Reading 33

Moody's Investors Service 2011, Residential MBS, Sector Comment, *Australian Government's recommendation for flood insurance is credit positive for RMBS*, extracted from *Moody's Weekly Credit Outlook*, 21 November.

Note:
This report is provided purely for educational purposes and must not be relied upon, reproduced, disseminated or otherwise used in any manner whatsoever. The information in this document may not be current and must not be used for the purpose of making a decision in relation to a particular financial product or class of financial products.

MOODY'S
INVESTORS SERVICE

SECTOR COMMENT

Australian Government's Recommendation for Flood Insurance Is Credit Positive for RMBS

Extracted from "Moody's Weekly Credit Outlook", dated November 21, 2011

Analyst Contacts:

SYDNEY 612.9270.8117

Arthur Karabatsos 612.9270.8160
Vice President – Senior Analyst
arthur.karabatsos@moodys.com

Dylan Bourke 612.9270.8119
Associate Analyst
dylan.bourke@moodys.com

On 15 November, in response to floods that devastated Queensland early this year, the Australian government released its Natural Disaster Insurance Review (NDIR). The government aims is to increase the use of flood insurance by homeowners and improve the extent of the coverage. If implemented, these NDIR recommendations are credit positive for Australian residential mortgage-backed securities (RMBS) because they will increase flood payouts, leading to lower mortgage delinquencies and lower loss severity in the event of default owing to flooding. The NDIR recommendations mandate flood cover in all policies with a standardized definition of flood, mandate full replacement value, and limit claims assessment periods to four months.

Mandating flood cover with a standardized flood definition. By making flood insurance mandatory under home insurance policies, the proposal will lower delinquencies resulting from flood damage. Through the proposal, government aims to increase flood insurance usage to 80% from 50% in one year.

The government's proposal will improve coverage by eliminating different definitions of water damage and creating a standard flood definition. This simplification will increase claims certainty because policies will cover all forms of water damage.[1] Currently all home insurance policies cover storm damage, but many do not cover flood damage. Some insurance policies exclude flood damage, but nevertheless cover damage caused by flash flooding .

The flood exclusion in existing policies meant that many policyholders in the Queensland flood did not receive a flood payout, which contributed to increased delinquencies. Fifteen months before the floods severely affected two areas, Toowoomba (post code 4350) and Brisbane (post code 4000), both areas had 30-day or longer delinquencies of around 1%. Five months after the floods ,Toowoomba's delinquencies remained flat while Brisbane's reached 4.82%.[2] Insurers classified water damage in Toowoomba as covered storm damage, but they classified water damage in Brisbane as uncovered flood damage, resulting in low flood payouts and increased delinquencies.

[1] The proposed definition for flood is: *"Flood means the covering of normally dry land by water that has escaped or been released from the normal confines of: (1) any lake, or any river, creek or other natural watercourse, whether or not altered of modified; or (2) any reservoir, canal or dam."*

[2] See our Australian Delinquencies by Postcode, 28 September 2011.

Mandating replacement value. Because the recommendation mandates that policies be for the full replacement of the home, flood-related mortgage loss severity will decline, which is credit positive for RMBS. Under current practice, most insurers limit their cover to a sum specified at origination by the policy holder. Generally, the homeowner underestimates the replacement cost of the home. After the Queensland floods, many homeowners suffered financial hardship even though they had a valid insurance policy because the cover was less than the damage.

Limiting claims assessment periods. The recommendation also speeds up recoveries by reducing the amount of time an insurer will take to either accept or reject a claim to a maximum of four months. Furthermore, the simplified definition of flood and the inclusion of flood cover in all policies will remove complexities that slowed the assessment process after the Queensland floods.

Report Number: SF268451

Authors
Arthur Karabatsos
Dylan Bourke

Senior Production Associate
Shubhra Bhatnagar

Moody's
INVESTORS SERVICE