commencing first after three years (i.e. in 2025) and then at least once every five years (from 2030). In response to stakeholders’ support of some form of monitoring, the pool would be established with a monitoring program to be undertaken by the ACCC. The objectives of the monitoring program would be to monitor the impact of the pool in improving the affordability of property insurance for households and small business and monitoring the pass through of insurer savings to policyholders.

A case study is provided below that demonstrates in greater detail the process of how stakeholder feedback has been incorporated into the design of the reinsurance pool.

Case study: defining small business

On 4 May 2021, the Government announced its intention to establish a reinsurance pool that would provide coverage for small business, in addition to home and strata property. To capture small business under the pool’s coverage, the Taskforce needed to define what should constitute a ‘small business’ for the purposes of coverage eligibility.

There are currently no consistent definitions of ‘small business’ or ‘small business property insurance’ in the market. There are many varied definitions of ‘small business’ in use, including:

- a business that has a turnover of less than \$1 million and 5 or less full-time equivalent workers (the Insurance Contracts Regulations 2017);
- under the General Insurance Code of Practice, a manufacturing business with fewer than 100 employees or a non-manufacturing business with fewer than 20 employees; and
- for most small business tax concessions, a business that has less than \$10 million in turnover.

There are trade-offs when weighing different definitions. For instance, a turnover threshold could result in businesses near the threshold fluctuating between being eligible and ineligible for coverage, while other definitions may impose a greater administrative burden on businesses, insurers, and the reinsurance pool.

During initial stages of consultation, the Taskforce considered a standard definition recommended by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) as a business with less than \$10 million in turnover or fewer than 100 employees. Submissions to the consultation paper from non-insurance industry actors (i.e. consumer advocacy groups) supported the inclusion of the ASBFEO test, while submissions from industry stakeholders raised concerns regarding the ability to operationally implement such a test, noting that relying on these metrics would be problematic. Insurers do not collect or verify metrics that are often used by governments to define small business, such as turnover and number of employees, for the purposes of property insurance. Similarly, small businesses do not provide insurers with detail of their turnover or employee counts, which can vary with throughout the year.

Industry and other stakeholders suggested an alternative test of specifying a 'sum insured' limit. The 'sum insured' under an insurance policy is the maximum amount that a policyholder can claim from an insurer if their property is damaged or destroyed because of an insured event. Further advice on this approach was sought through the two standing roundtables.

Through consultation, the Taskforce considered that the sum insured test provided a relatively flexible eligibility threshold for small business property policies, that would capture the intended beneficiaries of the policy, with minimal administrative impost on small business and the insurance industry. It would be neutral between business property policies where most of the sum insured amount is the value of the building owned by the business, and policies for businesses that rent the property and most of the sum insured amount is the value of the business contents. The Taskforce sought data from insurers through targeted consultation to understand the distribution of sums insured. These data helped the Taskforce to specify an appropriate sum insured threshold, suggesting that a sum insured threshold of \$5 million would capture most businesses. The sum insured threshold would be reviewed overtime to ensure it remains set at an adequate level.

6. Best option of those considered

In summary, the three options considered have been:

- Option 1: status quo (no reinsurance pool);
- Option 2: mandating in legislation that insurers must participate in the reinsurance pool if they hold eligible cyclone risks (with appropriate transition arrangements); and
- Option 3: leaving it to insurers to elect to participate in the pool but requiring them to pass on a proportion of all eligible cyclone risks if they do.

Of these, Option 2 is the best option.

Option 1 (status quo)

Option 1 has no regulatory impact.

However, in the absence of further government action, acute property insurance affordability issues for households and businesses in high cyclone risk areas are likely to continue to worsen. Current mitigation efforts (including that of the Government through the National Recovery and Resilience Agency and the Preparing Australia Program) should result in some premium relief in the long term but not in the short term.

As noted in section 5, stakeholder consultation reaffirmed the problem of insurance unaffordability in northern Australia. Submissions from consumer, business and community organisations shared data, case studies and anecdotes demonstrating the impact of insurance affordability issues of the lived experience of northern Australia residents and the resilience of their communities.

Option 1 would be the best option if the costs of Option 2 and Option 3 outweighed the benefits. However, this is not supported by the analysis in section 4.

Options 2 (mandatory pool) and 3 (voluntary pool)

The nature and extent of insurer participation in the pool would have a significant impact on the premium reductions that it could achieve:

- The more insurers participate and the more cyclone and related flood risk that they pass on to the pool, the greater the influence the pool could have on the cost of cyclone cover.
- In the absence of a direct government subsidy or a levy, the pool would only be able to provide meaningful premium relief to medium-to-high cyclone risk properties if it were to take on a balanced portfolio of risks from insurers that also included lower-risk properties.

The primary trade-offs in considering these options are the degree of participation and premium reduction that can be achieved by the pool balanced against the extent of market disruption and regulatory burden imposed on insurers.

- Option 2 maximises participation in the scheme and enables the greatest potential premium reduction.
 - Modelling indicates that the pool could generate annual total premium savings of about \$290 million for eligible insurance policies across Australia, with a higher proportion of savings going to household policies.³⁸ Premium

³⁸ The modelling does not explicitly account for the effect of new entrants and increased competition.

reductions would be targeted to high-risk areas, which are largely located in northern Australia. The pool would not be expected to significantly affect average premiums outside of cyclone-risk areas.

- Option 3 presents significant uncertainty about the extent to which insurers would choose to participate and consequently the pool's efficacy in improving insurance affordability.
 - A rough estimate informed by modelling is that about half of the premium reductions in high-risk areas would be available, as compared to Option 2.
- Some insurers have indicated that market dynamics alone might be sufficient to incentivise participation (that is, if the pool offers cheaper reinsurance than the commercial market, then insurers would use the pool as a matter of sound business decision-making). However, given the transitional costs of transferring existing reinsurance arrangements to the pool, there may not be sufficient take-up for the pool to offer sufficiently discounted rates.
- Under Option 2, the estimated regulatory impact (\$0.44 million average annual regulatory cost) is greater than under Option 3 (\$0.25 million average annual regulatory cost). However, this is primarily due to the higher level of participation under Option 2.
 - The proposed transitional arrangements under Option 2 would reduce transition costs as insurers would either be able to sign up as their current reinsurance contracts cease (without needing to renegotiate or exit existing contracts) or would have sufficient time to renegotiate longer-term multi-year contracts on favourable terms.
 - Under both Option 2 and 3, insurers would have the option of passing on only new or renewing policies from the date they sign up for coverage, which they could choose to do if it reduces disruption to their existing reinsurance arrangements. Otherwise, they could agree to cede all eligible policies to the pool.

On the basis of a mixture of quantitative and qualitative analysis, Option 2 has the highest net benefits. It would maximise the pool's ability to improve the affordability of insurance for household, strata and small business property policies in northern Australia, and this benefit outweighs the estimated additional regulatory impact over Option 3.

7. Implementation and evaluation

Implementation plan

Implementation would commence following the Government's decision to proceed with a cyclone reinsurance pool and the preferred design, expected in late 2021. Should the Government decide to implement the reinsurance pool, the pool would commence operating on 1 July 2022.

In broad terms, there are two key elements to the implementation task:

- The ARPC undertaking necessary preparations to take on its new role, under the oversight of the independent ARPC board, who are the accountable authority for the financial management of the entity for the purposes of the *Public Governance, Performance and Accountability Act 2013 (PGPA Act)*.
- Implementing the legislative framework for the reinsurance pool to operate within.

ARPC preparation for its new role

Implementing a cyclone reinsurance pool would require major organisational change for the ARPC and a broadening of its capabilities. The cyclone scheme would be significantly larger in scale and complexity than the Terrorism Insurance (TI) scheme and, unlike the TI scheme, the cyclone pool would be expected to pay frequent and, occasionally substantial, claims.

In particular, the ARPC would need to develop catastrophe modelling capability, develop reinsurance contracts and processes, and establish actuarial modelling and pricing. It would also need to update its existing claims payment systems and IT systems, and hire new staff to manage its increased responsibilities.

Given the implementation challenge, the ARPC would need to commence its implementation planning as soon as possible to mitigate any risks to commencement of the pool on 1 July 2022.

To manage this risk, the Government has amended the Terrorism Insurance Regulations 2003 to expand the ARPC's functions to include preparing for providing reinsurance cover from 1 July 2022 for cyclones and related flood damage. The Government made this regulatory change before a final decision on whether to proceed with a cyclone reinsurance pool.

This will provide sufficient time for the ARPC to commence preliminary planning and undertake preparatory work so that the cyclones and related flood damage reinsurance scheme can be operational, if agreed by Government, from 1 July 2022.

Implementing the necessary legislative framework

Following the decision to proceed with a cyclone reinsurance pool and the approval of a final design, Treasury would proceed to develop draft legislation to implement the legislative framework supporting the pool. Once the primary law has been introduced and received Royal Assent, supporting delegated legislation would be finalised. Targeted stakeholder consultation would be undertaken to assist with settling matters of detail in drafting the legislation.

Evaluation plan

As administrator of the scheme, the ARPC would hold considerable ongoing responsibility for ensuring that community expectations are met and that the pool is managed sustainably. Arrangements for the pool's initial and ongoing evaluation must be fit for purpose and apply an adequate level of scrutiny to the scheme.

The success of the pool would be measured by the reduction in the price of high cyclone-risk insurance premiums, and any increased coverage, attributable to reduced reinsurance costs.

It is also important that regular reporting and review measures be established to support an active ongoing review of the financial sustainability of the pool and its effectiveness in meeting its objectives.

A monitoring program would be undertaken by the ACCC. The objectives of the monitoring program would be to monitor the impact of the pool in improving the affordability of property insurance for households and small business and monitoring the pass through of insurer savings to policyholders.

The ACCC would publish an annual report on its monitoring activities that would identify any insurers that are not passing on savings to policyholders. The ACCC's analysis would also inform future evaluations of the reinsurance pool as well as any subsequent adjustments to its design.

Effective governance arrangements and, the oversight role of the ARPC Board, provide an appropriate foundation for the ongoing evaluation of the scheme. Under the PGPA Act, ARPC is classified as a corporate Commonwealth entity and is subject to the financial and non-financial requirements of the PGPA Act. In 2019, an Australian National Audit Office (ANAO) performance audit found that 'ARPC's governance arrangements enable effective oversight and management of the scheme... [and that] the ARPC Board is effective in overseeing the scheme'.³⁹

Under the TI Act and the PGPA Act, the ARPC Board currently produces regular reporting on the operational and financial performance of the ARPC each financial year, with financial reporting independently audited by the ANAO. These existing review mechanisms would be strengthened by additional reporting requirements following the establishment of the cyclone pool. Evaluation measures would include:

- annual reporting to the Minister by the ARPC Board, that is timed to inform Budget processes, on the financial position, premium adequacy, and risk outlook for the scheme, with the Australian Government Actuary (AGA) playing a role in reviewing the report; and
- a formal review of the scheme, undertaken first after 3 years and then at least once every 5 years by the Treasury, in collaboration with the AGA.

³⁹ Australian National Audit Office (2019) *Management of the Terrorism Reinsurance Scheme*, Auditor-General Report No 48, 19 June 2019, available at: www.anao.gov.au/work/performance-audit/management-the-terrorism-reinsurance-scheme.

Additional information

RIS status at each major decision point

A draft RIS informed the Government's decision to announce its intention to implement a cyclone reinsurance pool. This decision was announced on 4 May 2021. The draft RIS was not assessed by the Office of Best Practice Regulation ahead of the Government's decision to announce its intention on the cyclone reinsurance pool.

This final RIS has been prepared to inform the Government's decision on whether to proceed with a cyclone reinsurance pool.