



Australian Government

Australian Government Actuary

**SECOND REPORT ON STRATA TITLE INSURANCE
PRICE RISES IN NORTH QUEENSLAND**

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1 Introduction

Background

- 1.1 On 3 October 2012 I reported on the results of an investigation into the causes of premium increases for residential strata title insurance in North Queensland (NQ). Cumulative premium increases of several hundred per cent had been observed over the years leading up to 2012.
- 1.2 In that report I concluded that a number of inter-related factors and a convergence of events led to the premium outcomes that had been observed. Those factors included:
- historical under-pricing;
 - the cost of reinsurance; and
 - recent losses caused by natural disasters and the associated accumulation of risk in NQ.
- 1.3 I also found that while there was only limited commercial competition in the NQ strata insurance market, it was not clear that this had resulted in prices which were unreasonably high when assessed against the underlying risk.

Expanded study

- 1.4 In December 2013 the Government asked me to conduct an expanded study into strata insurance pricing in NQ.
- 1.5 This expanded study is intended to put the NQ experience into a broader context. Specifically, I have been asked to:
- consider the causes of premium increases in NQ, taking into account an 8 year timeframe beginning in 2005-06 (the earlier study had considered a 6 year timeframe commencing in 2006-07); and to
 - compare strata insurance pricing across Northern Australia and other east coast centres and consider the reasonableness of any significant variation in pricing across geographic areas.
- 1.6 This report sets out the results of my investigation.

Brief summary of main findings

Causes of premium increases in NQ

- 1.7 This current study has confirmed my earlier findings that the steep premium increases experienced in NQ, particularly over the few years leading up to 2011-12, were a result of:
- historical under-pricing;

- increases in the cost of reinsurance and a shift towards a more risk-based allocation of the cost of reinsurance; and
- losses caused by a number of natural disasters which highlighted both the extent of the under-pricing issue and the challenges associated with an accumulation of risk that a strata insurance portfolio in a weather-exposed region entails.

1.8 The inclusion of 2005-06 in the investigation period for this expanded study meant that the claims experience associated with Cyclone Larry was captured in the data. This additional experience provided further evidence that historical premium rates were simply too low for the risk that was being carried. As well, one NQ insurer was able to provide more complete NQ experience data for this investigation than for the 2012 investigation. This additional data again highlighted the accumulation risk associated with a residential strata portfolio in a weather-exposed region.

Comparison of prices across Northern Australia and other centres

- 1.9 I have found that prices being charged in east coast centres (Brisbane/Gold Coast, Sydney, Melbourne and Adelaide) are much lower than NQ prices.
- 1.10 According to the data provided to me, premium rates in these other east coast centres in 2012-13 were, on average, around 20 per cent of NQ premium rates.
- 1.11 The volume of residential strata business in Darwin is smaller than in NQ and so some care is needed in interpreting the data. Nonetheless, prices being charged in Darwin appear to be significantly lower than in NQ (on average, around 40 per cent of NQ rates).
- 1.12 A very limited volume of pricing data was provided in relation to north-west Western Australia. This data suggested that prices being charged in that region are broadly comparable with those being charged in NQ.

Reasonableness of price variations between NQ and other east coast centres (Brisbane/Gold Coast, Sydney, Melbourne and Adelaide)

- 1.13 Claims costs in NQ were both higher and more volatile than those in other east coast centres during the 8 year period of the investigation. These other centres are not exposed to cyclone risk in the same way as NQ. Thus, the actual claims experience data provides evidence of a substantial difference in insurance risk between NQ and these other east coast centres.
- 1.14 This difference explains most of the price variation but in my view there is a reasonable likelihood that a small part of the difference can be attributed to the presence of competitive pricing pressure in east coast centres and the absence of competitive pricing pressure in NQ.

Reasonableness of price variations between NQ and NT

- 1.15 The average claims cost experience for Darwin over the 8 year period of the investigation was less than 35 per cent of that for NQ. In comparison, according to the data provided, the average premium rate in Darwin in 2012-13 was about 40 per cent of the average NQ premium rate at the same time.
- 1.16 The cost of catastrophe reinsurance for exposure in Darwin appears to be significantly lower than the estimated cost for exposure in NQ. Although this sounds somewhat surprising it is consistent with catastrophe modelling output discussed with me by a major insurer.
- 1.17 The difference in premium rates between Darwin and NQ is therefore consistent with the differences in the observed claim cost experience and the estimated cost of catastrophe reinsurance.

Reading this report

- 1.18 The purpose of this report is not to make recommendations, rather to document the findings of an investigation.
- 1.19 This report is intended to be read in its entirety. In particular, it is not appropriate to draw or infer conclusions about the reasonableness of price variations between NQ and other regions without careful consideration of the whole document.
- 1.20 The analysis and results in this report are based on aggregating data from a number of participating insurers. They do not reflect the position of any individual insurer.
- 1.21 In general the charts in this report summarise data items relative to NQ. Thus NQ is shown with a (initial) value of 100 and other regions are shown relative to this. This approach has been taken to protect the commercially sensitive nature of the data provided.
- 1.22 Commentary on pricing in this report relates to residential strata title insurance only and does not relate to any other business segments written by these insurers.

Structure of this report

- 1.23 As noted above, the inclusion of 2005-06 in the investigation period meant that the claims cost associated with Cyclone Larry was included in the experience data. This simply reinforced the findings in my October 2012 report¹ regarding the causes of premium increases in NQ. Therefore there is no need in this current report to revisit that analysis.

¹ http://www.aga.gov.au/publications/Strata_Title_Insurance_Price_Rises/default.asp

1.24 Accordingly, this current report focuses on the comparison of prices in NQ with those in other east coast centres and an examination of the reasonableness of any price variations. It also looks at the variation between NQ prices and Darwin prices. This report is therefore structured as follows:

- **Approach:** brief description of the approach taken to undertake the investigation
- **Data:** brief description of the data sources for this investigation
- **Prices:** comparison of average premium rates in NQ with those in other east coast centres
- **Claims costs:** analysis of the relative claims experience in NQ and in the other east coast centres over the 8 year period of the investigation
- **Reinsurance:** consideration of the cost of catastrophe reinsurance
- **Commissions and other expenses:** consideration of the contribution of commissions and other expenses to the insurance premium
- **Capital:** consideration of the cost of capital
- **Expected technical price differential:** consolidates the earlier discussion to develop an expected difference between technical prices in NQ and those in other east coast centres.
- **Competition:** discussion of the role of competition in the pricing process
- **Darwin:** discussion of the Darwin experience
- **Conclusions**

2 Approach

2.1 The main focus of this current investigation is to consider the reasonableness of any significant price variations between NQ residential strata insurance prices and residential strata insurance prices elsewhere.

2.2 There is significant variation between NQ premium rates and premium rates in the main east coast centres (Brisbane/Gold Coast, Sydney, Melbourne and Adelaide). Accordingly, this report focuses on that variation.

2.3 To consider the reasonableness of price variations between NQ residential strata insurance prices and east coast residential strata insurance prices I have set out to examine the reasons for any differences in the (estimated) profitability of premium rates in these regions.

2.4 The approach that I have taken can be described as follows:

- Estimate the implied profitability in prevailing (2012-13) NQ premium rates. The implied profitability can also be described as the expected profitability. This will differ from the actual observed profit in any one year, particularly in a region like NQ where claim cost experience (and therefore profit) is volatile².
 - Estimate the premium rate needed in other east coast centres³ to deliver the same (estimated) implied profitability as prevailing NQ premium rates given the differing risk profiles. I have referred to this rate as the expected average east coast premium rate.
 - Then consider the reasons for any difference between the expected east coast average premium rate (that is, the rate that is estimated to deliver the same level of profitability as NQ rates) and the actual east coast average premium rate. This discussion, in effect, considers the reasons for any difference in the implied profitability in NQ rates and that in east coast rates.
- 2.5 In order to estimate the implied profitability in prevailing NQ premium rates it is necessary to estimate the composition of prevailing NQ premium rates.
- 2.6 For this current purpose, I have estimated the expected net cost of claims⁴, the cost of catastrophe reinsurance, the cost of commissions and the cost of other administrative expenses. Any remaining premium is then taken to represent implied profitability⁵. I have estimated the various premium components by having regard to the experience data provided by participating insurers for the investigation. Chapters 5 to 7 discuss the experience data provided (covering claims costs, reinsurance costs, commissions and expenses).
- 2.7 Chapter 8 discusses the issue of a reasonable target profit margin for residential strata business.
- 2.8 Chapter 9 then sets out the results of the calculations. It finds that, although there is a significant difference between NQ premium rates and east coast premium rates, most of this difference can be reasonably explained by the historical experience data. However, in my judgement, it is reasonably likely that competition issues also play a subordinate role and this is considered in chapter 10.

² Claims cost volatility is a feature of insurance in a weather-exposed region

³ Brisbane/Gold Coast, Sydney, Melbourne, Adelaide

⁴ The cost of claims after any recoveries from catastrophe reinsurance

⁵ I have not considered other reinsurances apart from catastrophe reinsurance. This means that my estimate of implied profitability is likely to be overstated, all else equal. However, this effect is offset to an extent because, for simplicity, I have not allowed for investment earnings.

- 2.9 Finally chapter 11 looks at Darwin premium rates in a similar way, although the volume of experience data is smaller than in either NQ or the other east coast centres and so the analysis is at a higher level.

3 Data

- 3.1 For the purpose of this report, NQ is taken to include the Marlborough region along with areas in and around Mackay, Proserpine, Townsville, Ingham and Cairns.
- 3.2 I sought historical data from six insurers: Territory Insurance Office, QBE, Allianz, CGU, Suncorp⁶ and Zurich.
- 3.3 The data provided by these insurers relates to residential strata title insurance business in NQ, Darwin, north-west WA, Brisbane/Gold Coast, Sydney, Melbourne, and Adelaide. The data covered the 8 financial years from 2005-06 to 2012-13.
- 3.4 Very little data was provided in relation to north-west Western Australia. The available data suggested that prices in that region are broadly comparable with those applying in NQ.
- 3.5 I have relied on the accuracy of the data provided, along with a number of discussions with the insurers. I carried out brief reasonableness checks on the data and believe the data to be suitable for the current purpose. However, I was not in a position to independently audit the data.
- 3.6 The data provided for this investigation differed somewhat from the data provided for the 2012 investigation. One insurer was able to provide more comprehensive data for this current investigation than for the earlier investigation. Nonetheless, as noted above, the new data did not contradict my earlier findings.
- 3.7 I acknowledge the efforts of the insurers in providing me with the data and responding to my subsequent questions.

4 Prices

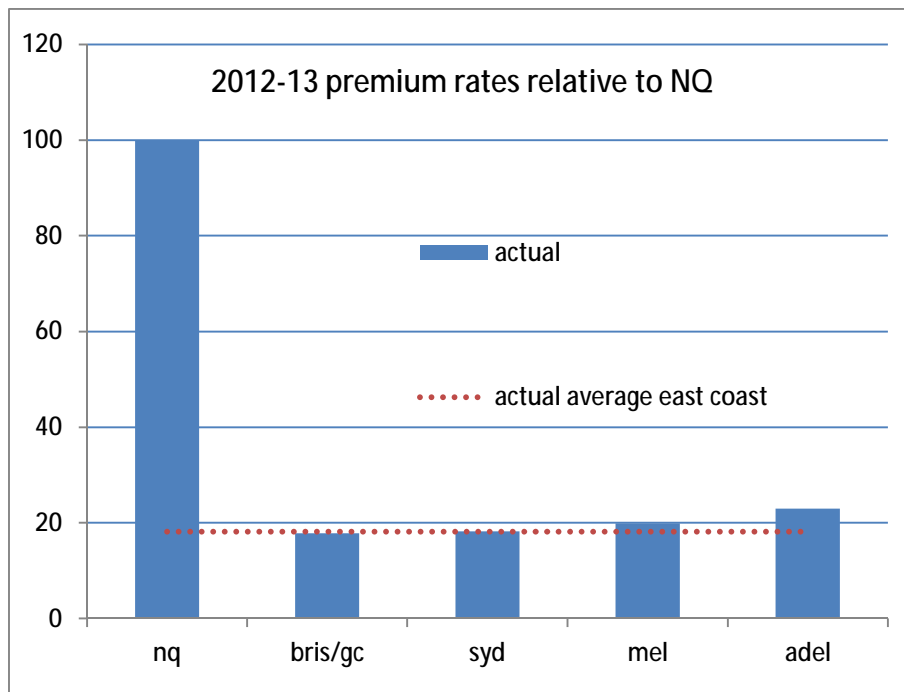
- 4.1 The chart below compares the average NQ premium rate⁷ in 2012-13 with the average premium rates in other east coast centres at the same time⁸.

⁶ Including data for Longitude, underwritten by Vero

⁷ Premium rate refers to premium charged per \$'000 Sum Insured. The premium rate is for property damage only and excludes any taxes and charges.

⁸ The vertical axis is simply an index, to protect the commercial sensitivity of the underlying data. All charts in this report are structured similarly, with an initial value for NQ of 100 and other values shown relative to this.

- 4.2 Individual insurance policies (and, indeed, individual insurers) would be expected to have different premium rates from this average. Some policies (and insurers) would have higher premium rates than the average and some would have lower premium rates than the average depending, for example, on insurer assessments of risk.
- 4.3 The averages shown here are weighted averages⁹ of the premium rates implied within the insurer data provided for the investigation.
- 4.4 This chart shows that the average 2012-13 premium rate in the east coast centres (red dotted line) was less than 20 per cent of the average prevailing premium rate in NQ.
- 4.5 The chart also shows that premium rates in the other centres were reasonably similar although Adelaide rates were, on average, higher than other rates.



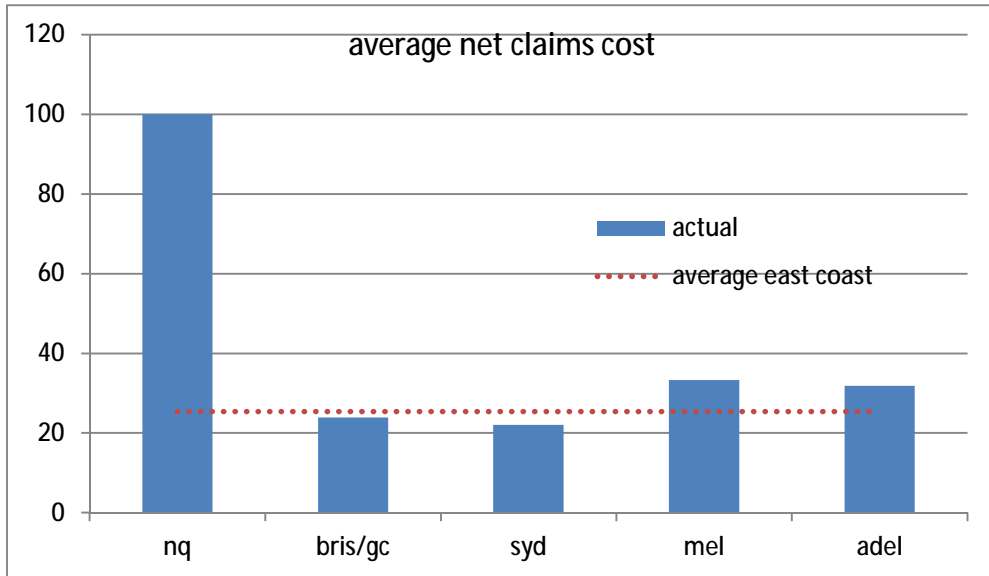
- 4.6 Although it is clear that east coast rates are considerably lower than NQ rates, this chart needs to be interpreted carefully. For example, it would not be correct to conclude that the premium for a residential strata complex in an east coast centre would be around 20 per cent of the premium for an identical residential strata complex in NQ. Premium rate refers to premium per \$'000 Sum Insured. Average sums insured in east coast centres are higher than average NQ sums insured. Premium rate is expected to decrease as sum insured increases, all else equal. As a result, even if the underlying risk was the same, average NQ premium rates would be somewhat higher than average east coast premium rates, all else equal.

⁹ Weighted by the aggregate exposure of individual insurers in each region

5 Claims costs

5.1 A major driver of premium rates is the expected claims cost. Premiums must be sufficient to cover claims costs, reinsurance costs, expenses and provide a reasonable return on capital. Higher expected claims cost means higher premiums, all else equal.

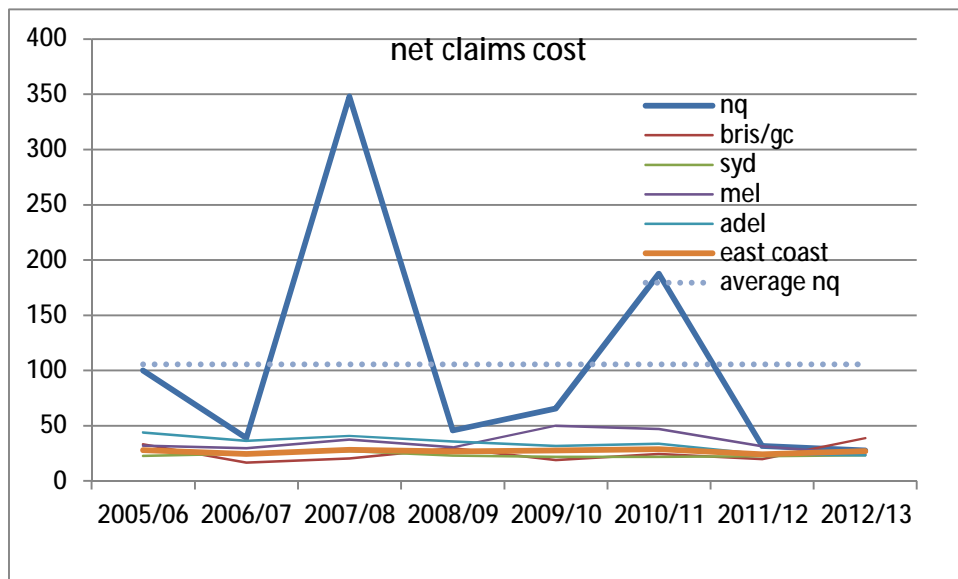
5.2 The chart below compares average net claims cost¹⁰ for NQ over the 8 year period of the investigation with each of the other east coast centres.



5.3 On average over the 8 year period of the investigation, net claims costs per \$'000 Sum Insured in east coast centres were about 25 per cent of those in NQ.

5.4 The chart below compares the net claims cost trajectory over the investigation period in NQ with the other centres.

¹⁰ Net claims cost refers to total property damage claims cost per \$'000 Sum Insured less any recoveries from catastrophe reinsurance (but not any other reinsurance recoveries).



5.5 This chart shows that net claims costs were significantly more volatile in NQ than in the other centres.

5.6 The impact of the Mackay storms in 2008 is noteworthy. When all insured losses are considered (that is, combining strata losses with losses on other business lines – eg home buildings and commercial property), this event resulted in lower total claims costs than either Cyclone Larry in 2006 or Cyclone Yasi in 2011. However, the Mackay storms had a disproportionate impact on participating insurers’ residential strata portfolios. This highlights the significant accumulation risk that goes with residential strata business in a weather-prone region.

5.7 In summary, claims costs in NQ have been both higher and more volatile than in the other east coast centres.

5.8 Both higher expected average claims cost and higher claims cost volatility¹¹ would be expected to result in higher premiums, all else equal.

6 Catastrophe reinsurance

6.1 Insurers purchase reinsurance to transfer some of the risk from their balance sheet. Without reinsurance, an insurer would be exposed to the risk of very large losses arising from a single catastrophic event. In Australia, the major events that need to be considered include cyclone in NQ, earthquake in some capital cities and hail, for example, in Sydney, Brisbane and Melbourne.

6.2 Property insurers typically purchase what is known as catastrophe reinsurance. This type of reinsurance responds when a single catastrophic event leads to losses of a

¹¹ Claims cost volatility has economic value which will be reflected in premiums.

specified amount for the insurer. The specified amount is called the attachment point. For example, an insurer might carry catastrophe reinsurance with an attachment point of \$50m. This means that any single catastrophic event which led to claims against the insurer of less than \$50m would not be covered at all by the catastrophe reinsurance. However, if claims against the insurer from a single catastrophic event exceeded \$50m, then catastrophe reinsurance would cover the excess claims cost over and above \$50m.¹²

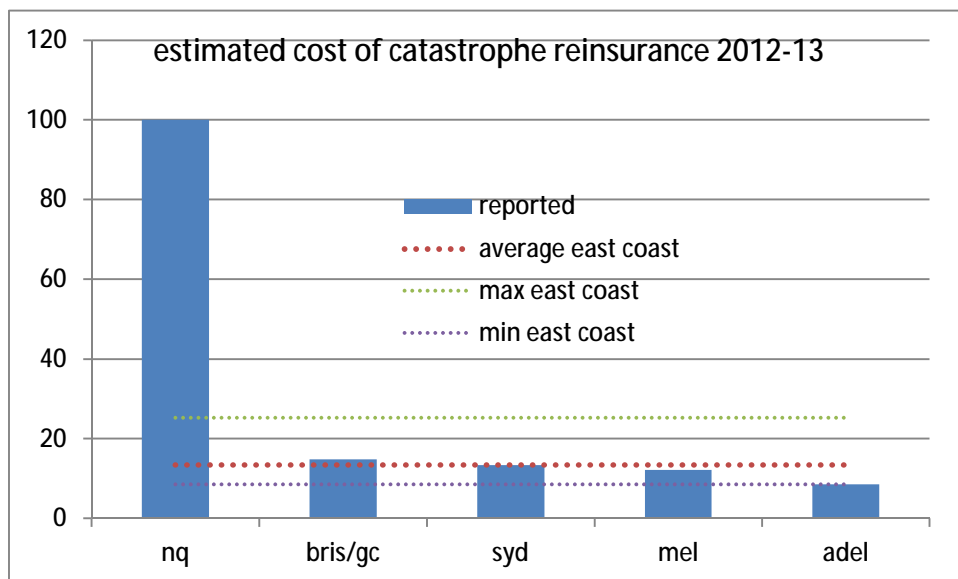
- 6.3 Catastrophe reinsurance policies are typically purchased in respect of an insurer's entire property portfolio. That is, there will usually not be separate catastrophe reinsurance policies for separate blocks of property business. Rather there will usually be one policy covering the whole property portfolio. It is important to note that strata title insurance in NQ is likely to represent only a small percentage of an insurer's portfolio. An insurer's catastrophe reinsurance policy would therefore provide protection for far more of its business than just its NQ strata title business.
- 6.4 The cost of the catastrophe reinsurance cover needs to be passed on to policyholders. In other words, each policyholder's premium must include an allowance for an equitable share of the cost of catastrophe reinsurance.
- 6.5 There is no single correct way for an insurer to determine the share of the catastrophe reinsurance premium that is to be allocated to individual policies. In recent years, this process has been informed by catastrophe modelling. The level of sophistication of this modelling is improving, allowing more granular estimation of risk. As a result, catastrophe reinsurance costs are now increasingly allocated in line with the assessed risk presented by the underlying policy. Having said that, catastrophe modelling remains an inexact science.
- 6.6 Under a risk-based cost allocation methodology, the cost of catastrophe reinsurance that is to be allocated to a particular policy will depend on the extent to which that policy is expected to 'benefit' from the catastrophe reinsurance protection. This, in turn, will depend on:
- The insurer's exposure in the relevant region. More exposure to a particular region increases the likelihood that a catastrophic event in that region will trigger the catastrophe reinsurance, all else equal.
 - The frequency of catastrophic events in the relevant region.
 - The potential scale of losses from a catastrophic event in the region.
- 6.7 These factors interact in a somewhat complex way. Further, the frequency and scale of catastrophic events can only be estimated within a fairly wide band of uncertainty. Nonetheless, the significantly higher frequency of cyclone in NQ

¹² Up to the limit of the catastrophe reinsurance policy

compared with the frequency of, say, earthquake in the capital cities means that the cost of the catastrophe reinsurance cover is likely to be skewed substantially towards NQ if an insurer has exposure in NQ. In other words, an additional dollar of exposure in NQ is likely to result in significantly more catastrophe reinsurance premium than an additional dollar of exposure in, say, Sydney.

6.8 Reflecting the imprecise nature of catastrophe reinsurance cost allocation, there was variation (in the data provided for the investigation) between insurers in respect of the estimated cost of catastrophe reinsurance, particularly in the east coast centres. Perhaps somewhat surprisingly there was closer agreement among participating insurers on the estimated cost of catastrophe reinsurance in NQ.

6.9 The chart below summarises the insurer data provided to me. It compares the estimated average cost of catastrophe reinsurance per \$'000 Sum Insured for NQ in 2012-13 with that in the other east coast centres. The red dotted line shows the weighted average estimated cost across all east coast centres. Because of the variation among insurers in respect of the estimated cost of catastrophe reinsurance in east coast centres the chart also includes two further dotted lines in order to give an indication of the extent of the variation among participating insurers.



6.10 On a sum insured weighted basis, the estimated average cost of catastrophe insurance in east coast centres was only about 15 per cent of the corresponding cost in NQ although one insurer put it as high as 25 per cent.

6.11 The cost of catastrophe reinsurance is a material component of the strata insurance premium, accounting for perhaps 20 to 40 per cent of the underlying premium. Accordingly, if catastrophe reinsurance costs are allocated on a risk-weighted basis, the large difference in the estimated risk-weighted cost of catastrophe reinsurance between NQ and other east coast centres (as illustrated above) will lead to a significant difference in the underlying premium. As noted above, insurers are,

indeed, increasingly taking a more risk-weighted basis to the allocation of reinsurance costs.

7 Commissions and other expenses

- 7.1 According to the data provided to me for this investigation, commissions paid in respect of many NQ policies are now around or less than half those being paid on other east coast policies, when expressed as a percentage of premiums. This is likely to be related to the large difference in average premium rates described earlier. Having said that, there was substantial variation within the data.
- 7.2 For the purpose of the analysis in this paper, I have assumed an underlying commission rate in NQ of 9 per cent of premium. While this is based on the experience data provided for the investigation, I have chosen an assumption close to the low end of the range contained within the data provided. My commission rate assumption for NQ is intended to err on the low side, if anything. A low assumed commission rate will yield a higher estimate of implied profitability, all else equal.
- 7.3 I have further assumed an underlying commission rate of 18 per cent of premium in the other east coast centres. While 18 per cent is somewhat lower than the average reported commission rates in those other east coast centres, this assumption is intended to be a realistic estimate of the underlying costs of commissions, taking into account the practices and distribution arrangements of participating insurers.
- 7.4 Administration expenses include back office, policy-related and claims handling expenses. Claims handling expenses are likely to be higher in NQ than elsewhere given the higher volume of claims.
- 7.5 For the purpose of the analysis in this report I have largely relied on the data provided by the insurers. I have assumed that for NQ an expense loading of 5 per cent of premium is reasonable and that for the other east coast centres an expense loading of 7 per cent of premium is reasonable. These assumptions, again, are based on analysis of the experience data provided for the investigation but are close to the low end of the range contained within the data provided.

8 Capital

- 8.1 Insurers are required to have access to capital to ensure that they are in a position to meet their claim obligations to policyholders. In effect, capital is required to support the risk that premiums collected in advance might not be enough to cover the cost of claims.
- 8.2 The experience in NQ shows that there is a material risk that premiums collected in a given year might not be sufficient to cover the cost of claims. Accordingly, capital is required to support that business. The more volatile the claims cost experience, the greater is the risk that capital will be called upon, all else equal. It is clear that the claims cost experience in NQ is likely to be more volatile than in other centres.

Further, insurers are required to hold enough capital to survive a large catastrophic event, after allowing for any recoveries from catastrophe reinsurance.

- 8.3 More generally, an insurer's capital will be allocated across its business lines. The capital to be allocated to an insurer's strata business will depend on the mix and location of the insurer's various business lines (including strata), the perils to which the business lines are exposed and reinsurance arrangements. It is possible that different insurers will have quite different capital requirements as a result of this. Similarly, it is possible that the capital to be allocated to residential strata will vary quite significantly from insurer to insurer.
- 8.4 Capital needs to be serviced.
- 8.5 A target profit margin of perhaps 10 to 20 per cent of premium for strata (before any allowance for investment earnings or reinsurance other than catastrophe reinsurance) is likely to provide a broad indication of the industry's approach for strata business. The reason that this range appears wide reflects the possibility of significantly different capital requirements for residential strata from one insurer to another in line with the discussion above.

9 Expected technical price differential

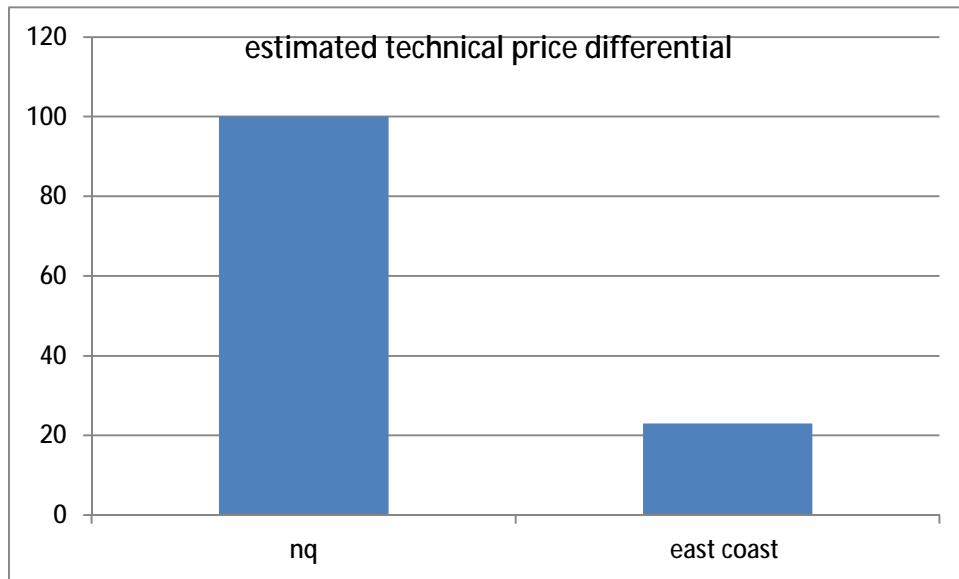
- 9.1 This section of the report consolidates the observations and analysis above and sets out to estimate a realistic expected price differential between NQ and other centres, taking into account the difference in risk between NQ and other east coast centres.
- 9.2 In line with the analysis above, the premium can be thought of as comprising amounts to cover net claims cost, the cost of catastrophe reinsurance, commissions, other expenses and a target return on capital.
- 9.3 As a first step, I have sought to estimate the implied profitability in prevailing NQ premium rates.
- 9.4 To do this, I have relied on the data provided for the investigation. Accordingly, I have assumed that the observed average net claims cost over the 8 year period of the investigation is a reasonable estimate of expected net claims cost for NQ. I have also assumed that the cost of catastrophe reinsurance can be estimated as the average (across participating insurers) estimated cost of catastrophe reinsurance in 2012-13. Finally I have assumed a commission rate of 9 per cent of premium and an expense rate of 5 per cent of premium.
- 9.5 When the assumptions set out above are taken in conjunction with the actual average NQ premium rate for 2012-13, an implied target profit margin of around 14

per cent of premium¹³ is derived (before any allowance for investment earnings). In other words, to the extent that the adopted assumptions are reasonable, the premium rate actually being charged in NQ in 2012-13 (averaged across all NQ policyholders) appears to be broadly in line with a realistic estimate of the sound average premium rate¹⁴.

- 9.6 It is important to understand, however, that the estimate of implied profitability obtained above unavoidably depends on the assumptions adopted. Different assumptions will yield different results.
- 9.7 By way of simple example, if the expected net claims cost for NQ is assumed to be 20 per cent less than the actual observed average net claims cost over the 8 year then (holding all other assumptions unchanged) the implied profitability in NQ premium rates increases from 14 per cent to 20 per cent. Similarly, if commission and expense rates are assumed to be 12 per cent and 7 per cent, then the estimated implied profitability decreases from 14 per cent to 9 per cent, all else equal.
- 9.8 This highlights the difficulty in estimating implied profitability with confidence.
- 9.9 In order to consider the reasonableness of the variation between NQ premium rates and the premium rates applying in east coast centres, I have estimated an expected price differential (between NQ and east coast premium rates). The expected price differential is arrived at by estimating the average east coast premium rate needed to deliver the same level of profitability as the average NQ premium rate.
- 9.10 To estimate an expected price differential, I have assumed that expected net claims cost for east coast centres is 25 per cent of the NQ expected net claims cost (on a Sum Insured weighted basis). This is in line with the observed experience over the 8 year investigation period as discussed earlier in chapter 5. I have also assumed that the cost of catastrophe reinsurance in these other east coast centres is around 15 per cent of the corresponding cost in NQ (again on a Sum Insured weighted basis), as discussed in chapter 6. I have also assumed a commission rate of 18 per cent of premium and an expense rate of 7 per cent of premium. Finally, for consistency with NQ premium rates, I have assumed that the required return on capital for east coast business can be achieved with a target profit margin of 14 per cent of premium.
- 9.11 Taking all of those assumptions together results in the following estimated price differential.

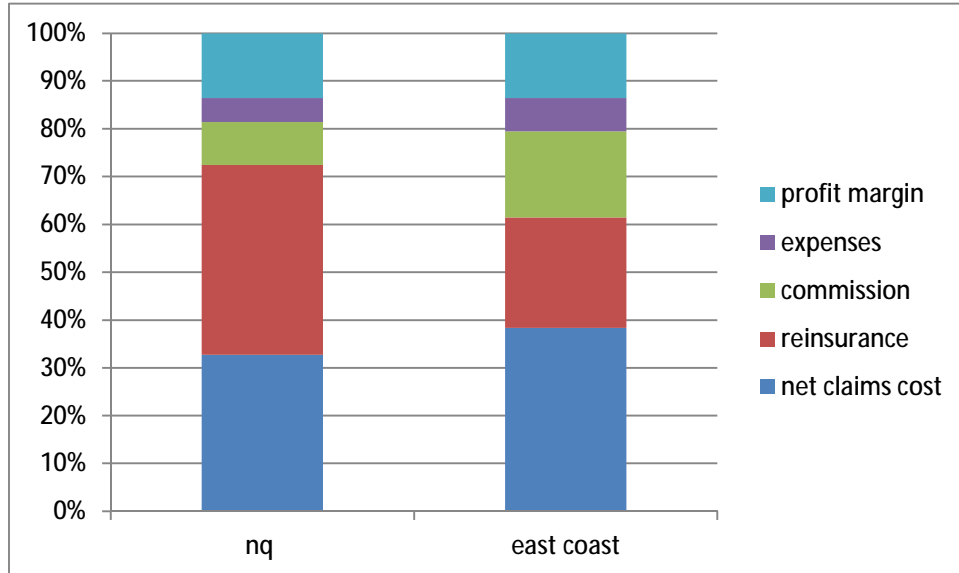
¹³ This lower than the actual profit in 2012-13 which experienced much lower claims activity than the average over the 8 year period.

¹⁴ The rate needed to cover the costs of claims, reinsurance and expenses and to provide a reasonable return on capital.



9.12 That is, the analysis suggests that east coast prices should be around 23 per cent of NQ prices (on a Sum Insured weighted basis) in order to deliver the same level of profitability as implied within NQ rates.

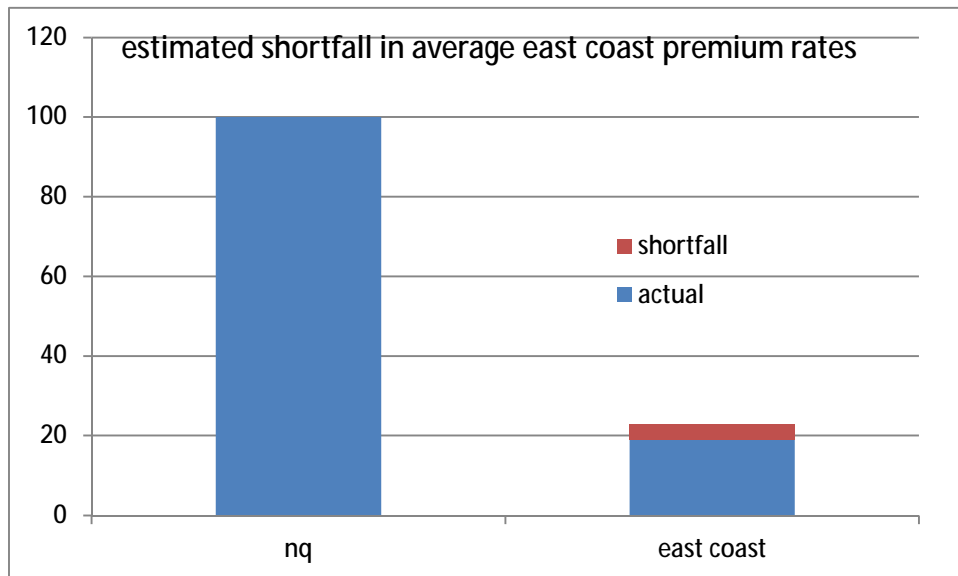
9.13 The chart below illustrates the composition of the estimated technical premium rates. It shows that, despite the very significant difference in the absolute premium rate levels, the composition is broadly similar.



Actual vs expected

9.14 The analysis above concluded that, based on the data provided for the investigation, average east coast premium rates should be around 23 per cent of average NQ premium rates in order to deliver the same level of profitability. The discussion in chapter 4 noted that actual average premium rates in east coast centres in 2012-13

were less than 20 per cent of NQ rates. That is, actual east coast rates were less than expected as illustrated below.



9.15 There are a number of possible reasons for this.

9.16 First, any high level analysis is inevitably and unavoidably approximate. Thus, while the analysis presented in this report provides support for the existence of a substantial differential between NQ and east coast rates, it is not possible here to be precise about the appropriate size of the differential. Insurance pricing is an inexact science. I also noted above that even fairly small changes in the various assumptions adopted in this analysis can result in fairly large changes in implied profitability. Finally, as noted earlier, this analysis considers an average across all participating insurers and does not reflect the position of any one insurer.

9.17 Second, and importantly, the analysis above has focussed on the technical aspects of insurance pricing. The discussion has not so far considered the commercial aspects of insurance pricing. Thus, insurance prices are set within a competitive marketplace and, as a result, it is quite common for the actual price being charged in the market to differ from the sound price. The impact of competition on insurance pricing is considered in the next chapter.

10 Competition

Background

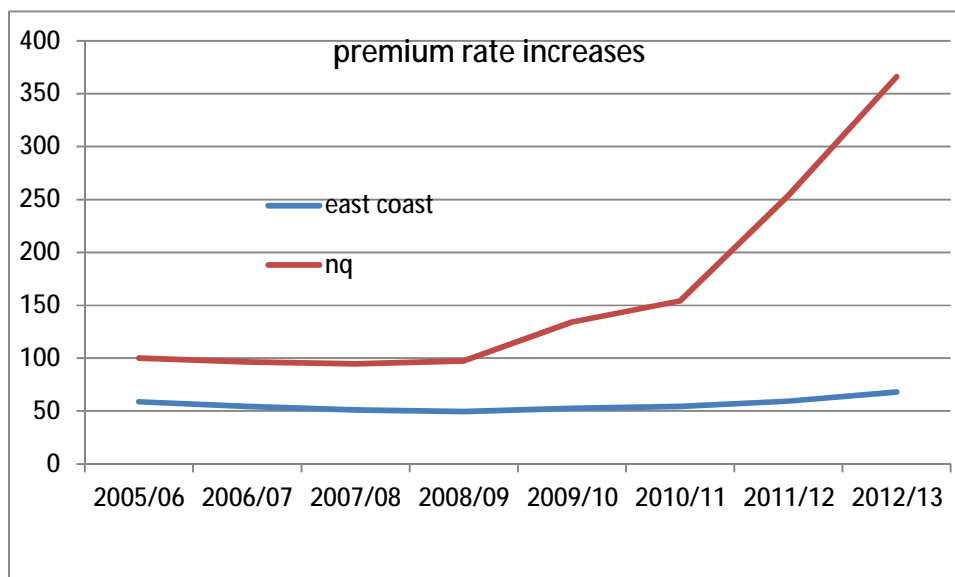
10.1 The comments below are taken from my 2012 report. They remain relevant.

10.2 Deep and competitive markets tend to deliver good price outcomes for consumers. When there is abundant supply of a product, downwards price pressure can be expected. Conversely, when supply is limited and demand is high, prices can tend to be higher.

- 10.3 The insurance market is not immune from cyclic behaviour. The insurance cycle is characterised by periods of good supply and relatively low prices (referred to as a soft market) and periods where supply is more limited and prices are relatively high (referred to as a hard market). Insurance markets tend to harden following periods of loss making.
- 10.4 The available evidence supports a view that the strata title insurance market in NQ is not deep. Supply has been affected by the withdrawal of some insurers from this region.

Discussion

- 10.5 Premium rates in NQ have increased faster in NQ than in other centres.
- 10.6 The chart below illustrates¹⁵. During the period in question, premium rates in NQ have more than tripled while there has been a much slower rate of increase in the other centres (in the order of 40 per cent over the past few years).



- 10.7 There are likely to be a number of reasons for the widening of the gap between NQ prices and prices in other east coast centres. The price differential started to widen from 2009-10 onwards.
- 10.8 By around 2010 insurers participating in the NQ strata market had formed the view that prices were too low for the risk being carried. The reaction from insurers was to set prices on a steeply increasing trajectory.

¹⁵ The trajectory for NQ is slightly different from that shown in my 2012 report. One participating insurer provided more comprehensive data for this current investigation than for the 2012 investigation.

- 10.9 This approach understandably left policyholders annoyed and questioning the reasonableness of the price increases.
- 10.10 It is likely that the speed of increase was related to the scale of losses that had been incurred in the several preceding years. Over the four years to June 2009 participating insurers collectively suffered insurance losses in NQ of more than 100 per cent of premium before accounting for the cost of catastrophe reinsurance (more than 150 per cent of premium taking the cost of catastrophe reinsurance into account). The data shows that the average claims cost in NQ during the four years prior to 2009-10 was more than five times as high as in other east coast centres. Thus, the scale of the losses in NQ during the four years to 2008-09 was large. As well, the estimated cost of catastrophe reinsurance is higher for NQ exposure than for exposure elsewhere and the differential here has also widened over the period since 2009-10. Both of these factors are likely to have contributed to the speed of the price adjustments that occurred in NQ. Cyclone Yasi in 2011 provided further impetus.
- 10.11 In addition to the technical reasons set out above, I have found that there is likely to be another more subtle reason for the speed at which the gap between NQ prices and other prices has widened. This concerns the related issues of risk appetite and competition. These are commercial pricing factors rather than technical pricing factors.
- 10.12 Whenever there is an appetite to gain or protect market share, competitive pressure can and will be brought to bear on prices. In my view this competitive pricing pressure is largely missing in NQ while it appears present in other regions. As a result, it appears that the presence of a competitive market in other east coast centres may have had an impact on the pricing decisions of insurers in those regions while this competitive pressure has been largely absent in NQ, at least in recent years.
- 10.13 Thus, in my view, there is a reasonable likelihood that competitive pricing pressure in these east coast centres has resulted in prices which appear unlikely to be sufficient to generate the same expected return as NQ prices.
- 10.14 In contrast, many insurers choose to have little or no exposure in the NQ market. Those insurers who do participate in the NQ market do not appear particularly anxious to protect or grow market share in that market. Although the active participants in the NQ market appear willing to continue to accept risks, my judgement is that they are less inclined to actively compete for business on price. Accordingly, it is possible for insurers participating in that market to achieve actuarially sound prices¹⁶, largely unconstrained by competitive forces.

¹⁶ Prices which are estimated by the actuary as being sufficient to cover all costs and to provide a reasonable return on capital

10.15 In a competitive market, it is not always possible to achieve the rate of return that would be expected by shareholders in prices. Rather, sometimes, the best that can be done is to seek to maximise the rate of return that can be achieved without losing market share, even if this means that the rate of return achieved is less than what would be expected by shareholders. That is, in a competitive market, insurers face a trade-off between the rate of return and market share.

Are NQ prices too high?

10.16 Based on the data provided for this investigation, my judgement is that prevailing rates in NQ are likely to be reasonably profitable in expectation, rather than highly profitable in expectation. My high level estimate of the implied profitability in 2012-13 premium rates is 14 per cent of premium.

10.17 It is, however, possible that the underlying profitability in 2012-13 NQ rates is more 14 per cent in expectation.

- For example, 2011-12 and 2012-13 have both seen good returns.

However, it is noteworthy that both of these years were benign claims years with no major severe weather events. As a proportion of sum insured, the claims costs in these two years were less than 25 per cent of the average claims costs in the preceding six years. Accordingly, these most recent two years cannot be considered typical.

- Although my analysis above suggested that implied profitability in NQ prices did not appear unreasonably high when the experience of the 8 year investigation period is used as a baseline, it also highlighted that even fairly small changes to the underlying assumptions would result in a conclusion of somewhat higher expected profitability.
- Relevantly, insurers are likely to react conservatively to uncertainty, particularly when they are relatively unconcerned about protecting or growing market share.

10.18 On the other hand, it is also possible that the underlying profitability in 2012-13 NQ rates is less 14 per cent in expectation. As noted in paragraph 7.2 my assumptions regarding commission rates were close to the low end of the range within the data provided. Adopting assumptions closer to the average of the range within the data provided would result in a significantly lower estimate of implied profitability.

10.19 The discussion above demonstrates that estimating the actual implied underlying profitability in NQ prices is challenging. Among other things, the volatility of the recent claims experience highlights the difficulty in estimating the expected net claims cost and, as a result, the implied underlying profitability.

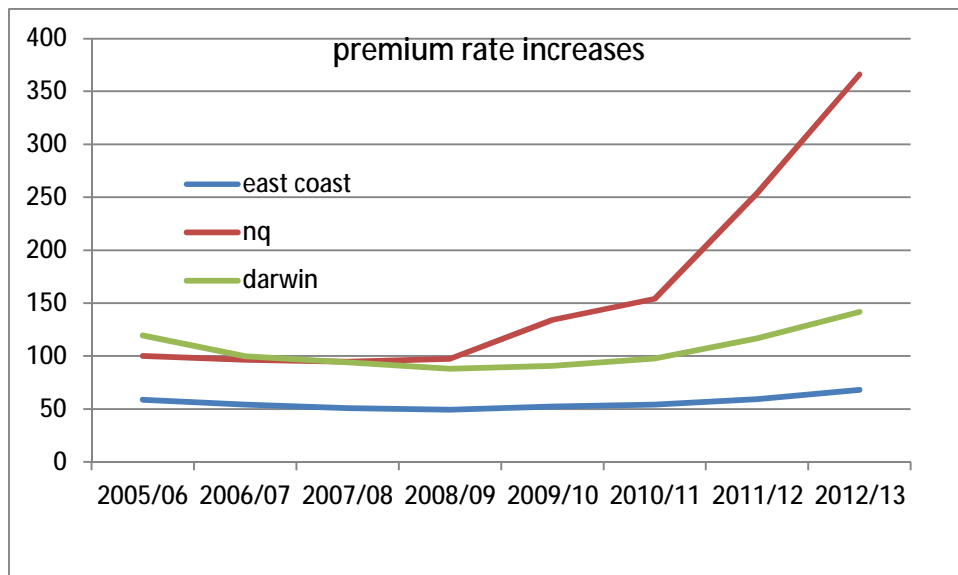
10.20 In summary, although it is possible that the prices being charged today in NQ are highly profitable in expectation, the data provided for this investigation did not provide support for such a conclusion. Rather, despite the absence of competitive

pricing pressures in NQ, the data pointed more strongly to a conclusion of reasonable profitability, albeit within a band of uncertainty.

- 10.21 Finally, the comments below are from my 2012 report. They remain relevant.
- 10.22 Price gouging can occur in a market where there are barriers to entry. 'Barriers to entry' refers to the difficulty that potential new suppliers have in entering a market, for example, as a result of substantial regulatory burden. Where there are no barriers to entry, economic theory suggests that price gouging can only occur for short periods, if at all. This is because new supply will emerge quickly when prices that can be charged are abnormally high.
- 10.23 In this regard, it is noteworthy that at least one significant player in the national strata title insurance market still does not currently participate in the NQ market. There is no reason to believe that this is as a result of any barrier to entry. Should the insurer wish to participate in the NQ market, it could do so. It is also reasonable to assume that, if it believed that the prices that could be charged in NQ were sufficiently profitable for its own risk appetite, it would, indeed, choose to enter that market.

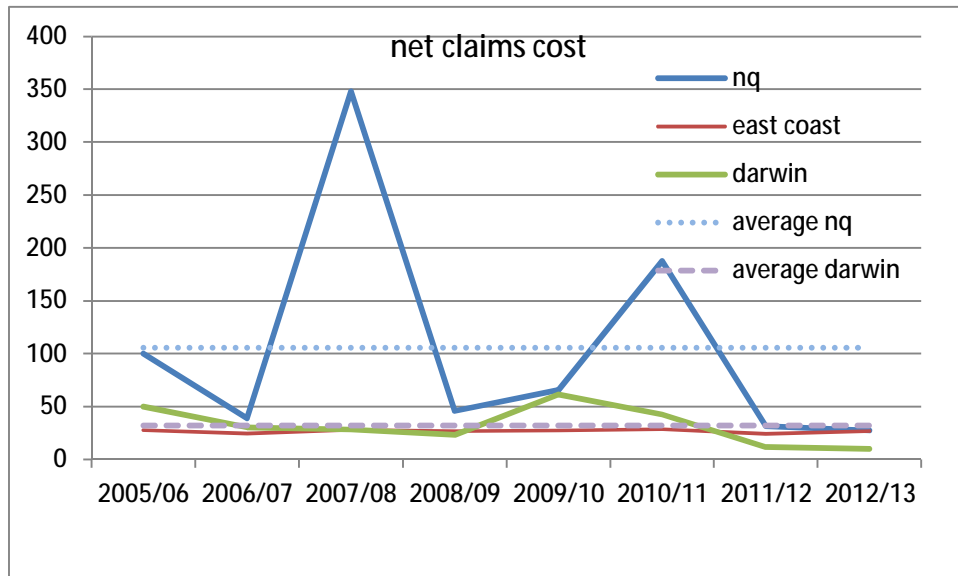
11 Darwin

- 11.1 In paragraph 1.15 I noted that average premium rates in Darwin were about 40 per cent of average NQ premium rates. The chart below shows the trajectory of Darwin premium rates over the period of the investigation.



- 11.2 Premium rates in NQ started to increase rapidly following the four years to 2008-09 during which participating insurers suffered losses of more than 150 per cent of premium due to poor claims experience.

11.3 Darwin rates have increased by about 60 per cent since 2009-10 but remain much lower than NQ rates. It is instructive to compare the claims experience in Darwin with that in NQ over the same time period.



11.4 The chart shows that claims costs in Darwin were lower than those in NQ in the four years to 2008-09 (as well as overall). Over the 8 year investigation period average claims costs in Darwin were less than 35 per cent of average net NQ claims costs (per \$'000 Sum Insured). The chart also shows some volatility in the Darwin claims experience. Cyclone Carlos contributed to the experience in 2010-11 although losses from this event were not substantial.

11.5 There are likely to be a number of reasons for the lower claims cost in Darwin than in NQ. Probably the most important reason is that Darwin has not experienced major weather-related insurance losses during this period. This may reflect a lower underlying risk exposure for Darwin. It probably also reflects an element of luck. It was also reported to me that most of the residential strata stock in Darwin has been built in the last twenty years and to a high safety standard.

11.6 The cost of catastrophe reinsurance should also be considered. As discussed earlier, it is hard to estimate reliably the cost of catastrophe reinsurance that should be allocated to residential strata. Although there was some variation between the estimated cost of catastrophe reinsurance between insurers who participate in the Darwin market, the cost estimates were broadly in line and were considerably less than for NQ. One participating insurer advised me that this is consistent with the catastrophe modelling that they use.

11.7 Taking all of the above together I conclude that the difference in premium rates between Darwin and NQ is in line with the difference in the observed claim cost experience and the estimated cost of catastrophe reinsurance. Although Darwin rates are significantly lower than NQ rates this appears mainly due to the absence of major weather-related insurance losses over the past several years which, when

combined with the output from catastrophe models, has led insurers to assume a commensurately lower risk level for Darwin.

12 Concluding remarks

- 12.1 The average premium rate in NQ in 2012-13 was considerably higher than the average premium rate in other east coast centres. Indeed, according to the data provided, the average east coast rate was only around 20 per cent of NQ rates.
- 12.2 Similarly, the average Darwin rate in 2012-13 was around 40 per cent of NQ rates.
- 12.3 A very limited volume of pricing data was provided in relation to north-west Western Australia. The data that was provided suggested that prices being charged in that region were broadly comparable with those being charged in NQ.
- 12.4 The claims experience data provided to me for this investigation has revealed a strong correlation between actual claims experience over the past 8 years and premium rates in NQ, NT and the east coast capitals.
- 12.5 In my judgement, most of the price variation (between NQ and the east coast capitals) can be attributed to the relatively lower risk in the east coast centres, compared with NQ. Specifically, these other centres are not exposed to cyclone risk in the same way as NQ. As a result, claims costs in NQ are expected to be both much higher and more volatile than those in other east coast centres.
- 12.6 Although most of the variation between prices in NQ and prices in the east coast capitals can be explained by differences in risk, not all of it can. In my view there is a reasonable likelihood that a small part of the difference can be attributed to the presence of competitive pricing pressure in east coast centres and the absence of competitive pricing pressure in NQ.
- 12.7 Many insurers choose to have little or no exposure to the NQ market and those insurers who do participate in the NQ market do not appear particularly anxious to protect or grow market share in that market. Although the active participants in the NQ market appear willing to continue to accept risks, my judgement is that they are less inclined to actively compete for business on price. Accordingly, it has been possible for insurers participating in that market to achieve actuarially sound prices, largely unconstrained by competitive forces.
- 12.8 On the other hand, there is some evidence that the market is more competitive in the other east coast centres. In these centres, market share considerations appear to be factored into pricing decisions. Thus, in my view, there is a reasonable likelihood that competitive pricing pressure in these east coast centres has resulted in prices which appear unlikely to be sufficient to generate the same expected return as NQ prices.

- 12.9 Despite the absence of competitive pricing pressures in NQ, my judgement is that prevailing rates in NQ are likely to be reasonably profitable in expectation, rather than highly profitable in expectation.
- 12.10 Differences between NQ rates and Darwin rates appear consistent with differences in the recent claims experience and in the estimated cost of catastrophe reinsurance.
- 12.11 There are likely to be a number of reasons for the lower claims cost in Darwin than in NQ. Probably the most important reason is that Darwin has not experienced major weather-related insurance losses during the last several years. This may reflect a lower risk exposure for Darwin. Relevantly, the estimated cost of catastrophe reinsurance provided by insurers who participate in the Darwin market, were considerably less than for NQ.



Peter Martin
Australian Government Actuary
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