

IPART Draft Report on Multi Peril Crop Insurance Incentive Measures

Submission by

Allianz Australia Insurance

Allianz appreciates the opportunity to provide a submission in response to the Draft Report as part of IPART's review of multi-peril crop insurance incentive measures.

Introduction

The aim of this submission is to address the key concerns that IPART has identified in its Draft Report, to offer suggestions on the proposed subsidy scheme with a view to achieving optimal outcomes and to raise other issues considered relevant.

Our main suggestion in relation to the proposed premium support scheme would be to introduce a stable subsidy for the term of the scheme rather than the step down mechanism proposed.

Other issues which we wish to bring to the attention of IPART include the:

- report's assumptions about the cover that can be provided by multi-peril agricultural insurance products;
- interaction of MPCl with the broader Commonwealth-State drought assistance framework;
- narrow evaluation framework, which has led to the benefits of MPCl being understated;
- benefits of accompanying a premium support scheme with a stamp duty waiver;
- report's assumptions about the uptake of MPCl; and
- individual impact on farmers, that is, the human element of drought.

Allianz is one of the largest agricultural insurers in the world with extensive experience in crop and livestock insurance. Currently, Allianz Group offers agricultural insurance programs in more than 30 countries which provides us with unique resources and professional experience in this highly specialised area of insurance. With the annual agricultural premium income of over A\$1 billion, Allianz is one of the top three global agricultural insurers (along with Munich Re and Swiss Re). As a result, Allianz has very good understanding of the challenges that governments and insurers face when introducing multi-peril agricultural insurance programs, both private and government-supported.

Unfortunately, we have experienced a number of instances where inappropriate decisions made during the program planning stage have resulted in program failure which either led to the failure/closure of the program or an unnecessary slowing in the development of multi peril agricultural insurance. If the NSW Government decides to introduce a premium support scheme for MPCl, Allianz offers its global knowledge and experience to the government to assist in the detailed design of a potential MPCl premium support scheme which maximises the ability of the scheme to achieve the government's objectives.

Comments on issues raised in the Draft Report

Removal of cover during droughts

The draft report stated:

"MPCl is not likely to be effective in mitigating the risk to farmers of drought." (p.4)

"MPCl is a more suitable product for insurance against non-drought climatic events" (p 4)

"As existing MPCl products are offered on a year-by-year basis, this means farmers and insurers can opt in or out of the market each year, depending on the forecast conditions. It is unlikely that MPCl would be made available at an affordable premium in prolonged drought conditions." (p. 5)

The above statements appear to be based on a misunderstanding of the role MPCl can play as an integrated part of a broader framework to support and assist farmers plan for, mitigate against and recover from extreme weather events and climatic conditions, particularly arising from insufficient rainfall and/or drought. Internationally, MPCl is not generally perceived as a pure drought relief instrument. The main task of an MPCl program is to provide timely assistance to the farmers suffering crop loss from different weather perils, including drought.

The key function of any insurance program is to return the insured to the same or similar (depending on the level of cover) financial position that would have pertained had the risk event not occurred. Usually, MPCl claims are paid within 1-3 months after crop harvesting or failure, which results in expedited assistance compared to the drought assistance payments often delivered through government drought mitigation and relief measures. Under appropriate scheme design arrangements, an MPCl program can be offered during extended dry periods lasting for more than one year/season. Insurers can effectively manage such events via reinsurance programs,

additional prevented planting (no-planting) components of MPCl coverage, insuring drought through the alternative solutions (e.g. weather index structures) or multi-year or auto-renewal policies. There is a vast suite of solutions employed by insurance companies globally to address the concerns raised by the draft report in this area.

The Allianz Group participates in MPCl programs across Asia, Africa, Europe, South and North America and is capable of managing an array of possible options to Australia. We are more than willing to share our knowledge with the government if a more comprehensive assessment of potential scheme design option is to be undertaken.

The price of MPCl does not fluctuate year-on-year in the same magnitude as rainfall. Like other insurance products that cover risks vulnerable to 'regular' extreme weather events (eg flood and cyclone risk), rating is done on a long-term basis, where premiums are smoothed out so the offering is viable in the long-term. Reinsurance is also used extensively for broadacre insurance in response to its highly seasonal nature and exposure to systemic risk. Stop loss reinsurance, for example, which comes into force only when loss ratios exceed a certain threshold.

A multi-year product or automatic renewal product could also help in the provision of MPCl during extended droughts. Some jurisdictions (e.g. Canada and America) have adopted specific rules for farmers to participate in the subsidised MPCl program (e.g. continuous participation and multi-year policies). The introduction of continuous participation requirements in the program (e.g. through multi-year contracts) has been known to enhance market penetration and reduce some insurance problems originating from low participation (e.g. adverse selection, high administration costs). An example of the effectiveness of such arrangements is currently occurring in the USA. While California is currently in the third year of drought, MPCl is still offered in the State. Similar successful MPCl programs in prolonged drought currently include some provinces of Spain.

Multi-Peril crop insurance is unlikely to displace other government drought assistance

The draft report included a statement that the MPCl cannot provide a substitute for drought assistance offered by the government. This is not consistent with international experience. Many countries have introduced a comprehensive framework for managing risks in the agricultural sector. This approach is used to address the range of different needs for risk management in the face of extremes of weather. The role of the MPCl program is to provide an effective and timely assistance to help commercial farmers recover after adverse weather events. When integrated into a broader agricultural assistance framework, MPCl can become a direct substitute for traditional drought relief support arrangements. For example, in the Australian context, MPCl (depending on

levels of cover) could be a direct substitute for Federal Government programs such as the Farm Household Allowance and Farm Management Deposit scheme. For example, if fully integrated into the existing Federal and State drought assistance arrangements farmers could be given the choice between receiving MPCl premium support payments and access to other drought relief programs that provide similar types of support or support in similar circumstances. Indeed, existing programs may need to be adjusted to take account of farmers' participation in an MPCl premium support scheme or the government may risk some farmers being eligible for drought assistance in circumstances where they have received an MPCl payout and as such don't suffer the same financial deprivations of uninsured farmers.

For example, Canada has implemented an integrated Business Risk Management program for agriculture which includes AgriInvest, AgriStability, AgriInsurance and AgriRecovery components. In addition to these program components, which are co-financed by the federal and provincial governments, the federal government also administers and finances innovation, competitiveness and marketing programs to assist commercial farmers with a full suite of risk mitigation instruments. Some of these components are similar to the Farm Management Deposits program and concessional loan programs in Australia, as well as to some other NSW Government drought assistance programs, however, Australia's suite of agricultural assistance measures is missing the AgriInsurance (MPCl program) component of such an integrated framework.

MPCl only covers crop farmers, neglecting livestock farmers

IPART's draft report stated:

Insurers currently offer multi-peril crop insurance to cropping farmers only, whereas over 80% of government assistance goes to livestock farmers. (p. 45)

While this may be true, this is not a strong argument for inaction on MPCl. Firstly, broadacre represents a suitable starting point for drought-related insurance as it is highly volatile in production yields and is also the most straightforward agricultural industry to insure. Indeed, the Draft Report noted that:

Crop insurance products are the most developed type of insurance for agriculture, representing almost 90% of the total value of agricultural insurance policies written globally. This is because weather-related risks are the highest for this sector. Between 1966 and 2011, grains and oilseeds exhibited the highest degree of volatility in the value of farm

production across the Australian agricultural sector, at 1.8 times the average volatility. (p. 19)

To disregard the potential for premium support to encourage the wider benefits to the crop and mixed farming sectors of a significant increase in participation in MPCl on the basis of the exclusion of the livestock sector lacks merit. While the majority of drought assistance may go toward livestock farmers, this does not change the fact that MPCl could be used to effectively stabilise income for crop farmers during periods of drought.

MPCl is also an ideal starting point for further consideration of the benefits of government support for drought-related insurance products in the agricultural sector. On the basis of success in encouraging an expansion of the uptake of MPCl, an insurance offering could be developed for livestock farmers in the future.

Livestock and cropping management strategies for drought are vastly different. A livestock manager has many options available to maintain stock (some at an additional cost) including transporting animals to a different location, managing paddock rotations, reassessing property carrying capacity and destocking, utilising stored feed or the purchase of off-farm fodder and weaning stock. On the other hand, once a Crop manager decides to invest and plant a crop they are heavily reliant on rainfall with little management strategies possible to mitigate loss.

That said, internationally, there are insurance programs offered for forage crops (including forage supply payouts) or margin/income based products that can provide insurance cover for livestock farmers and act as a substitute for some traditional livestock drought support measures. For example, index solutions for forage crops and pastures have proved effective in some countries.

MPCl uptake will mainly be by best-practice farmers

IPART said in its draft report:

Farmers who are furthest away from best practice are the least likely to purchase MPCl, but the most likely to encounter financial difficulties during drought. (p. 45)

This contradicts the notion of adverse selection that plagues all insurance products, that is, those who are more likely to experience a loss are more likely to take out insurance to cover that loss. Many studies have found that the expected rate of return of insurance

leads to increased participation. Additionally, that farmers who received disaster payments in the past were more likely to take out insurance. Other analysis has found that farmers who were more highly leveraged, less wealthy, riskier, and operate larger acreages engaged more extensively in insurance.^{i,ii,iii}

Productivity in Australian agricultural has stalled since 1997.^{iv} Any initiative that encourages productivity increase, as MPCl does, rather than entrench existing practices, as drought assistance can, is welcome. Australian farmers' variable climatic conditions and low profitability during the millennium drought has reduced capital investment in new technologies. MPCl has the potential to be a new source of capital to farmers and encourage greater upfront investment of inputs with the surety of greater income certainty. This is especially true for those farmers who have been unable to lift themselves to best practice and for whom MPCl could be the nudge they need to increase their productivity.

Market failure

IPART said in its Draft Report:

There is no market failure because:

- *It is more probable that low uptake is due to high structural costs, and*
- *While information shortages may have impeded the market for this insurance in the past, this is no longer an issue. (p 43)*

In regard to the first point, it is true that the high structural costs of MPCl and the resulting high premiums are what lead to the affordability problem for farmers. The more relevant question, however, is whether there are market failures that drive the high structural costs of MPCl in the first place. In this regard, Allianz would argue that asymmetric information and the resulting moral hazard and adverse selection faced by insurers form part of the reason for the high cost of MPCl.

In its report, the CIE stated that:

*There may be information asymmetries that hamper the MPCl market.
(p 5)*

This statement would appear to conflict with IPART's Draft Finding that there is "no market failure". In addition to the information asymmetries discussed above, Allianz believes that there is also a lack of information available on the benefits of MPCl, which leads to time-inconsistent preferences among farmers. In this regard, IPART noted that "the farming sector's general reluctance to adopt new tools and technology until they are tried and tested may be another important barrier" (p 50). One study^v showed that

24% of farmers did not take out MPCl due to issues other than the cost of coverage, which included limited information. A farmer (Sharon Maguire) mentioned at the IPART Roundtable on the draft report that they were initially reluctant to take up MPCl as they had no experience of it and also didn't know of anyone who had experience of it.

It is also arguable that MPCl creates positive externalities that are difficult to quantify, price and obtain payment for from the beneficiaries of those positive externalities. For example, a more financially prosperous and stable farming sector has a range of positive benefits that extend beyond the farm gate. These include more financially stable regional communities. This contributes to the commercial viability of non-farm agricultural businesses such as farm machinery, seed, fertilizer and pesticide providers as well as other regional businesses more generally.

Stronger and more financially viable farmers and regional communities create more stable regional populations, enhancing economies of scale and scope in the provision of public services (eg education, health), reducing associated social costs (eg family breakdown, mental illness and suicide) and retaining or attracting greater private sector investment in agriculture. Insurers are unable to extract a premium contribution from the beneficiaries of these externalities, hence, increasing the reliance on the premium contribution from the more direct beneficiaries of MPCl (ie the farmers themselves), adding to the lack of affordability of the product in the eyes of the majority of eligible farmers.

Narrow evaluation framework

Allianz suggests that the evaluation framework and some of the assumptions used has resulted in the benefits of MPCl being understated. The benefits of the cost-benefit analysis were limited to the productivity increases flowing from farmers' increased production in good seasons. However, this neglects other benefits that come from income stabilisation to both the community and to farmers personally. Farmers will have the ability to invest more in their businesses and communities, in terms of money and also human/social capital. There are two main facets of insurance which provide farmers with this ability to contribute to the wellbeing of the community.

Firstly, insurance contracts provide certainty to farmers that if a covered event occurs and leads to a loss of revenue/yield they will receive a payout. Secondly, the claims process leads to a timely payment so farmers are not left in uncertain circumstances and can make sound decisions soon after they have suffered a loss and longer term investment decisions more generally. When the growers are confident that an insurance policy will offset potential catastrophic losses from severe but low-frequency events, they invest in better production technologies which results in further productivity gains.

This point was strongly made by one of the farmers that attended the Roundtable on the draft report.

Allianz suggests that a general equilibrium economic analysis would have better captured the full range of impacts of an MPCI premium support scheme. For example, there are benefits of transferring some drought risk from Australian taxpayers to international reinsurance markets. For example, for a reinsurance premium of \$10 million associated with MPCI, it is possible to get reinsurance coverage of more than \$200 million which, in case of severe drought, would represent a capital inflow from global reinsurance markets rather than from NSW and/or Australian taxpayers.

In terms of the cost-benefit analysis conducted by the CIE, Allianz suggests that it understates the benefit of MPCI due to the following assumptions:

- a 7% real discount rate appears too high in the current interest rate environment. For example, it is significantly higher than the NSW Government's borrowing costs. Further, as the costs of the possible program are incurred over five years but the benefits are measured over 20 years, an excessively high discount rate biases the resulting benefit cost ratio against the benefits of the modelled program.
- As noted above, Allianz believes that MPCI is an effective substitute for some existing drought relief programs, albeit that these are generally Commonwealth Government programs. To the extent that expenditure on an MPCI premium support scheme can be diverted from or would otherwise reduce expenditure on other drought programs, the CBA assumption of a 35% excess burden in relation to the revenue that it is assumed needs to be raised to fund the subsidy is also arguably excessive. This also biases the results of the analysis against the benefits of the modelled program.

Stamp duty waiver

IPART said in its Draft Report, that a Stamp Duty waiver:

does not comply with the drought framework as it would not be effective in achieving its objective of increasing the uptake of MPCI. (pg. 60)

Numerous participants at the draft report roundtable mentioned that, while the stamp duty is small at only 2.5%, it is still a stumbling block for many farmers in the purchase of MPCI. As premiums are very high, this percentage can translate into a very large material monetary amount. Farmer's willingness to pay for MPCI is very sensitive as it is an unfamiliar product for them so even such a small price impact can be the difference between the decision to purchase or not purchase MPCI.

Uptake of MPCl

IPART noted in its submission:

CIE assumed that farmers who do not currently hold single-peril insurance would not purchase multi-peril insurance, and estimated the upgrade rates by interviewing farming consultants and other stakeholders about the willingness to pay for insurance. (pg. 51)

Allianz disagrees with the assumption that farmers would not transition from no insurance to multi-peril insurance. While there is definitely an overlap between named peril and multi-peril crop products, some farmers may live in areas where hail, frost and fire, are not a very high risk, but rainfall is highly variable, which could lead to flood or drought in different seasons. Global experience indicates that there is a higher uptake in both types of insurance products if they are available to farmers in circumstances where farmers are assisted with the affordability of MPCl.

Cover provided by MPCl

In the Draft Report IPART only referred to MPCl as a protection method against drought. While the focus on drought relief is appropriate as MPCl as being assessed against the Drought Evaluation Framework, this narrow view fails to acknowledge the broader coverage of MPCl. MPCl products cover the traditional perils of hail, fire and frost, as well as drought, flood, excessive rainfall, wind, excessive heat and wildlife damage. Of particular note here is flood, excessive rainfall and wind cover (storm coverage). The NSW Rural Assistance Authority provides Natural Disaster Relief Assistance against storms, floods and also bushfires to ensure that farmers can continue their farming operations. This is a lengthy application and approval process. MPCl therefore can provide benefits for farmers impacted by these events and also reduce government spending in these areas.

Impact on farmer wellbeing

IPART's Draft Report stated that:

Government support for MPCl...:

- Assists farm families to adapt to and prepare for the impacts of increased climate variability.
- Encourages farm families and primary producers to adopt self-reliant approaches to manage their business risks.
- Enhances the long-term sustainability and resilience of farmers. (pg. 38)

While the social and personal impacts of MPCl were acknowledged in the Draft Report, Allianz feels that they were understated or ignored in the analysis of the costs and benefits of MPCl assistance. Further, that the Drought Evaluation Framework neglects the relevance of these issues. There were two farmers present at the public hearing who both gave first-hand experience of MPCl. Their main comment was that MPCl had improved their overall wellbeing. While one farmer had not experienced an event leading to a claim, the peace of mind gained was unquantifiable. The other farmer mentioned that their productivity had increased as they were able to invest more in their crop with the knowledge that these costs could be recovered in the event of failure. These benefits are harder to quantify but should not have been ignored from any analysis of impact on economic and social welfare of increasing the uptake of MPCl and would have been highlighted by a more comprehensive and deeper analysis of the benefits of government support for MPCl.

References

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^{iv} Keogh, M. (2015) Why has Australian agriculture productivity growth stalled? *Australian Farm Institute*, <http://www.farminstitute.org.au/ag-forum/australian-agriculture-productivity-stall>

^v Kondinin Group Research Report (2016), Multi-Peril Crop Insurance – Reducing the Risk, <http://www.farmingahead.com.au/articles/1/12202/2016-07-13/research-reports/mult-peril-crop-insurance-reducing-risk>