Feedback on Draft Drought Resilience Funding Plan

Economic Resilience for an innovative and profitable agricultural sector

for

Department of Agriculture
Executive Summary

The purpose of this submission is to set out a way to improve an existing scheme to better provide economic resilience for an innovative and profitable agricultural sector. The crux of the proposal is to take the existing Farm Management Deposit scheme and make it more fit for this purpose. This would be achieved by:

- Expanding the scheme to allow all majority owned family farming enterprises to make climate risk provisions from pre-tax profits;
- Allowing the provisions to be invested in a range of approved investments rather than a low yielding bank account;
- Applying similar rules to the climate risk provisions that apply to Self-Managed Superannuation funds;
- Limiting the amount of the provision to the audited fixed costs of the individual farming enterprise;
- Allowing provisioning for fixed cost for the duration of expected droughts for the specific region farmed;
- Relying on the insurance sector to provide climate risk insurance for fixed costs that exceed the provisioning of the farming enterprise; and
- Establishing a reinsurance pool for droughts of a catastrophic duration that will exceed the efficient use of private sector insurance risk capital.

This evolutionary approach seeks to:

- Limit the budgetary effects to the foregone tax from profitable farming enterprises;
- Make majority owned family farming enterprises self-sufficient by funding their own economic resilience;
- Draw in private sector risk capital to cover fixed costs that exceed these provisions to the extent that this is an efficient use of private sector risk capital; and
- Limit government support to catastrophic climate event durations through a reinsurance pool that insurers draw on.

Insurance underwriting expertise has been used to detail how private sector insurer risk capital can be utilized to provide climate risk insurance without any government assistance. The experience in other countries has shown that premium subsidies are bad policy and should not be adopted in Australia.

The adoption of the suggested climate risk provisioning and insurance would represent the most efficient use of farmer, insurer and taxpayer resources to achieve economic resilience for an innovative and profitable agricultural sector.

David Blackett
December 13th, 2019
# Table of Contents

## EXECUTIVE SUMMARY

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXECUTIVE SUMMARY</td>
</tr>
</tbody>
</table>

| TABLE OF CONTENTS | 2 |

## INTRODUCTION

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>HOW BAD IS THIS DROUGHT?</td>
</tr>
<tr>
<td>A FRESH APPROACH</td>
</tr>
<tr>
<td>THE PREMIUM SUBSIDY ROAD</td>
</tr>
<tr>
<td>ARGUMENTS AGAINST THE PREMIUM SUBSIDY ROAD</td>
</tr>
<tr>
<td>THE NEED FOR AN ECONOMIC RESILIENCE ROAD</td>
</tr>
<tr>
<td>ECONOMIC RESILIENCE TOOLS NEED TO BE FIT FOR PURPOSE</td>
</tr>
</tbody>
</table>

## THE ROAD TO ECONOMIC RESILIENCE

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDIVIDUAL CLIMATE RISK PROVISIONING</td>
</tr>
<tr>
<td>LIMITING THE AMOUNT OF THE PROVISION</td>
</tr>
<tr>
<td>ACCESSING PROVISIONING</td>
</tr>
<tr>
<td>HOW WOULD PROVISIONING WORK?</td>
</tr>
<tr>
<td>CLIMATE RISK ECOSYSTEM</td>
</tr>
<tr>
<td>CLIMATE RISK INSURANCE</td>
</tr>
<tr>
<td>REMOVING THE CHALLENGES</td>
</tr>
<tr>
<td>THE SIGNIFICANCE OF A FIXED COST SUM INSURED</td>
</tr>
<tr>
<td>FOR THE INSURER</td>
</tr>
<tr>
<td>FOR THE FARMER</td>
</tr>
<tr>
<td>INSURANCE PRICING</td>
</tr>
<tr>
<td>EXPENSES</td>
</tr>
<tr>
<td>COSTS OF CAPITAL</td>
</tr>
<tr>
<td>VIABLE CLIMATE RISK INSURANCE</td>
</tr>
<tr>
<td>THE HISTORICAL CONTEXT</td>
</tr>
<tr>
<td>PORTFOLIO MANAGEMENT</td>
</tr>
<tr>
<td>FARMER INCENTIVES TO INSURE CLIMATE RISKS</td>
</tr>
<tr>
<td>NET LOSS RATIO</td>
</tr>
<tr>
<td>THE CRUX OF THE SOLUTION</td>
</tr>
<tr>
<td>CONCLUSION</td>
</tr>
<tr>
<td>ABOUT THE AUTHOR</td>
</tr>
</tbody>
</table>

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Introduction

Over ten thousand years ago, our ancestors stopped being nomads and became farmers. This one decision made possible a food surplus that allowed some in the community to specialize in activities other than food production. This shift underpinned everything we now take for granted in our modern world.

Today, the only real difference is that our farmers have become vastly more efficient. Now over 80% of the world’s population specialize in something other than food production—in Australia its over 97%1. In Australia this dependence on less than 3% of the population has not been considered a risk. But if our farmers were forced out of business, then this dependence could expose our modern way of life to extreme risk—MI5’s maxim is that society is “four meals away from anarchy”.

If there was an adverse increase in rainfall variability, this dependency would represent a real and present danger to the food security of the 97%. The extent of the current drought gives cause for concern that something is happening with the climate. With food security potentially becoming a real issue for the 97%, it might be a good time to consider renegotiating the social contract with the 3%. Trading some taxpayer funds to strengthen food security in return for a way to provide farmers with economic resilience sounds like a bargain worth making.

But isn’t this alarmist talk, isn’t drought an ever-present risk that our farmers have adapted too?

How bad is this drought?

An objective evaluation of the current drought is the first step in determining if a better social contract needs to be negotiated. A historical contextual analysis can be done by using the historical rainfall data from Bureau of Meteorology. Using the Northwestern New South Wales region as an example, the historical rainfall data averaged across Wee Waa and Boggabilla has been used to compare the current drought with previous droughts—see graph below.

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1 World Bank – World Development Indicators 14th October 2016. For the world farming employment accounted for 19.8% in 2010 and for Australia 2.6% in 2013
The red areas on the graph represent rainfall deficiency, defined for this region as rainfall less than 400 mm during the preceding 365 day, averaged across the two sites. The 400 mm level is estimated to represent an annual rainfall probability of less than 10%. Severity can be measured in terms of the duration of this level of deficiency.

During the one hundred and thirty-five years of recordings from 1884 to 2019, there were seventeen periods of more than ninety days where total rainfall for the preceding 365 days was below the 400 mm level as shown in the graph below—on average a drought every eight years. On this simple measure, at 620 days as at the beginning of December, the current drought has exceeded the Federation drought of 414 days. So, it does look like the current drought is the worst recorded drought as, by this definition, it has lasted about a third longer in this region.

This measure of drought is too simplistic as the Federation drought was preceded by a period of dryer than normal conditions as was the current drought (refer graph on page 3). These dry conditions would have had a detrimental effect on soil moisture and the ability to grow crops. In addition, both the end of the First World War and the succession of droughts through the Second World War period are worthy of further consideration.

Using the starting point as the last day the annual rainfall was above the median annual rainfall of 585 mm, the durations for five periods are shown in the graph opposite. Unsurprisingly, this shows that no two droughts are the same. The Second World War droughts do represent an unusual period of sustained below median rainfall with double dip severe droughts. However, cropping opportunities
occurred with a rainfall period above 400 mm at the eighteen to twenty-four-month mark. After considering overall rainfall deficiency and duration in this way, the two longest droughts are the Federation drought and the current drought. The current drought has remained below the 400 mm threshold for over a third longer than the Federation drought—and the current drought is not over yet.

So, the answer to the question is, that, yes this is a very bad drought, the worst in recorded history in this region and suggests other regions may have the same experience.

A fresh approach

For the period May 1902 through to April 1903, rainfall in the Federation drought dropped below 300 mm, lower than it has during the current drought. It’s hard to imagine what life would have been like during this severity of drought. Without modern transport, refrigeration, air-conditioning or communications, their lives must have seemed like hell on earth.

But one thing hasn’t changed. Farmers are still frustrated by the fact that they are still not able to access risk financing tools that provide economic resilience for their families from droughts. Although transport, electricity, communications and the financial services sectors would be unrecognizable to farmers from a hundred and twenty-years ago, the frustration faced by today’s farmers from the inability to assess risk financing tools would be immediately recognizable.

For Australian farmers, successive governments at the state and federal levels have resisted calls for a formal risk financing solution that would provide economic resilience, preferring ad hoc farm relief in times of drought. This position has been driven by the legitimate desire to avoid any open-ended funding commitments and a need to be seen not to be providing farm subsidies while calling for the removal of subsidies from other countries during trade negotiation. Prior to this unprecedented drought in the major cropping region of Northwestern New South Wales, this was a tenable position. With an apparent reversion to the rainfall variability experience in the first half of last century and in the face of this unprecedented drought, this approach should now be challenged.

This is not to say that the government and taxpayers should be drawn into open-ended commitments to farmers. As this submission will argue, there are alternative risk financing solutions for the government to consider that would allow farmers to become economically resilient and which do not amount to open-ended commitments to subsidies. This alternative approach would retain the current government objectives while providing economic resilience for farmers.

This submission will also suggest that Australian agriculture is at a crossroad. One option is to go down the premium subsidy road that the rest of the world has taken, while the other is to go down a different road of our own making that will create economically resilient farming enterprises. This submission will set out the reasons against going down the premium subsidy road and what going down the economic resilience road would look like.

The premium subsidy road

Farmers in many countries have access to risk financing tools such as Multi-peril Crop Insurance (MPCI). This is because their governments have been prepared to provide premium subsidies for insurers to offer a heavily subsidized insurance product. These MPCI products have evolved in countries with strong farmer representation, farmers who only crop and have lower levels of rainfall variability. Recent attempts to introduce them in Australia without premium subsidies have
failed. The higher pressure applied on other countries’ governments for premium subsidies, by farming enterprises that are solely dependent on cropping, and the lower variability in rainfall have allowed these products to survive where they have not in Australia.

The cost to an Australian Government for MPCI, in the driest arable continent on earth, would be proportionally greater than in the countries where it was developed, because the variability in rainfall results in greater levels of variability in insurance results and therefore drives the need for higher levels of government premium subsidies. Australian governments have been prudent in avoiding premium subsidies and would be wise to continue to do so. Due to the greater variability in rainfall, Australia needs to develop a set of unique risk financing solutions.

**Arguments against the premium subsidy road**

Partly because Australian governments have resisted the calls for premium subsidies for MPCI, Australian farmers have had to become the most efficient and adaptable farmers on earth. The incentive to continue to adapt to variable rainfall and any adverse change in rainfall patterns for our farmers should be maintained. This imperative to adapt has driven the innovation in agronomic practices and will be needed to drive adaptation to any future adverse change in rainfall patterns. This imperative to adapt creates a competitive environment that provides the conditions that allow more efficient farmers to grow.

Premium subsidies weaken adaptation by artificially supporting poor agronomic practices and distorting property values. A guarantee of an insured yield and price under MPCI policies encourages farmers in marginal areas or seasons to plant crops that they would otherwise not plant. The incentive to alter planting intentions is driven by the reality that the farmer receives income whether the crop fails or not. This minimal risk environment does not encourage innovation as the consequences of crop failure are limited.

Subsidized MPCI effectively provide farmers with two sources of income—a crop income and a MPCI income. This is due the fact that governments are topping up the premium that farmers pay through a subsidy. In some cases, governments premium subsidies are multiples of the premium farmers pay. In these situations, farmers are getting back far more in claims than they pay in premium. This additional income source increases the returns from owning farmland. This inflates the value of farmland, making farm consolidation and economies of scale more difficult to achieve for efficient farmers thus reducing the efficiency of the farming sector overall.

Australian taxpayers should not be asked to support premium subsidies that reduce farming efficiency. An Australian plan for economic resilience must maintain the financial imperative to adapt while providing support to viable farming enterprises—economic resilience for an innovative and profitable agricultural sector.

**The need for an economic resilience road**

The regional analysis of the historical rainfall in the Northwestern New South Wales region puts the variability of rainfall into context but how should this variability be viewed? Is it the red troughs or the blue peaks that are the key to resilience?

It can be argued that early European settlers looked at the rainfall variability the wrong way. It’s not so much the ability to survive drought that should be the focus but rather the ability of the farming enterprise to capitalize on rainfall events that holds the key to economic resilience.

Our flora speaks to this. The flora of this country is very different from that of other countries because our flora has had to evolve drought tolerance not because it is a periodic event but rather it is the natural state of varying durations that are ended by rainfall events. This is not Europe.
where flora has evolved with more reliable annual rainfall. Australian flora survives because it can make it to the next rainfall event and farmers economic resilience will be achieved by assisting farming enterprises to do the same.

Yet the expectation of regular annual rainfall was the mindset that early European settlers brought with them to this country and that they have successfully unlearnt. The problem that Australian farmers now face is, that city based financial professionals, once removed from the physical Australian environment, still provide financial approaches and solutions developed in Europe.

It’s time for the Australian financial sector to also unlearn the experience from Europe.

**Economic resilience tools need to be fit for purpose**

Annual financial products like insurance and annual profit determinations make sense in European countries with reliable seasonal rainfall but not in large parts of this country. The main determinant of profitability for Australian farmers is surely the farmers ability to capitalize on drought breaking rainfall events that are not annual. Any risk financing tool that is meant to provide Australian farmers with economic resilience, that is fit for purpose, must straddle these rainfall events and these will be several years apart for many farming enterprises. Any sensible measure of a farmer’s financial viability can only be made by amortizing the profit in rainfall years over the subsequent dry loss-making years.

Part of any economic resilience plan must include an ability for farmers to provision for future drought. This would involve the introduction of drought or climate risk provisioning. This is not a radical approach as a limited form of provisioning already exists in the form of Farm Management Deposits. In addition, insurers establish provisions from current premiums for claims that will be paid in future years from events that have occurred, why not farmers? Why shouldn’t farmers be able to set up provisions for fixed operating costs that will be paid to maintain the farm between rainfall events and thus provide them with economic resilience?

Like insurers, farmers could be required to maintain funds in approved assets classes. These climate risk provisions should replace the Farm Management Deposits and be more flexible and farmer-controlled rather than bank-controlled. They could be managed under similar rules as those applying to self-managed superannuation funds.

These funds should be able to be invested in approved asset classes to increase the investment returns, thus increasing the funds available to cover drought losses and provide economic resilience. Adopting this approach would make climate risk provisioning attractive for farmers as they would control their financial planning and economic resilience to survive their unique level of drought exposure.

Over time this approach is tax neutral. Initially there will be a loss of taxation revenue for the government, but this is only a timing issue as farmers eventually claim tax deductions for losses carried forward from loss making drought years. What is being proposed, is that farmers draw this deduction forward after the next rain event and provision for the next drought. It is a timing effect for the individual farming enterprise.

The budgetary effect will not occur in one financial period. A separate timing effect is that not all farmers will be provisioning at the same time. Not all regions are currently in drought so those farmers not in drought could start provisioning now while farmers like those in Northwestern New South Wales will not be able to provision this financial year as they will still be in drought.
This provisioning would also be less distortionary than the current taxation rules. In profitable years, farmers look to minimize their tax liability and often overcapitalize in farm machinery to reduce their tax. If there was another avenue to reduce their tax liability through climate risk provisioning, more rational capital equipment choices would be made.

It is also envisaged that such a farmer climate risk provision would become a primary risk financing mechanism with a secondary multi-year climate risk insurance product that would be provided after this is exhausted, providing additional economic resilience to the climate risk provisions the farmer has set aside. Farmers would control their own risk financing by prudently provisioning for individual enterprise fixed costs of operating and expected drought durations, with the ability to choose to purchase insurance to cover unexpectedly long drought events.

If this secondary insurance protection was exhausted, then a tertiary Government reinsurance pool could be called on to cover catastrophically long droughts. Under this proposal, the Government would be providing a risk capital subsidy only in years of prolonged drought rather than premium subsidy every year. A capital subsidy would only be called upon in catastrophically long droughts and only after the private sector insurance markets risk capital had been utilized. This layering of the risk would be the most efficient use of capital for farmers, insurers, reinsurers, and taxpayers.

The climate risk insurance product would be a consequential loss-based product that initially covers the fixed costs of maintaining the farming enterprise for up to five years. It should cover all the farming enterprises activities. Australian dryland farmers have already diversified their risk through cropping and grazing with many diversifying further into off farm income activities. To reduce the variability, insurers should view the enterprise risk rather than just the cropping risk.

This highlights one of the reasons MPCI is not fit for purpose. As it singles out crop losses for coverage, it increases the risk for insurers as they do not have the advantage of the risk diversification that grazing offers—a failed cereal crop still has value as it can be grazed or cut for hay. Another reason MPCI is not fit for purpose is that it fails to remove the need for government drought assistance—in NSW, over 80% of government drought assistance went to livestock farmers.  

As the driest arable continent on earth, Australia is different. Applying the same farming approaches adopted in other countries has been shown not to work. Expecting risk financing solutions for farmers that have been developed in other countries to work in Australia is an exercise in trusting hope over experience.

Rather than going down the premium subsidy road with its agronomic and market distorting twists and solutions not fit for purpose turns, this submission will argue for taking a more direct road to Australian farming economic resilience.

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The Road to Economic Resilience

Australian agriculture is at the economic resilience crossroads. Do we follow down the road the rest of the world has taken of climate risk insurance premium subsidies in the hope that it will also work in the driest continent on earth or is there a better road we can follow? What follows is the case for taking a different economic resilience road.

Other countries’ solutions to climate variability have involved governments subsidizing premiums for MPCI. This effectively provides farmers with an addition source of income that adversely influences their agronomic practices and inflates property values that retards efficient farmers’ growth. This impedes adaptation which will be essential if the current generation of farmers is to adapt to the resumption of a historical frequency and severity of drought, let alone the consequences of any increased rainfall variability.

The best way to reward innovative and profitable farm enterprises that adapt to climate variability would be to allow them the ability to provide for their own economic resilience through climate risk provisioning. Developing primary financing of climate variability from retained earnings before tax, would allow for the development of a secondary climate risk insurance product designed to be triggered after these primary climate risk provisions have been exhausted. Insurers and reinsurers would require less capital to protect farming enterprises if they are covering the risk of these provisions being exhausted by an unexpectedly long drought rather than from the first dollar of loss.

This would reduce the cost to farmers as it is the most efficient use of private sector risk capital. The most efficient way for the government to assist farmers would be to prove a catastrophic tertiary climate risk reinsurance pool that responded when the farmers provisioning and private insurance sectors cost efficient risk capital has been exhausted.

This approach aims to allow:

- viable farming enterprises to develop their own economic resilience plan based on their individual risk tolerance and risk exposure;
- insurers to enter the market on an “excess of loss” basis rather than a “ground up” basis reducing underwriting risks such as moral hazard, morale risk and adverse selection;
- insurers to efficiently utilize their risk capital to insure low frequency high severity climate events that exhaust the individual enterprises climate risk provisions up to an agreed catastrophic limit; and
- the government to participate at the catastrophic level when the use of private risk capital becomes inefficient.

This approach differs from the premium subsidy approach by positioning the governments involvement at the point that the private market prices itself out of the market.

Individual climate risk provisioning

Each individual farming enterprise should be able to assess their individual risk tolerance and risk exposure. No two farming enterprises will have the same risk tolerance and this risk tolerance will change over time. The individual farming enterprise is best positioned to assess their tolerance to risk. Risk tolerance will vary for several reasons. These include:

- level of savings;
- amount of debt;
• off farm income; and
• diversity of farm income.

As with risk tolerance, risk exposure will vary from farming enterprise to enterprise. Different farming activities will be exposed to risk differently. The individual farming enterprise is best positioned to assess their exposure to risk. Risk exposure will also vary for several reasons. These include:

• regional climate variability;
• agronomic adaptation strategies employed; and
• level of fixed costs.

The complexities of the interaction of these factors makes it difficult to externally set the level of a climate risk provision. It is envisaged that the individual farming enterprises would determine their own level of climate risk provisioning needed. However, this would not be open-ended.

Limiting the amount of the provision
As a first step, farming enterprises should determine their individual climate risk provisioning. Under this proposal, viable farmers would build up provisions during good seasons from before tax earnings to cover their fixed costs during climate events of an expected duration. The amount of any climate risk provision should be limited by the:

1. fixed costs of the farming enterprise net of any off-farm income;
2. expected duration of drought in the region based on historical records; and
3. cost of secondary climate risk insurance.

Climate risk insurance premiums would be paid annually to provide protection for unexpectedly long climate events so should be included in the ongoing fixed costs of the farming enterprise.

An external audit of the farming enterprises proposed climate risk provision limit should be required to limit the abuse of provisioning. The farming enterprises accountants could verify the fixed costs as being consistent with current expenditure adjusted for future inflation. Off-farm income could also be verified based on previous income used to support the enterprise.

The Bureau of Meteorology could provide guidance on the expected duration of drought of an agreed severity in the enterprise’s region. National guidelines on the frequency and severity of climate risk that would need provisioning would need to be developed. Using the Northwestern New South Wales region as an example, the graphs on page 3, would suggest that droughts that exceed two years have a frequency of about one in twenty-five years. A climate risk provision limited to the two years of audited net fixed costs seems a prudent limit.

As provisioning would occur annually, any change in the tolerance and exposure to risk could be used to adjust the limit if needed.

Accessing provisioning
Provisioning will not provide economic resilience for all farming enterprises. Only the innovative and profitable sections of the agricultural sector will be able to provision. For the purposes of discussing climate risk provisioning, farming enterprises could be categorized into four groups:

1. Hobby or lifestyle;
2. Non-viable;
3. Over-extended; and
4. Profitable.

Provisioning from profit will only provide economic resilience to the profitable agriculture sector as the provisioning will be made from profits.

**Hobby or Lifestyle**

Hobby or lifestyle farming enterprises do not make profits and would not be able to provision for climate risk from non-existent profits. If it was felt necessary, climate risk provisioning could be limited to enterprises that have paid tax in the preceding five years.

**Non-viable**

Enterprises that are non-viable may have paid tax in the last five years but had been struggling before this drought. Non-viability can occur for many reasons, some of them beyond the control of the enterprise. The decision to allow a dignified exit from farming or not is beyond the scope of this submission but it must be recognized that the proposed climate risk provisioning will not help this category of enterprise.

**Over-extended**

The current unprecedented drought has exposed some otherwise profitable enterprises as being over-extended by debt. In the medium term, climate risk provisioning will not be able to help these enterprises, but it is not in the 97%’s interest to have these farmers forced out of the agricultural sector. Many of these enterprises will be victims of their own success. They should be supported through this drought by other forms of government assistance.

**Profitable**

Profitable enterprises will be able to take advantage of climate risk provisioning and strengthen their economic resilience. The issue for the most prudent of these enterprises will be that they have already provided for climate risk through off-farm investments from after tax earnings in the past. In a way, providing climate risk provisioning for these enterprises after they have taken prudent after-tax provisioning, is punishing them. An equitable formula for them to be able to quarantine off-farm investment income from reducing their fixed cost to zero and thus excluding them from participating in climate risk provisioning will need to be determined.

Finally, climate risk provisions could be open to abuse and should only be available to certain farming enterprises. It is proposed that the ability to set up climate risk provisions should initially be limited to family farming enterprises. These could be defined as sole traders, partnerships or limited liability companies that are majority owned by members of a family by birth or marriage.

**How would provisioning work?**

It is not the intention of this submission to be exhaustive in determining who and how the profitable agriculture sector accesses this economic resilience plan, but rather to outline how such a plan could operate. To this end, three hypothetical case studies are presented below that show how this new climate risk ecosystem would operate.

**Case Study One—Small Climate Cost**

Wal Smith operates a family farming enterprise in Northwestern New South Wales. Wal currently has just enough off-farm income to survive this financial year but needs the drought to break soon. Fortunately for Wal, March 2020 sees good rain and Wal feels confident enough to plant a winter cereal crop.

In year one of his ability to contribute to a climate risk provision, Wal makes a before-tax profit of $200,000 and he decides to place $150,000 in his climate risk provision account. He approaches his accountant and produces invoices for all his fixed costs including a market salary for himself. The
accountant verifies these and provides Wal with an interim climate risk certificate that confirms his fixed costs as $225,000 that he can take to his bank to set up a cash account, like he has for his self-managed superannuation, that can be used to transfer funds to and from his chosen investments.

Wal also approaches insurers to enquire about climate risk insurance products being offered. At the time there are only three insurers offering these covers and two of them send out representative to discuss their covers and provide Wal with a quotation. Wal chooses the best deal and agrees to pay the first year’s premium of $25,000 in four instalments during the next year.

Wal takes this invoice back to his accountant to add the amount to his fixed costs for the next year, bringing the revised annual fixed cost figure to $250,000. His accountant has also referred to the Department of Agriculture and found that in the region where Wal is farming has a provisioning limit equivalent to two years of fixed costs. The limit for his climate risk provision is $500,000.

In year two Wal has an even better year and makes a profit before tax of $260,000. He puts $210,000 of this into his climate risk provision, which increases his provision to $360,000. Wal’s insurer reduces his renewal premium in recognition that his climate risk provision is now 144% of his fixed costs. The reduction in his premium is offset by other increase in costs so his fixed costs remain at $250,000.

Year three sees more difficult conditions and he only makes a before tax profit of $75,000. He puts all this into his climate risk provision.

Year four sees the continuation of the difficult seasonal conditions and he makes a before tax profit of $50,000. Again, he puts all this into his climate risk provision.

Year five sees a return of dry conditions and Wal makes his first loss in five years of $50,000. Wal draws down $50,000 from his climate risk provision to make up the short fall. He advises his insurer that he has made a drawdown from his climate risk provision. As Wal has made a drawdown, his insurers trigger the five-year policy period limit.

Year six sees further deterioration in conditions and Wal has a second loss of $100,000. Wal again draws down $100,000 from his climate risk provision to make up the short fall to cover his fixed costs.

Year seven does see a small improvement in conditions but Wal still makes a loss of $50,000. Wal again draws down $50,000 from his climate risk provision to make up the short fall to cover his fixed costs.

Years eight, nine and ten are all profit years so Wal continues to keeps putting funds into his climate risk fund until year ten when he can only put in $40,000 of his $100,000 profit because his fund has hit the climate risk provisioning limit of two times his fixed costs or $500,000. Insurers lift the five-year policy limit in year eight as Wal has started provisioning again.

This case study is shown graphically on the next page.

**Case Study Two—Early Return to Drought**

In this case study, Wal takes the same steps he did in years one and two. In year three, the region returns to drought earlier than expected. In this year Wal make a drawdown of $100,000 to make up the shortfall cover his fixed costs and insurers trigger the five-year cover limit. In year four conditions deteriorate further and he makes a loss $150,000 and he draws this amount down from his climate risk provision to make up the shortfall to cover his fixed costs.
In year five, Wal makes a $200,000 loss and pays out all his remaining climate risk provision of $110,000 leaving a shortfall of $90,000 which he claims from his insurance. Year five turns out to be his worst year with year six recording a lower loss of $100,000 which he again recovers from insurers. Year seven is also a loss-making year but with a reduced loss of only $50,000 which he again recovers from his insurers.

Years eight, nine and ten see Wal return to profit and sees him rebuilding his claims risk provision. This case study is shown graphically above.
Case Study Three—Early Catastrophic Drought

In this case study, Wal again takes the same steps he did in years one and two in the previous case studies, but the region experiences a catastrophic drought with four years when Wal can earn no on-farm income. In year three, Wal makes a drawdown of $250,000 to cover his fixed costs. This triggers the insurers five-year policy period limit.

In year four he again makes no on-farm income and draws down the remaining $110,000 of his climate risk provision to make up the shortfall and needs to claim $140,000 from insurers to cover his fixed costs.

In year five, with no climate risk provisions left, he needs to claim his full fixed costs from insurers. Under his insurance arrangements, Wal is limited to making claims equal to his climate risk provision limit of $500,000. By the end of year five, he has claimed $390,000 so only has $110,000 of his sum insured remaining.

In year six he is once again unable to make any on-farm income and exhausts the remaining sum insured of $110,000. His insurers notify the government climate risk reinsurance pool and claim $140,000 on his behalf. Having insured for five years, Wal become eligible to claim from the government climate risk reinsurance pool.

Although Wal can make some on-farm income in the seventh year, his efforts still result in a $50,000 loss which his insurers claim from the government climate risk reinsurance pool. As in the other case studies, years eight, nine and ten are profit years for Wal and he re-builds his climate risk provision.

In this example, insurers exhaust their cover during year six. This is only four years into their five-year policy period. The coverage offered by insurers would have the dual limitation of five-years or the limit of liability under the policy of $500,000, whichever occurs first. The government reinsurance pool would be triggered if either of these limitations were reached.
Climate risk ecosystem
The three case studies are meant to provide a simplified view of the climate risk ecosystem and its three participates interaction: the farming enterprise through climate risk provisioning; the insurer through the provision of climate risk insurance; and the government through the provision of a climate risk reinsurance pool. These simplified case studies ignore inflation and investment income for the sake of clarity. In a real-world operation, the provisions value and investment returns will alter the balance of the climate risk provision held by the farming enterprise from year to year. An assessment of the risk associated with the investment strategy of the farming enterprise would be included as part of the process of costing of the insurance.

These case studies show that the insurers are not providing “ground-up” cover but sitting over the farming enterprise’s climate risk provisions. This significantly alters the underwriting risk as will be shown next. As the final case study shows, the government is only asked to respond when the farming enterprises’ provisions are exhausted and insurer risk capital becomes inefficient—an explanation of this is also provided below.

Climate risk insurance
Underwriting agricultural crop and livestock risks is challenging. The insurance industry has used this to argue that the only way for them to be involved in drought insurance would be if the government provided premium subsidies. As set out in the introduction on page 5 and 6, this is not good policy as it weakens adaptation by supporting poor agronomic practices and distorts property values.

Furthermore, such premium subsidies effectively turn the insurer into a cost-plus supplier with little to no incentive to reduce claims or administrative costs. It is indicative of the historical failure of the insurance market when it comes to drought, that instead of providing their risk capital to absorb losses, they seek to use taxpayer funds.

Removing the challenges
The proposed climate risk provisions provide a basis for the insurance sector to engage with insuring climate risk that is less challenging because it operates above a known level of risk that is self-funded by the farming enterprise. The consequence of this proposal is that the underwriting risk is reduced significantly through a combination of limiting cover to audited fixed costs and providing cover that will be triggered several years into the future after self-funding is exhausted. What follows is an underwriter’s perspective on the challenges faced by MPCI products and how climate risk provisioning solves many of these challenges.

Asymmetry of information
Farmers have a better understanding of their exposure to risks for the season ahead. This comes from decades, if not generations, of local experience. Insurance underwriters have lacked the ability to achieve an equal level and quality of information so are at a disadvantage when trying to price a risk transfer product such as MPCI for farmers.

This asymmetry of information is insurmountable when trying to determine the risk of drought on a cereal crop that has already been planted, which is what underwriters are doing with the current attempt at MPCI products in Australia. Without detailed planting information, soil moisture profiles, field fallow history and a detailed rainfall outlook, the chances of an underwriter, sitting in an office in a capital city, to accurately price the exposure to risk are vanishingly small. Even if it was possible, the effort involved would likely price the product out of the market.
With the passage of enough time, this information asymmetry vanishes. The further into the future the evaluation of risk occurs, the less predictable an outcome becomes so there is no asymmetry of information. The risk of drought in 2022 is unknowable by both parties to a drought insurance policy today.

Under the proposed climate risk insurance product, the farming enterprise is establishing a provision from the current year’s profits, before the end of the financial year. By this point in the year, the next season’s winter crop will be planted, and the climate risk provision will have been established that represents a proportion of the fixed costs that need to be available to pay the fixed costs in the first year. In effect, the climate risk insurance will only be called on to cover losses to the following seasons’ crop and livestock trading results.

The nature of weather events in twelve to eighteen months’ time is unknowable so farmers will not have an asymmetry of information. This time lapse will also avoid adverse selection.

**Adverse selection**

Adverse selection is said to exist when only worse than average risks are insured, thus undermining the underwriters’ pricing. In agricultural insurance, the farmer often has a better understanding of the exposure to risk than the underwriter.

For ease of pricing, underwriters’ premiums are often based on aggregate data that produces a community rate that will underprice higher than average risk farmers. Farmers are in a good position to judge the fairness of the community rate compared to their assessment of their exposure to risk.

With a better understanding of the risk, a higher proportion of higher risk farmers and a lower proportion of lower risk farmers will insure. The premium set by the underwriter based on averages will be inadequate to pay the losses. Over time the accumulated effect of this is a non-viable product.

For climate risk insurance, several factors reduce the issue of adverse selection. These are:

- Individual rating will be needed as each farming enterprise will have a different risk profile.
- All weather perils will be covered so it is more difficult for the farmer to accurately determine their exposure to all risks.
- Farming enterprises will have established a climate risk provision that will cover a likely shortfall in fixed costs in the first year.
- New cover will only be available in favorable seasons and unavailable in unfavorable seasons for the same reason new fire cover is not available in a bushfire.
- Covers will be for a rolling multi-year period so it will not be possible for farming enterprises to pick and choose when they want to be insured.

Farmers are very astute, and it would be unwise for an agricultural underwriter to underestimate their ability to game any insurance product, but the very design and operation of the climate risk provisioning and insurance makes gaming the system difficult.

**Systemic risk**

A systemic risk is one where there is a strongly positive correlation in loss events. This is the case with drought risk and mortgage default risk. The basis of insurance is to spread the premiums of the many amongst the losses of a few. Generally, systemic risks cannot be insured as the losses are highly correlated so most policyholders will suffer a loss at the same time.

For a systemic risk such as drought, solutions must be found to remediate the exposure to loss by spreading the losses over more policyholders’ premiums.

There are two methods for dealing with the systemic risk of drought.

- The first, is to spread the risk geographically. This would aggregate several climate zones into the portfolio of insured farmers so the probability that most farmers are affected by drought at the same
time is reduced. Although Australia is prone to drought, the size of the country means that there are several different climate zones which are negatively correlated for drought.

- The second, is to *spread the risk temporally*. This can be achieved by spreading the risk across multiple seasons. Drought is a cyclical systemic risk that spans one or more seasons. If a policy period is long enough, then the good seasons premium can pay for the bad season losses.

Both these methods will be needed to remediate the systemic risk of drought if it is to be insurable.

Systemic risks have traditionally been dealt with by matching the duration of the risk with the duration of cover. An example would be mortgage insurance where the duration of the policy matches the duration of the loan. Pooling risk from many loans over many years provides an adequate premium pool to fund systemic default periods.

Climate risk products should be for a duration of at least five years, and ideally seven. Enquiries made with the international reinsurance market indicate that the current maximum policy period is five years. Periods longer than this have regulatory considerations—mortgage insurance policies have traditionally had additional reserving and capitalization requirements to protect policyholders.

Before a multi-year climate risk product is offered to Australian farmers, the Australian Prudential Regulation Authority (APRA) will need to develop provisioning regulations for the product. This is needed to limit the recognition of profit, so the appropriate level of premium is retained to pay future claims as this is still a systemic risk and will be subject to high variability in annual underwriting results.

**Moral hazard**

A moral hazard is said to exist if an insured takes out cover with the intention of claiming non-fortuitous or fraudulent losses. Underwriters’ risk assessment must be robust enough to prevent farmers who represent a moral hazard from becoming part of their portfolio. Underwriters’ products must also have adequate protections to prevent farmers who have already experienced a loss or know they are almost certain of suffering a loss from taking out insurance and becoming part of the insurer’s portfolio.

Under our definition, moral hazard relates to the insurability of the individual farmer. An indicator of poor moral hazard farmers would be a history of fraudulent claims. Moral hazard minimization is a proactive pre-coverage attachment issue for underwriters that focuses on the individual farmer seeking cover. Under the proposed climate risk provisioning, normal underwriting procedures will be sufficient to deal with the moral hazard.

**Morale risk**

Morale risk is said to exist if the existence of the insurance will alter a policyholder’s behavior. Underwriters must design their products in such a way as to minimize the likelihood that the existence of the insurance cover will alter the risk minimizing behavior of insured farmers.

Under our definition, morale risk is created by the existence of the insurance so is a post coverage attachment issue for underwriters that focuses on the portfolio of insured farmers. It is minimized through specific product design features that impose stipulated actions that must be undertaken under set conditions. Such conditions already exist in traditional insurance covers.

An example of a morale risk prevention mechanism would be the implied condition of all policies that the policyholder must take all reasonable steps to prevent or minimize further loss—in most policies this is only implied but in some crop policies it is written into the contract and the insurer undertakes to reimburse farmers for the reasonable costs incurred.

Limiting the sum insured to fixed costs also removes many of the underwriting challenges that are prevalent with agricultural insurance as discussed below.
The significance of a fixed cost sum insured

By insurers only offering to cover fixed costs, adverse selection, moral hazard and morale risk are greatly reduced. This will make the insuring of climate risk feasible for insurers where insuring MPCI in its current form is not. One reason for this is, that by not covering profit and variable costs, the financial incentive to adversely select against the insurer is minimized as there is no profit in it. Moral hazard is reduced for the same reason.

Another reason the proposal is feasible is, that morale risk is also reduced. Case Study Two—Early Return to Drought (see page 13), can be adjusted to illustrates this. In the third year in Case Study Two, Wal makes a $100,000 loss. This is not the accounting result but rather the insured result. The difference is that an insured result is the result before accounting adjustments such as depreciation—it’s the cash position. For the purposes of determining the insured loss, only two figures need to be determined. They are the insured result and the fixed costs, with the latter being subtracted from the former and a negative difference being the definition of a loss.

With the fixed costs of $250,000, for Wal to only make a loss of $100,000, he would have engaged in some cropping and grazing activities that covered their own cost and generated a surplus of $150,000. Variable costs incurred by Wal are not recoverable from either the Climate Risk Provision or Insurance. Any loss greater than the fixed costs would need to come from cash or from a credit provider. The incentive for Wal to continue to manage the agronomic risks associated with whatever cropping and grazing activities he undertakes remains unchanged by the existence of the climate risk provision or insurance as they are not covered.

To reframe Case Study Two to illustrate this, let’s assume that Wal’s cropping activities were significantly affected by frost in year three and he had no costs or income from any other activity.

To grow the crop, his variable costs for were $300,000 and his revenue was only $250,000, so on these activities he lost $50,000. He still had fixed costs of $250,000 so his combined loss is now $300,000 as shown in the graph above.
The purpose of the climate risk provision and climate risk insurance is to ensure Wal’s economic resilience. It is not its purpose to underwrite his agronomic decisions. In year three, Wal can draw down the fixed costs for the year, but he must fund the $50,000 cropping loss. As this risk is not covered, through either the provision or insurance, a morale risk is not created.

For an insurer, this is significant, as they do not need to be involved in the agronomic management of the farming enterprise as they are not exposed directly to the loss. The farmer still has a significant incentive to take responsible agronomic decisions. However, there are two ways that this provisioning and insurance may alter the outcome:

- A loss from the cropping activities in the example above increased Wal’s drawdown in year three. This had the knock-on effect of increasing the insurance claim in subsequent years from a total of $240,000 to $390,000 or an increased claims cost to the insurer of $150,000 over the five years of loss making by Wal.
- Most farmers live to farm and find it challenging to decide to do nothing when nothing is the economically sensible thing to do. When the financial imperative to pay for the enterprises fixed costs is also present, then the agronomic decision making is made under financial duress.

By having the fixed cost covered, better agronomic decisions are likely to be made as this financial duress is reduced knowing the fixed costs will be paid.

Neither of these outcomes is terminal for the proposal as discussed below.

For the insurer

In Case Study Two, the early return to drought would have been unwelcome for insurers but not financial disastrous. Let’s consider the premium income the insurer would have received over the ten years of the case study. The initial premium rate Wal accepted was 10% and then the insurers reduced it due to the increase in his provision amount to say 7.5%. It would have been locked at this level during the five-year policy period that the insurers would have triggered in year three, the first loss year. At the end of this five-year policy period, the premium rate would have been renegotiated. In the table below, it has been increased to 12.5%.

<table>
<thead>
<tr>
<th>Year</th>
<th>Fixed Costs</th>
<th>Rate</th>
<th>Premium</th>
<th>Cumulative Premium</th>
<th>Claims</th>
<th>Cumulative Claims</th>
<th>Gross Loss Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>250,000</td>
<td>10.0%</td>
<td>25,000</td>
<td>25,000</td>
<td>0%</td>
<td>0%</td>
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<tr>
<td>2</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>43,750</td>
<td>0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>62,500</td>
<td>90,000</td>
<td>90,000</td>
<td>144%</td>
</tr>
<tr>
<td>4</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>81,250</td>
<td>100,000</td>
<td>190,000</td>
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<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>118,750</td>
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<td>240,000</td>
<td>175%</td>
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<tr>
<td>6</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>168,750</td>
<td>100,000</td>
<td>240,000</td>
<td>202%</td>
</tr>
<tr>
<td>7</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>231,250</td>
<td>240,000</td>
<td>240,000</td>
<td>120%</td>
</tr>
<tr>
<td>8</td>
<td>250,000</td>
<td>12.5%</td>
<td>31,250</td>
<td>240,000</td>
<td>240,000</td>
<td>240,000</td>
<td>104%</td>
</tr>
<tr>
<td>9</td>
<td>250,000</td>
<td>12.5%</td>
<td>31,250</td>
<td>231,250</td>
<td>240,000</td>
<td>240,000</td>
<td></td>
</tr>
</tbody>
</table>

The table on the next page shows the result for Case Study Two with the frost loss included.
Again, the gross loss ratio for this one farmer in one region that experienced an early return to drought and frost was 169%.

Again, not desirable but by no means terminal for an inherently high-risk insurance product that could be remediated by a higher rate increase.

<table>
<thead>
<tr>
<th>Year</th>
<th>Fixed Costs</th>
<th>Rate</th>
<th>Premium</th>
<th>Cumulative Premium</th>
<th>Cumulative Claims</th>
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<td>18,750</td>
<td>43,750</td>
<td></td>
<td>0%</td>
</tr>
<tr>
<td>3</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>62,500</td>
<td>40,000</td>
<td>64%</td>
</tr>
<tr>
<td>4</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>81,250</td>
<td>200,000</td>
<td>295%</td>
</tr>
<tr>
<td>5</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>100,000</td>
<td>340,000</td>
<td>340%</td>
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<tr>
<td>6</td>
<td>250,000</td>
<td>7.5%</td>
<td>18,750</td>
<td>118,750</td>
<td>390,000</td>
<td>328%</td>
</tr>
<tr>
<td>7</td>
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<td>7.5%</td>
<td>18,750</td>
<td>137,500</td>
<td>390,000</td>
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<td>8</td>
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<td>12.5%</td>
<td>31,250</td>
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<td>231%</td>
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<td>9</td>
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<td>31,250</td>
<td>200,000</td>
<td>390,000</td>
<td>195%</td>
</tr>
<tr>
<td>10</td>
<td>250,000</td>
<td>12.5%</td>
<td>31,250</td>
<td>231,250</td>
<td>390,000</td>
<td>169%</td>
</tr>
</tbody>
</table>

Only providing insurance cover once the farmers provisioning is exhausted, limiting cover to fixed costs and spreading the risk temporally over five years makes insurance feasible. Add to this the fact that adverse selection, moral hazard and morale risk are minimised by the provisioning structure, and it’s reasonable to assume that insurers familiar with agricultural risks would be willing to develop an insurance product.

For the farmer

Farmers and underwriters are at opposite ends of the risk tolerance spectrum—their career choices have led them there. Farmers are optimistic when assessing the chances of growing a crop while underwriters would only see uncertainty and risk. If underwriters were farmers, we would most likely all starve.

For this reason, underwriters should not get involved in agronomic decisions. If variable cost and profit were to be insured, then underwriters would want to place restrictions on when farmers could and couldn’t plant crops or retain stock levels if seasonal climate conditions deteriorated. Not only are underwriters’ temperaments not suited to this task, their physical remoteness from the individual agronomic conditions on the ground plus the costs and time delays in determining the appropriate decision would make any insurance product that covered more than fixed costs unworkable.

Relieved of the financial duress-inducing problem of finding the funds to cover their fixed costs, farmers are likely to make more balanced decisions about sitting out a poor season and not increasing their financial difficulties. Not only does this provisioning structure make family farming enterprises more economically resilient but also in a better position at the start of challenging climate conditions to make the right agronomic decisions.

Insurance Pricing

The financial attractiveness of any insurance product for farmers will obviously depend on the cost. If the cost of risk transfer through the mechanism of insurance was frictionless then this would be easy, but insurance is not frictionless.

The Gross Loss Ratios shown in the tables above are not the net result for the insurer. The Gross Loss Ratio is calculated by dividing the gross premium by the claims. The gross premiums include expenses and the cost of the risk capital employed to support paying claims if they exceed the
premium collected. The net premium available to pay claims will be less than the gross premium by the amount of the expenses and the cost of capital.

**Expenses**
For a Climate Risk Insurance product to be financially attractive to farmers, the expenses need to be as low as possible. The major expenses for agricultural insurers are distribution, loss adjusting and administration.

**Distribution**
The remoteness of farmers from the underwriting offices of insurers makes distribution expensive. Most agricultural insurers rely on insurance intermediaries to distribute their products in regional areas. This is primarily through insurance brokers. They are paid by commission. For products like crop insurance, commissions of between 10% and 20% are paid depending on the crop and the influence of the broker.

To keep the premium acceptable to farmers, they are going to expect a reasonable return on their premium dollar. Having up to 20¢ in the dollar going to distribution will make this challenging. Keeping distribution costs to 5% will be necessary for farmers to see value.

**Loss adjusting costs**
Loss adjusting costs for crop losses are typically around 2.5% to 7.5% depending on the crop and type of damage. This is because an agronomist is needed to inspect the damage and assess the loss, for some crops this will involve multiple farm visits. One of the benefits of only covering fixed costs is that the need for crop inspections will be minimal for most claims as the adjusting process will focus on the cash flows of the enterprise not the level of crop damage.

Much of the loss adjusting should be able to be carried out by the enterprises accountants and be ancillary to their normal task of preparing financial statements for existing purposes. Basic physical inspections of crops and stock will likely be necessary for some claims but loss adjusting costs should be able to be limited to 5%.

**Administration costs**
Insurers incur costs to underwrite, administer policies and claims, manage the business, and comply with prudential and consumer regulations. With the complexities of the risk assessment, underwriting will require specialist underwriters that will be required to spend time assessing the agronomic risk profile, the provisioning amount available and investment risk for each individual farming enterprise to determine the price required.

The other costs of administration will be standard. It would be expected that the administration costs for this product would be able to be kept under 10%.

Being able to bring expense in at under 20% will be necessary to make this insurance financially attractive to farmers.

**Costs of capital**
For a climate risk insurance product to be financially attractive to farmers then the cost of risk capital needs to be contained. This can be achieved through a multi-year period and utilizing risk capital efficiently. Insurance is a capital-intensive business. Pure risk premiums are estimated based on average historical losses. However, by definition, for one season in two, losses will exceed the premium collected. In these seasons’ risk capital will be needed to make up the short fall between premiums and claims.

Generally, insurance risk capital providers look for a 10% rate of return. The cost of capital will be determined by applying this rate of return to the amount of risk capital required. The amount of risk capital required will be determined by the variability of the portfolio of claims about the
average underwriting year result. The greater the variability, the more capital that is required and the more of the premium that is required to cover the return on the risk capital that is needed.

To illustrate this, consider a hypothetical ideal underwriting portfolio. It is made up of reasonably homogeneous insured assets so that the portfolio is not exposed to a single large loss because all policyholders are insured for a similar value. The assets are also well spread out over Australia so there are no large concentrations of risk that are exposed to single events.

In addition to this, losses are not correlated. Such a portfolio is ideal for insurers as it would have a low variability in annual claims as it is only really exposed to variations in the frequency of events in the year not their disproportionate effect on the portfolio.

For this example, distribution of annual losses is assumed to normally distributed, with an average annual loss of $10 million and the standard deviation in losses is $3 million. The expected distribution of annual losses is shown in the graph below.

Even for this hypothetical ideal portfolio, risk capital is required as a pure risk premium of $10 million, equal to the average annual expected losses is being charged. A prudent amount of risk capital to absorb a probability of annual losses, should be set at a frequency of one in two hundred and fifty. Using the normal distribution, the amount of risk capital needed is determined to be $8 million—the frequency of losses over $18 million is one in two hundred and fifty.

Assuming the expenses are 20% (as suggested above), then the premium required to insure the portfolio would be $13.5 million made up of a pure risk premium of $10 million, a cost of capital of $0.8 million and an expenses cost of $2.7 million. This is shown graphically on the next page for the column shown as Maximum Probable Loss or MPL of 180% from the expected distribution above.

This pricing structure returns 74¢ in the dollar to policyholders. This would be considered a cost-effective insurance risk transfer product. As the variability increases the cost-effectiveness reduces as shown. Once the MPL reaches 1,000%, the pricing structure only returns 42¢ in the dollar.
Farmers, who can determine the value of transferring their risk are very likely to see this as bad value and not insure. And they would be right.

Providing insurance that is seen as value for farmers is always a challenge as they are good risk managers. Attempts at unsubsidized MPCI have provided value for farmers but at the cost of unsustainable losses for insurers and reinsurers. The proposed climate risk provisions provide a foundation for climate risk insurance by reducing the underwriting challenges for insurers.

Viable climate risk insurance

A key element of the proposed climate risk ecosystem is the availability of climate risk insurance. A discussion of the feasibility of climate risk insurance being viable is necessary. The authors confidence in climate risk insurances viability may seem optimistic so here are the reasons for this optimism.

The historical context

A sceptic would argue that the MPCI experience shows that climate risk is uninsurable. However, any experienced agricultural underwriter will know that the reason for the failure of MPCI was that is was exposed to fatal adverse selection. The author warned that this would happen publicly in 2016 in an IPART submission.

At the risk of going over old ground, the fatal structural flaws of MPCI are set out below. Included with them are the reasons for the optimism that the climate risk ecosystem proposed will solve these structural flaws.

Asymmetry of information

The developers of MPCI tried to overcome this by requiring a five-year accounting history of the individual farming enterprises performance. This was a sensible step, as it focused on the individuals risk profile, but it was shown to be adequate to the task of eliminating the asymmetry of information.
Accounting records are a poor risk assessment tool. Agronomic risk factors would also need to have been collected to have enough information about the individual’s exposure to climate risk. The underlying challenge with asymmetry of information is that it exists because it is too time consuming and costly for a city-based underwriter to bridge the gap in information.

If the farming enterprises is self-funding the next season’s risk through climate risk provisions, then the first time an insurer is exposed to climate risk is the following season. The farmer is in a similar position to the insurer in terms of the information available to determine the exposure to climate risk in a years’ time. In practice, if climate risk provisioning is commenced as soon as a farmer comes out of drought, then the farmer should have a couple of good years to set aside provisions and the climate risk insurer these years before they are exposed to climate risk claims.

The effective introduction of a waiting period of years between when the insurance is taken out and the cover starts removes any asymmetry of information as both the farmer and the insurer have equal information on the exposure of risk.

**Adverse selection**

Providing an annual policy for a systemic risk can at best described as courageous. Allowing farmers to delay insuring until after planting can best be described as imprudent. These structural flaws allowed farmers to adversely select against insurers based on asymmetry of information about the agronomic conditions they faced when it came time to elect to insure or not.

The climate risk provision has effectively removed the asymmetry of information through what amounts to a waiting period of a year or more. The climate risk insurance policy period of five-years once the farmer starts drawing down form provisions removes the ability of the farmer to move in and out of insurance. These two elements prevent the type of selection against the insurer that destroyed MPCI.

**Moral Hazard**

The risk of fraud will be similar for all forms of insurance but the risk of farmers insuring based on facts known to them alone, that greatly increased the exposure of risk was present for MPCI. Again, this was due to the structural flaw that allowed farmers to insure after planting.

The climate risk provision and the fact the variable costs of planting a crop are not covered removes the increased moral hazard that was associated with MPCI.

**Morale Risk**

For farmers who had insured under MPCI the potential to change planting intentions was high. Once insured a farmer could decide to plant his whole farm. Without the insurance they would have been more prudent and only planted a proportion of the farm area.

All annual MPCI products suffer from morale risk and managing this is problematic as described above. By only insuring fixed costs, the morale risk is mostly removed. Apart from the exposure to behavioral change described on page 19 the exposure to morale risk is low in comparison to MPCI.

**Systemic Risk**

The systemic risk was not addressed at all through the structure of MPCI. This facilitated farmers ability to adversely select against insurers and only insure in years or regions exposed to greater risk. The core multi-year structure of the proposed climate risk insurance is designed to deal with the systemic risk through spreading the risk temporally and removing the ability to adversely select against insurers.

Comparing the structural differences between MPCI and the proposed climate risk provides the basis for optimism that the proposed insurance will be viable. Another aspect to consider is portfolio management.
Portfolio management

A climate risk insurance portfolio is by no stretch of the imagination like the hypothetical ideal portfolio discussed on page 22. The primary task of portfolio management for an underwriter is developing an underwriting criterion that selects a portfolio of lower exposure to risk policyholders. This will result in a portfolio with lower variability than a portfolio of high exposure to risk policyholders.

For the proposed climate risk insurance, the heavy lifting for portfolio selection has already been done as only profitable farmers are able to fund climate risk provision. High exposure to risk non-viable farmers will be excluded from the portfolio by virtue of them being unable to fund climate risk provisions. This focus on the innovative and profitable agricultural sector performs a vital portfolio selecting role for the insurers—the provisioning structure is self-selecting a lower exposure to climate risk portfolio.

A comparison between the ideal portfolio and the likely makeup of the climate risk portfolio can further demonstrate whether the optimism that climate risk insurance as proposed is viable is warranted. A discussion of the other elements of portfolio management is set out below.

Concentration

Limiting climate risk provisioning to majority owned family farming enterprises limits participation to a subset of farmers that will tend to consist of smaller more homogeneous farmers. There will still be variability in the sum insured but this will be lower than the variability would be if corporate farmers were also able to participate.

Although a long way short of an ideal portfolio, it is an improvement to the general population of farmers. This will self-select a lower sum insured policyholder, thus reducing the concentration of risk in individual policyholders.

Accumulation

The job of managing the accumulation of exposure to risk will still falls to the underwriter under the proposed climate risk insurance. However, avoiding an accumulation of risks in one location is a primary concern of any underwriter’s portfolio management. Developing a good geographical spread of risk is essential to limiting the variability of any insurance portfolio so is risk shared by all insurance portfolios.

Risk Correlation

One portfolio management task for the underwriter is to select a portfolio of policyholders who have an un-correlated exposure to loss. Climate risk is a systemic risk so there is a strong positive correlation between policyholder losses. This is unavoidable but manageable in the context of multi-year policies.

The proposed climate risk insurance will be based on a rolling multi-year policy structure. At any point in time the policy has a minimum policy period of five years. If the climate risk deteriorates, the insurer is locked into the next five years of the farmers exposure to risk. Conversely, if climate risk improves, the farmer is locked into continuing to pay premiums for five years.

The temporal spread of risk broadens the portfolio premium pool to compensate for the policyholders correlated risk.

The inherent structure of the climate risk ecosystem improves the risk selection opportunities for insurers and minimizes the risk correlation to the level that insurers should be prepared offer climate risk insurance in the absence of government subsidies. It would be helpful if there was a strong incentive for farmers to buy climate risk insurance. This can be achieved with minimal intervention in the market by government.
Farmer incentives to insure climate risks
The take up rate by farmers of climate risk insurance will be pivotal to the success of this product, so creating an environment that encourages farmers to take up climate risk insurance will be essential. There are only two steps that would need to be taken by the government to incentivize take up rates.

1. All government relief should be withdrawn from farmers in regions that come out of drought. Once farmers in these regions can start funding their climate risk provisions, this should be the end of direct government relief.
2. Access to indirect government support through catastrophe climate risks should be limited to farmers with climate risk insurance. As the name suggests, the government reinsurance pool should only be accessible by insurers. This would limit government assistance to prudent farmers with climate risk insurance.

This minimal government intervention should provide the necessary incentive for farmers to take up climate risk insurance.

Net Loss Ratio
The Gross Loss Ratio performance of Wal Smith was presented above and later said to not represent the true result for insurers. This begged the question, what was the true result for insurers? To divert from the narrative for a moment, the Net Loss Ratio is shown below.

Assuming that the portfolio was written to a MPL of 250%, then the net loss ratios for Case Study Two and Case Study Two with frost are shown in the table opposite. Again, these results are not desirable but again this is one policyholder’s result and this is for an unfavorable set of climate events. Individual results such as this in a well selected portfolio are easily absorbed and the basis of insurance.

The ability to manage variability across an insurance portfolio is the primary job of the underwriter. The secondary job of the underwriter is to protect the portfolio against unacceptable variability through sharing the risk with reinsurers.

This involves assessing the most efficient use of the available risk capital. The final part of this submission addresses this issue of efficient risk capital utilization.

The crux of the solution
Returning to the ideal portfolio example, it illustrates that the higher the variability in expected losses, the more risk capital is needed and the higher the proportional cost of risk capital is in the premium. This is shown in the table below. The cost of capital proportionally increases for higher variability in losses. This fact is at the crux of the matter of the available insurance solutions.
The systemic nature of climate risk means that the variability in losses is high compared to other insured risks. A realistic estimate of the un-remediated risk would be an MPL of at least 1000%. At this level the cost of risk capital is 38¢ in the dollar. Together with the expenses of 20¢ in the dollar, a total of 58¢ in the dollar in frictional costs of expenses and cost of risk capital will price the product out of the reach of farmers.

The generally adopted solution is to subsidize the premium to reduce these frictional costs. Not only is this bad policy for the reasons already discussed but it is a subsidy for the cost of risk capital provided by insurance company shareholders. It would be far more efficient for the government to take the variability out of the insurance pricing by reducing the variability and therefore reduce the amount for private sector risk capital needed. This could be done by providing risk capital for the catastrophe climate events through a reinsurance pool and let the private sector operate where it is efficient.

Before the government reinsurance pool is exposed to climate risk losses, the private sector risk capital should be allowed to be utilized where it is efficient to do so. Allowing the private sector to develop a product and pricing model that reduces the variability in losses is essential to the efficient use of the available risk capital.

Reducing variability
As previously discussed, there are underwriting portfolio selection methods available to reduce the variability. These reduce the need for risk capital by:

- Limiting the exposure to a concentration risk by insuring only small farmers or spreading the risk of large farmers by reinsuring them or by co-insuring them with other insurers—out of fashion locally but an integral part of insuring difficult risk at Lloyds;
- Limit exposure to an accumulation of risk by ensuring that the portfolio is well spread geographically;
- Limit exposure to systemic risks by spreading the risk temporally over a multi-year period; and
- Limit exposure to catastrophes through the transfer of variability to reinsurers.

All these methods must be utilized if a financially affordable pricing model is to be achieved for climate risk insurance. The first four of these have been discussed above. It is the reinsurance method that needs further discussion here.

Purchase reinsurance
Under this proposal, private sector reinsurer risk capital would be employed by insurers to limit the exposure of their risk capital. This is commonly used in all forms of insurance as the cost of reinsurer risk capital is lower than insurer risk capital. This is due to the reinsurers ability to aggregate the experience of many insurers regionally and globally. This aggregating provides a superior spread of risks, which lowers the variability of the portion of the risk reinsured by individual insurers.

Reinsurance has developed because it is an efficient use of the available global private sector risk capital because their geographical spread of risk is significantly broader and their risk volatility significantly lower, than an individual insurer. This means their cost of capital will be lower than the individual insurer. Insurers who enter the climate risk insurance market should be free to access the reinsurance market to maximise the efficient use of available private sector risk capital.

In the absence of a detailed actuarial assessment of this proposal, from an experience with agricultural risk, it is conceivable that the structure of the primary climate risk provision, a sum insured limited to two seasons fixed costs, a five-year policy period and utilization of the reinsurance risk capital, that the risk capital requirement could be limited to MPL of 250%. At this level, farmers would receive 70¢ in the dollar, which would represent reasonable value.
However, to achieve this it will be necessary for the government to take the risk of losses with a lower frequency of over something in the order of one in fifty years. Again, without a detailed actuarial assessment of this proposal, the sum insured limit of double the annual fixed costs of the farm enterprise and five-year coverage limit should already limit insurers exposure to losses with a frequency in the order of one in fifty years. Under this proposal the government reinsurance pool would cover loss frequencies of less than one in fifty years, thus limiting the required private sector risk capital to 250% of the premium.

How each individual insurer splits the risk capital requirement between shareholders and reinsurers would be a matter for the individual insurer. APRA already has the appropriate regulator controls to manage this. All that is proposed is that the government establishes a farmer’s climate risk reinsurance pool to allow for the efficient use of private sector risk capital.

The climate risk being covered by the reinsurance pool would be a catastrophe level of climate risk with an expected frequency of less than one in fifty years. The nature of a climate risk with this frequency would currently be expected to be funded by the government. The benefit of the proposal is that the government is only being asked to fund known levels of loss with an uncertain frequency.

This funding would be after the farmer has exhausted their own provisioning and the insurance sector has utilized the efficient level of risk capital. This proposal vastly improves the government’s ability to manage climate risk for an innovative and profitable agriculture sector.

**Conclusion**

The thumb nail sketch of the proposal in this submission could appear complex but all it requires from the government is for the allowance of climate risk funding, which is an evolution of the existing Farm Management Deposit scheme and the formalization of an ad hoc funding of extreme weather events through a government reinsurance pool.

Of course, this submission does pre-suppose that the insurance industry will have the ability and inclination to provide climate risk insurance to all the majority owned family farming enterprises that want it. The alternative of premium subsidies is far more attractive for insurers. As outlined above, except for the availability of enough available risk capital, there is no technical reason why providing climate risk insurance isn’t feasible. The availability of willing risk capital to participate in agricultural insurance is not infinite.

The staged introduction of climate risk provisioning by virtue of the difference in timing of the ending of the drought in different regions should help by reducing the immediate demand for risk capital. However, there is no getting away from the fact that this represents significant deployment of additional risk capital. For this to be occurring at a time when investors are chasing the level of investment returns that insurance can provide is an advantage that should not be underestimated.

What is being proposed is not easy, but it is too good an opportunity not to be investigated further.
About the Author
The author has over forty years of insurance experience both in the Australian insurance market and at Lloyds. For over twenty-five years he has specialized in agricultural insurance. Having created the Agricultural Underwriting section at GIO Australia in 1995 he introduced several innovative new product and coverage features. After a stint as Senior Underwriter at Agricola Underwriting Management, he setup his own specialist crop insurance broking business and successfully advised farmers on crop insurance for thirteen years. In 2014, Dutch agricultural insurer, Achmea appointed him as their Australian Chief Operating Officer. In this role he had the dual responsibility for insurance operations and underwriting results.

Since 2015 he has joined with other insurance professionals to establish and agricultural underwriting agency, AgInsure, to develop climate risk financing solutions. AgInsure is 50% owned by Innovative Risk Transfer.