



2009 Victorian Bushfires
Royal Commission

THE FIRE SERVICES LEVY AND INSURANCE

DISCUSSION PAPER

NOVEMBER 2009

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BACKGROUND

DISCUSSION PAPER

1. The purpose of this discussion paper is to assist interested parties to comment on issues relevant to the 2009 Victorian Bushfires Royal Commission's (the Commission) consideration of the fire services levy (FSL) and insurance. The paper provides an overview of some issues surrounding the funding of Victoria's fire services and property insurance.
2. *The Commission welcomes comments on all aspects of this paper.* To prompt comment, a number of specific questions have been included in italics at relevant places in the paper. The questions are also summarised at the end of the paper. Respondents should not feel confined to the issues raised by these questions and may comment on any issues relevant to the funding of fire services and insurance cover. Those who have already made a submission to the Commission on these issues need not repeat their submissions as they have already been reviewed by the Commission and will be further considered with other responses to this paper. However, previous writers may raise additional issues if they wish.
3. This paper has been developed for discussion purposes only. Although the paper has been approved by the Commissioners for release as a discussion paper, it should not be assumed that any of the views expressed represent the views of the Commissioners. Rather it is designed to raise issues, enabling responses to be taken into account in the development of the Commission's final report.
4. The Commission notes the October 2009 release of a Victorian Government Green Paper - *Fire services and the non-insured* - seeking community feedback on the current model of fire services funding and alternative policy options.¹ The Commission is aware of the potential overlap between this discussion paper and the Green Paper, but notes that the timelines outlined in the Green Paper indicate that the Victorian Government will not finalise its position until February 2011. The Commission will deliver its findings in July 2010. The Green Paper indicates that the Commission's final report will be considered by the Victorian Government in formulating its final position.
5. This discussion paper is available on the Commission's website at www.royalcommission.vic.gov.au or by contacting the Commission on 1800 243 650.
6. Interested persons should provide any written responses to this paper to the Commission by Monday 21 December 2009. Responses can be submitted electronically or by post. All responses must include a coversheet which can be found on the Commission's website at www.royalcommission.vic.gov.au. To facilitate responses, a response template has been prepared and is also available from the Commission's website.
7. Emailed Response: Email your response, if smaller than five megabytes, along with a coversheet to enquiries@royalcommission.vic.gov.au. Files larger than five megabytes, should be posted.
8. Postal Response: Postal responses including a coversheet should be sent to:

Response to Discussion Paper
2009 Victorian Bushfires Royal Commission
GPO Box 4358
Melbourne VIC 3001

¹ Department of Treasury and Finance, *Fire services and the non-insured*, 2009.

9. In all but exceptional cases the Commission will treat responses as public documents and publish them on its website, and may also cite submissions in its reports. Further information about confidentiality is available at www.royalcommission.vic.gov.au

THE COMMISSION

10. The Commission's terms of reference are broad. The Commission is to inquire into and report on the causes and circumstances of the bushfires, the response to the fires and any other matters the Commission deems appropriate. The Commission is directed to make such recommendations arising out of its inquiry as it considers appropriate, including recommendations for governments, emergency services, other entities and the community.
11. The Commission is seeking to inform its identification of issues through a range of sources including submissions to the Commission by individuals and organizations.

THE SCOPE OF THIS PAPER

12. In addition to a catastrophic loss of life, Victoria's 2009 bushfires caused widespread loss of property. In information provided to it to date, the Commission has identified two broad issues of relevance to property loss and insurance. The first issue is dissatisfaction with the funding arrangements for Victoria's fire services, which include a significant contribution from insurance companies which recover this cost through imposing the FSL on building and contents insurance policies. The second is concern about the inadequacy of the insurance coverage for property lost in the 2009 bushfires. The two issues can be viewed separately but are also linked—the current system allows those who are not insured or are under-insured to have access to fire services without making an appropriate contribution to their funding.
13. Section 1 of the paper describes the funding arrangements for Victoria's fire services and outlines some arguments for and against these arrangements. When examining reform options the paper provides an overview of the property-based funding systems used in most other jurisdictions as one of three policy options. Section 2 of the paper examines the role played by insurance in compensating those affected by the 2009 bushfires.

SECTION ONE: FUNDING VICTORIA'S FIRE SERVICES

THE CURRENT INSURANCE-BASED MODEL

14. Three broad approaches to the funding of fire services are used in Australia:
- insurance-based models,
 - property-based models, and
 - funding from general government revenue.
15. In Victoria, there is an insurance-based model. Under this model, fire services in Victoria are largely funded by contributions from property and other related insurers which are passed onto those taking out insurance through the FSL on premiums.²
16. The Metropolitan Fire and Emergency Services Board (MFB) is funded by insurance companies (75 per cent), the State government (12.5 per cent), and metropolitan municipal councils (12.5 per cent). The proportion of funding by each contributor is determined under Section 37 of the *Metropolitan Fire Brigades Act 1958*.
17. The Country Fire Authority (CFA) is funded by insurance companies (77.5 per cent) and the State government (22.5 per cent). The funding proportions are determined under Section 77A of the *Country Fire Authority Act 1958*.
18. In addition to the legislative requirements outlined in the preceding paragraphs, the MFB and the CFA receive additional funding from a number of sources including the Transport Accident Commission, interest payments, public donations, and training and consultancies.
19. The Minister for Police and Emergency Services determines the amount of contributions from each source with reference to the estimated expenditure and revenue of the CFA and MFB. The MFB and the CFA then determine the amount of each insurer's contribution based on its share of total gross premiums. To cover this cost, the insurance company passes the cost of their contribution on to consumers by imposing the FSL on premiums for relevant insurance policies. The FSL is based on a percentage of the premium and is generally based on a rate recommended by the Insurance Council of Australia (ICA).
20. In addition to the FSL, insurance premiums are subject to first GST of 10 per cent and then stamp duty of 10 per cent on the total amount including GST. Table 1 shows how the combination of the FSL, GST and stamp duty increases the final cost of insurance to consumers.

Table 1: Victorian FSL Rates, GST and Stamp Duty—\$100 premium

	Metropolitan		Country	
	Home	Business	Home	Business
Premium	\$100	\$100	\$100	\$100
FSL	\$20.00	\$50.00	\$31.00	\$84.00
GST	\$12.00	\$15.00	\$13.10	\$18.40
Stamp Duty	\$13.20	\$16.50	\$14.41	\$20.24
TOTAL COST	\$145.20	\$181.50	\$158.51	\$222.64

² The fire services provided by the Department of Sustainability and Environment as part of its land management function are funded from the Department's budget.

21. The pool of funding available to the MFB and the pool of funding available to the CFA are mutually exclusive—they bear no relationship to each other apart from sharing a common methodology in their calculation. Table 1 shows that a higher rate of FSL is applied to country as opposed to metropolitan premiums, and commercial as opposed to residential premiums. The rate of FSL to be applied to a premium is a commercial decision for the insurer, as the legislation only prescribes how contribution amounts are to be calculated for each insurer, and not how these amounts may be recovered from policyholders. It would appear that the following factors may contribute to the differences in the rates applied:
- Insurance companies are required to contribute a substantially higher amount overall to the CFA than the MFB. This is largely due to the fact that the CFA receives substantially more funding than the MFB. In 2009/10, the estimated expenditure of the CFA is just over \$391 million, compared to under \$275 million for the MFB. As a result, insurance companies will be required to provisionally contribute almost \$100 million more to the CFA than to the MFB.
 - In determining the amount to be contributed by each insurance company, consideration is given to the different classes of insurance policies. A higher weighting is applied to a commercial policy than a residential policy. Therefore, insurance companies may decide that the different weighting should be reflected in the FSL rate applied to the different policy classes. This may explain in part the higher FSL rate for commercial premiums.
 - There are fewer policy holders in country Victoria than metropolitan Melbourne. If insurance companies only recover the amount to be contributed to the CFA from country and outer metropolitan policyholders, a smaller pool of policy holders is required to contribute a higher amount, leading to the application of a higher rate of FSL.
22. New South Wales has a similar model to Victoria's. However, Queensland (in 1985), South Australia (in 1999) and Western Australia (in 2003) have all switched from an insurance-based model to a property-based model, which involves a charge being imposed on all property owners for the funding of fire services and, in some cases, other emergency services. Tasmania uses a hybrid model with an insurance levy on commercial insurance and a levy on residential rates. The ACT introduced a property-based model in 2006–07 and the Northern Territory funds fire services directly from consolidated revenue.

ASSESSING THE INSURANCE-BASED MODEL AND THE FSL

23. The principal arguments in favour of Victoria's insurance-based model are that:
- the FSL is notionally risk rated because it is based on insurance premiums that are assessed to reflect risk
 - it provides a stable revenue base for fire services with low administration costs
 - it provides asset owners with some degree of incentive to manage fire risk through the use of fire prevention systems and the development of on-site fire fighting capacities. These activities may reduce the insurance premium, and thus reduce the amount of FSL payable.³

³ A detailed assessment of the current system can be found in Department of Treasury and Finance, *A Review of Victorian Fire Services Funding Arrangements*, 2003, Chapter 4.

24. The major objection to the insurance-based model and the FSL is that it is inequitable because those who adequately insure subsidise the provision of fire services to those who do not insure or who under-insure.⁴ This argument was raised in many of the submissions to the Commission that commented on insurance. Related to the question of ‘who pays’ for fire services are the following considerations:

- Although the MFB and CFA may impose a charge on uninsured property owners when they require fire services they have discretion to waive these charges. The CFA, for example, did not charge uninsured property owners for fire services provided in Victoria’s 2009 bushfires.
- Opportunities exist to minimise the payment of FSL through the structuring of insurance policies, such as policy splitting and increasing the excess payable (which reduces the base premium on which the FSL is levied). Victoria’s 2001 review of business taxes noted there had been a shift to partial self-insurance by large corporations, whereby property owners carry some of the risk by having a large excess on their policies.⁵
- Vacant land, which may sometimes be a fire hazard, is not insured and therefore owners of vacant land do not pay the FSL.
- Vehicle owners and their insurers do not contribute to the funding of fire services, despite being responsible for approximately 15 per cent of MFB call outs and 10 per cent of CFA call outs.⁶

25. Fire risk comprises only a small component in the assessment of residential property premiums. The primary determinants of residential property insurance premiums include:

- the value of the property
- the date of construction (from which the standard of construction may be inferred)
- the design and construction of the building, including the building material used, in particular the floor and roof materials (from which fire and storm risk can be inferred).

26. The method for calculating premiums means that any difference in premium between a metropolitan residential property (for example, in Ringwood) as opposed to a residential property in a bushfire-affected area (for example, in Kinglake) would not primarily be based on the risk of bushfire. Rather it will largely be based on the age of the house, the method of construction and the sum insured.⁷ Therefore, the FSL on residential property insurance cannot be said to reflect directly the risk of fire. Fire risk is a much greater consideration in the assessment of insurance premiums for commercial properties.

27. The importance of fire risk can be determined by examining the proportion of fire claims to overall claims. Victoria’s 2003 review found that fire claims constitute approximately 50 per cent of the value of claims in the commercial sector, 40 per cent for residential buildings and

⁴ Non-insurance refers to a situation in which a property owner is not insured. Under-insurance is the purchase of an amount of insurance that is insufficient to cover the full cost of rebuilding the property and replacing the contents.

⁵ Department of Treasury and Finance, *Review of State Business Taxes, Full Report*, 2001, p. 80.

⁶ Insurance Council of Australia, *Submission to the Victorian Parliamentary Economic Development and Infrastructure Committee Inquiry into State Government Taxation and Debt*, 2009, p. 7.

⁷ Information sourced from the insurance industry.

12 per cent for residential contents.⁸ This indicates that factors other than fire risk are important drivers of the insurance premiums on which FSL contributions are based.

28. Given the above, the argument that the FSL encourages fire prevention activities may have validity for the commercial sector, where fire risk can impact significantly on overall premium levels, but appears to have less relevance for residential house and contents policies.
29. The method of collecting the FSL in Victoria creates a perception that the cost of insurance is higher than it really is, and creates a potential disincentive to taking adequate insurance cover. The impact of the FSL on the uptake of insurance has not been widely researched in Australia. Victoria's 2003 review of the FSL observed that those states with a property-based system and presumably lower insurance premiums (such as South Australia and Western Australia) have lower insurance cover in some cases than those states that have insurance-based funding arrangements (Victoria and New South Wales).⁹ However, a more recent study prepared for the ICA found a significant negative relationship between state premium based imposts and the uptake of both house and contents insurance. The study estimated that removing the FSL in Victoria would reduce non-insurance of property by 26,000 households, or just over half of its estimate of the state's non-insured households.¹⁰ Non-insurance and under-insurance are discussed in detail later in this paper.
30. Victoria's current model may also be difficult to sustain in future (particularly if recent large increases in MFB and CFA expenditure continue), as any reduction in the number of insured properties would increase the FSL on remaining policies, which may act as a further deterrent to the take up of insurance.
31. In Victoria, other agencies that provide emergency services are more broadly funded. Victoria Police and the Victoria State Emergency Service are almost entirely funded from government revenue. The Metropolitan Ambulance Service receives 59 per cent of funding from government grants (with 20 per cent from memberships and 19 per cent from service fees). Life Saving Victoria derives 45 per cent of its income from State and Commonwealth government grants, with the remainder from sponsorships, investment income and other sources.¹¹

FUNDING FIRE SERVICES—REFORM OPTIONS

A PROPERTY-BASED MODEL

32. Replacing the existing insurance based model with a property-based model received strong support in submissions to the Commission.
33. Both the 2008 New South Wales and 2001 Victorian state tax reviews recommended replacing statutory contributions by insurance companies with an equivalent, property-based levy collected by local councils.¹²¹³ Under a property-based levy, all property owners contribute to the provision of fire services. The following design questions would need resolution if Victoria were to move to a such a levy:

⁸ Department of Treasury and Finance, *A Review of Victorian Fire Services Funding Arrangements*, 2003, p. 41.

⁹ Department of Treasury and Finance, *A Review of Victorian Fire Services Funding Arrangements*, 2003, p. 33.

¹⁰ http://www.royalcommission.vic.gov.au/Submissions/SubmissionDocuments/SUBM-002-030-0080_01_R

¹¹ Funding details from 2007-08 annual reports.

¹² Independent Pricing and Regulatory Tribunal, *Review of State Taxation, Report to the Treasurer*, 2008, p. 7.

¹³ Department of Treasury and Finance, *Review of State Business Taxes, Full Report*, 2001, p. 80.

34. The services to be funded: Property-based fire service funding systems in Western Australia and South Australia support a broader range of emergency services than fire services alone. By contrast, Queensland's Urban Fire Levy funds only urban fire-fighting services.
35. The revenue base: Western Australia uses gross rental value, South Australia uses capital value and Queensland imposes charges based on the location, use and size of the property.
36. Adjustment of the levy for risk: If a uniform rate is used across all property, fire risk is no longer a determinant of funding contributions. Setting a uniform rate would redistribute the funding load from high risk to low risk groups, a particularly significant change for the commercial sector. Also, it may reduce the incentives for owners of high fire risk assets to manage those risks.
37. To counter this, properties could be classified according to their fire risk and their levy rate adjusted accordingly. While the residential sector could be treated as a relatively homogenous group for fire risk purposes, some form of risk rating, although difficult, would be desirable for commercial properties.
38. Victoria's 2003 review of the insurance based model drew attention to the near impossibility of achieving an accurate risk assessment of all Victorian properties. The review noted that although the property-based systems of Western Australia and South Australia reflect some differences in the degree of fire risk between sectors by imposing a higher rate on commercial property than on residential property there was no link between fire risk and levy payment *within* each sector.¹⁴ Given that, particularly for residential insurance, the link between insurance and fire risk appears weak, it is not clear that these deficiencies in property-based systems would result in worse outcomes than the current arrangements.
39. Collection agency: This could be the State revenue office (South Australia) or local government as an addition to rates notices (Queensland and Western Australia). South Australia and Tasmania use their motor vehicle registration agency to collect the levy on motor vehicles. The Commission notes that the relevant Victorian local governments already make a direct contribution to the MFB which is raised from rate revenue.
40. One fund for all fire services: Moving to a property-based option could involve all property owners contributing to a central fund for the funding of all fire services, as opposed to separate contributions from metropolitan and country areas for the MFB and CFA. A central fund for all fire and emergency services is used in South Australia and Western Australia.
41. Provision of concessions: Western Australia, South Australia and Queensland offer concessions to seniors, pensioners and concession card holders.
42. Treatment of State assets: To comply with competitive neutrality obligations, all publicly owned business assets are levied. In Western Australia and South Australia, other State assets are subject to the levy but in Queensland, these assets are exempt although the Queensland Government makes a contribution to fire services funding which nominally represents its land holdings. Commonwealth properties are exempt from a State levy.

¹⁴ Department of Treasury and Finance, *A Review of Victorian Fire Services Funding Arrangements*, 2003, p. 44.

WIDENING THE FIRE SERVICES LEVY

43. The major criticism of the FSL is that it allows the non-insured and under-insured to avoid or reduce their contribution to the funding of fire services, therefore increasing the amount paid by others. This could potentially be overcome by supplementing the FSL with a levy on non-insured or under-insured properties. The additional levy could, for example, be calculated by reference to the capital improved value of properties found on rate notices. This valuation is, however, generally acknowledged as conservative and may become out-of-date between rating valuations. To counter this, the levy rate could be adjusted annually so as to raise a target level of funding. Further potential drawbacks of widening the FSL include difficulties (such as privacy concerns) in identifying non-insured and under-insured properties and the ultimate costs involved in establishing and maintaining parallel collection systems, together with the enforcement regime required for collection of the additional levy.
44. In addition, the use by motor vehicle owners of fire services could be recognised by imposing a flat rate levy on motor vehicles via the vehicle registration process. This paper previously noted that vehicle-related call outs account for between 10 and 15 per cent of fire services. With approximately 3.8 million vehicles currently registered in Victoria, a levy of \$18 would raise \$68 million of revenue for fire services, or just over 10 per cent of the projected expenditure for the CFA and MFB for 2009-10.

COMPULSORY PROPERTY INSURANCE

45. Compulsory property insurance would also ensure that all property owners would contribute to the funding of fire services if the FSL was retained. On the other hand, compulsion does not recognise that it may be a legitimate decision for some to self-insure. It may also be difficult to prevent under-insurance. If valuation for insurance purposes is based on rating valuation, under-insurance will occur if local government valuations lag behind increases in property values. A more complex valuation method may be required to counter this potential problem. As with the previous option, an enforcement mechanism would be required. Compulsory insurance is discussed further at paragraphs 67 and 68 below.

FUNDING FIRE SERVICES—DISCUSSION QUESTIONS

1. *What are the advantages and disadvantages of requiring insurance companies to fund a major part of the fire services?*
2. *What are the advantages and disadvantages of applying a levy to non-insured and under-insured properties (while maintaining the FSL on other properties)?*
3. *What are the advantages and disadvantages of funding fire services through a property-based levy on all Victorian property and vehicle owners? Are there any factors that make a property-based levy more or less practicable in Victoria compared with other states?*
4. *What are the advantages and disadvantages of all Victorian property owners contributing to one fund for the funding of both the MFB and the CFA?*
5. *What are the advantages and disadvantages of introducing compulsory property insurance to address issues associated with the FSL?*

SECTION 2: BUILDING AND CONTENTS INSURANCE

INTRODUCTION

46. Under commercial and residential property insurance contracts, the insurer agrees to provide cover for the costs of repairing or replacing the insured building in the case of damage or loss caused by nominated events, including fire. As noted previously, residential premiums are largely based on the age of the house, the method of construction and the sum insured. Premiums for commercial property insurance are determined primarily by the business activity on the premises and the building's design, type of construction and fire protection, all of which affect fire risk.
47. Residents can also purchase policies to cover damage or loss to the contents of the property. Insurance sector data indicates that the typical percentage split in insurance value between residential buildings and contents is approximately 76:24, reflecting the greater potential loss from damage to a building.¹⁵
48. Submissions received by the Commission and public comments indicate concern about people having no insurance or insufficient insurance to cover their property and contents losses from bushfires. Individuals have different approaches to risk and those with a high tolerance of risk may consciously choose to forgo insurance. For example, the property concerned may be a small part of a larger asset portfolio, and the owner may consider that the potential loss is not worth insuring. Others may deliberately under-insure, preferring to accept part of the risk. However, it is likely that many property owners experience difficulty in accurately assessing the risks posed by catastrophic events and using means (including insurance) that mitigate the adverse consequences.

NON-INSURANCE AND UNDER-INSURANCE

ESTIMATES OF NON-INSURANCE AND UNDER-INSURANCE

49. Findings on the extent of non-insurance and under insurance of residential property in Australia vary widely.
50. In the Australian Capital Territory's 2003 bushfires, only 6 of the 488 houses destroyed were completely uninsured. However, approximately 20 per cent of houses did not have contents insurance.¹⁶ The ICA has estimated that 4 per cent (approximately 51,000) of Victorian households do not have property insurance and 26 per cent (approximately 490,000 households) have no contents insurance.¹⁷ Nationally, the ICA estimates that the relevant percentages for non-insurance are 4.1 per cent (for property) and 28 per cent (for contents).¹⁸
51. The Department of Human Services (DHS) reported to the Victorian Bushfire Reconstruction and Recovery Authority (VBRRA) that 2131 properties were destroyed in the fires and the ICA reported (as at 30 July 2009) that there were 1853 'total loss' properties (requiring reconstruction or significant repair before reoccupation). The DHS and ICA data suggest that approximately 13 per cent of total loss properties were not insured in the affected areas. Different definitions of a 'total loss' by the VBRRA and ICA make it difficult to draw definitive

¹⁵ Department of Treasury and Finance, *A Review of Victorian Fire Services Funding Arrangements*, 2003, p. 29. Of each \$100 of premium received by insurance companies, \$76 relates to building insurance and \$24 is for contents.

¹⁶ ACT Bushfires Recovery Task Force 2003, *Final Report*, 2003, pp. ix, 98 and 99.

¹⁷ Insurance Council of Australia, *Submission to the Victorian Parliamentary Economic Development and Infrastructure Committee Inquiry into State Government Taxation and Debt*, 2009, p. 16.

¹⁸ Insurance Council of Australia, *The Non-Insured: Who, Why and Trends*, 2007, p. 12.

conclusions about the level of non-insurance, but the data does indicate a significant level of non-insurance.¹⁹

52. In its 2005 report on under-insurance (in part prompted by the ACT bushfires), the Australian Securities and Investments Commission (ASIC) reviewed evidence on the extent of under-insurance in Australia. ASIC cited research from 2000 that found 87 per cent of homes were under-insured and of these, the average level of under-insurance was 34 per cent. ASIC also noted a 2002 survey of the largest insurance companies conducted by the ICA, which suggested that 27.5 per cent of homes were under-insured by 10 per cent or more, and 7.5 per cent of homes were under-insured by 30 per cent or more.²⁰ Following the ACT bushfires, the Insurance Disaster Response Organisation reported that structures destroyed in the ACT bushfires were under-insured, on average, by 40 per cent of their replacement cost.²¹
53. For Victoria's 2009 bushfires, Suncorp's submission provides estimates of under-insurance for its insurance brands. Suncorp concluded that for building insurance, those who were insured (other than those who had opted for complete replacement cover) were substantially under-insured.²²
54. The insurance industry considers that under-insurance is a greater issue than non-insurance. The industry has found that following the 2009 bushfires, most policy holders who were faced with significant loss elected to receive a lump sum payment rather than choosing to rebuild.²³ The industry has interpreted this as due, at least in part, to under-insurance. However, there are alternative explanations. Having suffered a traumatic loss, those policy holders may, for example, have been unwilling to risk rebuilding in the same area.
55. The Victorian Government's announced in its Green Paper a pilot study to provide an estimate of non-insurance and under-insurance.²⁴ The study will collect data from insurers on properties insured within sample geographic regions. The State Revenue Office will then cross check this with information it holds about property values. The study will assist in the assessment of the policy options outlined in the Green Paper but will not be available in time to inform the Commission's final report.

THE DETERMINANTS OF NON-INSURANCE AND UNDER INSURANCE

56. The literature on insurance identifies budget constraints and risk assessment difficulties on the part of consumers as the two most significant determinants of non-insurance. In the Australian context, the ICA has found that most of those non-insured in Victoria are lower income households, but noted that a significant number of households on the upper end of the income scale also do not to take out property insurance.²⁵
57. For Victoria's bushfire affected areas, the Bushfire Cooperative Research Centre (Bushfire CRC) found that the proportion of low-income households was above the national average in only four of the eight areas studied, suggesting that low income levels are insufficient to explain the apparent high levels of non-insurance. Other factors examined by the Bushfire CRC do not indicate higher rates of socio-economic disadvantage in the areas affected by the fires.²⁶

¹⁹ Department of Treasury and Finance, *Fire Services and the non-insured Green Paper*, 2009, p. 11.

²⁰ ASIC (Australian Securities and Investments Commission), *Getting Home Insurance Right*, 2005, p. 15.

²¹ Insurance Council of Australia, *Submission to the House Committee Into Recent Bushfires*, 2003, p. 6.

²² http://www.royalcommission.vic.gov.au/Submissions/SubmissionDocuments/SUBM-002-032-0007_R

²³ Information sourced from the insurance industry.

²⁴ Department of Treasury and Finance, *Fire services and the non-insured*, 2009, p. 12.

²⁵ Insurance Council of Australia, *Submission to the Victorian Parliamentary Economic Development and Infrastructure Committee Inquiry into State Government Taxation and Debt*, 2009, p. 16.

²⁶ Exhibit 126 - Bushfire CRC interim Report (CRC.300.001.001_R) at 0383_R to 0413.

58. The impact of budget constraints may be exacerbated by the impact of the FSL, insurance stamp duty and the GST on the final cost of insurance to the consumer. As noted previously, a rural home insurance premium of \$100 has a final cost to the consumer of \$158.51 due to the FSL of \$31, GST of \$13.10 and stamp duty of \$14.41. As noted in paragraph 29, there is a shortage of information about the sensitivity of insurance consumers to changes in the price of insurance. The study referred to in paragraph 29 found a low (but still noticeable) degree of responsiveness.
59. Difficulties in assessing risk may also be a problem for many consumers considering insurance. In evidence before the Commission, Professor Douglas Paton noted that ‘People commonly face bushfire hazard with unrealistic optimism. Preparedness is over-estimated and the hazard (or the likelihood of it occurring to the individual) is underestimated.’ In addition, ‘People commonly over-estimate the contribution of others (including agencies such as fire authorities).’²⁷
60. Evidence also suggests that past experience of disaster (as opposed to estimates of future risk) plays an important role in the insurance decision.²⁸ The areas most affected by Victoria’s 2009 fires had not been the subject of significant fire activity for many years, and this may have contributed to an underestimation of fire risk.
61. It is sometimes argued that post-disaster assistance creates the ‘Samaritan’s dilemma’ by reducing the economic incentives of potential victims to take protective measures prior to the event. However, evidence (predominantly from the USA) on the role of disaster relief suggests that individuals and communities may not base their decisions on whether or not to invest in mitigating measures by focusing on the expectation of future disaster relief.²⁹ The Australian insurance industry places little credence on the ‘Samaritan’s dilemma’. The industry has experienced a strong uptake of insurance in bushfire prone areas following the 2009 bushfires, suggesting that residents are not looking to government and charitable assistance in the event of future fires.³⁰
62. In addition to the potential causes of non-insurance outlined above, another reason for under-insurance may be the difficulties faced by property owners in calculating the amount of insurance cover required to rebuild their property. This difficulty can be exacerbated by increased building costs which can accompany post-disaster rebuilding, particularly since the most common type of residential property insurance policy in Australia is a ‘sum insured’ policy.
63. A ‘sum insured’ policy caps the insurer’s liability for rebuilding in the event of a total loss at an amount specified by the property owner, called the ‘sum insured’. Under this type of policy, property owners are responsible for determining the sum insured and are likely to under-insure if they lack information about current building costs. In 2005, ASIC found only a small number of insurers provided property owners with access to reliable or comprehensive tools for estimating the cost of rebuilding their home.³¹ ASIC also noted the failure of property owners to increase the sum insured, over time, to keep up with changes in building costs and the possibility that property owners do not increase their level of cover after renovations.

²⁷ Exhibit 69-Statement of Paton (WIT.031.001.0001) at 0005.

²⁸ M J Brown and R E Hoyt, The Demand for Flood Insurance: Empirical Evidence, *Journal of Risk and Uncertainty*, 2000 (3), pp. 291-306.

²⁹ R J Daniels, D F Kettl and H Kunreuther, *On Risk and Disaster*, University of Pennsylvania Press, Philadelphia, 2006, p.183 and P Raschky and H Weck-Hennemann, Charity Hazard - A real hazard to natural disaster insurance, *Environmental Hazards* 7, 2007, pp. 321-329.

³⁰ Information sourced from the insurance industry.

³¹ ASIC (Australian Securities and Investments Commission), *Getting Home Insurance Right*, 2005, p. 5.

64. Increased building costs frequently accompany post-disaster rebuilding, exacerbating the problem of under-insurance. ASIC noted reports that costs increased by 75 per cent following Cyclone Tracy in Darwin in 1974, by 35 per cent in Newcastle after the 1989 earthquake and by 30-50 per cent in the Oakland area of California after fire destroyed 3000 homes in 1991.³²
65. Evidence on post-bushfire building costs from the ACT's January 2003 fires is less conclusive. However, clients of an advisory quantity surveying service established by the ACT Bushfires Recovery Taskforce received quotes for rebuilding typically ranging from \$1,200-\$1,500 per square metre, considerably higher than the \$800 to \$1,100 range that prevailed in the months prior to the fires.³³ Many factors may contribute to increased post-disaster building costs including shortages of tradespeople, a preference on the part of those rebuilding for more complex design with above-standard finishes, and changed building standards.

INSURANCE REFORM OPTIONS

66. The following paragraphs outline some policy options that potentially address non-insurance and under-insurance.

COMPULSORY PROPERTY INSURANCE

67. Many submissions supported compulsory property insurance and several drew on the example of compulsory insurance for personal injuries in motor vehicles or at the workplace. However, there is no Australian precedent for requiring individuals to insure their own property, although examples exist elsewhere: Switzerland has mandatory insurance for buildings and Spain also has obligatory property insurance against natural hazards (flood, storm, earthquakes) offered by a state monopoly. In the United States, mandatory flood insurance is required for new buildings in flood prone areas.³⁴
68. Compulsory property insurance removes the choice of non-insurance, including for those property owners who, for reasons apart from low income, decide either not to insure their property or to under-insure. In addition, it may be difficult to ensure that property owners have an adequate level of cover. Enforcing compulsory insurance would require each property to be assessed against an independent assessment of its value, most probably the capital improved value shown on its local government rating certificate. Under-insurance would occur if local government valuations lag behind increases in property values.

REDUCING THE COST OF INSURANCE: CHANGING THE FIRE SERVICES FUNDING MODEL AND REMOVING STAMP DUTY

69. As previously noted, the FSL adds to the insurance 'bottom line' for property owners which potentially reduces the uptake of insurance. If the FSL was removed and replaced with a funding mechanism not related to insurance, then the cost of insurance to the consumer should fall and insurance uptake may increase. However, as discussed in paragraph 29, there is little information on the potential uptake. The ICA's study indicates that removal of the FSL would halve the estimated number of uninsured households in Victoria.³⁵

³² Ibid, pp. 50 and 52.

³³ <http://www.bushfirerecovery.act.gov.au>, Final Report, Chapter 12.

³⁴ P Raschky and H Weck-Hennemann, Charity Hazard - A real hazard to natural disaster insurance, *Environmental Hazards* 7, 2007, p. 327.

³⁵ Insurance Council of Australia, *Submission to the Victorian Parliamentary Economic Development and Infrastructure Committee Inquiry into State Government Taxation and Debt*, October 2009, p. 20. The ICA estimates that there are 51,000 households without building cover and that approximately 26,000 of these would insure if the FSL was removed.

70. Removing stamp duty on insurance premiums would also reduce the cost of insurance to consumers and possibly encourage more households to take up insurance. This tax has been criticised when the subject of independent reviews.³⁶

71. Table 2 shows that removing the FSL and stamp duty on premiums would reduce the price of a \$100 premium for coverage of a rural house by \$48.51. The reduction would be less, but still significant, for urban property owners. If both the FSL and stamp duty were removed, the ICA’s study estimates that 110,000 additional Victorian households would take up insurance cover for contents and 30,000 additional Victorian households would take up building cover.³⁷

Table 2 Removing the FSL and Stamp Duty on Insurance - Country Area House and Contents Policy

	Current	Post reform
Premium	\$100	\$100
FSL	\$31.00	
GST	\$13.10	\$10
Stamp Duty	\$14.41	
TOTAL	\$158.51	\$110

PROVIDING MORE INFORMATION ON INSURANCE AND PREMIUM DISCOUNTS FOR FIRE READINESS

72. The take up of insurance might be encouraged by providing consumers with more information about:

- the limitations of ‘sum insured’ policies and the factors required to adequately assess the cost of rebuilding a property for the purpose of calculating the sum insured
- the availability of other types of property insurance policies such as ‘total replacement’ policies under which the insurer agrees to pay the full cost of rebuilding the property to the same size and quality and “extended replacement” policies under which the insurer agrees to pay the sum insured plus an additional amount to protect against under-insurance
- insuring for bushfire risks generally.

73. Further, unlike protection against theft, where insurance premiums can vary according to actions taken by the householder to protect their property, no similar discounts and incentives are available for bushfire insurance. It appears that objective measures exist to rate houses for fire safety, but these are not used by insurance companies.

74. Several submissions supported premium reductions in return for the insured undertaking specified measures to minimise fire risk, including a proposal that variations to insurance premiums be based on fire readiness and preparation as assessed by CFA personnel.³⁸ In its Interim Report the Commission recommended ‘The CFA consider the means of providing individual advice to residents in bushfire prone areas, as to the defendability of their homes.’³⁹

³⁶ <http://www.hihroyalcom.gov.au/finalreport>, Recommendation 55 and Independent Pricing and Regulatory Tribunal, *Review of State Taxation, Report to the Treasurer*, 2008 p. 106

³⁷ Insurance Council of Australia, *Submission to the Victorian Parliamentary Economic Development and Infrastructure Committee Inquiry into State Government Taxation and Debt*, October 2009, p. 20.

³⁸ <http://www.royalcommission.vic.gov.au/Submissions/SubmissionDocuments/SUBM-002-004-0325> at 0328

³⁹ B Teague, R McLeod and S Pascoe, *Victorian Bushfires Royal Commission August 2009, Interim Report*, 2009 Recommendation 7.2, page 203.

There may be scope to use information from these assessments in assessing insurance premiums.

SUBSIDISING INSURANCE FOR LOW INCOME HOUSEHOLDS

75. If budget constraints are a key reason for households choosing not to insure or to under-insure in Victoria's bushfire prone areas, then one option for increasing the level of insurance may be for the government to subsidise cover for low income households. Currently, government assistance to households is typically provided after a fire (for example, by assistance with rebuilding). Another option may be to offer an insurance subsidy which provides assistance before the fire, perhaps accompanied by an understanding that less government assistance for private property will be forthcoming in the event of future disasters.

INSURANCE—DISCUSSION QUESTIONS

6. *Is non-insurance and under-insurance a problem in Victoria? Do we have accurate data on this issue?*
7. *What reasons, if any, are there for the government to ensure residents in bushfire prone areas are adequately insured? What form should any government involvement take?*
8. *What effect would removing the FSL and stamp duty on premiums have on the uptake of property insurance?*
9. *Are there better tools, for example web sites, ready reckoners etc that could be made available to property owners to assist them in accurately calculating the replacement cost of their property? Would the availability of such tools reduce under-insurance?*
10. *Would it be practical for insurers to rate houses in bushfire prone areas for fire safety? If so, would this affect premiums? What are the practical advantages and disadvantages of involving the CFA (or persons accredited by the CFA) in reporting a property's fire readiness for insurance purposes?*

APPENDIX - FUNDING FIRE SERVICES IN OTHER JURISDICTIONS

NEW SOUTH WALES

76. Fire services in New South Wales are funded largely by the insurance industry, similar to Victoria. The NSW Fire Brigades that provide urban fire services are funded by:

- Insurance companies - 73.7 per cent
- State government - 14 per cent
- Local government - 12.3 per cent.⁴⁰

77. Local government councils pay their contribution only if there is a station in their 'fire district'. Accordingly, all Sydney councils are required to contribute, and many councils in towns and cities outside Sydney also contribute.

78. The NSW Rural Fire Service is funded by:

- Insurance companies - 73.7 per cent
- State government - 13 per cent
- Local government - 13.3 per cent.⁴¹

QUEENSLAND

79. About 75 per cent of funding received by the Queensland Fire and Rescue Service (QFRS) stems from urban fire levies on properties, which are collected through local government rates. Other funding comes from the State and Commonwealth governments and from a range of smaller fees and charges.⁴²

80. The Urban Fire Levy Scheme was introduced in 1985. Levies are set by regulation and vary according to the classification of the property and its location (based on urban districts and classifications established by the QFRS).⁴³ The Queensland system differs from those in both Western Australia and South Australia as it does not rely on any valuation of the property in question.

81. The urban fire levy is not paid in areas serviced solely by rural fire brigades. These brigades are funded through direct government funding, and any special rates and charges levied by local governments for rural fire brigades operating in their districts.

WESTERN AUSTRALIA

82. Fire and emergency services in Western Australia are funded through an Emergency Services Levy (ESL), which was introduced in 2003-04. The ESL funds emergency service groups, including all career fire stations, volunteer fire brigades, State Emergency Service units and the multi-purpose volunteer emergency service units.⁴⁴

⁴⁰ <http://www.nswfb.nsw.gov.au>

⁴¹ <http://www.bushfire.nsw.gov.au>

⁴² <http://www.fire.qld.gov.au>

⁴³ Queensland Fire and Rescue Service, Urban Fire Levy Administration Procedures Manual V3.0, October 2008.

⁴⁴ <http://www.fesa.wa.gov.au>.

83. The location of a property determines which ESL category it is in. There are five ESL categories, depending on the level of fire and emergency services available (such as a permanent fire brigade or a volunteer fire brigade). The charge for each property is calculated by multiplying the ESL rate for the category of property by the gross rental value of the property. The ESL is collected by local governments that are paid an administration fee to cover their costs.
84. The ESL provides approximately 75 per cent of the funding required to provide emergency services. The state government funds almost all the remainder.

SOUTH AUSTRALIA

85. South Australian fire services and a number of other emergency services are funded through an Emergency Service Levy on property. The ESL is paid into a Community Emergency Services Fund, which in turn funds the various services. The ESL was introduced in 1999 and replaced an insurance based model.⁴⁵
86. The levy on fixed property consists of a fixed fee plus a variable component that derives from capital value, an 'area factor' and a 'land use' factor.
87. The levy funds approximately 50 per cent of the costs of emergency services in South Australia and applies to all fixed property owners and vehicle registrations.⁴⁶ The state government funds almost all the remainder. RevenueSA is the main collection agency for the levy.⁴⁷

TASMANIA

88. Tasmania has a hybrid funding system for its fire services. In 2007-08, the main contributions to the Tasmania Fire Service were from:
- a Fire Services Contribution paid by land owners via local government rates (46 per cent of funding)
 - an Insurance Fire Levy paid by commercial property owners and levied on specified forms of commercial property insurance (25 per cent)
 - a levy on motor vehicle registrations (9 per cent)
 - State Government contribution (9 per cent).⁴⁸

AUSTRALIAN CAPITAL TERRITORY

89. The ACT Fire Brigade and the ACT Rural Fire Service form part of the ACT Department of Justice and Community Safety. They are funded through a property-based system introduced in 2007. The levy on residential and rural properties is \$94.60 with commercial properties levied on the basis of the average unimproved land value over three years.⁴⁹

⁴⁵ <http://www.revenuesa.sa.gov.au>.

⁴⁶ Anecdotal evidence indicates that while, in theory, the CFS and MFS receive almost all of their funding through collection of the levy, in practice this is about 50 per cent and the remainder is sourced from general revenue. When the levy was introduced, it sought to match existing contributions through insurance policies, so those who did insure and paid a fire levy paid no more when contributing to the ESL. In practice, this meant that the Government still had to contribute significant funds and in addition, there was a substantial collection fee through RevenueSA that previous insurance companies achieved at no cost to government.

⁴⁷ <http://www.revenuesa.sa.gov.au>.

⁴⁸ <http://www.fire.tas.gov.au>, Annual Report, 2007-08.

⁴⁹ http://www.treasury.act.gov.au/budget/budget_2009/files/paper3/07revenue.pdf

NORTHERN TERRITORY

90. Fire services in the Northern Territory form part of the Northern Territory Police, Fire and Emergency Services and are therefore funded through consolidated revenue.⁵⁰

⁵⁰ <http://www.nt.gov.au/pfes/>