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Inquiry into residential strata title insurance

Thank you for the opportunity to contribute to this inquiry. As the peak body for the strata services sector, Strata Community Australia is uniquely placed to assist the Committee in understanding both the specific challenges facing communities in northern Australia and the broader strata sector. This submission builds on earlier contributions to this Committee's broader inquiry into the operation of the insurance industry during disaster events and to the Natural Disaster Insurance Review completed in late 2011.

About Strata Community Australia

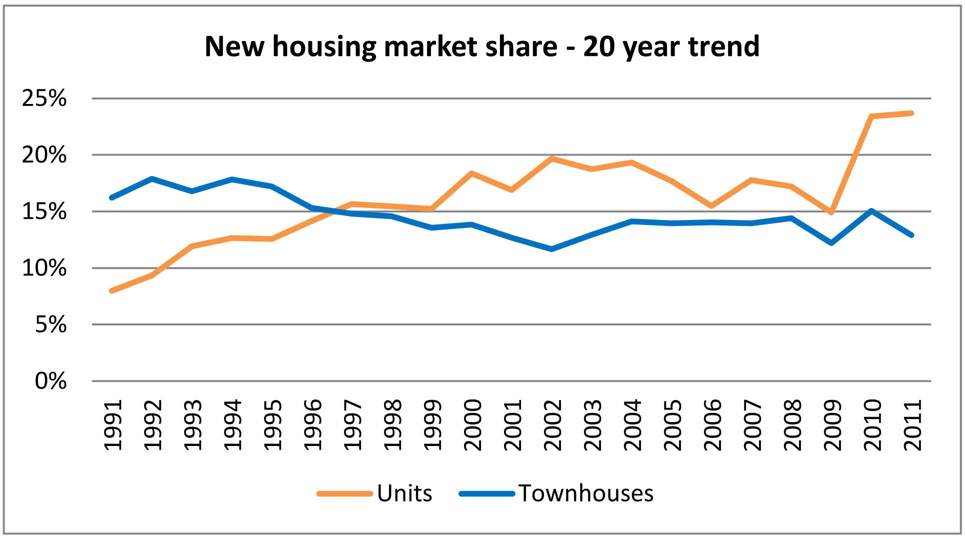
Strata Community Australia was launched in July 2011 following a restructure of the former National Community Titles Institute, bringing together under one brand and a new governance structure six state and territory organisations. In recent years these bodies have outgrown their origins in strata management to include a range of other specialist service providers. Total membership now exceeds 2500 businesses and individuals. Unlike most industry bodies based on defined product or service categories, the common denominator is the customer base - more than 275,000 owners corporations and bodies corporate etc ("Owners Corporations").

Strata sector profile

A comprehensive national view of the strata sector needs some estimation as there is no central equivalent of a company register. Such records that do exist are dispersed among state lands title offices and local government authorities.

The 2006 Census had 22.5 per cent of households living in medium and high density housing types, predominantly strata titled. This would include some traditional terraces and public housing, but exclude lower density community association style developments with similar legal structures and governance arrangements to strata title. It also does not account for commercial and retail strata, an increasingly popular form of property investment particularly for self-managed superannuation funds, or holiday and second homes.

The sector's growth trajectory is clearer. The share of apartments in the ABS building approvals series has more than doubled in the past two decades as the following graph illustrates:



As the National Housing Supply Council's *State of Supply Report 2011* found:

> *Most regions are projected to see a greater relative increase in demand for flats, apartments and townhouses than for detached houses.*

at least through to 2030. An ageing population, changes in household formation patterns, urban consolidation around existing infrastructure and trends in the labour market are all driving demand for higher density housing.

Tropical Strata

Industry estimates suggest that there are about 70,000 units and townhouses in tropical Queensland, mostly built since the 1980s. Demand factors have changed over time with the original drivers of tourism and retirement lifestyle choice being overtaken by the needs of the resources sector and related development where the flexibility of medium and high density housing is better suited to a more mobile workforce.

Similarly, northern Western Australia has perhaps 10,000 units. This number is expected to grow rapidly over the next decade in response to the demands of the resources sector, with the WA Government planning for the construction of up to 50,000 additional homes in strata-type complexes through its Pilbara Cities program.

In the Northern Territory, strata-type developments have been a major source of new housing stock for many years. The Australian Bureau of Statistics building approvals series shows units and townhouses averaged 46 per cent of all new NT housing in the decade to the end of 2011. This figure reached 57 per cent in the year to October 2011. Unlike tropical Queensland and WA, the availability and affordability of insurance is not a constraint on the sector's growth in the NT as this submission will discuss in more detail.

Strata Insurance

APRA premium returns do not separately identify strata as an insurance class. Industry estimates suggest the annual premium pool of about $700 million - a substantial specialist product line. This figure does not include GST or state taxes such as stamp duties and, in some cases, fire services levies at creating effective rates as high as 63% (country Victoria) which means the actual spend by consumers is considerably more than the premium pool.

Strata insurance has some characteristics of ordinary homeowners insurance in that it deals with property damage and public liability. It has also been likened to commercial insurance with features such as directors and officers' cover. More so than retail homeowner insurance, which is relatively commoditised and automated in its underwriting and distribution, strata insurance is written on an individual basis because of the diverse nature of the risks, from simple duplexes to large multi-use complexes with hundreds of lots. As with commercial insurance products, brokers (and many strata managers) play an important role as intermediaries in sourcing the most appropriate covers for each building and in managing claims. Market-based commissions are usually included in premiums to meet these costs.

Strata insurance differs from both residential and commercial insurance in two critical and related aspects. Because of these unique features, it needs to be considered on its own terms and not as a subset of another insurance class.

Firstly, state and territory legislation in every jurisdiction mandates that Owners Corporations take out insurance. This means that going without insurance, or effectively self-insurance, is not an option for the 276,000 legal entities subject to these provisions. The exact form of the statutory obligation varies between jurisdiction and the wordings of the relevant statutes and regulations require some interpretation as to the scope of the compulsion i.e. whether all types of cover are mandatory and if excesses, retentions etc are permitted. That said, the underlying policy intent is clear.

Strata insurance needs to be mandatory because of the unlimited liability of each owner to the entity. Should a building suffer an uninsured loss, each owner is jointly and severally liable to make good whether or not they approved or indeed had any role in making insurance arrangements. In effect a building cannot become insolvent unless every owner is also insolvent or bankrupt. To overcome this moral hazard, the statutes and regulations require those responsible for the building's management to mitigate the risks of losses through insurance. The only alternative to meeting uninsured losses is termination of the strata title as a route to sale of the whole site.

These issues now confront many of the estimated 400 strata schemes which suffered uninsured losses in the Brisbane floods 12 months ago because flood cover was either not available or, in many cases, not taken up because of the cost. It is noteworthy that the compliance status of these buildings against the relevant state statutes requiring insurance cover does not appear to have been tested to this point.

Committee Terms of Reference

> ***(a)*** *The magnitude of the increases in the cost of residential strata insurance over the past 5 years, the reasons for these increases and whether these increases are likely to be sustained;*

Strata Community Australia has received overwhelming anecdotal evidence of large price increases across the board for strata titled properties in tropical regions of Queensland and Western Australia. Members began reporting jumps in renewals of 100, 200, 300 per cent and more from late in 2010. The increases had little apparent relationship to risk factors such as age, construction method, location or claims history. The strata management industry is highly competitive and companies generally regard the outcome of insurance negotiations on behalf of clients as commercially sensitive, which means large scale quantitative information on actual cost experience is difficult to obtain from these sources.

However to assist the Committee one northern Queensland SCA strata management company member has provided the following examples of recent renewals:

CAIRNS

	Sum Insured ($m)		Premium		Cost/Unit	
No of Units	2010	2011	2010	2011	2010	2011
26	8.4	8.9	$ 20,342	$ 41,009	$ 782	$ 1,577
22	4.6	4.9	$ 11,900	$ 24,770	$ 541	$ 1,126
63	13.9	13.9	$ 16,957	$ 46,861	$ 269	$ 744

AIRLIE BEACH

	Sum Insured ($m)		Premium		Cost/Unit	
No of Units	2010	2011	2010	2011	2010	2011
37	7.8	8.2	$ 19,736	$ 47,107	$ 533	$ 1,273
16	8.4	8.8	$ 18,693	$ 65,657	$ 1,168	$ 4,104
8	15.7	15.7	$ 41,232	$ 90,271	$ 5,154	$ 11,284
42	33.6	34.2	$ 60,348	$ 139,403	$ 1,437	$ 3,319
38	9.3	10.1	$ 19,122	$ 47,354	$ 503	$ 1,246

TOWNSVILLE

	Sum Insured ($m)		Premium		Cost/Unit	
No of Units	2010	2011	2010	2011	2010	2011
71	37.3	39.1	$ 91,830	$ 159,420	$ 1,293	$ 2,245
12	2.6	2.7	$ 6,134	$ 18,850	$ 511	$ 1,571
24	7.4	7.7	$ 15,095	$ 40,261	$ 629	$ 1,678
107	115.0	115.0	$ 97,565	$ 234,418	$ 912	$ 2,191

Significantly, members advise that increases of this magnitude began to appear in late 2010, before the two major weather events of early 2011, the Brisbane region floods and Cyclone Yasi.

The impact was compounded by the lack of competition as a number of insurers stopped writing new business or began to run off their portfolios and exit the market altogether. By December 2011 it appeared that only one insurer was still providing quotes on most categories of buildings with some types of older and high-risk (eg resort island) buildings unable to obtain cover from any source. Insurers have advised that 2012 reinsurance renewal negotiations point to more increases and even less capacity this year.

Reasons given were poor claims experience by the insurers themselves and the impact on reinsurance markets of losses from both the Australian disasters and much larger losses in Japan's Tsunami and the Christchurch earthquakes. Adding to this, specialist strata insurers that do not cover tropical zones continue to advise that prices being quoted are still some way below the level they would need to reconsider their position.

> ***(b)*** *The ability of insurers to price risk and the availability of accurate data to allow for this;*

Insurance pricing has both objective and subjective elements. Claims history provides objective measures but its predictive value is limited by the relevance, sample size and thus statistical reliability of the available data. Subjective judgments - the weighting given to each variable and the choice within the range of statistically predicted outcomes - then take over. This is where the skill and experience of insurance underwriters come into play.

Market size means those insurers participating in tropical strata necessarily operate with limited data sets and experience. The largest specialist strata insurer has never written cover in the north and nor do many of their competitors. They argue that such claims data that is available has shown clearly for some time that prices on offer did not match the level of risk. The inference is that the participants in this market have made a commercial decision to offer strata insurance to accommodate the needs of their broking network and customer bases rather than as core business.

If strata insurance was underpriced until recently, it follows that subjective pricing judgments proved too optimistic. The Insurance Council of Australia has put total losses from the two major Queensland weather events of 2011 at $3.8 billion. No breakdown is available of the losses attributed to strata insurance portfolios but there is little doubt that the experience has created a more conservative and risk-averse approach to underwriting.

The detached residential and commercial property markets have also been referenced by some stakeholders. It does appear that ordinary home insurance prices have risen significantly in recent years in northern Australia. But this has occurred in a much more orderly and progressive manner and within a reasonably competitive market. Similarly the cost of commercial insurance has increased in a reasonably competitive way.

The value of this type of claims data or direct price comparisons is limited as the risk profile of strata buildings is different to that of detached housing or commercial property. A typical apartment block has only one roof - the most vulnerable part of a detached house in severe weather - for all units but will have electrical and mechanical components like lifts and pumps that are expensive to replace or repair after water damage. As discussed earlier, most commercial insurance does not have to deal with the issues of compulsion and unlimited liability inherent in strata. However the difference in competitive pressures is relevant.

> ***(c)*** *The extent to which there is a failure in the insurance market for residential strata properties either generally across Northern Australia or in some regions in particular, for example due to a lack of competition between insurers.*

The quantum leap in prices in 2010 and 2011 was clearly associated with a collapse in competitive tension in the tropical insurance market. Some insurers withdrew altogether while others would quote for renewals and not new business. By late 2011 there was effectively only one major insurer taking new business other than on a highly selective basis. Even then, this insurer drew the line at some of the risks seen to be at the higher end of the spectrum, such as buildings on resort islands and older (pre-1980s) buildings which may not meet current cyclone standards. These have been effectively uninsurable.

There is anecdotal evidence that the new price levels have attracted some interest from other insurers. But interest is all that it has attracted: no insurer has actually committed new capacity and there is no sign of any new product offerings in the foreseeable future.

> ***(d)*** *Whether consumer awareness of different insurance options should be enhanced;*

Strata Community Australia's core purpose is to improve knowledge and understanding of the operation of strata-type schemes and strongly supports initiatives to this end. Every building has different needs and there are some obvious risks in any policy or program that sought to treat strata insurance as a generic or commoditised product. There is an established support network of SCA member specialist professionals who are well qualified to advise individual executive committees and owners on their specific needs. Outside of the tropical regions this market appears to be working well and there are no issues with availability or affordability. In the tropics, these professionals are playing a critical role in sourcing coverage and often for little or no personal gain as commissions are being frequently reduced or waived to cushion the impact of price hikes.

> ***(e)*** *The extent to which the nature of body corporate arrangements are contributing to affordability difficulties;*

The concept of strata title is a relatively novel one in the evolution of property law, having first appeared in statute form only half a century ago. In that short time the Owners Corporation has become an integral part of the Australian economic and social fabric. The insurance market is only one of many areas of service delivery that are still coming to grips with the concept of the Owners Corporation as a consumer and customer in its own right. Even the terms of reference here refer to "individuals and businesses" when the subject matter actually involves a subset of 276,000 legal entities that are neither.

That said, the strata insurance market is well established and appears to be working normally outside of the tropical north. As discussed earlier, there is scope for greater clarity and consistency around compulsory insurance requirements in state and territory legislation. For example, there is an ongoing debate about whether statutory obligations to insure for full replacement value actually permit the use of excesses and retentions, even though these are commonplace in the market. In the north this debate is relevant because many Owners Corporations have considered the use of large cyclone excesses to offset price increases and need to be reminded that each owner remains jointly and severally liable for any shortfall.

> ***(f)*** *Whether the conclusions regarding (a)-(e) provide justification for government intervention in the residential strata insurance market, noting the existing responsibilities of Commonwealth, state and local governments. For example:*

- *the Commonwealth Government has responsibility for insurance regulation under the Insurance Act and the Insurance Contracts Act and competition and consumer regulation under the Competition and Consumer Act; and*
- *state governments (and local governments where appropriate) have responsibility for strata title legislation, building regulation, land use planning regulation and specific state government interventions in insurance markets (for example home builders warranty*

On November 14 and 15, 2011, SCA hosted community forums in Cairns, Townsville and Airlie Beach that were attended by about 400 units owners and other stakeholders. SCA and an insurance industry representative outlined the factors behind the current situation and heard at times distressing feedback about the impact on local communities. Examples included:

- Pensioners and other retirees on fixed incomes struggling to cope with massive insurance-driven rises in body corporate fees, already their largest single expense;
- Investors facing almost negative returns before interest, caught in a perfect storm of soaring outgoings, a soft rental market and collapsing property prices;
- Real estate salespeople who said they could not ethically sell apartments as a viable investment;
- Builders and other tradespeople dealing with the impact of complete collapse of any new strata-type construction activity; and
- Building executive committees concerned about the long term effects of slashed maintenance budgets, usually to help offset rising insurance costs, on the quality of life of residents and asset values.

There was discussion at the meetings about the role of government in insurance markets and the risks to competition inherent in a regulatory response. On a show of hands, all three meetings were unanimously of the view that the situation had reached the point where government intervention was justified.

It is also clear at the meetings that all three levels of government were seen to share some level of responsibility. At the first instance, local government has approved high-density development in vulnerable locations. More broadly, state-level policies and planning frameworks have encouraged or at least not discouraged these kinds of developments. Even today, the Western Australian Government is actively promoting and providing extensive financial support for major new high-density development through its Pilbara Cities program.

State Governments are also responsible for the legislative underpinnings of strata schemes, including compulsory insurance provisions. While demand is effectively mandated, there is currently no countervailing regulation of supply in strata insurance. The precedents here are well understood - compulsory motor vehicle third party, workers compensation, home owners warranty, other professional indemnity schemes etc. All are either highly regulated or delivered through state monopolies. On the face of it strata insurance would fall into the same category.

However there is no evidence of broader market failure. The problems identified are specific to a limited number of locations and a relatively narrow range of risks. These other statutory schemes for compulsory insurances also predate the Commonwealth's overhaul of insurance regulation following the collapse of HIH a decade ago. It is also open to conjecture whether the Commonwealth would play a greater role if these statutory schemes were created now.

In *Attorney-General (Vic) v Andrews [2007] HCA 9; (2007) 233 ALR 389; 81 ALJR 729 (21 March 2007)* the High Court considered in some detail the application of s51(xiv) of the Constitution which empowers the Commonwealth to make laws with respect to:

> *" insurance, other than State insurance; also State insurance extending beyond the limits of the State concerned".*

As Gleeson CJ put it:

> *The expression "State insurance" means the business of insurance conducted by an insurer owned or controlled by a State, that is to say, a business of State government insurance.....*
>
> *As a matter of history, State governments, through government insurance offices of various kinds, have conducted insurance business. It is, however, important to distinguish between a State legislative scheme which makes insurance of a certain kind compulsory, and a State owned or controlled business of insurance.*

The relevance of this decision is that the fact States made strata insurance compulsory does not over-ride the Commonwealth's primary responsibility for insurance regulation.

The Commonwealth has also played a lead role in promoting development in northern Australia at least since World War Two, firstly for strategic defence reasons and more recently to support economic activity, including tourism and now resources. Strata-type properties are already playing a large and growing role in the creation of viable communities to support key economic projects in the north. Anecdotally, the current insurance situation appears to be acting as a brake on new development in many of these areas.

Unlike flood insurance, where in most cases only individual buildings and/or households are be affected, the availability and affordability of strata insurance has implications for the economic viability of whole communities. In the tropics, where a disproportionate (relative to population) part of Australia's economic and strategic interests lie, this in turn becomes a matter of genuine national interest.

On this basis the Commonwealth has a clear responsibility in taking a lead role in stabilising northern strata insurance markets and facilitating the return of more normal competitive tensions. The states, and perhaps local government, also have a role to play but the situation is unlikely to resolve without Commonwealth intervention.

Insurance taxes

Both the Commonwealth (through GST collections) and the states (through stamp duties) benefit significantly from the excessive levels of taxation on certain insurance classes, including strata insurance. While Queensland and Western Australia do not impose fire service levies that add substantially to insurance costs in Victoria and New South Wales, they do collect significant percentage based stamp duties. A major by-product of runaway strata insurance costs has been a revenue windfall for both states as well as the Commonwealth as these taxes inflate the cost of higher base premiums.

Northern Territory

Darwin provides a useful reference. Strata development has been providing more than half of the city's growth in housing supply for at least a decade with apartments accounting for 57 per cent of Northern Territory building approvals in the year to October 2011. Recent announcements regarding the expansion of the United States military presence in Darwin suggest demand will increase further. Relatively speaking, new development in northern Queensland and WA is at a standstill yet they have similar needs in a relatively transient population and mobile workforce.

Darwin, however, has the benefit of the Territory Insurance Office (TIO), a statutory agency with a specific mandate to ensure insurance is available in the Territory. Its mission statement is simply:

> "*Helping build confidence and resilience in the Territory*"

Backed by an extensive but tailored reinsurance program, TIO operates profitably and on fully commercial lines in every respect except that its government guarantee substitutes for private prudential capital. While strata insurance remains expensive relative to southern capitals, it continues to be quoted at levels well below those now on offer in north Queensland and northern WA and with no material recent changes in price levels or restrictions on coverage.

In most respects the TIO mirrors the State insurance offices that in every other instance have been privatised in recent decades. On occasions the Northern Territory Government has considered and rejected the option of a similar privatisation because of concerns about the impact on availability and affordability of insurance in the NT. Based on recent experience in strata insurance the rest of tropical Australia, it would appear these concerns were well founded.

The TIO differs from the other former State insurance offices in another important respect. The Northern Territory is not a State, and the TIO therefore is not a provider of "State insurance" within the literal meaning of s51(xiv) and thus not beyond the Commonwealth's jurisdiction. Indeed, it could be seen as a delegated instrument of Commonwealth authority to the extent that the NT is ultimately governed by Commonwealth legislation.

Australian Reinsurance Pool Corporation

Another example of effective government intervention to stabilise insurance markets, the ARPC, was established following the collapse of the global market in reinsurance cover for terrorism following the World Trade Centre attack in 2001. It provides reinsurance against terrorism for eligible insurance contracts, which include most forms of property but exclude residential property, including strata buildings. In SCA's view this exclusion is anomalous given that many larger central city buildings may face similar levels of terrorism risk to commercial buildings. If they did suffer an attack, the individual owners would suffer the loss.

A decade later, the ARPC has raised in excess of its original premium pool target of $350 million, holds a $2.75 billion retrocession cover and a Commonwealth guarantee of a further $10 billion to give a total protection of $13.1 billion. This facility has yet to be called on.

Natural Disaster Insurance Review

The flood risk reinsurance facility recently recommended by the Natural Disaster Insurance Review is in line with SCA's submission to that inquiry and, as the final report suggests, is capable of extension to deal with the issues surrounding extreme weather risk in northern Australia. As with flood, such a solution can be designed to ensure government intervention is confined to specific risks and locations. The Review's final report notes this approach would minimise any impact on the broader market and deliver better value for any taxpayer support:

> *Importantly, the recommended approach would maximise, in expectation, the level of premium discount that can be achieved for a given level of external funding support because the support is only called upon when a claim is made upon the pool, not each year as premiums are paid.*

Similarly, the Review's broader solution involving a Commonwealth agency specifically tasked with managing flood risk could be readily extended as a policy tool to influence the community’s response to other extreme weather risks. With a reinsurance facility, this agency could apply pricing and terms and conditions to influence the balance between climate change adaptation and the timely development of economic infrastructure. This can be done in a way that minimises financial risk to the Commonwealth through commercial pricing principles wherever this is appropriate, as the NDIR final report suggests. State Governments could also be asked to jointly underwrite these facilities, consistent with their historical role in the creation of such exposure to extreme risks.

Conclusion

The crisis in strata insurance for cyclone risk in vulnerable areas of northern Queensland and WA presents, in this submission's view, a clear cut example where the test articulated in the Committee's terms of reference:

> *Government intervention in private insurance markets is justifiable only where, and to the extent that there is clear failure by those private markets to offer appropriate cover.*

has been met. Appropriate cover is simply not available on anything approaching competitive terms - and in many cases not at all. Nor is there any evidence that this is a short-term situation that is likely to change in the foreseeable future.

The NT's TIO presents a case study in government normalising market conditions in an otherwise difficult cyclone insurance environment. Competition exists for most classes of insurance and, as an agency run on fully commercial lines, the TIO continues to operate profitably without direct support from taxpayers other than through a guarantee.

Given that the TIO can only operate with the Commonwealth's effective backing, It would seem inequitable that residents of northern Queensland and WA must continue to rely on the vagaries of the private insurance market.

The second test in the terms of reference:

> *Individuals and businesses should be encouraged to insure themselves where practicable.*

is rendered moot by the current statutory obligations on Owners Corporations to insure and the policy rationale for compulsion. This does, however, raise the question of the appropriate role of the different levels of government in responding this issue.

As noted earlier, the Commonwealth has clear constitutional responsibility for regulation of insurance. State involvement in insurance regulation has been confined historically to specific regulation of other compulsory insurance schemes (eg workers compensation, motor accident, builders warranty). Until now, no state has felt it necessary to impose similar arrangements on strata insurance and this issue has arisen only due to the extreme risk profile in specific regions rather than the inherent nature of strata insurance.

On this basis the Commonwealth has a clear responsibility to take the lead through the establishment of a reinsurance pool facility along the lines proposed by the Natural Disaster Insurance Review. The combined resources of the Australian Reinsurance Pool Corporation, the TIO and private market specialists should be leveraged to develop a tailored solution for both extreme flood and cyclone risk. Given the ongoing role of state governments, it may be appropriate to seek their direct support, for example, through a joint underwriting or guarantee arrangement involving the Commonwealth, Queensland and WA Governments effectively similar to the current situation in the NT.

Further Information:

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