

Chapter 1

Introduction

Terms of reference

1.1 On 22 November 2016, the Senate referred matters relating to Australia's general insurance industry to the Senate Economics References Committee for inquiry and report by 22 June 2017.¹ On 20 June 2017, the Senate granted an extension to the committee to report by 10 August 2017.²

1.2 The terms of reference for the inquiry are:

- (a) the increase in the cost of home, strata and car insurance cover over the past decade in comparison to wage growth over the same period;
- (b) competition in Australia's \$28 billion home, strata and car insurance industries;
- (c) transparency in Australia's home, strata and car insurance industries;
- (d) the effect in other jurisdictions of independent home, strata and car insurance comparison services on insurance cover costs;
- (e) the costs and benefits associated with the establishment of an independent home, strata and car insurance comparison service in Australia;
- (f) legislative and other changes necessary to facilitate an independent home, strata and car insurance comparison service in Australia; and
- (g) any related matters.³

1.3 Several submitters to the inquiry highlighted the fact that strata insurance is a specialised commercial product that is very different to home and motor⁴ insurance and that, as such, some of the inquiry's terms of reference are less relevant to this form of insurance. Consequently, most of the evidence received for the inquiry and discussed in this report relates primarily to home and motor insurance.

Conduct of the inquiry

1.4 The committee advertised the inquiry on its website and wrote to relevant stakeholders and other interested parties to draw attention to the inquiry and invite them to make written submissions.

1 *Journals of the Senate*, No. 17, 22 November 2016, p. 561.

2 *Journals of the Senate*, No. 46, 20 June 2017, p. 1494.

3 *Journals of the Senate*, No. 17, 22 November 2016, p. 561.

4 Home insurance is also commonly known as householders, homeowners, or residential building and contents insurance. For the remainder of this report, the term 'home insurance' is used to refer to insurance covering both an individual's home building and home contents unless otherwise specified. The terms car and motor insurance are used interchangeably throughout this report.

1.5 The committee received 23 submissions as well as additional information and answers to questions taken on notice, which are listed at Appendix 1.

1.6 The committee held two public hearings: Sydney on 12 April 2017 and Melbourne on 13 April 2017. The names of the witnesses who appeared at the hearings are listed at Appendix 2.

1.7 References to the Committee Hansard are to the Proof Hansard and page numbers may vary between the Proof and Official Hansard transcripts.

1.8 The committee thanks all the individuals and organisations who assisted with the inquiry, especially those who made written submissions and appeared at hearings.

Background

1.9 Insurance touches many aspects of human activity. Adequate insurance cover is integral to protecting consumers' most valuable assets and to maintaining and protecting the living standards of all Australians and the economy overall. As seen in the wake of a number of natural catastrophes, unsuitable financial products, including insurance, can have significant and devastating impacts on people's lives. To that end, accessibility, transparency, affordability and competition are crucially important features of a well-functioning general insurance market.

Principles of insurance

1.10 Insurance is based on the principles of pooling and spreading risk. Insurance products allow individuals to shift some or all of their personal risk to another party, an insurer. A policyholder pays a premium to an insurer to take on their personal risk relating to certain assets, such as their home or motor vehicle. In return, that insurer finances the risk by covering the policyholder for certain losses when an agreed event occurs. Allianz explained the principles of pooling and spreading risk in their submission:

Pooling risk

Insurance is based on the principle of pooling risk. That is, a large number of policyholders pay a relatively modest premium into a 'pool', out of which is paid larger amounts of money to a relatively small number of policyholders that make a claim during the period of insurance, which is normally 12 months.

A basic, but difficult, task of an insurer is to calculate the size of the premium pool that will be required. To do this, insurers need to estimate how many claims might be received (the claims 'frequency') and what the cost of those claims will be (the claims 'severity').

For 'short tail' insurance, the objective is that, in each year, the premium 'pool' collected by an insurer (e.g. for car or home insurance) is sufficient to pay the claims made by customers, as well as to cover the operational and other costs (e.g. commissions paid to intermediaries) of running the

insurance company, including a fair and reasonable profit (out of which is paid a return to shareholders).⁵

Spreading risk

Insurance is also based on the principle of spreading risk across policyholders with different risk profiles. Insurers will seek to spread their risk geographically, for example, so they don't have a concentration of home insurance policyholders in areas particularly vulnerable to natural perils (e.g. flood, cyclone or bushfire).

...

If an insurer is over-represented in an area vulnerable to a particular natural peril, then it will be more adversely impacted than its competitors when such an event occurs.⁶

The role of insurance

1.11 As explained above, the key role of insurance in an economy is the mitigation of insurable risk. Through the pooling and efficient allocation of risk across policyholders, insurance encourages and enables individuals and businesses to pursue economic activities, expansionary initiatives, and investments that would otherwise be cost-prohibitive. In other words, by transferring risk to an insurance provider, insurance cover frees economic resources (including government taxpayer funded resources) and provides a safety net that allows those resources to be used more productively with a lower threat of social and economic harm. Events such as the global financial crisis and natural catastrophes like that recently seen with Cyclone Debbie emphasise the importance of a robust and sustainable insurance industry.

1.12 Governments play a significant role in insurance by providing efficient and effective policy or regulatory oversight of the industry. Furthermore, they can assist by ensuring adequate mitigation strategies are developed and employed in areas prone to natural catastrophe, thereby alleviating pressure on insurance premiums. Other forms of intervention include levies, such as the fire or emergency services levies, designed to cover the risk of those who may not be fully insured, especially in cases of natural catastrophe. Mitigation is discussed in more detail in chapter 5.

What is general insurance?

1.13 General insurance is broadly defined as insurance policies that provide cover for events that cause financial losses, property damage or personal injury. It does not include life or health insurance. Home building and contents and motor vehicle insurance are some of the most common forms of general insurance, with these classes

5 Allianz, *Submission 4*, pp. 2–3.

6 Allianz, *Submission 4*, p. 4.

accounting for over 40 per cent of the industry's gross earned premium (GEP)⁷ for the year ending 30 September 2016.⁸

1.14 General insurance products may be purchased either directly from an insurer or through an intermediary, such as an insurance broker, financial institution or online comparator.⁹ In Australia, most general insurance is sold directly to consumers by insurance companies.¹⁰

1.15 General insurance products, such as home and motor insurance, are types of 'short tail' insurance, referring to policies where the premiums received and related claims are generally paid within the same 12 month period.¹¹

Home insurance

1.16 Home insurance provides cover for financial losses resulting from damage to an individual's house or personal household belongings. Consumers can choose to take out home building cover, home contents cover, or both. Home insurance generally provides cover for damage caused by weather events, vandalism and theft, water damage, accidental damage and essential temporary repairs.¹²

Motor insurance

1.17 Motor insurance provides cover for financial losses resulting from damage to a motor vehicle, and related legal liability. There are varying levels of motor insurance cover available to consumers. The highest level of motor cover is comprehensive insurance, which typically includes accidental damage, fire and theft, as well as damage caused to another person's vehicle or property. Alternatively, a consumer can choose to take out third party insurance. This lower cost form of motor insurance covers damage caused to another person's vehicle or property, but not the policyholder's vehicle.¹³

Strata insurance

1.18 Strata insurance, also sometimes known as body corporate cover, provides cover for common property which is under the management of a strata title or body corporate entity, such as residential apartment buildings or multi-unit townhouses. Typically, strata insurance covers common or shared property, such as the building

7 Gross earned premium (GEP) is the total premium on insurance earned by an insurer or reinsurer during a specified period on premiums underwritten.

8 Professor Allan Fels AO and Professor David Cousins AM, *Submission 23*, p. 5.

9 QBE, *Submission 16*, p. 2.

10 Mr Timothy Wedlock, President, National Insurance Brokers Association, *Proof Committee Hansard*, 12 April 2017, p. 9.

11 Allianz, *Submission 4*, p. 3.

12 QBE, *Submission 16*, p. 18.

13 QBE, *Submission 16*, p. 18.

structure, lifts, car parks, pools and gardens. It also provides public liability cover in the event that a person is injured on common property.¹⁴

1.19 Strata insurance is a statutory product mandated by each state and territory's relevant strata legislation. Strata managers or body corporates generally negotiate strata cover through an insurance broker or specialist underwriting agency.

1.20 Unlike home and motor insurance, strata insurance is a specialist commercial insurance product and premiums are tailored to the needs of each strata property. Owners of strata titles typically share the premium costs of strata insurance as part of their strata fees and liabilities.

General insurance pricing

Risk rating

1.21 An insurance premium is the amount of money that an individual or business pays for an insurance policy for a set timeframe. Premiums for general insurance policies are set using a 'risk rating' approach. That is, higher risk policyholders, such as younger drivers or those living in flood or cyclone-prone regions, are charged a higher premium than lower risk policyholders. In other words, policyholders are charged a premium that reflects, and is commensurate with, their assessed level of risk.¹⁵ This pricing approach can result in apparently similar people, even those living on the same suburban street, having very different assessed levels of risk, and consequently, very different insurance premiums.

1.22 When an individual or business applies for a general insurance quote, insurers collect information in order to assess the applicant's level of risk. For example, for home insurance policies, insurers will seek information regarding where a property is located, the size of the property, and what materials it is built from. Likewise, when assessing an individual's risk for comprehensive motor insurance, an insurer will ask an applicant about the model and age of the vehicle, as well as the age and driving history of the drivers.¹⁶

Components of a premium

1.23 For insurance to be sustainable and adequately meet its claims liabilities, insurers must collect enough shared premium from policyholders to cover the cost of claims, internal expenses, acquisition costs (including commissions to intermediaries), reinsurance, profit margins, taxes, levies and stamp duty.¹⁷ The most significant component of an insurance premium for home, strata and motor classes is claims costs.¹⁸

14 QBE, *Submission 16*, p. 18.

15 Allianz, *Submission 4*, p. 6.

16 QBE, *Submission 16*, p. 3.

17 QBE, *Submission 16*, p. 3.

18 QBE, *Submission 16*, p. 5.

Relevant reviews and inquiries

1.24 There have been a range of government and industry reviews carried out in recent years that are of relevance to this inquiry.

1.25 The Financial System Inquiry (FSI) brought renewed attention to the efficacy of disclosure practices in the general insurance industry, finding that while disclosure 'plays an important part in establishing the contract between issuers and consumers', mandated disclosure, in itself, 'is not sufficient to allow consumers to make informed financial decisions'.¹⁹ The FSI also found that 'although general insurance has a specific product disclosure regime, the industry lacks standard practice in describing a policy's key features and exclusions'.²⁰

1.26 The Productivity Commission's inquiry into National Disaster Funding also highlighted the importance of effective information disclosure for insurance, noting that 'consumers may not make efficient choices with respect to insurance in the absence of relevant and understandable information'.²¹ The inquiry report also noted the implications that a lack of consumer understanding about their personal risk and insurance coverage can have with regard to underinsurance or non-insurance.²²

1.27 In 2015, responding to concerns raised during the FSI that the existing product disclosure regime was not optimising consumer outcomes, the Insurance Council of Australia (ICA) established the Effective Disclosure Taskforce (the Taskforce). The purpose of the Taskforce was to investigate and develop initiatives for improvement with regard to product disclosure for general insurance.

1.28 The Taskforce concluded that 'a major shortcoming in the disclosure regime to date has been its sole focus on information provision without the necessary regard for the consumer's ability to make use of that information'.²³ Commenting on the regulatory trends in product disclosure in recent years, the Taskforce also acknowledged the shift towards an onus being placed on the industry for selling insurance products suitable to consumers' needs. Specifically, the Taskforce noted that 'product issuers should not only be obliged to make the prescribed disclosures, but should have greater responsibility for consumer understanding and decision making'.²⁴

19 Financial System Inquiry, *Final Report*, November 2014, p. 193.

20 Financial System Inquiry, *Final Report*, November 2014, p. 229.

21 Productivity Commission, *Natural Disaster Funding Arrangements*, Vol. 2, December 2014, p. 434.

22 Productivity Commission, *Natural Disaster Funding Arrangements*, Vol. 2, December 2014, p. 434.

23 Effective Disclosure Taskforce, *Too Long; Didn't Read: Enhancing General Insurance Disclosure*, October 2015, p. 3.

24 Effective Disclosure Taskforce, *Too Long; Didn't Read: Enhancing General Insurance Disclosure*, October 2015, pp. 14–15.

1.29 With the endorsement of the Insurance Council's Board, the ICA is currently undertaking a two-year work program in order to implement the 16 recommendations made by the Taskforce. The program is due to be completed by the end of 2017.²⁵

Purpose of inquiry

1.30 The current inquiry is interested in reviewing competition and transparency in the home, strata and car insurance markets in Australia. In particular, the inquiry examines how these broader objectives are performing in relation to product disclosure and comparability, and how these aspects of insurance could be improved to maximise consumer outcomes and ensure that Australians are getting a fair go when it comes to insurance.

Structure of report

1.31 This report comprises five chapters, including this introductory chapter:

- Chapter 2 provides an overview of the general insurance industry in Australia, including its regulatory framework, premium trends, and views on competition in the market.
- Chapter 3 focuses on the transparency of the current product disclosure regime for general insurance and examines potential areas for regulatory reform.
- Chapter 4 looks at the costs and benefits associated with the establishment of an independent insurance comparison service in Australia.
- Chapter 5 discusses other matters raised during the course of the inquiry.

25 Insurance Council of Australia, *Submission 13*, p. 23.

