

HENRY DAVIS YORK

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**BY ONLINE SUBMISSION
& BY MAIL**

Ms Jessica Robinson
Multi-Peril Crop Insurance Incentive Measures Review
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop NSW 1240

Dear Ms Robinson

Submission to IPART Multi-Peril Crop Insurance Incentive Measures Review

Henry Davis York (**HDY**) welcomes the opportunity to provide a submission in response to the Draft Report on multi-peril crop insurance (**MPCI**) incentive measures.

HDY is one of Australia's leading independent law firms. We offer end-to-end expertise in insurance law, from corporate, transactional and regulatory matters through to technical policy wording and coverage issues. The firm also specialises in significant and complex litigated claims, across life, private health, general and reinsurance matters. Our clients include major Australian and international insurers, corporates and the public sector.

We look forward to further discussions on this subject between government, IPART and interested stakeholders.

Executive Summary

HDY has provided legal advice and commercial guidance to a variety of MPCI market participants and potential participants. It is clear that both insurers and potential insureds are invested in the development of a strong and viable MPCI market in Australia.

In our view, that development is best achieved through direct government subsidies for premiums, which would offer farmers an opportunity to take advantage of this important risk mitigation strategy.

Although we consider that the Draft Report raises some valuable issues, we respectfully disagree with the conclusion that MPCI could only play an 'indirect role' in increasing farmers' self-reliance during droughts¹. In fact, we submit that an effective MPCI industry has the potential to play a direct and critical role in producing such self-reliance.

¹ IPART Draft Report (July 2016) *Review of multi-peril crop insurance incentive measures*, p. 3

We are also of the view that many of the concerns raised by the Draft Report are likely to be alleviated by innovative and competitive product offerings by insurers. Although we acknowledge that logistical issues associated with cover exist at this stage, we have already seen moves within the market to meet these challenges as the market grows and matures.

However, so long as MPCl penetration remains low, and government drought assistance payments remain common practice, the market for MPCl is likely to be unsustainable. That reality is echoed by a breadth of international experience. Appropriately structured government subsidies offer an opportunity for the MPCl market to develop and strengthen, whilst significantly reducing long-term government spend on recovery and disaster relief payments.

The market for MPCl in Australia

HDY has been approached by participants and interested parties on both sides of the MPCl market to provide advice and guidance in relation to the legal structure of MPCl product offerings. We have also engaged in comprehensive policy reviews, to provide insight into commercial viability and coverage.

It has been clear from our discussions with market players over a period of time that there is genuine appetite among farmers seeking to manage and mitigate some of the most significant risks in their industry. It is also clear that Australia presents as an attractive market for insurers offering this product, especially given its geography and the opportunity to hedge environmental risk across different continents.

In our view, the operational and regulatory environment of the Australian market poses appropriate and manageable barriers to entry; we do not consider there to be broad legal impediments to market participation. These factors, along with the prospect of growth, have contributed to a small but diverse commercial market, which has already seen innovative product offerings.

As a result, we have witnessed enthusiasm for MPCl in the Australian market from insurers, insureds and potential insureds. However, our engagement with members of the industry also reveals that the most challenging aspect of the continued viability of MPCl remains the high price of premiums.

Evidence suggests that farmers are keenly price-sensitive commercial consumers, particularly with respect to insurance products. Insurance experts in the field with whom we have consulted considered that farmers in Australia were generally unwilling to spend more than 5 per cent of the total sum insured on insurance premiums. By contrast, a typical MPCl policy can often equate to between 7 and 12 per cent of sum insured.

The high premiums associated with MPCl are not unique to Australia. Globally it represents an expensive product due to the broad number of risks covered, high concurrence of pay-outs in the wake of events, and the difficulties of adverse selection. As highlighted by the Australian Bureau of Agricultural and Resources Economics and Sciences, well-established MPCl markets internationally have relied upon high levels of permanent government subsidy to survive².

² Hatt, et al (2012) *Options for insuring Australian agriculture*, Department of Agriculture, Fisheries and Forestry (ABARES Report), at p. 28

Structuring subsidies – the relationship between government assistance and MPCl

The international experience in MPCl indicates that where governments offer ad hoc disaster payments to farmers, it stifles the development of insurance products³. This is because low penetration of MPCl in the market will not offset the requirement for government to intervene when loss occurs. Government assistance therefore creates a moral hazard – preventing farmers from participating in private insurance schemes as a consequence of competing public safety nets.

This situation has been addressed in other jurisdictions by governments that make any post-event assistance contingent upon a farmer maintaining a base level of insurance cover. The MPCl subsidy model employed by the United States government offers an interesting case study in this respect. In 1994 the US made participation in the crop insurance program mandatory in order for farmers to be eligible for deficiency payments under price support payments, loans and other benefits. The private premiums were subsidised by the government at reasonably high levels. MPCl premiums account for approximately 9 per cent of sum insured across the market, but this expense to the farmer is mitigated by premium subsidies which are applied at approximately 58 per cent⁴.

Although the element of mandatory participation has since been repealed, farmers who accept government assistance are still required to purchase insurance as a condition of receiving benefits, or otherwise waive their rights to relief. The result has been that levels of subsidies crop insurance in the US tripled in the space of ten years⁵.

We consider that there are valuable learnings from the US experience, where government disaster assistance (although not completely replaced) has fallen dramatically as a result of subsidised MPCl coverage. We would also suggest that the cost of the subsidy provided is likely to be outweighed by the cost of ad hoc assistance that would otherwise have been provided in the absence of insurance. However, we recognise that this is an issue which would benefit from further research.

Current challenges can be cured by innovation and competition

The Draft Report raises a series of valuable concerns about the practical operation of MPCl. However, we submit that many of these challenges can be overcome through innovative and competitive offerings by insurers.

The Draft Report recognises that most droughts can be foreseen months in advance, thereby enabling insurers to opt-out of the market each year if the risk posed is too high. The effect of this would be to undermine certainty of cover within the MPCl market and to leave farmers without cover during the very periods when they are most susceptible to loss.

We consider that as the market develops and matures, insurers will be forced to offer increasingly attractive policies, which lend greater power to farmers as consumers. This process is already underway. Several commercial offerings in the Australian MPCl market provide for early sign-on processes, where policies are written before drought indicators can be assessed. This ensures that the pricing of risk is 'blind' to indicators for the coming

³ Diaz-Caneja et al (2009) *Risk Management and Agricultural Insurance Schemes in Europe* (JRC Report: European Commission), p. 10 at:

http://www.preventionweb.net/files/12515_jrcreferencereport200909agriins1.pdf

⁴ *ibid*, p. 11

⁵ USDA Risk Management Agency – History of the Crop Insurance Program at:

<http://www.rma.usda.gov/aboutrma/what/history.html>

season, and instead relies upon past aggregate data. The result is that cover for farmers is guaranteed before season-specific information is released.

Several products also offer year-on-year renewal in this manner, such that farmers enjoy the benefit of increased certainty in relation to premiums. It is to be noted that the more established and secure the market for MPCl, the more likely products of this nature are to be offered.

The Farm Business Skills Professional Development Program

As acknowledged by the Draft Report, the MPCl market in a number of countries involves standardised cover, heavily subsidised by the government. The argument in favour of standardised policy terms is that they may result in increased awareness and understanding of products among insureds.

Although still relatively small, Australia's MPCl market is diverse; the policies currently offered differ significantly in application process, price and design. HDY remains of the view that such diversification is positive for both insurers and insureds. It enables insurers to compete on a variety of factors and stimulates innovative commercial solutions to market problems.

Nonetheless, we acknowledge that Australian farmers suffer from limited information regarding the types of policies offered and their specific features. We suggest that this can be alleviated in part through increased farmer education under the Farm Business Skills Professional Development Program, to which the NSW government allocated \$45 million as part of a \$300 million Drought Strategy response in 2015⁶.

The Draft Report correctly identifies that funds under the program have limited educational value in the context of MPCl, insofar as they can only be used to offset the costs of preparing an application for insurance, which represent a very low proportion of the total cost⁷. We consider that there is value in allocating certain of that funding to independent educators who engage with farmers, such as peak bodies and representative organisations, in order to provide farmers with greater information about competing commercial schemes. This approach would expand farmers' understanding of available commercial products and offerings, and likely increase MPCl take-up.

HDY appreciates the opportunity to contribute to the IPART Review. We look forward to continued and valuable discussions on this complex and important issue.

Yours faithfully
Henry Davis York

Louise Cantrill
Partner

⁶ Farms Business Skills Professional Development Program, NSW Department of Primary Industries at: <http://www.raa.nsw.gov.au/assistance/professional-development-program>

⁷ IPART Draft Report (July 2016) *Review of multi-peril crop insurance incentive measures*, p. 8