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New Inquiry into Residential Strata Title Insurance - Submission by Zurich Australian Insurance Limited

Information about Zurich

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Zurich is a wholly owned subsidiary of the global Zurich Financial Services Group (Zurich Group). The Zurich Group was established in 1872. It employs approximately 70,000 people and operates in more than 170 countries.

In Australia, Zurich operates a general insurance, life risk insurance, investments and superannuation business through its wholly owned subsidiaries. Zurich is the only global financial services group providing general insurance, life risk insurance, investments and superannuation solutions in Australia under the one brand.

Zurich's general insurance business is operated by Zurich Australian Insurance Limited (ZAIL). Zurich offers general insurance products (including property and liability insurance) to small to medium sized enterprises and corporations. The general insurance products issued by Zurich are predominantly distributed through insurance brokers.

Zurich has offered strata property insurance in Australia since 1 January 1995.

Background

We acknowledge that there have been steep increases in North Queensland strata insurance premiums in recent years. While there is a genuine commercial basis for premium increases, we appreciate that the cost of strata insurance is causing hardship for customers.

Zurich therefore welcomes this inquiry and looks forward to working towards outcomes that address the affordability issue and ensure the long term viability of strata insurance.

Submission responses to new terms of reference relating to Residential Strata Title Insurance

(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**

The first of Zurich's significant price rises was in 2009. It followed an internal review which concluded that the performance of the portfolio was highly volatile and significantly impacted by catastrophes. Over the previous period of four years, Zurich had incurred significant losses on the North Queensland strata portfolio. The review recommended a rate increase for the entire strata portfolio of 57.7%. However, in order to ensure Zurich remained competitive and maintained its strong relationship with brokers and their clients, a decision was made to increase rates by only 25%. That rate increase became effective from 1 July 2009.

Zurich then determined it would be necessary to acquire significant additional reinsurance under its property catastrophe treaty to cover its exposure to strata claims in North Queensland. The cost of this additional layer of reinsurance was approximately $10m in total. As a result, on 8 March 2010, Zurich increased its strata premiums in North Queensland by 35%.

Following the withdrawal of other insurers from the region, Zurich's strata property portfolio in North Queensland continued to grow in late 2009 and throughout 2010. Due to the cost of capital associated with this growth, and the poor performance of this portfolio, Zurich implemented a further premium increase of 20% on 16 October 2010.

It has also been necessary for Zurich to allocate additional capital against its exposure to catastrophes in North Queensland. Zurich's capital allocation for North Queensland strata business is 220%, driven by the high volatility of catastrophe claims. This is more than double Zurich's capital allocation for strata insurance outside of Queensland.

As a result of a further review conducted in late 2010, the increase in capital allocation to North Queensland strata business and further increases in reinsurance costs, Zurich determined it would be necessary to either cease offering its strata product in North Queensland or charge the appropriate technical premium. The technical premium is the premium Zurich needs to charge in order to cover all costs of supplying the product and generate Zurich's minimum required rate of return on capital. Once the technical premium was calculated, it was determined that current premiums would need to increase on average by 302% to implement the technical price.

We consulted with key brokers in North Queensland on whether to withdraw from North Queensland or offer to renew policies at the technical price. Based on feedback from brokers, Zurich elected to offer and accept renewals of existing business at the technical price. An average price increase of 302% was applied to all renewals on and from 7 February 2011. Due to the late implementation, this was averaged out to be 198% across 2011.

It is worth noting that from 2005 to 2011, Zurich has paid out significantly more in claims than it has received in premiums with a loss ratio of 115%. This does not account for non-claims costs associated with operating the strata portfolio. This situation was further exacerbated in

2011 with a loss ratio of 184 per cent. This means for every $100 we collect in premium we have paid out $184 in claims.

While the level of recent price increases are unprecedented and unlikely to continue it is difficult to predict if premiums will continue to increase in the foreseeable future. As noted above, it is very expensive to do business in North Queensland – driven primarily by day-to-day claims costs, catastrophe claim costs, the capital adequacy requirements linked to the risk exposure and of course reinsurance costs.

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

All of Zurich's portfolios are subject to an appointed actuary providing a Financial Condition Report to be submitted to APRA on a regular basis. In addition to this, Zurich has access to a variety of data to accurately price risk – including further actuarial reviews from both internal and external sources.

Risk is priced in the following manner:

- Zurich determines its base premium rate. The base rate takes into account our estimated cost of future claims, reinsurance costs, management costs, the cost of allocating capital to the strata portfolio and our required rate of return on capital.

- The base rate is then adjusted after taking into account specific characteristics of the property relevant to the risk of providing the insurance cover, including:
    - Location
    - Coverage details such as sum insured and various liability limits
    - Whether or not extra catastrophe cover is included
    - The type of building (single/multi/townhouse)
    - The age of the building
    - Whether or not the building is heritage listed
    - The construction of the roof, walls and floor
    - The number of units and stories
    - The number of pools, lifts, gyms and tennis courts
    - The total floor space for business
    - Whether or not building is available for holiday letting
    - Whether or not there is an onsite manager
    - Various other voluntary excesses

Other general insurable risk factors that will also impact the price of Zurich's strata insurance policies include:

- broker commission;
- our estimate of the cost of future claims – calculated in conjunction with data extracted from an independent sophisticated catastrophe risk pricing model;
- reinsurance costs;
- management costs; and
- the cost of capital required to be allocated to our strata portfolio.

(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**

Some areas in Australia, like Northern Australia, are more prone to higher risk of cyclone events, thereby impacting the price and inclination of insurers to offer insurance products in that region.

Zurich appreciates that the recent price increases warrants increased scrutiny however as noted in recent Insurance Council of Australia (ICA) fact sheets[i], strata insurance premiums, when divided by the number of individual units within a complex, are comparable to the price paid by home owners for building insurance for a freehold property.

It is also worth noting that prior to imposing the 2011 price increase, Zurich's retention rate on North Queensland strata business was 80%. The policy retention rate has now fallen to 20% as brokers place their clients' business with other insurers. This indicates that there is still competition for the supply of strata insurance in North Queensland, despite a number of insurers exiting the market in recent years.

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

Zurich believes that all insurers should act in a transparent manner and that consumers should have ready access to any information which helps them make an informed decision.

Zurich is an active member of the ICA and supports them in the development of information collateral for consumers.

As Zurich sells insurance solely through intermediaries, Zurich is committed to broker education programs, including online workshops. The idea behind this is to empower brokers with the necessary information to pass onto and educate consumers.

It is agreed however, that given the complex nature of strata insurance, the industry can always do more to educate consumers on the matters that should be considered when selecting strata insurance.

We note that strata insurance customers do not strictly fit within the definition of 'retail client' for the purpose of s761G(5) of the Corporations Act[ii]. This is because the body corporate purchasing the residential strata insurance is not an individual or a small business. Therefore, the retail client disclosure provisions of the Corporation Act do not apply to strata insurance. Irrespective of this position, the current industry practice is to provide the body corporate with disclosure documents consistent with those a retail client would receive.

Current industry practice can involve body corporate managers undergoing training to become an authorised representative of a licensed insurance provider. When agreeing to act as an authorised representative, body corporate managers contract to carry out certain functions and commission is paid to the body corporate managers for those services.

Zurich would support further investigation being undertaken in relation to these arrangements to ensure that strata owners understand the services provided by body corporate managers and their remuneration arrangements. It is also important to ensure that body corporate managers are appropriately trained and qualified to advise their clients on strata insurance.

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Zurich has not appointed any body corporate managers as authorised representatives.

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

Zurich's experience on claims frequency on strata insurance in North Queensland is around 30-40%. This means for every 100 customers, we are getting 30-40 claims each year. In comparison, a personal lines home building insurance portfolio generally runs at less than 10%.

Zurich believes the main reason for such a high claims frequency in strata insurance is historically low excesses. As communicated by the ICA[iii], non-strata households in Australia negotiate an average excess of $500. This is paid by the policyholder at the time of making a claim and brings the annual premium down in cost. Many strata managers and body corporate negotiate excess payments as low as $100 for the entire strata complex, meaning the annual premium can become very expensive. This is done by some strata managers so that many small claims can be made during the year to help with the overall costs associated with running a strata titled property. However using insurance to cover general maintenance issues rather than responding to larger claims and disaster events only puts upward pressure on insurance premiums.

Zurich believes the high claims frequency trend in strata insurance is further exacerbated by body corporate regulation which allows for a single lot owner to be liable for an excess.

For the managers of a body corporate charging an excess to an individual (who may have been directly responsible for the damage, or the damage only impacts them) makes sense from a 'user pays' perspective. Keeping excesses at low levels also creates less 'friction' for the body corporate manager while dealing with an individual on a claim. While this seems to favour an individual consumer, the higher premium costs impact all owners contributing to strata insurance costs. The table below illustrates the savings which can be made if a higher excess is charged:

CAIRNS		
Excess	**Building Premium ($5m sum insured)**	**Discount**
$5,000	15,906	- 12%
$2,000	16,280	-9%
$1,000	16,808	-6%
$200	17,976	

(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 insurance, compulsory third party insurance).**

After due consideration of the new terms of reference relating to strata insurance, Zurich believes the community would benefit from government coordination at state and federal levels, specifically to address the selling arrangements and the requirements for who is liable for the claims excess.

In summary

The magnitude of North Queensland strata premium increases is a direct correlation between the claims experience and the cost of doing business in Northern Australia. Whilst Zurich believes it is highly unlikely that premium increases will continue at recent levels, to a large extent these premium increases bring strata premiums broadly in line with the cost of insurance for freehold properties.

Zurich prices according to the regulatory framework set out by APRA, which involves the use of internal and external actuarial resources. While the volatility of catastrophes in North Queensland is difficult to factor into pricing, the industry has the information and tools required to price risk accurately.

Zurich is satisfied that there is competition among insurers. However with some insurers exiting the strata insurance market, and the frequency of cyclones, the market is no longer as competitive as it once was.

Zurich believes that as a result of the unique complexities of the compulsory requirements of the strata product, combined with the fact that the body corporate entity purchases insurance on behalf of unit holders, there is a need for greater consumer awareness within the market. Zurich would support further investigation by the regulator to ensure these arrangements are working in the best interests of the unit owners.

Along with consideration of the regulatory framework, Zurich would also like to see some investigation into the impact of single lot owner liability for an excess, as compared with making the body corporate liable.

Zurich appreciates that the recent price increases warrant enhanced scrutiny and discussion. We have recognised this as an issue for some time and sought to proactively discuss this with government representatives. We look forward to continuing to be part of discussions to improve strata insurance affordability for the region.

[i] ICA, October 2011, Residential strata insurance in Australia - http://www.insurancecouncil.com.au/Portals/24/documents/Insurance%20Council%20-%20Strata%20Insurance%20QnA%20Fact%20Sheet%20071011.pdf

[ii] ASIC, April 2011, Licensing: Financial product advisers – conduct and disclosure - http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg175-010411.pdf/$file/rg175-010411.pdf

[iii] ICA, October 2011, Residential strata insurance in Australia - http://www.insurancecouncil.com.au/Portals/24/documents/Insurance%20Council%20-%20Strata%20Insurance%20QnA%20Fact%20Sheet%20071011.pdf