What the Insurance Companies don't Tell You

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Our summer of catastrophes has shown up the injustice of Australia's powerful insurance industry. Ben Eltham and Ian McAuley look at how the system could be improved.

On 20 January, The Australian published an interview with Queensland home-owners Bill and Maria Gilbert. The Gilbert's house in the Ipswich suburb of Bundamba was one of thousands rendered uninhabitable by south-east Queensland's historic 2011 floods. But despite holding an insurance policy for fire, theft and flood damage with national insurer AAMI, the Gilberts weren't covered. AAMI informed them that their policy did not cover "rising rivers".

The Gilberts are an excellent example of the enduring injustice of the insurance industry. Householders can pay premiums for years — only to find out that their policy useless when they need it most. The floods in Queensland have turned the spotlight on an industry where sensible public policy takes a back seat to rent-seeking.

In the wake of the tragedy, politicians and media commentators soon called for better definitions of "flooding" in insurance policies, and by the end of January the Insurance Council of Australia, the peak body representing insurers, had released a "10 point plan" (pdf) calling for the government to amend the Insurance Contracts Act "to include a common definition of flood".

True to form, however, the Insurance Council also argued that any insurance law reform should still allow insurers to include get-out clauses in their policies, arguing that "to maintain competition and consumer choice" the government should "retain the right to derogate and amend the definition under the 'unusual terms' section of the Act."

Some think-tanks and commentators went further. The Australian Strategic Policy Institute released a special report last week arguing that governments should consider a form of mutual obligation for disaster relief recipients, "requiring assistance recipients to take up their own insurance for all subsequent events." Meanwhile, the reinsurance giant Swiss Re has suggested that the government itself take out insurance against natural disasters. (The Queensland government was not insured, covering its disaster relief and rebuilding costs from normal revenue.)

The power of the insurance industry is one of the great constants in Australian politics. When it comes to the contest between insurance companies and ordinary consumers, insurers almost always win. In many aspects of daily life, the government compels us to buy insurance coverage, mostly from for-profit providers. When it comes to health, the federal government pays insurers fat subsidies in return for our custom.

In the most rational of worlds we would cover from our own resources the small day-to-day risks that we can finance from our own reserves. A broken windshield, a little damage to plasterboard from a roof leak, and so on. Such self-insurance makes sense, because commercial insurance is expensive; for every dollar we spend on insurance only 70 cents comes back as paid out claims — insurers have to cover their administrative costs and to make some return on their investment.

But for large risks, or life events that would quickly exhaust our personal resources, it makes sense for the rational individual to seek commercial insurance, reasonably expecting our own liability to be capped by some affordable deductible or co-payment.

Unfortunately, humans are poor judges of risk. What usually happens is that we tend to over-insure in some areas, and leave ourselves completely exposed in others. We would reasonably expect the rich to self-insure, but in fact the reverse holds: those with means tend to be the most likely (pdf) to take out full cover packages, even for minor contingencies, such as "electric motor fusion". People who are fastidious about small risks can also leave themselves uncovered for contingencies which are genuine possibilities, but are not everyday events — as many high net-worth individuals discovered when the global financial crisis suddenly hammered their investments.

Insights into such behavior are provided by the discipline of behavioural economics (pdf). Humans often perceive events incorrectly. We tend to be more aware of small but frequent risks, such as minor automobile accidents, than infrequent but catastrophic events, such as a flood or a bushfire. We also tend compartmentalise our lives: we try to buy out of certain risks altogether, while ignoring others. Observe, for example, people who are obsessive about keeping household bacteria at bay, while failing to exercise regularly. And people are often irrationally over-confident: behavioral research confirms the perverse finding that, like the children in Garrison Keillor's Lake Wobegon, most of us consider ourselves to be "above average".

Insurers respond to these biases in ways that serve their commercial interests. They pander to our irrationalities — indeed, they would be punished by analysts and shareholders if they did not. As a result, insurers offer products that generate revenue, rather than those best suited to protect customers. So, for instance, insurers encourage us to take out household contents insurance, while refusing to cover flood risks — even though most of us could, with some minor difficulty, replace our contents, but would find it impossible to rebuild an uninsured house.

In particular, insurers offering domestic cover do not offer policies involving significant co-insurance. Most insurers offer no more than $1000 as the maximum deductible on house insurance, even though it would make sense for insurers to offer risk-sharing products. Someone willing to take the first $50,000 or $100,000 worth of risk themselves is likely to be a good customer, for he or she has an strong incentive to take some personal responsibility — to have low "moral hazard" in the quaint language of insurers. Such policies, if offered, should be cheap, and would offer a far better prospect for people than the choice of taking out an expensive comprehensive policy or no insurance at all. A $100,000 liability may be tough, but it's a lot better than the devastation of loss of a completely uninsured property.

But this is not the way insurers' business models work. Even if such risk-sharing policies may be profitable, they do not offer the cash flow of more comprehensive or "first dollar" policies. Economists often assume that firms seek to maximise profits, but in many industries firms seek to maximise growth. Those small claims keep business turning over and allow the firms to grow. They offer secure business, because there is far less actuarial risk in covering car insurance, for example, than in covering catastrophes: the number of car crashes varies little from year-to-year, while floods and bushfires are highly unpredictable. Insurers even offer "insurance" against certainties — many firms offer funeral cover, for example. Funeral insurance is really just a compulsory savings plan, in which you pay the insurer a fee for the service!

It is notable that insurers are ready to negotiate risk-sharing policies with businesses, but not with households. Businesses have more bargaining power, and larger businesses have the capacity to assess their own risks. In theory at least, business insurance is a more rational market.

It gets worse. One of the ways that insurers try to manage their own risk is by limiting their own liability, leaving individuals bearing open-ended risk — exactly the opposite to the way insurance should work. This is particularly relevant for natural disasters. Because such disasters are regionally concentrated, there is usually a big call on local resources such as builders and electricians, and there are often extra accommodation and travel costs, driving up re-building costs. And it is a normal practice for governments to impose tougher standards on replacement buildings.

Catastrophic cover is an area where governments simply have to be involved. That doesn't mean they should be offering "first dollar" coverage. The private sector does an acceptable, if high cost, job in covering small everyday risks. If people are irrational enough to over-insure in some areas, that's their business.

The form of involvement may be for national cover for house replacement in the event of natural disasters, funded by a special government levy, but only cutting in after a reasonably high co-payment. That gives governments a strong stake in ensuring there are sound building standards and zoning requirements. Involvement could possibly be through regulation of insurers, requiring them to offer such policies at agreed prices, but this would be difficult and conflict-ridden.

And because of this potential difficulty, instead of regulating insurers, many are suggesting governments focus on ordinary citizens instead - for instance, by subsidising householders with low incomes to buy insurance. Such policies represent the worst form of financial churning, with money being recycled first through the tax system and then again through the private insurance system. Not only do these policies offer little incentive for insurers to share risk, much of the subsidy will disappear into insurance industry profits. This is precisely what happens in subsidised private health insurance.

The proposal that the government itself take out re-insurance is just as ridiculous. The only OECD country to do so is Mexico, and that's because it lacks the fiscal resources of wealthier countries. Re-insurance is very expensive — at least 30 per cent is taken up in administrative costs and in profit. Queensland's Treasurer, Andrew Fraser, has pointed out that the last time Queensland shopped around for a quote for disaster insurance, the price was too high. "Previous market soundings have indicated reinsurance is not cost-effective, given Queensland's history of natural disasters and the length of the state's road network," Fraser told The Australian's Lauren Wilson. Insurance industry profits represent taxpayers' money that could be better spent preparing for disaster: for instance, on better funding for emergency services agencies.

One of the reasons that re-insurance can generate such profits is because it is so risky. Recent years have seen the collapse of many financial institutions, and it was only public funding that saved AIG, one of the world's biggest insurers, from collapse. It is quite conceivable that a major regional catastrophe could wipe out one or more re-insurers. In that scenario, the government won't be covered. Worse, taxpayers might even have to bail out a large insurer to prevent a financial panic.

As we've pointed out recently here:

> "The only agency with the resources and the wherewithal to respond to such events is the state. Disaster responses require helicopters and ships, sophisticated warning systems, and a workforce of thousands, from meteorologists to swift water rescue teams. All this takes money. Lots of it. From taxpayers."

We have a liability to repair the flood damage; we must confront it. If governments borrow to discharge that liability we are not adding to that liability; our net liability remains unchanged. We must think clearly, without the distractions of the self-interest of commercial insurers and the puerile economics of intrinsic aversion to debt.