FIRE SERVICES LEVY MONITOR

Enhancing the consumer experience of home insurance:

Shining a light into the black box

DISCUSSION PAPER

July 2014

State Government Victoria

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Glossary

Term	Description
aggregator	A web site or computer software that aggregates a specific type of information from multiple online sources.
ARI	average return interval (in years) for flood
ASIC	Australian Securities and Investments Commission
base premium	commercial premium *less* statutory charges
bushfire attack level	A formally recognised measure of fire risk, used in building regulations and by local government authorities in planning approval processes, that takes into consideration a number of factors including the Fire Danger Index, the slope of land, types of surrounding vegetation and its proximity to any building.
bushfire, flood and reinsurance information request	Notice issued under section 30 of the FSLM Act in September 2013 to insurers seeking relevant information focussing specifically on how factors relating to bushfire and flood risk, as well as reinsurance costs, translated to the setting of base premiums for home insurance. The notice was issued to nine insurers that, combined, accounted for 70 per cent of home insurance market share in Victoria with broad coverage of policyholders in both CFA and MFESB areas.
CFA	Country Fire Authority
commercial premium	The amount actually charged by an insurer for a contract of insurance that includes any relevant statutory charges – also referred to as 'total premium'.
Corporations Act	*Corporations Act 2001* (Commonwealth)
FEZ	flood exclusion zone
fire & industrial special risk	fire and perils, business interruption, accidental damage and crime
FOS	Financial Ombudsman Service
FSL	fire services levy
FSLM	Fire Services Levy Monitor
FSLM's public hearing	A public hearing conducted by the Fire Services Levy Monitor on 18 June 2013 attended by Suncorp Group Limited, IMA, CGU Insurance Limited, Allianz Australia Insurance Limited and QBE Insurance (Australia) Limited that provided an opportunity for major insurers to explain to the FSLM and the public the insurers' intended pricing practices following the removal of the fire services levy. The transcript of the hearing is available at: http://www.firelevymonitor.vic.gov.au/home/news+and+information/public+hearing/public+hearing+transcript.
FSLM Act	*Fire Services Levy Monitor Act 2012*
GNAF	Geocoded National Address File (GNAF) Persistent Identifier Geocoded National Address File Persistent Identifier (GNAF-PID) location search identifies the address and latitude/longitude coordinates for a GNAF-PID. The GNAF-PID is a 14-character alphanumeric string that uniquely identifies each GNAF address in the GNAF database (a database of Australian locations). The PID is constructed from a combination of the major address fields of the GNAF database.
ICA	Insurance Council of Australia
Insurance Contracts Act	*Insurance Contracts Act 1984* (Commonwealth)

Term	Description
KFS	Key Facts Sheet – a legislated requirement for insurers to produce (from November 2014) a standardised two page summary of key features of a general insurance contract.
MFESB	Metropolitan Fire and Emergency Services Board
NDIR	National Disaster Insurance Review (Commonwealth Government)
NFID	National Flood Information Database (ICA)
NFRIP	National Flood Risk Information Project (Geoscience Australia)
PDS	product disclosure statement
technical price	Determined via statistical analysis of the (expected) loss experience combined with expense assumptions and profit targets to provide the price that is expected to deliver on target profit outcomes for an insurer.
total premium	See ‘commercial premium’

Executive summary

The Fire Services Levy Monitor (FSLM) is a statutory office with the responsibility to ensure savings from the abolition of the fire services levy (FSL) on property insurance policies are passed on to Victorian consumers.

A study has been conducted into how effectively insurers communicate with the insured. The study concludes that insurers could do much more to provide consumers with useful and accessible information about the coverage and pricing of their home insurance policies.

Given the complexity of property insurance, assessment of whether the FSL has been removed from premiums necessarily involves some detailed examination and analysis of insurer pricing practices – a level of examination that does not appear to feature prominently in the activities of any other regulatory or complaint handling bodies related to the general insurance industry.

This paper:

- outlines the characteristics of the property insurance market that contribute to a lack of transparency of contracts of insurance to the detriment of policyholders
- proposes some measures that could be undertaken to redress the information imbalance that currently exists in favour of insurers.

The paper builds on the investigation of complaints to the FSLM and insurers' responses to a request for information on how bushfire, flood and reinsurance are reflected in residential property insurance premiums. These activities have enabled the FSLM to make some observations about how key rating factors for insurance affect policies and premiums.

Although the responsibilities of the FSLM extend to both 'residential property insurance' and 'fire & industrial special risks' – as classes of business that were subject to the FSL – this paper focuses on residential property insurance and its sub-classes. The more narrow focus on residential property insurance is driven by the fact that residential property policyholders are more likely to be in need of assistance to understand some of the complexities of their insurance policies and how they are priced.

The areas this paper focuses upon include:

- the nature of the relationship between insurers' general assessment of policyholder risk and the price offered for a policy
- factors relevant to insurers' assessment of risk associated with bushfire and flood
- the nature of existing information disclosure between insurers and the insured
- the case for changing the balance of information provision between insurers and the insured
- proposals to enhance consumer experience of home insurance.

Relationship between risk and price

Residential property insurance is subject to several types of risk including fire, flood, storm, earthquake, theft, accidental damage and malicious damage. The rating given to that risk will be affected by property location, use and construction, as well as the age and claims history of the insured.

In simple terms, an insurer will establish a *technical price* for a policy based on:

- risk ratings
- the long-term expected value of claims
- an appropriate allocation of reinsurance, administrative overheads and required return to shareholders capital.

Commercial premiums reflect a judgement made by underwriters to depart from the technical price having regard to:

- existing policyholders' propensity to shop around
- the need to maintain revenue and attract new business
- competitors' current pricing for similar policies
- expected response of competitors to a premium change.

Insurers use strategies to optimise business mix, including:

- marketing policies with 'loyalty discounts' or 'no claim bonuses' to prevent the loss of existing business
- limiting premium reductions or increases on renewal – if the current best view of appropriate technical price differs from the prior year's premium – to maintain revenue and prevent the loss of existing business
- aggressive discounting applied only to first year premiums to attract new business.

Although payment by instalment is marketed by insurers as a convenience measure, payment by instalment can sometimes add significantly to the total price paid by policyholders.

Assessing risks associated with bushfire and flood

Some of the larger insurers have recently made significant advances in the development of address-specific risk assessment. For example, rather than rating bushfire and flood risk at the postcode or suburb level, as was common practice just four or five years ago, insurers now have access to information that provides them with the basis to apply different risk ratings to adjacent properties where ratings are informed by property specific characteristics.

On the basis of information provided by insurers in response to the bushfire, flood and reinsurance information request, bushfire risk assessment is generally not yet as sophisticated as is flood risk assessment. Many large insurers still rate bushfire risk by suburb or postcode, although movement towards use of finer, geographically specific factors is being made.

The proportion of Australia-wide residential properties with a material level of flood risk is crudely estimated to be around seven per cent. Evolution of the National Flood Information Database, on which many insurers rely for their risk modelling, is such that it now covers around half of all properties thought to have material flood exposure. Where information *is* available, insurers rate individual properties on the basis of the probability of flooding over the ground and the likely water depth for specific floods events.

As more information is collated around bushfire and flood risk, the evolving understanding of risk has created some significant changes in premiums charged to individual policyholders as properties are re-rated in accordance with insurers' latest models.

Information disclosure between insurers and the insured

A well functioning, competitive and efficient insurance market requires consumers of insurance to be well-informed. That is, consumers need to be able to clearly understand, or easily become informed about, all the relevant characteristics of an insurance policy they are considering to purchase.

Consideration of complaints by policyholders to the FSLM regarding premium changes around the time of the abolition of the FSL in mid-2013, led to a closer examination of the range of information provided by insurers to policyholders – including invoices, renewal notices, product disclosure statements (PDSs), websites and other written explanatory material.

The general assessment of documentation related to residential property insurance policies is that there is much room for improvement with respect to presenting key policy information to consumers in an accessible way.

Although a PDS might seem to be an appropriate vehicle by which to deliver information of value to consumers of insurance products, the long-form version of a PDS does not contribute greatly to the understanding of complex insurance contacts, nor does the PDS contribute greatly towards promoting product comparison.

Difficulties in understanding and comparing policies arise because there is no standardised form for presentation of a PDS and the relatively unsophisticated policyholder is likely to be overwhelmed by the volume of information presented in the PDS. Summary tools such as the Key Facts Sheet (due to be introduced from November 2014) would be useful both in helping to aid understanding of policies and in promoting product comparison.

Without clear indication from insurers of the types of inclusions and exclusions in their policy, policyholders are at risk of buying the wrong type of cover for their needs. If a nominated event occurs, policyholders might be surprised to find they are under-insured for that event or even not insured at all.

Benchmark information provision that facilitates appropriately informed insurance policy choice should incorporate clear and accessible information regarding (at least) the following elements of an insurance contract:

- basic policy inclusions and exclusions
- the nature of the risks the insured might face and, arguably, the insurer's assessment of that risk
- the contribution of statutory charges to the total premium
- how much (and why) the premium for a policy changes with renewal
- what additional charges are being incurred as a result of choosing to pay the premium by instalments rather than up-front.

Such information would be helpful in comparing different levels of cover offered by a single insurer and also in comparing similar policies offered by different insurers.

The case for changing the balance of information provision

There are indicators suggesting that general insurance markets are not operating efficiently, nor are consumers of insurance necessarily well-informed. Insurance is already a strongly regulated market – regulated because, left to its own devices, the insurance market might fail to adequately protect the interests of policyholders. However, if the regulated market still fails to deliver efficient outcomes and the interests of policyholders remain compromised, it must be concluded that there is also a degree of regulatory failure.

The indicators of insurance market inefficiency and disadvantage to policyholders that currently characterise residential property insurance include the following:

- many insurers offer substantial discounts for new business, yet there is no objective evidence available on rates of switching between insurers to suggest such discounting is widely known
- some policyholders subsidise others by paying for cover they do not need
- some insurers use unverifiable 'no claim bonuses' and 'loyalty discounts' to discourage policyholder switching between insurance providers
- insurers fail to disclose the extent of additional charges incurred by policyholders who choose to pay premiums by instalments
- existing regulated policy disclosure requirements are misdirected
- insurers fail to adequately explain, or even acknowledge, substantial premium changes on renewal
- insurers' assessment of key property risks such as flood is imperfect but consumers do not have adequate opportunity to correct inaccurate information used by insurers
- (some) insurers make hollow claims regarding restrictions on their ability to share information with policyholders
- there are substantial differences in the premium charged for similar cover on the same property by different insurers
- high profitability has been sustained within the general insurance industry for several years without being competed away, even during a period of significant natural disasters and a global financial crisis.

The insurance industry claims there is strong competition in the residential property insurance market given there are several suppliers and only moderate barriers to entry. However, the indicators identified above do not paint a picture of robust price competition – there are clearly problems on the demand side of the market.

Proposals to enhance consumer experience of home insurance

By improving the efficiency of insurance markets, through removing information asymmetry and making competition more effective, policyholders will be better informed and premiums will fall, thereby making insurance more accessible.

Some proposals for action to achieve this goal are provided as a contribution to public policy development as outlined below:

- Change insurers' existing information disclosure requirements:
    - **Replace long-form PDS with short-form version** – a short-form PDS that incorporates a standardised presentation of key policy features would be a more effective way of presenting accessible information to (prospective) policyholders.
    - **Clearly present changes in policy price components** – insurers should be prevented from obfuscating year-to-year base premium changes and additional charges incurred by choosing to pay the premium by instalments.
    - **Provide additional information on assessment of individual risks** – by providing 'negligible', 'low', 'medium', 'high' or 'very high' ratings for key perils consumers will have a better basis for policy comparison between insurers and a point of questioning risk assessment if the insured believes the insurer has it wrong.
- Facilitate consumer awareness measures:
    - **Support the development of home insurance price comparators** – the introduction of aggregators in other markets has increased consumer awareness about price and choice of provider.
    - **Provide easier access to information and dispute resolution** – by removing hurdles to information provision by insurers and dispute resolution by the Financial Ombudsman Service, consumers are less likely to be disadvantaged by opaque risk rating practices of insurers.
    - **Take action to reduce the incidence of under-insurance or non-insurance** – by making available packages of insurance that are easily understood and eliminate unnecessary costs, the uninsured might be encouraged to take up cover that is still profitable business to insurers.

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1. Introduction

1.1 Background to this paper

The Fire Services Levy Monitor (the 'FSLM') is a statutory office created under the *Fire Services Levy Monitor Act 2012* (the 'FSLM Act') – some of the key functions and powers of the FSLM are outlined in Box 1. The fundamental purpose of establishing this office was to ensure the fire services levy (FSL) was removed from commercial and residential property insurance premiums following the fire services levy reform.[1]

Box 1 The FSLM's key functions and powers

The FSLM's functions under the FSLM Act, include:

- to provide information, advice and guidance in relation to fire services levy reform [s6(1)(a)]
- to monitor insurance premiums for insurance against fire [s6(1)(b)]
- in respect of matters arising out of the administration of the FSLM Act:
  - to investigate those matters [s6(2)(k)(i)]
  - to conduct research [s6(2)(k)(i)]
  - to collect and collate information [s6(2)(k)(i)].

To assist the FSLM to perform these functions, the FSLM has the power to:

- require a person who the FSLM believes is capable of providing information or producing documents that may assist the FSLM, to produce those documents [s18]
- require a person who the FSLM believes is capable of providing information in relation to a matter that constitutes or may constitute a breach of the FSLM Act, to appear before the FSLM [s19(1)(c)]
- monitor prices to assess the general effect of the fire services levy reform on prices charged by insurance companies for regulated contracts of insurance [s30(1)(a)]
- require a person to give the FSLM specified information, or documents containing information, relating to prices or the setting of prices that the FSLM considers will or may be useful in monitoring prices [s30(2)].

Given the complexity of property insurance, assessment of whether the FSL has been removed from premiums necessarily involves some detailed examination and analysis of insurer pricing practices – a level of examination that does not appear to feature prominently in the activities of any other regulatory or complaints handling bodies related to the general insurance industry.[2]

In pursuit of understanding relevant aspects of fire-related property insurance, the following activities have been undertaken:

- general monitoring of property insurance premiums and the conduct of relevant research (section 6 of the FSLM Act)

[1] Abolition of the insurance-based levy from 1 July 2013 as defined in section 3 of the FSLM Act.

[2] Activities currently conducted by ASIC and the Financial Ombudsman Service are discussed in more detail in section 8.

- receipt and actioning of complaints about insurance company premiums including base premiums and FSL components of premiums (section 6)
- analysis of insurer responses to formal notices issued by the FSLM to provide general premium (price) information (sections 18 and 30)
- conduct of detailed investigations into potential breaches of the FSLM Act, including:
  - analysis of insurer responses to formal notices issued by the FSLM to provide specific information (section 19)
  - formal examination of insurance company executives (section 19).

The FSLM has had to have close regard to the level of competition in general insurance markets affecting fire-related property insurance. The ‘pass-through’ to customers of FSL reductions, and removal of FSL from premium charged, will be affected by the level of competition within insurance markets.

1.2 Purpose of this paper

This paper has two purposes:

1. to explain how bushfire and flood risk is reflected in pricing of property insurance
2. to highlight information issues that became evident in work for purpose 1.

There are several factors that lead to consideration that a lack of transparency of residential property insurance policies is a problem worthy of being tackled. When viewed in isolation, individual factors might be dismissed as minor indicators of lack of market perfection but, when viewed together, a more consistent picture emerges of both market and regulatory failure.

A lack of transparency can contribute to a range of problems for consumers:

- they are unable to clearly compare alternative policies, leading them to pay too much or to pay for cover they do not need
- they fail to understand policy coverage, leading them to buy the wrong type of cover for their needs
- they lack understanding of the adequacy of their insurance to fully cover the costs of re-building in the event of a total loss, leading them to under-insure
- they lack understanding of the risks they face, leading (some of) them to not insure at all.

The economic inefficiency created by consumers paying too much or paying for insurance cover they do not need does more than just create an unwarranted wealth transfer from the insured to insurers – the latter three factors listed above carry a contingent social cost in the event of natural disaster, where public funding of the uninsured, the under-insured, or persons with the wrong cover, might be called for.

This paper:

- outlines the characteristics of the property insurance market that contribute to a lack of transparency of contracts of insurance to the detriment of policyholders
- proposes some measures that could be undertaken to redress the imbalance that currently exists in favour of insurers.

Aside from the provisions the FSLM Act, which will sunset on 31 December 2014, ongoing regulation of the insurance industry is governed by the generic Australian Consumer Law[3] and the (Commonwealth) *Insurance Contracts Act 1984* (the 'Insurance Contracts Act') as administered by the Australian Securities and Investments Commission (ASIC). The provisions of the Insurance Contracts Act, the administrative obligations that flow from it and other relevant Commonwealth legislation are taken into account in the discussion within this paper.

Note that this paper deals only with the process of buying insurance and does not deal with any processes with respect to making a claim on a contract for insurance.

1.3 Structure of this paper

This paper is structured as follows:

- section 2 explores the reasons for examining insurer cost structures and risk rating practices
- section 3 presents an outline of different types of insurance, industry relationships and insurance markets of specific interest
- section 4 describes the process by which insurers translate overall risk assessment into individual commercial premiums
- section 5 deals with detailed assessments of specific risk factors, focussing in particular on bushfire and flood
- section 6 discusses the nature of information disclosure by, and information needs of, both insurers and the insured
- section 7 summarises the case for changing the existing arrangements within the insurance industry on the basis of lack of transparency
- section 8 discusses consumer protection activity that is being conducted by agencies other than the FSLM
- section 9 presents some proposals for change that would enhance the consumer experience of home insurance.

[3] Albeit excluding the unfair contract provisions of the Australian Consumer Law.

2. Why examine insurer cost structures and risk rating practices?

2.1 Initial observations regarding insurer risk pricing

In exercising relevant functions and powers as outlined in section 1.1, the following observations have been made:

- complaints regarding increases in base premiums for residential property insurance were mostly related to properties insured in the CFA region where the FSL rates and base premium increases were highest[4]
- one insurer increased base premiums by an average of more than 35 per cent over a period of six months coincident with the removal of a similar amount of FSL
- insurers claimed that many premium changes were being driven by:
    - increasing reinsurance costs following a series of years in which natural perils claims were unusually high
    - insurer reassessment of individual property risks in relation to bushfire and flood as a result of application of more sophisticated rating models
- several insurers failed to make clear that the FSL was being removed from insurance premiums.

Initial observations of insurer pricing practices, and commentary on natural perils from industry representatives, led to an hypothesis that changes in base premium may have been driven by factors more apparent in the CFA region than in the MFESB region. Given industry claims that understanding of bushfire and flood risks was evolving, it appeared that properties in CFA areas, where such risks were highest, were more likely to be subject to unfavourable reassessment of insurance premiums. Further examination of this issue was deemed to be warranted.

2.2 A need to better understand natural peril risks and associated costs

Given the bundled nature of home insurance products – insurance against fire is bundled with insurance against a range of other perils including, for example, flood, theft, malicious damage – it is not possible to understand the price of supplying insurance against fire, without also seeking to understand the costs involved in providing insurance against other perils. To put it another way, insurers' allocations of costs with respect to bushfire risk, flood risk, and reinsurance will necessarily affect the price of insurance against fire. As indicated later (in section 4.2.1), natural peril and reinsurance costs combined could account for between 35 to 70 per cent of the total cost of a policy for residential property insurance.

Accordingly, a notice under s30(2) of the FSLM Act was issued in September 2013 to insurers seeking relevant information (the 'bushfire, flood and reinsurance information request'),[5]

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[4] In the first half of 2013, complaints showed a trend of disproportionately larger increases for policies in the Country Fire Authority (CFA) areas, compared to those in the Metropolitan Fire and Emergency Services Board (MFESB) areas. Complaints received detailed many cases of Victorian country property premiums increasing by between 30 and 50 per cent in one year.

[5] A copy of the notice can be found at: http://www.firelevymonitor.vic.gov.au/home/insurers/section+30+notice+schedule.

focussing specifically on how factors relating to bushfire and flood risk, as well as reinsurance costs, translated to the setting of base premiums for home insurance. The notice was issued to nine insurers that, combined, accounted for 70 per cent of home insurance market share in Victoria with broad coverage of policyholders in both the CFA and MFESB regions.

The objective of the request for information was to understand:

- whether bushfire and flood risk were separately assessed and priced
- the extent to which bushfire risk and flood risk were assessed on a property-by-property basis
- the nature of the source information and modelling used by insurers to assess bushfire and flood risk and how informational gaps were covered
- the timing of any key changes leading up to and beyond the fire services levy reform (from 1 July 2013) in relevant source information and bushfire and flood risk assessment methodologies
- the extent of reinsurance costs allocated to home insurance policies and how reinsurance coverage and costs changed over the couple of years leading up to the fire services levy reform.

This understanding would assist the assessments of complaints and monitoring data relating to premium movements during 2012-13 and 2013-14.

The quality and comprehensiveness of the responses received from insurers was varied. Two insurers provided very helpful responses to the flood, bushfire and reinsurance information request that included:

- useful summaries of contemporary source information with respect to risk assessment and internal modelling of risk
- descriptions of modelling algorithms that provided a good indication of how relevant risk factors interact
- detail of regional variation on flood risk and the proportion of properties and premiums affected by the introduction of effective flood cover
- indications as to how flood risk translates to flood premium
- indications of rationale for using suburb / postcode average risk assessments rather than specific address risk assessment
- indications of how bushfire risk and flood risk are combined to produce specific premium loadings
- indications of how policyholders would be informed of changes to policy coverage
- differences in treatment between new business and renewing business
- indications of how policyholder feedback on changes to premiums would be used and incorporated within future pricing and customer advice strategies
- sufficient detail with respect to reinsurance arrangements (both coverage and cost) to understand how changes in reinsurance cost impacts home insurance premiums.

A few insurers provided cursory responses to the flood, bushfire and reinsurance information request that merely consisted of:

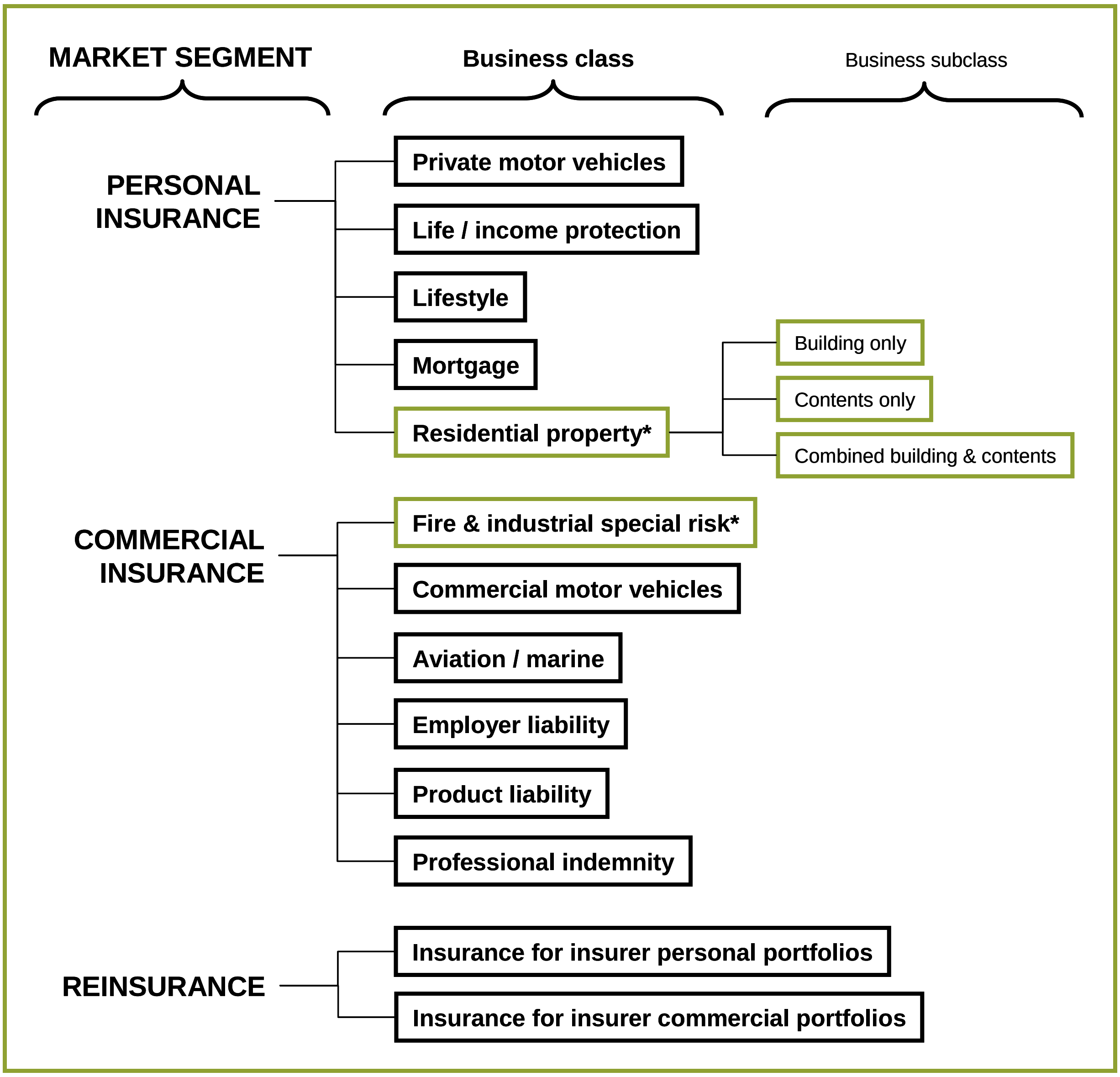
- confirmation that bushfire risk and flood risk are treated separately, but no indication as to how
- general descriptions of key external databases
- acknowledgement that modelling algorithms existed and the names of some relevant factors applied within the algorithm, but little indication as to how relevant factors interact
- names, but nothing else, of some source material
- summaries of reinsurance costs, but no indications of changes in reinsurance coverage.

3. Insurance market structures

3.1 Types of insurance – markets and sub-markets

The insurance market is comprised of different segments, business classes and business subclasses, examples of which are depicted in Figure 1.

Figure 1 Insurance market segments, business classes and business subclasses



* Subject to FSL in Victoria prior to 1 July 2013.

Although the purposes of the FSLM Act extend to insurance for both 'residential property' and 'fire & industrial special risks' – as classes of business that were subject to the FSL – this paper focuses on residential property insurance and its sub-classes.

The more narrow focus on residential property insurance is driven by differences in the likely level of sophistication of policyholders. Commercial policyholders are much more likely to be in a position to understand the nuances of their policies[6] while residential policyholders tend to lack the resources and ability to gain a proper understanding of the very complicated residential property insurance policies that dominate the market. Further, complaints received from policyholders regarding difficulties in communicating with insurers were almost exclusively in relation to residential property insurance.

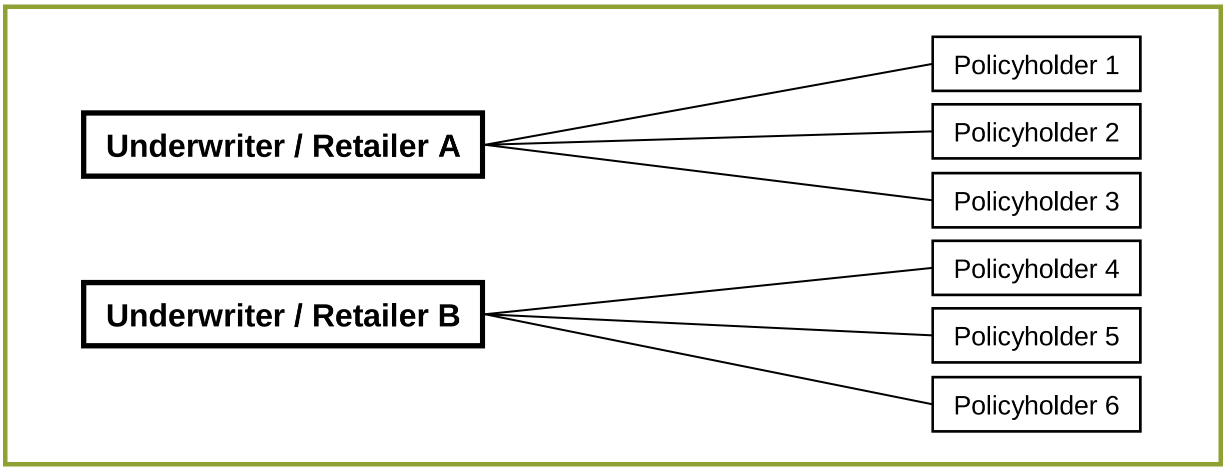
3.2 Insurance industry relationships

An underwriter is the party responsible for paying a claim should the person insured be able to demonstrate the loss suffered is covered by his or her contract of insurance. For any given type of insurance policy, there are several possible forms of the relationship between underwriter and policyholder. Each of these types of relationships have a place in well functioning and efficient insurance markets.

3.2.1 Underwriter / retailer direct relationship with policyholders

An underwriter can have a direct relationship with their customers through their own retail outlet and the same entity will be responsible for managing sales, customer relationships and claims (Figure 2).

Figure 2 Underwriter / retailer relationship with policyholders

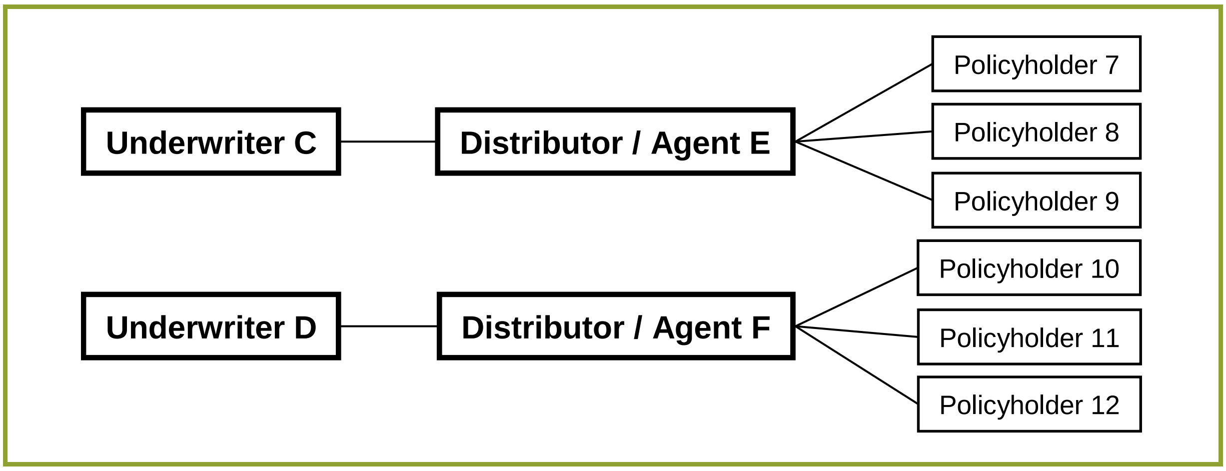


3.2.2 Distributor / agent relationship with policyholders

An underwriter can have an exclusive relationship with a distributor / agent for the sale of particular types of insurance policy for which the distributor / agent would earn a commission (Figure 3). In these circumstances, the underwriter and the distributor / agent could share policyholder information, although the distributor / agent would be responsible for managing ongoing customer relationships, claims handling where required could revert directly to the underwriter.

[6] Commercial policies are likely to be procured by commercially sophisticated individuals and such policies are possibly also structured quite differently to residential policies.

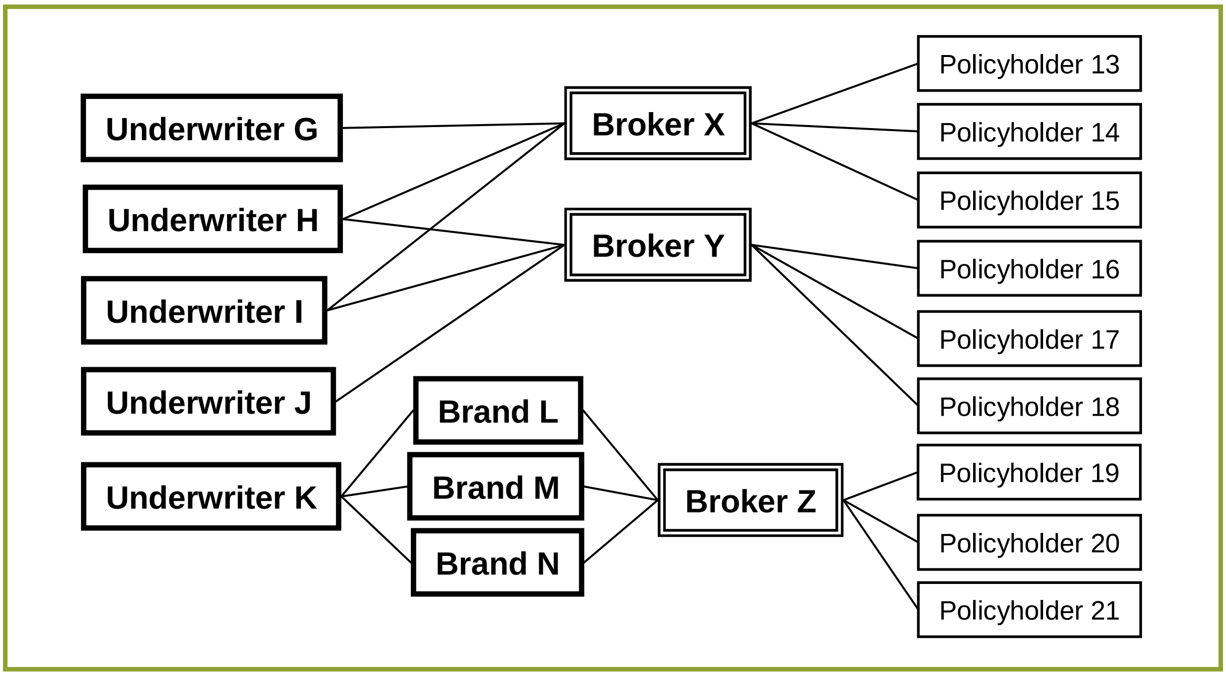
Figure 3 Distributor / agent relationship with underwriters and policyholders



3.2.3 Broker relationship with policyholders

An underwriter can have non-exclusive relationships with brokers for the sale of particular types of insurance policies for which the broker is likely to earn a commission from the underwriter (Figure 4). The basis of this model is that the broker can claim to be acting in the interests of the customer by facilitating competition and doing the hard work of identifying the best insurance deal for the customer's specific circumstances from choice among range of insurance products, in return for which the broker earns a fee from that customer and likely, also, a commission from the underwriter. In these circumstances, the broker would be responsible for managing ongoing customer relationships and claims handling.

Figure 4 Broker relationship with underwriters and policyholders



As depicted in Figure 4, Broker X and Broker Y each have non-exclusive relationships with three different underwriters – for example, Broker X has a relationship with Underwriter G, Underwriter H and Underwriter I – and are in a position to provide their customers with real choice of underwriter.

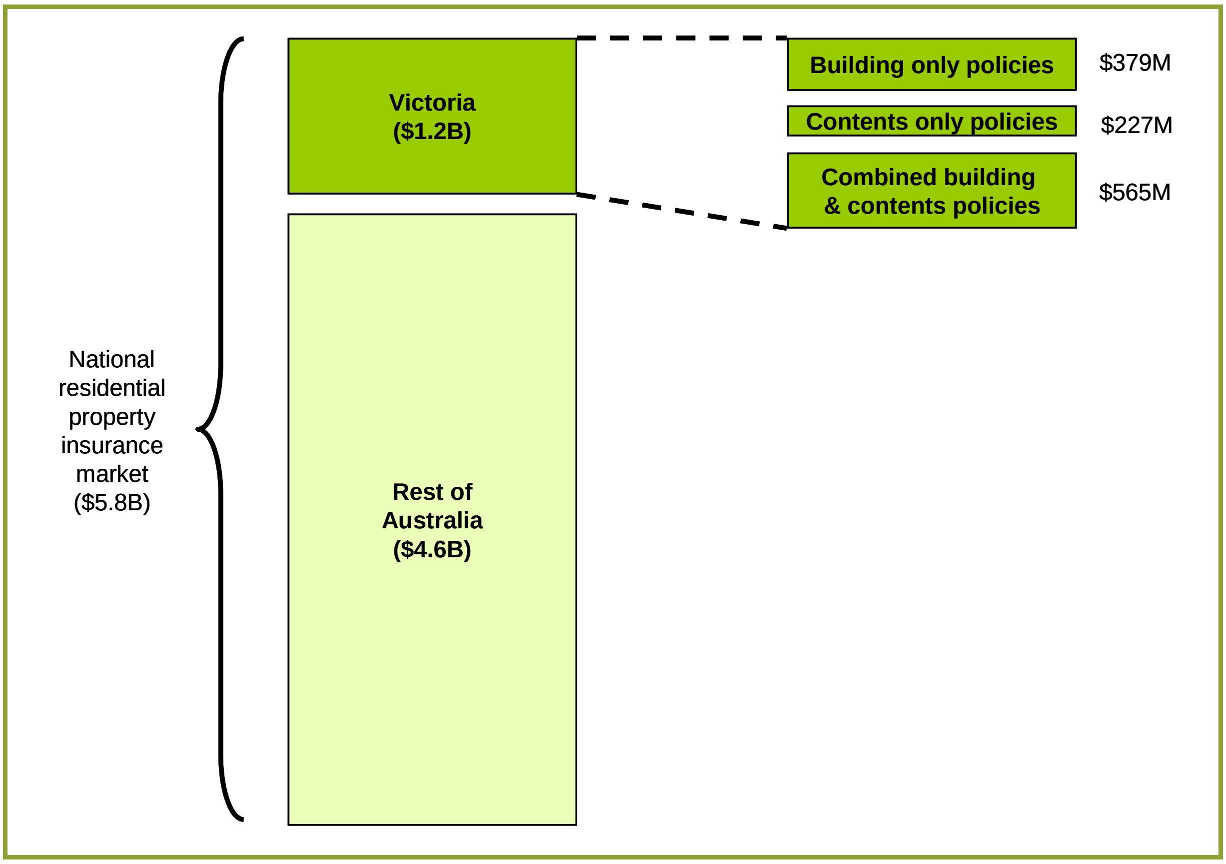
A variation on the broking model is represented through Broker Z as depicted in Figure 4 where Broker Z nominally purports to represent a choice of policies from among three different brands – Brand L, Brand M and Brand N. In this case, Broker Z would still claim a commission from the relevant underwriter / brand and a broking fee for 'identifying' the best policy from the choice of available brands, but the fact that all brands are supported by a single underwriter suggests that Broker Z could be more accurately deemed to be a distributor / agent rather than a true broker.

3.3 The residential property insurance market

In the context of this paper, for the reasons outlined in section 3.1, the primary interest is in the *residential property* insurance class of business and relevant subclasses.

The value of the Australian residential property insurance market for which the various insurers were competing in 2012-13 was close to $6 billion in gross premium (including FSL).[7] The $1.2 billion Victorian portion of that market (and sub-markets) is depicted in Figure 5.

Figure 5 Residential property insurance market gross premium incl. FSL (2012-13)



Source: FSLM estimates

[7] In 2012-13, only Victoria and New South Wales imposed a fire services levy on residential property insurance.

The top brands by Victorian residential property insurance market share are noted in Table 1.

Table 1 Residential property insurance Victorian market share – 2012-13

Companies / underwriters	Brands	Market share
Insurance Manufacturers of Australia Pty Limited	RACV	18.8%
Australian Associated Motor Insurers Limited	AAMI	15.0%
QBE Insurance (Australia) Limited	QBE	11.3%
CGU Insurance Limited	CGU	9.2%
GIO General Limited	GIO	7.8%
Commonwealth Insurance Limited	CommInsure	7.4%
Australian Alliance Insurance Company Limited	APIA	6.3%
Westpac General Insurance Limited	Westpac	5.0%
Allianz Australia Insurance Limited	Allianz	3.3%
Wesfarmers General Insurance Ltd	WFI / Coles / OAMPS / Lumley	3.0%
Vero Insurance Limited	Vero	2.3%
Chubb Insurance Company of Australia Limited	Chubb	1.8%
Calliden Insurance Limited	Calliden	1.3%
Auto & General Insurance Company Limited	Budget	1.2%
Youi Pty Ltd	Youi	1.2%
Others (31 different underwriters / brands)		5.1%

Source: MFESB, CFA and FSLM estimates

The business models of the dominant brands in the Victorian residential property insurance market reflect a variety of relationship types between underwriter and policyholder:

- Insurance Manufacturers of Australia (IMA) sell their residential property insurance in the Victorian market exclusively under the 'RACV Insurance' brand and through the RACV network – RACV is a 30 per cent shareholder in IMA, the remaining 70 per cent of IMA being ultimately owned by Insurance Australia Group Limited
- AAMI, GIO, APIA and Vero brands are each sold through their respective branded retail networks but all are 100 per cent owned by the Suncorp Group, which had a total 2012-13 market share in Victoria of 31 per cent[8]
- QBE sell their insurance through a combination of direct (retail) and intermediated broker outlets
- CGU insurance is almost exclusively sold through brokers – CGU is 100 per cent owned by Insurance Australia Group Limited.

Suncorp Group (AAMI, APIA, GIO, Vero), Insurance Australia Group (RACV, CGU) and QBE interests combined accounted for over 70 per cent of the Victorian residential property insurance market in 2012-13.

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[8] On 1 July 2013, AAI Limited became the single underwriter for all general insurance products within the Suncorp Group in Australia. The various insurance companies in the group became a single legal entity from 1 July 2013.

4. Relationship between risk and price

Any general insurer involved in multiple market segments and/or classes of business is likely to try to ensure that each segment / class is profitable if measured on a stand-alone basis. Profitability measures could also extend to regional measures within a class or even subclass.[9]

In a well functioning and competitive insurance market, any sustained high levels of profitability for a class of business should attract new entry or at least competitive pressure that would, over time, erode any super-normal profits.[10] This means that the extent of any cross-subsidies[11] between (sub)classes of business, or cross-subsidies between regional markets, need to be carefully managed by the insurer so that (long-term) premium revenues reflect underlying (long-term) costs.

Corporate strategy will dictate the level of tolerance (if any) for cross-subsidisation between portfolios and for how long that cross-subsidisation could be sustained through the various business cycles. Getting that balance right is not a straightforward exercise and in the residential property insurance market it requires an understanding of:

- residential property insurance risk factors and events occasioning property damage
- exposure to natural perils, long-term risk management and reinsurance
- actuarial considerations involving the probability of occurrence of event types and the value of damage likely to be caused
- insurance customer behaviour and propensity to shop around – translating the ‘technical price’[12] for a policy into a ‘commercial premium’.

4.1 Residential property insurance risk factors

The overall risk that is accepted by an insurer, or probability of an insured person making a substantive claim under their insurance policy, is a function of both the types of risk covered under a policy and the characteristics of the property insured.

4.1.1 Types of risk

The types of risks commonly covered in a residential property insurance policy include damage or loss caused by:

- fire and explosion – for example, bushfire
- flood – for example, the covering of normally dry land by water escaping from the normal confines of a river[13]

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9 For example, residential property building-only insurance in NSW compared to residential property building-only insurance in Victoria.

10 If a firm makes more than normal profit it is called super-normal profit. Super-normal profit is also called economic profit, and is earned when total revenue is greater than the total costs. Total costs include a reward to all the factors, including capital. (See http://www.economicsonline.co.uk/Business_economics/Profits.html.)

11 In simplistic terms, a cross-subsidy arises when the costs of one part of a business are (partly) underwritten by revenues from a different part of the business.

12 ‘Technical price’ is determined via statistical analysis of the (expected) loss experience combined with expense assumptions and profit targets to provide the price that is expected to deliver on target profit outcomes for an insurer. See section 4.2.1 for further discussion of technical price.

- storm – for example, hail storm and/or wind storm
- earthquake
- lightning
- theft and burglary
- actions of the sea – for example, storm surge associated with cyclones
- malicious damage – for example, vandalism
- impacts – for example, vehicle running off a road into a house
- escape of liquid – for example, burst water pipes in a home.

Some of the above risk factors may be subject to express exclusions in individual insurance policies and other risk factors could also be covered by individually tailored polices or specialist insurers. Insurance premiums will tend to be higher, the higher an insurer's assessment of the probability of occurrence that a specified (covered) event will occur.

4.1.2 Property and resident characteristics and effect on assessed risk

The range of risk factors relevant to residential property insurance and how those factors are likely to affect premiums is outlined in Table 2.

Table 2 Risk factors and effect on premium

Category of risk	Risk factor	How premium is affected
Property location	Proximity to bushland, shopping areas, railway stations, main roads and schools	Closer increases premium
	Proximity to a flood plain	Closer increases premium
	Elevation above nearby watercourse	Lower increases premium
	Corner block or abutting vacant land	More exposed boundary increases premium
Property use	Residential and / or business	(Part) business use increases premium
	Owned or rented by the insured	Rented increases premium
Property construction*	Year constructed	Older increases premium
	Construction material for roof and walls	Colourbond roof / timber walls increases premium
Insured person	Age of the oldest insured	Younger (more likely to be away from home) increases premium
	Claims history of the insured	Higher number of (recent) claims increases premium

* Some insurers ask whether the property to be insured is free standing house or part of a block of apartments / flats. However, it is not clear how the answer impacts the direction of the premium.

Risks associated with bushfire and flood will be discussed in more detail in sections 5.1 and 5.2, respectively.

[13] A regulation made in June 2012 under the (Commonwealth) *Insurance Contracts Act 1984* provides a standard definition of flood that now applies to all contracts of insurance. This standard definition is reflected in the PDSs of all major insurance companies undertaking general insurance business in Victoria.

Higher risk of theft and burglary are presented by locations with proximity to shopping areas, railway stations, main roads and schools due to a greater volume of passing foot traffic. Properties on a corner block or abutting vacant land present more property boundary exposure that translates into a higher likelihood of theft and burglary. Proximity to a main road presents a higher probability of impact from a vehicle.

Although property and resident characteristics are difficult to change, there are some things that persons seeking insurance can do to mitigate the risks involved and perhaps be rewarded with lower premiums. Some common factors insurers take into account that could reduce the premium otherwise payable include:

- house construction / design that minimises the 'bushfire attack level'[14]
- house construction on stilts or with main living areas on upper floors to minimise exposure to flood damage
- installation of deadlocks on external doors and locks on accessible windows to minimise burglary risk
- installation of a home alarm.

Further measures that can be taken to reduce the cost of a policy by transferring risk from the insurer to the insured are:

- reducing the value of the sum insured – although this is highly undesirable if it results in under-insurance and consequential financial hardship for the insured should a total loss ever be experienced and the insured is unable to rebuild to the standard previously enjoyed
- increasing the claims excess – a higher threshold in the value of loss on the part of the insured must then be reached before any claim is paid by an insurer.

4.2 The technical side of insurance pricing

4.2.1 A long-term view of overall costs

A 'technical price' for insurance against specified risks at a given property takes account of a long-term (in excess of 100 years[15]) view of:

- the amortised value of expected claims expenses

plus

- an appropriate allocation of administrative overheads and required return to shareholders capital.

[14] Bushfire attack level is a formally recognised measure of fire risk, used in building regulations and by local government authorities in planning approval processes, that takes into consideration a number of factors including the Fire Danger Index, the slope of land, types of surrounding vegetation and its proximity to any building.

[15] To account for highly infrequent but highly damaging events such as extreme weather or earthquakes.

For business planning purposes in the medium term (say, 10 to 20 years), aggregate premium revenue should meet or exceed the amount an insurer expects to pay out over that period in:

- working losses – the cost of claims for events such as theft, burglary, accidental damage, malicious damage
- retained natural perils exposure – the cost of claims met from insurers' own reserves as a result of events such as widespread bushfire or flood, earthquake, storms
- reinsurance – the cost of purchasing insurance for insurers to cover against very large claims arising from events such as widespread bushfire or flood, earthquake, storms
- administration and overheads – the cost of business acquisition (for example, commission), policy administration, claims handling, general overheads
- cost of capital and return to shareholders – the opportunity cost of capital.

Each of these items will be expressly budgeted for in some way by an insurer – see Table 3 for an indicative allocation of shares of technical price to cost items for residential property insurance. Variations in these shares will be driven by each insurer's overall portfolio structure and long-term strategies for managing costs.

Table 3 Indicative allocation of shares of technical price to cost items for residential property insurance

Cost item	Share of technical price
Working losses	10 to 30%
Retained natural perils exposure	15 to 25%
Reinsurance	20 to 45%
Administrative and overheads	15 to 25%
Cost of capital and return to shareholders	5 to 10%

Source: FSLM estimates

The technical price for insurance is an effort to bridge the gap between the 100+ year perspective and the 10 to 20 years business planning horizon by providing a basis on which to differentiate premiums between individual high and low risk properties.

As higher risk properties are expected to attract greater claims expenses over the long term, the technical price for a given level of cover on that property should be higher than the technical price for insurance of lower risk properties with the same cover. Accordingly, for each property to be insured, the insurer seeks to determine a technical price that is a function of:

- the probability of different risk events occurring in that location – for example, fire, flood, storm, theft
- individual property characteristics, including the value of the property to be insured
- mitigation measures undertaken by property owners

- the proportion of property loss / damage that is likely as a consequence of a specified event occurring.

The above factors will be brought together in technical models that assign specific probabilities, values and mathematical / statistical relationships between each of the relevant factors.

In addition to these property specific factors, the technical price will also include some allocation of expenses attributable to portfolio-wide reinsurance cover, business acquisition, policy administration, claims handling and general overheads. The technical price thus represents the amortised value of the premium the insurer needs to collect from policyholders to cover all budgeted costs.

The extent of differences in modelling by different insurers and the impact that may have on individual property premiums is discussed in more detail in section 5.

4.2.2 Managing natural perils and reinsurance

A significant exposure faced by insurers is to claims resulting from natural peril events such as bushfire, flood, storms and earthquake where large areas are likely to be damaged and the insurable costs of repairs will be high. In the absence of risk mitigation measures being taken by insurers, the consequence of having to pay all claims associated with a large natural peril event could cause substantial damage to an insurer's balance sheet.

For example, Victoria's Black Saturday Bushfires in February 2009 caused an estimated $1.3 billion worth of damage that was covered by insurance.[16] In the three years following the Black Saturday Bushfires, the Melbourne area experienced two major storm events[17] causing a further $1.9 billion worth of damage covered by insurance.[18] More than $3 billion of insured damages arose from just three events in three years.

To put these figures into context, in the five calendar years ending 2008 the total amount of claims paid by insurers against building and contents policies in Victoria for *all* events (natural perils and normal working losses) was less than $1.5 billion.[19]

Reinsurance is a mechanism for spreading risk. Given the risks to insurers' balance sheets posed by the occurrence of major natural peril events, insurers manage their exposure through reinsurance structures that set levels of retained risk, and cover beyond retained risk, for multiple separate events.

Through reinsurance, a reinsurer takes some portion of the risk assumed by the insurer (or other reinsurer). Catastrophe reinsurance covers events including widespread bushfires and floods, with cover typically indemnifying an insurer for all losses relating to a single event above a specified aggregate amount.

Insurers may hold a number of different forms of reinsurance cover that will protect against losses on individual policies.

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16 Insurance Council of Australia, *Historical disaster statistics*, normalised cost. Available at: http://www.insurancecouncil.com.au/industry-statistics-data/disaster-statistics/historical-disaster-statistics, viewed 3 March 2014

17 Labour Day in March 2010 and Christmas Day in 2011

18 Insurance Council of Australia, op. cit.

19 Insurance Statistics Australia

Common reinsurance structures are as follows:

- Excess of loss – the reinsurer indemnifies the insurer for individual losses that exceed a specified amount. This form of reinsurance can cover the insurance company either on a 'per occurrence basis' or for all the cumulative losses within a specified period.
- Proportional treaty – the reinsurer assumes a given percentage of losses and premium. The most simple form of proportional treaty is a 'quota share' in which the reinsurer receives, say, 50 per cent of the premium for the book of business reinsured and, in exchange, the reinsurer pays 50 per cent of the losses on the book.

The (contingent) allowance made by insurers to meet retained natural perils exposure, and the costs of purchasing reinsurance, each need to be allocated to policyholders as part of the technical price of a policy. Although catastrophe reinsurance cover is generally procured to cover exposure for an entire portfolio – for example, motor vehicles, commercial property and residential property – policy coverage and susceptibility to damage commonly result in the allocation of the vast majority of reinsurance expense to residential building risk.

An example of how surplus share arrangement reinsurance cover might be structured is provided in Box 2.

Box 2: Reinsurance cover for 2014-15 purchased by 'Insurer A' from a combination of 'Reinsurer B' and 'Reinsurer C'

Insurer A purchases reinsurance from Reinsurer B that is structured as follows:

- Insurer A covered for up to four separate natural peril events during 2014-15.
- Retained natural perils exposure for each event occurring during 2014-15 whereby Insurer A accepts the first $50 million dollars worth of claims.[20]
- Separate layers of reinsurance purchased for each event occurring during 2014-15, whereby:
  - Reinsurer B indemnifies Insurer A for claims above $50 million but less than $300 million (the first layer)
  - Reinsurer C indemnifies Insurer A for claims above $300 million but less than $600 million (the second layer).[21]

Early in 2014-15 a major hail storm hits, causing damage to Insurer A's customers worth a total of $500 million. As a consequence, Insurer A pays out a total of $500 million to its customers, but recovers $250 million from Reinsurer B and $200 million from Reinsurer C, thus leaving Insurer A only having an effective net exposure to the major hail storm of $50 million.

However, should either or both of the following occur:

- the number of natural peril events occurring in any single financial year exceed the number of events for which the insurer has purchased reinsurance
- the magnitude of a natural peril event is such that the insurable cost exceeds all purchased layers of reinsurance for that event

then the insurer's balance sheet will be exposed to net costs beyond $50 million per event.

[20] The retained natural perils exposure for each event is the equivalent of an individual policyholder's excess.

[21] The top of the highest layer of reinsurance is the equivalent of an individual policyholder's total sum insured.

Depending on the cost of purchasing reinsurance and an insurer's appetite for retaining risk on its own balance sheet (a contingent expense),[22] the total (potential) effect on the insurer's bottom line is strategically managed through:

- varying the level of retained risk for each natural peril event – other things being equal, lower retained risk reduces contingent expenses but increases reinsurance costs
- varying the size and number of each layer of reinsurance cover – larger size and number of layers reduces contingent expenses but increases reinsurance costs
- varying the number of natural peril events for which the reinsurance applies – larger number of events reduces contingent expenses but increases reinsurance costs.

The size of the reinsurance program relative to written premium will vary greatly from insurer to insurer and depend on an insurer's individual circumstances.

A reinsurance program is generally tailored closely to reflect the buyer's (that is, the insurer's) portfolio. Hence, each contract is individually priced to meet the particular needs and risk level of the reinsured. In pricing reinsurance cover, reinsurers will need to take account of:

- the region(s) for which reinsurance cover is being sought and the propensity for, and scale of, natural peril events within that region
- the overall value of property for which an insurer is seeking reinsurance cover
- the cost of making capital available to be applied to cover for a natural peril event should it occur.

Prudential standards imposed on authorised general insurers by the Australian Prudential Regulation Authority (APRA) require relevant insurers to maintain minimum levels of reinsurance cover.[23] Key aspects of these standards include specification of minimum:

- vertical requirements – the (potential) net loss to the insurer's portfolio from the occurrence of a single natural peril event
- horizontal requirements – the (potential) net loss to the insurer from the occurrence of several smaller, but significant sized, events in a given year.

The relatively high number of natural disasters in the Asia-Pacific region in the few years to the end of 2012 created an increase in the unit price of reinsurance given the calls on reinsurance capital.[24] Australian insurers responded to that environment by adjusting their reinsurance structures and lifting premiums to cover higher expenses. Information available to the FSLM indicates that increases in reinsurance expenses faced by insurers were between 10 per cent and 60 per cent.

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22 Although allowances for the nominated retained natural perils exposure will be made in budgets, if the natural peril event does not occur, the expense is not realised thus benefiting the insurer's bottom line outcome compared to budget.

23 Further information on how these components are calculated, including details on the whole of portfolio approach and the use of reinsurance to mitigate insurance concentration risks, is detailed in *Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge*.

24 Christchurch earthquakes; Japan earthquake and tsunami; Thailand floods; Victorian bushfires, floods and storms; Queensland, floods and cyclones

However, the more benign recent natural perils experience has led to a more favourable reinsurance environment:

> *Australian reinsurance rates are on the decline, with the flood of global reinsurance capital that has weakened international rates flowing on into this year's renewals.*
>
> *A relatively benign international and local catastrophe period last year has helped traditional reinsurer balance sheets, while capital from non-traditional sources has contributed to overcapacity.*[25]

As reinsurance rates decline, the recent upward pressure on residential property insurance premiums should reduce.

4.3 Translating technical price into a commercial premium

To the extent that an insurer is seeking to manage the profitability of each (sub)class of business, the technical price of a policy will serve as a guide to commercial premiums but will not necessarily determine them.

Commercial premiums reflect a judgement made by underwriters to depart from the technical price (plus any relevant statutory charges) having regard to:

- existing policyholders' propensity to shop around
- the need to maintain revenue and attract new business
- competitors' current pricing for similar policies
- expected response of competitors to a premium change.

Given insurance represents a pooling of risks, an insurer's first priority is that inflows of premium from all policyholders exceed outflows in the form of reinsurance, (net) claims, administration and overheads by a margin sufficient to keep shareholders satisfied. An insurer may be prepared to make a loss (commercial premium less technical price) on one risk address over time provided it was confident of making offsetting profits on other risk addresses.

Variation between technical price and commercial premium is usually driven by an insurer's assessment of the propensity for a customer to shop around. To an insurer, the ideal customer is one that will renew their policy without looking elsewhere. The FSLM has not seen any objective evidence that any significant proportion of residential property insurance policyholders seriously shop around.

Insurers will use a variety of strategies in order to optimise their business mix – strategies (outlined in more detail in Table 4) will include:

- marketing policies with 'loyalty discounts' or 'no claim bonuses' to prevent the loss of existing business – see Box 3
- limiting premium reductions or increases on renewal to maintain revenue and prevent the loss of existing business
- aggressive discounting applied to first year premiums to attract new business.

[25] Insurance News, *Reinsurance rates take a dip as capital pool swells,* 24 February 2014. Available at: http://www.insurancenews.com.au/analysis/reinsurance-rates-take-a-dip-as-capital-pool-swells, viewed 3 March 2014

Table 4 Insurer pricing strategies

Strategic objective	Strategy
Maintain revenue and prevent the loss of existing business	**Limits in the percentage *decrease* in a premium from year-to-year** (also referred to as 'collar' or 'cup') following re-rating of property risk as a consequence of updated technical models. There are two reasons why an insurer might adopt this strategy: ▪ avoid the loss of revenue from policyholders that will stay despite the fact that there has been a larger reduction in the technical price than has actually been passed on ▪ insurers identify thresholds of premium reduction that would encourage a policyholder to start looking elsewhere for insurance even if they do not ultimately change insurers[26]
	Limits in the percentage *increase* in a premium from year-to-year (commonly referred to as 'cap') following a re-rating of property risk as a consequence of updated technical models – insurers identify thresholds of premium increase that would encourage a policyholder to start looking elsewhere for insurance even if they do not ultimately change insurers
	Loyalty or association membership discounts – for example, one insurer offers various levels of discounts from the 'normal' premium if the insured is a member of a specified motoring organisation, another insurer offers discounts if they have maintained their policy with that insurer for a specified number of years
	No claim bonuses – if a policyholder has maintained a claims-free record for a specified period, a discount from the 'normal' premium will be provided
Attract new business	**Providing discounts compared to the technical price** – some insurers appear to discount new business by as much as 25 per cent compared to the premium offered on a similar risk to a renewing customer, even though the cost of writing new business is significantly higher than the cost of renewing existing business

Box 3 How real are loyalty discounts and no claim bonuses?

Loyalty discounts and no claim bonuses are actually very difficult to verify.

Given:

- the complexity of the process required to establish the appropriate technical price
- the lack of any willingness on the part of insurers to divulge to policyholders the components of the technical price
- the improbability of a policyholder being able to compare their renewal offer with a contract offer made by the same insurer to other (similar) policyholders

policyholders are beholden to insurers to be advised of the base from which a renewal premium discount is applied.

Accordingly, an insurer could offer a 'special' class of customer a, say, 25 per cent loyalty discount from the 'normal' premium, knowing that normal customers are not part of their strategic business mix and the insurer is quite indifferent as to whether normal customers buy their product. In such an environment, the normal premium could be set at whatever level the insurer determines is necessary to deliver a 'discounted' target premium to the special customer.

[26] This may seem counter-intuitive, but it is accepted through the insurance industry that offering reductions in premium compared to the previous year can actually encourage a policyholder to shop around if the premium reduction is large.

In addition to these strategies, insurers could also manage the introduction of new policy features through cross-subsidisation between policyholders. Through use of opt-out models for flood cover, at least one insurer charges additional premium to policyholders who do not choose to opt-out of flood cover, even though the risk of flood at some addresses is negligible.[27]

Within the range of possible premium changes between caps and collars, 'Insurer A' will also take account of market research around how their competitors are pricing similar policies and how competitors might respond to any premium change implemented by Insurer A. Revenue optimisation in a commercial environment would require all insurers to have a good understanding of how responsive their own customers (or prospective new customers) may be to changes in the price of their own product and changes in the price of substitute (competitors') products.

As an additional service to policyholders, and in an effort to encourage a policyholder to not go elsewhere, insurers may also offer to allow the insured to pay the policy by instalments. In the case of one large underwriter's online quote, if the offered monthly instalment payments were translated to a loan for the up-front annual premium being paid off over a 12 month period, the effective annual interest rate on that loan would more than 33 per cent, although no information of that nature is disclosed to the policyholder.[28] Under the component pricing rules of the Australian Consumer Law:

> *A single price for services supplied under a contract that allows periodic payments does not have to be displayed as prominently as the component prices.*[29]

That is, where a periodic payment is applicable, the 'single price' still needs to be displayed, albeit not necessarily as prominently as the periodic payment. However, in *not* indicating the total price that would be paid if paying by instalments, it appears as though insurers are relying on an exception within the Australian Consumer Law that applies when there is an option of periodic payments instead of payment up-front.[30]

As a consequence of employing these strategies, insurers will end up with a portfolio of customers whose actual premium can differ substantially from the insurer's own assessment of the technical price. Over the long term, this strategy is only sustainable if the revenue lost through under-priced policies is offset by revenue gained through over-priced policies.

Inevitably, there will be some point at which insurers will re-rate risks and not be prepared to continue offering substantial discounts to retain the business. In these circumstances insurers will either:

- offer (close to) technical price and accept that the customer may look (and possibly go) elsewhere

[27] At the FSLM's public hearing on 18 June 2013, when commenting on flood cover implemented on an opt-out basis, a representative of Allianz Insurance stated that 'we started our rollout in September 2012, and the customers that we've offered renewal to, to date, about 80 per cent have taken up the flood option'. It is accepted by the insurance industry that only (approximately) seven per cent of residential properties Australia-wide have any material risk of flooding (see section 5.2.2).

[28] The fine print on this insurer's website does indicate that 'it is cheaper to pay annually', but no indication is provided as to how much cheaper. If instalment payments were made by credit card and the credit card was not paid off in full each month, credit card interest rates would apply in addition to those effectively applied by the insurer.

[29] Australian Consumer Law, Sales practices: A guide for business and legal practitioners, p21. Available at: http://www.consumerlaw.gov.au/content/Content.aspx?doc=the_acl/guidance.htm, viewed 6 May 2014

[30] Section 48(7)(a) of the Australian Consumer Law

- not offer a renewal, effectively saying they are no longer prepared to accept the risk presented by particular customers.

5. Assessing risks associated with bushfire and flood

The discussion of technical prices in section 4.2 referred to modelling to underpin an insurer's understanding of the risks it is accepting. The more an insurer understands about a specific property and the more accurate are the insurer's models, the greater is an insurer's ability to manage the risk.

Insurers will gather data on each type of risk and property characteristic using a variety of published sources, in-house research and commissioned research. Data gathering by insurers for the purpose of incorporation within technical models might include:

- crime statistics in relation to theft and burglary hot spots
- rates of accidental damage and malicious damage in specific locations
- relationship between property age / construction, the likely damage arising from specific events and the costs of damage repair
- storm paths and hail corridors[31]
- long-term observations with respect to the probability of occurrence of bushfire and flood events
- topographical information that will influence the probability of damage to a particular property by either bushfire or flood.

Mathematical and statistical models incorporating the above data will then be used by insurers to convert knowledge of specific location and property characteristics into a quantification of expected value of annual claims associated with that property.

Some of the larger insurers have recently made significant advances in the development of address-specific risk assessment. For example, rather than rating bushfire and flood risk at the postcode or suburb level, as was common practice just four or five years ago, insurers now have access to information that provides them with the basis to apply different risk ratings to adjacent properties where ratings are informed by property specific characteristics. New models developed to measure catastrophe exposure attempt to estimate the total economic impact of a catastrophe for different locations and allocate this to the total sum insured by the insurer.

The following sections provide some detail around the form of information now used by insurers to rate bushfire and flood risk.

5.1 Bushfire risk

Long-term bushfire risk for any individual property is a function of:

- climatic conditions
- topographical factors
- actions of a property owner in response to the above.

[31] Effort is being expended by insurers into detailed analysis of weather patterns, with a consequence that some are adopting revised views as to the likelihood of hail storms in specific locations that translates into sub-region specific risk and premium adjustment.

There is no clear evidence that the risk of bushfire associated with climatic conditions and topographical factors has changed in recent times. However, mitigation measures introduced following the 2009 Victorian Bushfires Royal Commission should have the effect of diminishing the risk for at least some properties.[32] Further, as the modelling and understanding of bushfire risk evolves, as it also does with flood risk, insurer assessment of bushfire risk at various locations may change.

With rare exceptions, up to three or four years ago insurers relied predominantly on their own historical records and suburb or postcode averages for bushfire risk assessments. On the basis of information provided through the (section 30) bushfire, flood and reinsurance information request, bushfire risk assessment is generally not yet as sophisticated as is flood risk assessment. Many large insurers still rate bushfire risk by suburb or postcode, although movement towards use of finer, geographically specific factors is being made.

As insurers gain a better understanding of bushfire risk at an individual property level, adjustment to premiums is inevitable. Suncorp has indicated:

> *… there is a rebalancing, I suppose, in our portfolio around some risks which are higher bushfire risks and will receive higher premium increases as opposed to those with no bushfire risk, which will receive lower premium increases.*[33]

Current 'best practice' bushfire risk assessment will incorporate consideration of:

- distance of building from bushland
- direction to bushland – relevant because likely prevailing wind on high fire danger days will affect the probability of ember attack
- topographical position – for example:
  - whether surrounding land is flat
  - slope of the land on which is the building located
- type and density of surrounding vegetation
- house construction
- assessed bushfire attack level.

The proprietary information sets currently available and in use by insurers include:

- Finity Consulting Model – developed by the actuarial firm Finity Consulting, which provided algorithms to be used to calculate expected claims costs for properties by perils. The algorithms vary according to the circumstances of separate perils (bushfire, cyclone, earthquake and storm) across dimensions including:
  - postcode
  - construction type
  - building standards.

[32] For example, revisions to building regulations and enhanced vegetation management.

[33] Transcript of the FSLM's public hearing, p11, available at: http://www.firelevymonitor.vic.gov.au/home/news+and+information/public+hearing/public+hearing+transcript

- Risk Frontiers Bushfire Data – produced by Risk Frontiers,[34] which developed bushfire risk assessments for properties at an address level. Using data from major historical bushfires, Risk Frontiers found the distance from a property to the bushland fringe to be the single-most important factor determining the probability of building destruction given an extreme bushfire in adjacent bushlands. The data applies a five-point scale to addresses in bushfire prone areas.
- Willis Re Bushfires Model – a model developed by Willis Re to predict the bushfires probabilities using hazards modelling techniques. The database is only available on a subscription basis.

With respect to how models affect premium, at the FSLM's public hearing, a representative of QBE stated:

> *… proximity to bushfire exposure, even things like proximity to fire stations, those sorts of things, have an impact on our individual risk pricing, so we've taken quite a few steps to continually evolve our pricing methodology as new data, new techniques and new modelling comes to hand.*[35]

5.2 Flood risk

5.2.1 Definition of flood

One uncertainty with respect to the assessment of flood risk has now been removed with the adoption by the insurance industry of a common definition of flood as prescribed by relevant regulations as follows:

> *(1) For paragraph 37B (2) (a) of the [Insurance Contracts Act], the word 'flood' means the covering of normally dry land by water that has escaped or been released from the normal confines of any of the following:*
>
> *(a) a lake (whether or not it has been altered or modified);*
>
> *(b) a river (whether or not it has been altered or modified);*
>
> *(c) a creek (whether or not it has been altered or modified);*
>
> *(d) another natural watercourse (whether or not it has been altered or modified);*
>
> *(e) a reservoir;*
>
> *(f) a canal;*
>
> *(g) a dam.*
>
> *Note Under subsection 37B (3) of the [Insurance Contracts Act], the meaning of 'flood' set out in subregulation (1) will apply in the prescribed contract even if the meaning of the word provided by the prescribed contract (or by a notice or other document or information given by the insurer in relation to the prescribed contract) is different from the meaning set out in subregulation (1).*[36]

[34] An independent risk research centre specialising in the study of natural hazards with the sponsorship of the ICA.

[35] Transcript of the FSLM's public hearing, op. cit., pp38-39

[36] Paragraph 29D of *Insurance Contracts Amendment Regulation 2012 (No. 1)*, made 14 June 2012

The above definition of flood is now reflected in the product disclosure statement (PDS) of each of the major insurers reviewed by the FSLM.

5.2.2 *Assessment of flood risk*

Assessment of flood risk on the part of an insurer involves an understanding of:

- the probability of a flood event – average return interval (ARI) in years
- the height of a flood when it does occur
- the amount of damage a flood of a given height is likely to cause.

With rare exceptions, up to three or four years ago insurers relied predominantly on their own historical records and suburb or postcode averages for flood risk assessments. Where flood insurance was available, insurers relied on policy exclusions to manage their risk.[37]

The insurance industry now commonly use two separate tools as a basis for assessing flood probability at relevant properties or 'address points':

- National Flood Information Database (NFID)

  The NFID was developed by the Insurance Council of Australia (ICA) with the assistance of state and territory governments using available flood studies and terrain data. Geocoded National Address File (GNAF) provides the basis for assessing flood probably at relevant address points, with flood measures that include, for each address point:

  - the probability of flooding over the ground (and 1 metre and 2 metres above ground)
  - the water depth for fixed probability floods events at 20 year ARI, 50 year ARI, 100 year ARI and extreme flood.

  Not every flood prone area in Australia is covered by the NFID, as some local governments and floodplain management authorities responsible for this information have yet to release adequate digital flood mapping.

- Flood Exclusion Zones (FEZ)

  Flood exclusion zones, as the name suggests, indicates areas where flood is *not* likely to occur. The FEZ database was developed by Risk Frontiers. The database can be used in geographical areas where local government flood mapping is not available and where insurers have few other options to assess the level of flood risk.[38]

In rating flood risk, insurers generally take account of whether the ground floor of the building is elevated, and some insurers also take account of the position on the property at which building is located – flood damage risk will be lower the more elevated is the ground floor. Given an understanding of flood ARI and height, insurers will then apply some form of damage curves to calculate the likely extent of the value of loss arising from a flood of a given height through a property as proportion of sum insured.

[37] Past practice was also confused by differing definitions of 'flood'. Industry has now adopted the (regulated) common definition of 'flood'. Exclusions from flood cover do, however, differ between insurers.

[38] Paraphrased from ICA Media Release, *New flood database expands insurers' knowledge of risk*, 20 December 2012

The proportion of Australia-wide residential properties with a material level of flood risk is crudely estimated to be around seven per cent. This estimate has been in common usage by the insurance industry for several years and its accuracy will only be known when the NFID and FEZ are fully completed. If the seven per cent estimate were, in fact, reasonably accurate then the current form of the NFID covers somewhere in the order of half of all flood exposed properties.[39]

Collectively, the NFID and FEZ cover 84 per cent of residential addresses Australia-wide with some (albeit not necessarily complete) level of information regarding flood risk. Flood risk assessment by insurers of the 16 per cent of residential properties not covered at all by either NFID or the FEZ, along with those addresses incompletely covered by NFID and FEZ, is subject to:

- historical loss experience
- third-party research to supplement NFID and FEZ information – for example, Willis Re flood model,[40] Quantium flood model, Aon Benfield damage curves
- postcode or suburb averages.

All but one of the insurers surveyed through the bushfire, flood and reinsurance information request reported that they used the NFID – and presumably, also, the FEZ[41] – as the primary basis of their assessment of flood risk.

Five years ago, only 5 per cent of properties with a material flood risk were covered by the NFID and the FEZ had yet to be developed. Given the NFID and FEZ now cover (at least partly) 84 per cent of residential addresses Australia-wide, the evolving understanding of flood risk could create some significant changes in premiums as properties are re-rated in accordance with insurers' latest models that take account of the latest NFID, FEZ and third-party supplementary information.

At the FSLM's public hearing, a representative of Suncorp stated:

> *… something like a million addresses in Victoria have seen significant or material changes in some of that underlying flood information, and that obviously gets passed on as well. I guess it's worth noting that in a lot of cases the changes in premium that result from that are not due to the actual risk changing; it could be due to the insurer's understanding of that risk changing as better information is available. We believe that charging appropriate prices ensures the sustainability of the insurance pool over time.*[42]

and

> *… flood premiums are often the ones that give rise to very large changes in premium because the nature of floods are it's reasonably predictable whether it happens, so once the information is available to understand flood risk, the risk associated for those properties is*

39 Unfortunately, not every flood prone area in Australia has been covered by the NFID, as some local governments and floodplain management authorities responsible for this information have yet to release adequate digital flood mapping.

40 A model developed by insurance advisers Willis Re to predict the flood probabilities using hazards modelling techniques.

41 Given the FEZ is complementary to the NFID.

42 Transcript of the FSLM's public hearing, op. cit., p11

> *pretty large and can be very expensive, and obviously premiums in the thousands are not unheard of in terms of understanding what that particular risk is.*[43]

The challenges of incomplete information sets are acknowledged by insurers. At the FSLM's public hearing, a representative of Allianz stated:

> *In larger events, as we've seen recently, areas flood that were not expected to flood. I think just relying purely on the numbers that had been modelled comes with its own challenges.*[44]

When it comes to pricing flood risk, it is clear that insurers take different approaches:

- some offer opt-out flood cover and cross-subsidise by charging some level of additional premium to those who do not opt-out
- some offer flood cover across-the-board but only apply additional premium to policyholders with a material flood risk, although the lack of certainty around where flood risk ends will inevitably mean a degree of conservatism on the part of insurers in identifying where that boundary lies.

5.3 General observations regarding bushfire and flood modelling

Where insurers have used external data sources based on long-term analysis, they are more likely to produce insurance pricing reflecting long-term experience (and therefore less likely to be significantly changed after a single event).

Where models and data are weighted towards the short term, insurers are more likely to respond more to, for example, the recent bushfire experience. This is because a longer history (more than 10 years) for bushfires is typically preferred in consideration of natural peril claims as a large part of the cost factored into premiums for natural perils relate to very large events that happen infrequently, for example once every 100 years.

Consequently, picking any 10 year window of actual losses that happens to have one of these events in it would significantly skew the claims cost experience. Reinsurance modelling tries to get around this by looking at much longer histories and using these to model what might happen in future.

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43 Transcript of the FSLM's public hearing, op. cit., p18

44 Transcript of the FSLM's public hearing, op. cit., p73

6. Information disclosure between insurers and the insured

A well functioning, competitive, and efficient insurance market requires consumers of insurance to be well-informed. That is, consumers need to be able to clearly understand, or easily become informed about, all the relevant characteristics of an insurance policy they are considering to purchase. Arguably, this requirement should also extend to consumers having easy access to clear explanation as to why the conditions and price of a policy might change from year-to-year.

The information exchange between insurers and the insured needs to occur efficiently regardless of the nature of the relationship – that is, whether the relationship is conducted:

- directly between a retail insurer and the policyholder
- indirectly through a distributor, agent or broker.

Information asymmetry imposes a disadvantage on those who are relatively information poor – for example, a (prospective) policyholder who does not know what risks they face is not in a good position to make an appropriate choice on the nature of insurance cover they might select. It is recognised, however, that even if good quality and relevant information is made available, there will still be some people who are not in a position to use that information effectively; such people are likely to need additional assistance from social welfare agencies to manage their insurance needs. Even if vulnerable or disadvantaged consumers of insurance have the information, analysing their options and make good choices is not a straightforward process or a guaranteed outcome.

By way of comparison, government has attempted to address potential difficulties in being able to understand contractual terms in relation to consumer credit. Commonwealth consumer credit legislation obliges credit providers to make calculations and issue warnings precisely because the product is too complicated to expect the average consumer to assess the consequence of entering into the arrangement without active assistance, not merely passive information.[45]

6.1 Legislative requirements around information disclosure

The (Commonwealth) *Corporations Act 2001* (the ‘Corporations Act’) requires insurers to produce a PDS with respect to a contract for general insurance.[46] ASIC’s regulatory guidance on the content of a PDS indicates ‘Good Disclosure Principles’ as follows:

(a) disclosure should be timely;

(b) disclosure should be relevant and complete;

(c) disclosure should promote product understanding;

(d) disclosure should promote product comparison;

(e) disclosure should highlight important information; and

(f) disclosure should have regard to consumers’ needs.[47]

45 *National Consumer Credit Protection Act 2009, Schedule 1: National Credit Code*

46 The main requirements of a PDS are laid out in s1013D of the Corporations Act.

In addition to the requirements under the Corporations Act for a PDS, the Insurance Contracts Act has three separate groups of provisions relating to requirements for disclosure of information between insurers and the insured:

1. The insured's duty of disclosure to the insurer (sections 21 to 22 of the Insurance Contracts Act) – including an obligation on the part of the insured to disclose to the insurer every matter relevant to the decision of the insurer whether to accept the risk.

2. Provision of a 'Key Facts Sheet' (KFS) by the insurer to the insured (sections 33A to 33D of the Insurance Contracts Act) – a requirement to commence from November 2014 that obligates an insurer to lay out in two page standardised form, the following (among other things):

    - whether each of 13 key events are covered under the policy – for example, fire, flood, storm
    - limitations on coverage and policy specific examples thereof
    - whether policyholders are covered for legal liability (that is, legal costs).[48]

3. Provision of general information by the insurer to the insured (sections 69 to 75 of the Insurance Contracts Act) – for example, if you are a policyholder who:

    - has been offered a renewal at a significantly higher premium than in the preceding year

    and

    - following an effort to clarify your policy conditions, has been advised by your insurer that your property has been assessed as a higher risk – for example, with respect to burglary, bushfire, flood

    you are entitled to further explanation from your insurer if you remain unsatisfied.

Also, there are recent changes to the Insurance Contracts Act with respect to the 'duty of the utmost good faith':

> *A contract of insurance is a contract based on the utmost good faith and there is implied in such a contract a provision requiring each party to it to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith.*[49]

It is understood that ASIC is currently giving consideration to possible guidelines on the application of this duty.

6.2 Information offered by insurers

The FSLM is not aware of any concerns on the part of insurers that they do not have adequate opportunity to source appropriate information from purchasers of insurance regarding an

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47 Regulatory Guide 168.4 from ASIC, *Regulatory Guide 168, Disclosure: Product Disclosure Statements (and other disclosure obligations)*, September 2010. Available at: http://www.asic.gov.au/rg, viewed 13 March 2014

48 The current version of the Insurance Contract Act provides for a KFS. The specification of the KFS is laid out in regulations that were made in November 2012, but will only have effect from November 2014.

49 Insurance Contracts Act, s13(1)

insurer's ability to adequately assess the risk the insurer might accept. However, an observation based on performing functions in relation to the FSLM Act, is that there is much room for improvement with respect to insurers presenting key policy information to consumers in an accessible way.

The effectiveness of communication between insurers and the insured is heavily reliant on an insured's understanding of formal PDSs. Although a PDS might seem to be an appropriate vehicle by which to deliver information of value to consumers of insurance products, the form of PDS actually available to consumers is not necessarily helpful. ASIC's indication that a PDS should be 'relevant and *complete*' would tend to mean that a PDS associated with a complex underlying insurance contract is likely to be longer rather than shorter – a PDS of less than 60 pages would tend to be the exception rather than the rule.

It is unlikely that long-form versions of a PDS contribute greatly to the understanding of complex insurance contacts. It is also unlikely that long-form versions of a PDS contribute greatly towards promoting product comparison, because:

- there is no standardised form for presentation of a PDS
- the relatively unsophisticated policyholder is likely to be overwhelmed by the volume of information presented in the PDS and the formality of wording often adopted.

Summary tools such as the KFS would be useful both in helping to aid understanding of policies and in promoting product comparison.

As noted in the final report of the National Disaster Insurance Review (NDIR):

> *Insurance is a complex product with terms and conditions set out in lengthy policy documents and Product Disclosure Statements (PDS), which many consumers either don't read or don't understand. Further, the move towards more direct sales of general insurance policies by telephone under a no advice model means that consumers may not have access to information and documentation in a form they can readily understand before entering into a general insurance contract.*
>
> *…*
>
> *From a community perspective, consumer confidence in and understanding of general insurance is vital especially as insurance plays a key role in protecting their assets. However, there is ample evidence … that the disclosure regime with extensive documentation has failed consumers.*[50]

In their plan to tackle disasters, the ICA offered policy and industry initiatives aimed at developing a more effective and sustainable response to disasters in Australia, including:

> *Industry commitment to simplify and improve insurance product disclosure statement summary arrangements to enhance consumer understanding of insurance cover.*[51]

Some progress towards providing insureds with relevant information will be made when the requirement for insurers to produce a KFS becomes effective from November 2014.

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[50] The Treasury, *Natural Disaster Insurance Review. Inquiry into flood insurance and related matters*, September 2011, p101

[51] ICA media release, *10-point plan to tackle disasters*, 27 January 2011

The initial scope of the KFS was explained in the then Minister for Financial Services and Superannuation's foreword to The (Commonwealth) Treasury's discussion paper:

> *Many people find insurance documentation daunting more generally and would be hard pressed to clearly explain the scope of their coverage. Clearly this is not an acceptable situation given the critical role that insurance plays in protecting people from risk.*
>
> *That is why this Government is committed to implementing a mandatory one page Key Facts Sheet. The Key Facts Sheet will be a one page summary that clearly sets out what is covered and what is not covered. It will both improve people's understanding of their cover and make it easier to compare policies.*[52]

The important features of the KFS – that would be provided in addition to the PDS – are standardised (simple) explanations of the events that are covered and indications of the types of exclusions from coverage contained within their contract of insurance. Although only examples of exclusions would be required in the KFS, it would provide an important indicator to (prospective) policyholders as to circumstances where their insurance cover could fail them.

Delivery of a Key Facts Sheet would represent a step forward, but it does not go far enough in advising customers of the important terms and conditions of their insurance policy or the reasons why their premium might change significantly from year-to-year. The KFS would tell the insured *some* of what is included (and excluded) from their policy, but insurers can still do a lot more to clearly inform policyholders of the content and relevant features of their policies. Without clear indication from insurers of the types of inclusions and exclusions in their policy, policyholders are at risk of buying the wrong type of cover for their needs – should a nominated event occur, the policyholder might be surprised to find they are under-insured for that event or even not insured at all.

The large insurers offer similar lists of factors that will influence premiums, such as:

- property location
- construction material of property
- year constructed
- type of property – for example, house or unit
- the way the property is used – for example, residential or business
- how the property is occupied – for example, rented or owned
- sum insured
- security features
- the age of the oldest insured
- who occupies the property
- relevant claims history
- excess.

The items on the list will differ from insurer to insurer. The FSLM could not identify any insurer who articulates all of the above in its published explanatory material – the form of words to

[52] The Treasury, *Key Facts Sheet: Home Building and Home Contents Insurance Policies, Discussion Paper*, February 2012

describe similar concepts varies between insurers and some insurers indicate more items than others. With respect to what insurers *do* publicly reveal about the factors taken into account in the assessment of the premium, the following observations can be made.

No insurer from among those whose policy documentation was surveyed gives any prominence in their policy documentation to any list of risk factors – to the extent that factors are listed, their placement varies from:

- a first reference on page 5 of a 65 page PDS
- a (separate) document first referred to on page 64 of a 90 page PDS.

No insurer from among those whose policy documentation was surveyed includes in their primary policy documentation information more detailed than ‘property location’. However, it was noted in section 4.1.2 of this paper that relevant aspects of property location relevant to risk assessment by the insurer included whether the property was:

- with proximity to bushland, shopping areas, railway stations, main roads and schools
- within a flood plain and / or minimal elevation above a nearby watercourse
- on corner block or abutting vacant land.

Given the lack of prominence of information regarding risk factors, it can only be concluded that insurers either do not consider such information to be important or else are concerned that by providing such information, they may deter business.

6.3 Information of value to the insured

Benchmark information provision that facilitates appropriately informed insurance policy choice should incorporate clear and accessible information regarding (at least) the following elements of an insurance contract:

- basic policy inclusions and exclusions
- the nature of the risks the insured might face and, arguably, the insurer’s assessment of that risk
- the contribution of statutory charges to the total premium
- how much (and why) the premium for a policy changes with renewal
- what additional charges are being incurred as a result of choosing to pay the premium by instalments rather than up-front.

Such information would be helpful in comparing different levels of cover offered by a single insurer and also in comparing similar policies offered by different insurers.

6.3.1 Why a premium might change

From time-to-time, insurers will have legitimate reasons to make changes to insurance contract content and the associated premiums. Such changes should not be discouraged, provided the insured has a reasonable opportunity to understand the basis of the change.

If a policyholder is in a position to renew their policy with the same insurer, they might find their premium has changed to reflect the insurer’s assessment of risks and costs that need to be passed through to policyholders.

Premium change could occur for any one or several of the following reasons:

1. changes to the level of overheads being experienced by the business – for example, higher wages and administrative expenses
2. inflation in the value of sum insured – this usually occurs as a matter of course, although the insured will have the option of nominating their preferred sum insured
3. new crime statistics or information on the rates of accidental damage become available for an area that changes an insurer's assessment of the probability of a claim or average claim size
4. changes in the balance of retained overall natural peril risk and reinsurance coverage
5. changes in reinsurance costs[53]
6. changes in assessed probability of natural peril events – for example, more frequent bushfires, floods or storms[54]
7. the overall natural peril risk might be unchanged, but new models change the relative risk assessment of a given property – for example, the previous premium may have reflected suburb / postcode average bushfire or flood risk, but new information and models now rate the property as a high risk within that suburb / postcode
8. end of the new business discount at the first renewal – as noted in section 4.3, the FSLM understands that in order to attract new business some insurers will apply a discount of up to 25 per cent to the premium the same customer would face if they were renewing.

With the exception of the need to increase the value of sum insured due to inflation, the FSLM is not aware of any insurance underwriter or intermediary that would share any material information of this type with relevant policyholders.

6.3.2 How policyholders can respond to premium change

The fact that substantial new business premium discounts can end with the first renewal (reason 8, above) is sufficient cause in itself for persons seeking insurance cover to shop around every time they are renewing an insurance policy.

Another reason to shop around, or at least to challenge the insurer's assessment of a premium, is that the bushfire and flood models used by insurers are not necessarily accurate in their rating of risk.

As noted in section 5.2, the databases on which most insurers rely for assessment of flood risk are incomplete, so an insurer is not necessarily aware of features of a property that would affect an assessment of flood risk.

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[53] Many insurers claimed this to be one of the most significant factors in driving premium increases through the 2011-12 and 2012-13 financial years.

[54] See commentary on this issue in sections 5.1 and 5.2

Consider the following hypothetical example:

> *'Property X' is located on significantly raised ground in an otherwise flat area. The relevant area has been subject to an update of NFID and FEZ databases that now rate the area as a high flood risk. However, the database update is only partial and there is no specific property-by-property information on flood risk. 'Insurer A' now has to apply a flood risk rating to Property X in order to determine an appropriate technical premium, although Insurer A has no information by which to distinguish flood risk at Property X from flood risk at other properties in the same area. Because the general area has a high flood risk rating, Property X (on raised ground) is also given a high flood risk rating with a consequence that the offered renewal premium is much higher than was previously the case, even though the flood risk at Property X is substantially lower than surrounding properties.*

In an ideal world, the affected policyholder would call the insurer and inform them of the fact that their property is not a high flood risk because of its relatively elevated position and the policyholder would be rewarded with a premium reduction. The ICA has stated:

> *If a consumer has evidence their property may have been incorrectly assessed and is in a low-risk flood area, they are encouraged to present this information to their insurer. This evidence may be taken into consideration by some insurers when setting the premium.*[55]

However, this assumes that the policyholder has sufficient information to challenge the insurer's assessment of their premium. It is noted that some property-by-property flood information is available to many persons through flood mapping facilitated by local councils. Nevertheless, in order to usefully access such information, a (prospective) policyholder would have to:

- know such information existed
- know who they should approach to gain access to the information
- be in a position to understand either the flood mapping itself or the relevant council's interpretation of that mapping.

Although consumers of insurance have a clear interest in understanding the risks they face and insurers invest great effort in gathering and analysing relevant information, insurers are reluctant to share the information they have with the insured, despite the fact that policyholders are often in no position to obtain relevant, accessible information. At the FSLM's public hearing, the attitude of Allianz in this respect was stated as:

> *It's up to the customer to decide on what their exposure is to a flooding risk.*[56]

When asked by policyholders to provide more information regarding the reasons for changes to base premiums, insurers tend not to be forthcoming. A frequently recurring theme of complaints around the abolition of the FSL was that insurers failed to advise renewing policyholders why their base premium increased. Many complaints were about increases of 30 to 50 per cent in a single renewal.

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55 ICA statement quoted in Macleay Argus, *Flood cover rises in the Macleay are here to stay*, 4 December 2012. Available at: http://www.macleayargus.com.au/story/1163292/what-the-insurance-council-of-australia-says/, viewed 31 March 2014

56 Transcript of the FSLM's public hearing, op. cit., p73

Enquiries to insurers' call centres (apparently) often elicited vague responses from the call centre operator along the lines of: 'our costs have increased' or 'risks at your property have been re-rated'. When pressed for further information, call centre operators were mostly not able to provide further detail. This type of response is not at all helpful to a policyholder who is seeking to manage their own risks through an understanding of what it is about their circumstances that causes insurance premiums to change – particularly in cases where year-to-year premium increases are very large. If 'risks have been re-rated', what risks were affected? Bushfire? Flood? Theft?

Many complaints were received that indicated an inability or unwillingness by front-line staff of insurers and intermediaries to provide policy holders with accurate and adequate information to address their concerns regarding their policies. Of particular concern is apparent misinformation given to policyholders when they seek reasons for premium change. See Box 4 for some examples of insurer / intermediary responses provided to policyholders who made enquiries.

Box 4 Examples of reported responses by insurers / intermediaries to policyholders' enquiries regarding premium increases

Failure to give any reason for premium change

One complaint forwarded to the FSLM was from a policyholder seeking an explanation for a 39 per cent increase in the base premium following a 33 per cent increase the previous year.

The policyholder rang the insurer's call centre and the operator explained that premium increases were capped and the system would not allow increases above a certain percentage. However, because the operator did not work in 'Pricing', they did not know what the percentage increases were for certain types of insurance and/or areas.

The FSLM's subsequent enquiries to the insurer on the policyholder's behalf revealed a substantial change in the insurer's bushfire risk assessment for the relevant property.

Reported misleading information provided by insurers / intermediaries

… *Increase in premium [36 per cent] is consistent with all insurers' increases because of the high number of claims due to major insurance events in the preceding 12 months.*

… *There has been a 42 per cent increase across the board due to an increase in natural disasters and the claims that have resulted.*

… *The ICA policy is to load premiums in bushfire areas.*

… *The insurance company won't charge a fire levy but are increasing the cost of payments due to 'climate changes'.*

… *Consumer can choose to omit the levy from premium but if there is a fire they will not be covered.*

… *Higher premiums are due to an increase in administrative costs in winding up the current FSL model.*

… *Not charging an FSL but are charging a property based levy imposed by the State Government.*

… *We are operating according to Government instruction.*

Note: These examples are drawn from complaints made to the FSLM around the time of the abolition of the FSL.

6.3.3 Insurer obligations to respond to policyholder queries

The FSLM has anecdotal evidence that at least one insurer has expressed concern about providing information regarding the flood risk assessment of a property[57] for the reason that such information could be construed as providing 'personal financial advice'.

How factual information regarding an insurer's assessment of a risk could be construed as providing personal financial advice is difficult to understand. Also, if true, it would be difficult to maintain such a position and also comply, if required, with section 75(1)(d) of the Insurance Contracts Act which states:

> *Where an insurer … by reason of some special risk relating to the insured … offers insurance cover … on terms that are less advantageous … than the terms that the insurer would otherwise offer, the insurer shall,* if the insured so requests in writing given to the insurer*, give to the insured a statement in writing setting out the insurer's reasons … for offering insurance cover on less advantageous terms … [emphasis added]*

How could an insurer both:

- refuse to provide information on (change in) bushfire or flood rating assessment on the grounds that it may constitute personal financial advice

and

- give to the insured a statement in writing setting out the insurer's reasons for offering insurance cover on less advantageous terms as required under section 75(1)(d) of the Insurance Contracts Act?

Practices may vary across insurers regarding the degree of information provided on natural perils risk rating. For example, the following comment was made by a representative of Insurance Manufacturer's of Australia at the FSLM's public hearing:

> *We have referral processes in place in and around price and any questions, so I can take flood as an example is that we would advise the customer that they are in a flood area, and if they disagree with that, there is a referral process through where we can individually look at the price to determine whether we believe it is correct or not, and they can provide us additional information in around the risks.*[58]

6.4 Risk information provision overseas

6.4.1 European Union

Although new rules are yet to be implemented, in February 2014, Members of the European Parliament amended draft rules on sales of life and non-life insurance products and services to introduce similar information requirements and level the playing field between insurance companies and insurance distributors (agents / brokers).[59]

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57 For further context, see the hypothetical example in section 6.3.2.

58 Transcript of the FSLM's public hearing, op. cit., p59

59 Europarlamento24, *Better transparency on insurance contracts,* 26 February 2014. Available at: http://www.europarlamento24.eu/better-transparency-on-insurance-contracts/0,1254,107_ART_6076,00.html, viewed 10 April 2014

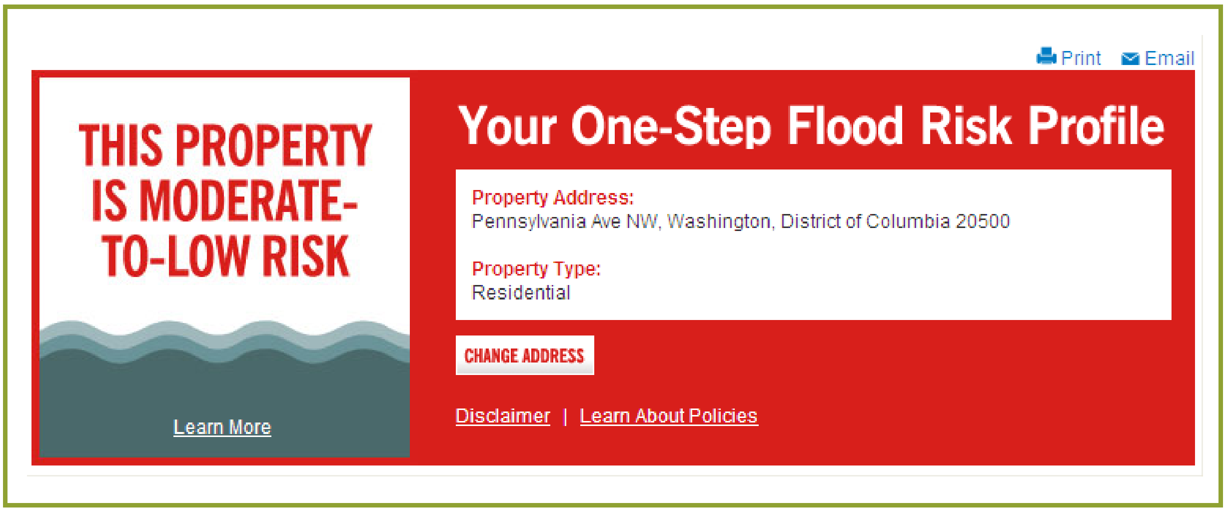
The amended rules would seek to ensure that, before signing a contract, buyers would have to be given standard information on the type of insurance, obligations under the contract, risks insured and excluded, means of payment and premiums, in plain and easily understandable language.

6.4.2 United States (US)

A comprehensive survey of rules around insurance policy information provision in the US has not been made, but at least one US Government agency does provide assistance to insurance consumers in understanding the risks they face.

The United States' Federal Emergency Management Authority has a National Flood Insurance Program that incorporates a 'Flood Smart' tool.[60] Flood Smart does not have uniform national coverage, but does offer clear accessible information about properties for which flood risk data is available (see Figure 6).

Figure 6 Snapshot from (US) FloodSmart.gov website enquiry for a given address



60 National Flood Insurance Program, FloodSmart.gov. Available at: https://www.floodsmart.gov/floodsmart/pages/landing_pages/landing0000_1.jsp, viewed 10 April 2014

7. The case for changing the balance of information provision

If general insurance markets were truly competitive, efficient, and effective, consumers would be well-informed. Further, similar premiums would prevail on similar covers on similar risks.

Economic efficiency has three dimensions – allocative, technical and dynamic. Efficient outcomes in the context of insurance markets would, therefore, reflect the following:

- allocative efficiency – there is a close correspondence between the nature of the cover required by a policyholder and the cover supplied by the insurer
- technical efficiency – insurers deliver their services in ways that use internal resources in a non-wasteful manner and at prices that reflects their true costs
- dynamic efficiency – maintenance of allocative and technical efficiency over time.

The need for efficiency within insurance markets was echoed by a representative of QBE at the FSLM's public hearing:

> *… from a societal perspective, the one thing that you have to have in an economy is an* efficient *and effective insurance industry that is able to pay its claims.*[61] *[Emphasis added.]*

It is not disputed that the insurance industry is able to pay its claims, but the indicators summarised below suggest that insurance markets are not operating efficiently, nor are consumers of insurance necessarily well-informed. Insurance markets are already strongly regulated – regulated because, left to its own devices, the insurance industry might fail to adequately protect the interests of policyholders. However, if the regulated market still fails to deliver efficient outcomes and the interests of policyholders remain compromised, it must be concluded that there is also a degree of regulatory failure.

As outlined in section 6, the level of information disclosure that actually occurs seems to favour insurers over the insured to the extent that many insured are unable to make properly informed decisions regarding the appropriateness and/or value of the cover they are offered. It may be that in many cases, consumers do have the right level of cover and they pay no more for insurance than they need to. However, the profitability of the general insurance industry over the past few years – despite insurers' repeated reminders that it has been a very intensive period for large claims resulting from a series of natural disasters – suggests that many policyholders are paying for cover they do not need or paying too much for the cover they do need.

7.1 Indicators of insurance market inefficiency

The previous sections have outlined several indicators of both allocative and technical efficiency failures within insurance markets and, hence, disadvantage to policyholders. In summary, these indicators are:

- many insurers offer substantial discounts for new business, yet rates of consumer switching between insurers are relatively low (sections 4.3)
- some consumers are subsidising others by paying for cover they do not need (sections 4.3)

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61 Transcript of the FSLM's public hearing, op. cit., p47

- some insurers use unverifiable ‘no claim bonuses’ and ‘loyalty discounts’ to discourage policyholder switching between insurance providers (section 4.3)
- insurers fail to disclose the extent of additional charges incurred by policyholders who choose to pay premiums by instalments (section 4.3)
- regulated policy disclosure requirements are misdirected:
    - residential property insurance is a very complex product and requirements to explain contract terms in a long-form PDS are ineffective at delivering accessible information to the average policyholder in a manner that promotes product comparison and informed policy choice (section 6.2)
    - the proposed mandatory Key Facts Sheet would be a useful policy comparison tool but it only goes part the way to explaining critical aspects of a policy that are of legitimate interest to the consumer (section 6.2)
- insurers fail to adequately explain, or even acknowledge, substantial premium changes on renewal (section 6.3.1)
- insurers’ assessment of key property risks such as flood is imperfect (section 5.2.2) but consumers do not have adequate opportunity in practice to correct inaccurate information used by insurers (section 6.3.2)
- some insurers make hollow claims regarding restrictions on their ability to share information with policyholders (section 6.3.2).

In addition, regular monitoring of online offers for home and contents insurance for various hypothetical properties by the FSLM has found substantial differences in the premium offered for similar cover on the same property by different insurers. In at least some of these cases, the property in question would not be subject to any bushfire or flood risk, so the premium differences cannot be accounted for by different approaches to filling gaps in bushfire and flood risk databases. Although there may be some qualitative differences in policy coverage, such differences seem unlikely to account for the magnitude of price differences observed. If the insurance market were truly competitive, and consumers of insurance well-informed, such differences could not be sustained.

Also, as discussed in the following section 7.2, high profitability has been sustained within the general insurance industry for several years without being competed away, even during a period of significant natural disasters and a global financial crisis.

Finally, rates of non-insurance, driven by lack of understanding or lack of affordability, are high enough to suggest action needs to be taken to address these issues. In a discussion paper prepared for the 2009 Victorian Bushfires Royal Commission, it was suggested that approximately 13 per cent of total loss properties were not insured in the affected areas.[62] Other estimates of the rates of non-insurance vary widely, as shown in Table 5, but the most robust estimates suggest the true figure lies somewhere in the range 8 to 20 per cent.

[62] BRC Research, *The Fire Services Levy and Insurance*, Discussion Paper, November 2009

Table 5 Estimates of non-insurance of private dwellings Australia-wide

Source	Estimate	Currency*	Comment
Quantum Research [a]	4%	2013	No buildings insurance – likely to underestimate the true figure because the sampling methodology used was an online survey that would exclude households without an internet connection, the very type of household most like to be without some form of property insurance because of (among other things) affordability.
Roy Morgan [b]	8.6%	Ave of 5 years to 2007	Neither buildings nor contents insurance
ABS, Household Expenditure Survey [c]	23%	2003-04	Neither buildings nor contents insurance

* Time at which the estimate applies
Sources:

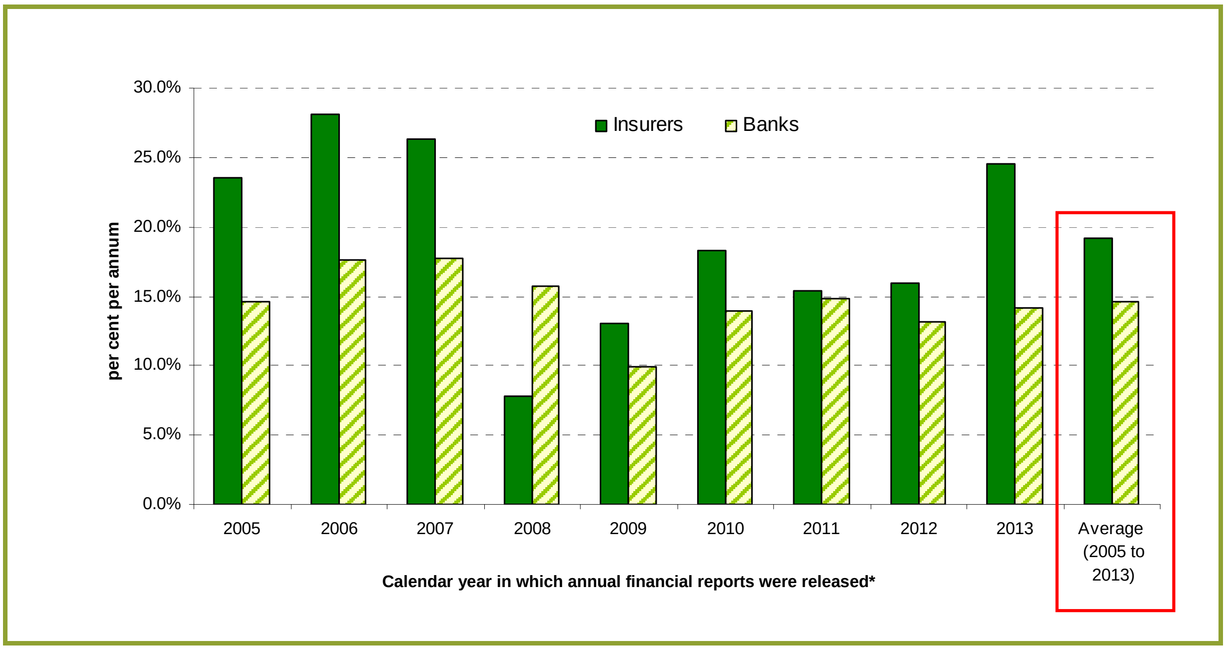
a. *The Understand Insurance Report*, October 2013, prepared by Quantum Market Research for the Insurance Council of Australia.
b. Department of Treasury and Finance*, Fire Services and the non-insured Green Paper*, 2009, p. 11
c. Department of Treasury and Finance*, Fire Services and the non-insured Green Paper*, 2009, p. 10

7.2 Insurance industry profitability

Although there are no publicly available estimates of the profitability of residential property insurance, general insurance is clearly a profitable business to be engaged in. If profitability as measured by return on equity is a guide, large insurers have generally been very effective in recent years in managing the overall balance between risks and premiums. Over the nine years to 2013, the annual average return on equity on general insurers' across-the-board portfolios was 19 per cent for underwriters with a significant presence in the Victorian residential property insurance market.[63] Profitability for these insurers over this period has, on average, exceed that of Australia's 'Big Four' banks (see Figure 7). If all general insurance markets were truly competitive and technically efficient, levels of profitability would not be expected to be that high.

[63] Sample chosen to represent all underwriters with a 2012-13 market share in Victorian residential property insurance of 2% or greater with the following exceptions: Suncorp Metway Insurance Limited included to avoid anomalies created by the effects of financial transfers between members of the Suncorp Group of companies; Wesfarmers Federation Insurance Limited is the forerunner to Wesfarmers General Insurance Limited.

Figure 7 Insurer and bank average after-tax return on equity (2005 to 2013)



* For example, 2013 includes results for entities with reporting years ending June 2013, September 2013 and December 2013.

Notes:

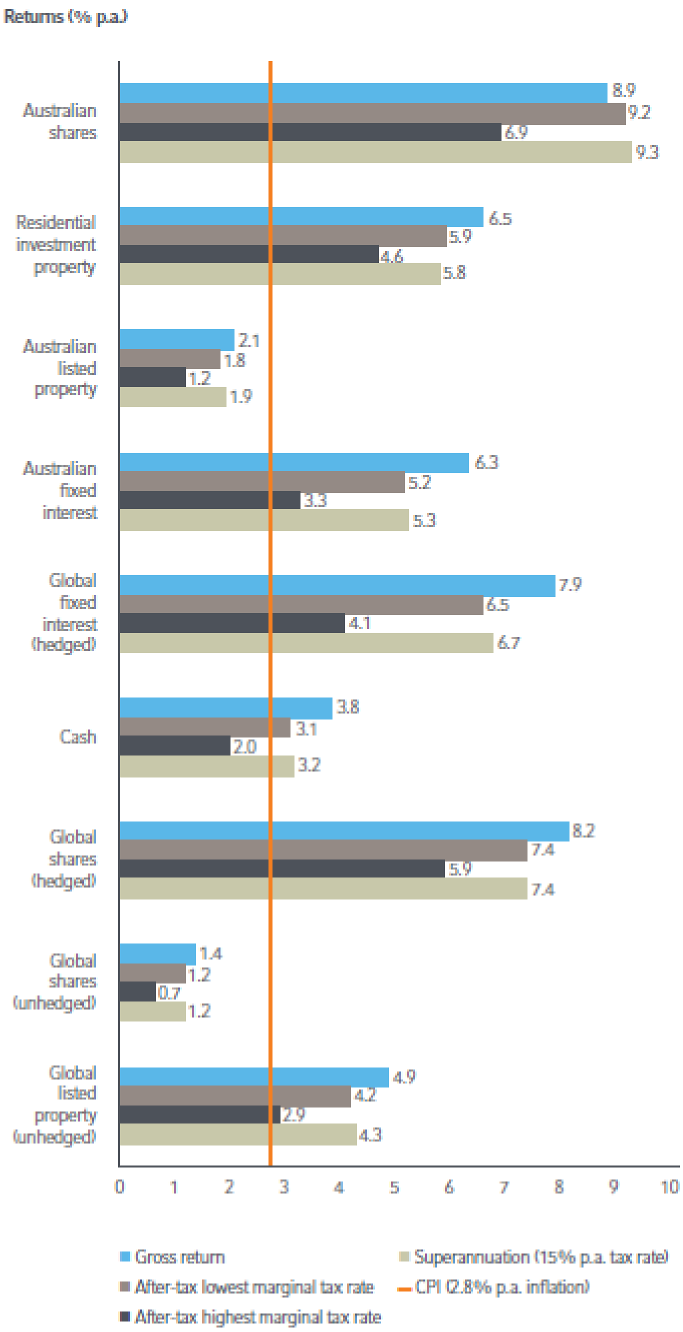
1. Insurance industry sample incorporates the following insurers: AAI Limited; Allianz Australia Insurance Limited; Australian Alliance Insurance Company Limited; Australian Associated Motor Insurers Limited; CGU Insurance Limited; Commonwealth Insurance Limited; GIO General Limited; Insurance Manufacturers of Australia Pty Limited; QBE Insurance (Australia) Limited; Suncorp Metway Insurance Limited; Vero Insurance Limited; Wesfarmers Federation Insurance Limited; Westpac General Insurance Limited; Wesfarmers General Insurance Limited.
2. Banking industry sample incorporates the following banks: Australia and New Zealand Banking Group Limited (ANZ); Commonwealth Bank of Australia (Commonwealth); National Australia Bank Limited (NAB); and Westpac Banking Corporation (Westpac).
3. Each year's annual average after tax return on equity is a shareholder's equity weighted 'after tax profit' *divided by* 'net assets' for companies in each of the insurer and bank samples, respectively.

Data sources:

1. APRA, *General Insurance Institution-level Statistics*, December 2013. Available at: http://www.apra.gov.au/GI/Publications/Pages/General-Insurance-Institution-Level-Statistics.aspx
2. ANZ, Commonwealth, NAB and Westpac annual reports.

To put the recent insurance industry performance into wider context, a research report issued by the Australian Stock Exchange and Russell Investments (ASX/Russell report) examined investment returns across a range of asset classes (see Figure 8). The ASX/Russell report found that average *after-tax* returns for investment in Australian shares over the ten years to December 2012 were between 6.9 and 9.2 per cent.

Figure 8 Before-tax and after-tax investment returns in various asset classes for the 10 years to December 2012

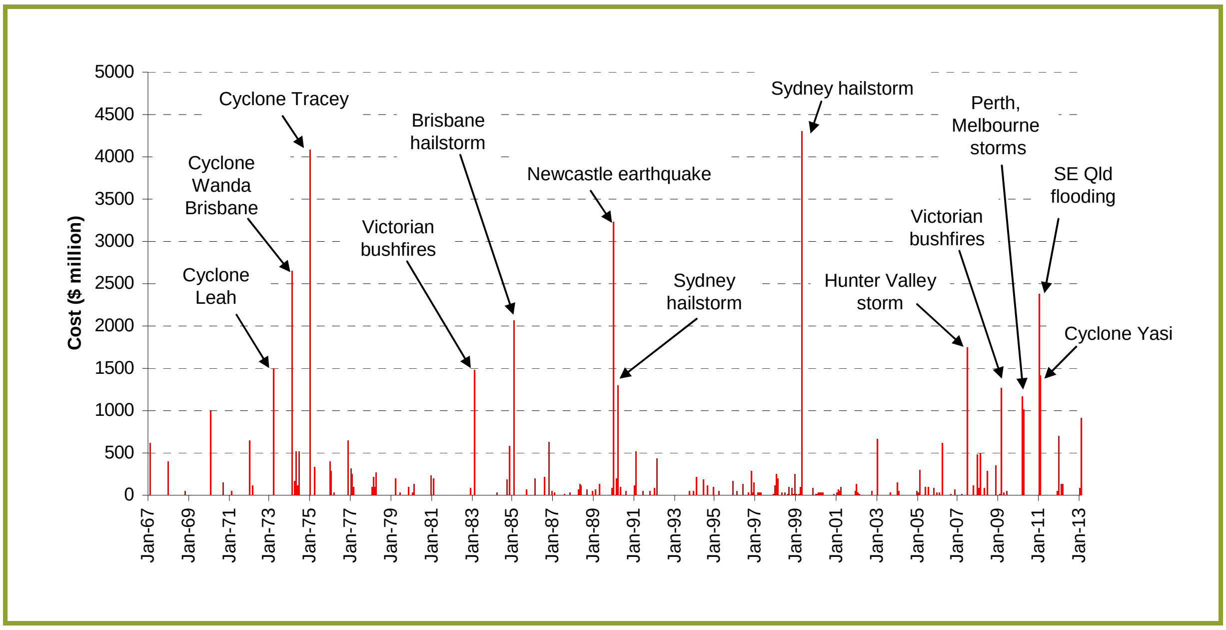


Note: All returns are net of costs.
Source: ASX and Russell Investments, *Long-term Investing Report*, July 2013, Exhibit 2

Strong profit results in the insurance industry have been achieved notwithstanding financial pressures caused by:

- a difficult investment climate following the global financial crisis of 2008 – insurers have a relatively strong reliance on investment income from the pool of funds retained from premiums pending return to policyholders via claims
- relatively high frequency of significant natural peril events over the past six years or so (see Figure 9).

Figure 9 Major natural peril events and associated Australia-wide insurance industry normalised losses (1967 to 2013)



Note: 'Loss normalisation' is used to estimate the losses sustained if past events were to impact present society.
Sources: http://www.insurancecouncil.com.au/industry-statistics-data/disaster-statistics/historical-disaster-statistics; and FSLM estimates.

The fact that high profitability has been sustained within the general insurance industry for several years without being competed away, even in a difficult environment, suggests that effective competition in insurance markets is not strong.

7.3 Insights provided by behavioural economics

The types of behaviours apparent on the part of each of the policyholder and the insurer as noted in earlier parts of this paper is the subject of analysis in the field of behavioural economics. Behavioural bias can arise when intuitive processes lead people, in systematic and predictable ways, away from otherwise logical conclusions. With biased consumers, information asymmetries can arise where consumers are able to access relevant information but are less able to process it. Making more information available is not the answer to addressing behavioural biases, but making relevant information available in an accessible form could help.

The Financial Conduct Authority (FCA) in the United Kingdom has produced a comprehensive analysis of behavioural economics as it applies to financial services for the purpose of identifying behaviours of retailers and consumers of financial products that will assist in identifying appropriate targets for market intervention.[64]

The FCA has identified biases and likely consequences that are relevant to the issues discussed in this paper. In particular:

> ***Most consumers find financial products complex.*** *Making financial decisions is hard, unpleasant and time-consuming. Consumers often lack motivation to invest time and effort to make informed decisions and, because of the complexity, cannot easily evaluate some products at all. Financial products have little inherent interest for most people and practical cognitive limitations, e.g. with numeracy and literacy, make many product concepts and descriptions difficult to understand.*
>
> ***Many financial decisions require assessing risk and uncertainty.*** *People are generally bad (even terrible) intuitive statisticians and are prone to making systematic errors. The influences on assessments of risk and uncertainty in insurance and investment markets may be subtle and opaque even to experts.*[65]

Among many other insights, the FCA also offers the following distinction between outcomes in markets with many players and outcomes where there is 'effective' competition:

> *One of the key insights of behavioural economics is that firm business models that result in consumer detriment may be sustainable even in a competitive market, here meaning a market lacking conventional 'market power' (monopoly and collusive practices). While we stress that competition is, by and large, a positive force that improves outcomes for consumers, it must be* effective *competition i.e. competition that benefits consumers through a combination of efficiency, price, quality and variety (innovation).*[66]

[64] Financial Conduct Authority, *Applying behavioural economics at the Financial Conduct Authority*, Occasional Paper No. 1, April 2013

[65] ibid., p16

[66] ibid., p22

8. Consumer protection activity beyond the scope of the FSLM

The Australian Competition and Consumer Commission has a general charter to protect the interests of consumers and has recently allowed mergers in the general insurance market on the basis that such mergers did not substantially lessen competition between insurers. However, for most aspects of financial services markets (including general insurance products), protection of consumer interests with respect to the provision of financial services falls within the responsibility of ASIC.

Policy makers, regulators and complaint handling bodies with particular responsibility for protecting the interests of consumers of insurance include:

- the (Commonwealth) Treasury
- the Australian Securities and Investments Commission
- the Financial Ombudsman Service.

8.1 The (Commonwealth) Treasury

The Commonwealth Government has recently articulated its view that insurance should be affordable and accessible; and reinforced the importance of insurance markets being efficient, competitive and responsive to community needs.[67]

In response to the Commonwealth Government's concerns about the high cost of strata title insurance in North Queensland, the Treasury has released a discussion paper[68] canvassing some measures that could address the Government's concerns. As well as encouraging consideration of the value of insurance aggregator sites, the discussion paper incorporates commentary consistent with the themes covered in this paper. For example:

> *Appropriate regulation that complements industry but fills in gaps in private sector efficiency may sometimes be necessary, after the costs and benefits of any such regulation are assessed.*[69]

> *… residents in all areas should be entitled to enjoy the benefits of an efficient market that ensures that prices paid are no more than necessary to reflect the underlying risk.*[70]

> *… ensuring that consumers are equipped with the knowledge and ability to compare insurance products and prices and select the most appropriately priced product that meets their needs.*[71]

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67 Senator the Hon Arthur Sinodinos, *Keynote address to the 2014 Insurance Council of Australia Regulatory Update Seminar*, 28 February 2014. Available at: http://axs.ministers.treasury.gov.au/speech/008-2014, viewed 4 May 2014

68 The Treasury, *Addressing the high cost of home and strata title insurance in North Queensland*, Discussion Paper, May 2014. Available at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/Addressing-the-high-cost-of-home-and-strata-title-insurance-in-North-Queensland, viewed 19 May 2014

69 ibid, page vii

70 ibid, page ix

71 ibid, page ix

8.2 Australian Securities and Investments Commission (ASIC)

ASIC's latest annual report lists its key responsibilities in the area of 'Investors and financial consumers – Deposit-takers, credit and insurers' as follows:

- ensuring deposit takers, credit providers, intermediaries and trustee companies are complying with the law
- implementing national consumer credit reforms.

The enforcement activity focus by ASIC in the area of 'Investors and financial consumers' is described as:

> *Financial services: investigating suspected misconduct and taking enforcement action to achieve criminal convictions … civil penalties or administrative sanctions. Focus on financial and credit products and advice.*

More specifically, ASIC is in the midst of a 'home insurance review', the purpose of which is for ASIC to better understand consumers' experience when purchasing home insurance policies and how this might be improved. ASIC has indicated that some of the themes they plan to examine in the home insurance review[72] include:

- the role of sales scripts at point of sale in providing transparent information and guidance to consumers when taking out insurance
- the use of calculators as a tool to assist consumers to set a sum insured
- how consumers can get readily accessible and consistent access to information about the policy through the sales process
- how issues of affordability affect consumer choice
- consumer behaviours and decision biases when purchasing home insurance
- the role of advertising in consumer decision making about insurance
- the relative importance of premium price compared to policy coverage and features.

The FSLM notes that there is no indication that unreasonably high price is a matter of consideration in either the home insurance review or any extant compliance strategy. Further, the home insurance review will not necessarily examine all of the indicators of insurance market inefficiency identified earlier in this paper and summarised in section 7.1.

ASIC's MoneySmart website is designed to provide generalised and accessible advice to consumers and is a useful resource for those who may be seeking some additional guidance with respect to insurance matters.

8.3 Financial Ombudsman Service (FOS)

FOS is a body established to ensure fair and independent dispute resolution between consumers (including some small businesses) and member financial services providers

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[72] Outlined in a speech by Peter Kell, Deputy Chairman, Australian Securities and Investments Commission, to the Insurance Council of Australia (ICA), 28 February 2014. Available at: http://www.asic.gov.au/asic/asic.nsf/byheadline/Regulatory-update-2014--Insights-from-the-Australian-Securities-and-Investments-Commission--speech?openDocument

(including insurers). The operations of FOS are governed by published Terms of Reference (ToR)[73] approved by ASIC that set out rules and processes, such as:

- power to consider disputes
- dispute resolution processes
- reporting obligations.

In accordance with the ToR, disputes eligible for consideration by FOS under the ToR include those between member financial services providers and holders of a 'Retail General Insurance Policy':

> *FOS may only consider a Dispute between a Financial Services Provider and an Applicant … that arises from or relates to … an entitlement or benefit under a General Insurance Policy by a person who is specified or referred to in the policy.*[74]

Although some disputes between residential property insurance policyholders and insurers may be within the jurisdiction of FOS, disputes that arise from lack of transparency of insurance policies are unlikely be considered.

The current ToR for FOS define some forms of dispute that are expressly outside the scope of FOS:

> *[FOS] may not consider a Dispute … about the level of a … premium … unless the Dispute concerns non-disclosure, misrepresentation or incorrect application of the fee, premium, charge or interest rate by the Financial Services Provider having regard to any scale or practices generally applied by that Financial Services Provider or agreed with that Applicant.*[75]

and

> *[FOS] may not consider a Dispute … in the case of a Dispute about a General Insurance Policy – about rating factors and weightings the insurer applies to determine the insured's or proposed insured's base premium which is commercially sensitive information.*[76]

FOS also has the discretion to exclude disputes:

> *FOS may refuse to consider, or continue to consider, a Dispute, if FOS considers this course of action appropriate, for example, because … the Dispute relates to a Financial Services Provider's practice or policy and does not involve any allegation of either Maladministration or inappropriate application of the practice or policy.*[77]

Therefore, notwithstanding that an insurance policy may:

- be offered with a premium the (prospective) policyholder believes to be unreasonable due to inappropriate assessment of risk

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[73] *FOS Terms of Reference – 1 January 2010 (as amended 1 January 2014)*. Available at: http://www.fos.org.au/about-us/terms-of-reference/, viewed 30 April 2014

[74] ibid., paragraph 4.2(b)(iv)

[75] ibid., paragraph 5.1(b)(i)

[76] ibid., paragraph 5.1(e)

[77] ibid., paragraph 5.2(c)

or

- have complex terms and conditions unable to be understood by a policyholder and, as a consequence, the policyholder finds they have an inappropriate policy,

dispute resolution via FOS may *not* be an option for consumers. Unless an insurer fails to comply with their (complex) contracted terms and conditions or established practices, no 'Maladministration or inappropriate application of the practice or policy' would be apparent and the dispute is likely to be rejected.

9. Proposals to enhance the consumer experience of home insurance

The FSLM considers that:

- residential property insurance is subject to substantial information asymmetry to the disadvantage of policyholders
- some regulation currently in place is ineffective in delivering good outcomes for consumers of insurance – regulation should be better targeted
- general insurance is a very profitable business and although significant pricing reductions did occur following FSL abolition, some consumers may have expected that reductions could have been greater
- to prevent consumers from being exploited in the future, *before* there is a change to a statutory charge that affects insurance premiums – for example, change to stamp duty rates or GST – consumers need to be clearly informed of the distinctions between base premium, statutory charges and total premium.

By improving the efficiency of insurance markets, through removing information asymmetry and making competition more effective, disadvantage to policyholders should diminish and premiums will fall, thereby making insurance more accessible.

Some measures that could be undertaken to provide consumers with better opportunity to understand their policy content are as follows:

- changes to existing standards of information disclosure – noting that consumer testing of the final form of any mandated forms of disclosure should be undertaken
- consumer awareness measures.

9.1 Information disclosure by insurers

9.1.1 Replacing the long-form PDS with more targeted measures

The requirement to produce a long-form PDS for general insurance contracts as the primary means to inform consumers of relevant policy detail should be reconsidered. There is a clear need for some form of a more concise approach to delivering relevant information to consumers.

The proposal to introduce a KFS goes some way towards promoting product comparison, but the combination of the long-form PDS and KFS is a compromise that will not provide sufficient accessible information to consumers seeking to understand the coverage of offered residential insurance policies, or to readily compare alternative policies and their pricing.

More accessible and useful information would be delivered to (prospective) policyholders if new regulated disclosure requirements reflected:

- removal of the requirement for insurers to deliver a long-form PDS to policyholders

- introduction of a requirement for a short-form PDS that incorporates a standardised presentation of key policy features that goes some way beyond the proposed KFS and includes information, or is accompanied by policyholder specific information, that at least covers:
    - basic policy inclusions and exclusions
    - the nature of the risks known to the insurer that the insured might face
    - the contribution of statutory charges to the total premium
    - how much (and why) the premium for a policy changes with renewal
    - what additional charges are being incurred as a result of choosing to pay the premium by instalments rather than up-front.

9.1.2 Presenting changes in policy price components

Insurers should be required to prominently indicate how elements of the total premium have changed since the previous renewal. Such a presentation would make clear to the policyholder:

- how much the base premium (the amount charged for insurance services) changes from year-to-year exclusive of any changes that may be made to statutory charges
- the additional charges incurred by choosing to pay the premium by instalments rather than paying the full amount due up-front.

Use of a form of 'Schumer boxes' for delivery of financial information would be desirable.[78] A presentation of relevant information along the following lines may be appropriate:

How the premium for your policy has changed in the past year …

	Policy period … [dates for policy about to expire]	***Policy period … [dates for policy renewal period]***
If total amount due is paid up-front …		
Base premium ($)	*$$*	*$$*
Statutory charges ($) (GST, stamp duty etc)	*$$*	*$$*
Total premium paid/payable ($)	*$$*	*$$*
If paid by instalments …*		
Monthly/quarterly instalment amount ($)	*$$*	*$$*
Additional amount paid over the term of the policy by not paying up-front	*$$*	*$$*

* Relevant parts of this table could be marked 'not applicable' if the 'instalment' option was either not offered or not taken up.

Having some form of transparency around the additional cost of payment by instalment is highly desirable, whether that be identifying either:

- the 'additional amount paid over the term of the policy by not paying up-front'

[78] The Schumer box is a summary of the costs of a credit card in the United States. It is named after Charles Schumer, the New York congressman (now United States senator) who was responsible for the late 1980s legislation requiring that terms of credit cards be clearly outlined in any promotional material.

- the implied 'discount rate'.

Organisations acting on behalf of consumers and seeking to deliver affordable insurance options for their client could pay additional attention to the consequences of payment by instalments. Although instalments may make it easier for some persons to budget for insurance cover, little attention seems to have been given to the overall cost of insurance by instalment. If payment for insurance up-front is not an option for a policyholder because of an inability to afford the full 12 month cost in one hit, they may be well advised to consider alternatives to the 'by instalment' plan offered by insurers, such as redraw on an existing mortgage or a personal loan.

9.1.3 Providing additional information on assessment of individual risks

The databases used by insurers to rate bushfire and flood risk are not in a form that is accessible to the general public, even if it were to be made generally available. At present, policyholders are reliant on insurer interpretation of the relevant databases.

The Commonwealth Government's National Flood Risk Information Project (NFRIP)[79] is being developed through Geoscience Australia. The NFRIP is seeking to make flood risk data more accessible through the development of an online Flood Risk Information Portal. The Portal will provide free access to authoritative flood studies and associated GIS flood mapping data to enable users to undertake their own analysis of the likelihood of flooding at a given location. Centralising this information will make it easier for planners, the public, insurers and engineering consultants to find out what flood mapping information exists, and to undertake their own risk assessments.

Although the NFRIP will represent a step forward in the availability of flood risk information, on the basis of the existing of presentation of the NFRIP, it seems unlikely to be user-friendly for the average insurance consumer. However, transition of the NFRIP to something like the FEMA (US) model of the FloodSmart.gov website information (see section 6.4.2, Figure 6) would be worthwhile; if that is not already the goal.

An alternative form of information could be disclosure of the insurer's own assessment of flood-risk at a property. In order to apply a premium to an insurance policy – regardless of whether reliable information is available at the property level or only at the suburb / postcode level – the insurer would have had to apply some flood risk assessment at least along a scale of 'negligible', 'low', 'medium', 'high' or 'very high'. Sharing such flood risk information with the insured, provided it is done in a careful manner, should be encouraged and similar principles could also apply to sharing bushfire risk ratings.

Availability of the 'negligible', 'low', 'medium', 'high' or 'very high' rating for key perils would then provide customer with:

- a basis for comparison between insurers
- a point of questioning an insurer's assessment of risk if the insured believes the insurer has it wrong.

Although there are other perils to which disclosure of insurers' risk assessment could also apply – for example, storm, theft, malicious damage – limiting this disclosure to just bushfire

[79] Geoscience Australia, National Flood Risk Information Project. Available at: http://www.ga.gov.au/hazards/flood/flood-capabilities/national-flood-risk-information-project.html, viewed 4 May 2014

and flood risk is reasonable. Bushfire and flood risk combined represent a substantial proportion of the costs that can be allocated by an insurer to a property on the basis of its street address – as distinct from more general postcode or suburb risks. Further, insurers have indicated to the FSLM, in response to representations made on behalf of complainants, that recent reassessment of these risks is the cause of many of the larger changes in premiums that have been observed.

In order to avoid insurer concerns that they are at risk of providing personal financial advice, ASIC could issue regulatory guidance as to the acceptable parameters of the proposed information exchange between insurers and the insured.

Where a risk rating for bushfire or flood has been (transparently) applied, and the policyholder believes the application to be mistaken, some form of dispute resolution should be made available – modification could be made to the current prohibition on FOS to consider a dispute about rating factors and weightings the insurer applies.[80]

Insurers clearly acknowledge the desirability of more sophisticated use of bushfire and flood risk information. A representative from Insurance Manufacturers of Australia commented as follows at the FSLM's public hearing:

> *… the industry generally is very active in talking to governments around the need for mitigation and around the need for better planning, and around the need for better building standards such that we can start to deal with some of the [insurance] affordability issues, which unfortunately exist for a small number of people as a consequence of the historical legacy of where we've built houses.*[81]

A possible long-term benefit of greater transparency around bushfire / flood ratings, is that it could eventually translate into pressure on local government to be more transparent around planning decisions: Why did Council X approve a development in a flood prone area? Surely it is best to ensure that people intending to purchase or build property have ready access to information regarding the risk of bushfire and flood and the consequences of continuing with their plans to purchase / build.

9.2 Consumer awareness measures

There are many steps that can be taken to educate consumers and facilitate opportunities for them to acquire information that is directly relevant to their choice of insurance policy, such as:

- supporting the development of home insurance price comparators
- giving greater prominence to existing consumer rights
- taking action to reduce the incidence of under-insurance or non-insurance.

9.2.1 Supporting the development of home insurance price comparators

Provision of support for the development of some form of residential property insurance price comparison tool would enhance consumers' ability to shop around.

Price comparator tools allow consumers to easily compare market offerings for relevant products. The ease of shopping around increases consumer activity and awareness in

80 *FOS Terms of* Reference, op. cit., paragraph 5.1(e)

81 Transcript of the FSLM's public hearing, op. cit., p58

markets and places greater competitive pressures on suppliers. Price comparator platforms are equally useful for consumers looking to enter the market, and for those who wish to compare their current product or service with that of other providers.

Aggregator[82] price comparator websites are used, both within Australia and internationally, for a number of products including loans, credit cards, superannuation, health insurance, car insurance, electricity and gas. While no price comparator currently exists for the residential insurance market in Australia, mature aggregator markets are present in the UK and US for many industries, including residential property insurance. The introduction of aggregators in these markets has increased consumer awareness about price and choice of provider, and has highlighted weaknesses in insurers' pricing strategies.[83]

More generalised comparators exist for residential property insurance in Australia, although these have proved inadequate in fully addressing consumer awareness and supply-side competition. Canstar,[84] for example, provides a comparison of the level of coverage across residential insurers, without looking at price. CHOICE[85] attempts to cover elements of both coverage and price, but operate off an insignificant sample size (only two Victorian properties looked at).

Given there is relatively little variation in the level of coverage on residential property insurance policies between insurers, it is likely that a price comparator – rather than a coverage comparator – that allows consumers all across Victoria to obtain relevant pricing information for their property specifications would be most beneficial to consumers. While it may not be practical to drill down to an exact quote for each property, there are some key specifications that heavily impact the price of the property more than others. These characteristics (sum insured, suburb, building material) could be used as inputs to create an indicative quote.

9.2.2 Providing easier access to information and dispute resolution

More prominence could be given to consumers' rights to be provided with a written statement of reasons by an insurer to explain changes in policy terms – as per section 75(1) of the Insurance Contracts Act. Perhaps if the premium changed by more than, say, 10 per cent, insurers should be required to draw attention to consumers rights' under section 75.

Insurers could (voluntarily) include within the renewal notice an explanation as to why the premium has changed. However, if attention is given to the section 75 obligation on insurers, insurers would have a choice to either:

- remain silent on the reasons for the change and then have to deal with the likely increased levels of enquiries from customers about why their premium has increased
- voluntarily provide, with their renewal notice, an explanation to minimise the enquiries load on call centres.

[82] Web site or computer software that aggregates a specific type of information from multiple online sources

[83] Chartered Insurance Institute (CII) and Ernst & Young, *Bringing profitability back from the brink of extinction: a report on the UK retail motor insurance market*, 2011

[84] Canstar is a research company that provides an interactive online service in retail and business finance.

[85] CHOICE is a consumer advocacy group.

To make it easier for consumers to get explanations of policy changes, section 75 of the Insurance Contracts Act could be modified by removing the requirement for the insured to request *in writing*, a statement of the insurers' reasons for offering cover on less advantageous terms.

To further support this change, ASIC (as administrator of the Insurance Contracts Act) might also provide regulatory guidance as to what level of response would be considered to be adequate in terms of a 'statement in writing setting out the insurer's reasons'.

9.2.3 Taking action to reduce the incidence of under-insurance or non-insurance

Following recent bushfire experiences, governments have modified building regulations and construction approval processes. As a consequence, the costs to replace a home in the event of a total loss could be higher than was previously the case. Many policyholders are unlikely to be aware of relevant regulatory changes and fail to adjust the value of sum insured on their property, with a consequent risk that they could find themselves under-insured in the event of a total loss.

Although insurers are *currently* under no obligation to inform policyholders of regulatory changes that could increase the costs of rebuilding, they could (voluntarily) value-add by alerting likely affected policyholders through the renewal process.

The fact that somewhere in the range 8 to 20 per cent of residential properties currently carry no building insurance represents an opportunity for the insurance industry. By making available packages of insurance that are easily understood and eliminate unnecessary costs, the uninsured might be encouraged to take up cover that is still profitable business to insurers.

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