Financial System Inquiry

Submission by

Allianz Australia Ltd

Introduction

Allianz Australia Ltd (Allianz) welcomes the opportunity to make a submission to the Financial System Inquiry. Allianz is Australia's fourth largest general (ie property and casualty) insurer and a wholly-owned subsidiary of Allianz SE, one of the largest financial services companies globally with activities spanning asset management, life and health insurance, and is the world's largest property and casualty insurer.

Allianz's submission focuses on:

- the affordability of home insurance with particular emphasis on the level of premiums faced by homeowners vulnerable to high natural hazard risks;
- the impact on insurance affordability generally from the high levels of taxation on insurance, as well as the adverse impacts on efficiency and equity arising from State insurance taxes; and
- the need to retain an appropriate balance between the benefits and costs of prudential regulation, particularly in light of potential international regulatory changes being developed in response to the global financial crisis.

Insurance affordability and high natural hazard risks

The affordability of residential home insurance for some Australians, specifically, those subject to the risk of floods and cyclones, is a significant public policy and community issue.

If governments and/or the Financial System Inquiry determine that regulatory intervention should be considered in order to address a lack of insurance affordability faced by homeowners vulnerable to extreme weather events, Allianz supports the development of an industry-led solution in the form of a natural disaster reinsurance pool, which, at no cost to taxpayers, could be established to give Australians living in high risk locations access to essential and affordable home insurance.

Increasing costs of providing home insurance

In recent years, home insurance premiums have increased for all Australians. One of the significant drivers of these increases has been a large number of extreme weather events including the 2009 Victorian Black Saturday bushfires, the March 2010 Melbourne and Perth hailstorms, and 2011's Queensland floods, Cyclone Yasi and Melbourne's Christmas Day hail storm.

The impact of these events on insurers' claims costs and the cost of catastrophe reinsurance has flowed through to higher premiums. However, increases have been more pronounced for homeowners vulnerable to extreme weather events – specifically, flood and cyclone.

Availability and affordability of flood insurance

Insurance cover for 'riverine' flood damage is relatively new in the Australian market. Historically, residential insurance policies <u>excluded</u> cover for flooding. Widespread community awareness of this increased most recently in the aftermath of the 2011 Queensland floods.

Over the last decade, the technology insurers need to 'price' flood risk and the availability of government flood risk data has improved. As a result, residential flood cover has been progressively introduced into Australia since around 2007 and, today, most Australian insurers offer flood cover.

However, the price of cover in flood risk areas can be extremely high. For example, the annual premium of a home building and contents policy for an 'average' property (is a total sum insured of $400,000) with a <u>high</u> flood risk can be as much as $20,000. Premiums at such levels are likely to be unaffordable for most Australians.

Thus, while only around 5% of residential properties in Australia are clearly exposed to riverine flood risks which results in very high premiums, the insurance market is unable to provide affordable home insurance for many Australians living in high flood risk areas.

Allianz and affordability of flood cover

Two approaches to the provision of residential flood cover have been adopted by insurers:

- Mandatory flood cover – where inclusion of flood cover is standard in the policy, like other risks such as fire, storm and earthquake; and

- Customer Choice – where flood cover is optional and the policyholder can choose whether or not to purchase it.

Most insurers in the Australian market have adopted the mandatory flood cover approach. Allianz has taken a different approach and offers Customer Choice of flood cover.

In both cases, the premium charged will reflect the flood risk faced by the specific property, although the flood component of the premium may only be separately shown on policies that provide optional flood cover.

For insurers that provide mandatory flood cover, customers that do not wish to pay the higher premium for flood cover, or cannot afford to, are forced to seek insurance from another company if they wish to remain covered for the traditional home insurance risks (eg fire).

If all insurers adopted the mandatory approach, home owners that could not afford flood cover would be forced out of the home insurance market altogether.

As noted, so that our customers are not faced with such a dilemma, Allianz currently adopts the Customer Choice approach. As a result, even if our policyholder cannot afford flood cover, they can still obtain insurance protection against risks such as fire, storm, earthquake, burglary etc.

Unfortunately, however, due to the high cost of flood cover for many properties with a material flood risk, most customers opt out of flood cover. As a result, if their property is affected by 'riverine' flooding, they are not covered for flood damage.

Affordability of insurance for cyclone risk

Insurance premiums for properties exposed to cyclone risk, which affects northern Australia, particularly North Queensland, can also be very expensive. Like high flood risk, the annual premium for a home building and contents policy (eg total sum insured of $400,000) can be as much as $20,000.

Premiums at such levels are likely to be unaffordable for most Australians. The annual premium for the relatively small number of homes that are subject to both high flood risk *and* cyclone risk can be in excess of $30,000.

The examples above are based on stand-alone houses covered by residential home insurance. For some owners of apartments, units and townhouses subject to cyclone risk and high flood risk, similar affordability issues exist in the residential strata insurance market.

Addressing a lack of affordability

In Allianz's opinion, the Australian insurance market is unable to provide affordable insurance for some property owners facing cyclone and/or high flood risk. As a result, at some point governments may determine that intervention is required to enable home owners to obtain affordable insurance protection against cyclone and high flood risk.

There are existing examples in Australia where private insurance markets are not able to provide affordable cover to individuals with high insurance risks, for example, private health insurance and compulsory third-party (CTP) motor accident insurance. In these instances, governments use regulation to force insurers to introduce hidden cross subsidies into their pricing. On this point, Allianz's view is that this lack of transparency distorts insurer behavior and has other negative impacts, and that such cross subsidies should be explicit, for example, funded by separately identifiable levies.

Another example of government regulatory intervention which is instructive when considering responses to high natural catastrophe risk is the scheme currently used to ensure affordable commercial property insurance in Australia. Following the 9/11 New York terrorist attack, the international reinsurance market ceased offering terrorism cover. In response, governments around the world intervened in their insurance markets to ensure the continued provision of affordable commercial property insurance that included cover for terrorism events.

In Australia, the Commonwealth Government established the Australian Reinsurance Pool Corporation (ARPC). The ARPC manages a 'terrorism pool' which, in the event of an eligible terrorism event, can be drawn on to help pay insurance claims. The ARPC is funded by an explicit levy on all non-residential commercial insurance policies.

Insurance 'pool' arrangements are also used in other countries to assist in the provision of affordable flood insurance, such as the United States and United Kingdom. For example, in the UK, the government and the insurance industry have agreed to the establishment of a non-profit reinsurance pool, called Flood Re, to facilitate the provision of affordable flood cover to high-risk households. The pool, which commences operation in 2015, will be funded by a modest levy (around £10) on household insurance policies.

Addressing lack of affordability of insurance

Following the 2011 Queensland floods, the Australian Government established the Natural Disaster Insurance Review (NDIR) in response to issues that arose in the aftermath of the event, such as the widespread lack of flood cover.

Allianz's submission[1] to the review suggested that flood insurance could be made more affordable through the establishment of a 'reinsurance pool' as a mechanism to provide a subsidy to homeowners facing unaffordable flood premiums. The NDIR made a number of recommendations relating to the affordability of insurance, including:

"That an agency…be created to…operate a system of premium discounts and a flood risk reinsurance facility." – (Pivotal Recommendation 1)

"…an investigation be undertaken to ascertain whether there is a basis for granting affordability discounts for cyclone risk." – (Recommendation 27)

The report acknowledged Allianz's contribution to the review, stating:

"The idea of…the reinsurance pool was originally inspired by the Allianz Australia submission to the Review. (p61)

The NDIR's recommendations in relation to insurance affordability have not been adopted by the Commonwealth Government. However, Allianz remains of the view that a natural disaster reinsurance pool could be used to address the lack of affordability of home insurance premiums for those Australians facing high, weather-related insurance risks.

With appropriate government regulation, a natural disaster reinsurance pool could be established and operated by the insurance industry and funded by a modest levy on residential insurance policies, similar to the way the 'terrorism pool' is funded by a modest levy on commercial property insurance policies. No government or taxpayer funding would be required to establish and operate such a natural disaster reinsurance pool.

Complementary measures

There are a range of other regulatory measures and other initiatives that should be further pursued to help alleviate insurance affordability issues. These include mitigation (eg flood levies), adaption (eg building standards) and land-use planning and zoning. Some have argued that these measures alone will address home insurance affordability issues. While such measures have an important contribution to make, on their own, they are unlikely to provide a comprehensive solution. For example, the proponents of an exclusive reliance on such measures to address extreme home insurance affordability concerns are yet to indicate how it is possible to mitigate against cyclone risk.

[1] http://www.ndir.gov.au/content/submissions/issues_paper_submissions/Allianz_Australia_Insurance_Ltd.pdf

Taxation of Insurance

Despite the widespread benefits that accrue to society from the availability of competitively priced general insurance products, the Australian general insurance industry is characterised by highly inefficient taxation of insurance at the State level. In all States and Territories, general insurers are subject to insurance duty, otherwise known as stamp duty. Insurance stamp duties are transaction-based taxes levied on the purchase of insurance cover.

As outlined above, while many homeowners vulnerable to high natural hazard risks are facing significant affordability issues, home insurance premiums have significantly increased across the board over recent years due mainly to the large number of costly extreme weather events that have occurred over the last five years. As a result, many Australians are experiencing cost of living pressures associated with home insurance premiums.

In these circumstances, the abnormally high levels of taxation on insurance, particularly property insurance in some States, is unnecessarily exacerbating these cost of living pressures. Most goods and services are subject to the 10% GST and insurance is no different. Some goods and services that are regarded as having ‘negative externalities’ are subject to additional levels of taxation. Examples include tobacco, alcohol, petrol and gambling. Despite its positive social and economic benefits, insurance is also subject to additional taxation through the imposition of Stamp Duty, generally of around 10%, by State and Territory Governments.

Thus, unlike most goods and services, which are subject only to a 10% GST, insurance products are subject to double that amount, that is, around 20% tax. Ironically, in Queensland, where insurance affordability issues are the most acute due to its cyclone exposure, the State Government recently increased insurance Stamp Duty by 33%, that is, from 7.5% to 9%.

Allianz draws the FSI’s attention to previous submissions by the insurance industry in relation to insurance taxes, in particular, the Insurance Council of Australia’s 2008 submission to the Review of Australia’s Tax System (the Henry Review). That submission detailed the differences and disadvantages of insurance Stamp Duties compared to the GST. For example, that submission drew attention to that fact that, unlike the GST, which is a tax on the value added component, Stamp Duties are more akin to selective turnover-related taxes. Specifically, the submission described Stamp Duties as:

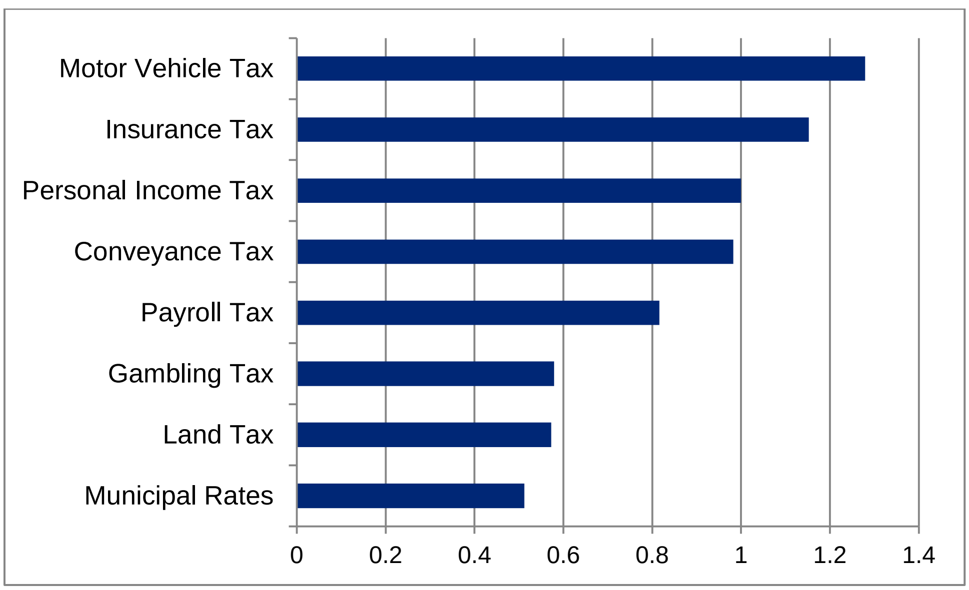
- selective, to the extent that only some transactions, such as insurance, are included in the taxation base. This contrasts with broad-based taxes like the GST;

- effectively turnover taxes, because the tax base is the total price of the transaction, not the value-added component as is the case for the GST; and

- economically inefficient, because they affect consumption decisions resulting in lower demand due to increased prices and, consequently, production decisions leading to lower output. In economic terms, the resultant misallocation of resources to less efficient uses, reduces welfare through the creation of dead-weight losses and reduced consumer and producer surpluses.

Research undertaken on behalf of the Insurance Council into the relative efficiency of various taxes indicates that insurance Stamp Duty is one of the least efficient of the major taxes levied by States and Territories – see figure below (a higher score indicates a more inefficient tax)

Tax efficiency rankings - selected taxes



Source: Access Economics (2008), "Analysis of State Tax Reform including Taxes on General Insurance"

The potential efficiency gains from the removal of State Stamp Duties/transaction taxes nationally (including insurance taxes) were estimated by Access Economics in a report commissioned by the Finance Industry Council of Australia (FICA) in 2008.

The Access analysis indicated that there would be significant potential gains from the removal of State Stamp Duties across Australia. The abolition of State Stamp Duties was estimated to increase household consumption by between 1.1% and 1.8% or $6.1 billion to $9.9 billion in 2005-06 prices. To put this in perspective, these gains exceed those from the proposed electricity reforms under the mid-1990s National Competition Policy (NCP) reforms, which were assessed at that time by the Productivity Commission to result in an increase in real household consumption of around 1.0%.

Impact of insurance taxes on underinsurance

Research previously conducted for the Insurance Council by the Australian National University (ANU) Centre for Law and Economics[2] assessed the impact of insurance taxation on noninsurance and underinsurance of home and contents cover. The study, "*The Non Insured: Who, Why and Trends*" analysed the demand for residential building and contents insurance and concluded that the imposition of Stamp Duties and the Fire Services Levy on insurance affected consumer's decisions regarding the purchase of insurance.

Unsurprisingly, the report found that the demand for home and contents insurance was negatively correlated to the price of insurance. It concluded that State-based taxes on general insurance premiums result in a smaller number of households purchasing insurance, hence, increasing the level of noninsurance in the community.

Subsequent research was undertaken on a more detailed analysis into the elasticity of demand for home and contents insurance.[3] This report found evidence that households who have purchased insurance respond to the increase in prices from taxes by reducing their premiums through either a reduction in their level of cover (ie underinsuring) or an increase in the level of their excess above the minimum required by the insurer (ie increasing their level of self-insurance). This analysis therefore indicated that insurance taxes increase the level of underinsurance in the community.

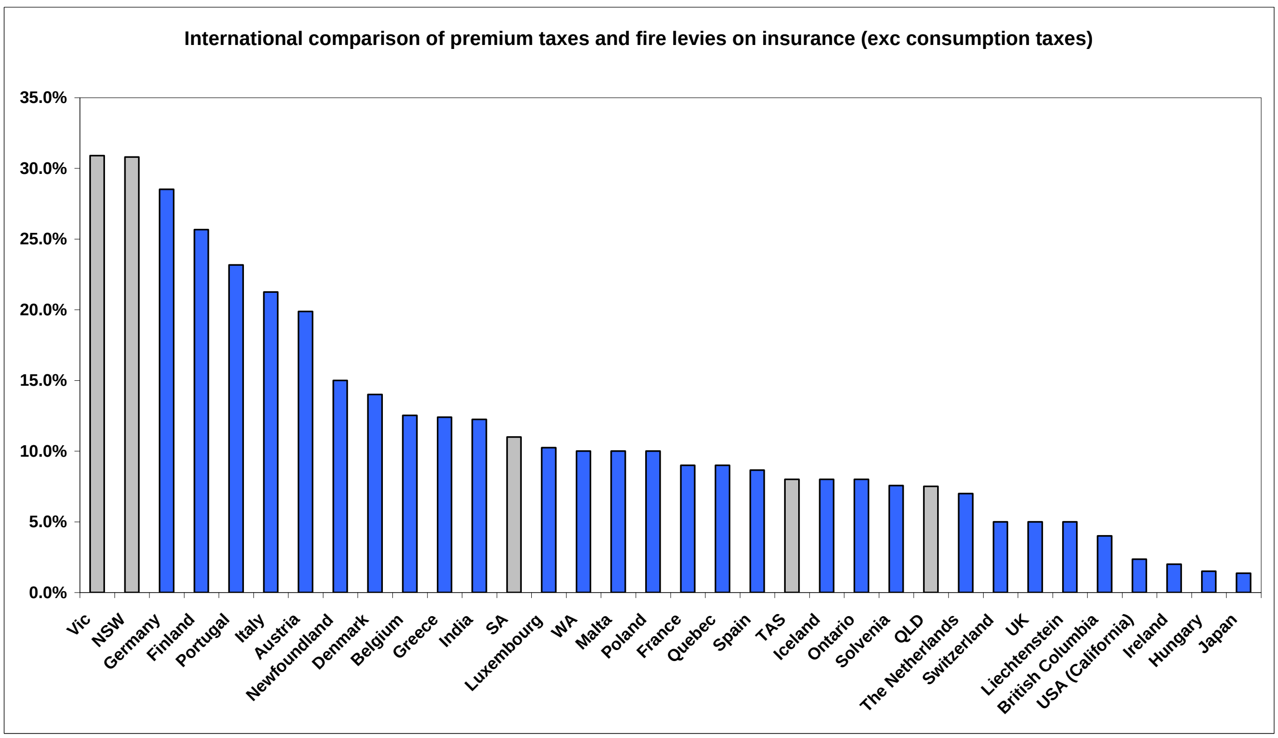
Noninsurance has a major direct, often devastating, financial impact on property owners that experience property loss or significant damage. This also creates adverse emotional and social impacts on affected individuals, their families and potentially, friends and others (eg suicide) and, in the case of large scale natural disaster events, whole communities. Moreover, governments are at times required to provide financial assistance to uninsured property owners, particularly in the aftermath of large 'total loss' events caused by natural disasters such as bushfires and floods. This has negative fiscal consequences for governments and hence avoidable impacts on all taxpayers.

[2] Insurance Council of Australia (2007) "*The Non Insured: Who, Why and Trends*" prepared by Dr Richard Tooth and Dr George Barker from the Australian National University, Centre for Law and Economics.
[3] Tooth, Richard (2007) "*An Analysis of the Demand for House and Contents Insurance in Australia*" (A report for the Insurance Council of Australia).

Taxes on insurance to fund fire services

States have also traditionally funded fire and/or emergency services through levies on property insurance – so called Fire Services Levies (FSL). Most States have now replaced these levies, generally with land-based charges levied by local government. Victoria is the most recent State to undertake this reform, ceasing the imposition of FSL on insurance policies on 30 June 2013. However, Australia's most populous State, NSW, still applies an Emergency Services Levy (ESL) to property insurance policies. The current ESL rate for residential property is 16% and for commercial property is 29%.

The graph below, constructed prior to recent FSL reforms in some States (notably Victoria), shows that NSW at that time, and as we understand it still, has the highest tax on insurance in the (known) world (excluding consumption taxes, such as Australia's GST).



Source: CEA Indirect taxation on insurance contracts in Europe. PWC international comparison of insurance taxes (March 2007). Governor's Budget California 2005-06 PW Guides Canada other indirect taxes.

The funding of fire services through levies on insurance is also highly inequitable because the financial burden is unfairly borne only by those that fully insure their property. Property owners that choose to not insure or to intentionally underinsure, make no or an unfairly low contribution to the provision of fire (and/or emergency) services. Yet, in the event of an emergency they receive the same level of fire services as fully-insured property owners.

The cumulative impact of taxation on property insurance in NSW (taking account of the State's 9% Stamp Duty) is 39% for domestic property and 55% for commercial property. On any analysis, such levels of taxation on insurance are punitive and counterproductive, and even at around 20% (as applies in other States), it is hard for the insurance industry to take government concerns about the affordability of insurance seriously when they are making such a significant contribution to the problem.

Prudential regulation of general insurance

Australia's prudential regime in relation to general insurance has evolved substantially since the establishment of the Australian Prudential Regulation Authority (APRA), in particular, through changes to capital requirements as a direct response to the collapse of HIH insurance and a number of subsequent reforms to capital and other requirements since that time.

Box 1 gives a brief overview of only some of the prudential changes that have been imposed on general insurers over the last decade or more. The box focuses mainly on capital-related and some reporting changes. Over this period, insurers have also been subject to changes relating to governance (eg Boards, Directors), fit and proper persons, outsourcing, risk management, business continuity management, audit and actuarial, and the industry remains in consultation on further reforms (eg relating to the Chief Risk Officer).

It is generally accepted that Australia's prudential regime reflects international best practice in many areas and was, in part, one of the foundations of our financial system that helped inoculate Australia from some of the stresses caused by the global financial crisis (GFC). However, it is critical that governments and regulators remain cognisant of the need for a balance between the benefits and costs of evermore regulation and between principles-based and prescriptive, rules-based regulation.

Box 1: APRA – A decade of prudential change

On 1 July **2002**, APRA prudential standards for general insurers came into force covering the areas of capital adequacy, assets in Australia, liability valuation, risk management and reinsurance.

In light of the recommendations of the HIH Royal Commission, in **2003** APRA launched Prudential Supervision of General Insurance – Stage 2 Reforms to further strengthen the prudential framework. These reforms revised the existing prudential standards and guidance notes and covered a range of technical, risk and financial management and governance issues as well as increasing disclosure.

In **2007**, APRA announced further refinements to the General Insurance Prudential Framework. During 2008 and 2009, a number of changes to the existing prudential framework became effective. The key ones related to capital adequacy(eg capital measurement, internal models, and investment, insurance, and concentration risk capital charges) and standards for Level 2 Insurance Groups,

From **May 2010**, APRA commenced reviewing the capital standards for general insurers and life insurers – the Life and General Insurance Capital (**LAGIC**) project. APRA's intention was to make its capital requirements more risk-sensitive and to improve the alignment of its capital standards across the industries it regulates. Key changes included a new minimum capital requirement (the Prudential Capital Requirement), incorporating an Insurance Concentration Risk Charge, Asset Risk Charge, Operational Risk Charge and Aggregation Benefit. APRA also introduced ICAAP – the Internal Capital Adequacy Assessment Process.

In **June 2010**, APRA issued the final version of new prudential and reporting standards to align APRA prudential reporting with Australian Accounting Standards Board financial reporting.

Subsequently, a **LAGIC refinement** process commenced covering supervision of conglomerate groups, confidentiality of general insurance data and changes to statistical publications (February 2013), harmonisation of cross-industry risk management requirements (May 2013) and reinsurance counterparty data collection (June 2013).

The GFC highlighted the interdependence between national financial systems and the risks of contagion arising from interconnected nature of the global financial system. Governments have responded with the development of international regulatory structures and initiatives aimed at developing more stringent prudential requirements underpinned by greater international harmonisation of regulation.

As a result, the amount of regulation of financial services more broadly and general insurance in particular will certainly rise. However, governments and regulators should be reminded by all the regulatory efforts (from Sarbanes-Oxley to Basel II) following the last period of turmoil from 2001 to 2003, that the quality of regulation is much more important than quantity of it.

Rules-based regulation is unsuitable for highly dynamic, rapidly changing, international financial markets. The harmonisation of the international regulatory framework requires principles-based rules which leave enough room to take account of national circumstances. Moreover, the desired greater coherence and convergence of regulatory frameworks is easier with principles-based regulation.

The prudential regime that has developed under APRA is, by necessity, a combination of principles-based rules complemented by more prescriptive guidelines. However, APRA has shown an ability to regulate individual companies flexibly, recognising that different corporate and ownership structures result in different risks that cannot always be accounted for through the strict application of prescriptive definitions and categorisations. APRA has also recognised the importance of organisational culture and the inadequacies of a ‘box ticking’ approach to regulatory compliance.

A good example is risk management. Regulation and supervision cannot be restricted to evaluating the existence and sophistication of risk models. It also needs to check the processes and principles of corporate risk management (eg whether all relevant risk aspects are covered, whether risk managers have the necessary competences and that early warning systems are in place). The decisive thing is to introduce a strong risk culture. There is a risk that post-GFC international regulatory developments will be based on a more prescriptive and less flexible regulatory approach than has proven highly successful in Australia.

It is true that the internationalisation of regulation and supervision has been lagging the speed of globalisation in the financial industry. Without an internationally harmonised regulatory framework, financial markets remain vulnerable to regulatory arbitrage and financial institutions have an incentive to seek out and exploit regulatory differences**.** Moreover, uncoordinated regulatory initiatives can increase national fragmentation and endanger the achievements of open, liberal financial markets which principally promote higher growth through the efficient allocation of resources.

In response to the GFC, Allianz is concerned about the potential for further regulation driven by international initiatives primarily directed at addressing regulatory shortcomings that existed in other countries but not Australia. Allianz urges the FSI to develop a set of clear and unambiguous principles which the Australian Government and its financial regulators can use to underpin their approach to the development of internationally harmonised financial regulations and against which a rigorous assessment of the merits of any subsequent international regulations can carried out.