CGU Insurance Limited

Submission to Inquiry into Residential Strata Title Insurance

20 January 2012

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CGU Insurance Limited – Submission to Inquiry into residential strata title insurance

Introduction

This submission to the Committee's Inquiry into Residential Strata Title Insurance has been prepared by CGU Insurance Limited (**CGU**), one of Australia's leading general insurance companies, and part of Insurance Australia Group (**IAG**). CGU distributes its products through a network of more than 1,000 insurance brokers and authorised representatives, and we partner with more than 100 major financial institutions.

CGU is the largest provider of insurance to Australia's regional and rural communities, one of the nation's largest providers of workers' compensation services, a leading commercial insurer, and is a leading provider of strata title insurance through its subsidiary Strata Unit Underwriters (**SUU**).

CGU's interest in the Inquiry

SUU distributes insurance products underwritten by CGU, and is one of Australia's leading providers of residential strata title insurance. Through participation in this Inquiry, CGU hopes to assist the Committee in developing a better understanding of the operation of residential strata title insurance in Australia as well as inform the Committee of the unique challenges facing the providers of residential strata title insurance in Northern Australia.

This submission is concerned primarily with Terms of Reference items (a) and (b). In relation to Terms of Reference (d) – consumer awareness – CGU is an intermediated insurer with our products predominantly distributed through insurance brokers and financial advisers. This distribution model allows the consumer to gain advice on what level and type of cover is available to best meet their needs.

This submission also seeks to explain why residential strata title premiums have needed to rise so significantly over the past few years. As discussed in this submission, these increases are essential to the sustainability of CGU's participation in the Northern Australian region.

Executive Summary

The price of residential strata insurance products distributed by SUU in Northern Australia has increased, in some cases significantly, over the past few years. These premium increases have not been limited to the Northern Australian region, and have been necessary to ensure that the pricing of this product is sustainable and more accurately reflects the cost of providing the product.

Much of this submission focuses on the key rationale for the current premium pricing and explaining the unique factors and circumstances which apply to residential strata insurance. CGU wants to continue to play a significant role in these communities, however without such premium increases CGU would be forced to critically reassess its participation in this region.

The increase in premium prices for residential strata title properties has given rise to a myth that these properties have been disproportionately impacted when compared to homes and other forms of dwellings. The reality is that the premium increases were overdue and have, broadly speaking, resulted in residential strata insurance premiums now being more closely aligned with (arguably on par with) premiums for single dwellings of similar value. While the increases in premiums charged to some residential strata properties in the region are notable, the overall affordability of these premiums is not, especially when compared to single dwellings.

CGU considers that the entry of more residential strata insurers into the Northern Australia would be welcome, and that this would aid in diversifying the current concentration of insured risks among a number of insurers associated with the region. This concentration of risk currently presents a challenge for CGU with an increasing exposure of policies in high natural peril zones.

The increase in CGU's residential strata insurance premiums in recent years has been necessary to ensure that premiums more accurately recognise the cost of providing cover. This factor would not change as a result of the introduction of more insurers into the region. To examine this aspect further, this submission identifies the nature of claims costs that are particularly experienced with residential strata insurance, and the impost of reinsurance costs attributable to these risks.

Background to residential strata insurance

Residential strata insurance is a unique offering, in that it is legislated cover for Bodies Corporate in every State and Territory. It is also unique in the breadth of cover it provides.

A typical residential strata insurance policy will provide cover for expected risks such as fire and storm damage to buildings and common contents, but it will also provide cover for liability claims against the strata's body corporate and personal accident on the strata premises and other forms of insurance protection for the body corporate. While much media and community commentary has been focussed on claims arising from cyclones and storms, it should be recognised that residential strata insurance provides cover that is much broader than just protecting the material damage risk of building and common contents.

Strata insurance market

Throughout Australia, each strata scheme is registered with the applicable State or Territory Government agency. Figure (a) provides a general overview of the number of registered strata schemes (these figures include both residential and commercial strata schemes as there is no breakdown between residential and commercial available).

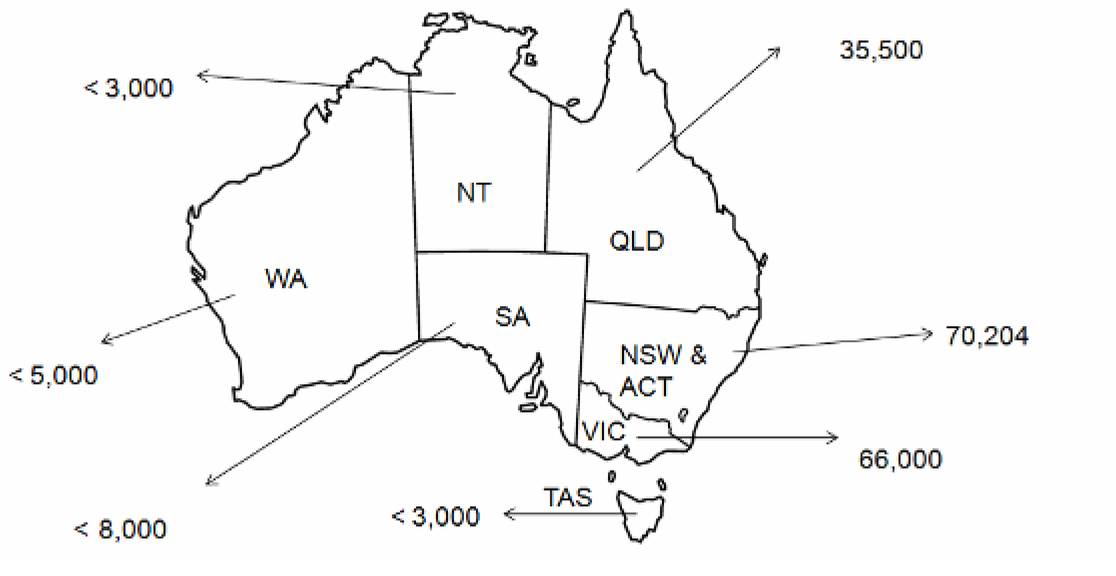
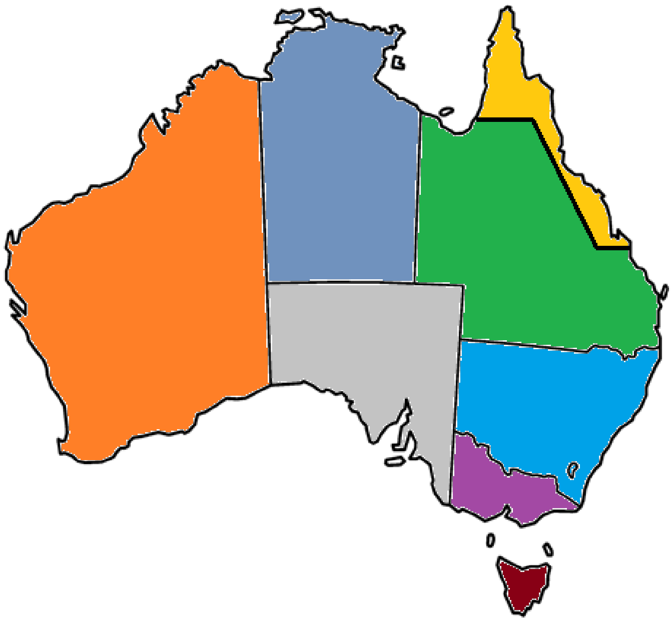


Figure (a) Registered strata schemes by state and territory. Source: Strata Community Australia

SUU's customer base is spread predominantly along Australia's east coast. This is due to the high saturation of residential strata title properties within these regions. Looking at Figure (b) it is clear that while a significant share of SUU's customers are located within the Queensland and Far North Queensland region, it is not the sole region where we underwrite business.

SUU estimates that it accounts for approximately 21% of gross written premium of the total residential strata insurance market in Australia. The geographical spread of SUU's policies is depicted in Figure (b) – these percentages are based on written policies, not written premium.



State/Region	% of written policies
NSW	43%
QLD – Sth East & Inland	20%
QLD - FNQ	3.25%
VIC	22%
WA	4%
NT	0.1%
SA	5%
TAS	2.7%

Figure (b) Spread of SUU policies in force at 30 June 2011. Source: Strata Unit Underwriters

Strata insurance in Northern Australia

The distribution of residential strata insurance in Northern Australia, particularly in Far North Queensland, became increasingly competitive a number of years ago in response to the rapid urban development in this region. The growth in the number, size and density of strata developments was, for a period, accompanied by an increase in the residential strata insurance "capacity" for this region[1].

This high level of competition, particularly when compared to the distribution of strata insurance in southern Australia, led in some sub-regions of Northern Australia to premium pricing at unsustainable levels.

However, the increasing frequency and severity of severe weather events, including cyclones, highlighted to CGU a number of years ago the unsustainable nature of such pricing and the urgent need for reassessment of how premiums were set (what insurers call "portfolio remediation").

CGU's initial attempts at remediation, introducing modest premium increases prior to tropical cyclone Yasi, did not keep pace with the inflationary trends in claims costs and, in particular, the costs borne by primary insurers such as CGU for reinsurance cover that is a fundamental

[1] The term "capacity" is used by insurers to describe the willingness of insurers and reinsurers to underwrite particular types of risks

requirement of being able to offer insurance protection in this area. These issues were further exacerbated by tropical cyclone Yasi.

While reinsurance costs had remained relatively stable for a number of years, the last two years have seen a significant increase in reinsurance costs, driven mainly by reinsurers' adverse reassessments of the natural peril risk profile for the Asia Pacific region (including Australia and in particular, FNQ). This has resulted in both reduced reinsurance capital being available to primary insurers as well as significant increases to reinsurance rates being offered where capacity is available.

CGU supports competition for the distribution of residential strata insurance within Northern Australia. While CGU does not believe that this will necessarily lead to lower premiums, it will dilute the current concentration of catastrophe exposure in Northern Australia which currently resides with a limited number of insurers. CGU would welcome other insurers into, or to return to, the region to address the risk inherent in this concentration of catastrophe exposure.

The challenges faced by insurers with high concentrations of risk are explained in more detail on page 8 of this submission.

Distinct features of residential strata insurance

Residential strata insurance has distinct features that have conspired to magnify recent premium increases. These include:

- The total value of a residential strata building is higher than a home, so the scale of losses is potentially higher.
- Concentration of risk – as opposed to insuring 100 homes dispersed over a large area, a residential strata building may represent 100 homes on a smaller square footage. If a storm hits that particular area it could lead to a higher number of insurance claims in terms of value and severity of damage, than if the risk was spread across a broader geographical area.
- Clustering – residential strata buildings are often clustered together in particular areas of a town, which further exacerbates the concentration risk. See below Figure (d) and (e)
- Location – residential strata buildings in Northern Australia are often along or near the coastline and built for their sea views or holiday letting potential. This puts them at higher risk of cyclone and storm damage than other properties located inland.
- Repairs – costs are influenced by availability to materials and labour. Major catastrophes can result in a sharp rise in costs due to high demand. The engineering involved in large residential strata complexes can require specialist attention unlike that of traditional homes. This draws upon specialist skills that may not be readily available within the local region further exacerbating the cost to repair. Equally, in many cases the high value plant and equipment used for the provision of services (water, electricity, air-conditioning, etc) in residential strata complexes is centrally located in flood prone areas, such as basements, significantly adding to the cost of repairs incurred in even minor events.
- Increases in peripheral costs – residential strata policies provide temporary accommodation costs to tenants in the event the premises is temporarily uninhabitable. This cost is magnified with multi-tenanted risks, such as a 50 dwelling apartment building.

How CGU prices residential strata insurance

CGU is heavily reliant on the use of actuarial techniques for the pricing of insurance products including strata insurance, employing a team of actuarial professionals for this purpose. One of the core roles of the CGU Actuarial Pricing Team is to utilise historical claims experience data (from both internal and credible external sources where available) and apply robust statistical techniques to arrive at an appropriate level of "risk based" premium rates which take into account the specific risk characteristics of each policy.

The aim of the statistical pricing approach is to ensure that the overall level of premiums charged for the portfolio of insurance policies is set an appropriate level to cover the expected cost of all insurance claims and operating costs for the business (including allowance for a fair return on shareholders' funds) with the added objective of charging premium rates to individual policies that are reasonably equitable based on the risk profile of each policy. In practice, this involves segmenting policies into groups that exhibit relatively similar risk characteristics and determining premium levels that appropriately reflect the relative risk profile of each group.

The statistical premium rates comprise a number of specific components including the following:

- Risk Premium: The average (or "expected") cost of insurance claims made on the policy during the coverage period using the statistical segmentation methodology discussed above.

- Reinsurance costs: In order to ensure the ongoing solvency and capital strength of CGU in accordance with regulatory and prudent business management requirements, CGU (as do other primary insurers) relies heavily on the use of reinsurance companies to spread and diversify the insurance risks that are underwritten. The cost of reinsurance (i.e. the premiums that reinsurers charge CGU for taking on a share of the written policy risks) represents a significant component of the premium rates charged to the end customer, particularly for strata insurance that typically requires substantial reinsurance support to fund natural peril exposures.

- Expenses: Allowance for a share of the operating costs of the business including claims handling costs, policy administration and day-to-day running costs of the business e.g. claims and policy administration systems, office rent, technology and staff salary costs etc.

- Distribution Costs: In relation to an intermediated insurer such as CGU, this is primarily the cost of commissions paid to intermediaries in sourcing the insurance business. A direct insurance model would incur different distribution costs, such as the cost of call centre operations.

- Government Levies and Taxes: This includes GST, Stamp Duty and Fire Services Levy (FSL is only applicable to cover provided in New South Wales and Victoria).

- Profit Margin: As an insurance business, CGU aims to achieve a profit margin on its insurance business in order to provide a fair return on the capital provided by shareholders supporting the business.

The key components of premium cost that impact on strata dwellings, particularly in relation to the variability in cost by geographic location of each strata dwelling, are the risk premium and reinsurance costs. Both of these components are closely related.

The Risk Premium represents the average or "expected" cost of claims on a policy during the policy coverage period. The Risk Premium can be broken down into the following components:

Working Losses: These are the more typical types of claims that occur on a policy and are generally the lower average cost and higher frequency type claims. Examples on strata policies would include smaller scale water damage from leakages or small storms, broken windows, personal accident claims on maintenance workers etc.

In practice, a number of "risk rating factors" are adopted in actuarial techniques to determine an equitable allocation of working losses in the premium to be charged to different strata dwellings. Key rating factors include construction type, age of building, geographic location and prior claims history.

Large Claims: These are less common types of claims with a much higher average claims cost and much lower frequency than working losses. Examples include large scale fire and liability claims.

Large claims tend to be of a more "random" nature than working losses and a key element of actuarial pricing is to ensure as much as possible, that an equitable spread of allowance for large claims are included across all insurance policies.

Natural Peril Events: When Natural Peril events occur (e.g. cyclones, hail storms, earthquake, bushfire), they may have a significant impact on an individual strata property but typically also on multiple strata properties in the area of impact of the event. Given this potential to impact multiple insurance policies at the same time, an appropriate loading must be included in premiums in order to adequately spread a share of these event costs across policy holders.

The Natural Perils component of an insurance premium covers the expected cost of claims arising from events such as cyclones, hailstorms, earthquakes and bushfires.

Given the typically low frequency of natural peril events, simulation models, i.e. models which simulate the occurrence of natural perils and the estimated costs arising from such events, are used to develop a view on the average cost of covering natural perils.

The cost of natural perils and the insurer's reinsurance costs (natural peril reinsurance costs represent by far the main component of reinsurance costs applicable to strata dwellings) are then allocated based on policy characteristics that would influence the cost of natural peril claims. The key rating factors in this allocation include geographical area (e.g. potential exposure to cyclones), building construction type and age of building.

As with other property-related insurance products, exposure to storms and cyclones forms only a single component of the total assessment of risks that our residential strata customers are exposed to. A thorough insurance assessment needs to adequately price for all potential perils and types of losses.

That being said, a key area of focus for both primary insurers and reinsurers operating within Australia has been the exposure to catastrophic events, and in particular, the emerging evidence of the increasing frequency and severity of weather events associated with variations in climate.

Table 1 sets out an example of how premium is allocated to short-term and expected long-term losses, as well as costs for reinsurance, catastrophes and taxation:

Allocation of Premium charged to a Policyholder

Risk location: Mackay, Queensland
Building Sum Insured: $2.6 million
2011/12 Premium Charged: $19,523

Breakdown of Premium Allocation		% of Allocation
Premium allocated to Liability and Other Accident Risks		7%
Claims	Allowance for Working Losses	6%
	Allowance for Large Losses	1%
	Allowance for Natural Peril Losses	15%
Distribution Costs / Commission		17%
Reinsurance and Catastrophe Costs		28%
Policy and Claims Administration Expense		3%
Allowance for Profit		7%
GST, Stamp Duty and FSL*		16%
Total		**100%**

*FSL, or Fire Services Levy, is included on all strata premiums in New South Wales and Victoria. For the purposes of this premium breakdown the FSL inclusion is noted but does not factor into the allocation calculations for a Mackay policy.

Figure (c) below shows historical data from Munich RE identifying the volume of weather events occurring on the Oceania region. It is clear from this data that the frequency of such events is increasing. It is apparent from this graph that in 2010, there were more meteorological events (i.e. storms) than all events combined in 1980.

Number of Events in Oceania

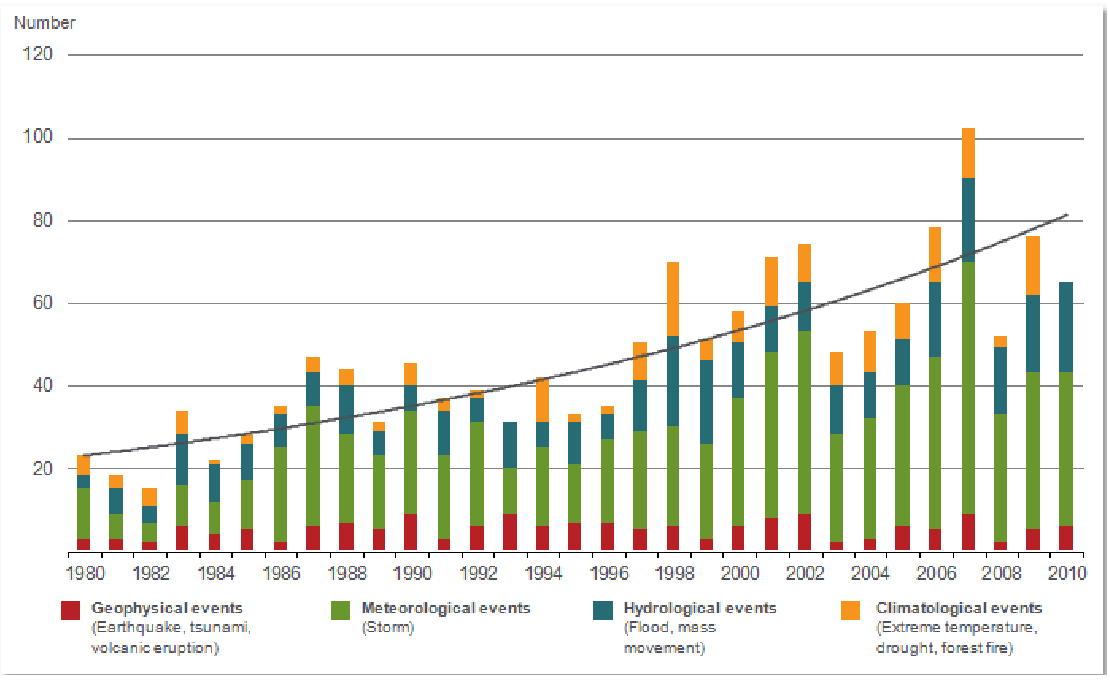


Figure (c) Recent major catastrophes and their effects. Source: Munich RE, *Quantifying the impacts of climate related natural disasters in Australia and New Zealand*

A sustainable insurance offering needs to collect enough premium to cover the costs associated with offering it. The increases to strata insurance premiums over recent years highlight the challenges faced by insurers in offering a sustainable product that is both accessible and affordable.

Potential for future price movements

It is difficult to predict the future costs of residential strata insurance in Northern Australia. As discussed elsewhere in this submission, the last 12-24 months has seen significant correction of pricing in the market based on costs experience to date and modelled exposures. CGU hopes that any future pricing changes will be more modest, but recognises the need for ongoing assessment of the factors that contribute to pricing, including any escalation in materials and labour for repair costs.

What is not in our control is the future weather or catastrophe size losses and the changes to reinsurance costs that may result from such events. It should also be recognised that the past decade has seen significant real estate development in parts of Northern Australia and the growth in assets exposed is likely to result in the need for insurers to purchase more reinsurance which also comes at a cost.

Strata versus home insurance

The increase in development within the FNQ region over the last 15 years has changed SUU's mix of customers and therefore its risk profile, including through the increased concentration of risk that a residential strata property holds when compared to an area of free-standing homes.

It is important to recognise that residential strata insurance policies and home insurance policies are not "apples and apples". Although it may be tempting to rely on premium comparisons to support a point, there are material differences in product features – the inherent building risks that are covered, recognition that many strata risks are designed and built to greater engineering standards, protection for the Body Corporate committee – that are obviously not required in a home policy.

Keeping this in mind, comparisons between strata risks and home risks can be useful to illustrate the particular risk exposures that arise with strata insurance.

The following satellite images illustrate an area of approximately 40,000sq metres at Airlie Beach, Queensland. The current site comprises three residential strata schemes (197 lots) with a total replacement value of $150 million and is currently insured via SUU/CGU. A similar sized site if utilised for free standing housing would comprise 50 lots of 800sq metres in size.

Assuming an average home replacement value of $700,000 this site would represent a total value of $35 million. As illustrated, the clustering and concentration of risk within this site creates a considerably higher exposure to an insurer.

An insurer that holds a higher concentration of risk faces the prospect of reaching their "cap" for any designated region. An insurer's cap is the ceiling at which they are unable to write any more cover without purchasing further reinsurance, often at a considerable cost due to the higher concentration of risk.

Figure (d): Airlie Beach, Queensland Source: Google

Figure (e): Airlie Beach, Queensland Source: Google

A further peculiarity with the above example is that if the area was occupied by free-standing homes, it would be highly unlikely that a single insurer would be underwriting every home, further diluting the concentration risk exposure.

Claims example – tropical cyclone Yasi

It should be noted that current building codes are designed to allow the safe exit of the building by any occupants, not the long-term structural protection of the building.

Through flying debris, high winds and water, significant damage can still be caused without reducing the structural integrity of the building.

On 3 February 2011, tropical cyclone Yasi crossed the Queensland coastline at Mission Beach, midway between Cardwell and Innisfail. The destruction was widespread with many claims from Cairns and Townsville as well as multiple claims from further inland.

Australian building standards are designed around occupant safety, allowing those inside time to egress before a building becomes untenable. Constructing a property to cyclone standard does not mean the property will survive untouched, as evidenced by the following example.

Property location:	Cardwell, Qld
Property type:	Residential strata complex of 4 units
Building age:	2008
Sum insured:	$1,365,000
Damage estimate:	$780,000

This property was closely located to the eye of tropical cyclone Yasi and structurally withstood the event (i.e. the roof and walls remained intact). However, the nature of a cyclone causes strong wind gusts that have a hammering effect on the building for a number of hours.

What follows is water ingress through door and window seals and other broken glass. The resulting water ingress causes significant swelling of skirting boards, internal walls, kitchen cabinetry, internal flooring etc. The total damage bill to rectify the “internal” damage to this property is currently estimated at $780,000.

A role for Government

CGU advocates that the Government could serve the community better by:

- Ongoing research into developing and enhancing building codes that improve the integrity of buildings to withstand structural damage from wind loads generated by cyclones.

- Requiring those buildings built prior to the existing building code be refurbished and upgraded to better align to the current code. Following tropical cyclone Yasi, James Cook University undertook building inspections and identified older buildings, where not maintained, had suffered rot and rust onset by atmospheric conditions. Requiring older buildings to meet key aspects of current building codes would not only improve the ability of a building to withstand extreme weather conditions but insurers would look upon these risks more favourably when being asked to insure them than the case at present.

- Whilst buildings are now built to the current building code, there was some evidence following tropical cyclone Yasi of poor quality workmanship in initial construction and in repairs carried out. Improved building certification practices may ensure completed work does in fact meet building standards.

The structural integrity of a building and its ability to withstand damage from weather perils is a key factor considered by insurers when approached for cover. Claims costs are a significant component to the cost of insurance. Ultimately if claims costs can be minimised through improved resistance to extreme weather then the impact on premiums can also be minimised.

Consumer awareness

CGU, as an intermediated insurer, distributes the majority of our products through insurance intermediaries such as brokers and financial advisers. We believe this method of distribution affords the consumer the opportunity to discuss their own personal requirements and to gain professional advice as to the most suitable cover available for their needs.

There are strict licencing requirements for insurance brokers and financial advisers to ensure they consider the customer's needs and offer solutions appropriate to their circumstances.

Conclusion

CGU is Australia's largest regional and rural insurer, and as such its desire has always been to remain in the strata title market in Northern Australia. This will only occur if CGU can operate a sustainable business through recovering the costs associated with offering the strata title product through appropriate premium levels.

Despite the withdrawal of insurers, strata title insurance continues to be available across Northern Australia, and more broadly across Australia. CGU acknowledges that premiums for certain properties in certain areas have risen significantly. This is due to the fact that for many years the strata title product in Northern Australia (FNQ in particular) has been priced at a level well below the cost of offering it. It is also due to a much better understanding of the true claims costs and as a result of a more granular approach to pricing risks that better reflect the true costs associated with making a sustainable offering.

This process identified increasing claims costs, which were compounded by the rising costs of reinsurance. Extreme weather events, both in Australia and the broader Asia Pacific region, have impacted the global reinsurance market and led to an increase in the region's risk profile.

Given that strata title insurance is still available in Northern Australia, CGU does not believe that there is a case for Government intervention into the insurance industry. CGU believes there is a need for greater emphasis by government on community adaptation to these events, including stronger building codes to protect structures from extreme weather hazards - tropical cyclones, severe storms, hailstorms, bushfires and flood; more risk-appropriate use of land and greater emphasis on hazard mitigation infrastructure.

In considering the impact - or likely impact - of any government intervention in the provision of Strata title insurance in Australia, the views of Ken Henry, former Secretary of the Australian Treasury are of note:

"…the fact that your industry won't insure certain things does not, in most cases, provide an argument for the government stepping in to do so. Yet it is the failure to appreciate this simple point that underlies most calls on the government to subsidise various forms of activity. For that reason, most such calls will be resisted. (Ken Henry, Address to the Insurance Council of Australia Conference, 22 August 2002).

CGU appreciates that the Federal Government is mindful of a general policy, adopted by successive Australian Governments in recent times, to the effect that where commercial markets, including insurance markets, operate efficiently and effectively on their own, the government should be reluctant to intervene.

CGU notes the Geneva Association's *Climate Risk and Insurance Project - Tackling Climate Risk: An Insurance Contribution to the COP Discussions* (December 2011) view:

"In order to maximise the industry's contribution to climate change mitigation and adaptation, policymakers should resist the temptation to distort market forces. Private incentives to mitigate and adapt to risk can and are being undermined by ill-designed public vehicles, e.g. public disaster relief schemes which remove individuals' incentives to manage risk or government sponsored or owned insurance initiatives that set premiums below the level at which a private sector insurer could run a viable business, as in some natural catastrophe prone parts of the U.S." (p.3)

CGU remains committed to the strata title insurance market in Northern Australia and would welcome other insurers into, or to return to, the market. While not a panacea for reducing premium prices perse, an increase in the number of insurers willing to service this market would help address the cost to customers of the risk inherent in the current concentration of catastrophe exposure to a very small number of market participants.