

EXPLANATORY STATEMENT

**Issued by authority of the Minister for Financial Services and
Superannuation**

Insurance Contracts Act 1984

Insurance Contracts Amendment Regulations 2011 (No.)

The *Insurance Contracts Act 1984* (the Principal Act) regulates the terms included in insurance contracts and insurer conduct in relation to such contracts.

Section 78 of the Principal Act provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act.

The Principal Act sets out a standard cover regime that is to apply to prescribed contracts of insurance. Under this regime, standard cover (that is, minimum levels of cover for prescribed events) will be deemed to be included in certain classes of prescribed insurance policies, including home buildings and home contents insurance (other than cover notes and renewals). Exclusions and limitations to the standard cover which an insured might not expect are to be brought to the insured's notice before the contract of insurance is entered into.

However, although the *Insurance Contracts Regulations 1985* (the Principal Regulations) prescribed the events to form part of the standard cover regime, definitions of the prescribed events were not provided.

The *Insurance Contracts Amendment Act 2011* (the Amending Act) amended the Principal Act to provide a legislative framework to allow regulations to be established for a standard definition of the prescribed event 'flood' for riverine flooding in home building and home contents (whether offered separately or in combined form) insurance contracts and contracts held by small business and strata title residences.

The Regulations amend the Principal Regulations to define 'flood' and the classes of contracts of insurance to which the definition of 'flood' is to apply.

The standard definition of 'flood' involves introducing a standard form of words to describe riverine flooding and reserve the term 'flood' and other variations of the word 'flood' for flooding in this context (whether as an included or excluded event).

While the Principal Regulations provided interpretations of home buildings and home contents that were appropriate for these purposes, it does not provide interpretations of small business and strata title residences. The Regulations amend the Principal Regulations to provide a definition of 'strata title residence' and a test to identify whether a business is a small business.

In 2010-11 there were a number of severe floods in Queensland, New South Wales and Victoria. These events highlighted the importance of insurance in assisting individuals and communities to recover from disasters when they strike. However, they also highlighted the fact that many consumers lacked insurance cover against the particular type of inundation that commonly occurred; namely, riverine flooding. This circumstance is thought to be partly attributable to consumer confusion in

EXPOSURE DRAFT

2

relation to the definition of 'flood' in home building and home contents policies, which differed between policies.

The purpose of introducing a standard definition of 'flood' is to reduce consumer confusion regarding what is and what is not included in flood coverage, thereby potentially reducing the risk consumers will purchase cover that is not inappropriate for their needs. It will avoid situations where neighbouring properties, affected by the same inundation event, receive different claims assessments because the policies covering them use different definitions of 'flood'. It will also improve consumers' ability to evaluate potential insurance policies and compare policies between different insurers.

Consumer confusion over whether their insurance contracts include cover for riverine flooding applies to contracts for residences, home contents and small business. Residences include both home buildings and strata title residences.

Following the 2010-11 floods, the Government undertook targeted consultations with representatives of consumer groups, the insurance industry and the legal profession on insurance-related matters. These consultations assisted the Government in developing the consultation paper 'Reforming Flood Insurance – Clearing the Waters' which it released for public comment on 5 April 2011.

The consultation paper included proposals to introduce a standard definition of 'flood' for use in insurance policies and a short key facts statement that would summarise the contents of insurance policies. The closing date for submissions was 13 May 2011. A total of 13 public submissions were received in response to the consultation paper.

In addition, the Natural Disaster Insurance Review, which the Government commissioned on 4 March 2011 to examine the availability and affordability of natural disaster insurance, undertook extensive consultations. The Review Panel recommended that the Government introduce a standard definition of flood in the form proposed in the 'Reforming Flood Insurance: Clearing the Waters' consultation paper.

Details of these Regulations are set out in the [Attachment](#).

The Regulations are a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

The Regulations will commence two years after the day they are made.

EXPOSURE DRAFT

Attachment

Regulation 1 provides that the name of the Regulations is the *Insurance Contracts Amendment Regulations 2011 (No.)*.

Regulation 2 provides that the Regulations commence two years after the day they are made.

This provides a transition period for the industry to implement necessary systems changes, staff training and new procedures.

Regulation 3 provides that the *Insurance Contracts Regulations 1985* (the Principal Regulations) are amended as provided for in Schedule 1 to the Regulations.

Under Section 37B of the Principal Act (as amended by the Amending Act), there is a power to define the meaning of ‘flood’ in regulations for the purposes of Division 1A of Part V of the Principal Act.

Division 1A requires a standard definition of the term ‘flood’ to be applied to all insurance contracts as prescribed in the Division. The provisions contained within Division 1A while acting independently remain consistent with other requirements in the Principal Act. A prescribed contract for the purposes of Division 1A is an insurance contract included in a class of contracts of insurance declared by the regulations to be a class of contracts in relation to which Division 1A applies.

The terms and conditions of the standard cover regime in Division 1 of Part V of the Principal Act are set out in the Principal Regulations.

Regulation 9 and Regulation 13 declare respectively that home building and home contents insurance are classes of contracts of insurance to which the standard insurance cover regime in Division 1 of Part V of the Principal Act applies.

Regulation 10 and Regulation 14 specify those events that are declared to be prescribed events in contracts of insurance referred to in Regulation 9 and Regulation 13 respectively. Prescribed events incorporate a wide range of events that include ‘flood’, which is identified as a prescribed event in subparagraph 10(a)(xi) and subparagraph 14(a)(xi).

Item [1] and Item [2] amend subparagraph 10(a)(xi) and subparagraph 14(a)(xi) respectively to indicate that ‘flood’ has the meaning given by regulation 29D.

Item [3] inserts Division 8, which defines ‘flood’ and specifies the classes of contracts of insurance that are to use the definition of ‘flood’.

Regulation 29A Definitions for Division 8

Regulation 29A defines ‘strata title residence’ for the purposes of Division 1A of Part V of the Principal Act.

A ‘strata title residence’ is defined to mean a residence to which the following apply:

- (a) the portion of land on which the residence is located exists as the result of the subdivision of the title to a larger portion of land into separate titles for use for residential purposes;
- (b) property that is common between the residence and one or more other portions of land is managed by a single body corporate (however described).

EXPOSURE DRAFT

4

The definition of ‘strata title residence’ provided in this regulation draws on definitions commonly used in State and Territory legislation, noting that laws relating to strata title residences fall within the jurisdiction of the States and Territories.

These properties can take a number of forms, from duplexes to gated communities to small and large apartment buildings. Individuals own a portion of the property and there is also common property, of which ownership is shared.

The regulation also provides an example of an ‘owners corporation’ that is drawn from descriptions in State and Territory legislation, as follows:

the title to the portion of land on which the residence is located is regulated under the law of the State or Territory in which the land is located as a ‘strata title’, a ‘community title’ or another description that refers to the title being created as described in paragraphs (a) and (b).

It is not intended that policies offered in respect of strata title properties that do not have a residential use be subject to the requirement to use the definition of ‘flood’. So, for example, a strata title property used exclusively for commercial purposes is outside of this definition.

Request for comment

The definition of ‘strata title residence’ is intended to be representative of definitions used in State and Territory legislation. It is also intended to capture all forms of residences to which a form of strata title applies.

- Does the definition of strata title residence proposed appropriately reflect definitions used in State and Territory legislation?
- Are there any limitations in defining a ‘strata title residence’ in accordance with definitions used in State and Territory legislation?
- Are there other forms of residences to which a strata title applies that are not captured by this definition?

EXPOSURE DRAFT

5

Regulation 29B Small businesses

Regulation 29B explains whether a business is a small business for the purposes of Division 1A of Part V of the Principal Act. This regulation uses two measures of business size; namely, current employee numbers and turnover, where turnover means turnover in the last completed financial year.

Paragraph 29D(2) specifies that where turnover is known, a small business is a business with a turnover of less than \$1 million or five or fewer employees.

Paragraph 29D(3) provides for those circumstances where a turnover figure for the previous financial year is not available. This may be due, for example, to the business being newly established or the turnover not having yet been finally determined. Where such circumstances apply, only the employee number is used such that a business is a small business if it has five or fewer employees.

Request for comment

The intention is that the requirements of Division 1A of Part V of the Principal Act apply to businesses that are sufficiently small that they are likely to purchase insurance directly.

Does the proposed test of whether a business is a small business achieve this result?

- Alternatively, should the test be narrowed to include businesses which have five or fewer employees and a turnover of less than \$1 million?
- Should the test be revised in another way? If so why and how should it be revised?

If it is considered appropriate to identify whether a business is a 'small business' in the manner proposed, is there a need to define 'employee' for these purposes?

Regulation 29C Prescribed contracts

Under Section 37A of the Principal Act (as amended by the Amending Act), there is a power to specify in regulations the classes of contracts of insurance to which Division 1A of Part V of the Principal Act applies.

Regulation 29C specifies the classes of contracts of insurance to which the definition of 'flood' is to apply.

These classes of insurance contracts comprise insurance for home buildings and home contents (whether offered separately or in combined form), strata title residences and small business.

The two key types of insurance contracts where it is considered to be critical for consumers to have a standard definition of flood are home buildings and home contents (both of these types of contracts are contracts to which standard cover applies).

It was also considered appropriate to include other similar insurance contracts that directly impact consumers. Therefore, the regulation declares insurance contracts covering small business and strata titles, as defined in the regulations, as prescribed contracts to which Division 1A of the Principal Act (as amended by the Amending Act) applies.

EXPOSURE DRAFT

EXPOSURE DRAFT

6

A small business for the purposes of Division 1A of the Principal Act is defined as a micro business that operates on a household level and experiences similar difficulties in processing complex policy documents as household residences.

In relation to strata title residences, the objective is to require that insurance policies offered in respect of residences utilise the standard definition of flood. As residences include strata title residences, it is appropriate that contracts of insurance for such strata title residences be prescribed contracts for the purposes of Division 1A of Part V of the Principal Act.

Regulation 29D Meaning of 'flood' in prescribed contracts

Under Section 37B of the Principal Act (as amended by the Amending Act), there is a power to specify in regulations the meaning of 'flood' for the purposes of Division 1A of Part V of the Principal Act.

Riverine flooding commonly refers to inundation caused by watercourses or catchments overflowing their banks due to long duration rainfall over large areas.

Accordingly, the word 'flood' is defined in paragraph 29D(1) to mean the covering of normally dry land by water that has escaped or been released from the normal confines any of the following:

- (a) a lake (whether or not it has been altered or modified);
- (b) a river (whether or not it has been altered or modified);
- (c) a creek (whether or not it has been altered or modified);
- (d) another natural watercourse (whether or not it has been altered or modified);
- (e) a reservoir;
- (f) a canal;
- (g) a dam.

The definition of 'flood' has been framed in a form that:

- allows consumers to consider the extent to which the risk exists in their location;
- is suitable for insurers to express either the inclusion or the exclusion of flood cover; and
- could be adopted without impacting negatively on the extent of flood cover currently provided.

The definition applies to lakes, rivers, creeks and other natural watercourses regardless of whether they have been altered or modified. This recognises that alterations and modifications do not fundamentally alter the nature of such watercourses.

However, the definition does not encompass the release of water from man-made watercourses. Therefore, water damage that results from the release of water from man-made watercourses does not constitute a type of 'flood' for the purposes of Division 1A of the Principal Act (as amended by the Amending Act). It is expected

EXPOSURE DRAFT

7

that insurers will cover losses from the release of water from man-made watercourses as part of the cover they provide for storm damage.

Request for comment

The proposed definition of ‘flood’ is based on that proposed in the consultation paper *‘Reforming Flood Insurance — Clearing the Waters’* that was released for comment by the Assistant Treasurer, the Hon Bill Shorten MP, on 5 April 2011. The associated consultation process indicated there was broad support for this definition.

- Is the proposed definition appropriate?
- Should the standard definition of ‘flood’ include the escape of water from man-made watercourses?

Paragraph 29D(2) places requirements on insurers offering insurance to businesses where the insurance contracts do not use the definition of flood provided in paragraph 29D(1).

Where insurers do so, paragraph 29D(2) requires that they take reasonable steps to ensure that the contract is not a prescribed contract. This means that insurers must take reasonable steps to ensure the businesses being offered the contracts of insurance are not small businesses.

The objective is to require insurers to take such steps only where the definition of flood used is not consistent with that specified in paragraph 29D(1). It is not necessary for an insurer to verify business size where the contract of insurance offered utilises the definition of ‘flood’. This serves to minimise compliance costs for insurers.

Request for comment

Is there a need to define ‘reasonable steps’ in the regulations?

- If so, what should ‘reasonable steps’ constitute?

Request for general feedback

Are the Regulations structured appropriately?