

Flood insurance: Premium subsidies vs premium discounts or, equivalently, premium subsidies vs claim subsidies

What are premium subsidies and claim subsidies, and how would they work?

For properties with flood risk such that affordability is seen as an issue –

1. Subsidies (i.e. premium subsidies)

A price for flood cover is arrived at and the insurer receives a portion of the flood premium each year as a cash subsidy, either directly from government or from government through the policyholder.

The key aspects of such an arrangement would be –

- Insurers receive the subsidies year in and year out, come rain, hail or shine or, more aptly here, come rain, drought, flood or bushfire
- The annual cost to government is likely to be of the order of \$200m and \$400m
- When there are no floods or minor flooding only, including of course all the drought years, most of this aggregate subsidy would fall into insurer profits (some would go into reinsurer profits in those years and some into expenses)
- The administrative arrangements needed to operate a subsidy scheme, with many transactions and price assessments needed every year, would be a major undertaking
- Even if the idea were palatable, price setting for the subsidies could be virtually intractable: how could prices be set such that both insurers and the government thought simultaneously that the prices were fair (it is hard to foresee that any assessment of the price, comprising the cost of flood risk, given all the uncertainties, plus the loadings for reinsurance, expenses and profit, would satisfy both parties, and the longer were any dry periods the more problematic it would be*)?
- In addition to dealing with the pricing questions, insurers would be underwriting the business corresponding to the subsidies and so would need to hold capital and buy reinsurance in respect of that exposure.

*To illustrate the pricing problem, consider Wivenhoe Dam and the Brisbane River. An insurer would be fully justified in pricing a major flood like 1974 or 2011 as a 3% to 5% probability (1 in 20 or 30 years), in order to price prudently, whereas, if the dam is managed in future more successfully than in 2011 (and that seems likely), flooding on the 2011 scale may never occur again!

2. Discounts (or, equivalently, claim subsidies)

A price for flood cover is arrived at but the policyholder pays only part of that price; the insurer bears the portion of the risk that corresponds to the price it receives and the government bears the remainder of the risk. No money changes hands in respect of the discount. Instead government underwrites its portion of the risk and pays claims only when floods occur that give rise to claims on its portion of the risk.

The key aspects of this kind of arrangement would be –

- The insurers underwrite their portion of the risk, at their prices, and receive those prices, without any involvement of government
- For the portion of flood risk ceded to the reinsurance facility, insurers would bear no risk and require no capital
- In years when there are no floods or minor flooding only, including of course all the drought years, the cost to government would be nil
- The next time there is a major flood like the 1974 or 2011 Brisbane flood, the cost to government could rise to \$1bn or more
- In respect of those occasional years when there are major floods, there is the possibility of government restructuring its various relief programmes to mitigate its claims costs under a discount scheme
- Price setting for the discounts would be in the hands of the manager of the reinsurance facility and would be independent of insurers' pricing and underwriting for the portion of flood risk that they cover, hence no need for agreement between insurers and government on price setting.

Note also that the Review Panel recommended phasing out the discounts, so that the costs of flood claims guaranteed by the government should eventually be covered by the accumulated pool of premiums (whether held in a pool, as we proposed, or simply retained each year as part of Consolidated Revenue).

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