9 June 2021

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Insurance Council of Australia
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Sydney

Dear Andrew

Commercial Insurance Consultation Paper

This letter responds to your consultation paper regarding Commercial Insurance and the Role of the Private Insurance Market. While I am a Principal at Finity Consulting, the views expressed are entirely my own. They do not represent the views of the firm, any of its clients, or any of my colleagues.

These are not new issues

The difficulties described for segments of SME businesses are not new. At least for the 50 years of my memory, there have been many episodes of insurance availability/affordability problems, often in specific segments and some more serious than others.

The 'liability insurance crisis' in Australia in 2001 and 2002 was an extreme example, and in my view, there is no great need to look beyond this example for learnings.

The publicly available descriptions of, reasons for, and responses to, this crisis are equally relevant now, while it must be acknowledged that some of the details and the impacted segments will be different.

Personally, I doubt that there is much more analysis that is helpful, other than to acknowledge that these situations do arise (not only in Australia), from time to time and that there are lessons to be learned about more or less effective responses.

While I am probably biased, I regard Australia's response to this liability crisis as a great success. It led to two decades of relative stability in liability insurance for businesses and insurers, well exceeding the expectations of experts at the time. What were the main contributors to that success?

- Civil liability law reforms around the country
- Recognising the important of knowledge and data (through the NCPD although this is still not ideal)
- Professional Standards legislation giving limits of liability for certain professionals in exchange for risk management initiatives.

Most of the problems are with Third Party (Liability) coverages

Looking at the examples in the report, they can be categorised into two groups:

a Third party (liability) coverages

b High exposure to natural perils.

In my view these types of difficulties need to be considered differently from each other.

Liability coverages

The common feature of these market problems is that they relate to insurance for an insured's liability to third parties for personal injury or financial loss of some kind. There are known characteristics of liability cover that makes it more susceptible to market problems, which I will not repeat here.

The emergence of a problem in this area (e.g. financial advisers or building certifiers) typically follows some adverse claims experience and an emerging view in the insurance sector that the risk is not quantifiable or controllable.

In my view what is needed in a situation such as this is:

1 Complete and objective information available to the insureds, insurers and policy makers – something that is not possible with our current arrangements for confidentiality of information

2 Potential changes to the laws and contracts governing the liability of insureds to third parties in the particular circumstances

3 Recommended systems and procedures for insureds to adequately mitigate the liability risks that have led to the problem

4 A pathway to re-establish viable and sustainable insurance coverage for the insured segment.

To achieve this action plan would require some institutional structures that are not currently available in Australia, due in part to Competition and Privacy laws. Perhaps a protocol could be established to enable insurance crises to be dealt in this way, and some further thoughts on this are later in this letter.

Peril coverages

This second category of insurance availability/affordability problems is likely to become more common in future in response to climate change and continually improving science to understand the relevant risks to property and business. It is also different from third party risks in that it is geographically localised, often very local. For this reason the economic impact on SME insureds can be very significant relative to their competitors in other locations. It also means that solutions often need to be localised, and who pays remains the difficult issue.

In theory the ultimate solution can only be in changes to land use, building standards and other aspects of the physical environment.

While it is a very preliminary thought, my suggested approach is to carve out the uninsurable perils exposure and insure/reinsure this risk on a pool or joint purchasing basis. It is clear that this is not an easy problem to solve and more will be learned during the process we are now embarking on with the cyclone pool.

Affordability

What does affordability mean in the context of SME insurance?

Insurance is one of many costs of doing business and there is no inherent reason why this cost cannot be absorbed into the business model and pricing of SMEs. Most businesses in a particular sector will have broadly similar insurance costs, possibly with adjustment for the relative perceived riskiness of a business.

So if, for example, the insurance cost increases from 2% of turnover to 4% of turnover, prices for the SME products/services will need to increase by 2% to achieve the same sustainability outcome for the SME. In my view this problem becomes one of transition and 'bill shock' rather than of fundamental significance to business viability. Early communication of this at an industry sector level, probably from industry bodies, will do no harm.

Achieving price increases for the goods or services of an SME may not be quick or easy, but is the necessary sustainable consequence. There can certainly be a shock at insurance renewal date, but a broad understanding that budgets and pricing will need to be adjusted over the coming twelve months or so will help with the transition.

Measuring and judging insurance cost as a percentage of turnover is a logical and generally effective benchmark. It also provides perspective across different industry segments.

The average premium rate will vary a great deal across different business types. For many professional activities it is in the range 1% to 5% of turnover.

As suggested in the paper it will be helpful to establish affordability benchmarks, going beyond the change relative to last year. For liability classes the NCPD is close to having enough relevant information to make benchmark measurements although some enhancement may be needed. The main needs will be a reasonably consistent measure of turnover and an ability to specify the type of business at a granular level.

Availability

Lack of availability of suitable insurance is a bigger problem than affordability, although the two cannot be entirely disentangled.

What leads to availability problems? My hypothesis is that it is a combination of two factors occurring together – high and uncertain riskiness with the cover, and a widespread concern across insurers that it cannot be written profitability in current conditions.

Real world riskiness

The high riskiness will nearly always be related to an increase in claims –often large claims. This was the case for financial advisers and for building certifiers for example. This is a 'real world' issue – not one deriving from insurance market structures or behaviours.

It can be very difficult to get a complete and accurate picture of the risk levels – absence of good data, the fact that many claims may have been lodged but not yet resolved, and that the situations of concern are likely to give rise to claims in future, whether from past or future activities. Nevertheless, developing effective solutions requires an evidence-based assessment.

When an assessment of the 'real world risk' is available, one stream of attention is reducing or mitigating that risk. Examples of actions include changing legislation or regulations, changing contractual arrangements regarding liability and improving risk management measures in the relevant SMEs.

It is worth mentioning the role of Professional Standards Schemes in this context. This is not a solution for all availability problems, but I think that for those occupational groups with a PSS it has made a substantial contribution to available and affordable professional indemnity insurance over nearly 20 years. A PSS must, however, be accompanied by the risk management and disciplinary procedures expected of a 'profession' and in my view it is no surprise that financial advisers (for example) have not been able to establish a PSS.

Insurance market response

Insurers are often accused of over-reacting in times like this. I have no doubt that there is some truth in this argument. Insurance underwriting is as much art as science. Given that it is about 'predicting the future' it is inevitable that there will be differing opinions. There is also a fair degree of interconnectedness in the industry, including via reinsurers and the Corporation of Lloyd's. All insurers have some form of control system over offering their capacity and a particular segment can become 'unfashionable'.

It is difficult if not impossible for insurers (or the ICA) to refute arguments of this kind.

Even if there are new insurers interested in a market segment, they do not have access to any relevant data and so are hamstrung (this was the case with HIH in respect of large parts of the liability market because they had such large market share and data was tightly held).

Joint responses by insurers

I am really in two minds about the merits or otherwise of insurers sharing underwriting risk as part of a solution to availability/affordability problems. There are very few examples of joint underwriting initiatives that have been sustainable and successful over a long period (NTI is often quoted as an example, and this joint venture had to survive litigation between the joint venturers).

On balance I think a specialist underwriting agency is the most likely approach to succeed. It would be feasible for several insurers to provide capacity.

I think it is important with any solution of this kind for there to be a planned 'exit' or 'return to normal' strategy. A limited life of say five or seven years with non-compete obligations on supporting insurers for that time, followed by an orderly unwinding of joint underwriting may have merit.

Lloyd's of London

Lloyd's is mentioned in many places in the report. I agree that for decades Lloyd's has played an important role in the Australian commercial insurance market, with syndicates willing to take on bespoke and specialised segments that may not be attractive to large Australian insurers.

However, it is not realistic to place too much reliance on the Lloyd's market as a backstop. Since its reformation at the end of the 1990's the Corporation of Lloyd's (and its government regulators) have been much more intrusive in the business activities of Lloyd's syndicates. We saw the impact of this over the last three years when the Corporation of Lloyd's 'fell out of love' with Australia and put a lot of pressure on syndicates to reduce exposure to Australia especially in casualty lines.

We have an insurance regulatory structure whereby Lloyd's is equally available as an insurer as any Australian insurer. There are some limitations and extra costs of doing business with Lloyd's, but these are because of Lloyd's, not because of any Australian regulation or market practice.

In my view, in the context of this report, Lloyd's needs to be accepted as part of the landscape, neither inherently good nor bad. It is essential to cover Lloyd's in any explanation of the insurance market, but of no assistance to either sing its praises or criticise its influence.

Discretionary Mutual Funds

Many groups consider a DMF as an option in tough market conditions. This method of protection was effectively legitimised after the Potts review in 2005. Soft market conditions meant that few new arrangements were started in the next 15 years, but there are now many organisations developing or considering DMF arrangements. There are also at least five organisations actively promoting establishment and management services for DMFs.

Thinking from a public policy perspective I struggle with the concept of Australia having a formal regulated insurance market (relatively highly regulated from a prudential perspective) along with an informal and partly regulated DMF market.

A properly run DMF is, itself, dependent on satisfactory reinsurance arrangements (technically insurance because the DMF is not an insurer), typically both excess of loss and aggregate. A DMF can be regarded as a mutual 'insurance' organisation, and it can also be regarded as a 'group purchasing arrangement' for insurance, with a shared self-insured retention.

A further concern I have is that, while it is difficult to establish a DMF, it is even harder to unwind one. The consequence is that the DMF tends to be permanent and is not seen as a temporary solution for availability/affordability problems.

To my knowledge there has been a good track record of DMFs in Australia meeting their obligations to members and not suffering financial crises, with the notable exception of MDOs and some others during the liability crisis, which was as much to do with the failure of their reinsurance with HIH as anything else.

Extra issue with Claims Made policies

Many, but not all, of the insurance products with availability/affordability problems are claims made policies.

For an occurrence policy (such as most public liability) the financial dynamics are simpler. The insurer having issued a policy is liable for claims arising from actions during the period of the policy. The insured is covered for past actions even if an aggrieved party does not make a claim until sometime in the future.

Claims made policies are more complex. Existing insurers will generally be stuck with 'notifications' as well as claims actually made, but with 'laundry list notifications' that can be legally arguable. Any new insurer will have to grapple with prior acts and retroactive date. If a way can be found to ring-fence prior acts, the attractiveness of claims made coverage for new insurers (and therefore customers) is much greater. I wonder if there are mechanisms available to ring-fence prior acts, at least of some kinds (e.g. the flammable cladding in building sectors)? Perhaps a limited life DMF with levy collection powers might be possible.

There is not an established market in Australia for run-off cover and policies generally do not include guaranteed options to buy run-off cover.

A straw person for a solution approach

In an effort to continue to develop constructive thinking, here is a thought experiment about how it may be tackled.

The insurance crisis protocol

Develop an Insurance Crisis Protocol (an ICP) that sets out agreed approaches to be taken by various stakeholders in the event of an 'insurance crisis' impacting a particular market segment.

The ICP will be supported by ICA, NIBA, UAC, Lloyd's Australia and the Actuaries Institute. It will be known to ASIC, ACCC, APRA, the Professional Standards Councils, Federal and State Treasuries.

Any stakeholder may request ASIC to agree to the ICP being triggered. If it is triggered, then:

- A working group is established (an Insurance Crisis Team or ICT)
- Competition laws are suspended for the purpose of the ICT (I think within ASIC's powers)

- Confidentiality and privacy requirements are suspended in terms of providing information to the ICT (the ICT is then responsible for confidentiality and privacy requirements)
- Supporters of the protocol (brokers, insurers, underwriting agents) are then obliged to provide information to the ICT and to respond to questions from the ICT
- Other stakeholders (e.g. insureds and industry bodies) are invited to provide information to the ICT.

Work of the ICT

The ICT is charged with preparing a pack of factual information relating to the current 'crisis'. That pack will be available (subject to NDA) to relevant stakeholders such as an industry body or a potential underwriter. The ICT may suggest potential solutions.

The ICT then receives expressions of interest from stakeholders about potential responses to the crisis. It is charged with attempting to 'broker' one or more solutions that will best meet the needs of the insured businesses.

Funding of the ICT

The ICP will include arrangements for funding the work of the ICT. The general approach will be that relevant stakeholders will make people available to join the ICT at their own cost. Where independent expertise is needed such as actuarial, legal or market expertise, the cost will be funded on a pre-agreed basis by insurers and insureds, normally 50/50.

Brief responses to the consultation questions

My response above to the consultation paper does not align well with the questions that were put. However, I have prepared brief responses below without explanation.

2.1 To my knowledge widely available, particularly through premium funding offered by most brokers

2.2 In my judgement a relatively minor matter. There are many cash flow considerations in a small business and this will not be a large one

2.3 I have no problem with premium funding except that (a) a 20% fee is too high and (b) anecdotally some broker commissions are too high

3.1 It is not possible to give a general answer to this question. One of the inherent difficulties is that nobody knows (lack of suitable data)

3.2 I doubt that trying to espouse principles of this kind is helpful. Governments will always be reluctant (with good reason). Stakeholders need to work with that, and it is up to the Governments not insurers to explain that to the consumer stakeholders.

3.3 A very simple statement, if any. Tactically it is not wise to tell Governments what they should think.

5.1 I am sceptical about whether there is any real benefit. Regulatory authorities seem to be finally accepting the limitations of 'disclosure' in helping consumers. Have Key Fact Sheets made a positive difference for consumers of Home insurance? The variations in commercial operations are huge.

5.2 I think this direction is more 'being seen to do something' than actually doing something useful. We got rid of the Tariff in 1974 and returning to that direction likely creates more problems than it solves.

5.3 The problems that led to this report are very specific and very narrow. I think the responses need to be equally as specific and narrow.

5.4 Repeat the answer above.

5.5 Of limited value, and there are two big assumptions. If there are to be such standards or notes the ICA is entirely the wrong body to develop and promulgate them – it is the industry body for insurers and almost always regarded as 'the enemy' by consumers troubled by market problems.

5.6 etc This set of questions is not possible to answer in respect of 16 overlapping options and the plethora of industry segments and coverages that might have problems.

Concluding remarks

I appreciate the efforts of the ICA in commissioning this study and publishing it. I would be happy to discuss my thoughts with the ICA and/or the authors if that would be of assistance.

Yours sincerely

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