OWNERS CORPORATION NETWORK

16 January 2012

The Secretary
House Standing Committee on Social Policy and Legal Affairs
House of Representatives
PO Box 6021 Parliament House
Canberra ACT 2600

Inquiry into residential strata title insurance

Dear Dr Dacre

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.

The Owners Corporation Network of Australia Inc (OCN) is the peak body representing residential Strata Title and Community Title owners, primarily in NSW and in other parts of Australia. OCN members and directors are all owners of residential strata lots. OCN is therefore the key consumer voice in this Inquiry.

OCN's mission is to protect the rights of present and future strata owners. OCN:

- lobbies for necessary changes to Government policy and legislation and sits on various Government and industry boards and panels to advocate owners' views;
- educates Executive Committee members and individual owners through meetings, seminars, workshops, guides, and a discussion forum to share experiences and disseminate information.

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

1. inadequate regulation of suppliers and service providers to ensure effective market operation and fit-for-purpose products;
2. lack of competition;
3. lack of transparency;
4. lack of consumer education;
5. cascading government taxes;
6. lack of disaster mitigation activities;
7. inability to access Federal terrorism pool.

OCN welcomes this inquiry as the affordability of strata insurance covering Owners Corporation (also called strata corporations, corporations, bodies corporate, and company title, depending on the state or territory) as well as individual policies is of significant concern to the growing number of affected consumers.

Yours faithfully
Gerald Chia
Secretary, Owner Corporation Network
[redacted]

PO Box Q933, Queen Victoria Building, NSW 1230
ABN 60 3828 90103
E: secretary@ocn.org.au, www.ocn.org.au

OWNERS CORPORATION NETWORK

Inquiry into residential strata title insurance

Terms of Reference

That the House of Representatives Standing Committee on Social Policy and Legal Affairs inquire into and report on the affordability of residential strata title insurance, particularly in Northern Australia, and factors influencing this, including:

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;
b) The ability of insurers to **price risk** and the availability of accurate data to allow for this;
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;
d) Whether **consumer awareness** of different insurance options should be enhanced;
e) The extent to which the nature of **body corporate arrangements** are contributing to affordability difficulties;
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).

Within this submission, the following terms are used:

SM's means strata managers, or caretakers and other managers performing the duties normally provided by strata managers.
OC's means Owners Corporations (the term used in NSW) and Bodies Corporate (the term used in most other states). Company Title is assumed to be synonymous with Strata Title.

OCN's General Assessment of the Strata Title 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 title insurance in general.

The aim of strata title 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, executive committees, result in effective protection for strata plans at 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 strata plans will often simply renew their existing policy or act on the recommendation of the strata manager. Where the premium exceeds the amount where alternative quotes must be obtained, OC's are obliged to conduct a selection process to acquire cover for the next period of insurance. This process will involve the executive committee and the insurers who provide proposals, and often also insurance brokers and strata managers who assist the executive committee. Ideally, insurance brokers are seen as the experts in insurance who can answer detailed questions about the alternative product offerings and strata managers are seen as the experts in the management of strata plans who assist the executive committee in selecting from alternative insurance proposals by advising on relevant considerations and common practices in the acquisition insurance in strata plans and knowing what questions to ask in the selection process. In reality, many executive committees, comprised of volunteers drawn from all walks of life, simply do not have the interest, time, expertise or experience to fully master the strata title insurance product offerings and the differences between them. Executive Committees tend to rely on strata managers as independent management advisers without realising that they may receive commissions and therefore may not be truly independent. Although claiming to be independent, brokers may also be paid by insurers for performing a customer service function and are unlikely to express critical opinions.

In most cases the whole selection process is run on "autopilot" without sufficient transparency and critical analysis. Selection of insurers is often decided mainly on premium pricing without due consideration to the differences of coverage and the potential impact of such differences on the strata scheme. Although it may be assumed by the owners that the mere involvement of all these parties has delivered the best insurance protection for the scheme, such confidence may be misplaced. In the worst case, **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 recent Queensland experience.

To bring about improvement in this situation we suggest that the following would be helpful:

1. A clear statement of the purpose and desired objectives of strata insurance products and markets.
2. Descriptions of the perceived roles and responsibilities of the various parties involved in operation of this market (suppliers, executive committees, strata agents, insurance brokers), conducive to achieving the desired objectives. These descriptions should identify the value-add that service providers are expected to provide to justify the fees for their involvement.
3. As part of the above, ensuring that strata managers and brokers acting as professional advisers to OCs are truly independent in this role and are obliged to provide advice to owners corporations according to their best professional judgement. Their 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 and to make their alliance clear.
4. Making it illegal for strata managers to accept commission from suppliers. Strata managers are an administrative extension of the OC, usually carry delegated authorities of all office holders, and in some situations may be called upon to act in an executive role. For strata managers to assist in the selection of suppliers and to accept commissions is clearly a case of conflict of interest as it would be for a member of the executive committee.
5. Simplifying and standardising strata title insurance product offerings by prescribing minimal core standard coverage for all such products, in the forms of a standard "no frills" policy offered directly to owners corporations (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.
6. In conjunction with the above, the provision of a brief, preferably one A4 sheet Key Facts Statement, with prescribed content, to accompany a simplified Product Disclosure Statement (PDS). This KFS would summarise events covered in the policy, to assist in comparability, and clarify contentious cover such as 'flood'. An unambiguous 'flood' definition needs to be prescribed by government. And policies should be written in Plain English.

7. Improving consumer awareness through the education of executive committees and owners, highlighting the importance of strata title insurance in case of damage or disasters and their role in protecting the common property. This education should be delivered by an independent consumer organisation such as OCN (already doing this but not on a large enough scale) 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 (see Annexure A - Case Studies 1 and 2):

- Inclusion of commissions;
- Broker fees may also be grossed into the premium;
- Multiple taxes ie Stamp Duty, Fire Service Levy (in NSW), GST.

Brokers may receive a commission as well as a brokerage fee for arranging insurance cover. This commission is not transparent as brokers have no duty to disclose this information. The commission and often the brokerage fee are grossed into the premium which then attracts multiple taxes.

Strata managers, who commonly arrange insurance cover for OCs, also receive a commission (up to 20% and built into the premium) except in rare cases where they choose to rebate this. This commission is a clear conflict of interest, significantly impacting the choice of insurer and a disincentive to reduce the premium. See our comments on General Assessment comments above.

Cascading taxes 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 inequitable, inefficient, lack transparency and, in the case of the Fire Service Levy, are unsustainable.

OCN would like to see:

1. The removal of commissions grossed into the premium on strata insurance;
2. Full transparency in all contractual arrangements made on behalf of owners;
3. All fees for service charged and disclosed separately to the insurance premium;
4. Stamp duty (where applicable) and the Fire Service Levy (NSW) abolished;

b) Pricing risk and data availability

Major insurers appear to be strongly data driven. However they are currently unable to access accurate flooding data, which impacts on their ability to accurately risk price.

OCN would like to see:

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 described in our opening remarks, market failure also results from the lack of competition. There are currently only four core strata insurance providers: CHU/QBE, CGU/SUU, Alliance and CHUBB (premium market only). Zurich and Wesfarmers have a small share.

CHU has the dominant market share as a result of developing strong ties with strata managers. Other insurers, such as ACE and Affiliated FM (US based company) have withdrawn from the market due to insufficient premium base.

This lack of competition adversely impacts the cost of strata insurance via inefficiencies and inflated premiums. Without an incentive to price products more keenly, the cover offered tends to be 'one size fits all' resulting in inflated premiums as well as, in many cases, underinsurance in such areas as machinery breakdown, public liability, and office bearer's cover.

A glaring failure in the residential strata arena is coverage for terrorism. There are now many buildings in major Australian cities which have been converted from commercial to residential use. It is an anomaly that these residential (or predominantly residential) buildings do not qualify for participation in the government's terrorism coverage scheme. The building site, exposure and risks remain essentially the same as the former commercial building. Meaningful terrorism insurance is not available through local insurers following the withdrawal of Affiliated FM, a US based company, from the market. It can 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.

Yet 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 (without rebating the cost of the lost cover), and the local industry's refusal to offer one-off cover for the term of the 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.

OCN would like to see:

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.

d) Consumer awareness of insurance options

See our general comments on the operation of the strata insurance market, as well as Case Study 1.

A frequent area of confusion for owners and OC's arises from the fact that building insurance for strata plans 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.

This is not an acute problem but 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.

e) Owners Corporation arrangements

There is a direct correlation between risk minimisation and reductions in costs and increases in the extent of 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.

f) 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.

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

OCN would like to see:

1. Control of the payment of service providers in insurance matters as in (a);
2. Elimination of fire service levies, still current in NSW, and stamp duty where applicable. Insurance premium costs are calculated on all cost inputs, and so premium costs are inflated as in (a);
3. Development of a strong legislative framework to regulate risks associated with flooding (in NSW these are the subject of mere guidelines) as in (b).
4. The Government's terrorism scheme opened up to include participation by all residential strata and community title buildings, as covered in c);
5. Prescribed minimal core standard coverage for strata insurance, as well as a prescribed common definition of 'flood', as in (c);
6. Government funding to provide education for executive committee members, leading to legislative requirements for compulsory certification for executive committee members for buildings 100 units and larger.

RECOMMENDATIONS:

OCN strongly recommends the following:

1. Full transparency in all contractual arrangements made on behalf of owners;
2. Elimination of commissions on strata insurance; to be replaced with separate, transparent fee for service so that the gross premium is not artificially inflated;
3. Abolition of stamp duty and fire service levies on insurance (State responsibility);
4. Federal Government supply of reliable, national flood mapping data so insurers can develop effective flood insurance products, potentially increasing affordability and availability;
5. Federal Government 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 executive committees and owners delivered by an independent consumer organisation such as OCN or Choice, and funded by government;
8. Simplified and standardised strata title insurance product offerings by prescribing minimal core standard coverage for all such products in a standard "no frills" policy offered directly to the public;
9. A one sheet Key Facts Statement, with content prescribed by government, to accompany a simplified Product Disclosure Statement (PDS) and summarise events covered in the policy, to assist in comparability;
10. Policies to be written in Plain English;
11. A prescribed common definition of 'flood';
12. The Government's terrorism scheme to be opened up to include participation by the residential strata industry;
13. Sensibly priced local product offerings for building rectification/replacement as a result of major works;
14. A strong national legislative framework to regulate risks associated with flooding (in NSW these are the subject of mere guidelines);
15. Consideration should be given to realigning the coverage of strata building insurance to the boundary between common property and individual lots, and making complementary adjustments to contents insurance for strata lots to include fittings and everything else inside the lot boundary.

Other Recommendations:

This inquiry follows on from a number of inquiries into the provision of insurance and the insurance industry's response to disaster events. OCN endorses recommendations for improvements made to those inquiries as follows:

1. Insurance Council of Australia '10 Point Plan to Tackle Disasters' January 2011
2. Consumer Law Action Centre 'A Fair Go in Insurance', January 2011
3. National Insurance Brokers Association (NIBA) submission regarding disaster events, July 2011
4. NIBA submission regarding reforming flood insurance, May 2011

Appendix A - Case Studies

Case Study 1 – Small OC (Cost, Consumer Awareness, Owners Corporation Arrangements)

A complex of five single storey villas in a NSW suburb with insurance arranged by the Strata Manager. The owners are provided with a 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, will not spend more than 15 minutes on a claim without charging a fee, and has no incentive to reduce premiums due to the commission structure.

2011 insurance premium of $2,827.00 (representing 29.13% of the annual budget) comprises:

Base Premium (includes 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 guided to consider increasing the excess in order to reduce the premium.

The level of cover is not questioned. But, alarmingly, the smaller the OC, the greater the likelihood of significant/total loss, for example as the result of a fire. These OCs of 2 – 5 lots, which in NSW alone at September 2011 comprised 52.3% of the total strata lots, have the greatest need to ensure they have accurate sums insured.

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

First year cover arranged by Strata Manager, 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, OC Arrangements)* *(effect of "rolled in" commissions and conflict of interest with strata manager taking commissions from broker)*

The EC had been accepting the broker's recommendation passed on via 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 EC into action. The next year the EC 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 EC 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 EC the quotes any sooner.*

The EC 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 EC 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 EC 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 EC 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.*