The Specialists in Strata and Community Title Insurance

A Strata Insurance Perspective

Natural Disaster Insurance Review

Inquiry into flood insurance and related matters

CHU email submission to NDIR@treasury.gov.au 14.07.2011

CHU submission - NDIR

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Introduction

This submission responds to the questions posed in the Natural Disaster Insurance Review (NDIR) Inquiry into flood insurance and related matters, providing recommendations specifically from a Strata and Community Title perspective and highlighting the unique situation for Bodies Corporate. We have also provided commentary on the three suggested options being:

- Automatic Flood Cover
- Automatic Flood Cover with Opt-Out
- Status Quo

However, critical to this is the funding mechanism for the option ultimately selected.

About CHU

CHU Underwriting Agencies Pty Ltd was founded in 1978. Its two founding partners created the very first strata insurance plan in Australia and, unnoticed by its larger competitors, it calmly established itself as the number 1 strata insurance provider. CHU is the leading specialist in Strata and Community Title Insurance in Australia, with over 100,000 schemes and $400 billion assets under its management.

CHU's reputation for strata specific expertise rests in its ability to reduce the financial risk and exposure for Bodies Corporate and Strata Managers. The CHU approach has been mimicked by some competitors and we have replicated our successful model in the USA, operating across 30 states and more recently, the CHU brand has been launched in the United Arab Emirates and UK markets.

In 2004 CHU became a wholly owned subsidiary of QBE Insurance (Australia) Ltd. QBE is one of Australia's most successful and secure insurance brands and a top 25 insurer, worldwide.

CHU remains at the forefront of strata insurance product development and its market leading cover is constantly reviewed, taking it beyond the minimum legislative requirements. To do this, CHU keeps abreast of National and State issues that affect the strata industry and this is why more strata managers, brokers and lot owners trust CHU with their strata insurance requirements than any other intermediary or insurer.

Overview

Our recommendations consider not just the current climate of insurance and frequency of natural disasters, but also the future environment. We have made specific commentary on how this impacts on strata communities.

Strata and Community Title Insurance

Body Corporate (Strata and Community Title) properties represent a uniquely complex issue given that, unlike the case with home insurance, insurance for Bodies Corporate is compulsory. Further, a

Body Corporate is an unlimited liability legal entity, meaning its members have an uncapped – and in many cases/jurisdictions joint and several – liability to the Body Corporate.

The assumption under the various State-based legislation relating to strata, is that the strata consumer is fully protected against financial loss. However, due to different legislative wordings, and interpretations, some perils are simply not covered by insurance such as:

- Nuclear
- War
- Biological

and others are subject to market availability such as:

- Terrorism, and more specifically
- Flood

Any solution which made flood or similar insurance compulsory as part of strata insurance would increase dramatically the liability and associated obligations upon the office bearers and members. In strata the market, flood cover is more limited than is the case for home insurance, and cover for numerous perils are either unavailable (such as flood in most high risk areas) and/or attract significantly higher premiums. Such unavailability and/or high premiums are consistent with the technical cost of risk associated with the relevant location.

Complexity of Community Title

Community Title adds additional complexity to the proposals detailed in the review. Community Titles undertake what would otherwise be governmental responsibilities. That is: management and maintenance of roads and services parks and reserves; provision of utilities and sanitary responsibilities. All of these responsibilities are without the limitation of liability afforded to governmental agencies (local councils etc).

The obligation to manage and maintain such services on behalf of governments, whilst maintaining unlimited liability, is unique to Community Title. Therefore any solution that does not require full participation nationally would impact more adversely on any participant who is required by legislation to insure compared to those who are not. In other words, an opt-out model would clearly disadvantage Strata and Community Title entities and members which in our view, would be inequitable.

Breadth of Reform

It is our assertion that any solution must not focus singularly on flood but also on other risks that are similarly geographically concentrated, and subject to similar constraints upon market availability. That is, tropical cyclones.

A recent paper/study released by the Commonwealth Government: “CONSULTATION REGULATION IMPACT STATEMENT (RIS 2010-01) Proposal to Revise Building Code of Australia requirements for

Construction in Cyclone Affected Regions March 2010," highlighted the damage cost resultant from tropical cyclones in Australia to residential property as being approximately $260 million per annum in the 35 years span to 2006. These losses do not incorporate subsequent events, however, the same paper showed that the damage cost of tropical cyclones to residential property in Australia was significantly higher than that of flood.

Tropical cyclones have traditionally been insured by the insurance sector. However, costs associated with these locations are becoming increasingly prohibitive, and capacity at reasonable pricing is diminishing. The best example of such an issue is insurance in the Northern Territory which is essentially a monopoly through the Government-subsidized insurer TIO.

The reduction in capacity to insure in cyclonic regions may represent a significantly greater problem for Governments in the future. The same paper referred to above also indicated that it was likely Brisbane would be subject to a Category 3 Severe Tropical Cyclone in the next 50 years. The effect of such events on financial markets and the Australian economy would significantly outweigh the financial cost of any flood event.

The notion of universal flood cover is in the interest of the broader community. The events of early 2011 had a clear financial impact on Australia nationally. Therefore any solution for catastrophes/natural disaster events which are currently either limited in capacity or unaffordable, or unavailable, should be viewed in the national context rather than geographically-centred.

It is CHU's view that solutions must be nationally inclusive, and must incorporate tropical cyclone risk. Further, should the cyclone risk be removed from retail insurance markets, it is likely to generate more competition in the markets where capacity is limited and or non-existent, creating greater consumer benefits, at the same time as better protection.

Commentary on 3 Proposed Options

Our commentary on the three proposals is based on the need to provide a solution for greater consumer protection. Any system that is not Government funded will be highly likely to fail in its intended purpose. Due to the compulsory nature of strata insurance, any alternative system designed to provide greater flood cover will disproportionately impact on strata properties if the remainder of the home insurance community is not also compelled to obtain cover.

The size of the strata market is insufficient to self-fund perils such as flood, due to high concentration of risk, without participation in a broader Government-funded scheme.

Automatic Flood Cover

The inclusion of automatic flood cover will not in itself ensure participation. If automatic flood cover is going to be introduced it is our assertion that Government intervention is necessary. The variability of coverage remains a complex issue and it is not likely to be considered until after the event. In strata there is a focus by most committees on the financial cost of administering the property. The decision to insure for flood is not at a personal level but a collective level. It is likely that conflicting and potentially divisive issues will arise if it is left to market conditions to determine whether to insure or not. Our experience is that very few properties choose to insure for flood when presented with the additional cost of including flood into their insurances.

Automatic inclusion will impact to a greater extent on the socio-economically disadvantaged. Insurance Council of Australia studies undertaken on non/under-Insurance indicate that those most likely to not insure are the most economically disadvantaged members of society. That is, when presented with no Government requirement, those least able to afford a loss are the least likely to insure and those most significantly affected by an event. Ultimately, this means that Government and Non-Profit Organisations (community) will bear the associated remedial costs.

The nature of insurance is to underwrite each risk based upon its statistical and technical risk data. Specifically for strata risks, a further layer of complexity exists in relation to below habitable level property exposure, which must be aligned with any Government-produced flood/peril mapping. Without accurate peril data, and individual risk exposure knowledge and characteristics, the ability to effectively price the risk is limited.

Any market-based solution (meaning: insurance and financial market capacity solution) is dependent upon financial availability of capacity. This capacity is not static nor is the cost associated with the capacity.

Costs within a market environment are also higher for specific perils cover than those through a Government-managed fund. That is, the cost of the peril would require significantly higher additional on-costs as well as being less flexible in solutions to cover the peril. These on-costs include company profits, commissions, taxes, levies and duties. In States with Fire Service Levies, the cost associated with $100 additional premium (before taxes) for flood charged by the insurer will see around $80 retained by the insurer and around $140+ charged to the consumer, or almost 75% costs in addition to the cost of funding flood cover or another defined catastrophe peril (cyclones).

A market-based solution requires providers to make a return on the investment associated with the cover. If the benefits are restricted to consumers only then it is likely that participants will withdraw, preferring to utilise their capital elsewhere. Therefore the $80 example above must also further include investor profits.

It has been demonstrated in other markets that the introduction of compulsory insurances may lead to the ultimate withdrawal of participants. One of the most recent examples of such market forces operating is in the case of Builder Warranty Insurance.

Any withdrawal of participants will ultimately lead to reductions in coverage available. Not only in available providers, but also in the breadth of benefits available.

In geographic regions affected by cyclones, for example, the compulsory nature of insurance including coverage for cyclone damage has led to the loss of competition and providers. Rather than ensuring coverage for cyclones the actual resultant effect is the loss of cover for all perils via insurers withdrawing from the region.

The compulsory nature of strata Insurance would inherently discriminate against Body Corporate members relative to retail/direct consumers who, even under an automatic flood cover regime, may choose not to take out insurance. That is, lot owners in strata communities will ultimately end up subsidising these other consumers.

Automatic Flood Cover with Opt-Out

The opt-out option is inherently flawed. While the option of not insuring may create greater consumer awareness, the resultant effect of opting-out will be detrimental to the national interest. By way of example, the QLD Premier's Fund does not discriminate between those that chose not to insure for flood and those that were unaware that they were not covered for flood. Similarly, in the event of implementing a model for automatic flood cover with an opt-out option, the community and Government would still ultimately contribute to the costs of those not insured, via non-profit organisations and Government funding.

The political implications of not providing assistance would be disastrous. It is reasonable to also highlight that essentially all properties built in flood or other peril areas have ultimately been approved by Government (local). Accordingly, the extent of damage from natural disasters in these areas is at least partially attributable to initially incorrect data, and/or Government policy.

The majority of the Strata Community is, currently, generally self-insuring for flood risk, without any form of Government intervention. Further many Government benefits such as the QLD Premier's Fund are targeted at individuals (home insurance): as Bodies Corporate are legal entities they may be excluded from many benefits otherwise available to individuals.

As detailed above any Government or community assistance creates a disincentive to participate. Our experience is that when presented with the cost of flood insurance cover, most entities choose not to accept the offer.

The greater proportion of entities opting out would lead to increasingly problematic pricing issues. A general underfunding would exist.

Specifically in respect to strata, an opt-out model would be discriminative. Owing to the compulsory nature of strata insurances, strata properties in most jurisdictions would be obligated to insure, with the result that strata would represent a higher percentage contribution of insured properties than their actual percentage of properties at risk.

As in the earlier 'Automatic Flood Cover' option , costs within a market environment are also higher for specific perils cover, than those through a Government-managed fund. That is, the cost of the peril would require significantly higher additional on-costs as well as being less flexible in solutions to cover the peril. These on-costs include company profits, commissions, taxes, levies and duties. In States with Fire Service Levies, the cost associated with $100 additional premium (before taxes) for flood charged by the insurer will see around $80 retained by the insurer and around $140+ charged to the consumer, or almost 75% costs in addition to the cost of funding flood cover or another defined catastrophe peril (cyclones).

Again, under this option, any market-based solution will require providers to make a return on the investment associated with the cover. If the benefits are only for consumers then it is likely that participants will withdraw, preferring to utilise their capital elsewhere. Therefore the $80 example above must also further include investor profits.

Status Quo

It is identified that the status quo has led to numerous uninsured losses. The effect of no change would be to maintain the current problems without rectification. Our experience is that when presented with the cost of a flood cover option, most consumers choose not to insure for the specific peril.

As highlighted in our comments on Automatic Flood Cover, the Insurance Council of Australia's studies undertaken on non/under-Insurance indicate that those most likely to not insure are the most economically disadvantaged members of society. That is, when presented with no Government requirement those least able to afford a loss will most likely be those most significantly affected by an event. Ultimately, this means that Government and non-profit organisations (community) will bear the associated costs.

The majority of the Strata Community is, currently, generally self-insuring for flood risk, without any form of Government intervention. Further many Government benefits such as the QLD Premier's Fund are targeted at individuals (home insurance): as Bodies Corporate are legal entities they may be excluded from many benefits otherwise available to individuals.

Recommendation

With regard to automatic flood cover, in reviewing the 3 options proposed in the NDIR paper, the most effective solution is automatic flood cover (compulsory), however additional perils must be included and any solution must be Government- managed (administered fund).

CHU's Proposal

In reviewing the various options presented the NDIR paper, CHU is of the opinion that an automatic natural disaster perils fund is the solution which represents the greatest benefits and certainty to the community. This fund would be administered in conjunction with/by the Australian Reinsurance Pool Commission (ARPC).

The fund would incorporate all catastrophe disasters designated by legislation (to be enacted as appropriate) to be covered by the fund. The suggested perils to be incorporated into the fund are:

1. Flood (Riverine Flood)
2. Named Severe Tropical Cyclones (Category 3 or greater at any point of coastal impact)
3. Storm Surge

Why these classifications?

1. Riverine Flooding – Once standard definitions in relation to flood are agreed, the insurance market would have little or no difficulty in providing cover for water events excluding Riverine Flooding.
2. Severe Tropical Cyclones – Cyclones of categories less than 3 are less likely to cause damage by wind, and their wind strengths are consistent with other forms of storm and weather conditions (strengths) seen in non-cyclonic regions of Australia.
3. Storm Surge is a common exclusion in many insurance policies and is a condition associated with cyclones. Its inclusion would remove confusion between cyclone damage (wind) and storm surge.

How should it be funded?

There are two possible options which may be mutually exclusive or combined:

1. Insurance Levy - An additional insurance levy similar to the current Terrorism Levy arrangement, however, with no retention by the insurers.
2. Land Rates - Council/Land Rates-based levy similar to how Fire Services Levies are funded in QLD and WA.

What are the advantages/disadvantages of each option?

1. Insurance Levy –
   a. There is existing infrastructure to support the collection of the levy;
   b. Insurers' processes are aligned with premium collection;
   c. Banks and other financial institutions are already aligned;
   d. A disadvantage is that any charge on insurance premiums delivers extra costs to clients via taxes, duties, levies and commissions above the actual cost of funding the exposure.
2. Land Rates –
   a. There is little or no under-insurance or non-insurance complexities associated with underfunding or non-participation;
   b. Contributions can be scaled based upon the engineering exposure;
   c. Contributions can be scaled based on occupancy classification or land zoning;
   d. Contribution is paid by the property owner who is the beneficiary of the cover provided by the fund.

Who should be included?

Any or all of the following, which can contribute at variable rates based on classification:

1. Residential Properties – whether they are houses or strata/community title developments.
2. Residential Contents – occupiers of properties.
3. Mixed Use Properties – mixture of Residential and Commercial - whether they are owned or strata developments.
4. Commercial Properties – All forms of commercial properties being office, retail, commercial, industrial - whether they are owned or strata developments.

5. Commercial Occupiers – Should commercial occupiers have the ability to opt-in/opt-out. It was identified that ongoing financial stability was an integral part of the purpose of the original Terrorism Pool, after the withdrawal of the commercial sector at sustainable premiums. Should a similar contribution exist for commercial occupiers.

Should the cover be capped or unlimited?

If there is a need to cap the contribution to a loss, it is suggested that any capping should be a sufficiently high value as to avoid residential home owners, including lot owners living in strata, from a co-contribution other than is explicitly identified.

An example of capping might include the pool covering proportional amounts only- say, 80% of any loss, with the lot owner/property owner covering the remaining 20%. Such measures would ensure moral issues around risk mitigation would be limited.

Other benefits?

The intervention in capital markets is limited, and will create greater market capacity for all other risks, by enabling the introduction of increased competition and providers.

The benefits are for the whole of Australia, with an impediment removed from the development of property (especially strata and community title in Northern Australia), whilst the national mapping of these perils will improve Government's ability to plan and manage future developments in risk associated areas.

Funding further allows for extreme circumstances such as those forced upon the New Zealand Government in Christchurch. That is, the repossession of properties in areas now considered to be permanently unsuitable to residential construction.

Such a fund allows for the creation of innovative and sustainable re-insurance programmes, or to source other financial instruments from broader financial markets, such as catastrophe bonds.

Finally, the costs associated are lower, due to the removal of stakeholder/investor returns. That is, any contributions by lot owners are paid directly and available specifically for damage/losses associated with the defined perils, rather than a proportion going towards funding private investor returns.

Conclusion

The position statement provides specific responses to the breadth of questions, however, CHU would be willing to meet and consult on any specific questions which may require further consultation in respect of strata.

Whilst we have provided a proposed recommendation/option for consideration, CHU is only in favour of proceeding with an Automatic Flood Cover model subject to the cover being compulsory and via a Government fund. Further, the fund must incorporate other perils (specifically tropical cyclones) with a similar complexity.

The strata insurance market is not large enough to self-fund Automatic Flood Cover, accordingly any funding for flood must be part of a broader, Government-funded scheme. There are approximately 360,000-380,000 strata properties throughout Australia, compared with the over 6 million homes. In the case of strata, any geographically-concentrated event is more acute due to the higher asset values of properties, and lower numbers available to share exposure.

Capital capacity to insure is heavily limited in cyclonic regions, and has resulted in reduced availability or unavailability of insurance for some strata properties. In addition, strata properties are currently subject to significant premium increases as a consequence of the reduction in capacity, and more accurate pricing associated with the peril. Such premiums are in the magnitude of up to $5,000 per lot (the equivalent of over 5 times the average household rate throughout Australia) in high risk regions.

The compulsory nature of strata insurance requires participation, and accordingly any option that includes strata but does not also compel the remainder of the community to insure will result in strata consumers disproportionately over-funding any solution for flood and other perils.

CHU Underwriting Agencies Pty Ltd

12th July 2011