2 July 2024

Senator Mehreen Faruqi
Chair
Select Committee on the Impact of Climate Risk on Insurance Premiums and Availability
By email: climaterisk.insurance.sen@aph.gov.au

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Dear Chair,

Inquiry into the Impact of Climate Risk on Insurance Premiums and Availability

APRA welcomes the invitation of the Select Committee on the Impact of Climate Risk on Insurance Premiums and Availability to make a submission to this Inquiry.

There is clear evidence of the importance of the general insurance industry in the fact that last financial year, APRA-regulated general insurers paid out over $44 billion in claims to their policyholders, almost $9 billion of which was paid to those with household insurance cover.[1] In line with APRA's requirements, insurers remain well capitalised, which should provide Australians with confidence that policies can be relied upon for insured risks.

Given the central role that insurance plays for the Australian community and Australia's economy, APRA has a role to play in ensuring not only that insurers remain financially sound but also that they can continue to offer insurance protection widely to Australian households and businesses.

However, as the Committee will be aware, affordability and availability challenges in obtaining household insurance have accelerated recently. Increasing costs of claims associated with natural disasters, changed reinsurance appetite settings for natural disasters in Australia, together with supply chain disruptions and skills shortages adding to inflation in reconstruction costs, are all factors that have contributed to rising premiums. These premium increases are leading to the emergence of a widening insurance gap where people are either deciding to underinsure, or to not take out insurance at all.

There is no easy solution to these challenges. The drivers of premium increases are complex and potential solutions are multi-faceted, requiring a collaborative approach across industry, regulators, all levels of government, and consumers.

APRA's role

APRA's role is to ensure that Australians' financial interests are protected by establishing and enforcing prudential standards and practices designed to ensure that under all reasonable circumstances, financial promises made by insurers – to pay valid policyholder claims – are met within a stable, efficient, and competitive financial system. APRA's prudential standards for general insurers fall within three core categories: capital, governance, and risk management, which includes general risk management and operational resilience.

However, APRA's role does not extend to setting prices or premium levels – these remain commercial decisions for insurers. To remain prudentially sound, insurers would ordinarily set premiums that accurately reflect risk, recoup costs over time, and ensure they are able to access sufficient reinsurance protection.

APRA also does not determine the investment or underwriting decisions of insurers, nor does APRA specify "net zero" or other specific emissions targets for the entities that we regulate. Rather, our role is to ensure that decisions made by entities are well-considered, and to encourage actions that increase the prudential strength of entities in the face of emerging risks whatever form those risks may take.

A key role that APRA plays is to collect data from insurers and provide stakeholders with transparency over key trends. **Annex 1** provides insights into **home insurance** over the past decade, including that:

[1] Source: APRA quarterly general insurance performance statistics.

- there has been a general upward trend in the volume and cost of claims paid by insurers, due to increases in claims following natural catastrophes;
- rising reinsurance expenses are also contributing to premium increases, particularly more recently, albeit to a lesser degree than claims;
- insurers' gross written premiums (GWP) have trended higher over time; and
- despite rising GWP, home insurance remains unprofitable for insurers at an industry level.

In addition to data collection, our supervisory activity also provides the opportunity for APRA to influence insurers to consider how their action or inaction contributes to the widening insurance protection gap, and importantly what more they can do as a result. We support actions insurers take to provide education, research and guides on resilience actions to minimise potential losses that individuals experience from events.

APRA is also a member of the International Association of Insurance Supervisors (IAIS) task force on natural catastrophe insurance protection gaps[2], and APRA, alongside the Reserve Bank of Australia, is a member of the Network for the Greening of the Financial System (NGFS). The NGFS has recently established a Task Force on Adaptation, which is co-chaired by APRA, and includes consideration of the impact of climate change on insurance protection gaps.

APRA's approach to climate risk

APRA considers the financial risks associated with climate change through the lens of its potential impact on the safety and soundness of the financial system, particularly how it may impact the ability of financial promises to be met within a stable, efficient, and competitive financial system.[3]

APRA has a program of work underway to understand how boards and regulated entities consider the different risks arising from potential changes in the climate, such as the physical and transition risks that arise from climate change. As part of this program, APRA has:

- initiated a voluntary Climate Risk Self-Assessment Survey against *Prudential Practice Guide CPG 229 Climate Change Financial Risks*;
- completed a Banking Climate Vulnerability Assessment (2022), which assessed Australia's five largest banks under different future climate scenarios, improving understanding of physical and transitional climate risks primarily affecting mortgage portfolios and select aspects of agricultural and corporate lending activities; and
- commenced an Insurance Climate Vulnerability Assessment, which will explore how household insurance affordability could change over the medium term (to 2050).

The Insurance Climate Vulnerability Assessment, which APRA is currently conducting on behalf of the CFR, brings together regulators, the Insurance Council of Australia, and the five largest general insurers in Australia to gain a better understanding of how affordability may change into the future under two climate scenarios. Insights garnered from this initiative will be relevant for insurers, the broader financial sector, policymakers and the Australian community in responding to the challenges of general insurance affordability.

Next steps

On 31 January 2024, APRA released an interim update on APRA's supervision and policy priorities to bridge to the 2024-25 Corporate Plan, which is due by the end of August 2024. While the interim update covers a short time horizon, it reinforces APRA's continued focus on how insurers achieve an appropriate balance between their financial health to be able to pay policyholders claims and enable access to affordable and well-designed insurance.

More generally, APRA recognises that improving affordability and access is a complex issue that will require sustained action by all levels of Governments, industry and regulators. For example, this could include mitigating

[2] See IAIS press release "IAIS outlines actions for insurance supervisors in addressing natural catastrophe protection gaps" (https://www.iaisweb.org/2023/11/iais-outlines-actions-for-insurance-supervisors-in-addressing-natural-catastrophe-protection-gaps/)

[3] APRA's Statement of Expectations has been updated to include that APRA "promote prudent practices and transparency in relation to climate-related financial risks and the adoption of climate reporting standards by regulated entities". Climate risk is one of APRA's four key challenges in its 2023-24 corporate plan.

initiatives, such as, building flood levees or making buildings more fire and storm resistant, as well as avoiding future risk by avoiding development in higher risk areas.

APRA is also working with insurers, government, and peer regulators on ways address risk and affordability, including through programs such as the Hazards Insurance Partnership. However, we understand that the impact of many mitigation activities will take time to flow through to premium benefits to consumers. Consumers will also benefit from increased insurer transparency, especially regarding the drivers of premium changes and individual property adaptation activities.

Yours sincerely

Sean Carmody

Executive Director, Insurance

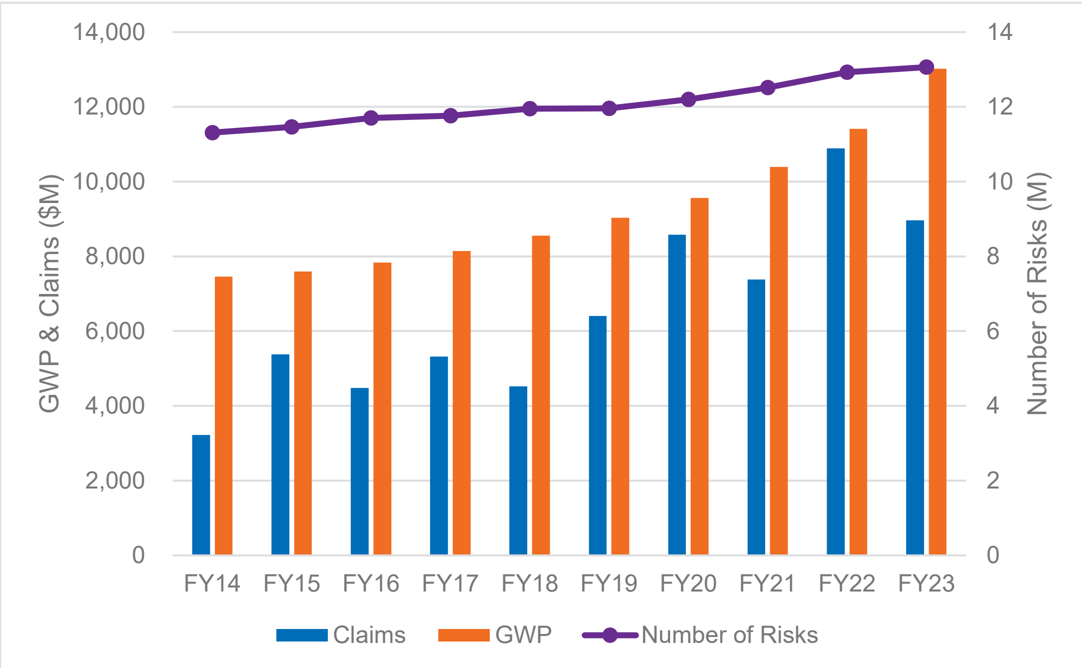
Annex 1 – Key home insurance insights from APRA data

Figure 1 shows aggregate data for all insurers' "written risks", claims and premiums for home insurance over the past decade.

- The purple line shows the number of written risks, which can be broadly characterised as the total number of homes insured.[4] As expected, the number of homes insured naturally increases alongside population growth.
- The blue bars show total claims, which have been trending upward at a much faster rate than written risks. While there is natural volatility in claims year to year, there has been a general upward trend in the overall volume and cost of claims. Reasons for this include:
  - an increase in claim volumes related to natural catastrophe events, particularly floods, and an increased number of households now under threat from catastrophe events that were not at risk in the past; and
  - an increase in the cost of claims, particularly due to sustained inflation in the construction and resources sectors.
- The orange bars show the aggregate of all insurers' gross written premiums (GWP), which measures the total value of premiums collected by an insurance company. GWP has similarly been increasing over time as insurers have increased premiums to continue to be able pay claims. Despite rising GWP, home insurance remains unprofitable for insurers at an industry level (see Figure 3 for more detail).

Figure 1: Aggregate Insurers' Written Risks, Claims and Gross Written Premiums (GWP) – Home Insurance

Source: APRA quarterly general insurance statistics



[4] Insurers' number of risks also include non-housing stock covered by a home policy e.g. a garden shed.

Figure 2 shows a comparison of home insurance policy components, being GWP, claims, underwriting expenses and reinsurance expenses. Underwriting expenses are costs related to writing a policy (e.g. staff and administrative costs) and reinsurance expenses are incurred when insurers take out reinsurance contracts to protect against large losses. Figure 2 reveals the higher growth rate in claims and GWP relative to both underwriting and reinsurance expenses. Reinsurance expenses have seen a step up over recent years and so have contributed to more recent premium increases.

Figure 2 – Aggregate Insurers' Policy Components – Home Insurance

Source: APRA quarterly general insurance statistics

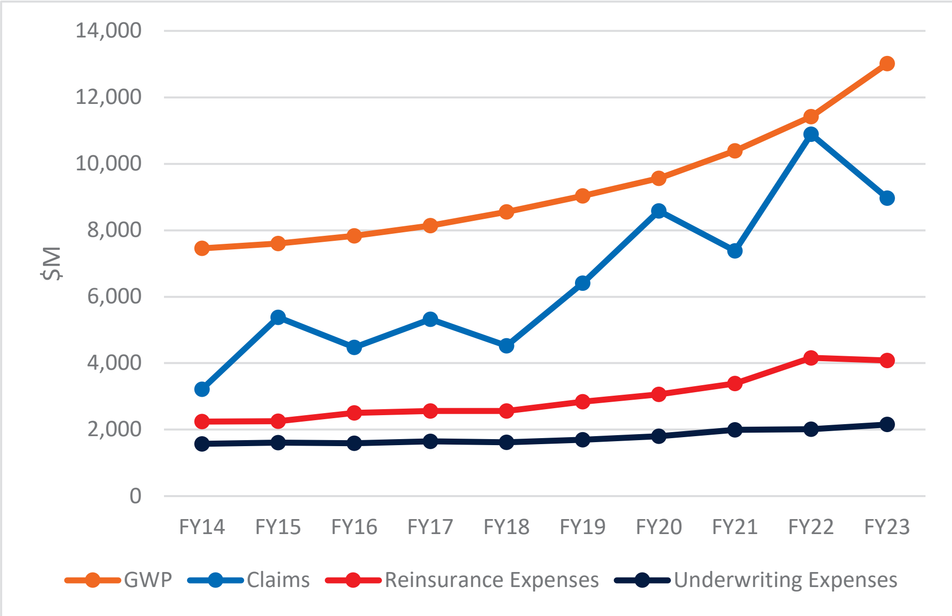


Figure 3 sets out the average Combined Operating Ratio (COR) for all insurers' home insurance business over the past decade. The COR is a key metric that measures an insurance company's underwriting profitability by comparing its incurred losses and expenses to its earned premiums. A COR below 100% indicates underwriting profitability, while a COR above 100% indicates underwriting losses. The figure shows that, despite rising GWP, home insurance has been unprofitable for insurers at an industry level for several years.

Figure 3 – Average Insurers' Combined Operating Ratio – Home Insurance

Source: APRA quarterly general insurance statistics