

# Australia's new Cyclone Reinsurance Pool: Implications for insurance in a climate changed future

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## Introduction

On 1 July 2022, the Australian Government brought into effect the Cyclone Reinsurance Pool (CRP). Administered by the Australian Reinsurance Pool Corporation (ARPC) and established under the Treasury Laws Amendment (Cyclone and Flood Damage Reinsurance Pool) Act 2022, the CRP's purpose is to address Australia's growing insurance crisis. Property insurance against extreme weather disasters is becoming increasingly unaffordable or unavailable in some locations, most commonly through Northern Australia where premiums are more than double those in the rest of Australia.<sup>1</sup> CSIRO identified rising insurance costs in its 2022 megatrends report as a pressing issue in adapting to climate change.<sup>2</sup> In addition to reduced affordability, the increasing threat of extreme weather disasters means that as many as 1 in 25 Australian homes are expected to be uninsurable by 2030.<sup>3</sup> Already, some 1 million Australian households are experiencing extreme levels of insurance stress where insurance premiums are greater than four weeks of average pre-tax income.<sup>4</sup> Half of these are vulnerable households, meaning that high premiums are heavily affecting those in socioeconomically disadvantaged areas, who have low savings, and reduced current or future earning capacity.<sup>5</sup>

Australia's exposure to the climate crisis is, thus, also generating a disaster insurance crisis. This crisis matters because, without insurance, individuals and businesses struggle to recover from disasters, generating social and economic hardship for them and their communities. The effects are also significant for wider society, as those unable to access disaster insurance on their properties will struggle to get or to maintain mortgages, so affecting homeownership, a key source of individual wealth and retirement savings in Australia.<sup>6</sup> Furthermore, society pays, as public money goes into disaster recovery and reconstruction rather than into other public services. Supporting people to maintain disaster insurance in the face of increasing frequency or severity of these disasters is important for us all.

## What is reinsurance?

- Reinsurance is insurance for insurers. Insurance companies buy reinsurance on the international reinsurance market so that when a large-scale disaster occurs, causing losses to many properties at once, insurance companies have the capital to pay the claims and remain solvent. Reinsurance is an important way that insurance companies ensure they can provide disaster insurance. However, the more that insurers suffer disasters that make them claim upon their reinsurance, the more that the reinsurance costs them. Hence, as extreme weather disasters increase in Australia, so does the cost of reinsurance for Australian insurance companies. That is one reason why the premiums that insurers provide go up in price — to cover the cost of reinsurance and ensure solvency to pay claims.

## Why an Australian Cyclone Reinsurance Pool?

- Through the CRP, the Australian Government will provide an annual guarantee of \$10 billion to cover damage from cyclones and related wind, flood and storm surge. This means that instead of buying reinsurance on the international market to cover their cyclone risk, insurers will buy reinsurance through the CRP, which they will be able to access more cheaply because of the Australian Government guarantee.
- Insurers will take premiums from policyholders and pay a proportion of those premiums into the CRP.
- How much insurers pay into the CRP for each policy is based on a formula that takes account of the policyholder's location and risk of cyclone and related wind, flood and storm surge damage.
- If there is a cyclone disaster, the CRP will provide the capital to pay the claims on the insurance companies.

## Background

Unaffordable or unavailable insurance leaves homeowners exposed to extreme weather disasters. As many people in Northern Australia found themselves without access to affordable insurance for cyclone and associated flooding and storm surge, on 4 May 2021, the Australian government announced its intention to create a reinsurance pool. The aim was to encourage insurers to continue to offer cyclone insurance into the Northern Australian market and, ideally, to also address the problem of affordability for those facing high premiums. A government supported CRP has the potential to reduce premiums, and complement the government's disaster mitigation programme.<sup>7</sup>

Following this announcement, the Reinsurance Pool Taskforce facilitated three public consultation phases in May 2021, December 2021, and March 2022. During these consultation phases, stakeholders, including the public, had the opportunity to influence the development of the pool by addressing a series of questions and providing comments on the draft legislation and regulations. Finally, a public hearing was held on 8 March 2022, and the Treasury Laws Amendment (Cyclone and Flood Damage Reinsurance Pool) Act 2022 was passed by Federal Parliament on 30 March 2022 and commenced 1 July 2022.

## Reinsurance pools overseas

Reinsurance pools are used around the world, including the United Kingdom, Spain, France, and Switzerland. These pools help to reduce premiums, increase the number of households with property insurance, and to ensure that financial support is paid out quickly following a disaster, thus providing financial resilience to disaster. Reinsurance pools are most effective at ensuring widespread protection against disaster within a country when coverage reaches 85% or more of households. Typically, such pools work by making disaster insurance compulsory and ensuring that all households pay a flat rate against multiple disasters, including wind, flood, earthquake, and so forth.<sup>8</sup> Under a compulsory, "flat rate" model, the pooled premiums ensure everyone is covered for all such disasters. As all disasters are unlikely to occur in the same place or at the same time, these pools effectively spread the risk of loss and the cost of the premiums across the population. Centralised coverage for natural disasters through a state-owned reinsurance pool also facilitates improved data collection and analysis to better develop, implement and fund mitigation and resilience programs.<sup>9</sup>

## Australia's CRP

Australia's CRP is a positive step toward recognizing the problem of insurance for those at most risk of

cyclone and associated flooding in Australia. Importantly, in addition to homeowners, the CRP will include strata title properties and small business up to \$5 million, so boosting both individual and community financial resilience to cyclone in these areas.<sup>10</sup> However, it is not compulsory and therefore policyholders have a choice about whether to pay for cyclone cover. Further, the CRP is limited to cyclone and related flood, wind, and storm surge damage, meaning the CRP does not cover all natural disasters.<sup>11</sup> For example, the 2022 floods of southeast Queensland and northern New South Wales would not be covered as the flooding was not caused by a cyclone. Without being compulsory and without covering a wider range of disasters, it's unlikely that the CRP will reach the ideal 85% or more of market penetration that is ideal to ensure widespread protection and flat rate premiums.

Other limitations of the CRP include the fact that because the proportion of a policy that pertains to cyclone is small, insurers will still need other reinsurance to cover the remainder of their property disaster risk. Thus, insurers will still purchase reinsurance in the international market, which will influence the price of premiums. Further, while insurers pay into the CRP from a prescribed pricing matrix, insurers can choose how much they charge policyholders for cyclone cover. Hence, anticipated savings for policyholders are uncertain. Thus, while a positive first step in acknowledging the problems of cyclone insurance in Australia, this first iteration of the CRP is unlikely to have significant impact on the wider problem of how climate change is making disaster insurance in Australia unaffordable or unavailable.

## How might the CRP evolve?

The CRP for Northern Australia is acknowledged as a first step on a pathway to greater financial resilience for property in the face of worsening climate induced disaster. Stakeholders participating in the engagement process have been able to shape the CRP to varying degrees. Insurers required clearly delineated boundaries for the scheme. Having established the CRP with these narrow boundaries, there is potential for expansion in the future once the CRP is fully operational.

We note the call for an expanded CRP to cover climate induced disasters across the whole of Australia when the early 2022 floods hit eastern Australia. Memories of extreme bushfire seasons are also not far back in the memories of property owners in Australia. Each Australian cyclone will provide an opportunity for gathering data and testing the CRP in the future. Furthermore, such data will provide important information that can feed into improving the physical resilience of properties and communities to disaster. Finally, other

disasters, such as flooding and bushfires are also likely to increase scrutiny of the CRP and potential calls for it to be expanded to address the wider problem of insuring extreme weather disasters in Australia.

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## Footnotes

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