Reinsurance Pool
FOR CYCLONES AND RELATED FLOOD DAMAGE

CHU UNDERWRITING AGENCIES PTY LTD
CONSULTATION PAPER SUBMISSION

CHU

EXECUTIVE SUMMARY

CHU Underwriting Agencies Pty Ltd (CHU) has specialised in strata insurance for over 40 years and operates in all states and territories.

CHU is Australia's largest provider of strata insurance, acting under a binder agreement with QBE insurance. This market position and our engagement with strata owners and the network of strata suppliers gives us great insight into the issues and challenges of the strata community, particularly in relation to insurance.

The Australian Government's proposal to establish a reinsurance pool covering the risk of property damage caused by cyclones and cyclone-related flood damage is truly welcomed. We believe that a simple structured reinsurance pool with tiered rating and administered by the Australian Reinsurance Pool Corporation (ARPC) could improve the accessibility and affordability of insurance for strata properties in cyclone-prone areas such as northern Australia.

It will be important for the reinsurance pool's design to assess and cater for the unique needs of strata properties (residential and commercial) and residential homes separately. The industry consultation process should engage both strata / strata insurance specialists and home insurance as they are not the same.

As a provider of strata insurance in cyclone-prone areas, we are keen to be part of the industry consultation with QBE to help shape the reinsurance pool's final design. The key will be a simple design and utilising the existing insurance claims infrastructure and catastrophe response teams. They have been tried and tested over the past decade with numerous extreme and devastating weather events in northern Australia such as Tropical Cyclone Yasi and the Townsville floods.

The consultation process, pool design and implementation should not be rushed. This is a great opportunity to address the inherent issues in the high risk market and encourage new entrants. There will be considerable work involved in pricing, amending systems and documentation so setting a realistic delivery date is vital to its success. We look forward to providing further input and consultation so that we can better support owners in the affected regions.

ABOUT **CHU**

CHU Underwriting Agencies Pty Ltd is an underwriting agency specialising in tailored insurance packages for Strata Title buildings and bodies corporate in Australia.

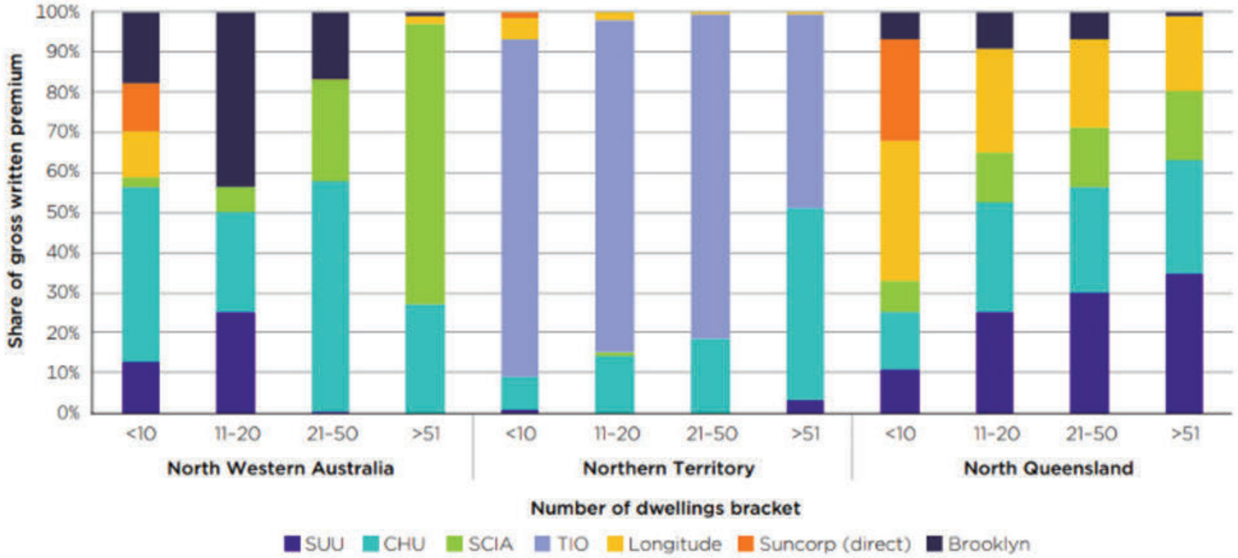
The company was established in 1978 and today insure around 125,000 strata schemes in all states and territories of Australia. We are proud to be Australia's largest provider of strata insurance.

CHU operates under a binder agreement with QBE and have full underwriting and claims settling authority for individual building sums insured up to $240M.

CHU is wholly owned by the Steadfast Group of Companies.

It should be noted that although CHU currently has limited participation in the Northern Australia strata insurance market, we have aggregated risks circa $10BN in the region.

Figure 16.25: Insurer brands' and insurer intermediaries' share of total gross written premium for strata insurance products, by region and dwelling bracket, 2018–19



Source: ACCC analysis of data obtained from insurer intermediaries.

WHY IS STRATA INSURANCE DIFFERENT FROM HOME INSURANCE?

It is important that strata insurance is considered separately and as a different type of insurance product from home insurance. Strata Title buildings unlike freestanding homes have more complex building characteristics, ownership structures and are governed by specific legislation requirements in each state and territory.

It is also mandatory for Strata Title buildings in all states and territories of Australia to insure for full replacement value. As a result, Strata Title buildings have a lower risk of underinsurance and has a higher contribution to duties, taxes and levies in all products where these are calculated as a percentage of the base premium.

Insurance is typically the largest expense item in any strata schemes annual budget. This is despite the fact that the ICA has shown the rate of strata insurance premiums to be up to 50% cheaper per owner than the equivalent home building insurance by sums insured. In Northern Australia this cost is exacerbated by the high cost of reinsurance.

Owners in a strata title building are jointly and severally liable to meet expenses, meaning the risks of underinsurance can become a significant burden on individuals in the event of an uninsured or underinsured loss, particularly in the event of a total loss. This liability can also prevent the sale or reduce the saleable value of units whilst a debt is unquantified or is found to be significant per unit.

Unlike home insurance, individual strata title buildings can range in sums insured from $500,000 to greater than $2 Billion. The complexity of the ownership arrangements can go from a 2 owner duplex, to dozens of individual bodies corporate with committees all governed by a representative Building Management Committee (BMC). These committees are essentially a fourth tier of government.

Most strata insurance policies are placed via an intermediary. Predominantly brokers, followed by strata managers acting as authorised representatives of the insurers/underwriting agencies. So, in terms of distribution models, strata insurance has more similarities with small business insurance than it does with home insurance. Strata insurers (or their underwriting agencies) also don't tend to be household names, as their acquisition costs come in the form of intermediary commission for distribution services rather than advertising spend.

REINSURANCE POOL COVERAGE

QUESTION
1

How should 'cyclone' and 'cyclone-related flooding' be defined for the purposes of defining the reinsurance pool's coverage?

CHU are comfortable with use of the term "Named Cyclone" however would accept the use of the Bureau of Meteorology definition of cyclone as this is independent of the insurance industry.

> *A non-frontal low pressure system of synoptic scale developing over warm waters having organised convection and a maximum mean wind speed of 34 knots or greater extending more than half-way around near the centre and persisting for at least six hours.*

Flood is more difficult to define in this context. The pool needs to specify where the coverage starts and stops. The working example of Cyclone Oswald (2013) produced significant flooding in southern QLD and Northern NSW. The low pressure system subsequently continued all the way south. This was further evidenced by Cyclone Yasi in 2011 where the initial category 4 cyclone broke land in far north Queensland, damaging townships like Innisfail, the tail end of the tropical low created a catastrophic weather system in Melbourne which was a larger insured loss for CHU.

It is difficult to quantify cyclone flood vs non-cyclone flood (i.e. from normal heavy rain), especially in non-cyclone-prone areas. This needs to be clear and simple in order to be adequately priced by both the insurers and the reinsurance pool, and it needs to be fair. It may be prudent to implement a time clause in relation to a single weather event.

There is a potential gap in coverage for high-risk flood clients in southern Australia. An example of this is the banks of Brisbane River which would not be covered by the reinsurance pool but has a very high risk of flood due to continuous heavy rain.

QUESTION
2

Should storm surge be covered by the pool and included in a definition of 'cyclone-related flooding'?

Yes. Storm surge should be included as it is excluded in most policy wordings yet has the potential to cause significant damage to buildings.

Insurer wordings would need to be amended to alter the definitions and/or exclusions surrounding action of the sea/storm surge/sea surge/high water/high tide/tidal wave or similar to exclude cyclone related events.

QUESTION
3

Is it desirable for the use of standard definitions of 'cyclone' and 'cyclone-related flooding' to be required in policies covered by the pool?

Yes, then all insurers will determine claims for the same event under the same terms. This will also reduce the likelihood of brand damage for insurers using different definitions in the same region.

Risk to brand is a material consideration for insurers. In strata, due to insurance being mandatory, premiums being high and active unit owner advocacy groups, there is a level of risk to a brand for simply operating in the region.

Any measures that can be taken through the pool to reduce the risk to an insurer's brand through negative media attention, would have a positive impact on an insurer's decision regarding whether to enter the market.

QUESTION
4

Are there any difficulties which may arise from including home building, home contents, or residential strata policies in the reinsurance pool and how should the scope of this coverage be clarified?

CHU recommend separately defining strata from normal home and contents insurance. The definition of strata should include Residential, Commercial Strata, Build to Rent and Community Association type schemes.

The pool should cover all aspects and inclusions of insurers property coverage sections. This includes but is not limited to, all property covers, loss of rent, accommodation, common area contents, machinery breakdown.

We recommend the pool cover all property covers plus special and additional benefits as per CHU wording.

QUESTION
5

Are insurers able to separately price or estimate the value of the property component of business insurance packages?

Not applicable to CHU

QUESTION
6

Are insurers able to separately price or estimate the value of the residential and small business components of mixed-use strata title policies?

All residential, commercial and mixed-use strata should be covered by the pool. The insured in these situations is a Body Corporate of owners. All CHU's products define these clients as retail clients.

Further complexity exists in instances where multiple individual Body Corporates can exist within a single building or complex on the same parcel of land.

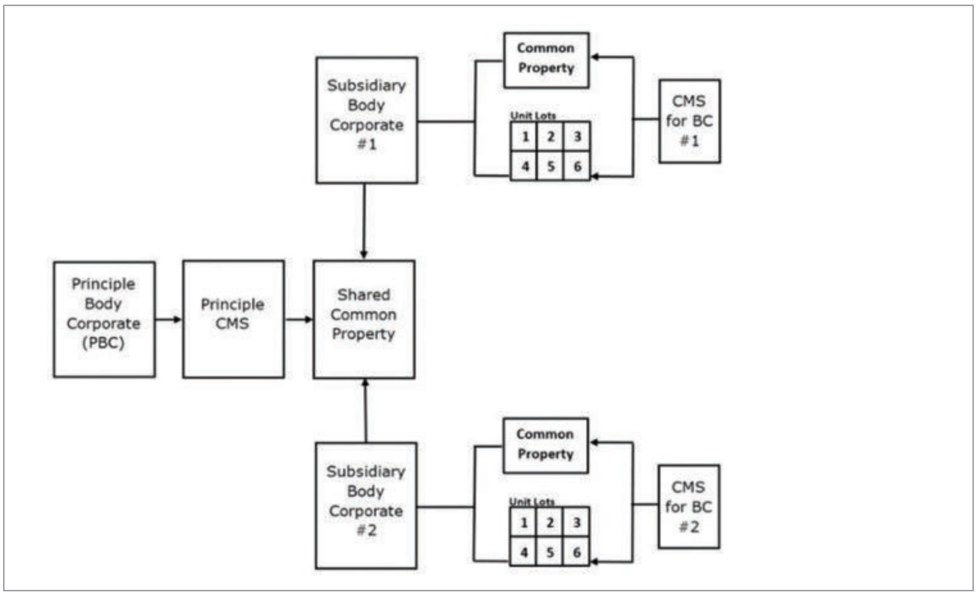
In these cases, there may be central common property or facilities that are utilised and/or shared by all the Body Corporates such as a central road, common lift or basement.

To manage these shared areas, there are 2 main strata organisational structures utilised in QLD:

1. Layered Schemes; and
2. Volumetric Format Plans

The type of structure implemented is dependent on the nature of the complex. Both these development structures are typically used for the more complex large developments which can have both residential and commercial lots and usually require one large, combined building policy.

DIAGRAM 1: LAYERED SCHEME ORGANISATION



Attempting to separate small business from other commercial lots would be problematic. We do not currently collect data on turnover/employees/etc to enable this separation nor would it serve any underwriting purpose to do so (from a property owners insurer's perspective).

We also note that the reinsurance pool's pricing will not be perfectly in sync with the insurers and may be markedly different given the highly uncertain nature of estimating cyclone and flood risk. So there may be instances where the premium moves the opposite way to public expectation. For example, a large commercial tenant is replaced by smaller tenants that qualify for the pool, but the premium goes up because the pool's estimate of risk is higher than the insurer's.

QUESTION
7

Are there any difficulties which may arise from including mixed-use strata title policies in the reinsurance pool and how should the scope of this coverage be clarified?

See previous page. The insured in these situations is a Body Corporate of owners. All CHU's products define these clients as retail clients. Suggest that all strata-title policies be covered, regardless of size and nature of tenancy. Strata, by definition, houses multiple owners and tenants. Attempting to classify tenants or treat them differently will create a greater administration burden on all parties and is likely to be detrimental (potentially significantly) to the customers that the pool is aimed at protecting.

QUESTION
8

How should 'small business' be defined for the purposes of eligibility?

See previous page – suggest no definition for the purpose of strata

QUESTION
9

Are there any difficulties which may arise from including small business property insurance policies in the reinsurance pool and how should the scope of this coverage be clarified?

No comment as this is not our area of speciality.

REINSURANCE PRODUCT DESIGN AND INSURER PARTICIPATION

QUESTION
10

What is the current approach used by insurers to assess and measure cyclone, storm surge, and related flood damage risks, to what extent are individual policy level data available, and how are cyclone related risk premiums calculated in insurer pricing models?

CHU prices at a risk-address level, and its technical price is a build up of estimates for a number of perils. This includes windstorm estimated as a separate peril.

It is important to note that storm surge is not currently priced and given this is a common exclusion in most general insurance products due to the difficulty in pricing such a risk (highly localised, with scanty historical data).

QUESTION
11

How should the reinsurance pool design a risk rating system for cyclone and related flood damage risks, and what are the trade-offs associated with using risk tiering and with the level of granularity used?

As above, this an area of pricing that's dependent on the modelling of low frequency / high magnitude events, with limited historical data points in some cases. It is unlikely that the individual insurer's estimate of risk will be in sync (or stay in sync, as pricing sophistication is enhanced over time) with the reinsurance pool. Simplicity of the pool approach is desirable in many ways (e.g. customer understanding, insurer and pool administration and implementation), but regardless of the approach, customer expectations will need to be managed as there may be material swings in premiums (up or down) as the insurer's cyclone premiums are replaced with the pool's version.

CHU support a tiered rating system.

QUESTION 12

How much risk exposure should primary insurers retain?

The simplest approach would be for nil insurer retention. If this is not the case, insurers will need to estimate (and price) their retained portion of the risk. The more complex this retention model is, the greater the uncertainty in this pricing estimate. This is likely to form a material consideration for insurer's considering entrance (or a return) to this market.

If some level of insurer retention is required, then a per risk retention is likely to be the least complex. In that case, an insurer can price based on their own (known) level of exposure. If, on the other hand, a form of aggregate excess of loss cover were to be implemented, the level of individual insurer exposure becomes more difficult to predict and price. For example, if the pool only responded after market losses reached a certain level, then insurers would need to factor in the probability of that level being reached, and their likely share of any recovery should that threshold be reached. These are insurance market factors that are outside the direct control of each individual insurer, and are factors that are in addition to the inherent uncertainty in modelling the frequency and severity of the weather event alone.

QUESTION 13

Would implementing a reinsurance pool have any effect on the claims management process, and how could this be addressed in the reinsurance pool's design?

Insurers should manage the claims as they currently do and then recover the cost of those claims from the pool. CHU manages around 30,000 strata insurance claims per year with a spend more than $300M. Our net promoter score soars above the industry average of 0 with an NPS of 43. For this reason, CHU would never seek to outsource any type of claims management to a third party.

It is further noted that the ARPC have not needed to manage claims for the terrorism pool and that insurers are best placed to manage the claim process and recover the cost of the claims from the pool.

The benefit of the reinsurance pool's coverage including cyclone related flood and storm surge would mean that there is less effort and cost required by insurers to determine the exact cause of water damage (e.g. obtaining hydrologists reports) and rather focus on rectification of the building and reinstating the insured to their pre-loss position.

QUESTION
14

What is the appropriate level of participation in the pool, and how should considerations of coverage and the amount of risk to be ceded be addressed?

For the pool to be successful, it must be mandatory for participation to be adopted by all general insurers.

Retention thresholds should also be mandated to simplify the scheme. As previously stated, the simplest approach would be for nil insurer retention. If this is not the case, insurers will need to estimate (and price) their retained portion of the risk. The more complex this retention model is, the greater the uncertainty in this pricing estimate. This is likely to form a material consideration for insurer's considering entrance (or a return) to this market.

Also note the comments in Q12 re the structure of the reinsurance (per risk vs aggregate).

QUESTION
15

How should industry transition be managed and what is the best format and timeframe for it to take place?

In order to simplify the commencement of the scheme, it is preferable that there is a fixed date for all insurers and policy holders. This will have the benefit of insurers being able to coordinate an industry approach to adoption and implementation of the scheme.

Depending upon the final structure of the pool (i.e. insurer retention, disclosure requirements), there will undoubtedly be significant work required for insurers to restructure existing reinsurance arrangements, amend pricing algorithms, update systems and amend the extensive documentation sent to the client. Therefore, we believe the current proposed implementation date of 1st July 2022 is optimistic.

REINSURANCE POOL GOVERNANCE AND MONITORING

QUESTION
16

What should be the key goals for a regular review of the reinsurance pool and what would be the optimal timeframe?

A minimum 12 months lead time from resolution of the model to allow time for insurers to negotiate with reinsurers, implement systems, alter pricing models etc. educate consumer base on how this pool will work.

It is vital that insurers have time to adequately plan and implement changes required by the scheme and communicate effectively with intermediaries and consumers. This will help mitigate against confusion in the broader market.

QUESTION
17

Should the reinsurance pool have a planned exit date?

No. The inherent risk of the region will not go away or reduce by a given date. If the pool has an exit date it will reduce the likelihood of new competitors entering the market. It needs to be a permanent solution to encourage insurers to write policies in the region for the long term. History has seen insurers enter the market, gain market share then soon after a major weather event leave and as risk appetite changes.

QUESTION
18

Which mechanisms will ensure the pass-through of reinsurance premium savings to insurance policyholders? For example:

18.1 Explicit price monitoring of insurance premiums?

There are more factors in premium pricing than just reinsurance. It is difficult to imagine that a straight year on year premium comparison would tell the full story of the pricing changes from year to year.

18.2 Additional requirements to disclose the cost of reinsurance to policyholders?

This works well with the terrorism insurance component for Commercial policies, and we support a similar approach being used to disclose changes in the reinsurance pool pricing/rating from one year to the next. It will help consumers to better understand the total cost of their cover, including the (potential) materiality of the cyclone & flood component.

However, we do not currently calculate the cyclone & flood reinsurance components of each existing policy premium, so a transitional comparison of pre and post-reinsurance pool premiums at a policy level would be extremely difficult (or misleadingly approximate).

18.3 Any additional mechanisms that may be appropriate?

Nothing to note.

LINKS TO RISK REDUCTION

QUESTION
19

To what extent do insurers price in discounts into insurance premiums for mitigation action undertaken by or affecting policyholders?

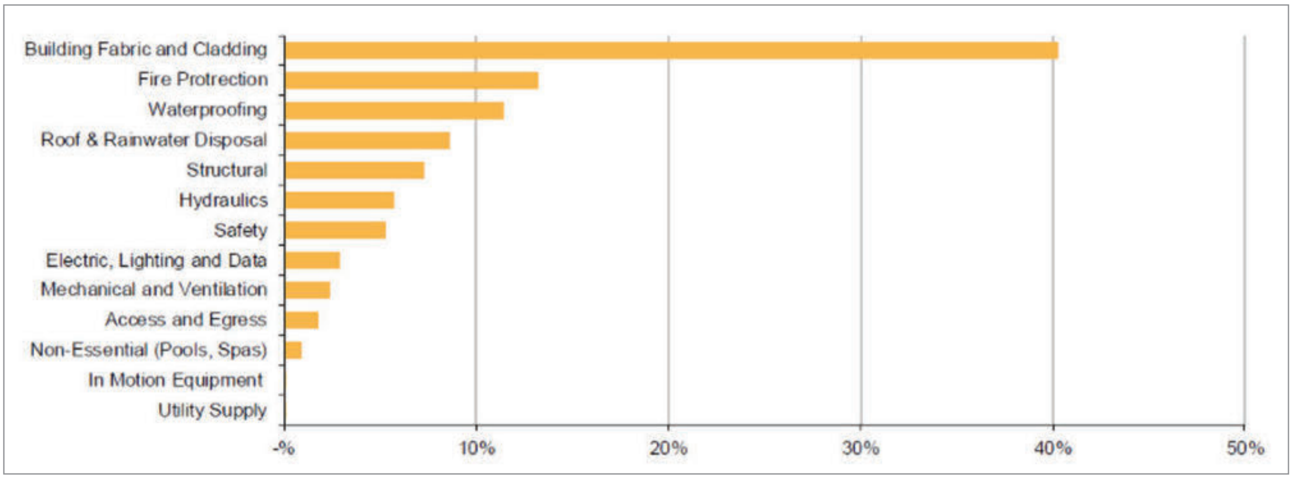
The problem with mitigation discounts and strata titles are that for the most part insurers and strata managers struggle to see buildings adequately built and maintained, with some 9/10 buildings registered under a strata title having some level of building defect.

This means that the "average" strata title building can be a below average insurable risk.

Even where defects or maintenance are formally identified within a strata scheme, it can be years before action is taken to rectify, if ever.

This means that whilst there will certainly be buildings in existence with prudent mitigation measures in place, these are the exception rather than the rule and discounting for mitigation measures on these properties would be dealt with by senior underwriters on a case by case basis.

FIGURE 7: PERCENTAGE OF PROPERTIES WITH DEFECTS: BY TYPE



Source: Deakin University, Griffith University, Macquarie Research, November 2020

QUESTION
20

How might mitigation be encouraged by the reinsurance pool's design?

20.1 Should the pool provide discounts for properties that undertake mitigation?

These would be difficult or expensive to quantify on an individual risk basis. CHU is certainly supportive of mitigation measures, but it is worth articulating that as previously stated apartment complexes are subject to well publicised defect issues (not only construction issues, but fire safety, cladding etc.). Insurers technical prices would not factor in these issues - therefore, for some clients who undertake mitigation measures to reduce their exposure to cyclone, flooding, etc - whilst they could obtain an underwriting discount for these measures, a combination of any defective issues may still be effecting their overall premium. Simply put, this means that mitigation does not necessarily result in a discount.

20.2 Should the pool have an explicit mandate to encourage mitigation?

Yes, mitigation is certainly desirable, particularly where conducted by state governments and local government authorities. In addition, new builds and construction codes should be strengthened for buildings in these high-risk areas in order to minimise exposure to cyclone and flooding which would negate the need for mitigation.

Mandating retrofitting of existing buildings may be prohibitively expensive. The cost of mitigation for some may then become the new unaffordable cost, shifting the issue from insurance affordability to mitigation affordability.

The pool can also play a critical role in advocating broader-scale mitigation projects and infrastructure to avoid the risk of damage when an event occurs. Most reviews of insurance risk in Northern Australia have advocated investment in mitigation over other government funding such as premium subsidies or funding disaster recovery after an event. The pool will be in a position to quantify elements such as the total premium relief (ie pool premium reduction) to a particular area (across all home, strata and small businesses) should their geographical risk rating be reduced.

QUESTION
21

How should the pool's design seek to discourage any increase in risky behaviour? For example:

21.1 Should there be a time-based cut-off to exempt new builds from the pool?

No, this will not encourage competition in the market. It needs to be an all-in approach.

New builds in Strata titles schemes are as (or more) likely to carry defects with the main difference being, the defects are often not yet known to the body corporate.

21.2 Should the pool only allow new builds that have been built to adequate standards and in suitable locations?

This makes sense but is not practical. There must be a rigorous certification process that does not involve private building certifiers. The onus is on government authorities to ensure new buildings meet the standards required to withstand risks and perils to with the region is prone. There should not be new building approvals in flood prone areas without strict construction elements that are unequivocally proven to perform against a flood event.

Strata schemes have a mandate to insure under strata title legislation in all states and territories in Australia and any restrictions on the pool should not reduce the ability for strata schemes to insure for full replacement value and/or obtain a minimum of two quotes for insurance each year, as this is also required under the major spending limit provisions of the Body Corporate Community Management Act 1997 (QLD).

QUESTION
22

To encourage further action by states and territories on insurance affordability:

22.1 What settings could be included in the design of the pool?

Changes to local and state government planning requirements to ensure buildings are fit for their physical situation in Australia. Buildings should be fit to withstand the likely perils in the area they are built. No buildings should be built in known high risk flood areas without strict construction elements that are unequivocally proven to perform against a flood event.

22.2 Which policy options could be introduced alongside the pool?

Potential for storm surge/ action by sea where this is not caused by a named cyclone.

Flood cover for high risk clients Australia wide including strata schemes.

Interactions with the ARPC's existing functions

QUESTION
23

What are the potential interactions between the terrorism reinsurance pool and the new cyclone and related flood reinsurance pool?

It is suggested that the Terrorism pools existing premium reserves could be used to subsidise the costs of the Cyclone/Flood pool.

CONCLUSION

CHU is supportive of the cyclone / flood reinsurance pool and a tiered approach to rating as currently exists for the ARPC Terrorism Pool.

It is essential that strata title insurance is considered as separate and different from home insurance and furthermore, it is applied to bodies corporate as an entity for simplicity of application rather than trying to divide coverage amongst small business and residential unit owners in the case of mixed use schemes

It is essential for the pool to be as simple as possible, with clear definitions of the pool's coverage. Misunderstandings of insurance risk and coverage are a major cause of brand damage to insurers, which is amplified in higher risk areas. Beyond financial risk, this brand damage is one of the key reasons for insurers opting out of some markets. Simplicity will also enable greater certainty, and therefore more efficient pricing, for insurers attempting to price the risk not covered by the pool.

The ARPC should consider using part of the existing Terrorism pool to subsidise the premiums payable for this new scheme.

A 12-month lead time is the minimum timeframe required to price the new policy structure and educate our consumer base about the changes, although this timeframe in itself appears optimistic given the complexity of issues required.

If you have any questions or feedback regarding this submission, please contact

[redacted]

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