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Senate Standing Committees on Economics
PO Box 6100
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Inquiry into Australia's General Insurance Industry

Strata is the fastest growing form of residential property ownership in Australia. Over half the new dwellings to be built in our metropolitan areas over the next decades will be strata titled. The growth of this sector raises increasingly important questions over property ownership and governance [1].

The Owners Corporation Network of Australia Limited (OCN) is the peak consumer body representing residential strata and community title owners and residents. As such, OCN is uniquely positioned to understand the impact that the legislative framework has on day-to-day machinations and community living. We have a lived experience and a practical hands-on approach to strata administration, issues management and resolution, and harmonious living.

OCN is therefore the key consumer voice in this Inquiry.

A number of factors adversely affect the effectiveness and affordability of strata insurance, including:

- lack of competition;
- lack of transparency;
- lack of consumer education;
- cascading government taxes;
- lack of disaster mitigation activities.

OCN welcomes this Inquiry as the transparency, adequacy and affordability of strata insurance covering owners corporations (also called strata corporations or bodies corporate, depending on the state or territory) as well as individual policies is of significant concern to the fast-growing number of affected consumers.

Sincerely
Karen Stiles
Executive Officer

[1] *City Futures Research Centre 'Strata Data' Issue 4, October 2011*

Terms of Reference

On 22 November 2016, the Senate referred the following matters to the Senate Economics References Committee for inquiry and report by 22 June 2017:

- the increase in the **cost** of home, strata and car insurance cover over the past decade in comparison to wage growth over the same period;
- **competition** in Australia's $28 billion home, strata and car insurance industries;
- **transparency** in Australia's home, strata and car insurance industries;
- the effect in other jurisdictions of independent home, strata and car insurance comparison services on insurance cover costs;
- the costs and benefits associated with the establishment of an independent home, strata and car insurance comparison service in Australia;
- legislative and other changes necessary to facilitate an independent home, strata and car insurance comparison service in Australia; and
- **any related matters.**

Within this submission, the following terms are used:

- SM means strata manager, or caretaker or other manager performing the duties normally provided by strata managers.
- OC means owners corporation (the term used in NSW) and body corporate (the term used in most other states). Company Title is assumed to be synonymous with Strata Title.
- Committee means strata committee (the term used in NSW) and executive committees

General Assessment of the Strata Insurance Market

Individual points of the Terms of Reference are addressed below, but we would be remiss if we failed to comment on the effectiveness of strata insurance in general.

The aim of strata insurance is to provide comprehensive protection against risks to which the Owners Corporation is exposed. A successful market operation in this area implies that choices by well-informed consumers, that is, OC committees, result in effective protection for the least cost.

In OCN's view this is not the case and a state of affairs exists, which is best described not merely as *market failure* but as *system failure*.

Owners corporations are bound by law to take out building and certain other insurance, and have the option of taking out other types of insurance. Small OC's are often blissfully unaware and simply renew their existing policy or act on the recommendation of their strata manager, often without the benefit of comparative quotes or expert advice. These small owners corporations, up to 10 or 20 lots, are the most likely to suffer a catastrophic event because of their scale. For example, a fire could easily burn through the entire complex vs a high-rise that will, in general, be partially impacted.

Ideally, insurance brokers would be recognised as the independent experts who can properly identify the building's specific needs and answer detailed questions about the alternative product offerings. Unfortunately, committees view SM's as the experts in the management of strata plans so many look to them to assist in selecting their insurance cover. Few committees know the questions to ask, and few SM's are qualified legally to give Personal Advice. And those – the vast majority – who receive a commission for dealing and arranging insurances have a clear conflict of interest, and disincentive to increase the excess to reduce the premium. Disclosure, as required by law, is not common.

In reality, many committees, comprised of unskilled volunteers from all walks of life, simply do not have the interest, time, expertise or experience to master the strata insurance product offerings. Committees therefore tend to rely on their SM's for advice without realising that the SM may receive commissions and therefore may not be truly independent.

In most cases the whole selection process is run on "autopilot" without sufficient transparency and critical analysis. Selection of insurer is often decided on premium pricing without due consideration of the differences in coverage and the potential impact of such differences.

The owners have a false sense of security and, in the worst case scenario, **a catastrophic event may be the first indication that insurance was in fact ineffective and not fit for purpose**, as in the case of the North Queensland experience.

In addition, unlike insurance brokers SM's do not have risk management structures in place to deal with Duty of Disclosure and thus jeopardise their client's cover in the event of a loss due to non-disclosure. Examples of Disclosure issues include:

- defects disclosure
- remedial or repair works greater than the policy limit
- outstanding Work Health & Safety issues
- building heritage issues
- outstanding Council Fire Orders etc

Myriad issues affect strata, especially new developments. Most new developments commission defects reports, but the defects are not disclosed by the manager to the insurer. Not complying with the condition of good faith is usually due to poor knowledge of the Insurance Contracts Act.

Where an SM does disclose the defects report, the insurer often imposes unreasonable defects exclusion endorsements. An SM with poor understanding of these endorsements and exposures cannot properly advise the OC.

Receiving poor or no advice can leave the OC and the committee members open to unlimited liability from a loss ie uninsured liability claim. Suing an SM for $100m is a poor replacement for the correct insurance policy, based on proper disclosure and a policy to match the client's specific needs.

This disclosure and analysis of risk is essential for a successful insurance program. An experienced strata insurance broker will not only deal with the duty of disclosure in a professional manner, but will be able to guide the OC through the maze of defects and defects rectification with advice and insurance polies tailored to suit the particular circumstances.

In the ever-changing strata landscape, including massive new developments, it has never been more critical for committees to receive professional, tailored Personal Advice. To put this in perspective, there is a trillion dollars of the common wealth managed by unskilled volunteers.

To improve this situation OCN recommends the following:

1. Produce a clear and simple statement of the purpose and desired objectives of strata insurance products and markets.

2. Descriptions of the roles and responsibilities of the various parties involved in the operation of this market (insurers, brokers, strata managers, and committees), conducive to achieving the desired objectives.
3. Ensure that insurance brokers and strata managers acting as professional advisers to OCs are qualified and truly independent.
4. The fee for providing this service must be transparent, and should be charged separately to the insurance cover so as not to artificially inflate the premium.
5. Make it illegal for strata managers to accept commission from suppliers, including insurers or insurance brokers. Strata managers are an administrative extension of the OC, carry delegated authorities of all office holders, and in some situations may be called upon to act in an executive role. For SMs to assist in the selection of suppliers and to accept commissions is conflict of interest, as it would be for a member of the committee.
6. Simplify and standardise strata title insurance product offerings by prescribing minimal core standard coverage for all such products, in the form of a standard "no frills" policy offered directly to OCs (not only through brokers), leaving insurers free to compete on additional coverage options and premiums. This should be done with a view to: a) ensuring products are fit-for-purpose; and b) making product offerings easier to understand and compare.
7. A simple Key Facts Sheet to accompany a simple Product Disclosure Statement (PDS) to summarise events covered in the policy, to assist in comparability and clarify contentious cover. Few OCs understand the need for eg machinery breakdown, but as complex high-rise buildings proliferate in Australia – with many now valued at $1Billion or more – this is essential. Policies should also be written in Plain English.
8. Improve consumer awareness through the education of owners, to highlight the importance of adequate, fit-for-purpose strata insurance in case of damage or disaster and explain their role in protecting the common property. This education needs to be delivered by an independent consumer organisation such as OCN or Choice, and funded by government.

Specific comments:

a) Cost

A clear contributor to the high cost of insurance is excessive charges woven into the premium:

- Inclusion of commissions grossed into the premium;
- Broker fees may also be grossed into the premium;
- Multiple taxes on this inflated premium eg Stamp Duty, Fire Service Levy, GST add a further burden. Like the Insurance Council of Australia and the National Insurance Brokers Association, OCN calls for abolition of all taxes other than GST on strata insurance. These taxes are inefficient and inequitable, and act to discourage people from taking out insurance.

OCN recommends:

1. Removal of commissions grossed into the premium;
2. All fees for service charged and disclosed separately to the insurance premium;
3. Full transparency in all contractual arrangements made on behalf of OCs;
4. Stamp duty and FSL or ESL (where applicable) abolished.

b) Pricing risk and data availability

The lack of accurate national flood data impacts on insurer's ability to accurately price risk.

OCN recommends:

1. Reliable, national flood mapping data so that insurers can develop effective flood insurance products, potentially increasing their affordability and availability;
2. Effective, risk-based land management and planning arrangements and other disaster mitigation activities developed and implemented by the Federal Government.

c) Market failure

In addition to the system failure previously described, market failure also results from the lack of competition. Australia has limited strata insurance providers.

To OCN's knowledge, CHU retains the dominant strata market share as the result of its strata manager commission model. Many managers have come to rely on insurance commissions to supplement unrealistic management fees due to undercutting practices. Other insurers have withdrawn from the market due to insufficient premium base.

This lack of competition adversely impacts the cost and diversity of strata insurance products, and can leave strata owners underinsured or uninsured in such areas as machinery breakdown, public liability, and office bearer's cover.

A glaring failure in the residential strata arena has been terrorism coverage. Many buildings in major Australian cities have been converted from commercial to residential use. It is an anomaly that these residential (or predominantly residential) buildings did not qualify for participation in the government's terrorism pool. Meaningful terrorism insurance is not available through local insurers following the withdrawal of Affiliated FM, a US based company, from the market. It could be separately purchased through Lloyds but the cost is prohibitive. If it is accepted that strata insurance should provide comprehensive cover for risks to which the OCs may be exposed, then lack of terrorism coverage renders such policies in effect not fit-for-purpose.

Fortunately OCN notes that the exemption of residential $50m+ strata buildings and predominantly residential buildings (mixed use) is under review, with Regulations out for comment this month. In the event of a terrorist event, failure to enact this legislative amendment could result in a serious impact on the economy. To put this in perspective, one Sydney CBD development, Central Park, is insured for approx. $3Billion.

Another failure is the suspension of the *entire* replacement component (damage, fire, storm, tempest etc) of an OC's cover whilst it is undertaking major works [1] (without rebating the cost of the lost cover), and the refusal by local insurers to offer one-off cover for the term of those works on the basis that they cannot price the risk. The OC is forced to seek cover via its builder, as an extendable option to the Builder's All Risk Policy. This cover is difficult to obtain, generally overseas, and expensive. See Annexure A - Case Study 4.

Yet another failure is the current situation where the building insurance covers common property, which in NSW at least includes fixed cabinets. If a strata lot owner installs eg a $250,000 bathroom or kitchen, they are obliged to inform the OC which should increase its cover accordingly. Few owners or owners corporations are aware of this requirement, which brings us back to lack of education and Personal Advice.

An recent failure (in NSW at least) is removal of the requirement to value the strata building at least every 5 years, to ensure it is adequately insured. Most price-driven OCs will simply forget or decide not to get a valuation, leaving all owners open to unlimited liability.

OCN recommends:

1. Access to the Federal Terrorism pool for OCs with greater than 50% residential content;
2. Local product offerings to cover building rectification or replacement during major works;
3. Prescribe regular / maximum time for revaluations.

d) Consumer awareness

See our general comments on the operation of the strata insurance market.

A frequent area of confusion for owners and OC's arises from the fact that OC building insurance includes the fittings, such as kitchen cabinets, which are not common property but are the property of lot owners. This means that a small component of the sum insured depends on the cost of fittings which lot owners may install and over which the OC has no control, and often no knowledge.

It would seem simpler if strata building insurance was limited to common property and contents insurance for strata lots covered everything else within the lot. However, this would require changes to the NSW Strata Schemes Management Act and possibly strata acts in other States.

There is a direct correlation between risk minimisation and reduced costs and increased cover. The direct involvement of owners in all aspects of insurance is the most positive influence in minimising costs and risks. See our comments under a) and c) and Case Studies 1 and 2.

[1] *This assumes the OC is aware of its obligation to do so, which many are not because they have been denied Personal Advice by relying on a strata manager who has no experience or expertise.*

e) Justification for government intervention

It is abundantly clear that government needs to intervene in each of these areas.

The single most important impact government can make on the cost of insurance is to focus on preventing catastrophic damage as a result of environmental factors such as flood, fire, and tempest. OCN agrees with both the Insurance Council of Australia and the National Insurance Brokers Association that government must, as a matter of urgency:

1. Provide national flood mapping data that would allow insurers to more accurately price risk;
2. Develop national land-use planning criteria that prohibits inappropriate land use in Australia;
3. Improve the community's disaster resilience by:
    a. Modernising the Building Code of Australia to include minimum standards for the durability of property to natural hazards; and
    b. Allocating adequate recovery funds dedicated to preventative infrastructure projects including levees, barrages, flood gates and improved drainage.
4. Introduce annual Productivity Commission reporting on the effectiveness of State and Federal disaster relief payments.

Unfortunately the free market forces do not ensure true transparency and good value for money.

OCN recommends:

1. Transparency and accountability of insurance providers and advisors;
2. Elimination of commissions which gross up premiums, and taxes other than GST where applicable both of which inflate premiums and discourage insurance take up;
3. Development of a strong legislative framework to regulate risks associated with flooding;
4. The Government's terrorism scheme opened up to include all residential strata and community title buildings;
5. Prescribed minimum core standard coverage for strata insurance;
6. Government funding to educate OC committee members, with a longer term view to compulsory certification for committee members of buildings with 100+ lots.

SUMMARY OF RECOMMENDATIONS:

1. Full transparency in all contractual arrangements made on behalf of strata owners;
2. Commissions on strata insurance to be replaced by separate, transparent fee for service so the gross premium is not artificially inflated;
3. Abolition of stamp duty and fire service levies on insurance, where relevant;
4. Supply of reliable, national flood mapping data so insurers can develop effective flood insurance products, potentially increasing affordability and availability;
5. Implementation of effective, risk-based land management and planning arrangements and other disaster mitigation activities;
6. Introduction of annual Productivity Commission reporting on the effectiveness of State and Federal disaster relief payments;
7. Education of strata committees and owners delivered by an independent consumer organisation such as OCN or Choice, funded by government;
8. Prescribed minimal core cover for strata insurance products in a standard “no frills” policy offered directly to the public;
9. A one page Key Facts Statement, with prescribed content, to accompany a simple Product Disclosure Statement (PDS) to summarise events covered in the policy, to assist comparison;
10. Policies to be written in Plain English;
11. The Government terrorism scheme to include residential and mixed use strata;
12. Sensibly priced local product offerings for building rectification/replacement as a result of major works;
13. Prescribe regular building valuations;
14. Consideration be given to realigning the coverage of strata building insurance to the boundary between common property and individual lots, and adjusting contents insurance for strata lots to include everything including fittings within the lot boundary.

Appendix A - Case Studies

Case Study 1 – Small OC (Cost, Consumer Awareness)
A complex of five single storey villas in a NSW suburb with insurance arranged by the strata manager. The owners are provided with only one single quote (uninformed owners accept the lack of investigation and comparative quotes). The owners deal only with the strata manager, who is not qualified to advise on the most appropriate cover ie give Personal Advice, will not spend more than 15 minutes on a claim without charging a fee, and has no incentive to reduce premiums via eg an increased excess due to the commission structure.

Insurance premium of $2,827.00 (representing <u>29.13%</u> of the annual budget) comprised:

Base Premium (incl. commission allowance)	*1,541.69*
UW Levy (underwriter levy – why?)	*40.00*
Fire Levy (23% on base $1,191.69)	*274.09*
GST (a tax upon a tax)	*240.66*
Stamp Duty (a tax upon a tax)	*179.76*
Broker Fee (possibly on top of a commission – not disclosed)	*550.00*
Total (who gets the $3.40 rounding up to $2827.00 premium??)	***$2,826.60***

Excess is $100. The OC has made one claim - broken glass $220 – in ten years, which has not been taken into account by quoting insurers. The OC has not been advised to consider increasing the excess in order to reduce the premium.

The level of cover is not specifically questioned. But, alarmingly, the smaller the OC the greater the likelihood of significant/total loss, for example as the result of a fire. OCs of 2 – 5 lots, which in NSW alone at January 2016 comprised 53.01% of total strata lots (2-10 lots made up 75.60%), have perhaps the greatest need to ensure they have accurate sums insured.

Case Study 2 – Large OC (Cost, Consumer Awareness)

New build, first year cover arranged by strata manager in 2005:
Premium *$93,000*
Insured Value $110m / Office Bearers $1m / Public Liability $20m / no plant & machinery cover

2011 cover arranged by Broker, at request of and in conjunction with well-informed OC:
*Premium** *$100,000*
Insured Value $172m / Office Bearers $20m / Public Liability $100m / Plant & Machinery $500,000
** Includes Stamp Duty $7,021.55 and FSL $11,651.10*

Case Study 3 – Large OC (> 250 apartments) *(Cost, Consumer Awareness)*

(effect of "rolled in" commissions and conflict of interest with strata manager taking commissions from broker)

The OC had been accepting the broker's recommendation, passed on by the strata manager, for many years, without particularly turning its mind to the detail of the various fees and commissions blended into the annual premium.

However, when the annual premium jumped from about $90K to $230K over two years, that jolted the OC into action. The next year the OC requested that the broker provide his quotes two months before renewal with the intention of then obtaining quotes from another broker to see if a better price could be obtained.

However, the broker they had been using refused to provide his quotes two months out and was quite up front about his reason: he said he didn't want to do a "whole lot of work" in obtaining quotes from different underwriters only to have us go elsewhere to get a better price. He said he would only provide his quotes at the committee meeting scheduled for two weeks prior to the renewal being due. The strata manager, who was getting a 20% commission on the premium, also appeared to have no interest in pushing the broker to give the OC the quotes any sooner.

The OC then went out directly to a broker who was completely independent of the strata manager to obtain its own quote, without telling the strata manager what it was doing.

At the committee meeting two weeks prior to renewal, the strata manager and broker made a big show of having done the OC a "huge favour" and having got the premium down from $230K the previous year to $195K for the renewal. The OC then surprised both the strata manager and broker by pulling out its own quote for $125K from the independent broker they had spoken to. Naturally, the EC decided to go with the $70K saving, much to the annoyance of the strata manager and the strata manager's preferred broker as both of them had to forgo that amount of commission.

*The broker the OC selected makes a point of charging a **fixed fee** for the work involved as he acknowledges that there is the same amount of work involved in obtaining quotes for a particular property, regardless of what the premium ultimately turns out to be. Moreover, that broker also acknowledges that it creates a **conflict of interest** for the broker if he can increase the amount of his fee by deliberately not getting the cheapest price for his client, the OC.*

Since that episode, the OC in question has changed it strata manager and made it clear to the new strata manager that it would need to factor into its strata management fees the amount of any insurance commission it would otherwise have hoped to have received as the OC would forbid the strata manager accepting any commission in relation to insurance as a condition of the strata management contract. This arrangement has now worked well for the last few years with proper transparency on the amount of remuneration the strata manager and the broker are receiving for their work done in arranging insurance each year.

Case Study 4 - Major Building Works

A medium sized OC needed to carry out building works valued at $2.8million. The OC insurer suspended the replacement component of the OC insurance cover for the term of the work (without refunding the lost cover pro rata). The building was valued at $14.2m for the purposes of rectification/replacement. The builder sought quotes locally and internationally to extend their Builder's All Risk policy, so that the building would be covered. This took considerable time and the quotes ranged from $85,000 to $280,000 (10% of the cost of the works), with a requirement for a litigation compliant Dilapidation Report which cost a further $12,500. What should *happen is the insurer analyses and costs the additional risk associated with the works and provides appropriate additional cover at a reasonable cost.*