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Reinsurers Count the Cost as Australia Endures Another Devastating Flood Season

Australia has seen a period of above-average weather-related losses in recent years

Principal Takeaways:

- Reinsurers are likely to bear the brunt of claims, with limited impact on primary insurers' balance sheets
- Demand surge and inflation caused in part by historically high oil prices and commodity shortages prompted by the conflict in Ukraine will push up claims costs
- Going into the next reinsurance negotiations, cat-exposed Australian insurers are likely to find pricing and conditions tougher, placing negative pressure on operating performance

Australia is enduring another devastating flood season. The Australian Prime minister has declared a national emergency amid flooding that has brought chaos to swathes of New South Wales and Queensland.

The final insurance bill from this event – and the likely medium-term implications for the price and availability of insurance cover – will depend on a number of factors. But the response of the reinsurance community will be crucial. Reinsurers have borne the brunt of recent loss events and will likely do again in this instance.

Figures from the Insurance Council of Australia (ICA) put insured losses so far in excess of AUD 2.5 billion, and that figure is likely to rise. The estimate reflects current claims reporting rather than an expectation of the final bill so this figure could rise as more claims are submitted.

The insurance cost associated with natural catastrophes is generally subject to "demand surge" inflation resulting from a localised increase in costs of labour and materials to rebuild. Prices of building materials are already at inflated levels due to supply-chain slowdowns and as demand intensifies in the aftermath of COVID-19-related lockdowns. The conflict in Ukraine has further exacerbated the upward price momentum by pushing up the price of oil and further constraining the supply of certain commodities.

Cost of weather claims is rising

While it is too early to determine the full extent of the damage, a comparison can be drawn from historical major flood events: the 2011 and 1974 Brisbane floods led to insured losses (at current values) of approximately AUD 2.1 billion and AUD 3.2 billion respectively.

More recently, there has been an increased frequency of extreme weather events in Australia, including the 2019 Townsville floods, 2019/20 bushfires, and January 2020 hailstorms (**see Exhibit 1**).

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Exhibit 1

Australia – Natural Catastrophes (Declared), 2019-2022

Event	CAT Number	Date	Incurred Loss (AUD billions)
Storms in South East Queensland and Northern New South Wales[1]	CAT 221	26-Feb-22	2.45
South Australia, Victoria & Tasmania Severe Storms	CAT 216	28-Oct-21	0.71
Victorian Storms & Floods/Severe Weather & Flooding	CAT 214	7-Jun-21	0.29
Tropical Cyclone Seroja	CAT 213	7-Apr-21	0.34
East Coast Storms & Floods/Extreme Weather Event	CAT 212	16-Mar-21	0.60
Perth Hills Bushfire	CAT 211	1-Feb-21	1.00
Halloween Hailstorm	CAT 204	31-Oct-20	1.06
South East Coast Storms & Flooding	CAT 202	4-Feb-20	0.97
January Hailstorms	CAT 201	18-Jan-20	1.68
November 17 Hailstorm (South East Queensland)	CAT 196	17-Nov-19	0.50
2019/20 Bushfires (New South Wales, Queensland, South Australia, Victoria)	CAT 195	8-Nov-19	2.32
Bunyip Bushfires	CAT 192	3-Mar-19	0.35
FNQ Monsoonal Flood	CAT 191	24-Jan-19	1.27

A ‘catastrophe declaration’ (CAT) from the Insurance Council of Australia escalates and prioritises the insurance industry’s response to support policyholders affected by the natural disaster that triggered the declaration.

1: Estimated as at Mar. 25, 2022.

Sources: BESTLINK

Insurance Council of Australia, AM Best data and research

The total insured cost of declared catastrophe events between fiscal years 2019-2021 is approximately AUD 11 billion, compared with a total of AUD 4.6 billion for the three previous years. Overall, the year-on-year catastrophe experience for Australia is highly volatile.

In recent history, the largest insurance losses from flood events have been in Queensland, rather than further south in New South Wales.

With the increased frequency of flood, cyclone and bushfire events resulting in large insured losses in Australia, AM Best expects to see an increased focus by (re)insurers on understanding, controlling and mitigating climate risk.

The Role of Reinsurance

Australian property insurers typically buy catastrophe excess-of-loss reinsurance with a limit above an expected 1-in-200-year loss, driven by national regulatory capital requirements. Losses associated with these floods are anticipated to fall well below this threshold.

In general, non-life insurers’ catastrophe reinsurance programmes have low retained exposures relative to their capital base. Additionally, Australian insurers typically purchase reinsurance from strongly-rated counterparties, lowering the credit risk associated with large recoveries.

As such, this flood event is likely to have a limited impact on balance sheet strength and solvency for most non-life insurers in Australia, with the majority of gross losses likely to be borne by the reinsurance industry.

However, the total net exposure of direct insurers is in part driven by reinsurance contract terms including the implications of the hours clause, which stipulates the reinsurer will cover all the financial losses accumulated in a defined number of hours. Treating the flooding as multiple events based on the hours clause could lead to significantly higher net cost or increased utilisation of annual aggregate reinsurance programmes for direct insurers.

A further consideration for insurers could be the additional cost associated with reinstatement premiums or purchase of additional aggregate excess of loss cover mid-year in order to maintain effective protection for events that may occur before full renewal of the programme.

The continued cession of material losses to reinsurers may result in further upward pressure on reinsurance rates and a tightening of terms and conditions in upcoming renewals for direct insurers.

Australia has seen a period of above-average weather-related losses in recent years (**see Exhibit 1**). This event is likely to add to reinsurance pricing pressure and potentially reduce reinsurers' appetite for Australian property risks.

There is likely to be concern among reinsurers over the number of large catastrophe events hitting the market year after year. Leading international reinsurers Swiss Re and Munich Re have both taken action to reduce capacity for property aggregate and event frequency covers. This falls within a picture of a sustained reinsurance industry hard market.

For Australian insurers with significant reliance on reinsurance, reinsurance pricing may have a substantial impact on operating results in future years. Those covering property risks in cat-prone areas such as the North Queensland coast will be most vulnerable to an increase in the cost of purchase.

The overall impact on profitability may depend on primary insurers' ability to increase pricing on risks in cat-prone areas.

Where primary carriers' reinsurance negotiations are becoming more challenging, management teams may consider increasing retention levels to control costs, or altering the mixture between proportional, aggregate and catastrophe covers.

Going into the next reinsurance negotiations, insurers are likely to find pricing and conditions tougher: how they fare will dictate the extent and levels of cover they are able to offer to policyholders.

In the wake of this flooding, questions have been raised over the political response to the disaster, and whether a government-supported flood pool should be created, as has recently been done for cyclone events in northern Australia (though this is not due to be operational until July 2022).

One option being discussed is whether to expand the cyclone reinsurance pool to cover other types of natural catastrophes, and to roll out the scheme to cover other parts of the country. This could have the effect of improving affordability for property policies, however there are objections linked to cost to the taxpayer and the incentivisation of development in flood-zones.

The Australian government has already made the decision to draw down on the Emergency Response Fund and provide AUD 150 million for immediate disaster recovery and future disaster risk mitigation and resilience initiatives.

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