

Inquiry into insurers' responses to 2022 major floods claims

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Submission from John Trowbridge

Experience and background

I offer this submission following extensive participation and involvement in the topic of natural disaster insurance over many years. In particular –

- I chaired the Government's Natural Disaster Insurance Review in 2011 following the Queensland floods of that year, and
- In 2021 I undertook a strategic review for the Insurance Council on the topic of affordability and availability of general insurance.

The commercial lines component of that investigation was published in September 2021 but the results of the personal lines component were not published. Most of the work was completed just before the Government decided in March 2021 that it would introduce the Cyclone Reinsurance Pool that was formally announced in the May 2021 Budget. It rendered superfluous at that time the personal lines component and much of the investigation into natural disasters.

This background comprises part of a career as an actuary, consultant, executive, company director and regulator, working mainly in financial services with an emphasis on insurance-related businesses. I founded Trowbridge Consulting in the 1980s which became a leading actuarial and management consulting firm in Australia and Asia, specialising in insurance and merging with Deloitte in 2000.

I have held senior executive positions at QBE and Suncorp and, from 2006 to 2010, I was the APRA Member for insurance. In 2015 I chaired an industry working group to recommend reforms in the life insurance industry which came into effect in 2018. In 2022 and 2023 I conducted a three phase independent review of strata insurance practices in Australia.

John Trowbridge
Sydney
3 January 2024

Submission

This submission responds to three only of the terms of reference, which are -

- 2b. The different types of insurance contracts offered by insurers and held by policyholders ... Page 9
- 2f. Accessibility and affordability of hydrology reports and assessments to policyholders ... Page 12
- 2g. Affordability of insurance coverage to policyholders ... Page 4

These items relate to policy coverage and Australia's system for the provision of insurance that aims to protect the risks to property in the case of adverse weather events including natural disasters.

The submission puts forward several propositions which are stated on the next page and explained in the three sections that follow. The most significant part of this submission relates to item 2g.

John Trowbridge

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Propositions

Proposition 1 - *a Government supported natural disaster insurance scheme*

The weather events of the last four years and their insurance consequences illustrate that -

- there is a greater need today than there was after the 2011 Queensland floods for the Government and the insurance industry to consider what might be done to improve the short and medium term affordability and availability of disaster insurance across the country
- and
- both the Government and the insurance industry should reconsider the desirability of introducing a Government supported natural disaster insurance scheme whose design follows the principles advocated in the 2011 NDIR report.

Proposition 2 - *the Cyclone Reinsurance Pool*

The existence of the Cyclone Reinsurance Pool, being a government initiative aimed at alleviating affordability and availability of insurance against cyclone and associated flood risk, is a valuable initiative that in due course will demonstrate –

- what can be achieved through the pooled funding of catastrophe risk
- the limitations of the CRP as to its design and its coverage
- what else needs to be considered if it is the judgment of governments and their communities that more needs to be done to support the affordability and availability of flood and other natural disaster insurance risks across the country.

Proposition 3 – *an industry initiated natural disaster insurance arrangement?*

To assist with the pricing and funding of flood losses, it is possible for insurers to establish a reinsurance arrangement in the form of a funding pool that operates without direct government involvement. Features of such an arrangement could be, under the right design and assuming competition law were not a barrier -

- Assuming that insurers would hold a first loss on every claim, consistent pricing across the market for flood and perhaps other water damage exceeding the first loss
- Lower prices on average for the flood risk because anti-selection is less likely and the pooling could lead to risk margins built into individual premiums to be lower than prices assessed by insurers within their own portfolios
- If the government were to grant tax free status to the pool, premium contributions could be accumulated in full, enabling the pool to be an efficient collector of funding for flood claims when they do arise.

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Proposition 4 - *under-insurance and the sum insured conundrum*

Under-insurance and the sum insured conundrum: I hold the view that insurers should be offering full replacement cover more widely. The full rationale is set out in the NDIR report of 2011 (extract at Attachment A) and also in my Phase 3 paper on strata insurance published last year (slightly different in strata because of state legislation but the principle still applies (extract at Attachment B)).

If this were to be accepted at Government level, it would place more onus on insurers to manage their offerings effectively, including -

- placing greater demands on the design of policy coverage and any initiatives aimed at alleviating affordability in areas of material flood risk, and
- exerting greater influence on the reinsurance market to work with insurers to facilitate replacement cover across the market.

Proposition 5 – *hydrology reports*

The best way to overcome accessibility and affordability of hydrology reports is to dispense with the need for them. The remedy is to ensure that all house policies include flood cover. The result would be that all water damage arising externally, whether from flood or rain (fluvial or pluvial) would be insured.

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2g. Affordability of insurance coverage to policyholders

it is widely recognised that flood insurance coverage is either very expensive or not available for numerous policyholders whose properties are in the medium to high risk flood zones so the property itself may be an individual house, a strata or multi owner property or commercial premises. The property may be building or it may include contents of buildings.

Recent history of flood insurance in Australia

The legislative position

In line with the Insurance Contracts Act and Regulations, home insurance policies will ordinarily cover all natural disaster risks including fire, storm, tempest, earthquake and flood unless clearly excluded. Cyclone is encompassed but precedent from many years ago led to flood becoming an exclusion by all insurers unless specifically included and is now also subject to strict definition.

Insurers fought long and hard against offering flood cover, even as an option, until 2008.

The advent of flood cover from 2008

Inclusion of flood cover began only in 2008, when Suncorp required policyholders to have flood cover, and from 2012 when almost all insurers began to offer the cover following the 2011 Queensland floods. Some insurers made flood cover mandatory, others offered it but allowed policyholders to opt in or out.

During and immediately after those floods, there was a furore of dissatisfaction and criticism of insurers by the community for lack of cover and disputes over cover. The Government then commissioned the NDIR (Natural Disaster Insurance Review), which completed its work in September 2011.

The NDIR recommended a scheme for the universal inclusion of flood coverage in home insurance policies. Insurers objected to such a scheme, which would have required some intervention by the Government in the private market. The government then decided not to proceed with the NDIR recommendations or any other form of flood insurance scheme.

In summary, the severe criticism of the industry in 2011 over the absence of flood cover and contested insurance claims, threatening possible government intervention following the NDIR report, can be seen to have spurred the industry into making flood cover widely available.

The NDIR report of 2011: principles for affordable flood insurance

Part of the thesis of the NDIR report was that, although insurers could be obliged through legislation to offer flood cover, it would not be affordable for a significant number of flood exposed properties unless there was some form of premium discount relative to risk available for owners of properties exposed to material flood risk.

The Review recognised that -

- Without government intervention, there would be no solution
- A solution should embrace flood cover as an automatic or compulsory inclusion in all home policies

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-
- Affordability: a system of premium discounts should be established for properties exposed to medium or high flood risk but such a system needs to minimise or avoid any prospect of flood exposure being increased and should seek to reduce risk; this concept implies several principles –
 - premiums net of any discounts should not compromise price signals,
 - the flood risk should be treated as a legacy problem, so that new buildings should pay the full risk cost of flood cover, with no access to discounts (and we know from experience that, unless state or local governments intervene appropriately in land use requirements, new properties will be built in flood prone areas)
 - for existing properties in flood prone areas where discounted premiums are made available, the discounts should be phased out over time (say 15 or 20 years) – intended as a risk mitigation incentive for those properties
 - insurers should receive the full price for the risks they underwrite and government intervention should be used for arranging the system of premium discounts
 - The funding of any discounts should be done by a centrally operated insurance entity and, in pricing terms, be based over time squarely on claims costs and not advance estimates built into premiums that are held by individual insurers (various conditions would have to apply including the need to avoid tax having to be paid on accumulating assets in years without flood claims).

These general principles are no less applicable today than they were in 2011. Applying them, however, requires developing a solution in a manner that is affordable not only to owners but also to government (which means taxpayers and/or, depending on scheme design, other policyholders who might be required to contribute in what may need to be seen as supporting the national interest).

These ideas assume that property insurance will offer full protection, i.e. meet replacement cost or some proxy such as a suitable sum insured, perhaps with some contribution by the owner in the form of a deductible.

What is different in 2023 and 2024?

In principle, nothing is different but in practice there are two important differences:

1. The 2022 floods and their severity, following as they did numerous other weather events beginning with the 2019 bushfires, have heightened risk assessments across the country. This is largely due not just to the weather events themselves but the widespread expectation that the changing climate is an underlying cause that will progressively exacerbate some of these risks.

Insurers are of course alert to the climate risks and, as acceptors of risk, are always cautious of any adverse changes in the natural, legal, economic and social environments that might affect their businesses. Community expectations are also following these same concerns.

So the thing that has changed in a dozen years in the insurance market is the prices that insurers are now charging to cover a wider and higher level of perceived risk. Not only is affordability generally affected, but in areas of flood risk some price rises are extreme. One consequence is that there appear to be an increasing number of owners opting out of flood insurance or going uninsured altogether (but note that statistics are very hard to obtain).

2. There is greater awareness by governments across the country of the costs of natural disasters, emphasised by our history of substantial recovery funding after events but totally inadequate advance funding, planning and mitigation activities. Change has begun to occur.

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Examples are the Disaster Ready Fund and the HIP (Hazard Insurance Partnership) on the back of the Disaster Royal Commission and the 2022 floods.

And what is to be done?

The most important philosophical aspect of any government intervention in the insurance market to alleviate affordability problems is the careful and astute design of whatever arrangement or mechanism is selected to meet the intervention objectives.

The NDIR panel in 2011 believed it had proposed a well designed framework for a national flood insurance scheme that could deliver a set of affordable premiums across almost the whole market and meet the various criteria and principles outlined above. The Government did not proceed, as noted above, leaving the whole issue untouched. It has, however, now introduced the Cyclone Reinsurance Pool (CRP).

On the back of the 2022 floods and other weather events in the last three or four years, we now have higher insurance costs across the board and very much higher flood premiums in some areas. Furthermore, we are witnessing extreme weather events occurring in areas not previously recognised as high risk locations (for example the 2019 bushfires and the heavy storms of December 2023) increase the difficulties for insurers in determining risk based pricing, as to both likely frequency and severity in different locations.

The current higher prices and perceived higher costs to Government or the community of any scheme may jeopardise any renewed efforts to design a national scheme today. Government policy objectives become critical and other factors will come into play, for example –

- the course of weather events in the near future (more or less severe than 2019 to 2022?)
 - *note Cyclone Jasper, widespread severe windstorms and flooding in December 2023*
- the effectiveness of risk management and risk mitigation efforts and investments now being made, by consumers, commercial entities and governments at all levels
- the effectiveness, limitations and equity considerations of the Cyclone Reinsurance Pool
- initiatives and developments that may occur in the insurance industry.

Proposition 1

The weather events of the last four years and their insurance consequences illustrate that -

- there is a greater need today than there was after the 2011 Queensland floods for the Government and the insurance industry to consider what might be done to improve the short and medium term affordability and availability of disaster insurance across the country

and

- both the Government and the insurance industry should reconsider the desirability of introducing a Government supported natural disaster insurance scheme whose design follows the principles advocated in the 2011 NDIR report.

The Cyclone Reinsurance Pool (CRP) and Cyclone Jasper

This submission has been prepared in the immediate aftermath of Cyclone Jasper and its associated rainfall, windstorm and flooding.

The CRP is clearly a useful initiative for regions exposed to cyclone risk but its coverage limitations have been exposed unexpectedly and swiftly by Cyclone Jasper.

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The primary coverage limitation is that the Pool covers windstorm and flood claims occurring from the moment that the Bureau of Meteorology declares a cyclone event until 48 hours after it is declared to have ended. This definitional restriction can be seen as artificial or arbitrary: in the case of Jasper, the 48 hour limitation on the 'claims period' ended at midnight on Saturday 16 December. After that time, record amounts of rain continued to fall for two or three days.

Flooding occurred after the end of the claims period, exacerbated by the continuing heavy rainfall. Flood losses occurring at this time are either not covered at all, for policyholders without flood cover, or, for policyholders with flood cover, the insurer will be liable without recourse to the Pool.

Unsurprisingly there has been some controversy and dispute over what is a CRP claim and what is not. And if it is not a CRP claim and there is no flood cover, there are disputes over whether the loss was caused by storm or flood (the traditional distinction around flood insurance).

Proposition 2

The existence of the Cyclone Reinsurance Pool, being a government initiative aimed at alleviating affordability and availability of insurance against cyclone and associated flood risk, is a valuable initiative that in due course will demonstrate –

- what can be achieved through the pooled funding of catastrophe risk
- the limitations of the CRP as to its design and its coverage
- what else needs to be considered if it is the judgment of governments and their communities that more needs to be done to support the affordability and availability of flood and other natural disaster insurance risks across the country.

Affordability of insurance coverage to policyholders

Affordability has become a vexed issue and the beginning of every discussion of it raises the question: what do we mean by affordability? My views on this topic were largely expressed in the NDIR report of 2011 and were extended in my 2021 report for the Insurance Council entitled "Role of the Private Insurance Market – Independent Strategic Review: Commercial Insurance". In brief, there is a complicated debate on the affordability of premiums –

There have been many reports, reviews and commentaries that refer to the affordability of insurance products, in both personal lines and commercial lines. In almost all cases, however, there is little consideration given as to how to measure or specify what is affordable and what is unaffordable. There is rarely reference to any kind of threshold or boundary or target which would separate the affordable from the unaffordable.

The most common idea usually discussed regarding affordability is based on *socio-economic assessments* which take direct account of a customer's financial circumstances. This idea has major flaws, both conceptually and practically. Also it is not applicable for businesses.

An alternative idea is *comparative premium assessments*. It relates exclusively to premium levels. It is not a panacea and has subjective elements but it does avoid the flaws of *socio-economic assessments*.

Moving beyond the definitional aspect, the question usually means: how can insurance premiums be reduced? Observations 4 and 5 in the next section about deductibles and risk management are the obvious ones. Greater efforts by insurers on underwriting of individual risks can have an impact but will not be uniform and may cause some premiums to rise and others to fall.

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Proposition 3

To assist with the pricing and funding of flood losses, it is possible for insurers to establish a reinsurance arrangement in the form of a funding pool that operates without direct government involvement. Features of such an arrangement could be, under the right design and assuming competition law were not a barrier -

- Assuming that insurers would hold a first loss on every claim, consistent pricing across the market for flood and perhaps other water damage exceeding the first loss
 - Lower prices on average for the flood risk because anti-selection is less likely and the pooling could lead to risk margins built into individual premiums to be lower than prices assessed by insurers within their own portfolios
 - If the government were to grant tax free status to the pool, premium contributions could be accumulated in full, enabling the pool to be an efficient collector of funding for flood claims when they do arise.
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2b. The different types of insurance contracts offered by insurers and held by policyholders

The most significant aspect of insurance contract terms that warrants attention by the industry is, in my opinion, the subject of **under-insurance**. Other topics have entered the debate recently in view of community experiences with flood insurance.

Recent insurance contract questions

Because of the very high cost of flood cover for the more exposed properties, some policy coverage variations have entered the debate, for example –

1. Flood only policies as a form of add-on protection
2. Under-insurance initiated by the insured
 - becoming more prevalent in order to reduce premiums
 - facilitated by insurers because they do not apply average
 - problematic if and when total losses occur
3. Reduced sums insured to reduce premiums as a conscious tactic by both insurer and insured
 - may expose the inadequate premium scales of insurers who do not price fairly above the first 30% or so of property value
 - would accentuate owner initiated under-insurance so more problematic
4. Higher excesses than current market – could also include not just a first loss charge, which is the norm, but a percentage of the total claim (e.g. 5% or 10% borne by the owner)
5. More variation in price on underwriting considerations and greater recognition by insurers of steps taken by owners on risk mitigation and risk management.

The first three of these ideas above would be, in my view, backward steps in any quest to improve coverage and reduce the 'protection gap' in relation to natural disasters, although the third could conceivably be fashioned adequately if the insured has a full understanding of the offering.

The last two have merit if well constructed by insurers.

All of these topics arise because of affordability issues in the context of insurance coverage for natural disasters. The most contentious issue beyond the general question of affordability is under-insurance when total losses occur.

Under-insurance

Under-insurance can also be referred to as the ***sum insured conundrum***.

Under-insurance often comes about either because owners do not know the cost of replacement in the case of a total loss or alternatively because they deliberately under-insure to save premium (usually in the belief that the risk of total loss or of any claim well above 50% of value is minimal).

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What is the sum insured conundrum?

The traditional insurance industry position is an age-old industry practice whereby every insured building requires a sum insured nominated by the insured party. The primary goal is to see that individual owners are protected from a situation where failure to obtain adequate insurance could put them at risk of financial loss in the event of a major claim.

This approach is intended to protect both insurers themselves and their reinsurers from risks that their insureds have not adequately identified. It is an important consideration for insurers. It also has the effect, however, of putting the onus on the property owner to assess the adequacy of the sum insured as a proxy for replacement value. That is a task that is extremely difficult for owners to meet.

It is also the case that, in practice, the way that insurers usually link premiums to sums insured means that a higher nominated sum insured leads to a higher premium, irrespective of the relationship between sum insured and replacement value. That puts the owners in a position where they have a financial incentive to under-insure. And yet insurers rarely have to meet claims for full replacement cost. ***It is a problem largely arising only when there are natural disasters that cause widespread property losses.***

What is the scale and the significance of under-insurance?

Two of the most vivid and financially damaging demonstrations of the sum insured problem were the Canberra bushfires of 2003 and the Black Saturday fires in Victoria in 2009. The average level of under-insurance, measured as the difference between the sum insured and replacement cost, was something like 30% to 40% for many policyholders. The level of under-insurance is exposed only when the insurer obtains quotes for replacement and discusses them with the owner or, for those who accepted cash settlements and then sought their own quotes.

The box below is an extract from the 2011 NDIR report and explains more about under-insurance.

Proposition 4

Under-insurance and the sum insured conundrum: I hold the view that insurers should be offering full replacement cover more widely. The full rationale is set out in the NDIR report of 2011 (extract at Attachment A) and also in my Phase 3 paper on strata insurance published last year (slightly different in strata because of state legislation but the principle still applies (extract at Attachment B)).

If this were to be accepted at Government level, it would place more onus on insurers to manage their offerings effectively, including -

- placing greater demands on the design of policy coverage and any initiatives aimed at alleviating affordability in areas of material flood risk, and
- exerting greater influence on the reinsurance market to work with insurers to facilitate replacement cover across the market.

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Replacement value and sum insured

Most insurers limit their cover to a sum insured specified by the policyholder for both home building and contents. Some insurers, however, offer full replacement or reinstatement cover on the home itself in the event of a total loss. Generally neither the homeowner nor the insurer knows how closely the sum insured corresponds to the replacement value.

Whenever there are disasters that cause homes to be total losses, the level of under insurance becomes visible. This phenomenon is most evident in bushfires. In both the 2003 Canberra bushfire and the 2009 Victorian bushfires the levels of under insurance were severe, typically 30 per cent or more, except for homeowners whose policies offered replacement cover.

By contrast, most other claims, being partial losses only, are covered by insurers on a replacement or reinstatement basis, so long as the loss does not exceed the sum insured.

It is widely accepted, within and outside the insurance industry, that replacement cover is a superior product for the homeowner to cover for a specified maximum sum insured. Nevertheless there are complexities and competitive problems for insurers to make a transition to replacement cover. Further, there is an adverse cycle occurring where some owners deliberately under-insure, to reduce their premiums, causing cross subsidies from those who do not knowingly under-insure, leading to insurers having to increase premiums for the lower (inadequate) sums insured.

In order to address **under-insurance** and to break the cycle of chronic under-statement of sums insured, the Review Panel is recommending that insurers make the transition to offering full replacement cover, but that they be given some reasonable lead time to do so.

Recommendation: Replacement Value

All home building insurance policies offering sum insured cover be modified by the end of 2014 so as to offer full replacement cover in the event of total loss of the home.

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2f. Accessibility and affordability of hydrology reports and assessments to policyholders

The sole reason for the need for hydrology reports is the existence of flood and related policy exclusions. Inclusion of flood cover in a policy effectively means that all water damage arising from external water ingress is covered, hence no need to examine the source of the water.

This problem is an age old one that causes great disputation between insurers and claimants in almost every flood.

Proposition 5

The best way to overcome accessibility and affordability of hydrology reports is to dispense with the need for them. The remedy is to ensure that all house policies include flood cover. The result would be that all water damage arising externally, whether from flood or rain (fluvial or pluvial) would be insured.

Attachment A

Natural Disaster Insurance Review

Inquiry into flood insurance and related matters

September 2011

CHAPTER 12: REDUCING UNDER-INSURANCE OF HOMES

Extract from Natural Disaster Insurance Review

Report published by the Treasury on 14 November 2011 -

See treasury.gov.au/publication/p2011-ndir-fr

Natural Disaster Insurance Review

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CHAPTER 12: REDUCING UNDER-INSURANCE OF HOMES

THE MAIN TYPES OF HOME BUILDING INSURANCE COVER

There are two main types of home building insurance cover offered by insurers in the Australian market. The first is often referred to as 'sum insured cover' under which insurers provide cover up to a specified dollar amount (that is, the sum insured). This amount represents the maximum liability of the insurer for damage to the home. The second is 'replacement value cover' under which a sum insured amount does not apply. Instead, the insurer commits to rebuild a damaged or destroyed home to its original size and standard, regardless of the cost involved.

The majority of home building insurance policies sold in Australia provide sum insured cover. Only a small number of insurers currently offer replacement value cover. This is despite the fact that replacement value cover is standard for home building insurance under Division 2 of the Insurance Contracts Regulations 1985 that is, most insurers choose to deviate from this aspect of standard cover as defined in subsection 35(2) of the *Insurance Contracts Act 1984*.

UNDER-INSURANCE OF HOMES IS LINKED TO SUM INSURED COVER

Under sum insured cover, generally neither the homeowner nor the insurer knows how closely the sum insured corresponds to the replacement value. This creates the possibility that when a home insured under a sum insured policy is destroyed (that is, becomes a 'total loss' for insurance purposes) and needs to be rebuilt, the sum insured amount may be insufficient to fully fund replacement of the home. In that scenario, the homeowner is under-insured. If the home is to be rebuilt to its original size and standard, the homeowner will have to fund the shortfall between the sum insured and the rebuilding costs.

Under-insurance has the potential to cause significant financial hardship for homeowners who experience the total loss of their home.

The existence of under-insurance is generally not readily apparent because most insurance claims are partial losses, rather than total losses, and the sum insured is usually adequate in such cases. As long as the replacement cost of the partial loss is less than its sum insured, the homeowner is generally covered for full replacement. However, whenever there are natural disasters that cause homes to be total losses, the level of under-insurance becomes visible. This phenomenon is most evident in bushfires. Indications following both the 2003 Canberra bushfires and the 2009 Victorian bushfires were that a substantial proportion of homeowners were under-insured to some degree. Following the Canberra bushfires, it was estimated that structures were under-insured, on average, by 40 per cent of their replacement cost.¹ The Insurance Council has noted that the average claim for homes that were total losses from the Victorian bushfires was \$132,000 compared with an average cost of building a home in

¹ Australian Securities and Investments Commission (ASIC), 'Getting Home Insurance Right', Report 54, September 2005, p 12.
[www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/underinsurance_report.pdf/\\$file/underinsurance_report.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/underinsurance_report.pdf/$file/underinsurance_report.pdf)

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Victoria of \$230,000, indicating here also an average level of under-insurance of around 40 per cent.²

CAUSES OF UNDER-INSURANCE OF HOMES

Under-insurance can occur for two main reasons.

Firstly, the homeowner can deliberately choose a sum insured that is insufficient to cover rebuilding costs in the event of a total loss. This practice is usually engaged in to obtain a lower premium. It actually gives rise to cross-subsidies from those who are careful to avoid under-insurance to those who do under-insure. The reason is that insurers' aggregate claims costs are not heavily influenced by the sum insured but their premiums do vary by sum insured; under-statement of sum insured therefore leads to the average premium per unit sum insured having to rise, adversely affecting those who have not under-stated their sum insured.

Secondly, the homeowner can underestimate rebuilding costs, resulting in inadvertent under-insurance. There are a number of factors that may contribute to homeowners inadvertently underestimating the cost of rebuilding.

Estimating replacement cost is a technical task and may require building industry expertise to be done properly. It requires time and effort by homeowners and, although professional advice can be obtained, it is not a practice that homeowners would see as worthwhile.

Although insurers provide online valuation calculators to assist homeowners to assess an appropriate sum insured value, the calculators have their limitations. The Australian Securities and Investments Commission (ASIC) has found that the calculators can vary in quality. Accordingly, ASIC recommends that homeowners try at least three different calculators before arriving at an appropriate sum.³

Most insurers automatically increase the sum insured each year, in an effort to counter building cost inflation, but this indexation of the sum insured value, while a useful step, is something of a 'hit and miss' approach because the results depend on both the adequacy of the original sum insured and the appropriateness of the indexation rates used.

A 'TOP-UP' TO THE SUM INSURED

Rebuilding costs following events where a large number of homes have been destroyed, such as natural disasters, may be higher than normal due to greater demand for labour and materials that inevitably follows such an event. Accurately estimating how much higher costs could be in such circumstances is difficult.

Some insurers provide a 'top-up' of the sum insured in the event of a natural disaster to account for higher than normal buildings costs. The 'top-up' is additional cover above the sum insured value, usually expressed as a proportion of the sum insured. For example, some insurers offer up to an additional 25 per cent.

² Insurance Council of Australia, Submission to the 2009 Victorian Bushfires Royal Commission responding to the Royal Commission's discussion paper entitled 'The Fire Services Levy and Insurance', January 2010, p 7. <http://www.royalcommission.vic.gov.au/getdoc/7ddec9c7-6c3c-4902-b4d4-1fa543085835/Insurance-Council-of-Australia-Ltd>

³ Centrelink, 'News for Seniors', Issue 84, 2011, p 11. [http://www.centrelink.gov.au/internet/internet.nsf/filestores/rt010_1104/\\$file/rt010_1104en.pdf](http://www.centrelink.gov.au/internet/internet.nsf/filestores/rt010_1104/$file/rt010_1104en.pdf)

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Although a 'top-up' can assist to reduce under-insurance, it does not represent a complete solution to the problem. It generally only applies following a natural disaster, rather than for all events that can cause a total loss and is only intended to address inflation of building costs following a natural disaster, rather than underlying under-insurance. It is capped at a percentage of the sum insured such that, even with the top-up, the sum insured may remain less than the replacement value. It could, perversely, also cause policyholders to reduce their sum insured, so as to lower their premium, knowing that a top-up to the sum insured will be provided by the insurer in certain circumstances. The restriction of the 'top-up' cover to natural disasters, however, is likely to avoid this possible 'arbitraging' of the sum insured.

INSURERS' PREFERENCE FOR SUM INSURED COVER OVER REPLACEMENT VALUE COVER

Under-insurance of homes is likely to remain a problem as long as sum insured cover continues to be the type of home insurance cover offered by most insurers. However, a switch to replacement value cover would eliminate under-insurance. This is because replacement value cover does not specify a sum insured but instead commits the insurer to reinstate the home in the event of a total loss regardless of the cost of doing so.

Insurers nevertheless have a preference to offer sum insured cover rather than replacement value cover. There are a number of factors underpinning this preference.

The key reason is that the sum insured clearly specifies the insurer's exposure in respect of an individual home whilst at the same time also limiting that exposure. The sum insured may also be used by the insurer in a number of other ways, for example, in premium calculations, to understand the insurer's aggregate risk exposure and to identify reinsurance requirements. Identification of a sum insured amount also facilitates cash settlement in the event of a loss. For some insurers, their computer systems are designed around having a sum insured.

Sum insured cover also places the responsibility for nominating the sum insured and for bearing the risk of under-estimating it squarely on the homeowner. The insurer, while perhaps trying to encourage a higher or more suitable sum insured, nevertheless usually accepts no responsibility for its adequacy.

In discussions with the Review Panel, several insurers expressed their dissatisfaction with the under-insurance phenomenon and the difficulties of breaking the cycle of chronic under-statement of sums insured. They also referred to efforts they had made to improve the adequacy of the sum insured as an estimate of the replacement value of the home, including 'top-ups' and improving the calculators made available to assist homeowners to estimate sums insured. None of the insurers that the Review Panel consulted considered that their efforts had been successful, particularly knowing that the sum-insured 'culture' including deliberate under-insurance seems well entrenched among the insuring community. Some of these efforts have been substantial but the problem persists.

Many home building insurance policies used to include 'averaging' or 'co-insurance' clauses which allowed an insurer to reduce the benefits payable at claims stage in proportion to the extent of under-insurance of the value of the property. However, section 44 of the *Insurance Contracts Act 1984* limited the practice by requiring an insurer to 'clearly inform' the insured of the clause and specified that an averaging clause was of no effect if the sum insured was at least 80 per cent of the value of the property. After the introduction of the Act averaging has largely disappeared with regard to home building (and contents policies), although it is still used in some small business and commercial policies.

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INSURERS' CONCERNS WITH OFFERING REPLACEMENT VALUE COVER

In contrast to a sum insured policy, under replacement value cover the responsibility for adequacy of cover is borne by the insurer rather than the homeowner.

There is uncertainty for the insurer as to the maximum exposure under replacement value. This uncertainty in respect of individual homes translates into a broader uncertainty as to the aggregate exposure and it may prove difficult for insurers to quantify this exposure with any degree of accuracy. This may also create difficulties for insurers in managing their reinsurance programmes, including satisfying reinsurers about their exposures.

The absence of a sum insured may also cause difficulties in insurers' relationships with some of their policyholders. Some homeowners are used to knowing their sum insured amount. Without it, there is also the potential for disputation over the amount of a cash settlement in the event of a total loss.

There are also administrative costs and quality control burdens on insurers associated with being responsible for rebuilding a home in the event of a total loss, as opposed to simply writing a cheque for the sum insured amount.

TRANSITION TO REPLACEMENT VALUE COVER

Notwithstanding insurers' preference for sum insured cover and the problems they may encounter in offering replacement value cover, the problem of under-insurance appears to be intractable and it is also contrary to the interests of policyholders who suffer total losses in natural disasters or otherwise.

Nevertheless, replacement value cover is acknowledged by many in the insurance industry to be superior for the homeowner to sum insured cover. It eliminates under-insurance of homes and is, therefore, significantly more effective for the recovery of individuals and the community following a natural disaster that results in total losses.

Despite the potential attraction of eliminating under-insurance, there does not appear to be any impetus from within the insurance industry to move to replacement value cover. Individual insurers who have contemplated it are discouraged from making such a move, partly by potentially adverse competitive consequences as a result of the transition. To the extent that replacement value cover exposes the insurers to greater uncertainty, they are loathe to offer it when their competitors do not. Insurers are effectively caught in the present system, which is perpetuating the chronic problem of under-insurance. Were all insurers to switch simultaneously, however, adverse competitive consequences would be avoided.

For these reasons, a transition to replacement value cover, with its acknowledged benefits for policyholders, is unlikely to emanate spontaneously from the insurance industry. The Review Panel also understands that a range of internal changes would need to be made by insurers as part of a move to replacement value cover. A move to replacement value cover is not, as a result, something that insurers could adopt quickly. However, given time to make the transition, they would be able to do so.

The Review Panel has concluded that the overall benefits of all insurers offering replacement cover justify the transition. The Review Panel therefore recommends that the *Insurance Contracts Act 1984* be amended to require insurers to offer replacement value cover for home buildings

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without the choice to opt-out but that a reasonable transition period should apply. Such a period, which should not be less than three years, would give insurers an opportunity to undertake necessary changes such as developing a capability to estimate replacement value for individual homes, reworking pricing systems as needed, making appropriate reinsurance arrangements, revising insurance policies and product disclosure statements and training both sales staff and claims staff.

REPLACEMENT VALUE COVER AND CASH SETTLEMENTS

The Review Panel recommends that as part of this transition to replacement value cover, insurers address a number of issues to ensure that replacement value cover meets the needs of homeowners following a natural disaster.

Cash settlements can facilitate a quick resolution of a claim and allow the homeowner more quickly to repair or rebuild their home. Some homeowners may choose this option given the delays that follow a natural disaster when there can be a very large number of properties that require rebuilding or repair.

A cash settlement can also allow a homeowner to relocate following a natural disaster. This can be an important part of mitigation and reduce the number of dwellings located in at-risk locations. Finally, cash settlements give homeowners the option of selecting their own builder and/or rebuilding their home to a different design.

Currently however, replacement value policies only give an insurer the discretion to offer cash settlements and a cash settlement can be imposed upon a policyholder. Whilst the Review Panel is of the view that cash settlements can enhance replacement value cover, it is important that they be provided with the full consent of the policyholder.

The Review Panel therefore recommends that the design of home building replacement value cover include that policyholders be able to apply for cash settlements following a total loss but that any cash settlement be by agreement. It would be advantageous if insurers were able to advise policyholders of the estimated replacement value of the home at the time the policy is purchased and renewed. This would give both parties greater certainty when considering whether to initiate or accept a cash settlement in the event of a total loss.

Further, it is important that a decision by a policyholder to rebuild at a new location or to rebuild incorporating mitigation measures should not automatically trigger a cash settlement.

Policyholders should be able to apply for cash settlements under replacement value policies following a total loss, but any cash settlement must be by agreement.

Recommendation 32:

That all home building insurance policies providing sum insured cover be modified by the end of 2014 so as to include replacement value cover in the event of total loss of the home.

That during the transition period insurers consider how the design features of home building replacement value policies should respond following a natural disaster, including the conditions under which cash settlements are to be offered and finalised.

Attachment B

INDEPENDENT REVIEW OF STRATA INSURANCE PRACTICES

Phase 3: ENERGISING THE STRATA INSURANCE MARKET A blueprint for affordability, availability, competition

Affordability topics

TOPIC 13: Replacement value cover: whose responsibility?

.... or the sum insured conundrum

Extract from paper prepared by John Trowbridge and published 16 May 2023 –

see www.johntrowbridge.com.au

Phase 3 - ENERGISING THE STRATA INSURANCE MARKET

Affordability and availability of strata insurance

Affordability topics

TOPIC 13: Replacement value cover: whose responsibility?

.... or the sum insured conundrum

Legislation in each state and territory requires owners' corporations (OCs) to obtain cover for replacement value of the building(s) including reinstatement in the event of a total loss. The cover is for construction or reconstruction costs that include removal of debris, professional fees and cost escalation associated with reconstruction. Valuations are required at maximum intervals of five years in all states and territories except NSW.

Sums insured in recent years for many strata properties have not kept pace with construction costs. Many SMs and brokers complain of difficulties in obtaining current valuations through their OCs.

It is a legal responsibility of the OC to see that this cover, referred to hereinafter simply as replacement value, is the sum insured recorded in the policy **BUT no underwriters offer replacement value cover – see further below.**

The general response of underwriters and brokers to apparent under-insurance and to increases in known construction and other costs is to implore SMs and their OC clients to obtain valuations regularly so that the OCs will meet their legal obligations.

In NSW, the absence of a minimum frequency of valuation has exacerbated under-insurance by allowing OCs to avoid updating their valuations if they so choose.

Proposition: there is a flaw in this system.

The system works as follows –

- Legislation requires replacement value insurance
- No underwriters offer such cover: they say they require a sum insured that is nominated by the OC as client that corresponds to replacement value
- Underwriters charge premiums linked to sums insured (not necessarily rising in proportion to sums insured but, certainly, the higher the sum insured, the higher the premium)
- OCs make their own decision on sum insured. Often it is less than replacement value.

BUT

- Underwriter and broker bear no responsibility for its adequacy
- Total losses of strata properties almost never occur
- The premium scale may give owners a financial incentive to under-insure and that incentive is stronger in a rising market, which we are witnessing at present.
- Insurers need a proper estimate of value to manage their own internal affairs including, most importantly in this context, their capital positions and their reinsurances (exposures, treaty terms and reinsurance premiums).

First conclusion: *These points call into question the approach taken by underwriters on both pricing and the setting of sums insured.*

The current practices are not well founded. Owners have a predicament which arguably is created by the insurers and their underwriting agencies. –

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Affordability and availability of strata insurance

- Underwriters' premium scales by sum insured do not generally reflect with any great analytical accuracy the nature and profile of claims costs. It is self-evident that the more valuable a strata property, the more insurance cover is needed *but* it is equally self-evident that the probability of total loss of strata properties is almost zero.

The outcome should be that there is little if any additional premium associated with lifting the sum insured from below replacement value up to full replacement value because there is little if any risk of a higher claim on account of the higher sum insured.

In practice, however, the way that insurers usually link premiums to sums insured means that a higher nominated sum insured leads to a higher premium, irrespective of the relationship between sum insured and replacement value.

So why this sum insured system?

Why then does the underwriter put the owners in a position where they have a financial incentive to under-insure yet the underwriters will almost never have to meet any claims that are remotely close to replacement cost?

At one level, the traditional insurance industry position, this situation is entirely rational. It is an age-old industry practice that every insured building requires a sum insured nominated by the insured party.

This approach is intended to protect both insurers themselves and their reinsurers from risks that their insureds have not adequately identified. It is an important consideration for underwriters.

The fact that legislation requires insurance for full replacement value is also entirely rational from a government perspective. The primary goal is to see that individual lot owners are protected from a situation where failure to obtain adequate insurance could put all members of an OC at risk.

The overall outcome, however, is not rational. Indeed at the owner level it could be seen as absurd –

- the law obliges full insurance
- owners often rely on others whom they assume are expert in offering sum insured advice
- owners also know that the chance of a total loss in any one year is negligible so they have no practical interest, only a legal interest, in the adequacy of the sum insured
- insurers can be suspected of exploiting the law because they can charge higher premiums for higher sums insured despite knowing that their risk exposure and hence their maximum potential cost is rarely more than say 30% of the sum insured.

Second conclusion:

This sum insured problem warrants attention but can only be solved if insurers and reinsurers are willing to take initiatives aimed at solving it. It is both an exposure question and a rating or pricing question – hence the conundrum.

The primary concern of insurers is of course being on risk for claims that are beyond their risk appetite and unquantified.

So is the problem one for the OCs themselves or others in the insurance chain?

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To summarise so far, it is the OCs who are seeking protection and, in general, the reinsurers and insurers are prepared to offer the required protection. The OCs, however, cannot be expected to assess for themselves the potential replacement costs. SMs and brokers can assist, for example by arranging advice from property valuers, and underwriters can give guidance. A concomitant issue, however, is the premium scales used by underwriters. That is where the incentive lies for owners to under-insure.

Illustrating the conundrum

By way of example, consider a property with 50 apartments where external guidance (from say an underwriter or broker or real estate agent) suggesting replacement costs of \$300,000 per lot or \$15m in total. Assume that the base premium is \$20,000 because the underwriter is satisfied that that is a fair price, on a portfolio basis, to meet all claims costs and other costs that need to be built into the premium.

Let us now assume that a new and more detailed valuation of the property persuades the owners that \$15m is an understatement of replacement costs and that they should have 20% more insurance, for a sum insured of \$18m instead of \$15m. What should the premium now be –

- (1) Is it $\$20,000 + 20\% = \$24,000$?
- (2) Is it still \$20,000?
- (3) Is it more than \$20,000 but less than \$24,000?

The right answer on an analytical basis is either (2) – still \$20,000 - or else a limited application of (3), namely \$20,000 plus a small margin [of say 1% or 2% (?), which is another \$200 or \$400] on the premium.

... and if that were the case, the incentive on owners to under-insure for price reasons would likely disappear.

In practice, underwriters typically adopt a stronger version of (3) where the premium for the extra cover is likely to be 10% or more on the additional sum insured –

... hence the incentive on owners to under-insure.

To illustrate further, there is an interesting aside to this proposition. It is that a premium of \$20,000 for a \$15m sum insured is at a rate of 13.3 cents per \$100 sum insured. The same premium on \$18m sum insured is say 12.5 cents per \$100 (a lower rate, which is proper) for a total of \$22,500, hence a 12½% increase for no change in exposure (only a change in the underwriter's perception of the exposure) and yet, from an insurer's conventional perspective, a reduction of 9.4% (12.5/13.3) in the premium rate for the same risk!).

How can this problem be addressed effectively in the strata insurance market? and whose responsibility is it to find a solution?

At law, it is the OC's responsibility to be properly insured but there are three main impediments –

- for owners, assessing replacement cost with any reliability is a difficult problem
- underwriting agencies, insurers and reinsurers are unaccustomed to accepting responsibility for full replacement cover without an owner-determined assessment of value
- SMs and brokers have limited ultimate influence –

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- SMs and brokers can also run into a barrier with the OC when they see what they believe is under-insurance: sometimes they are accused of wanting to see premiums lifted in their own interests (because of the flow-on effect for commissions and broker fees).

Third conclusion: *There has to be a better way! ... but what is it?*

In principle, there is actually a simple answer:

underwriters to offer replacement value cover and design their premium scales and policy offerings accordingly.

As simple as it sounds, however, orchestration of such a solution would require a change of mindset and a change of practice within the insurance industry.

This idea is not new. It has been rarely used in Australia for home building insurances but it does exist, for example through AAMI¹. To my knowledge it is not currently used at all in strata insurance.

Devising the solution

Insurers could contribute in two ways –

- they could reduce their reliance on the owner-determined sum insured which in any event is a proxy for replacement value
- they could set up premium scales that are better aligned to the profile of claims costs.

Both techniques would require insurers and underwriting agencies to accept more responsibility for the adequacy of insurance cover.

So how might such an outcome be achieved?

Any solution will have to take account of the disparate strata property population. It ranges from the very small (duplexes) to a small to medium range of 4 to 5 units up to say 20 or 30 units, a medium to large range from say 30 to 50 units per building and a higher range above 50 units. There is also a wide range of ages of buildings, from 50 years or more to the newly constructed, type of construction, quality of construction and quality of building condition.

¹ One insurer offering full replacement cover for home buildings, as an option in place of sum insured cover, is AAMI. Its current PDS states on p66 that -

“You may be able to insure the building under our Complete Replacement Cover® option, instead of on a building sum insured basis. This option can only be added to your policy at certain times, such as when you purchase your policy or renew it. If you would like this option, please ask us. We may ask you to supply additional details about the building. Your answers to our questions will be shown on your certificate of insurance and we will rely on your answers as the basis of our assessment of the cover we will provide. If the Complete Replacement Cover® option is added to the building insurance policy and you pay for this optional cover, it will be shown on your certificate of insurance and you will not have a building sum insured.”

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There is more than one possibility. Ideas might include, for example –

- (1) *On value*: insurers to make their own estimates of replacement value. They could –
 - (a) rely on, as is commonly the case today, a professional valuer's valuation or similar that the underwriter is satisfied to use, and/or
 - (b) obtain construction cost data on the property (original cost plus improvements, with dates), adjusting the costs upwards to the present time using a recognised construction cost index, and/or
 - (c) obtain building information such as number of units, average floor space per unit, number of storeys, common property description, age and condition of building, standard and type of construction (for which an insurance industry categorisation may need to be developed) and possibly some other features
- (2) *On insurance protection*: insurers to offer replacement cover as a matter of course and to do so by obtaining a valuation as at (1) above, possibly also loading that value by say 10% or 20% to cover contingencies
- (3) *On pricing*: underwriters to price in the same manner as today based on the assessed value, which would automatically include estimated full replacement value but, on a portfolio basis, should not require any increase in the premium pool
- (4) *On capital management and reinsurance*: insurers to treat the exposure (i.e. the sum insured) as at (3) as 110% or 120% of the assessed value.

if a system of this nature is to be introduced, investigation will be needed to ascertain whether, for example –

- the idea as developed so far could serve effectively as the basis for solving much or all of the under-insurance problem and mis-pricing that currently occurs
 - individual underwriting agencies and their insurers could introduce it without first mover disadvantage (i.e. could it be achieved without regulation of any kind, simply through the individual initiatives of one or more insurers? or would there need to be a regulatory foundation, either by legislation or through self-regulation through the Insurance Council?)
 - a 10% or 20% addition to the estimated value is the right adjustment for replacement value purposes
 - it could be conveyed and presented effectively to the relevant parties, being in the first instance insurers and their underwriting agencies, and secondly SMs and OCs such that they would embrace it
 - underwriters whose exposures are currently limited to modest levels, say \$5m or \$10m maximum, would be willing and able to adapt to the arrangement without any reduction in capacity.
-