INSURANCE COUNCIL OF AUSTRALIA

30 April 2021

Mr George Christensen MP
Chair of Joint Standing Committee on Trade and Investment Growth
PO Box 6021
Canberra ACT 2600

Dear Mr ~~Christensen~~ George.

INQUIRY INTO THE PRUDENTIAL REGULATION OF INVESTMENT IN AUSTRALIA'S EXPORT INDUSTRIES

The Insurance Council of Australia (ICA) welcomes this opportunity to make a submission to the Committee's 'Inquiry into the prudential regulation of investment in Australia's export industries'.

The general insurance industry recognises the importance of Australia's export economy, enabling over 53,000 goods exporters, transporting more than $373 billion worth of goods from Australia around the world in 2018-19.[1]

ICA members provide insurance products to enable effective risk management of export industries and their associated businesses spanning, commercial, corporate, specialty and statutory products.

General insurance works as a method of managing risk or uncertainty. The existence of general insurance allows the diversification and spreading of risk away from enterprises that are unable or willing to bear that risk or uncertainty.

Insurance products are highly complex products that require in depth understanding of the nature of the risk, the probability of the risk involved occurring, the likely loss that would be experienced, and the financial and regulatory factors that may affect the provision of insurance in the economy.

In a contemporary regulatory environment, key priorities for prudential regulators both domestically and abroad include responding to the risks being created by climate change.

On 22 April, the Australian Prudential Regulation Authority (APRA) issued a new draft guidance in coordination with the Council of Financial Regulators (CFR) highlighting heightened statutory responsibilities in relation to governance, risk management, scenario analysis and disclosure of climate change financial risks.

Similarly, major investor groups have issued calls for the treatment of climate change as a financial risk and a threat to assets and infrastructure exposed to the physical impacts of

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[1] https://www.dfat.gov.au/publications/trade-and-investment/trade-and-investment-glance-2020#exports

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INSURANCE COUNCIL OF AUSTRALIA

climate change. Investors are increasingly using shareholder capital to highlight the risks to businesses and industries that fail to prepare for a transition to a low emissions economy.

The general insurance industry will continue to support and enable the effective risk management of Australia's exporters and associated businesses consistent with a contemporary understanding of regulatory guidance and statutory obligations as a prudentially regulated industry.

Our submission outlines the role and contribution of general insurance to Australia's export economy, economic impacts of climate risk to general insurance, and further detail in relation to the regulatory and shareholder landscape faced by the general insurance industry.

Yours sincerely

[redacted]

Andrew Hall
Executive Director & CEO

INSURANCE COUNCIL OF AUSTRALIA

About the Insurance Council of Australia

The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent approximately 95 percent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

December 2020 Australian Prudential Regulation Authority statistics show that the general insurance industry generates gross written premium of $53.2 billion per year and has total assets of $143.6 billion. The industry employs approximately 60,000 people and on average pays out about $187.2 million in claims each working day ($47.2 billion per year).

Over the 12 months to the end of December 2020 the industry's net profit after tax (NPAT) was $35 million - a 98.9 per cent decrease from the prior year's NPAT of $3.1 billion. The industry's underwriting result was $78 million, falling sharply from $2.3 billion in the prior year[2].

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[2] https://www.apra.gov.au/quarterly-general-insurance-statistics

INSURANCE COUNCIL OF AUSTRALIA

1. The role and value of general insurance

General insurance works as a method of managing risk or uncertainty. The existence of general insurance allows the diversification and spreading of risk away from those that are unable or willing to bear that risk or uncertainty.

Insurance also encourages insured persons to minimise or avoid risks and can act as an important price signal to individuals through insurers' risk-based pricing model.

In the broader economy, risk-based pricing is integral to ensuring that resources are allocated efficiently and that behaviours are adjusted in response to the price signal. In the case of natural peril risk, risk-based pricing motivates land use managers and owners to adjust planning and development arrangements to mitigate against future risk and thereby reduce the overall cost of natural disaster perils.

General insurers play a vital role in the Australian economy, such as, protecting the financial well-being of individuals, households, businesses and communities. Insurance is widely used as an accessible and common form of risk management to protect against the risk of uncertain future losses. However, insurance also plays a broader and often multi-dimensional role in a modern economy.

Pooling and diversifying risk

As well as facilitating economic activities and providing peace of mind for individuals, private sector general insurance is an effective mechanism for the pooling and transferring of risk. All individuals and organisations face a wide variety of risks but only some of them will actually suffer a loss during the period of cover.

Insurance enables the pooling of such risks so that the risks are spread or shared between the many individuals or organisations that have contributed to the insurance pool. Those at risk contribute a relatively small amount for the risk insured based on the insurers' assessment of the nature of the risk and the policyholder's specific risk profile.

An intrinsic feature of insurance is diversification, which can be achieved by aggregating a disparate portfolio of risks, often spread across different products and geographies to lessen the concentration of risk. Insurers then further diversify, investing in assets whose risks are uncorrelated, or by reinsuring to reinsurers (who in turn will diversify) which shares and spreads the risk of economic losses across society and regions.

Insurers that carry on business throughout Australia and across the globe also lessen the concentration of risk that occurs than if they were restricted to a single region or a single country. Many insurers in Australia also achieve diversification through reinsurance protections with global reinsurers.

Facilitating household and business activities

Insurance enables many activities to be undertaken that would not otherwise take place, by mobilising savings and facilitating investment. Having access to insurance enables people and businesses to engage in activities that otherwise would be too fraught with risk, enabling many business initiatives to occur that would not otherwise be undertaken. For example, businesses may not invest in inventory or plant and equipment if insurance was not available

INSURANCE COUNCIL OF AUSTRALIA

to cover the risk of fire and other damage. If adequate liability insurance is not available to protect individuals against accident, then the propensity to travel diminishes.

Understanding and managing risk

Insurers provide highly complex products that require in depth understanding of the nature of the risk, the probability of the risk involved occurring, the likely loss that would be experienced and the financial and non-financial environmental factors that may affect the provision of the product in the particular economy. For example, property insurers need to know about building codes and materials, flood insurers need to know about geographic features and natural peril risk, workers compensation insurers need to understand about injuries and rehabilitation, lenders mortgage insurers need to know about economic indicators and housing trends, and so on. Identifying and understanding risk is the central focus of an insurance business.

Insurers are experts at managing risk. This is the central tenet of an insurance business. As such, insurance companies provide information, education and expertise to society through their work and the specialised nature of their experienced workforce. The general insurance industry in Australia has, over the last 15 years, developed numerous tools and provided extensive information to consumers, communities and governments about the identification, management and mitigation of risks.

Also important is the behavioural effect that peace of mind provided by insurance coverage gives. People's ability to cope with adverse effects is strengthened and they tend to behave in less risky ways when they know that certain risks are covered financially.

Recovery from natural disasters

Natural disasters are an ever-present risk for communities in Australia. The contributions of the insurance industry in the recovery of communities from recent catastrophes are significant not only in terms of the billions of dollars of claims paid, but also in terms of the evolving risk mitigation and emergency management initiatives that build resilience into our communities. The support that private sector general insurance provides for people, businesses and communities is a critical factor in assisting in the speedy economic recovery and rebuilding after unforeseen events or loss and misadventure occurs. Since September 2019, claims relating to the bushfires, together with those from the hailstorms across several states and the Australian Capital Territory, total some 390,228 with a value of $7.12 billion[3].

Broader contributions to the economy

The insurance industry also plays an important part in the functioning of the capital markets. Insurers are major financial intermediaries converting insurance premiums into investments that also sustain economic growth and provide investment funds and working capital across the economy. Insurers' own equity (shareholders funds) together with unearned premium and claims reserves is also a significant source of investment capital that contributes to the functioning of and liquidity in the economy.

[3] Insurance Council of Australia data as at 23 April

INSURANCE COUNCIL OF AUSTRALIA

2. Climate risk and general insurance

There is growing recognition that climate change and climate-related risks are a source of financial risk[4], having an impact on the resilience of individual financial institutions, including insurers, as well as on financial stability.

Climate change presents not only risks but also opportunities for the insurance sector. The insurance industry plays a critical role in the management of climate-related risks in its capacity as an assessor of risk, risk manager, risk carrier and investor, and is uniquely qualified to understand the pricing of risks. Notably, through risk-based pricing, insurers provide critical economic signals regarding the changing risk environment.

There is a key role for insurers to articulate the risks presented by the impacts of climate change, and best inform and stimulate prudential decisions by business, community, and governments. The insurance industry can mobilise hundreds of years' experience to best inform our stakeholders and lead by example by responsibly managing and holding our own capital in a climate-changed future.

A 2017 report[5] by Deloitte Access Economics found the total economic cost of natural disasters is growing and will reach $39 billion per year by 2050. These costs include significant, and often long-term, social impacts, including death and injury and impacts on employment, education, community networks, health and wellbeing.

Over the last ten years we have seen natural disasters, such as:

2011: The Queensland floods and Tropical Cyclone Yasi contributed to Australia's most costly year for natural disasters, and, at $5.5 billion, more than 60% of the insured cost of natural disasters that year. The floods led to 36 deaths and property damage costs of $1.5 billion (Queensland Floods Commission of Inquiry, 2012). Cyclone Yasi claimed one life and also incurred property damage costs of $1.5 billion.

2013: Tropical Cyclone Oswald cost $1.5 billion in insured costs.

2015: Tropical Cyclone Marcia and a cluster of east coast lows (extra-tropical cyclones) cost $2.9 billion in insured costs.

2017: Cyclone Debbie in Queensland and New South Wales (NSW) cost an estimated $1.7 billion in insured losses, with this total expected to rise further.

Queensland has been Australia's most disaster-prone state over the past decade and incurred an average total economic cost of $11 billion per year. This is 60% of the national cost. NSW and Victoria each incurred more than 15% of the total cost. The remaining 10%, equivalent to $1.4 billion per year, was borne across other States and Territories.

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[4] NGFS (2019), First comprehensive report: A call for action, Climate change as a source of financial risk;

[5] https://www2.deloitte.com/au/en/pages/economics/articles/building-australias-natural-disaster-resilience.html

INSURANCE COUNCIL OF AUSTRALIA

Availability and affordability for certain groups of insurance customers in high-risk areas remains a concern, specifically around cyclones in northern Australia. Cyclones alone have cost approximately $5 billion in damages across northern Australia over the last 10 years, including Tropical Cyclone Debbie in 2017 at nearly $1.8 billion and Tropical Cyclone Marcia in 2015 at $600 million[6].

At present no region in Australia is uninsurable. However, it is possible some regions may become difficult to insure in the future unless governments investing in appropriate mitigation and adaptation strategies.

[6] Insurance Council of Australia data, 2021

INSURANCE COUNCIL OF AUSTRALIA

3. Regulators on climate change

The ICA notes there is also an increasing global regulatory focus on the management of climate risks and opportunities by prudential regulators both domestically and abroad.

Examples include guidance and actions by regulators in the United Kingdom, United States, France, Singapore and New Zealand. Global regulatory developments may impact on the Australian insurance industry both in terms of the guidance issued by Australian regulators and for insurers that operate and are prudentially regulated in multiple countries.

Australian Securities Investment Commission (ASIC) and APRA are the government bodies with primary responsibility for regulation of insurers domestically.

Recent priorities for both of these regulators has been the development of guidance and frameworks for the assessment and monitoring of climate-related financial risks in the country's financial system. This regulatory guidance extends to the climate risks of underwriting the fossil fuel sector.

The following provides an overview with respect to guidance from regulators relevant to the general insurance sector.

APRA

In April 2021, APRA released a draft Prudential Practice Guide (PPG) on Climate Change Financial Risks[7]. The draft provides prudential guidance on the management of financial risks arising from climate change such as governance, risk management and disclosure.

The development of APRA's guidelines were first outlined in a letter to industry during 2020 on climate change financial risks. It is understood that APRA developed the PPG in collaboration with other agencies from the Council of Financial Regulators (CFR). This Guide has also been informed by APRA's engagement with peer regulators in other jurisdictions.

APRA Executive Board Member Geoff Summerhayes has previously said "as with the transition to the low carbon economy, someone will ultimately pay, and waiting to act will only lead to higher costs in the long-run[8]." The tone of regulators to industry is clear. Regulated entities must take steps to better understand and disclose climate-related risks.

APRA draft guidance states that climate risk is financial risk. To this extent, adequate disclosure and management of an organisation's climate risk exposure is now categorised as equal with traditional risk management practices and regulator expectations.

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[7] https://www.apra.gov.au/news-and-publications/apra-releases-guidance-on-managing-financial-risks-of-climate-change

[8] https://www.apra.gov.au/news-and-publications/executive-board-member-geoff-summerhayes-speech-to-australian-business

INSURANCE COUNCIL OF AUSTRALIA

APRA has also supported the recommendations from the Task Force on Climate-related Financial Disclosures (TCFD). This increases its scrutiny of institutions' climate risk management and will factor this into its ongoing supervisory activities.

APRA is also working with international regulators on climate risks through its involvement with the International Association of Insurance Supervisors (IAIS) and the United Nations Environment's Sustainable Insurance Forum (SIF), which APRA chairs.

ASIC

ASIC has similarly provided updated regulatory guidance that applies to all listed companies, their directors and advisors. ASIC recommends that listed companies disclose meaningful and useful climate-risk-related information to investors, and strongly encourages listed companies with material exposure to climate change to consider reporting voluntarily under the Task Force on Climate-Related Financial Disclosures (TCFD) framework.

In 2018, ASIC reported that most large Australian listed companies considered climate risks to some extent, with some identifying these risks as material. But climate risk disclosure was often too fragmented, general, or not comprehensive enough to be useful for investors[9].

In 2019, ASIC published updates to two Regulatory Guides, RG228 and RG247, to provide guidance on climate-risk disclosure. Importantly, RG247 highlights climate change as a systemic risk that might impact the company's future financial prospects, and that may need to be disclosed in an operating and financial review (OFR).

The updates followed the publication by ASIC in 2018 of ASIC Report 593 on Climate Risk Disclosure by Australia's Listed Companies. This report confirmed that a listed entity must disclose any material business risks — including, where relevant, climate-related risks — affecting future prospects in its OFR in accordance with the Corporations Act[10].

ASIC Commissioner, Cathie Armour in February 2021 wrote an opinion piece highlighting the disclosure and management of climate-related risk should be a key director responsibility[11].

ASIC has highlighted climate-related risk as a systemic risk in Australia's financial market that has the potential to significantly impact companies, investors and consumers.

Council of Financial Regulators

The Council of Financial Regulators (CFR) is the coordinating body for Australia's main financial regulatory agencies, comprising APRA, ASIC, the Reserve Bank of Australia (RBA) and The Treasury.

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[9] https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-593-climate-risk-disclosure-by-australia-s-listed-companies/

[10] s229A(1)(c) of the Corporations Act

[11] https://asic.gov.au/about-asic/news-centre/articles/managing-climate-risk-for-directors/

INSURANCE COUNCIL OF AUSTRALIA

The CFR has a formal working group on the financial implications of climate change. The group meets to consider and coordinate actions to address the implications of the changing climate for the Australian financial system. It reports to the CFR, as needed, on international developments, emerging regulatory gaps and risks to the financial system in relation to climate change.

In the October Quarterly meeting[12], the CFR noted a key element in the period ahead will be the "climate change financial risk vulnerability assessment announced by APRA. The assessment will involve the large ADIs estimating the potential physical impacts of a changing climate on their balance sheets, as well as the risks that may arise from the global transition to a low-carbon economy."

The CFR agencies continue to undertake a range of activities to understand climate risks and to promote understanding and management of those risks by regulated financial entities.

[12] https://www.cfr.gov.au/news/2020/mr-20-04.html

INSURANCE COUNCIL OF AUSTRALIA

4. Institutional capital on climate change

In the management of investment funds, insurers will typically consider traditional risk/ return criteria which balances expected return against volatility, capital (internal risk capital, regulatory and rating agency capital models) and liquidity. Consideration of traditional risk/return criteria typically leads to a substantial majority of insurance company investments being concentrated in high grade debt securities of relatively short maturity, and application of such criteria to varying degrees may limit investment capital deployed into export industries, depending on the nature of the investment.

Investing requires consideration of sustainable business practices, as well as traditional financial risk and return assessments and managers of institutional capital are considerate of environmental, social and governance (ESG) issues when constructing investment strategy and guidelines. According to a 2020 global survey by FTSE Russell13, more than seven in 10 asset owners globally are evaluating and implementing sustainable investment considerations in their investment strategies.

In 2006, the UN-backed Principles for Responsible Investment (PRI) was launched, 63 investment companies with $6.5 trillion ($USD) in assets under management signed a commitment to incorporate ESG issues into their investment decisions. By April 2018, the number of signatories had grown to 1,715 (which includes the big four general insurers) and represented $81.7 trillion ($USD).

In relation to climate change, managers of institutional capital around the world are increasingly reckoning with the question of climate change in the context of overall investment risk. From Australia to Europe, China to New York, fund managers are asking how they should modify their portfolios to account from climate risk. They are seeking to understand both the physical risks associated with climate change as well as the ways that climate policy will impact prices, costs, and demand across the entire economy.

The Australian Council of Superannuation Investors (ACSI), which represents investors that manage more than $1 trillion in retirement savings and hold about 10% of the shares in the top 200 companies in the country, said some boards were not tackling the climate crisis quickly enough.

Under a new climate policy, released in April by ACSI now expects companies to adopt and detail a corporate strategy in line with the international Paris agreement, which aims to limit heating to 1.5C, and commit to net zero emissions by 2050.

Chairperson and Chief Executive of Global Asset Manager, BlackRock wrote a letter to CEOs in 2020 stating a requirement for investment companies to adhere to adequate climate risk disclosure in addition to plans for operating under a scenario where the Paris Agreement's goal of limiting global warming to less than two degrees is fully realised. Last year BlackRock voted against or withheld votes from 4,800 directors at 2,700 different

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[13]https://content.ftserussell.com/sites/default/files/sustainable_investment_survey_press_release_8.6.20.pdf ?_ga=2.112757828.198551893.1616732185-721850553.1616732185

companies[14] where companies were not making sufficient progress on sustainability-related disclosure and business practices underlying them.

At the time of writing, BlackRock remain material equity shareholders in each of the four main general insurers in the Australian Market.

[14] https://www.blackrock.com/au/individual/larry-fink-ceo-letter

INSURANCE COUNCIL OF AUSTRALIA

5. Industry position on climate change

Members of ICA accept the international scientific consensus presented by the Intergovernmental Panel on Climate Change and supported by the CSIRO.

Our members support the ratification of the United Nations Framework Convention on Climate Change Paris Agreement by the Australian Government, including commitments to significantly reduce emissions below 2005 levels before the year 2030. The ICA is also a signatory to the United Nations Principles for Sustainable Insurance.

As a shared risk, and a shared responsibility, climate change presents several concurrent pressures for the insurance industry and wider Australian community:

1) Changing physical risk, extreme weather patterns, and the need for new tools, modelling and investment to inform decision making, climate adaptation and mitigation

2) The continued need for suitable and affordable insurance products to protect the community and businesses against perils

3) A changing economy and the transition to a low carbon emissions economy, and

4) The need to ensure the solvency and stability of prudentially regulated entities.

To achieve this, the ICA has established a Climate Change Action Committee (CCAC) which will operate as a member working committee reporting as required through ICA management to the Board of the ICA. The mandate of this committee is to:

1) Support the insurance industry to embed climate change issues and insights into decision making

2) Work with stakeholders to raise awareness of climate change and the impacts of climate change, manage risk and develop solutions including awareness of disaster preparedness in communities, and improve disaster response and recovery

3) Work with governments, regulators and other key stakeholders to promote action on climate change and other environmental issues

4) Support industry disclosure of climate risks and opportunities

The ICA has developed a draft strategy based on these four principles and has started work immediately to implement a coordinated industry response. We aim to enable Australia's transition to a resilient and low carbon economy and offer continued support to the communities we operate in for a sustainable future.