RACQ

CYCLONE REINSURANCE POOL

RACQ SUBMISSION TO THE SENATE STANDING COMMITTEE ON ECONOMICS LEGISLATION

March 2022

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INTRODUCTION

RACQ supports a Cyclone Reinsurance Pool. We have reinforced that support through four successive submissions to Government, and now the Senate, as well as numerous public comments in the media and to our members directly. We believe a pool can help curb the rising cost of insurance and make a difference to the lives of 1.3 million people who call northern Australia home.

However, RACQ's support is predicated on three key principles:

- The pool must be well-designed to ensure efficiency, practicality and minimise implementation costs.
- The pool must be part of a larger program of evidence-based initiatives to drive down the cost of insurance such as natural hazard resilience investment, tax reform and stronger building standards.
- The price monitoring regime should be simple and not become a costly administrative burden.

All our advice to date has been provided with the Government's policy objective front of mind – to improve the accessibility and affordability of insurance in cyclone prone areas. RACQ shares this objective with the Government which is why we have been so active in the pool consultation over the past 10 months. But we feel strongly that the pool's proposed structure and operation could be improved - maximising benefits for our members in the north.

That is why we welcome the Senate Standing Committee on Economics Legislation's consideration of the *Treasury Laws Amendment (Cyclone and Flood Damage Reinsurance Pool) Bill 2022.*

RACQ recommends two legislative amendments to address outstanding concerns we have previously expressed about the pool. If these recommendations are adopted, we believe several costs, complexities and uncertainties would be taken out of the system ensuring the pool is best placed to meet community expectations over time.

About RACQ

RACQ is Queensland's largest member-owned mutual with nearly 1.8 million members. RACQ provides motor vehicle roadside assistance across the state, together with insurance and banking. The Club has been operating for over 116 years and last year marked our 50th anniversary providing general insurance to Queensland homeowners and motorists. We have grown to become the state's largest motor insurance brand and second largest home insurer.

Unlike the majority of the market, we are not governed by the pursuit of profits. As a mutual, RACQ exists solely for our members who are our only shareholders. Approximately 300,000 north Queenslanders are members of RACQ, 20 per cent of whom have home and/or contents insurance with us.

RACQ is immensely proud of its record in putting our members' lives back on track after natural disasters. Our Assistance fleet is on the ground as our initial incident response and our Mobile Member Centre is often the first insurance vehicle in impacted regions. Our catastrophe response also features dedicated teams of assessors, claims managers and professionals as well as a vast network of builders, trades and other partners. This response activity often stretches far beyond insurance. The RACQ Foundation exists to help communities recover from adversity. For instance, in the aftermath of the Townsville Floods, the Foundation gave more than $780,000 to 22 impacted community groups such as sporting clubs and charitable organisations. We also sent 23 staff and skilled tradespeople to help 13 community groups and farms rebuild and repair their assets and properties after the floods.

Our continued advocacy

RACQ has long acknowledged that the cost of insurance in north Queensland is too high and becoming unsustainable. However, through many inquiries, the causes are now well understood. Disaster risk is increasing, climate impacts are being felt, communities have been put in harm's way, significant resilience investment has been absent, the "double-tax" (GST and stamp duty) on insurance is exacerbating and, more recently, COVID-related factors have added to these pressures. Finally, Australia is experiencing a construction boom that is driving intense competition for in-demand trades such as roofing. The main objective of our insurance pricing strategy is to collect enough premium from members to fully pay all projected claims costs.

Yet the Australian Competition and Consumer Commission (ACCC) noted that over the 12-year period to 2018-19, insurers in northern Australia, including RACQ, have experienced an estimated aggregate gross loss across home, contents and strata insurance products of approximately $856 million in real terms.

RACQ has remained committed to the market despite enormous challenges. North Queensland continues to be a core part of who we are as a company, a business, and most importantly, a club. We have remained a key part of the different local economies and social fabric despite the incredible challenges that insurers have faced in the region.

North Queensland needs a comprehensive plan for resilience and sustainable insurance agreed to by all levels of Government, one that leverages the expertise of insurers like RACQ to ensure it will result in tangible affordability outcomes.

We will continue to closely collaborate with the Government this year to ensure the pool is effective and works for Government, insurers and, most importantly, policyholders in northern Australia.

SUPPORT FOR THE POOL

RACQ pays proportionately more for reinsurance in north Queensland with a “rate on line” (ratio of reinsurance premium paid to maximum loss recoverable) nearly three times greater than south east Queensland.

Cyclone drives this higher rate due to past claims history and catastrophe models that point to increased risk. RACQ’s current catastrophe program costs $125 million. Eight of RACQ’s 15 costliest weather events in the past decade have occurred in north Queensland.

Given the cyclone peril constantly looms large in RACQ’s catastrophe program, any measure that transfers as much of this exposure as possible to a “not-for-profit” pool that delivers benefits to our members is supported.

RACQ has been very active throughout consultation on the pool and we have been pleased to see much of our advice adopted in the legislation.

We have successfully argued that:

- The pool should be mandatory
- The pool should have an appropriate transition period
- The pool should include cyclone-related flooding and storm surge
- The pool should adopt property-level pricing
- The pool should cover landlord insurance
- The pool should not have a designated exit date
- The pool should cover damage that commences during the “claims period” but ends after the “claims period”
- The pool should involve maximising the benefits to those who are in greatest need of assistance. This means a smaller cohort of higher risk policyholders are supported by gathering and redistributing the very small gains on the more numerous lower risk policies.

RACQ has also commended other decisions taken that help the pool achieve its policy objective. We particularly note that the pool will insure against 100 per cent of the insurer’s liability for eligible cyclone losses, meaning it will pay for the entire value of eligible cyclone claims after the policyholder’s excess amount.

However, we believe the legislation is also holding the pool back from reaching its potential because it will provide only partial coverage of cyclone-related damage.

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PROPOSED LEGISLATIVE AMENDMENTS

The partial coverage will build unnecessary cost into the system in a number of ways:

- RACQ will need to purchase "top up" reinsurance from the market to cover the gaps in coverage.
- RACQ will need to undertake new modelling to split the cyclone risk into different parts – a part that is ceded to the pool and the remainder that is purchased from the market.
- RACQ will need to invest in changes to its claims processes to preserve a seamless end-to-end experience for our members and ensure it is identifying costs that are to be recovered from the pool and those that are recovered from our commercial panel of reinsurers.
- RACQ expects additional resources will be required to reconcile costs and premiums with the pool's price monitor, the ACCC.

The "claims period" is the main cause of the pool's complexity and uncertainty. Most importantly, it will restrict the number of cyclone-related claims it covers, as will the exclusion of motor insurance. Insurers can only recover from the pool for cyclone-related losses that commence during the claims period.

The legislation and the draft regulations prescribe that the claims period begins when a cyclone has been declared and ends 48 hours after the cyclone has been downgraded.

RACQ recently completed an analysis of Australia's history of cyclones over the past 40 years. During that time, the Bureau of Meteorology declared 226 tropical cyclones that approached or crossed Australia's coastline. When applying the claims period over the cyclones' timelines and trajectories, we have determined that almost 50 per cent or 112 of these cyclones would experience a gap in pool coverage before or after the defined claims period. Some of these cyclones may not have been covered at all.

As part of the analysis, RACQ has looked back at every cyclone that has incurred losses since Cyclone Larry in 2006.

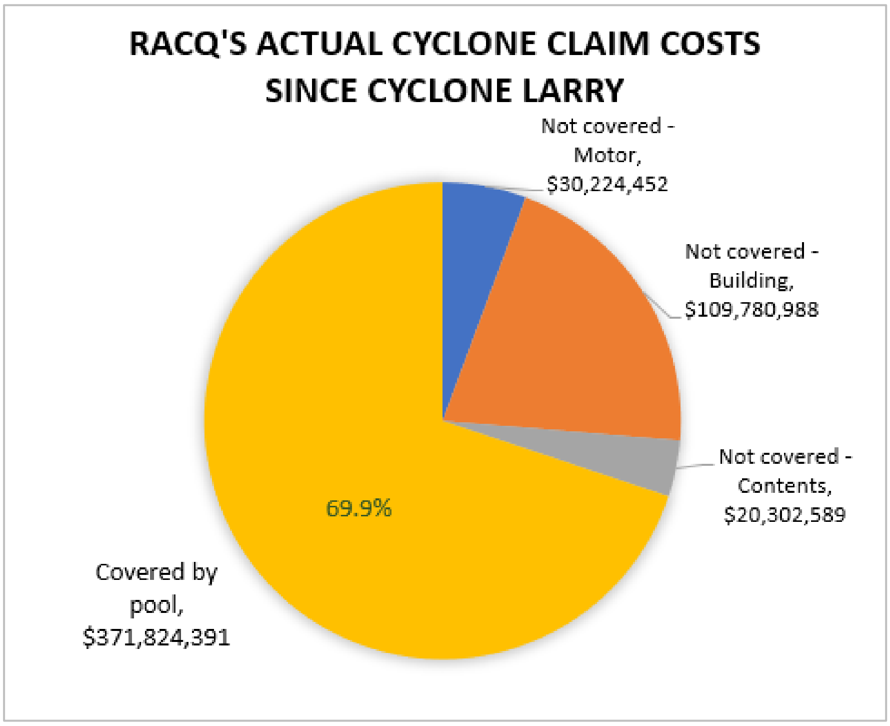

Figure 1: Pool coverage rules overlayed on RACQ's historical cyclone losses (in today's terms)
Source: RACQ internal analysis

RACQ members incurred more than $532 million in insurance losses (in today's terms) across 11 cyclones during this period. Approximately one third – $160 million – of this total would not have been covered by the pool had it been place.

These costs are a blend of motor claims, which is entirely excluded, as well as home and contents losses that occurred after the claims period. Approximately 25 per cent of RACQ's building costs, plus 33 per cent of RACQ's contents claims costs for the 11 analysed cyclones fall outside the pool coverage rules.

This kind of cyclone-related exposure needs to be covered through purchasing additional reinsurance in the global market which will feed back into the price of premiums and is counter-intuitive with the pool's purpose.

Analysis of three major cyclones during the past decade shows mixed results when determining the adequacy of the claims period.

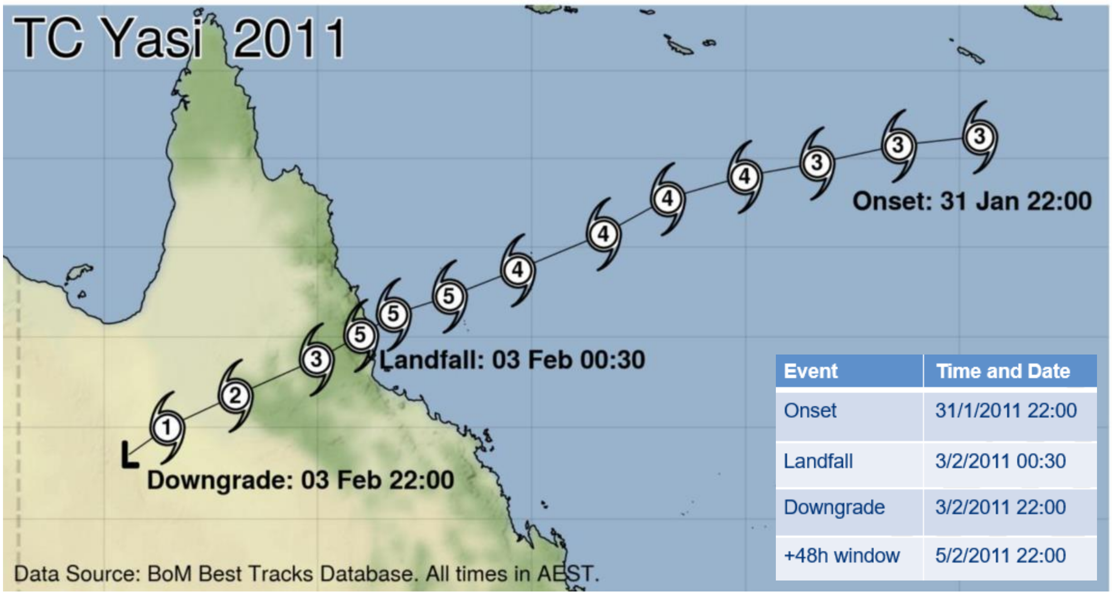

Figure 2: Tracking and timing of Tropical Cyclone Yasi
Source: BoM Best Tracks Database

Cyclone Yasi was a category five cyclone in 2011 that caused around $100 million in damage and loss to RACQ member property and possessions, in today's terms. TC Yasi was declared by the BoM on 31 January, made landfall at 12.30am on 3 February and was downgraded that night at 10pm. This means the pool's claims period would have ended on 5 February at 10pm when Yasi continued in a south-westerly direction. TC Yasi is an example of the pool fulfilling the 48-hour objective as 98 per cent of RACQ's claims would have been covered.

Cyclone Debbie was a category four cyclone in 2017 that cost around $75 million in damage and loss to RACQ member property and possessions, in today's terms. TC Debbie was declared on 25 March, made landfall at 12:40pm on 28 March and was downgraded at 10am on 29th March. This means the claims period would have ended at 10am on 31 March.

In addition to wind damage, Debbie inflicted significant flood damage as an ex-TC however most of that damage occurred within the 48-hour period and so 89 per cent of RACQ's TC Debbie claims would have been covered by the pool.

However, Cyclone Oswald is a different case study. Oswald was only a category one cyclone in 2013. However, it was a slow-moving system that brought incredible storm-related damage costing approximately $100 million in damage and loss to RACQ member property and possessions, in today's terms.

It was declared on 21 January, made landfall at 4am on 22 January but was quickly downgraded. The claims period would have ended at 4am on 24 January.

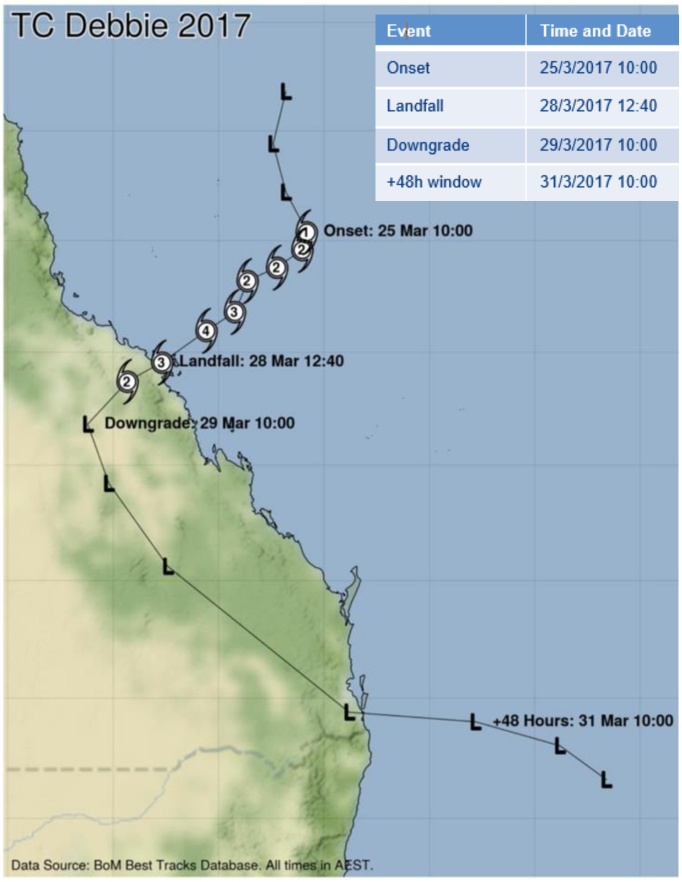

Figure 3: Tracking and Timing of Tropical Cyclone Debbie
Source: BoM Best Tracks Database

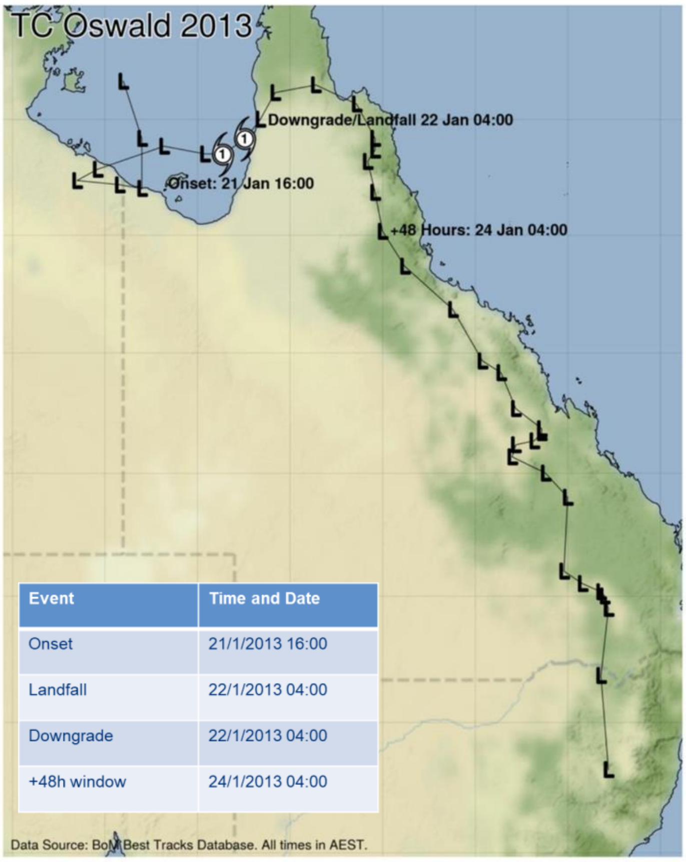

Figure 4: Tracking and Timing of Tropical Cyclone Oswald
Source: BoM Best Tracks Database

Because ex-TC Oswald caused most of its damage after the 48-hour period down Queensland's coastline, the pool would have covered virtually none of RACQ members' losses.

By allowing the BoM, via the ARPC, to make the start and end date determination, it is made purely on meteorological terms and the choice of date of loss is taken away from the insurer.

The claims period, as it is defined, is not an approach adopted by the global market and so its alignment with typical reinsurance treaties is yet to be properly tested. Any cover uncertainty or duplication will impact on member benefits.

Currently, an insurer chooses the start and end date of the catastrophe event for the purposes of making a reinsurance recovery. Should the insured event last longer than 168 hours (seven days), the insurer is able to choose which seven-day window from which it wishes to recover claims. For example, with Ex-TC Oswald, the claim period chosen for the reinsurance claim was 24 January to 30 January.

Interestingly, Oswald was not declared a cyclone when it first made landfall. It was a low-pressure system when it touched in the Gulf of Carpentaria, circled back east of the Northern Territory before intensifying to category one and hitting Queensland. In reading the legislation, the pool presumably would not cover losses caused by a system during the time between making landfall and being declared a cyclone.

These examples demonstrate there can be instances where the determination of the claims period can actually work against the policy objective of the pool. Setting seemingly "black and white" parameters for clarity could come at the expense of flexibility so the insurer cannot exercise judgement about when the pool can assist the most.

A "pre-cyclone" system could cause significant flooding or storm surge. Similarly, a slow-moving ex-TC could also cause these impacts after the claims period.

In addition, setting a narrow cyclone definition may be difficult when explaining to the broader community. A homeowner who is impacted by a system either shortly before a cyclone is declared, or after a cyclone is downgraded, is unlikely to appreciate such nuances and semantics and is likely to expect the pool to respond to their situation.

PROPOSED AMENDMENT: The definition of the claims period should be changed to align with standard reinsurance treaties and apply a "168 hours clause" (seven days). However, the seven-day period must overlap with a point in time when the weather event was a declared cyclone to meet the Government's policy objectives.

The claims period is the leading cause of friction issues associated with the pool. The closer the pool can move towards standard practice, the less uncertainty will be built into the system. RACQ recognises the Government's objective to link the pool's benefits to cyclone prone areas. Anchoring the seven-day period to any time when the event was a cyclone – even a category one – would ensure the pool covers the period when most losses are likely to occur. However, it would also allow for instances where a system is yet to become a cyclone (but making landfall) or has been downgraded and tracking through cyclone prone areas.

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If this recommendation is not adopted and the Government is committed to a shorter claims period, RACQ would argue for a change to the “48-hour rule”. In addition to the range of additional costs it will bring, we believe the 48-hour rule will lead to very poor claims experiences for many of our members. The claims period imposes a strong focus on exact time of loss that is not currently present in claims processes. Under current policy settings, insurers will be required to rely on their customers to correctly pinpoint the time of loss, to determine where they should recover from – the pool or another reinsurer.

Loss time is not currently a data point required for reinsurance due to the established practice of accepting any claim falling within the seven-day date of loss window nominated by the insurer. In the interest of public safety, residents are often evacuated to another place of shelter well in advance of the cyclone reaching the area. Homeowners may not discover if their house has been damaged by the cyclone (or related flood or storm surge) until evacuation orders have been lifted and they have been able to return home, which can be many days later. It will be impossible in these situations to correctly identify the time of loss and it also could be perceived as an overly specific and insensitive question to ask a distressed RACQ member whose home has been destroyed. RACQ strongly recommends shifting the focus to “day” rather than “time” to allow for a simpler claims process and better experience for our members.

ALTERNATIVE AMENDMENT: If a shorter claims period must remain, the “48-hour rule” should be adjusted to bring the end of the claims period to 11.59pm on the day in which 48 hours have passed since the cyclone was downgraded. For example, if a cyclone is downgraded at 3.30pm on 1 January, the claims period should effectively end at 11.59pm on 3 January.

PROPOSED AMENDMENT: The pool should also cover motor insurance to ensure efficiency and cost effectiveness.

Of the $160 million of uncovered cyclone-related losses referred to above, more than $30 million represent motor claims. Although not a large proportion of cyclone-related losses over the period, motor’s inclusion would minimise friction costs by eliminating the need to split out this cyclone exposure to purchase from the market.

Finally in relation to the legislation, RACQ has noted the Regulation Impact Statement estimates implementation costs of $440,000 across the industry. RACQ is unsure how this estimate was determined. RACQ believes it will need to spend significantly more than this amount on its own to get our systems and processes ready to participate in the pool. These are costs that are likely to be spread across the value chain from pricing and distribution to claims and ACCC compliance.

OTHER FACTORS

There remains a number of issues outside the legislation that need to be resolved.

Pricing

RACQ noted in the recent Federal Government announcement that the pool will lead to home insurance premiums reductions of up to 46 per cent. This is a significant reduction for an initiative that is largely relying on forgoing profit margins to provide savings.

To date, RACQ cannot assess the impact the pool will have on our member’s home insurance premiums, primarily because we have not received proposed pricing rates or associated modelling from the Australian Reinsurance Pool Corporation.

Theoretically, the pool will charge for the eligible exposures at a lower rate than what insurers and brokers would otherwise find in the open market.

In addition, we understand APRA will recognise the pool, including the $10 billion Government guarantee, in setting prudential capital requirements. This decision will be important because without the ability to reduce our 1-in-200 catastrophe cover, the premium benefits from the pool to our members will reduce. We look forward to ongoing discussion with APRA on the pool to confirm this position.

RACQ has already begun work to place the next catastrophe reinsurance program which commences at the same time as the pool. The annual program protects our members' capital from increasing disaster risk and needs to satisfy APRA's prudential requirements. A number of factors influence the structure, components and costs of the program, but pool participation will require an exact understanding of the liabilities the pool is covering and what value the market will put on these liabilities.

RACQ suggests if the modelling and the pricing formula was provided soon, RACQ would be in a stronger position to participate in the pool earlier than our deadline of 31 December 2023.

Other cost pressures in general insurance

While RACQ agrees a pool can make a positive difference as part of a larger program of initiatives, community and Government expectations need to be managed in the context of the recent and current operating environment of general insurers in Australia.

Cost pressures have significantly increased, pushing up insurance premiums throughout Australia. They are expected to continue on an upward trajectory as a result of rising catastrophe losses and COVID-19 impacts, similar to the challenges experienced by reinsurers. Globally, average annual losses are approaching $100 billion, up from about $20 billion just 30 years ago, as shown in the figure below. There have been more than 300 catastrophes every year since 1993.

The global experience is reflected in RACQ's recent history of catastrophe losses. Figure 5 below shows the upward trajectory of reinsurance costs and natural hazard allowances.

RACQ's reinsurance costs have increased from $25 million in 2008 to $99 million in 2021 while risk retention – used to offset these costs – has also significantly increased during the same period. Similarly, our actual natural hazard experience (net of reinsurance recoveries) has risen from $33 million in 2008 to $136 million in 2021. Climate change, alongside population and asset growth, will see insurers' annual losses significantly increase across most perils including cyclone and storm surge, even under a 2° warming scenario.

These pressures are driving up the cost of insurance in Queensland, particularly in high-risk areas, which the pool can only partially address.

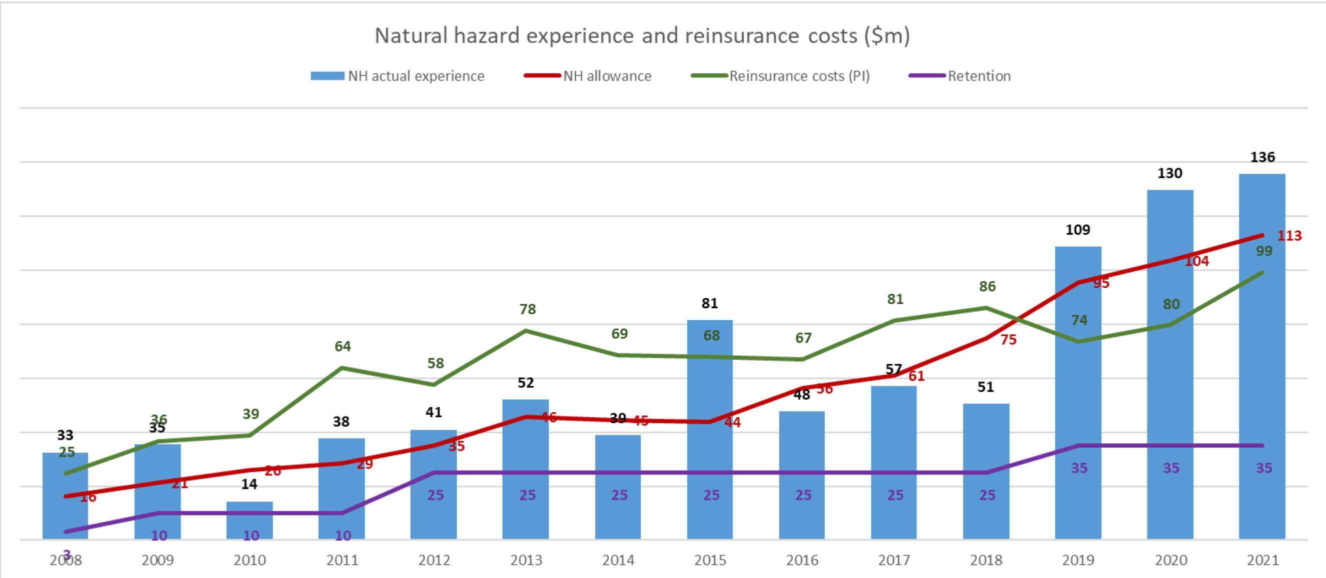

Figure 5: RACQ's natural hazard claims experience and reinsurance costs by financial year
Source: RACQ Internal Analysis

COVID-19 is still causing unprecedented impacts on insurers' claims operations. Supply chain and import disruptions, as well as border closures and uncertainty, have caused chronic trade and material shortages as well as logistical delays. Indirectly, Government stimulus packages for home builds and renovations, combined with persistent record-low interest rates, are exacerbating these shortfalls with insurers competing for in-demand trades, such as roofers. This, in turn, is leading to premium increases to cover various demand surges and longer wait times. RACQ is also currently experiencing similar issues in the motor insurance business, particularly a lack of new car imports, that are driving up the cost of second-hand vehicles as well as a shortage of motor parts pushing up the cost of claims.

How quickly the pool will respond to increased cost pressures will be an important consideration as well as the agreed process the pool will follow to change price.

Finally, the inclusion of stamp duty on top of GST on insurance policies is a significant driver of the cost pressures our members are facing. The “double tax” equates to 19.9 per cent of a home insurance premium in Queensland. RACQ does not believe it is fair that the more risk our members face, the more tax they pay on their insurance. We believe tax reform is required to ensure insurance remains accessible and sustainable, particularly in high risk areas.

Price Monitoring

The ACCC has been appointed the pool’s price monitor. We understand the policy imperative to ensure insurers are passing on the full extent of premium benefits that can be attributed to the pool.

RACQ believes the ACCC needs to be engaged as soon as possible to ensure the pricing arrangements between the insurer and the ARPC can be easily reconciled. We would recommend a price monitoring regime that is simple and does not become a costly, heavy-handed exercise that will run counter to the Government’s policy objective.

Every dollar spent validating premium benefits is a dollar not spent on actual benefits associated with the pool and so RACQ would urge simple audits rather than inquiry-like investigations.

CONCLUSION

RACQ joins with Government, local representatives and the broader community in wanting to see the pool achieve success and deliver on the policy objective. Our knowledge and experience in north Queensland can lead to meaningful engagement to help reach this outcome together.

We reiterate the need for the pool to run in tandem with significant disaster mitigation to reduce risk over the long term. We strongly support the Insurance Council of Australia’s current policy platform *Building a More Resilient Australia* which calls for all Australian Governments to collectively lift funding to $2 billion over the next five years. Tax reform on general insurance is also needed. We do not believe it is right that Queenslanders pay 19.9 per cent in stamp duty and GST on their home insurance.

Putting these issues aside, the Senate Standing Committee on Economics Legislation can play a key role in making the Cyclone Reinsurance Pool better. Removing the current claims period and including motor insurance will go a long way towards making the pool more efficient, certain, simple, clear and, ultimately, effective for the people of northern Australia.