

INSURING AGAINST DISASTERS: MINIMISING PERVERSE INCENTIVES AND PROMOTING MITIGATION



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ENCOURAGING INSURERS TO SHARE AND COMMUNICATE BUSHFIRE RISK WITH POLICY HOLDERS.

THE PROBLEM

Home and contents insurance involves the homeowner entering into an insurance contract with an insurer. In the event of disaster, the insurer covers the economic losses suffered by the homeowner.

A home owner may be reluctant to invest in risk mitigation when the economic costs of household loss have been shifted to the insurer.

Alternatively, if a home owner does reduce the risk of loss by undertaking precautionary mitigation measures, there is potential for an insurer to benefit substantially in the form of savings made on claim payments, and to profit from the homeowner's risk averse nature and their willingness to invest in risk mitigation.

This research, conducted as part of the BNHCRC Policies, Institutions and Governance of Natural Hazards project, offers solutions to reduce perverse incentives that currently prevent greater mitigation by householders and to encourage insurers to take a more active role in communicating risk and encouraging risk mitigation.

SIGNIFICANCE

This project:

- ▶ Proposes a more equitable system of insurance that improves upon the status quo whilst remaining compliant with legal requirements; and
- ▶ Identifies how to provide incentives for increasing individual homeowner mitigation measures.

END USER STATEMENT

"Sufficient insurance is a significant factor in community resilience when disaster strikes. Creating incentives that encourage property owners in high bushfire risk areas to take out enough insurance helps build that resilience. Just as important to insurers, the insured and the broader community should be complementary incentives to actively mitigate the risk of loss. This research points to a way forward." John Schauble, Lead End User.

FINDINGS

The best way for insurers to encourage mitigation and communicate risk is via a price signal in the homeowner's insurance premium. Lowered risk *should* lead to lowered premiums but insurance companies are unwilling to make individual assessments of risk.

Fire risk is minimal from the insurer's perspective. Fire has accounted for only 8 per cent of total losses when normalised to 2011-dollar values. The insurance sector easily absorbs such minimal losses. Other natural hazards – flood, cyclone and hail – are much more costly and are considered in finer detail by Australian insurers.

Simply put, it is impractical for insurers to risk-rate individual properties according to fire or other risk alone. Today, fire risk is insured under a standard homeowner's contract along with burglary, theft and other causes of loss.

RECOMMENDATIONS

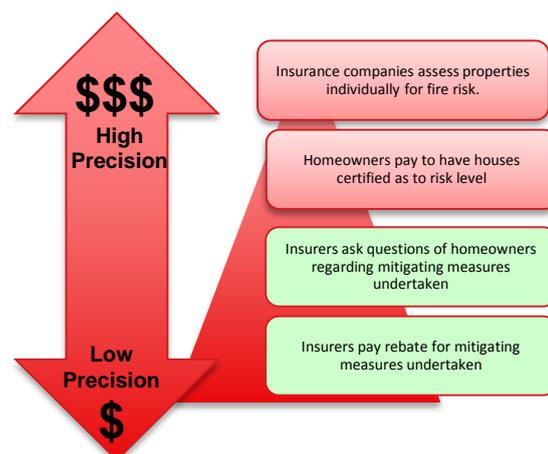
This research identified 4 potential solutions to communicate risk, encourage mitigation and therefore lower risk and price.

Options

1. Individually survey each home to assess risk and calculate a tailored premium along with an estimated premium if mitigation measures were undertaken.
2. Require homeowners to submit a certificate completed by a certifying authority that identifies the state of the property and the fire mitigation measures in place. Similar to annual motor vehicle registration checks this would give insurers detailed personal knowledge of each risk but the cost of the inspection is borne by the insured, not the insurer.

3. Require insurers to ask the insured a series of questions regarding any mitigation measures that may already have been undertaken by the insured. Insurers also provide an estimate for revised premiums if mitigation measures are implemented
4. Similar to health insurance, require insurers to provide discounts, refunds or rebates for any relevant fire risk mitigation measures the policyholder may wish to undertake

There is a direct relation between cost and precision. Option 1 would be the most precise but also the most costly; option 4 is the cheapest but is the least precise.



CONCLUSION

The 2 solutions in the red boxes, above, provide ideal outcomes - the price signal conveyed is strong due to high levels of accuracy in risk assessment – but they are financially onerous.

The solutions in the green boxes sacrifice accuracy and the signals conveyed are weaker, but these solutions still improve on the current model in creating incentives for risk mitigation.

