Flood Insurance, is there a problem? Is there a solution?

– a review of the workshop held at the Centre for Resource and Environmental Studies, ANU on 7–9 Feb 2001

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Australia is one of the few developed nations that does not offer comprehensive flood insurance. This unexpected fact was revealed at a workshop held at the Australian National University by the Centre for Resource and Environmental Studies (CRES) on February 7–9, 20001. This workshop was sponsored by CRES and supported by the Insurance Council of Australia and Emergency Management Australia to examine the issues of 'Residential Flood Insurance: The Implications For Floodplain Management Policy'. Within this workshop a number of issues were raised that are of national significance.

The origins of this workshop came from a similar meeting held on this topic by CRES some 10 years ago. However, unlike many of CRES's other initiatives nothing seems to have developed on this issue from it.

The original 1989 workshop highlighted the fact that there was:

- a lack of detailed data necessary to ascertain levels of risk
- there was a need for reserves held by insurance companies to be untaxed, a need for insurance coverage or other form of compensation for small businesses
- a divergent view on what insurance model would be most appropriate.[1]

If Australia has not developed some universal type flood coverage[2], why is this a problem or an issue? Discussions within the workshop revealed that many of the problems identified over a decade ago had not been resolved but were still in some process of resolution or showing some signs of changing. However, there was still some divergence of opinion within the industry over many of these matters, even within the insurance companies and their representatives. John Handmer points out in a paper presented to the workshop that many of the issues identified at the last workshop are still to be fully resolved. These were:

- that there would be adverse selection with only those at high risk taking out policies
- that the premiums would be too expensive for most people
- that insurance would discourage flood damage reduction activity
- that the risk is not evenly or randomly distributed, so that claims will be occasional and very large perhaps affecting many or most policy holders at the same time
- as claims are not random in space or time, ideally reserves would be accumulated to meet these claims. But such reserves are taxed in Australia.

So against this background, have we progressed or not?

The industry claims that it could provide such a universal coverage if it would make a profit; this is its first priority and in the context of a free market economy this is not unreasonable. However, it was acknowledged that the amount of property exposed to flood is quite small and the difference between flood, fire and other natural risks is only a matter of probabilities. Following the Wollongong floods and others we are starting to see some insurance companies cover and pay out for some type of flooding. This cracking of positions is causing some degree of concern within the industry of how to define flood. Already some companies offer flood insurance in Queensland and New South Wales (ironically the states with the greatest flood risks) but often the availability of this insurance cover is hidden in the general wording of the policy.

In the case of the Wollongong flood one householder left his property with the rising flood level, another householder stayed and had to eventually seek refuge by breaking through the ceiling and the was eventually found on the roof. When claims were assessed the householder who left received nothing as it was classified as damage due to flooding but the one who stayed, his damage was deemed as storm by the assessor due mainly to the hole in roof.

Many companies are caught up in definitional problems that affect the risks they will cover, their actuarial calculations, their assessments of cause and damage and ultimately their costs. This problem is caused by trying to differentiate between the concepts of 'storm', 'flash flood' and 'riverine flood'. If one views this from a consumer's perspective 'when is a flood not caused by a storm', (apart from earthquake and dam-break, both of which are probably covered by insurance anyway). Again taking a simplistic point of view it would be better to call all these flood and storm results 'water damage'.

This confusion applies also to policyholders or prospective policy holders. Common sense or day-to-day definitions of flood do not adequately meet the very precise, but company specific, need for a clear statement of the event to be insured. Even among the conference participants there was confusion and disagreement about the precise meanings of words such as 'flood'.

Many companies felt that somebody needed to set these definitions in law so as to prevent many of the disputes occurring. An alternative might be that

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1. John Handmer. Flood insurance: a backward glance and some current issues. Draft paper prepared for the Residential Flood Insurance: The Implications for Floodplain Management policy Conference. February 7–9, 2001. Centre for Resource and Environmental Studies. Australian National University.

2. David Ingle Smith. Discussions at the Residential Flood Insurance: The Implications for Floodplain Management policy workshop. February 7–9, 2001. Centre for Resource and Environmental Studies. Australian National University.

rather than having some set legal definition, if the industry were to just include 'water damage' within their policies rather than trying to differentiate types of flood, it would avoid many of the disputes, but would it cost more?

It was stated that the resistance of the industry to provide a low cost coverage was not based on historical or past events but the fear that we are going to 'get a big event in the near future and the last 30 years has not been a big problem'[3]. But why should Australia be different from any other comparable country that provides flood coverage? Claims that fire insurance is less an insurable problem as it was mitigated by having a fire brigade response and flood was a bigger problem does not seem to be valid. The buildings are seldom completely destroyed by flood as opposed to fire and that State Governments have undertaken extensive flood mitigation works in the last 10 years and continue to do so. Although there may be considerable differences between the States in regard to flood mitigation programs, it seems that all States are moving to address these issues.

It was acknowledged that government supported or sponsored schemes are not likely. Although a strongly supported view in the 60's, governments since then have adopted a non-interventionist perspective. This is strongly borne out in the political ideology of the then Treasurer and now the Prime Minister *'that governments and government authorities should, to the maximum extent possible, seek to avoid intervention in matters that can be left to the private sector'*[4].

The ideology of the market solving the problems was again stated by the Minister for Financial Services and Regulation in 1999 following the Wollongong floods in which he said:

'*The initiatives (NRMA offering flood coverage) here come about because of competition in the marketplace; they do not come about because of any detailed prescription from the federal government or state governments forcing insurers to take uncommercial decisions. The best pressure that comes about is because of Competition'.*[5]

It was thought that the current opposition would largely follow this line as it was felt it is unlikely that a Labour government would now hold a different perspective. Especially when last in government from 1983–1994 when they embraced the competition policy and did not have any alternative policy with regard to flood insurance from the 1979 Howard Policy. Interestingly, the now Labour opposition has now announced a new plan for improving flood insurance. This was announced in a Joint Statement by the leader of the opposition, the Hon Kim C Beazley MP and the Shadow Assistant Treasure, Kelvin Thompson MP on 13 February 2001.

But what should be the role of governments?

Apart from a non-interventionist approach within the market, governments still need to play a role in the provision of flood mitigation programs. The Labour party statement states that the 'Government has a role in the insurance industry. It cannot simply vacate the field and expect competition to deliver fairness and equity to consumers…Labour believes that Government has a role in:

- providing the overarching legislative framework for the operation of the industry
- providing the appropriate prudential framework
- intervening when the market fails to deliver fair and transparent outcomes for consumers.'

They believe that the '*greatest need for this currently exists in the area of insurance for water damage*'. It is interesting to note that the term water damage is used rather than flood damage. They further state that if elected they will establish a parliamentary inquiry into the issue of flood insurance and work with the insurance companies to implement recommendations of the June 2000 Australian Securities and Investment Commission into Flood Insurance.

It is hard to ascertain what would be the precise interventionist approach they will adopt but one would imagine that they might be prepared to consider some form of legislative stick if no development occurs in this area if the insurance companies do not adequately respond. However, it appears that there is more willingness on the part of the Labour opposition to pursue an active working relationship with the industry rather than let competition come to a solution which in the last 10 years it has failed to do so. So perhaps the days of non-intervention may be coming to a close.

The Labour opposition also states that it will work with the States and Local Governments to ensure that maps showing the areas that are subject to the 1 in 100 years floods are produced and published. The Insurance Council of Australia has welcomed this. It is interesting to note that the Council claims that the '*lack of flood mapping was one of the key reasons why flood insurance was not more widely available*'.[6]

The Insurance Council point out that the current Federal Regional Flood Mitigation provided only $20 million over three years for the whole of Regional Australia. This is provided on a 1:1:1 funding basis, which requires the same contribution from State governments and local councils. Representatives from local governments stress that this funding is inadequate and they do not have the funding base to contribute 30% of the funding to flood studies and the small allocation across Australia is often a disincentive rather than an incentive. Local governments claims that to ensure work is undertaken a 30:30:20 split would be more effective.

Governments certainly have a role here and not the Insurance Industry. A comprehensive mapping service is needed in which to map the flood risk areas. To walk away from this responsibility is to say to the general public that they are not interested in the safety and welfare of their citizens. Even if governments adopt a fixation that the market will resolve this issue, mitigation works and public information is not a role for the insurance industry. Government also has a role to ensure safety in the floodplain areas. This may be by some mitigation work, removing or purchasing property such as with the US FEMA scheme or at least informing people in potential danger. Not all people will have the capacity to insure against flooding and often the very poorest of people will seek accommodation in caravan parks because of the low rents. However, the caravans, in which they live and contain their valuables, are structures that are more likely to be severely damaged as against the more permanent structures of contemporary houses.

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3. George Walker. Discussions at the Residential Flood Insurance: The Implications for Floodplain Management policy workshop. February 7–9, 2001. Centre for Resource and Environmental Studies. Australian National University.

4. The Hon John Howard, M.P. A Policy Information Paper by the Treasure, May 1979, AGPS, Canberra

5. Joe Hockey, Minister for Financial Services and Regulation, Joint Statement by the leader of the opposition, the Hon Kim C Beazley MP and the Shadow Assistant Treasure, Kelvin Thompson MP. 13 February 2001.

6. Alan Mason, Insurance Council of Australia, Insurance Council Responds to Opposition Flood Policy, Media Release. February 13, 2001.

But will the consumers understand the link between flood mapping, mitigation work and insurance?

Consumers are voters and will ultimately have their say, whether it is on the GST, or petrol prices. Many of these concerns may be a matter for the ballot box including the availability of insurance and the need for effective and timely disclosure of flood prone areas. But where are consumers and the public generally placed in this arena?

A large proportion of the population do not have house or content insurance or are under-insured. Despite claims that governments and government authorities should, to the maximum extent possible, seek to avoid intervention in matters that can be left to the private sector, governments of all types legislate to provide safety nets for the poor, disadvantaged and needy or to cover risks that would otherwise be catastrophic for individuals. For example, it is compulsory to have third-party vehicle cover. So it is possible to point to contradictions in government pronouncements about avoiding intervention.

Ray Burby's paper revealed that in the US only 20% of those required to carry out flood insurance actually do so[7]. So one could not expect much difference in Australia. It is estimated that only 50% of the population take out contents' insurance and it would not be hard to assume that the lower socio-economic group would be a large proportion of the uninsured. Studies undertaken by James Cook University reveal that only 30% of policyholders actually know in detail what losses or risks their household policies cover. People often seek clarification of their policies after an event has occurred.[8] People view insurance as a payment which has no chance of winning but is intended to avoid them losing.

So when companies start arguing about the fine points of how water enters a house after a storm it is no wonder consumers feel treated as mug-punters. For the person who has been flooded such precise points of distinction are immaterial and in the circumstances of their loss can seem to be heartless and pedantic.

Would it be expensive to have coverage?

Estimates given at the workshop suggest that to cover flood risks for those people exposed would be extremely high. However, it was suggested that after examination of costs that all policyholders (not just those living on flood prone land) already pay a large proportion of their premiums for storm or water damage. Additional cover for flood, as water flow over ground from a watercourse, would be slight.

If consumers have difficulty understanding their policy content it would not be hard to assume that they would find it hard to understand the criteria by which insurance companies assess the risks to ensure a profitable outcome. From a simplistic point of view, to have flood (and all hazards) covered within in the policies, the insurance companies would need to spread the risk to all policyholders. But would this be excessive?

We already spread the cost of differential risk between policyholders; areas of low risk from burglary or theft or fire may subsidise areas of greater risk. Smith claims that if premiums were paid by all households in Australia, regardless of their risk to mainstream flooding, the annual premium per insured household would fall to $12 for the 1% probability flood and $28 for the Possible Maximum Flood (PMF).[9]

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Discussion within the workshop suggested that such a cover might cost in the vicinity of $50.00. In view of the increase of premiums over the last year due to the GST this might be acceptable. However, this does not resolve the problem of houses not insured, which will ultimately result in some hardship grant by the federal government if they are effected by flood. So the governments do have a role in times of flooding and it is not just a market issue.

Insurance premium costs are to some extent irrelevant for some sectors of the population. The resource poor may be unable to afford any premium at all. Some people, through poor decision making skills, or through inadequate information, may be unable to make informed or reasoned assessments of the benefits of insurance. Other people, such as those whose first language is not English or who have poor language skills, may not readily comprehend information about flood risks and may not easily understand insurance policy wording.

One suggestion to cover all residential buildings was that all local governments include in their rates a proportion to cover for flood damage and that this money be paid to the insurance industry. This would in effect spread the risk as wide as possible and some estimation of the premium would be about $18.00 per house. Both of these approaches may have a perceived problem of equity. People might be annoyed by paying for others. However, in some way most consumers are paying for someone else's misfortune and this is the way the industry spreads its risk. This approach would not address the people not covered by any content insurance. The UK approach was to build in some small amount into all rents, thereby having the biggest coverage of all and assisting the industry to spread the risk and ensure profitability.

Often overseas experience indicated that when universal insurance is provided it may result in a decrease in mitigation work and a lowering of priorities and expenditure in this area. Therefore, some degree of partnership between the industry and governments is needed to ensure a balanced approach. In view of the projected climate changes, where we can expect more of all types of hazards to occur, can we afford not to take a more active partnership role?

Whether the industry adopts some bundled approach to spread the risk, we are sure it will still ensure some type of

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7. Raymond J Burby. Residential Flood Insurance and Floodplain Management: Lessons from the United States. Paper prepared for the Residential Flood Insurance: The Implications for Floodplain Management Policy Workshop. February 7-9, 2001. Centre for Resource and Environmental Studies. Australian National University.

8. Linda Berry. Relief and the Community. Paper prepared for the Residential Flood Insurance: The Implications for Floodplain Management Policy Workshop. February 7-9, 2001. Centre for Resource and Environmental Studies. Australian National University.

9. David Ingle Smith. The What, Where and How Much of Flooding? The background to residential flood insurance. Paper prepared for the Residential Flood Insurance: The Implications for Floodplain Management Policy Workshop. February 7-9, 2001. Centre for Resource and Environmental Studies. Australian National University.

risk rating approach, which might be at odds with a universal system. However, consumer demands will be an increasing voice if nothing changes in the next few years. Companies will find it hard to differentiate between storm, flash flooding, riverine flooding and perhaps governments may have to take more seriously the role of mediation and resolution. Even then they may find it difficult to try to stick with concepts that pose more difficulties than to assist in any resolution.

What's the next step?

The issue needs some resolution. Although it may sound easy to adopt a model from the US or the UK it probably needs to be resolved both by the industry and governments. However, it was interesting to note that the ICA was not always able to command or bring together the companies on these issues. Companies, despite having a representative on the council often had to refer back to their parent organisation in the UK, Germany, US, Japan or other locations for direction. Often the resultant responses were based on the cultural preconceptions of the parent companies rather than solutions and joint recommendations by the council within Australia. As George Walker points out *'there are deeply entrenched attitudes within the insurance industry that ..provide a major barrier'* [10] to any move to resolve this issue.

One difficulty that was touched on in the conference related not to flood insurance or to its cost to insurance companies. Rather, individual companies were wary of putting themselves at a competitive disadvantage in relation to their other companies. This suggested that companies would be willing to offer flood insurance if others did also so ensuring that the risk was spread.

As stated at the workshop 'if the soft drink manufacturers can successfully market drinks with no nutritional value on taste alone, then insurance companies should be able to market their policies, which assist with safety and security of life. Indications from the workshop are favourable in this direction. What is clear from this meeting is that we cannot let another 10 years go by without some resolution and continued mitigation.

From a consumer point of view it is the Insurance companies that need to take the initiative. Consumers already feel that there is sufficient money paid in by their premiums to cover all types of hazards and there should be no distinction between storm and flood. We believe that consumers would be prepared to pay an addition small premium to ensure all hazards are covered. Consumers had increase their premiums by 10% last year to cover for the GST so a small or even a progressive increase would be acceptable. The fairest way would be payment through council rates, which would require some partnership with local government and enable the risk to be spread to every household not just the ones who insured. But there is a choice of direction and it is up to the companies to determine which would be the more acceptable way.

Governments, Insurance companies and the community need to look at novel and imaginative answers to these questions. New premium schedules, distributing risk across the community, new types of loss reinstatement.

The government and in particular the federal government could consider increasing funding to local government so that the regional flood mitigation program is provided on a 30:30:20 basis. This would ensure local governments undertake the necessary flood studies. It is also a matter of public safety to ensure that all relevant flood studies and maps are made freely available to the public who require it. We feel that a charge for such a service is not appropriate and goes against the whole notion of public safety. State governments need to increase work in identify and undertaking flood mitigation work. Figures revealed at the workshop indicate that where mitigation work has been undertaken the risks are greatly reduced and also premiums would reflect this reduced risk.

Perhaps in the end an arbiter or referee is required to enforce some of the critical thresholds identified at the conference. These would include:

- disclosure of flood risk by water authorities, municipalities and governments
- application of a common and easily understood definition of flood across the industry
- acceptance of data standards and types that are relevant to flood and risk assessment and evaluation
- cost (risk) sharing across the broader community, as now applies to perils such as fire.

What the conference identified was a willingness on the part of the insurance industry to move forward; but no one was willing to take the first step. Penguins on an ice floe dither about diving into the water because there may be a killer whale lurking there to snatch the bold, first penguin. So en masse they dither and hesitate, then gang up and push one of their number in to see if the predator is there. Surely we can do better than penguins.

For most householders insurance is the single most important action they can take to protect themselves from natural hazards. Where insurance is not available, or is not chosen for whatever reason, the people who suffer losses may be able to access some government assistance. This is usually inadequate to restore their losses in any significant way. We have seen people who have suffered major damage to their homes and contents and to their farms and businesses and who have not had insurance. The pain, distress and hardship they experience is profound and endures for many years.

This conference showed that the problems of providing flood insurance are not insurmountable and may indeed be relatively easily achieved if there is will and courage on the part of the industry and encouragement from government.

The big issues are not whether insurance companies can provide flood insurance nor whether they can afford to do so and still run profitably. In both cases the answer is affirmative.

The more difficult issues concern broader social and economic responses. Can we afford not to have universal flood cover? If we do spread the risk across a broader segment of the population (or even the entire population) then what equity issues must we confront? Would universal flood cover inadvertently promote riskier behaviour or reduce efforts to mitigate flood hazards? How would we deal with peoeple who are unable to afford flood insurance?

The workshop was positive. The representatives at the conference individually seemed to show strong commitment to resolving the matter of inadequate or inequitable availability of flood insurance. It is now up to their companies to take this further and for governments to work with them to address the broader issues of equity, planing controls, building standards, data availability, risk behaviour management and risk disclosure. Insurance companies are not managed for community benefit, but the benefit they provide to the community is massive.

Notes

10. George Walker. Insurability of Residential Flood Losses in Australia: a personal view. Residential Flood Insurance: The Implications for Floodplain Management policy workshop. February 7-9, 2001. Centre for Resource and Environmental Studies. Australian National University.