

INDEPENDENT REVIEW OF STRATA INSURANCE PRACTICES

Phase 3: ENERGISING THE STRATA INSURANCE MARKET
A blueprint for affordability, availability, competition



May 2023

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Phase 3 - ENERGISING THE STRATA INSURANCE MARKET

Affordability and availability of strata insurance

Foreword

About this initiative

Strata insurance in Australia is a growing class of insurance business as a result of the rising popularity and development of multi-owner properties across the country.

As a result, strata insurance has become a very competitive business, especially among insurance brokers, underwriting agencies and strata managers. At the same time it has generated two vibrant debates in recent times –

- *strata managers commonly receive rebates of broker commissions and simultaneously brokers charge fees to owners' corporations: both of these practices are confusing and controversial*
- *affordability and availability of strata insurance are problematic for some segments of the strata insurance industry.*

Brief to independent adviser

The Steadfast Group is conscious of these debates and wishes to see each of them explored in some depth and to contribute to solutions to them. To that end, Steadfast has engaged John Trowbridge to undertake an independent review of these issues. He has agreed to examine them, in consultation with interested stakeholders, with a view to proposing ways forward that can be taken on board by participants in the industry.

This paper

This paper is the third and final step in a journey intended to carry the strata management and insurance industries through a review in three phases.

Phase 1 related to the disclosure practices of intermediaries and Phase 2 was about the remuneration of intermediaries. Phase 3 (this paper) is about, affordability, availability and competition in the strata insurance market. It also consolidates the main outcomes of Phases 1 and 2.

The views, findings and recommendations in the paper are those of the author and are independent of the Steadfast Group and its commercial interests.

Steadfast's interest

Steadfast Group's interest in this project is commercially relevant to the Group's interests in both specialist brokers and specialist underwriting agencies active in strata insurance but it goes beyond the Group's direct interests. Steadfast believes that the market is to some extent dysfunctional through its value chain from customer (lot owners) to strata managers to brokers to underwriting agencies to insurers. Most of the issues under question have arisen gradually through the historical evolution of the market.

Steadfast wishes to see these issues thoroughly investigated, in conjunction with experts in the Steadfast sphere of interest and other stakeholders including strata managers, owners of strata properties, brokers and underwriting agencies not in the Steadfast camp.

The overriding goal is to identify meaningful initiatives aimed at overcoming the structural issues that are of concern to both the Steadfast Group and many other participants in this market.

The author

John Trowbridge has a distinguished career as an actuary, consultant, executive, company director and regulator, working mainly in financial services with an emphasis on insurance-related businesses. He founded Trowbridge Consulting in the 1980s, becoming a leading actuarial and management consulting firm in Australia and Asia, specialising in insurance and merging with Deloitte in 2000.

He has held senior executive positions at QBE and Suncorp and, from 2006 to 2010, he was the APRA Member for insurance. He chaired the Australian Government's review of natural disaster insurance following the 2011 floods and in 2015 he chaired an industry working group to recommend reforms in the life insurance industry which came into effect in 2018. In 2021 he conducted an independent strategic review for the Insurance Council on the affordability and availability of commercial lines of insurance in Australia.

Robert Kelly AM
Founder, Managing Director & CEO
Steadfast Group Limited
May 2023

Acknowledgments, reliances and limitations

This project has been sponsored by Steadfast but its conduct, findings and proposals have been arrived at independently of Steadfast and its commercial interests.

Much of the investigative work undertaken for this project has involved reviewing submissions, holding interviews, dialogue and supply of information enabling me to draw together a reasonably comprehensive picture of the intermediary market and the underwriting market for strata insurance. There has been extensive dialogue with a range of brokers, strata managers, insurer and underwriting agency executives and strata owner representatives.. This range of input has facilitated understanding, analysis and assessment of the strata insurance market in the context of affordability, availability and competition.

Acknowledgments

Cooperation and assistance from underwriting agencies and insurers participating in the strata insurance market as well as a range of representatives of the strata management, broking and lot owner communities have been invaluable.

Steadfast's role has been crucial. The Group's sponsorship is fundamental to the scope, access to information and quality of this project. That is because I have been able to obtain confidential information from numerous sources connected with Steadfast and also others in the wider insurance industry and strata management industry. Much of this information could not have been made available in any way other than with Steadfast's active support and assistance. As a result, I have been able to utilise first-hand authoritative information while simultaneously respecting the commercial confidentiality of that information for the purposes of the project. The same applies to discussions with individuals from strata owners, strata managers, brokers, insurance executives and others.

Independence

While facilitating this level of access for me, Steadfast has also been fastidious in not just respecting but also supporting my independence throughout.

All conclusions, findings and recommendations are my own and are independent of the Steadfast Group.

Reliances and limitations

I have relied on much of the information made available to me by others during this project and my own assessment of that information. I have sought additional information and explanations in many situations, while also testing all information for accuracy and reliability where I could. I make no representation, however, as to the accuracy or completeness of the information. The paper does not provide financial product or other advice. It is subject to copyright and may not be reproduced without my prior written consent.

To the maximum extent permitted by law, I am not liable for any loss or damage incurred by any person as a result of use of or access to this paper or its contents, including any error in any information, opinion or recommendation contained herein.

EXECUTIVE SUMMARY

Project Introduction

This paper is the final output of Phase 3 of an independent review and investigation by the author into the functioning of the strata insurance market. It follows Phase 1 and Phase 2 papers released in July and December 2022 respectively. The three phases are –

- Phase 1: Disclosure practices of intermediaries
- Phase 2: Remuneration of intermediaries and possible reforms
- Phase 3: Affordability, availability and competition in strata insurance.

Brief overview of Phases 1 and 2

The goal of Phase 1 was to identify disclosure limitations and to recommend ways forward aimed at achieving transparent disclosure for strata property owners and their strata committees. It recommended a **transparent disclosure regime** for intermediaries (strata managers and brokers). The recommendations have been widely supported but are yet to be introduced.

Phase 2 identified three conflicts of interest and expressed my conclusions that one of these three, broker commissions, is a manageable conflict but that the other two need to be addressed. These two are where -

- (1) the strata manager agrees with the broker on a share of commission to be rebated to the strata manager and
- (2) the broker agrees with the strata manager on a broker fee that is additional to the commission.

Together they comprise the *commission rebate/broker fee system*. Following analysis of these conflicts, I came to the view that the *commission rebate/broker fee system* should be phased out in three stages via a **structural realignment** across this year and next. This view is not widely supported by strata managers or brokers as many of them wish to maintain existing practices despite the issues identified in my Phase 2 paper.

The findings and recommendations in both papers are explained in summary form at Topics 4 and 11 of this paper.

Phase 3: affordability, availability and competition in strata insurance

The subject of affordability and availability has come to prominence in the last 3 or 4 years across most classes of general insurance. It is an unsurprising consequence of the current 'hard' insurance market. This hard market has been exacerbated and extended by the unusually large number of recent adverse weather events globally and locally. These events in Australia were dominated of course by the bushfires in NSW and Victoria in 2019 and the numerous flooding events across the country since then.

The chart on the next page is illustrative of price increases in the strata insurance market over the last decade.

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Affordability and availability of strata insurance

Market premium rate trajectory

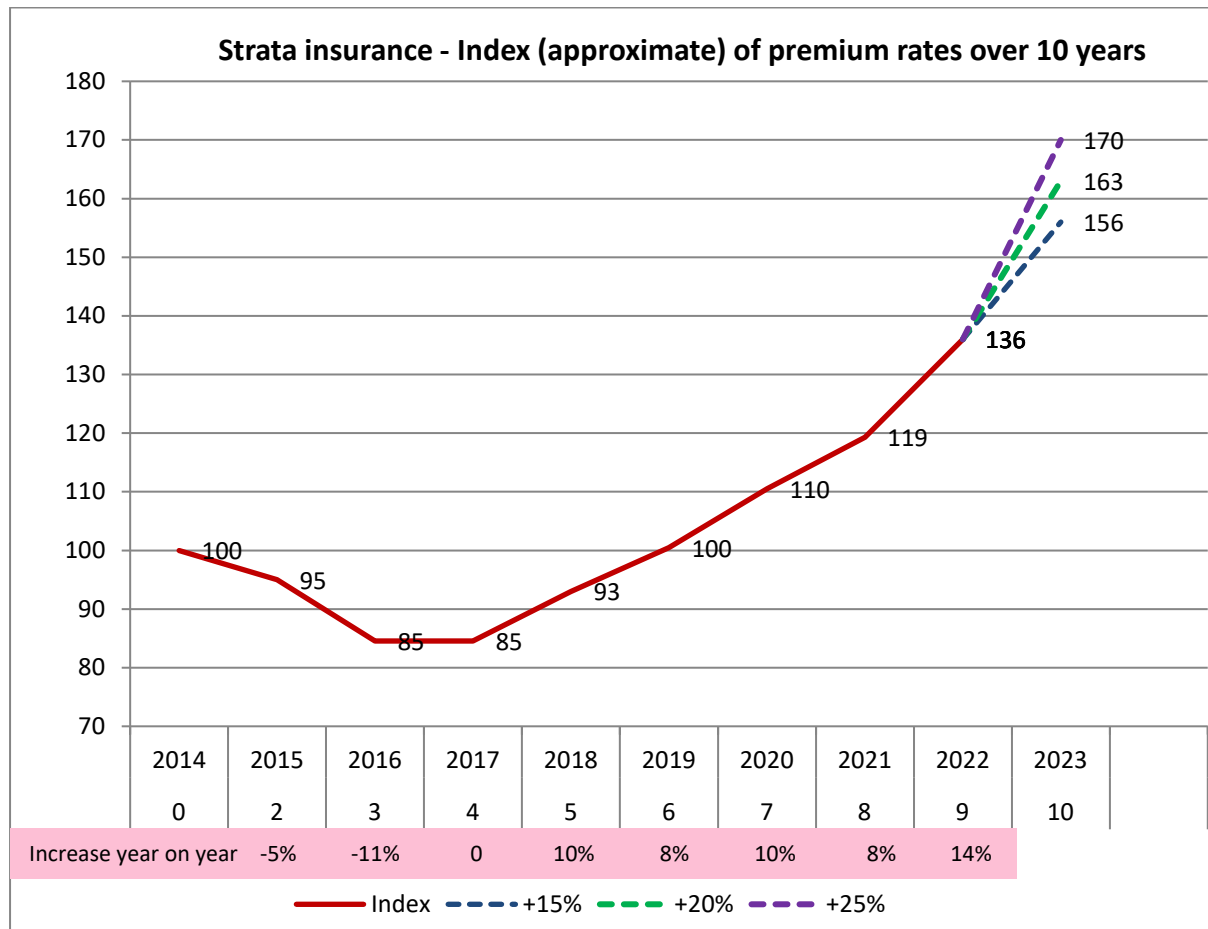


Chart relates to prices per unit sum insured for standard risks in low risk locations

Phase 3 – the process

Tackling the questions of affordability, availability and competition is not straightforward because there are numerous dimensions and many issues to consider.

The process I have chosen is to break down the questions into a number of topics, to consider each topic on its own, then to explore each topic in consultation with a range of interested and knowledgeable parties. This exploration has had three stages –

- (1) Consulting with individual representatives of each segment of the strata insurance purchasing chain on the range of topics I considered to be worthwhile to explore
 - these segments were lot owners, strata managers, brokers, underwriting agencies and insurers

- (2) Convening a forum of representatives of each segment, distributing to the forum participants in advance an agenda and a 40 page pre-reading document to cover the agenda topics. The participants were invited to express their comments and views on these topics at the Forum –

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Affordability and availability of strata insurance

- the Forum was held on 30 March 2023 and was attended by some 40 participants in person and another 20 on line
- there were 13 segment representatives who acted as panel presenters to assist the dialogue

(3) Preparing this paper in the form of a compendium of the topics, including a brief comment in each case on the feedback at the Forum, and preceded by this Executive Summary offering commentary on the agenda as a whole.

The Forum aimed to draw together for the benefit of all segments of the strata insurance purchasing chain a set of thought leaders in the field. Not only did it facilitate an exchange of ideas across the sector, which was a rare occasion, but it also has assisted me to refine proposals that I am now putting forward on several of the topics. In summary, these proposals comprise the outcomes of Phase 3 in the quest for a blueprint for responding to questions of affordability, availability and competition in today's strata insurance market.

Phase 3 – immediate priorities

It has become clear to me during this project that there are two important features of the strata insurance market that sit at the heart of consumer concerns and which should be and can be attended to without delay by industry initiatives. They are –

- **Topic 4: transparent disclosure** by strata managers and brokers and
- **Topic 5: insurance market capacity**, which is the province of insurers, their reinsurers and their underwriting agencies.

There is considerable interest in both topics across the industry and that interest was reinforced during the Forum. See further below.

Phase 3 – topics

The topics covered in this paper and which were considered at the Forum are –

Understanding and interpreting today's market

1. Four market segments –
 - a) The mainstream market – standard risks in low risk locations
 - b) The mainstream market – sub-standard risks in low risk locations
 - c) Southern Australia, adverse locations (flood, storm, hail, fire)
 - d) Northern Australia market, all locations
2. Underwriting consequences for sub-standard risks and adverse locations:
 - defects, repairs, maintenance, past claims, OC risk management, etc
3. Affordability: what does it mean, how is it measured?

The two priorities for 2023

4. **Transparent disclosure** (Phase 1) –
 - financial templates
 - broker and strata manager responsibilities in arranging insurance
5. **Market capacity**
 - fundamental to a competitive market

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Affordability and availability of strata insurance

The owner dimension

6. Owner responsibility for risk management, maintenance, remediation
 - owner education: everyone's dilemma? whose responsibility?

Upgrading market resources and customer support

7. Transactional efficiencies – quotes, platforms, claims etc.
8. Industry statistics

Affordability topics

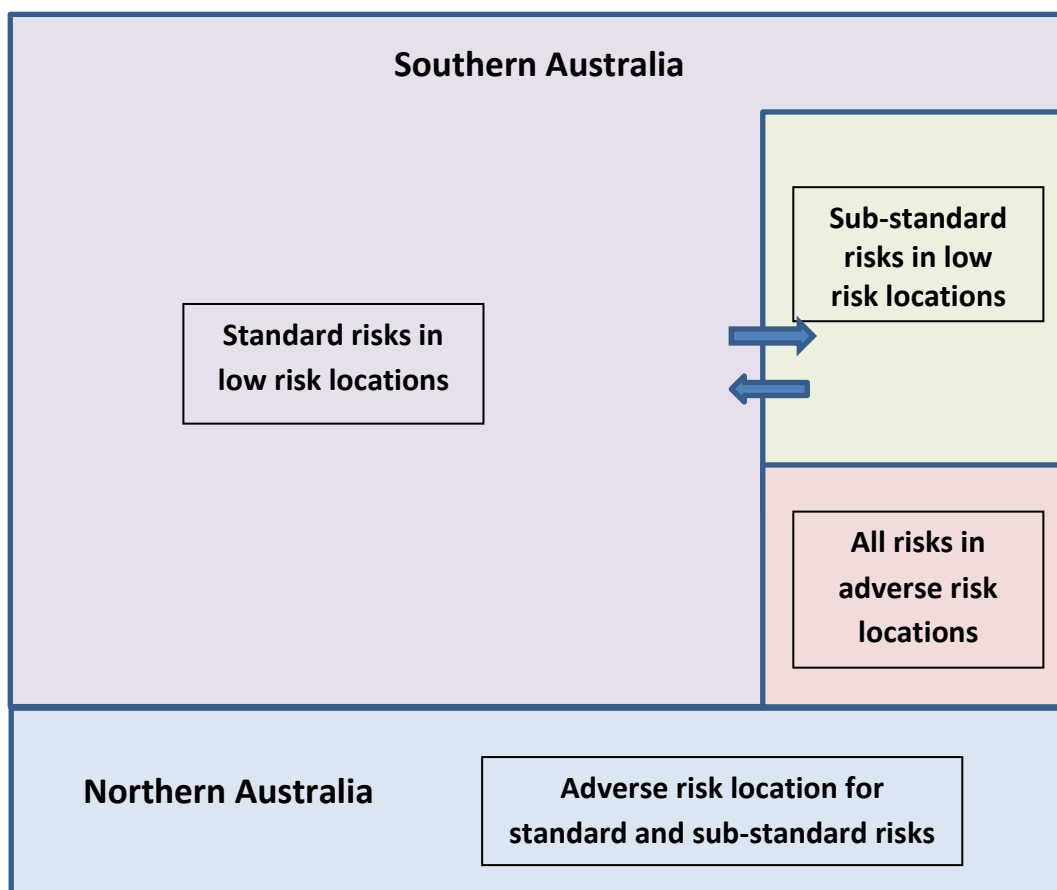
9. Economics of strata insurance - premium schematics, anatomy of insurer costs
10. Policy excesses
11. Intermediary charges (today's market practices + Phase 2)
12. Government charges
13. Replacement value cover: whose responsibility?

My assessment of each of these topics and some comments on them are summarised below.

Understanding and interpreting today's market

Topics 1, 2 and 3 are essentially information and scene setting –

- Topic 1 on **market segments** is a useful way of understanding the underwriting and pricing issues associated with strata insurance. It builds on the idea that there are standard strata insurance risks in low risk locations and then there are sub-standard risks in those locations and there are also adverse locations for some properties, namely northern Australia taken as a whole and some locations elsewhere that are prone to adverse weather events such as flooding and bushfires or to some other adverse underwriting feature.



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Affordability and availability of strata insurance

These segments are explained in Topic 1 which contains an extensive piece on north Queensland including reference to the Cyclone Reinsurance Pool.

- Topic 2 is an extension of Topic 1 because it outlines the consequences for lot owners of features of their properties and of the management of their owners' corporations that may be seen as adverse risk features from an insurance underwriting perspective.
- Topic 3 on **affordability** explains a technique for considering affordability in a quantitative way. It suggests a method of setting benchmarks based on relevant price comparisons and rejects the idea, often put forward, that socio-economic information can be used to assess insurance affordability in a property ownership context.

Looking ahead

With this background I have concentrated on actions that might be taken by various parties in the insurance purchasing chain that have the potential to alleviate some of the affordability and availability issues that have arisen in today's market. Some can be acted on quickly, others more slowly.

Note that all actions considered bar one are initiatives or actions that can be taken without formal regulatory intervention by governments. The exception is government charges that increase the costs of insurance and are outside the control of the insurance industry and its customers.

The two priority topics for 2023

Transparent disclosure was the theme of my Phase 1 paper released in July last year.

Since its release there has been widespread interest in and support for the recommended disclosure regime across the insurance purchasing chain. Further, that support is now active with the SCA in the process of preparing a professional practice standard for its members and also engaging with NIBA and some of its members for assistance in implementing the practice standard. It is a valuable initiative for the strata industry and will be enhanced by the 2022 Insurance Brokers Code of Practice which has introduced new disclosure measures for insurance brokers to address the issue of transparency.

... this is a 2023 initiative being led by the SCA

... it also promises to be the foundation for a more vibrant, professional and competitive strata insurance industry in the future.

The SCA's initiative on disclosure is to be welcomed and deserves the active support of all brokers and underwriters involved in strata insurance as well as all practising strata managers.

Market capacity is a clear priority but also a 'hard nut to crack'.

Underwriters have limited risk appetite in today's market and frequently take a defensive approach when offering capacity. At the same time, buyers (owners) often have little understanding of the issues that cause underwriters to limit their exposure, which they do by not quoting or by loading their prices and/or imposing restrictive conditions on their cover. As a result, there are strong appeals from many quarters for greater insurance market support.

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Affordability and availability of strata insurance

There has to be a better way than local insurers classifying a significant proportion of risks as sub-standard and, as result, not offering cover or offering it under onerous conditions of price or coverage (and also noting that different underwriters often have different criteria for deciding what is a sub-standard risk).

... the proportion classified as sub-standard is unknown but estimates range from 20% to 40% of properties in low risk locations.

With insurance being compulsory in every State and Territory, the capacity limitations pose a dilemma that the insurance industry needs to be encouraged to resolve if it possibly can, preferably without regulatory intervention.

Can the local insurance industry take steps to improve capacity and overcome or alleviate this market capacity problem?

Proposition: A variation on the Insurance Council's Business Advisory Council is a mechanism through which some solutions may be found. The idea is to arrange for an expert group in support of the interests of owners to engage with a representative group of insurer and underwriting agency executives in search of initiatives that might lift market capacity. The expert group would likely comprise a small number of broker, strata manager and owner representatives.

These two groups would investigate collaboratively the underwriting and other issues that limit market capacity with a view to enabling the insurance group to give advice or make recommendations to their principals that would form a basis for some expansion of local strata insurance underwriting capacity.

There is no short answer or assured favourable outcome of this process and there will be a need to protect the competitive integrity of all involved. Nevertheless there are several possible steps that could lead to increases in capacity which are worthwhile exploring and which would not be able to be explored without a collaborative process that embraces both the customer side and the insurance side.

Topic 6: Owners' responsibility for risk management

Many owners seem to believe that they are being unfairly treated when underwriters propose lifting prices or imposing terms and conditions on their insurance coverage that they think are unreasonable.

The other side of this proposition is that, as noted above, there are many instances where underwriters believe that OCs are failing to take responsibility for their insurance risk. The underwriting considerations mostly relate to (a) building condition, for example repairs and maintenance generally, along with remediation of defects, and (b) the effectiveness and performance of the strata committee in managing their insurance risks. There are many examples of poor governance and poor functioning of the strata committee or owners' corporation where funding, planning and decision making adversely affect building condition and hinder underwriting assessments.

Conclusion: owners should recognise that they have a collective responsibility for effective risk management of their properties and, if the OC is well governed, can optimise the costs and the effectiveness of their insurance arrangements.

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Affordability and availability of strata insurance

An important feature of this OC risk management challenge is the lack of knowledge and understanding by many lot owners of the implications of multi-owner building management and the basic workings and requirements of cooperative or collaborative owners' corporations. The need is already great and is expanding: the growth of apartment construction and apartment living across Australia brings an increasing proportion of first time apartment owners with no prior experience with apartment ownership. This experience gap is a widespread dilemma that flows through the system from owners to strata managers to brokers and underwriting agencies.

Conclusion: there is a need for some form of owner educational opportunities and incentives that extend beyond the basics of apartment ownership and responsibilities into the insurance and risk management domain.

... such educational resources and incentives could be made available by the private sector or the public sector and could be encouraged and facilitated by governments.

Valuable outcomes could be achieved from –

Upgrading market resources and customer support

- **Topic 7: Transactional efficiencies**

There is potential for streamlining across the industry of the underwriting, quoting and claims management processes.

The administration of strata insurance is less automated than for a number of other classes of insurance and is complicated to some extent by the existence in most cases of two intermediaries, the broker and strata manager.

Turnaround times on quotes can be slow, especially if there are underwriting questions to be explored. Underwriting agencies often find themselves with backlogs and bottlenecks, with brokers and strata managers being inconvenienced by the delays.

Most brokers and underwriting agencies recognise that there are efficiencies to be found, with efforts to find them backed in some cases by significant investment.

It remains to be seen how far and how fast the agencies and brokers proceed and whether those that invest well gain competitive advantage from doing so.

- **Topic 8: Industry statistics**

The introduction of two statistical data collections, one for portfolio management purposes and one for underwriting purposes, would be welcomed by many but the decision-making, planning and investment needed in each case would need interested sponsors.

It is possible that APRA will introduce some form of portfolio data collection in coming years.

Affordability topics

- **Topic 9: Economics of strata insurance** - premium schematics, anatomy of insurer costs

The two charts shown under Topic 9 are relevant to Topics 10 and 11 – see below.

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- Topic 10: **Policy excesses**

There is wide recognition that greater choice of voluntary excesses should be presented as a matter of course to owners' corporations.

The charts in Topic 9 illustrate, in their lower four bars, indicative levels of policy discount that can arise from policy excesses that are higher than standard.

Although the discounts available in individual cases for higher than standard excesses will not always appear to be a worthwhile trade-off for the extra exposure, **there are valuable affordability prospects for many strata schemes through greater use of policy excesses.**

- Topic 11: **Intermediary charges (today's market practices + Phase 2)**

This topic is controversial among the strata manager and broker communities because many are uncomfortable about change and fear that they may be adversely affected. On the other hand consumers and also some brokers and strata managers would welcome changes that signal an industry striving to strengthen its professionalism. The goal is to introduce changes that are better aligned to the scope, nature and quality of services being provided and that are more competitive. The remuneration should be transparent and structurally sustainable.

There are three facets to be considered, which are –

- the *commission rebate/broker fee system*, which I have recommended in my Phase 2 paper be phased out to eliminate its inherent conflicts of interest
- *charges that are above 'market'*: some brokers and strata managers are charging fees and commissions that are above market and unlikely to meet any reasonable test of fairness to the customer and customer best interests
- *benefits from rising premiums*: intermediaries whose remuneration is a percentage of premiums (which is the most common method) have received unexpected revenue gains arising from the large premium increases of the last three or four years, including the 2023 increases that are now being applied – some intermediaries have moderated their fees or commissions but, as far as I can tell, they are a minority.

The first relates to accountability of strata managers and brokers to their OC clients. It implies a structural realignment of remuneration but does not of itself imply any change in strata levies or remuneration levels (contrary to the claims of some strata managers).

The second and third relate directly to levels of remuneration which are fair to the customer and in their best interests. They are matters which, in a competitive market where disclosure is fully transparent and customers are well informed, should both be influenced by market forces. Evidently, however, we do not yet have transparent disclosure in most cases – see Topic 4.

In the absence of any regulation of intermediary charges, it becomes a matter for each OC and its strata committee to challenge or negotiate with their SM and broker for a structure and levels of remuneration with which they are satisfied.

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Affordability and availability of strata insurance

Implementation of the Phase 1 disclosure regime has the potential to bring about a more knowledgeable set of lot owners and strata committee members across the population of strata owners who are in a position to assess whether intermediary charges are fair and in their best interests.

- Topic 12: **Government charges**

Stamp duty in all States and Territories except the ACT and ESL in NSW have been widely criticised inside and outside governments for many years.

What can be done to persuade State governments and the Commonwealth to eliminate or, if that is unpalatable, to modify stamp duty, ESL in NSW and the Terrorism Levy to improve affordability and equity of these charges across the community?

Continued efforts are needed from all interest groups on State governments to reformulate or eliminate stamp duty and, in NSW, to replace ESL with a more equitable funding of emergency services. The Commonwealth through the ARPC should also be persuaded to modify the Terrorism levy as it applies to strata insurance.

- Topic 13: **Replacement value cover vs sum insured cover**

 - ... the sum insured conundrum*

Owners' corporations have a legal obligation to obtain replacement value cover for their properties but underwriters do not offer replacement value cover. Instead they pass the responsibility to the owners' corporation to provide an estimate of replacement value. They then offer sum insured cover only. They also charge premiums linked to sums insured and, as a result, their premium scales effectively give the owners a financial incentive to under-insure.

This system is flawed as to both pricing and adequacy of cover.

There has to be a better way. Orchestrating a solution is not easy, however, as it would require a change of mindset and change of practice within the insurance industry. Nevertheless insurers and underwriting agencies should be encouraged to work on finding an economic solution to offering replacement value cover and reworking their premium scales to fit.

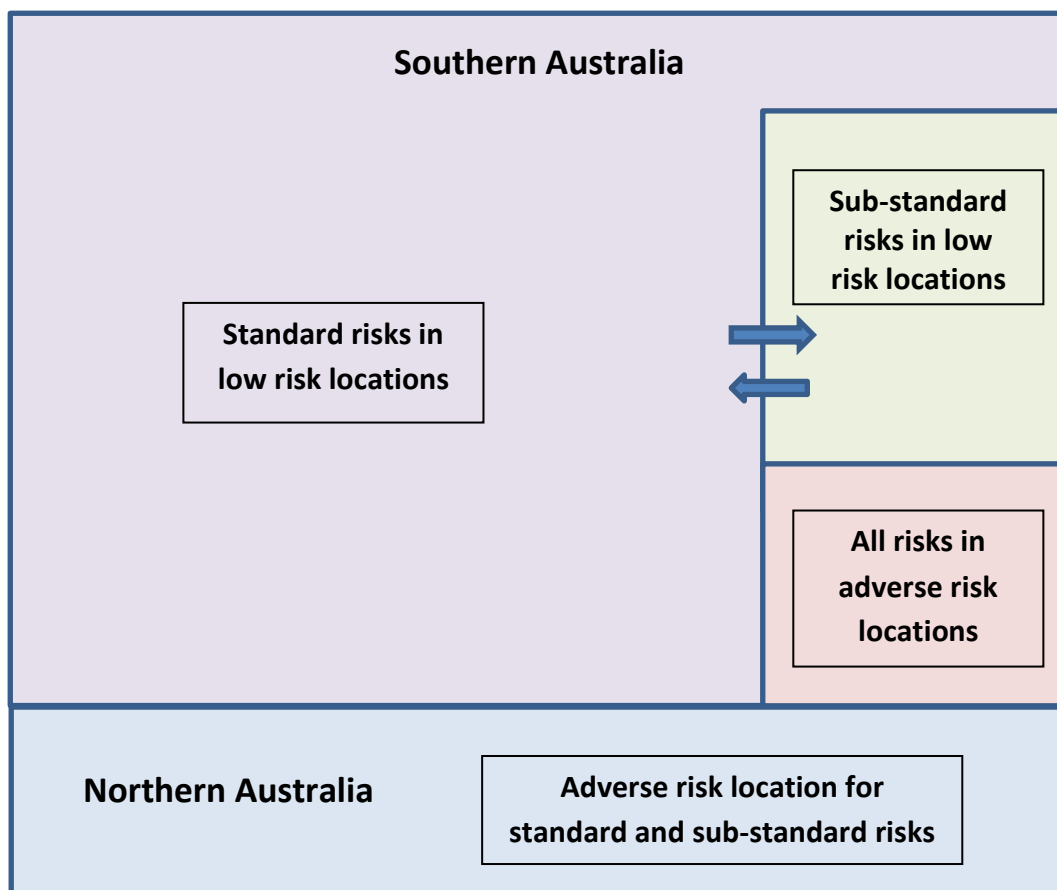
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Affordability and availability of strata insurance

Understanding and interpreting today's market

TOPIC 1: Four market segments

Regarding affordability and availability, we can define four main segments of the strata insurance market -

- (a) the **mainstream market** of average to good quality strata properties in low risk locations -
 - excludes northern Australia, flood and bushfire zones
 - i. ... referred to herein as **standard risks**
- (b) the **sub-standard market**: properties in low risk locations that are being treated by underwriters as below average to good quality
- (c) the **adverse location market**: properties located in a flood zone or bushfires zone but not in northern Australia.
- (d) the **northern Australia market**: properties located in north Queensland, NT and northern WA – treated overall as high risk locations



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Affordability and availability of strata insurance

More on standard risks, sub-standard risks and location risk

Q: What is an average to good or standard risk and what is a sub-standard risk?

A: Standard risks are generally where –

- age of the property is not a factor and its standard of maintenance is not under question
 - age can be a factor for older buildings (and some buildings also show their age – quality declines over time in a manner that depends among other things on type of construction and on quality and timeliness of maintenance
 - age can also be a factor for newer buildings, if underwriters have questions over the track record of the developer or builder or where construction quality is found not to be high
- the OC has a record of diligent attention to building maintenance and good housekeeping (including remediation when any defects are discovered or damage has occurred)
- past claims record is not a factor (no claims, small claims only or an unusually large claim where full rectification has been achieved and validated)
- no defects that have come to the attention of the OC or the strata manager or alternatively all known defects have been rectified -
 - assumes full disclosure historically (and new disclosure of a pre-existing defect can be problematic [see below])
- location of the property does not add risk, meaning that proximity to a flood zone, bushfires zone or a storm and cyclone zone may be problematic
- the building conforms to relevant building codes.

Q: What is a sub-standard risk?

A: Any property that is not standard but is in a low risk location.

- The questions that frequently arise from owners when a broker reports that one or more underwriters are treating a property as sub-standard is, firstly, whether the reasons for the treatment are based on accurate current information and, secondly, whether the treatment itself is reasonable from a risk perspective.
- Sub-standard risks are likely to attract one or more of a premium loading, a higher imposed excess¹, restricted policy conditions or, in some cases, declining to quote.

Q: What are high risk and low risk locations?

A: The categorisation relates essentially to natural disasters.

- Low risk locations are locations where natural catastrophes (generally weather events such as cyclone, windstorm, flooding and fire) are unlikely to occur such that insurers pay limited attention to them for underwriting purposes.
- High risk locations draw special attention from underwriters, not only because of their own risk assessments but also because of the high reinsurance prices they usually have to pay to protect their own capital positions.

¹ An imposed excess is a policy excess required by the underwriter
The alternative is a voluntary excess, being one selected by the owners.

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Affordability and availability of strata insurance

(a) The mainstream market

Prices have been rising substantially – see chart – and standard policy excesses have also been rising, from \$250 a few years ago to \$500, then to \$1,000 in 2021 and now \$1,500 to \$2,000 in 2023.

We are already observing in 2023 price rises commonly of 20% or thereabouts, although not evenly across the market.

Properties range in size from small (perhaps 2, 4 or 6 units) to medium to large to very large (several hundred units).

The market is reasonably competitive in most market segments and sub-segments. This is true despite the price increases being witnessed.

Market capacity is generally adequate for standard risks even though there is only a small number of active underwriters (insurers and their underwriting agencies) and there are capacity limitations in certain cases, mainly for sub-standard risks.

Underwriters need to balance their market share or growth aspirations with their risk exposures, noting that some risk reassessments have been made in the wake of the poor claims experience and increased claims costs of recent years, much of it attributable to weather events which have been showing greater severity or greater frequency than in many earlier years.

Underwriters regularly examine their portfolios to assess which of their insured properties they believe should be reclassified from standard to sub-standard (or vice versa). These assessments may be different from one underwriter to the next.

Market premium rate trajectory

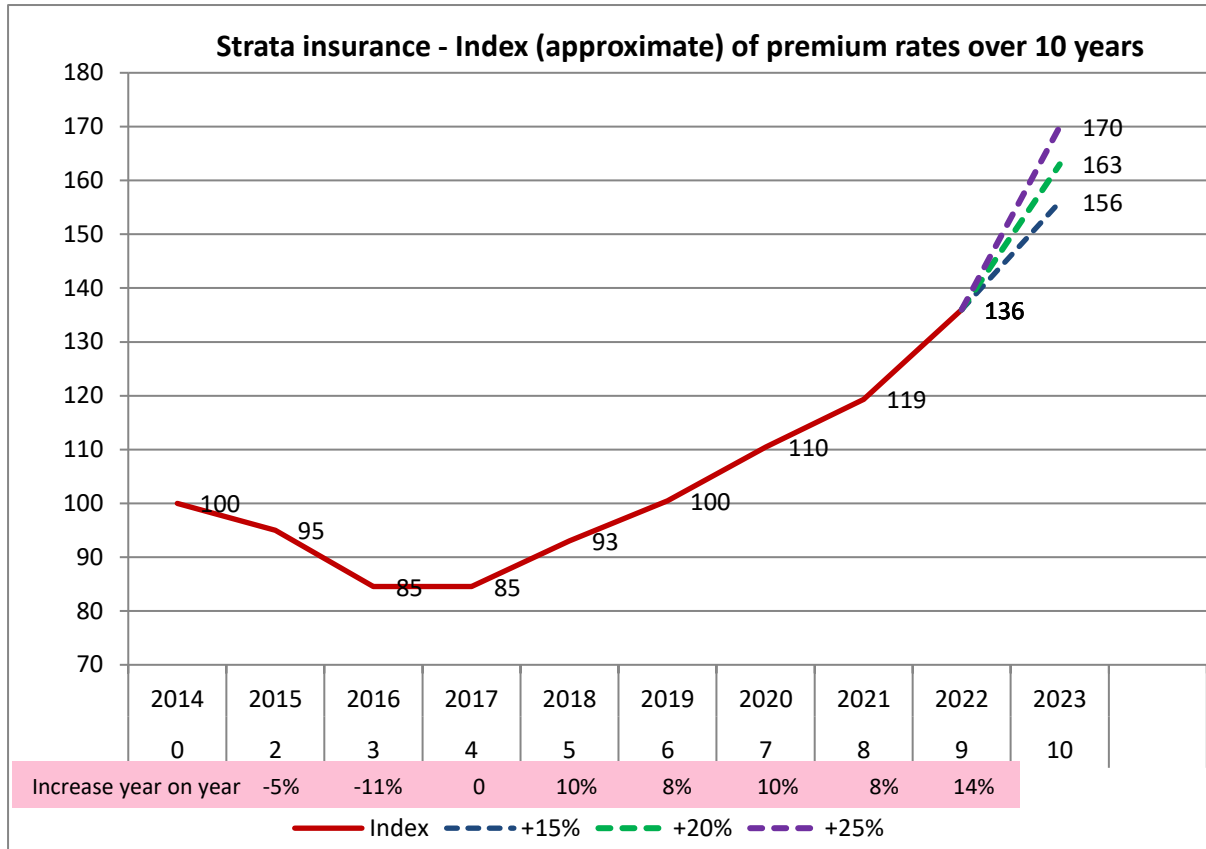


Chart relates to prices per unit sum insured for standard risks in low risk locations

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Affordability and availability of strata insurance

(b) The sub-standard market

This market segment comprises strata properties in low risk locations that are being treated by underwriters as below *standard* or below average to good quality.

The same factors are at play as for standard risks but there are several characteristics that can lead underwriters to mark a risk down from standard to sub-standard. The most common are –

- past adverse claims record
- defects not rectified
- repairs and maintenance
- building condition – can include age and quality of maintenance
- building complexity – machinery and other equipment (air conditioning, communications, embedded pipes, etc).

(c) The adverse location market

Outside of northern Australia there are locations regarded by underwriters as hazardous relative to most other locations. The hazards regularly identified are flood and bushfire zones.

Underwriters have become more conscious of the risks since the 2019 bushfires in NSW and Victoria, which for the most part occurred in regions that had never before seen such intensity of fires, and the extraordinary flooding that occurred from 2020 to 2022, mainly in Queensland and NSW but also in Victoria, Tasmania and South Australia.

(d) The northern Australia market

This market segment is location specific and comprises properties located in north Queensland, NT and northern WA. The majority of these properties are located in Queensland which is the main focus of this commentary.

Compared with the mainstream market, this market segment combines adverse location with, in many instances, sub-standard properties (having regard to the location as well as building vulnerability).

Availability of strata insurance in northern Australia

Queensland is of course the most populous of the northern regions but there are also strata properties in the Northern Territory and northern parts of Western Australia where cyclone and other weather events are not readily insurable and, when insured, may be at high or very high prices.

1. North Queensland

All the established underwriters have some presence in north Queensland but in each case there are limitations on the availability of cover from them, as outlined in the following table.

Inspection of the last column of this table shows that there is almost no capacity for new business in north Queensland when the sum insured exceeds \$5m.

Phase 3 - ENERGISING THE STRATA INSURANCE MARKET
Affordability and availability of strata insurance

Underwriting agency	Insurer	Max exposure any one property	Max aggregate exposure	Intermediary arrangements	Other main availability limitations
CHU	QBE	**	**	PICA brokers only - see separate note - or SMs, fees or commissions	New business highly selective + special arrangement with PICA
Longitude	Chubb	**	**	Brokers only, fees or commissions	New business: highly selective and strictly limited
SCI	Allianz	**	**	Brokers or SMs, fees or commissions	New business: highly selective and strictly limited
(Suncorp) →	Suncorp	Lower of \$5m and 10 units	**	No brokers or agents - direct only	No holiday lettings
Sure	Liberty	\$5m, excess layer possible with unassociated capacity	**	Brokers only, net premiums, no commissions	Holiday lettings maximum 50%
SUU	IAG	**	**	Brokers only, fees or commissions	New business: highly selective and strictly limited
(Chubb) →	Chubb	**	Not active	N/A	N/A

** Limit substantial enough to have no bearing on availability in the normal course of business

CHU and PICA Group

An historical agreement from 2015 gives OC clients of PICA (a strata management corporation) access to a product “Community Sure” issued by CHU and available only through PICA’s preferred brokers.

This agreement brought capacity to the north Queensland market because PICA, by a competitive national tender won by QBE and CHU (then owned by QBE), insisted that all of their strata managers across the country have access to a CHU product. The agreement brought new capacity to that market.

The agreement is scheduled to expire in 2024. CHU does not otherwise write business in north Qld other than renewal of some long standing policies that precede the PICA agreement.

The outcome of the agreement is twofold. It has increased the supply and so satisfied some of the demand that was previously not being met. At the same time SMs who are not part of the PICA group do not have access to this product. As CHU does not offer new business under its standard policy in north Qld, these SMs, on their own or through brokers not on PICA’s preferred list, cannot obtain cover from CHU and, in most cases where value exceeds \$5m, cannot obtain cover from anyone else.

There is now one exception where CHU and QBE have relaxed the PICA exclusivity. A broker not on PICA’s preferred list can obtain a letter of appointment from a body corporate that is an existing CHU client who wishes to use that broker to place the Community Sure renewal with CHU for that year. At the subsequent renewal, CHU will decline to offer renewal of the Community Sure product, due to the exclusive arrangement on the product with PICA’s preferred brokers, but can offer renewal under CHU’s standard product.

Commentary

Overall the market is disjointed and the outcome of the various limitations described in the table is that, for properties exceeding \$5m in value, there is very limited market capacity –

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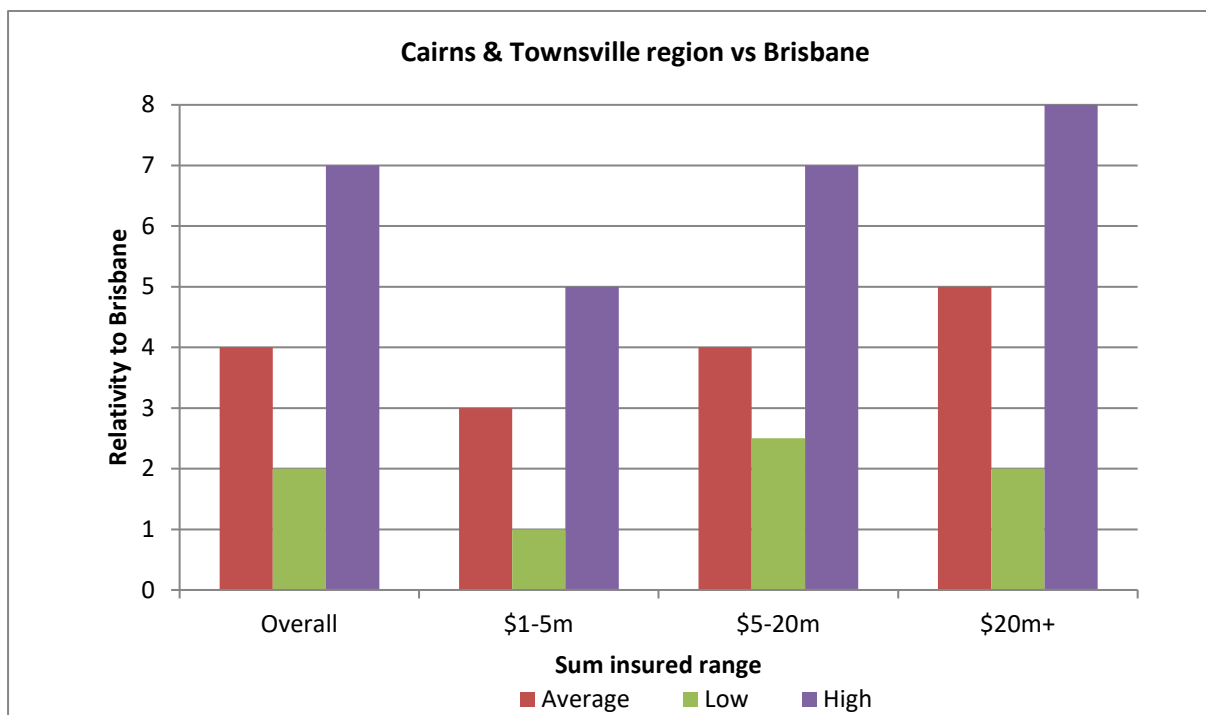
Affordability and availability of strata insurance

- some OCs are unable to obtain insurance, some are being asked to pay very heavy prices and some can obtain a dispensation from the Commissioner for cover above \$5m
- some brokers and strata managers are charging fees or commissions that, relative to elsewhere in Australia, are at reduced rates to recognise the burden of high premiums that are exacerbated by 20% or more in commissions and/or fees but not all brokers and strata managers are doing so
- underwriters, in being selective, are ready to acknowledge properties that are well constructed and well protected against the possible effects of cyclones and strong windstorms but, for properties unknown to them (i.e. for new business), these underwriters are somewhere between reluctant and unreceptive to accepting risk transfer in the form of insurance on properties that do not meet their underwriting guidelines or standards
- some brokers and strata managers are frustrated on behalf of themselves and their clients by the PICA-CHU arrangement that is not open to all brokers and which, to outside parties, appears to be anti-competitive (notwithstanding that, firstly, if this arrangement did not exist, CHU would likely be as reluctant as competing underwriters to accept risks that others will not accept and, secondly, as explained above, non PICA preferred brokers can obtain access to a CHU product on a CHU renewal).

How high are the premiums in north Queensland?

Obtaining a picture of the strata insurance premiums in Queensland is not straightforward but some relevant data are available. See below.

Relative rates per unit sum insured- approximate and rounded



These numbers show that, in the available sample –

- On the overall numbers –
 - the average rate per unit sum insured in the Cairns & Townsville region is 4 times the Brisbane average

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Affordability and availability of strata insurance

- the ‘low’ rates are double Brisbane’s average across the strata size spectrum and ‘high’ rates are 7 times the Brisbane rates
- Comparing properties across the size range –
 - for smaller properties (\$1m to \$5m), the relative rates are lower than for medium properties (\$5m to \$20m)
 - larger properties on the whole are experiencing higher premium rates than medium properties.

From a market perspective, these relative premium rates indicate in general terms that most properties in the Cairns & Townsville region are paying at least 3 times the Brisbane rates, in many cases they are paying 5 times and in some cases 7 or 8 times.

Cyclone Reinsurance Pool

The Pool will come into effect insurer by insurer during 2023 and 2024 for householders insurance. It is already being used by Sure for strata insurance and may be used by others from later in 2023 or in 2024. It is unclear at this stage how much effect it will have on the pricing and availability of strata insurance from existing strata insurers and their underwriting agencies. Each one will no doubt develop its own market strategy this year and next.

The Pool has some limitations. The main limitation of its design is that it offers coverage for windstorm and flooding only for BOM declared cyclones (which means Category 1 and above) and their immediate aftermath. Consequently there will continue to be severe weather events in the north that are not covered by the Pool.

Another limitation is that, for an OC to qualify, the property must be 50% or more residential with any commercial portion of the sum insured less than \$5m.

There is optimism in some quarters about the Pool and it will likely alleviate affordability and availability in cyclone prone areas but the degree of alleviation is yet to be fully understood.

Where to from here?

So what can be done for the future? There are some options, for example –

- (1) *On the Pool*, as noted above it may have a material effect on the market but how material and in what ways will not be clear for some time, perhaps another 12 months or more. Hence its full benefits and its effects on market participation, pricing and availability will emerge over a time horizon that extends beyond 2023.
- (2) *On the CHU situation*, while it has been demonstrated at law that the arrangement is not anti-competitive, there is availability for existing CHU policyholders who have appointed non PICA preferred brokers. It would also be within the powers of the underwriting participants, namely QBE and CHU, to make the CHU capacity available more widely.
- (3) *On alternative or additional local capacity*, an interest group, for example ACIL² or some other grouping of interested owners and/or brokers, could engage with a representative group of insurer and underwriting agency executives to explore whether, individually or as a consortium, there is a willingness for any of them to extend their geographical cover for new business in north Queensland –
 - the cover could be a primary layer or an excess layer
 - the main demand is for buildings with replacement value exceeding \$5m
 - the outcome of such an approach may depend on insurers’ activation for strata insurance of the Cyclone Reinsurance Pool.

² Australian Consumers Insurance Lobby

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2. Northern Territory and northern WA

Both of these markets are small and therefore receive limited attention from the insurance industry.

The NT market is serviced mainly by the Territory Insurance Office which is a division of Allianz Australia. Prices generally are noticeably lower than in north Queensland, as demonstrated in the 2020 ACCC Northern Australia report. The primary reason appears to be building standards that have been enforced during construction.

Understanding and interpreting today's market

TOPIC 2: Underwriting consequences for sub-standard risks

What can be done in the face of rising market prices?

What is to be done by individual OCs who seek to limit price increases, obtain lower prices than quoted or realise better terms and conditions?

Essentially just three things are possible, assuming the underwriting market is competitive –

- reduce the risk
- accept some policy exclusions or coverage limitations
- review intermediary charges and their appropriateness.

Reducing the risk is not always possible and, where it is, underwriter recognition of reduced risk may not be immediate. There may be some options, however, for example –

- Arrange a higher excess, thereby accepting that smaller claims and a part of large claims will be the responsibility of the OC rather than the insurer.

It has two secondary benefits –

- It avoids or reduces debates with the underwriter about whether any damage is a maintenance matter or an insurance matter (and it also reduces the associated inefficiency for all parties of having a debate or dispute about responsibility, which causes its own inefficiency, and can also complicate rectification)
 - It aligns more closely the interests of the insured (the OC) and the insurer, which is in the mutual interest.
- Rectify or remediate any known maintenance or building quality issues, along with investing generally in maintaining the quality and standard of the building
BUT
 - A common complaint of OCs who do upgrade their buildings, including rectifying defects or remediating the causes of any past claims, is that underwriters will rarely give credit in their premiums for effective risk reduction.
 - The counter point to these claims may be that the efforts made limit a price rise that would have otherwise occurred and may improve the future insurability of the property.

See also Topic 6: Owner responsibility for risk management

Accepting some policy exclusions or coverage limitations is a two edged sword because it means transferring less risk to the insurer, thereby increasing the exposure of owners.

- On a case by case basis, such steps may be warranted or may be imposed by the underwriter as a condition of obtaining cover at a price deemed by the owners as affordable.

Reviewing intermediary charges and their appropriateness: see Topic 11.

Understanding and interpreting today's market

TOPIC 3: Affordability: what does it mean, how is it measured?

The subject of affordability and availability has come to prominence in the last 3 or 4 years across most classes of general insurance. It is an unsurprising consequence of the current 'hard' insurance market. This hard market has been exacerbated and extended by the unusually large number of recent adverse weather events globally and locally. These events in Australia were dominated of course by the bushfires in NSW and Victoria in 2019 and the numerous flooding events across the country since then.

Governments and community members have drawn attention to affordability and availability questions while insurers have responded in various ways and so have governments. For example, in November 2022, APRA and ASIC explained their interest in the topic across the industry and signalled that it is a priority on their 2023 agendas.

Questions have been raised most strongly in respect of northern Australia. The ACCC's 2020 report contains an extensive set of related analyses, findings and recommendations. Some go beyond northern Australia and there are specific segments devoted to strata insurance. Since its publication, the government has legislated for the Cyclone Reinsurance Pool which is aimed at alleviating price pressures in areas of cyclone risk and is coming into force for strata insurance progressively.

Raising questions about affordability and availability is a simple matter ("I am paying too much" or "my premium has risen unfairly") but responding to these questions is not so simple. So –

- What exactly do we mean by affordability?
- Where, when and how do we observe lack of availability?
- What are the competitive issues associated with affordability and availability?

These notes³ explore these questions for strata insurance.

How is affordability to be understood for strata insurance?

A practical answer to this question is a prerequisite for identifying genuine affordability problems.

The most common idea usually discussed regarding affordability is based on *socio-economic assessments* which take direct account of a customer's financial circumstances. The idea has its difficulties for personal insurances but in any event it cannot be considered in strata insurance because of the multi-owner aspect of strata properties.

³ Notes adapted from my paper for the ICA in September 2021 on affordability and availability of insurance for SMEs.

Phase 3 - ENERGISING THE STRATA INSURANCE MARKET

Affordability and availability of strata insurance

A second idea and a more constructive one is the idea of a *comparative premium assessment*. It relates exclusively to premium levels. It has subjective elements, however, and its application needs to be developed beyond the ideas expressed below.

Comparative premium assessments

Affordability is largely subjective and is in the eye of the beholder: a customer may believe that there is an affordability problem while, on the other hand, the insurer may believe simply that the policy has been priced according to risk and is a fair price. Because strata insurance is compulsory, when the price seems high, the buyers can feel trapped – they do not have a choice about buying or not buying. From an insurance industry perspective, however, affordability is essentially a customer or buyer problem, not an insurer problem.

We can infer from this observation that affordability perceptions of insurance prices or price changes are built on expectations and that the expectations arise through a subjective combination of past history of insurance prices, comparisons with price changes for other goods and services (including inflation expectations) and perhaps also comparisons with insurance premiums payable for other insurance products or in locations where risks are lower (for example a property in a flood zone relative to a property with no flood risk).

In summary, affordability can be seen to relate to the expectations of customers on the basis that -

- customer expectations seem generally to be based on their historical experiences, i.e. what they are accustomed to paying and perhaps also what they understand their peers in other environments are paying
- OC members cannot be expected to have enough risk and insurance knowledge to make their own risk-based assessments of a fair price
- predictability matters to most customers, so affordability questions arise when insurance prices rise substantially from one year to the next or possibly over two or three years: we sometimes see increases in prices of 50% or more for some properties even when market average prices rise by lesser amounts
- affordability does not necessarily mean ability to pay and legislation tends to reinforce this position.

A practical affordability guide?

Building on this idea of customer expectations based on customers' own historical experience, an **affordability guide** can be suggested. Such a guide can be useful to distinguish between modest and severe price rises and thereby to set a basis or a foundation for prioritising initiatives aimed ultimately at solving the affordability problems. A useful starting point is to classify current premium levels on a comparative basis in order to establish affordability grades or categories.

It is important to note here that the circumstances of individual OCs and their strata properties can vary greatly so that valid comparisons of prices for one OC with another can be difficult to make. Although a broker can usually make some useful comparisons, the only clear reference point for most OCs regarding affordability is the OC's own past history of premiums and insurance coverage.

An affordability guide?

An Affordability Guide for assessing scale or severity of strata insurance affordability questions is being suggested that uses a Comparative Premium Assessment method.

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Affordability and availability of strata insurance

Suggested Affordability Guide

Affordability grade	Affordability category	2023 increase relative to comparable 2020 premium
0	Low	< 15%
1	Medium	15% to 30%
2	High	30% to 50%
3	Very High	50% to 100%
4	Severe	100% to 200%
5	Extreme#	> 200%

The “extreme” category can include the unavailable

There is nothing scientific about this Affordability Guide and its grades, the three year comparison, the category boundaries or their labels. Nevertheless it illustrates different levels of ‘sticker shock’ and it can be useful for **individual OCs** as follows –

- Firstly to categorise the price or affordability problem that an individual OC may be facing. The aim is to introduce a discipline around affordability questions by establishing a sound and accurate reference position (specified here as the 2020 actual premiums versus the properly quoted 2023 premiums on the same terms and conditions).
 - a properly quoted 2023 premium on the same terms and conditions as previously would be a genuine quotation from a broker or insurer to ensure that it is like for like and that it is more than a tentative or estimated premium

... note that OCs concerned about price increases need to be precise about comparing like with like.
- Secondly to establish where the real affordability pressure points are. The purpose is to guide insurers, brokers, owners and also governments, government agencies and other interested parties as to the scale of the problem and where most attention needs to be directed to respond to affordability pressures.

Referring back to the chart on page 16, it would seem that many buyers will be paying around 50% more in 2023 than in 2020, perhaps more on a like with like basis if the 2020 excess was \$1,000 and the 2023 excess is \$2,000 (which now appears to be the market norm). Such increases then fall into the ‘Very high’ category. That is part of why this study and this paper are important.

Phase 3 - ENERGISING THE STRATA INSURANCE MARKET

Affordability and availability of strata insurance

The two primary topics for 2023 (Transparent disclosure and Market Capacity)

TOPIC 4: Transparent disclosure (Phase 1)

Reviewing Phase 1

The goal of Phase 1 was to identify disclosure limitations and to recommend ways forward aimed at achieving transparent disclosure for strata property owners and their strata committees.

The Phase 1 paper found that, where strata manager and broker are both involved, the unorthodox structure of the strata insurance market, which embraces a *commission rebate/broker fee system*, is confusing -

- it is *convoluted* because, frequently, part or all of the commission is paid to the strata manager (SM) and a separate broker fee is charged to remunerate the broker for the broker's services: this is the *commission rebate/broker fee system*
- It is *complicated* because frequently not all of the commission is rebated to the SM, the remainder being retained by the broker.
- It is *compounded* in many cases by opaque or incomplete disclosure to the owners' corporation of insurance-related transactions.

The Phase 1 paper sought to ameliorate the first of these points and overcome the second and third by recommending a **transparent disclosure regime** comprising, for each owners' corporation –

- standardised financial disclosures and disclosure process
- description of scope of services of the SM and broker
- explanation of the business model of the SM and broker
- a disclosure matrix describing when and how these disclosures should be made.

The main recommendations are that -

- Financial disclosures in the form of broker quotations and invoices be prepared by reference to standard templates containing a minimum set of eight items with standard definitions
- Brokers and strata managers arrange to ensure timely transmission of quotations and invoices to the strata committee during the annual insurance renewal process
- Broker presentations of quotations be accompanied by a statement of scope of services by strata manager and broker and also by a description of how the strata manager and broker operate together
- SCA and NIBA consider the recommendations in detail and give effect to decisions they take on a self-regulatory basis by establishing guidance notes or practice standards for their respective members.

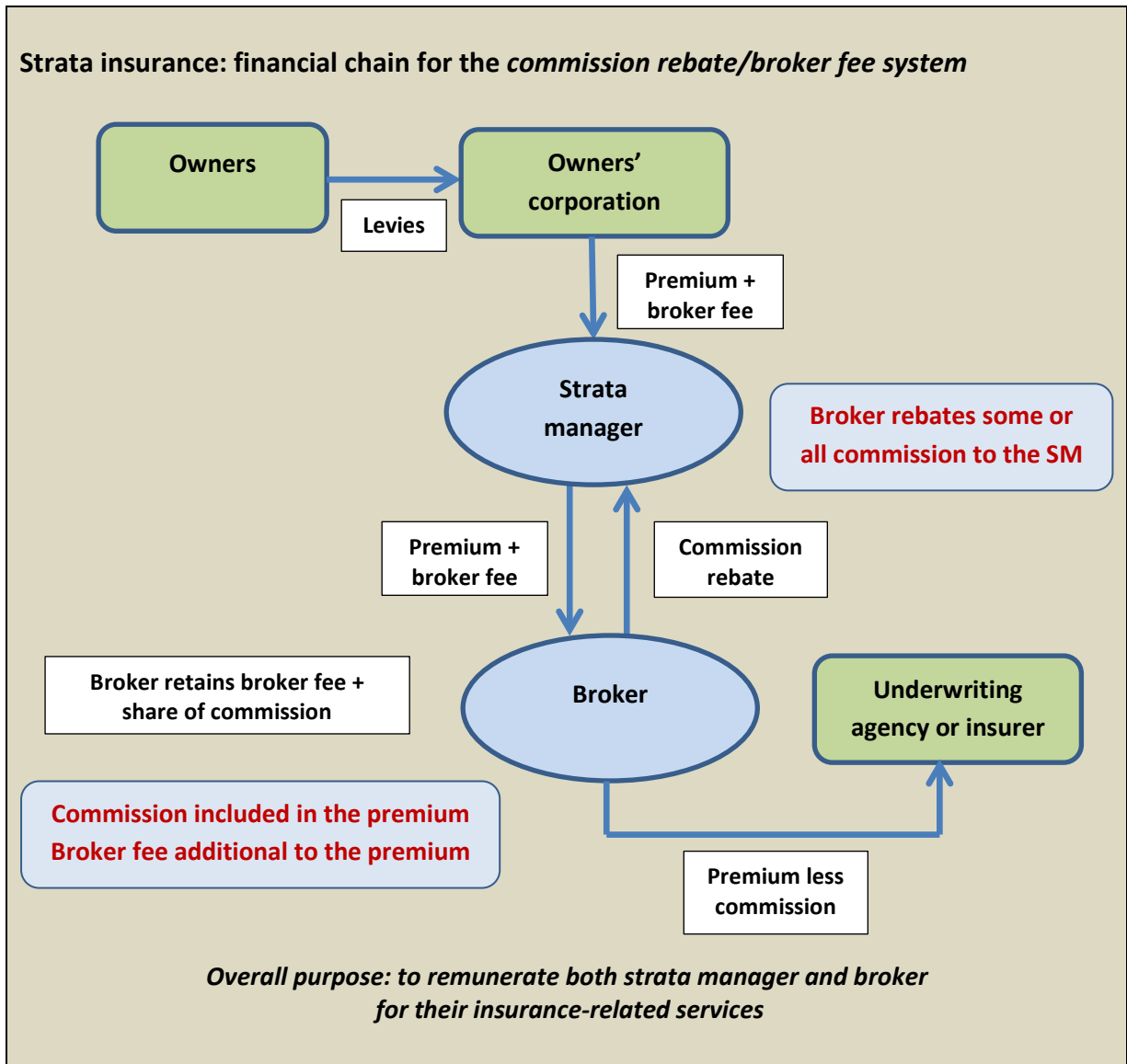
N.B. A small yet important part of the financial disclosures is for all parties to avoid misuse of terminology by being clear and accurate on what is the "premium", being the amount presented by the underwriter to the broker (excluding any broker fees), and whether the premium is gross or net of commission.

The next pages set out disclosure recommendations in five parts -

- Part A: Financial disclosures
- Part B: Disclosure Matrix – what, when and how
- Part C: Strata insurance business arrangements
- Part D: Strata insurance renewals: standard practice
- Part E: Scope of services: strata managers and brokers.

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Affordability and availability of strata insurance

The strata insurance financial chain



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Part A: Financial disclosures

There are three templates –

Standard Template – Quotation Version

Standard Template – Invoice Version

Simplified Template for Net Premiums

NB: Definitions and explanation of terms are on page 5.

STANDARD TEMPLATE – QUOTATION VERSION

Quote presentation template - 3 underwriters*

Undewriting agency Insurer	Last year	----- Quotations -----		
	[Name]	[Name]	[Name]	[Name]
	[Name]	[Name]	[Name]	[Name]
SECTION 1 - ITEMISED INSURANCE COSTS				
<i>Insurance charges</i>				
Base premium gross (includes commission)	9,000	10,000	10,400	10,800
ESL or FSL	1,170	1,300	1,352	1,404
GST	1,017	1,130	1,175	1,220
Stamp duty	1,080	1,200	1,248	1,296
Underwriting agency fee	200	200	100	150
Underwriting agency fee - GST	20	20	10	15
Total insurance premium	12,487	13,850	14,285	14,885
Broker fee	900	1,000	1,040	1,080
Broker fee - GST	90	100	104	108
Total insurance costs	13,477	14,950	15,429	16,073
SECTION 2 - REARRANGEMENT OF SECTION 1:				
ITEMISED INTERMEDIARY REMUNERATION				
<i>Initial remuneration before GST</i>				
Commission - within the base premium	1,800	2,000	2,080	2,160
Broker fee - additional to the premium	900	1,000	1,040	1,080
Total intermediary remuneration	2,700	3,000	3,120	3,240
<i>Allocation of remuneration</i>				
Strata manager: share of remuneration	1,575	1,750	1,820	1,890
Broker: share of remuneration	1,125	1,250	1,300	1,350
Total intermediary remuneration	2,700	3,000	3,120	3,240
Base premium net of commission	7,200	8,000	8,320	8,640
All other charges before GST	2,450	2,700	2,700	2,850
Total insurance costs before GST	12,350	13,700	14,140	14,730
GST	1,127	1,250	1,289	1,343
Total insurance costs including GST	13,477	14,950	15,429	16,073

* add or subtract columns to cater for more or fewer quotes

Notes for Section 2:

- A. *Allocation of remuneration* between Strata manager and Broker is by agreement between them.
- B. *All other charges before GST* = ESL + Stamp duty + Underwriting agency fee (from Section 1)

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STANDARD TEMPLATE – INVOICE VERSION

Invoice version the same as quotation version but showing previous and new premium and charges.

Invoice Template

	Last year	This year
Undewriting agency	[Name]	[Name]
Insurer	[Name]	[Name]
SECTION 1 - ITEMISED INSURANCE COSTS		
<i>Insurance charges</i>		
Base premium gross (includes commission)	9,000	10,000
ESL or FSL	1,170	1,300
GST	1,017	1,130
Stamp duty	1,080	1,200
Underwriting agency fee	200	200
Underwriting agency fee - GST	20	20
Total insurance premium	12,487	13,850
Broker fee	900	1,000
Broker fee - GST	90	100
Total insurance costs - amount payable	13,477	14,950
SECTION 2 - REARRANGEMENT OF SECTION 1:		
ITEMISED INTERMEDIARY REMUNERATION		
<i>Initial remuneration before GST</i>		
Commission - within the base premium	1,800	2,000
Broker fee - additional to the premium	900	1,000
Total intermediary remuneration	2,700	3,000
<i>Allocation of remuneration</i>		
Strata manager: share of remuneration	1,575	1,750
Broker: share of remuneration	1,125	1,250
Total intermediary remuneration	2,700	3,000
Base premium net of commission	7,200	8,000
All other charges before GST	2,450	2,700
Total insurance costs before GST	12,350	13,700
GST	1,127	1,250
Total insurance costs including GST	13,477	14,950



Notes for Section 2:

- A. *Allocation of remuneration* between Strata manager and Broker is by agreement between them.
- B. *All other charges before GST* = ESL + Stamp duty + Underwriting agency fee (from Section 1)

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SIMPLIFIED TEMPLATE FOR NET PREMIUMS

If there is no commission and the underwriter is offering a net premium, a simplified template can be used.

The standard template is not required because there is no need for separation into Section 1 and Section 2.

Invoice template – net premium version

Strata manager fee and broker fee separated from premium

Underwriting agency Insurer	Last year	This year
	[Name]	[Name]
	[Name]	[Name]
<i>Insurance underwriter charges</i>		
Base premium (nil commission)	7,200	8,000
ESL	936	1,020
GST	814	902
Stamp duty	864	960
Underwriting agency fee	144	160
Underwriting agency fee - GST	14	16
Total insurance premium	9,972	11,058
<i>Intermediary remuneration</i>		
Strata manager fee	1,575	1,750
Broker fee	1,125	1,250
GST on strata manager fee + broker fee	270	300
Total intermediary remuneration inc GST	2,970	3,300
Total insurance costs (invoice amount)	12,942	14,358

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Affordability and availability of strata insurance

8 items to be disclosed - Each is to be specified as a dollar amount.

<i>Item</i>	<i>Determined by</i>	<i>Origin</i>
1. <i>Base premium:</i>	Underwriter	
2. <i>Commission:</i>	Underwriter	
3. <i>ESL or FSL:</i>	Underwriter based on Government* regulation
4. <i>Stamp duty:</i>	Underwriter Government* formula
5. <i>Underwriter fee:</i>	Underwriter a modest administration fee is common
6. <i>Broker fee:</i>	Broker not part of premium
7. <i>GST:</i>	Calculated as 10% of all items except stamp duty.	
8. <i>Allocation of intermediary remuneration#:</i>	Sharing arrangement between strata manager and broker	

* State or Territory government

Definitions

Underwriter:	The entity accepting the insurance risk on behalf of the insurer – It could be the insurer itself or an underwriting agency appointed by the insurer
Underwriting agency:	Agency given underwriting, policy and claims authority by an insurer. – allows the agency to price and issue insurance policies on behalf of the insurer. – an underwriting agency is not an insurer
Customer:	The Owners Corporation (NSW, Vic, ACT), also known as Body Corporate (Qld, Tas, NT), Strata Company (WA), Community Corporation (SA)

Nomenclature

- **Base premium:** the premium quoted to the broker or, if no broker, to the strata manager. The base premium includes commission (if any) but not stamp duty, any other government charges, GST or any other fees that may ultimately form part of the total amount payable by the customer.
 - **Base premium gross** is a base premium that includes commission
 - **Base premium net** is a base premium that has no commission
 - **Commission:** any and all amounts included within the base premium that are to be paid or credited by the underwriter to the broker or, if no broker, to the strata manager
 - **Broker fee:** an amount added by the broker to the invoice received from the underwriter and included in the broker's invoice to the customer
 - sometimes referred to in documentation as a service fee or admin fee
- NB: Commission is part of total premium and charged by the underwriter to the broker
Broker fee is not part of the premium, shown only on broker invoice, not on underwriter invoice.**
- **Premium:** the base premium (including any commission) plus government charges (e.g. ESL and stamp duty). It may include or exclude GST.
 - This definition is standard insurance industry usage. Usually the underwriter makes it clear on any quotes and invoices what is included **but the underwriter will never include a broker fee.**
 - The premium may also be referred to as 'insurance premium' or 'total insurance premium'
 - The premium is shown on the underwriter's invoice and nominates which charges are included. *This usage of the term premium is also consistent with accounting standards (specifically AASB 1023), stamp duty legislation and industry data collections such as are undertaken by APRA.*
 - **Strata manager's share of remuneration:** that portion of the total intermediary remuneration that is credited to the strata manager
 - frequently referred to as the 'commission rebate' because it can be seen as the portion of the broker's commission that is paid by the broker to the SM.
 - **Broker's share of remuneration:** portion of the total intermediary remuneration credited to the broker
 - may also be referred to as broker fee plus retained portion of commission
 - **ESL or FSL (Emergency or Fire Services Levy)** in NSW, the State Government charges insurers for emergency services and insurers collect contributions from each policyholder to fund these charges.
 - levy rates differ across insurers and change whenever the Government reviews the charges
 - **Stamp Duty:** charged in all jurisdictions except the ACT – mostly 10% to 12% of base premium
 - **GST:** charged on all components of premium and other insurance charges but Stamp Duty is exempt.

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Part B: Disclosure Matrix – what, when and how

The Disclosure Matrix draws together all the steps required for strata managers and brokers to deliver a full quotation and invoicing disclosure package to their OC clients.

The Disclosure Matrix is simply a reference table to assist strata managers, brokers and lot owners to know what disclosure steps are to be undertaken during the course of the annual renewal process and also at the time of any changes in the arrangements with SM or broker.

Matrix of disclosure responsibilities*	1. Financial items	2. Business arrangements	3. Scope of services
What to document	Eight items #	Explain arrangements between SMs, brokers, underwriters	Allocation of SM and broker services
How to document	Template or full one page equivalent #	Complete questionnaire, and schedule	Complete check list, add notes if needed
When to document	1. At time of quoting 2. At time of invoice	On appointment then annually on any changes	On appointment then annually with quotes
When to communicate	1. When quotes ready 2. When invoice ready	On appointment then annually on any changes	On appointment then annually with quotes
How to communicate	Ensure timely and concurrent communication from broker to SM and OC	As for financial items	As for financial items

* Responsibility for Business arrangements lies with the SM. Many of the other responsibilities lie with the broker but some lie with the SM and others need to be arranged jointly between broker and SM.

See details in **Templates and financial disclosures**

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Affordability and availability of strata insurance

Part C: Strata insurance business arrangements

Schedule of business model characteristics: strata manager to tick one box in each segment

... some segments have some overlap with others

<p>A. Type of business model</p> <ul style="list-style-type: none"> • SM has appointed preferred broker but no tied or financial connection to broker • SM operates with preferred broker(s), SM and broker have a direct shared interest in the combined commission and fee revenue • SM has its own licensed broking firm • SM is owned by the broking firm it appoints • SM and broker have cross ownership • SM and broker have a JV using a CAR and share the CAR's income • SM receives full commission (no broker) • Broker receives and retains full commission (no SM) 	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		
<p>B. Third party entity between broker and strata manager</p> <ul style="list-style-type: none"> • None • Corporate Authorised Representative (CAR)* or other third party entity 	<input type="checkbox"/> <input type="checkbox"/>		
<p>C. Remuneration structure</p> <ul style="list-style-type: none"> • SM and broker share commission and fees between them • SM and broker share fees between them, no commission • SM and broker share commission between them, no fees 	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		
<p>D. Premium: gross or net?</p> <ul style="list-style-type: none"> • Gross: Commission in premium • Net: Premium contains no commission 	<input type="checkbox"/> <input type="checkbox"/>		
<p>E. Remuneration approach</p> <ul style="list-style-type: none"> • Fees only, net premium • Commission rebate and broker fee, gross premium • Composite commission & broker fee, gross premium • Commission only, some rebated to SM (no broker fee) 	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		
<p>F. Broker category</p> <ul style="list-style-type: none"> • Specialist strata insurance broking firm, other business ancillary only • Specialist strata insurance division within a wider insurance portfolio • General broker with strata insurance as incidental part of a wider portfolio • No broker appointed 	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		
<p>G. Strata manager category</p> <ul style="list-style-type: none"> • AR - Authorised Representative of the broker • Distributor for the broker or CAR • Referrer for the broker or CAR • No strata manager appointed 	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		
<p>* If a CAR or other third party entity exists -</p> <ul style="list-style-type: none"> • SM ownership 100% • Broker ownership 100% • Shared ownership SM and broker 	<input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>	<p>Income payable to SM and broker –</p> <ul style="list-style-type: none"> • Policy by policy • Periodic profit share, dividends or similar 	<input type="checkbox"/> <input type="checkbox"/>

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Part D: Strata insurance renewals: standard practice
.... including communicating across the renewal cycle

The renewal process for strata insurance usually commences eight or more weeks before renewal date. It may be earlier if, for example, there are underwriting questions likely to affect the price or placement or a change of broker is under consideration.

For the templates as recommended in Part A to deliver transparent disclosure will require three important execution steps to follow, which are:

- (1) the standard templates with definitions or their single page equivalents to be adopted by all brokers when preparing broker presentations and invoices
- (2) the presentations and invoices to find their way in a timely manner from the broker to the SM and also to the SC or the OC (noting that, in some cases where transmission does occur at present, it is not timely, i.e. It is conveyed after decisions have been taken).
- (3) the circle to be closed through an assured process for the broker to become aware that the SC has received the broker's documents.

The description below for steps 1 to 14 includes some extensions to current practice. They are intended to give effect to the three requirements above. The 2nd and 3rd (timely receipt by the SC of broker presentations and invoices along with knowledge by the broker that this receipt has occurred) are the primary communication changes being recommended.

Steps 2 and 3 are designed to ensure that the broker is aware of the existence and timing of transmission of broker information to the SC office bearer(s) and of the period of time between the SM receiving the information and the SC receiving it. The broker information comprises firstly the presentation of quotations and recommendation and, at a later time, the invoice following placement of the insurance.

The value of this arrangement is twofold –

- that the broker fulfils and has confirmation from the AR or the SC of fulfilment of the broker's obligation to know that the client (the OC) has received the information
- that there is a known delay, if any, between the SC office bearer(s) receiving the information from the broker or the SM and the broker being aware of the transmission.

The goal can be achieved in more than one way. Three suggested methods are -

Method 1

The broker sends firstly the presentation and, at a later stage, the invoice to the SM who forwards it by email or other electronic means to the relevant SC office bearers and includes the broker as a recipient of the email.

Method 2

The SM arranges with the SC for the AGM and insurance renewal dates to be coordinated, with the renewal due 2 to 4 weeks after the AGM. Either the renewal date or the AGM can be adjusted to achieve coordination. The SM includes the broker presentation in the agenda papers and copies the agenda paper to the broker when distributing it to the OC members.

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Method 3

The broker sends firstly the presentation and, at a later stage, the invoice simultaneously by email or other electronic means to both the SM and one or more SC office bearers –

- to enable the broker to do this, the SM will need to have notified the broker beforehand of contact details for the relevant SC office bearers.

In cases where there is both a SM and broker already appointed by the OC, recommended future practice is -

1. The SM, when preparing agenda and minutes for the client OC's AGM, is to include the broker invoice document prepared at Step 10. At least 8 weeks before renewal date, the broker and the SM begin collaboration for the renewal, including if requested by the broker a Pre-Renewal Declaration (PRD) from the SM.
 - Such declarations are aimed at ensuring that the broker has information for renewal purposes that is updated from the previous year, such as risk management steps taken, maintenance works, new or repaired defects, any claims that occurred.

2. The SM collects relevant information on behalf of the OC and supplies a completed PRD or equivalent disclosure statement and sends it to the broker -

The SM may also send up to date contact details for SC office bearer(s) for the information of the broker.

3. The broker prepares a quotation slip, taking account of any relevant new information, for presentation to several underwriters, usually including the holding underwriter.
4. Each underwriter either prepares a proposal with quotation or declines to do so, with reasons, and conveys its position to the broker.
5. The broker assembles the proposals, prepares a draft or final renewal presentation with quotations and recommendations for consideration by the SM and the OC or SC. If draft, the SM refers any queries or adjustments to the broker.
6. When finalised, the broker initiates transmission of the presentation with quotations and recommendations to the SM and the SC -

The method of transmission used needs to assure timely and preferably concurrent confirmation for the broker of receipt of the presentation by SC office bearer(s) -

The format and content of the renewal presentation are to conform with the recommended template (or its full equivalent on one page), disclosing the remuneration details for each quote.

7. The SM engages in dialogue with the SC, perhaps with the broker participating, in order to assist the SC to make an insurance decision on which quotation to accept.
8. The SM conveys the SC's decision to the broker and the broker conveys the decision to the selected underwriter –

If the SC's decision is late, the SM may be able to use delegated authority to give instructions to the broker (noting that the broker cannot take a late decision without authority from the SM).

9. The underwriter issues its policy and invoice to the broker.

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10. The broker prepares its own invoice document for the SM and the SC –

The broker's invoice will differ from the underwriter's invoice if there is a broker fee to be added. The underwriter's invoice will not usually be seen by the SM or the SC.

The format and content of the invoice are to conform with the recommended template (or its full equivalent on one page), disclosing the remuneration details corresponding to the invoice.

11. The broker initiates transmission of the invoice to the SM and the SC –

The method of transmission used, whether Method 1 or Method 3 described above or some other method, needs to assure timely and preferably concurrent confirmation for the broker of receipt of the invoice by SC office bearer(s).

12. The SM arranges payment of the 'total payable' to the broker, normally comprising the premium payable plus any broker fee.

13. On receipt of the premium and broker fee, the broker remits to the SM any commission rebate agreed in advance with the SM and remits to the underwriter the amount shown on the underwriter's invoice less any commission due to the broker. The broker therefore retains the broker fee and any share of commission not rebated to the SM.

14. The SM, when preparing agenda and minutes for the client OC's AGM, is to include the broker invoice document prepared at Step 10.

Within this sequence of events, there are two situations where information is conveyed from the broker to the SM, as has always happened in the past but now modified. They are steps 6 and 11 which, in short, are -

Step 6: broker presentation of underwriter quotations and recommendations sent simultaneously to the SM and the SC office bearer(s)

Step 11: invoice from broker (including any broker fee) sent simultaneously to the SM and the SC office bearer(s).

There are two important changes here from current practice because it requires that -

- the SC office bearer(s) receive the broker presentation with quotations and recommendation at the same time as the SM receives it.
- both the SC office bearer(s) receive the broker's invoice at the same time that the SM receives it.

There is no discretion for the SM on timing of transmission to the SC or OC of either the broker presentation or the broker invoice.

The additional communication discipline in Steps 2, 6 and 11 represents a substantial practical and cultural change from existing practices. It is designed to create transparency for the SC and OC and clear accountability for the SM and broker. It will arise through timely receipt by the SC of broker presentations and invoices along with knowledge by the broker that this receipt has occurred.

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Part E: Scope of services: strata managers and brokers

Three tables

There are three tables to be presented as a companion to the Financial Disclosure templates. They are intended as *guidance only* for strata committees, lot owners and other interested parties to become familiar with the roles and responsibilities of strata managers and brokers.

The tables are guidance only because there are many variations as to how individual SMs and brokers operate. The details in each case are ultimately a matter of agreement across SM, broker and SC. It is highly desirable that SM and broker work together to offer OCs a mutually agreed description of the services.

**Table 1: SCOPE OF INSURANCE SERVICES - POLICY RELATED
(ANNUAL, SEQUENTIAL)**

Strata Manager acting as agent for the OC	Strata Manager acting as agent for the broker	Broker
1.	1.	1. Prepare pre renewal documentation request for SM (if required)
2. Prepare pre-renewal declaration for broker if required, including any additional disclosure information such as revised valuation, defects, cladding matters	2.	2. Review pre renewal declaration and any additional disclosure information from SM such as revised valuation, defects, cladding matters.
3.	3.	3. Prepare quotation slip or risk profile for presentation to underwriters
4. Respond to any broker queries	4.	4. Arrange quotations including negotiating coverage, premiums and excesses, with underwriters, follow up as required, review outcomes and form a recommendation
5. Receive presentation from broker	5. Ensure concurrent receipt of the presentation by the SM, receipt by the SC or OC and confirmation of receipt for the broker	5. Prepare presentation for SM and OC with coverage details, market information, quotations and recommendation, advice on insurance program
6. Arrange OC instructions and communicate to broker	6. Arrange and attend insurance meeting with SC or OC, include broker if required	6. Attend and explain renewal presentation at a meeting of SC or OC (if required) and answer any queries
7. Convey insurance decisions to broker	7.	7. Receive and assess insurance instructions from SM
8. Receive invoice and pay premium to broker on behalf of client	8. Ensure concurrent receipt of the invoice by the SM, receipt by the SC or OC and confirmation of receipt for the broker	8. Procure insurance cover and present invoice to SM and SC
9. Include renewal information in AGM agenda and minutes	9.	9. Receive payment and issue certificate of currency

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**Table 2: SCOPE OF INSURANCE SERVICES - ADMINISTRATION AND RISK MANAGEMENT
(AS REQUIRED – NOT SEQUENTIAL)**

Strata Manager acting as agent for the OC	Strata Manager acting as agent for the broker	Broker
<ul style="list-style-type: none"> Keep records of renewal correspondence, annual PRDs, building information, etc. 	<ul style="list-style-type: none"> 	<ul style="list-style-type: none"> Offer risk management advice and insurance market advice
<ul style="list-style-type: none"> Monitor continuity of cover and renewal timetable 		<ul style="list-style-type: none"> Process any endorsements that arise
<ul style="list-style-type: none"> Arrange and obtain insurance valuation (at intervals of 2 to 5 years) 		<ul style="list-style-type: none"> Provide market and coverage commentary
	<ul style="list-style-type: none"> Undertake training as AR or Distributor for the broker and undergo periodic broker audits 	<ul style="list-style-type: none"> Arrange SM training and periodic audits to support the SM as AR or Distributor
<ul style="list-style-type: none"> Respond to 'make safe' emergency incidents (burst pipes etc) to minimise losses pending exploring maintenance vs insurance issues 		

**Table 3: SCOPE OF INSURANCE SERVICES - CLAIMS RELATED
(LARGELY SEQUENTIAL)**

Strata Manager acting as agent for the OC	Strata Manager acting as agent for the broker	Broker
1. Investigate incidents and potential claims, maintain associated records	1.	1. Advise SM on potential coverage matters relating to incidents and potential claims
2. Prepare claims information and lodge claim with the broker	2.	2. Lodge claim with underwriter
3. Represent OC throughout claims process. Communicate directly with SC where required.	3. Manage claim interaction with SC or lot owner(s) and with broker	3. Manage claim interaction with underwriter
4.	4.	4. Provide claims management advice to SM, including what to do and when
5. Facilitate assessor access and follow up progress	5.	5. Appoint or manage assessor involvement
6. Engage and instruct contractors for claims remediation	6.	6. Oversee claims remediation progress in consultation with SM
7. Facilitate stakeholder communication with SC, lot owner(s), broker, assessors, builders, contractors	7.	7. Advise and communicate as required to support the SM in interactions with SC, lot owner(s), assessors, builders, contractors
8. Review quality of claim settlement, owner satisfaction and potential for complaints and disputes	8.	8. Facilitate settlement negotiations including client (OC) advocacy when denials or disputes arise
9. Maintain records and log of claim activities for each claim	9.	9. Advocate for the client (the OC) with complaints and disputes with underwriter, internally in the first instance (IDR) and externally (AFCA) if appropriate

The two primary topics for 2023 (Transparent disclosure and Market capacity)

TOPIC 5: Market capacity

Market capacity is a 'hard nut to crack'.

Underwriters have limited risk appetite in today's market and frequently take a defensive approach when offering capacity. At the same time, buyers (owners) often have little understanding of the issues that cause underwriters to limit their exposure, which they do by not quoting or by loading their prices and/or imposing restrictive conditions on their cover. As a result, there are strong appeals from many quarters for greater insurance market support.

Capacity limits for strata insurance within the Australian insurance market lead to a variety of problems for some owners' corporations, most notably for sub-standard risks, risks in adverse locations (especially but not exclusively in northern Australia) and some larger properties. Consequences in individual cases can be opting out (despite the legal requirement for insurance and the personal liability exposure of strata committee members) or buying offshore cover at exorbitant and plainly exploitative prices.

There has to be a better way than local insurers classifying a significant proportion of risks as sub-standard and, as result, not offering cover or offering it under onerous conditions of price or coverage (and also noting that different underwriters often have different criteria for deciding what is sub-standard)

... the proportion classified as sub-standard is unknown but estimates range from 20% to 40% of properties in low risk locations

It is notable that many of the risks being classified as sub-standard could be improved materially if their OCs were to take more responsibility for risk management by investing more time, effort and funds into reducing their insurance risk. Such initiatives, however, will have a minor short term impact on market capacity.

Individual insurers and underwriting agencies have the freedom to decide which risks to insure and on what terms and conditions. At the same time we have the situation where collectively the industry is not offering the capacity that the insuring community of owners corporations is seeking. And of course the demand is continuing to increase as the strata sector continues to grow.

With insurance being compulsory in every State and Territory, the capacity limitations pose a dilemma that the insurance industry needs to be encouraged to resolve if it possibly can, preferably without regulatory intervention.

Can the local insurance industry take steps to improve capacity and overcome or alleviate this market capacity problem?

Proposition: A variation on the Insurance Council's Business Advisory Council is a mechanism through which some solutions may be found. The idea would be to arrange for an expert group in support of the interests of owners to engage with a representative group of insurer and underwriting agency executives in search of initiatives that might lift market capacity. The expert group would likely comprise a small number of brokers, strata managers and owners representatives.

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These two groups would investigate collaboratively the underwriting and other issues that limit market capacity with a view to enabling the insurance group to give advice or make recommendations to their principles that would form a basis for some expansion of local strata insurance underwriting capacity.

There is no short answer or assured favourable outcome of this process and there will be a need to protect the competitive integrity of all involved. Nevertheless there are several possible steps that could lead to increases in capacity which are worthwhile exploring and which would not be able to be explored without a collaborative process that embraces both the customer side and the insurance side.

The owner dimension

TOPIC 6: Owner responsibility for risk management

Two topics arise in recognising the important role that owners themselves and their bodies corporate play in the management of insurable risks for their properties. They are -

- Owner responsibility for remediation of defects, repairs and maintenance, risk management, funding for future maintenance needs, etc
- Owner education: everyone's dilemma? whose responsibility?

The role of insurance for owners' corporations is described in the box on the next page.

Many owners seem to believe that they are being unfairly treated when underwriters propose lifting prices or imposing terms and conditions on their insurance coverage that they think are unreasonable.

The other side of this proposition is that, as noted above, there are many instances where underwriters believe that OCs are failing to take responsibility for their insurance risk. The underwriting considerations mostly relate to (a) building condition, for example repairs and maintenance generally along with remediation of defects, and (b) the effectiveness and performance of the strata committee in managing their insurance risks. There are many examples of poor governance and poor functioning of the strata committee or owners' corporation where funding, planning and decision making adversely affect building condition and hinder underwriting assessments.

Conclusion: owners should recognise that they have a collective responsibility for effective risk management of their properties and, if the OC is well governed, can optimise the costs and the effectiveness of their insurance arrangements.

An important feature of this OC risk management challenge is the lack of knowledge and understanding by many lot owners of the implications of multi-owner building management and the basic workings and requirements of cooperative or collaborative owners' corporations. The need is already great and is expanding: the growth of apartment construction and apartment living across Australia brings an increasing proportion of first time apartment owners with no prior experience with apartment ownership. This experience gap is a widespread dilemma that flows through the system from owners to strata managers to brokers and underwriting agencies.

Conclusion: there is a need for some form of owner educational opportunities and incentives that extend beyond the basics of apartment ownership and responsibilities into the insurance and risk management domain.

... such educational resources and incentives could be made available by the private sector or the public sector and could be encouraged and facilitated by governments.

External support for the above conclusions

The following was included in a "Decennial Liability Insurance Ministerial Advisory Panel Advice to NSW Government August 2022"

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“Buildings are maintained effectively to prevent unnecessary defects emerging

“The delivery of competent design and building work will be critical to buildings being compliant, safe, and resilient at the point of occupation. However, responsibility for a building’s ongoing resilience also relies on building owners (strata bodies and managers) maintaining their assets in a way that performance standards are not compromised.

“The Panel considers that more needs to be done to educate strata bodies on their responsibilities for maintaining their buildings. Poor maintenance of buildings is the result of insufficient designs and maintenance information provided by the developer (to be addressed under the DBP Act and the work to rollout industry wide building manuals) but also insufficient capability, funding, and action from strata bodies.

“Maintenance costs for building assets are recovered from lot owners, who are required to make regular contributions into common pools of funds, such as capital works funds, or pay special levies when expensive treatment is required. While it is hoped that some of these additional costs will be avoided, led by predicted drops in remediation costs due to the DBP Act and RAB Act, there remains a base level of funding required to maintain assets. Under existing approaches, this creates significant variability in the effectiveness of maintenance, with some buildings having committed strata bodies that understand the need to stay on top of maintenance, and others who consider it as an avoidable cost.

“The Panel supports the Government’s proposed reforms to more clearly define the duty that building owners have to maintain their buildings. The Panel further supports the proposed education material that will be available to strata bodies and managers to lift understanding of what effective maintenance looks like. Building owners must have regular maintenance schedules and contract with trusted, capable operators rather than the cheapest. Money invested during this part of a building’s life cycle will not only improve safety and amenity in the short term but extend the life of building elements to make the building itself a more valuable asset.

“Strata bodies need to be committed to effective maintenance of their buildings to ensure that unnecessary risks of defects are avoided, as well as early indication that defects caused by non-compliant design or building work are starting to emerge. “

The role of insurance for owners’ corporations

Insurance is a risk transfer mechanism. It allows an entity (one or more persons or businesses) to transfer to the insurer, for a price, any risks that the entity does not wish to hold itself or is unable to hold. The transfer occurs if the entity and the insurer can reach agreement on the price to be paid to the insurer (premium) and on the terms and conditions of the coverage that the insurer is willing to offer.

Risk transfer through insurance is most effective if there is an **alignment of interests** between the insured and the insurer. Alignment is most effective when the insured party takes an active interest in managing the risks. The insurer will offer better terms and conditions if the insured takes steps to minimise or mitigate the risks.

In the case of strata insurance, the insurance supply chain is longer than for most other insurances, largely because the strata property has multiple owners:

- the owners operate collectively not individually and do so through the Owners’ Corporation (OC)
- the OC is managed through its Strata Committee (SC) or equivalent

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- in most cases the SC will engage a strata manager (SM) to assist the SC's management of the OC
- in most cases the SC will authorise the SM to engage an insurance broker to assist with the insurances required by the OC
- the broker will act as an insurance intermediary between the SC, usually with assistance from the SM, to negotiate and arrange the insurances with insurance underwriters.
- most of the underwriters are agencies who act for an insurer, with the insurer delegating most of its functions to the agency but retaining ultimate responsibility for the payment of claims.

Because of this long supply chain, effective alignment of interests is often more difficult to achieve than in many other insured-insurer situations. It can be difficult to obtain effective decision-making across this chain.

Particular features of today's insurance market that exemplify this situation are –

- if remediation work or other risk management initiatives are required of an OC to facilitate placement of the insurances, any delays or inaction on the part of the OC or its SC in taking the required steps can occur, often arising from some form of limited governance arrangements of the OC that manifest themselves as one or more of –
 - lack of effective or timely action by the SC or the SM, including failure of the SC to authorise the SM to have the necessary steps taken
 - lack of agreement within the SC on what actions are worthwhile to initiate
 - lack of agreement of lot owners to authorise the budget needed
 - an expectation by the SC or the SM that the insurance will be readily available without the SC taking the steps required
 - continuing poor maintenance of the property.

Features for strata property and its management that cause underwriters to seek increased premiums for individual strata properties that are higher than for average or good quality properties in low risk locations that are well-managed include but are not limited to –

- poor past claims history
- defects that have not been remedied
- remediation or risk management plans prepared but not implemented
- lack of diligence or good governance within the OC.

There can also be other features which are outside the direct control of the OC and its SC such as –

- building age
- quality of construction
- complexity of construction (which may include for example water pipes that are embedded in the building structure, boilers, air-conditioning, lifts, garbage disposal, telecommunications equipment)
- location: 'macro', such as in a cyclone or flood region, and 'micro' such as proximity to other buildings or geographical features that affect access for building repair or maintenance purposes.

Upgrading market resources and customer support

TOPIC 7: Transactional efficiencies

The administration of strata insurance is less automated than for a number of other classes of insurance and is complicated to some extent by the existence in most cases of two intermediaries, the broker and strata manager. Requirements in NSW and Queensland for more than one quote along with the now established industry practice of seeking several quotes, usually at least three, contribute to this situation.

Some underwriting agencies and some brokers have invested more than others in technological simplifications and streamlining the quoting process and other components of their businesses but the diversity and lack of common methods of operating appears to be a source of low efficiency across the industry.

Some brokers are using platforms for obtaining quotations and there is more than one platform being used with no platforms to which all underwriting agencies subscribe.

Turnaround times on quotes can be slow, especially if there are underwriting questions to be explored. Underwriting agencies often find themselves with backlogs and bottlenecks, with brokers and strata managers being inconvenienced by the delays. At the same time underwriting agencies see some of the quoting as thankless because of the low strike rates that they experience.

One can ask: to what extent is there potential for greater efficiencies, improved timeliness and more effective underwriting arrangements across the strata insurance sector, through the financial chain from underwriter to broker to strata manager to owners' corporations? The same question can be asked of claims administration and management

Most brokers and underwriting agencies recognise that there are efficiencies to be found, with efforts to find them backed in some cases by significant investment.

It remains to be seen how far and how fast they proceed and whether those that invest well gain competitive advantage from doing so.

Upgrading market resources and customer support

TOPIC 8: Industry statistics

Industry statistics for strata insurance do not currently exist. There are two types -

- (a) for underwriters (insurers and underwriting agencies)
- (b) for underwriters, brokers and strata managers

(a) Underwriters (insurers and underwriting agencies) are usually interested in industry statistics on exposures, premiums and claims –

- they represent a benchmark for all industry participants to compare with their own portfolios
- they assist with pricing, portfolio risk assessments, etc
- they can have a range of external uses for industry purposes (eg government enquiries, industry understanding for the public and other audiences)

(b) Underwriters, brokers and strata managers: some are interested in a national strata property database of individual strata properties.

- To be useful, it would need to contain addresses and main building characteristics such as no of units, no of storeys, floor area, age, nature and standard of construction and perhaps other items
- It would be a large undertaking but could begin with a narrow range of data items and, once established, could be extended over time with additional data items

Should initiatives be taken to establish industry statistics? And, if so, by whom?

(a) for portfolio statistics, might it be -

- APRA?
- Industry association(s) eg ICA, UAC, NIBA?
- A private contractor?

... and who should fund the establishment and operation of the system?

(a) for underwriting statistics, there are several possibilities, eg ICA, UAC, NIBA, SCA, a property industry body, a state government agency or two or more of these groups above in a consortium

... and who should fund the establishment and operation of the system?

It goes without saying that any initiatives of these kinds would need to be fully vetted in relation to competition laws.

FORUM INPUT

ASIC and APRA are considering portfolio statistics for strata insurance. Likely timing is not less than two years from now.

Affordability topics

TOPIC 9: Economics of strata insurance

Insurance prices are established by insurers by making assessments in advance of –

- the expected or estimated costs of claims, including reinsurance costs that take account of risks and uncertainties as best they can
- administration costs including underwriting resources, claims management costs and a range of ‘back office’ needs
- acquisition and distribution costs, i.e. costs of retaining existing customers and acquiring new customers
- a profit margin and the costs of the capital needed to maintain the insurer’s solvency position
- any applicable government charges and taxes

In the case of strata insurance, we can create a schematic or standardised illustration of these different components of price. Acquisition and distribution costs are represented by commissions and broker fees.

The position is shown schematically in the charts on the next two pages. The first chart includes commission but no broker fee and is set to a total of 100. Claims costs including reinsurance are shown as 55% of the total of 100.

Notable features of these two charts are –

- **distributions of claims by size**, indicated in the lower four bars of each chart
 - These distributions are relevant to consideration of alternative policy excess levels and associated premium variations
 - Of the 55, the charts are showing 7 for claims from \$1,000 to \$2000, 7 for claims from \$2,000 to \$5,000 and 6 for claims from \$5,000 to \$10,000. While indicative only and not uniform across the market, they suggest levels of discount that might be available for policy excesses of \$2,000, \$5,000 and \$10,000 respectively
 ... see further under Topic 10
- an indication of the **composition of insurance charges** according to the premium and intermediary charges that make up the total insurance costs (see Topic 11)
 - Total costs before intermediary charges are 80
 - If there is a broker fee involved, the total is higher than 100 as shown in the second chart where we see –

<i>Broker fee descriptor*⁴</i>	<i>Broker fee + premium</i>	<i>Broker fee</i>	<i>Commission</i>	<i>Total intermediary</i>
‘Modest’	105	5	20	25
‘Common’	110	10	20	30
‘Immodest’	120	20	20	40

⁴ The descriptors used here are informed by my observations that, where broker fees are charged in addition to commissions

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- part of the market applies 5% which, when added to commission of 20%, gives a total of 25% and is arguably the most competitive on intermediary charges
- another part of the market applies 10% or thereabouts
- a further part charges 15% or 20% or more
- some of the higher rates apply when the premiums are small (e.g. a minimum fee is applied, such as say \$300 to \$500) but some brokers also apply them more widely.

... see further under Topic 11 and the discussion "What is market?"

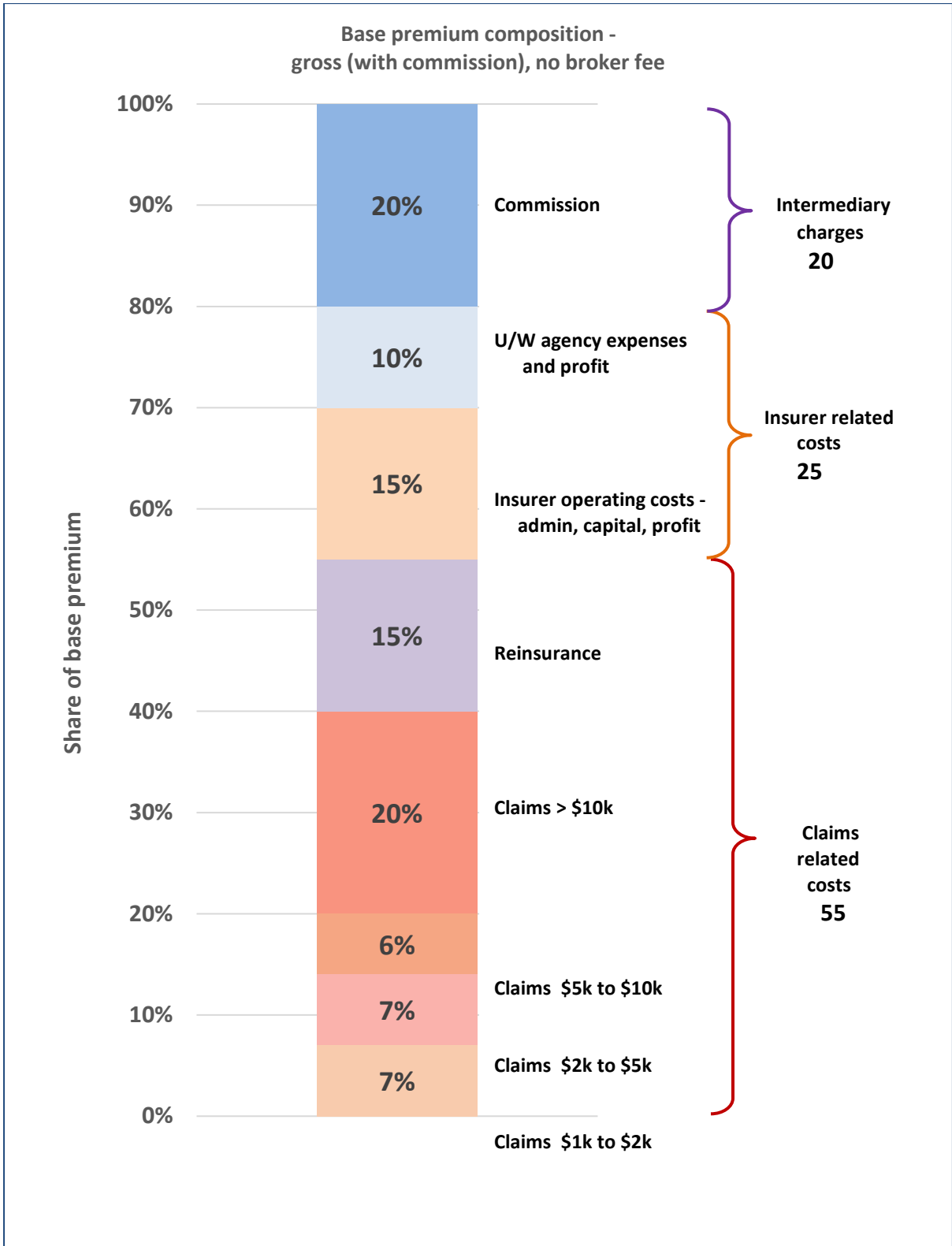
Government taxes and charges

The two charts shown exclude government taxes and charges which act to increase premiums and therefore to increase total insurance costs. Those charges are -

Stamp duty (most states) – at or near	...	10% compounding but no GST
GST		10% compounding
Emergency Services Levy (NSW) – around	...	15% + GST compounding

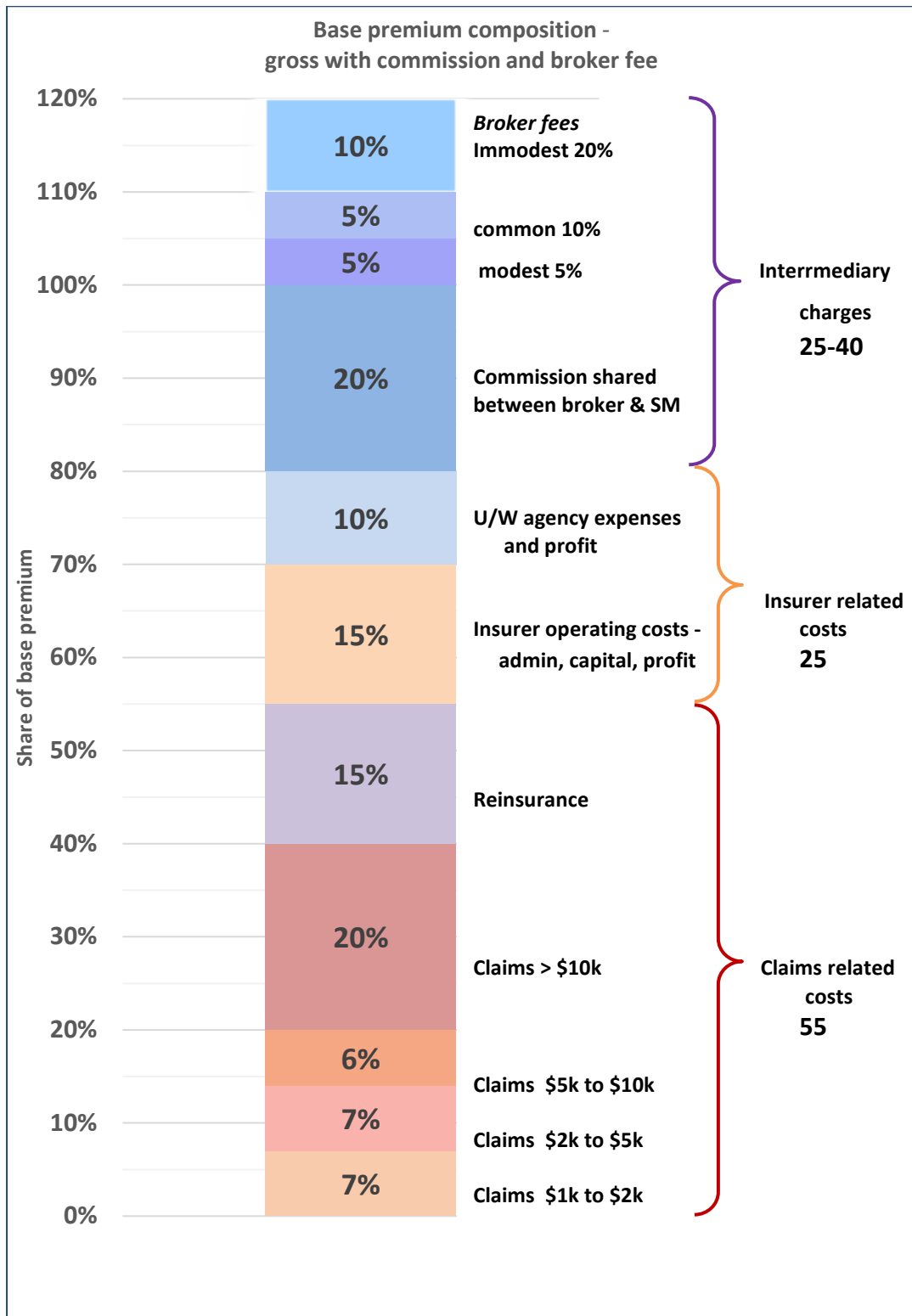
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Premium schematic before stamp duty, ESL and GST – no broker fee



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Premium schematic before stamp duty, ESL and GST – broker fee added



Affordability topics

TOPIC 10: Policy excesses

Current market position

A feature of the strata insurance market is the very low policy excesses that prevail generally across the sector. For many years there were no policy excesses but they have existed and been on the rise since 2015, before which insurance claims could usually be made in full for every insurable event, no matter how small. In or around 2015, excesses were introduced widely and the standard market level was \$250. They have moved progressively since, first to \$500 and more recently to \$1,000. Further increases are now occurring and it is likely that higher levels, probably \$1,500 to \$2,000, will become commonplace in 2023.

There are instances of higher policy excesses for larger properties, perhaps \$5,000 or more, and also excesses for specific perils or types of claim. For example if there is a history of burst pipes or other water damage, the underwriter may impose an excess of \$5,000 or more and in some large complexes as much as \$50,000 for water damage claims. These excesses are, however, the exceptions.

The market excesses can be compared with the more common levels for home, contents and motor insurance, which usually exceed \$500 and in many cases are \$1,000 or more. By contrast, a strata scheme of five units with a \$1,000 excess means an average of \$200 per unit, for 10 units \$100, 20 units \$50 and 50 units just \$20.

Therefore in today's market, there is ample scope for excesses that are higher than \$1,000 or \$2,000, noting that something like 75% of strata units are in schemes of more than five lots and 60% are in schemes of more than 10 lots.

The role of policy excesses

Policy excesses are useful in contributing to alignment of interests between insured and insurer, which is always desirable with insurances. They can also have a material effect on premiums. Insurer claims experience shows that, in most classes of insurance, and strata insurance is no exception, small claims can comprise not only a material component of the total claims costs but also a significant administrative burden on the claims management process. Small claims can also be confounded with maintenance requirements and it is not very productive for maintenance needs to be treated or to be 'tried on' as insurance claims.

It is therefore generally in the mutual interest of the insured and insurer that no claim be made on the insurer for small claims where the size of claim is not material to the insured.

We can ask: why is it that excesses for strata Insurance are so much lower on a per lot basis than for home, contents and motor (noting also that most owner occupiers of strata units will have a contents policy and many will have a motor policy, each with a \$1,000 excess)?

The answer seems to lie in several factors –

- Market participants, from OCs through to underwriters, are conditioned by market practice to the low policy excesses –
- market practice has an effect: for the SM and broker to follow the market practice is convenient for them because they do not have to 'sell' a higher excess to the SC

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- It is convenient for lot owners that most or all damage claims be covered in full or for the most part by insurance, even small claims, because funding the excess is then no inconvenience, administrative or financial, for the SC or the OC
 - low excesses can also be seen, however, as representing an over-reliance on insurance: see also box in Topic 5 on the role of insurance
- Correspondingly, high excesses can create a funding dilemma for some OCs if a claim occurs when there is no sinking fund or other provision of funds that can be readily called upon to meet an excess payment
- Although underwriters will generally offer lower premiums for higher excesses, and in many cases would prefer to do so, until the current hard market became evident the trade-off between the policy excess and the premium reduction could be seen by brokers and SMs in their advice to their OC clients to be an inadequate trade-off
- SMs and brokers whose remuneration is proportional to the premium generally have no financial incentive to promote higher excesses.

Can policy excesses influence affordability and availability of strata insurance?

Policy excesses can be established on the initiative of either the client or the underwriter –

- a higher than standard excess may be imposed by the underwriter, either for particular claim types or overall, if the underwriter is otherwise unwilling to offer cover
- a higher than standard excess may be sought by the client ('voluntary excess') if the client wishes to reduce premium and regards the reduction as a fair trade-off for the additional risk exposure while also having the means to fund the excess in the event of one or more claims during the policy period.

A favourable market feature of higher excesses is that more underwriter quotes may become available for OCs who voluntarily opt for higher excesses, even if their past claims record is good. Some underwriters will offer, as a matter of course, a scale of premiums for different policy excesses but it seems that there is little call by SMs or brokers on behalf of their OC clients to present this scale or to promote excesses that are higher than the prevailing market norms.

The trade-offs in today's market between premium and policy excess are advantageous in many cases. For example, compared with a \$1,000 excess, many OCs with good or very good claims records in low to medium risk locations might expect to see –

- for a \$2,000 excess, ... a 5% to 10% premium reduction
- for a \$5,000 excess, ... a 10% to 20% premium reduction, and
- for a \$10,000 excess, ... a 15% to 25% or more premium reduction.

These numbers are illustrative only and are based on interviews with selected underwriters.

NB: it appears that the first step, from \$1,000 to \$2,000, has already been absorbed into most underwriters' 2023 premium scales and in some cases a \$5,000 excess is applying as standard.

Comment:

There are valuable affordability prospects for many strata schemes through greater use of policy excesses.

All of the parties have a role to play in making policy excesses more accessible.

Affordability topics

TOPIC 11: Intermediary charges (today's market practices + Phase 2)

In this Phase 3, remuneration levels need to be considered because they are relevant to affordability. The Phase 2 paper released in December 2022 examined in some depth the remuneration practices of brokers and strata managers but did not consider remuneration levels directly.

This topic is controversial among the strata manager and broker communities because many are uncomfortable about change and fear that they may be adversely affected. On the other hand consumers and also some brokers and strata managers would welcome changes that signal an industry striving to strengthen its professionalism. The goal is to introduce changes that are better aligned to the scope, nature and quality of services being provided and that are more competitive. The remuneration should be transparent and structurally sustainable.

There are three facets to be considered, which are –

- the *commission rebate/broker fee system*, which I have recommended in my Phase 2 paper be phased out to eliminate its inherent conflicts of interest
- *charges that are above 'market'*: some brokers and strata managers are charging fees and commissions that are above market and unlikely to meet any reasonable test of fairness to the customer and customer best interests
- *benefits from rising premiums*: intermediaries whose remuneration is a percentage of premiums (which is the most common method) have received unexpected revenue gains arising from the large premium increases of the last three or four years, including the 2023 increases that are now being applied – some intermediaries have moderated their fees or commissions but, as far as I can tell, they are a minority..

The first relates to accountability of strata managers and brokers to their OC clients. It implies a structural realignment of remuneration but does not of itself imply any change in strata levies or remuneration levels (contrary to the claims of some strata managers).

The second and third relate directly to levels of remuneration which are fair to the customer and in their best interests. They are matters which, in a competitive market where disclosure is fully transparent and customers are well informed, should both be influenced by market forces. Evidently, however, we do not yet have transparent disclosure in most cases – see Topic 4.

Phase 2 and the *commission rebate/broker fee system*

The Phase 2 paper identified three conflicts of interest and expressed my conclusions that one of these three, broker commissions, is a manageable conflict but that the other two need to be addressed. These two are where

- (1) the SM agrees with the broker on a share of commission to be rebated to the SM and
- (2) the broker agrees with the SM on a broker fee that is additional to the commission.

Together they comprise the *commission rebate/broker fee system*.

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Some Phase 2 considerations

The *commission rebate/broker fee system* can result in over-compensation of strata manager, broker or both but hard to assess because of four factors:

- many SMs use commission rebates to subsidise their other (non-insurance) services
- lack of clarity on role of conflicts of interest in the financial arrangements.
- the “black box” nature of the intermediate entities when the *composite commission & broker fee system* is being used
- the inaccurate use in many cases of the term “premium” and lack of clarity on whether the premium properly described is gross or net of commission.

Two questions –

1. Do or can the conflicts of interest lead to outcomes that are unfavourable to OCs?
2. Would phasing out the *commission rebate/broker fee system* detract from or add to the current ‘ecosystem’ = constructive collaboration between strata manager and broker?

Some Phase 2 propositions

We need to acknowledge -

- the strength of the propositions in favour of continuing with the current system
- the conflicts of interest inherent in this *commission rebate/broker fee system* –
 - *the SM agrees on a share of commission with the broker*
 - it is anomalous that the SM arranges to receive a significant part of remuneration by agreement with the broker instead of with the OC as client
 - the SM’s remuneration is not related to the value of the services to be provided
 - *the broker agrees on a broker fee with the SM that is additional to the commission*
 - It is unsatisfactory that the broker gives away a significant part of commission and then enters into a second agreement to arrive at a broker fee to support the broker’s cost of services.

Following analysis of the conflicts and the above propositions, I have come to the view that the *commission rebate/broker fee system* should be phased out in three stages comprising –

Stage 1: introducing transparent disclosure (Phase 1) – see Topic 4

Stage 2: consolidating disclosure and preparing to phase out the system (2023 to 2024)

Stage 3: phasing out the system via structural realignment – the transition (from 2024)

The main outcome of *structural realignment* of remuneration should be greater accountability of SM and broker to the OC while also -

- maintaining fair compensation for SMs and brokers for the services they each provide
- maintaining a constructive and collaborative relationship that many SMs and brokers have developed to service the interests of their OC clients.

In my opinion this reform is an important one for the broking and strata manager industries to make in order to give support to the consumer requirement that both intermediaries act in the best interests of OCs, their stat committees and the owners.

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Intermediary charges in today's market - background

Intermediary charges are the fees and/or commissions being charged by brokers and strata managers.

Strata insurance commissions paid by underwriters to the broker or, in the absence of a broker, to the strata manager, are, in today's market, almost always 20%

It is evident that, in examining affordability, intermediary charges need to be examined.

Brokers are free to seek net premiums for brokers (no commission), in which case the underwriter's net premium will be 20% lower than the gross premium that includes commission. In these situations broker and strata manager will charge fees for their services to the owners' corporation.

It appears that some 80% of the broker market is today operating on commissions plus broker fees (the *commission rebate/broker fee* system) and the other 20% on fees.

Questions to explore include –

- are intermediary charges fair to the customer and in their best interests?
- are intermediary charges being set competitively?

Fairness, like affordability, can often be in the eye of the beholder but in general it is expected to reflect a reasonable price for services being rendered or goods being purchased. Best interests requires the intermediaries to put the customer's interests ahead of the interests of the intermediaries.

Competitiveness can be considered in the first instance by reference to market prices, on the assumption that the market is sufficiently competitive that buyers will take account of prices in their buying decisions.

To discuss this topic requires an understanding of 'market' rates for intermediary remuneration: see box below.

Q: What is 'market'?

A: The answer requires some explanation, in view of the convoluted remuneration structure -

- Where SM and broker are both appointed, most are remunerated via the *commission rebate/broker fee* system (see Phase 2 paper). My understanding is that, in this part of the industry, 'market' comprises total fees and charges of around 25% and perhaps up to 30% of the gross base premium.

To elaborate, under this system, anecdotal evidence collected during 2022 indicates that 'market' is –

- For strata managers, the most common rates are commission rebates of 15% or 17½% part of the broker's total commission of 20% of the gross base premium.
- For brokers, the most common charges are the residual 2½% or 5% of commission supplemented by a broker fee calculated as 7½% to 10% of the gross base premium.

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Together these charges yield total costs to the OC of, most commonly, 25% of the gross base premium and in many cases up to 30%.

- Where SM and broker are both appointed and rely on fees only, 'market' appears to be –
 - For medium-size properties (say from around 50 lots or \$10m to \$20m in value up to perhaps 100 or 150 lots and \$50m in value), fees are similar to the total charges applying under the *commission rebate/broker fee* system.

With fees only, net premiums apply and they are 80% of gross premiums. Hence to match 25% or 30% of gross premium, the fee rate needs to be 31% or 37½% respectively of the net base premium.

When fees only are used, the allocation between strata manager and broker is usually in the 50/50 to 60/40 range with the SM receiving the higher share.

- For larger properties, the fees and charges would normally be ascertained as an agreed discount against the market rates for smaller properties, arrived at to recognise the otherwise large payments that arise from a premium based on the full percentage rate as applied to smaller properties.
- Where a strata manager is appointed and no broker is involved, 'market' is the commission rate of 20% of gross base premium payable to the strata manager.

Fairness and best interests

To approach the questions of fairness and best interests, we can ask some questions:

- Are the fees and charges known to the owners?
 - in many cases, the answer is no.
 - the Phase 1 disclosure recommendations are aimed at rectifying this situation.
 - of course when the answer is no, the owners are in no position to take a view on the fairness of the charges.
 - ... hence the importance of transparent disclosure
- Comparative charges: comparing remuneration of both SMs and brokers across the market -
 - is your broker charging at 'market' or above 'market'?
 - is your SM charging at 'market' or above 'market'?
 - and, if one or both are charging above 'market' –
 - is the OC or the SC aware of the position?
 - If yes, is the OC satisfied with the position?

These questions are essentially matters for the owners but, until there is transparent disclosure and more public market information, it is difficult in many cases for owners to answer the questions.

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Are there opportunities for moderating intermediary fees and charges?

This question takes us to the two facets referred to earlier -

- *Charges that are above 'market'*
- *Benefits from rising premiums.*

Intermediary remuneration in a static market

Charges above 'market'?

Broker fees where payable are typically between 5% and 20% of gross base premium to yield total intermediary charges of 25% to 40%. As noted above, 'market' is believed to be 25% to 30%.

In cases where total charges are 40% of gross base premium (20% commission and a broker fee of 20%), on net premiums the equivalent is a total fee of 50%.

Above market charges are not related to rising premiums but rather are a feature or practice of the brokers and strata managers who apply them.

Anecdotal evidence indicates that, in most cases, OCs who are being charged above market are either unaware of the charges, through the absence of transparent disclosure, or alternatively know of their charges but are unaware that they are above market.

Intermediary remuneration in a rising market

The primary cause of rising premiums is rising claims costs including reinsurance.

The secondary cause is intermediary, government and other charges that are 'add-ons' to the claims costs. Most of them are pro rata on the claims costs.

In today's environment of escalating claims costs (higher claim frequency from weather events and the increasing costs of labour and materials), which add to the workload of brokers and strata managers, together with inflation pressures on salaries and other overheads, both groups are asserting that these increasing costs justify their increased revenue from rises in premiums.

Anecdotal evidence indicates that most brokers and strata managers have not moderated their fees and charges to adjust for the proportional increases driven by premium rate increases but some have done so.

Comments

In the absence of any regulation of intermediary charges, it becomes a matter for each OC and its strata committee to challenge or negotiate with their SM and broker for a structure and levels of remuneration with which they are satisfied.

As explained in my Phase 1 paper, there is currently a distinct absence of transparent disclosure for most OCs and their strata committees. As a result, most owners and their strata committees are not in a position to assess whether the charges are fair and in their best interests.

Implementation of the Phase 1 disclosure regime has the potential to bring about a more knowledgeable set of lot owners and strata committee members across the population of strata owners who are in a position to assess whether intermediary charges are fair and in their best interests.

Affordability topics

TOPIC 12: Government charges

Government charges comprise –

- Stamp duty in each state and territory except the ACT
... mostly 9% to 12% of base premium
- ESL (NSW) and FSL (Tasmania)
... in NSW, 15% to 18% of base premium for residential
- Terrorism levy
... for some strata properties only
- GST

These charges have been widely criticised inside and outside governments, State, Territories and Commonwealth, and a succinct statement as to why is an extract from a Productivity Commission report in 2014 which concluded on this topic that -

“Replacing state insurance taxes and levies with more efficient revenue sources, such as broad-based payroll or land taxes, would improve the price signal to policyholders and the effectiveness of insurance as a risk management tool and reduce the price of insurance. Taxes could be phased out over time, as is being done in the ACT. The resulting price decrease could also encourage households and businesses to take up insurance or increase their coverage. “

What can be done to persuade State governments and the Commonwealth to eliminate or, if that is unpalatable, to modify stamp duty, ESL in NSW and the Terrorism Levy to improve affordability and equity of these charges across the community?

Stamp duty

Despite appeals in every government enquiry and innumerable private sector reports and submissions, etc over many years, State and Territory governments have steadfastly resisted not just a continuation of stamp duty but also any change to its method of calculation. Governments are protective of the revenue streams. Similarly for ESL in NSW.

Recognising that adding another voice through this paper to the calls from many others to eliminate stamp duty is unlikely to have any effect, my attention goes to the method of calculation and the associated inequities of stamp duty.

Stamp duty in all jurisdictions is a percentage of premiums (between 9% and 11% on base premium and in some cases on additional items). The result is not only that, at times such as now, rises in market premiums generate additional revenue for governments, which can be seen as windfall gains, but also there are two kinds of inequity that arise:

- (1) For properties assessed by insurers as being at higher risk than others, stamp duty, as a percentage of premium, becomes an additional burden on the property owners because they will be paying higher premiums.

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- (2) There is no published rationale for stamp duty on insurance policies⁵. For example it is not hypothecated to any government activity that supports or makes demands on the owners of insured properties. It is a tax on those who purchase insurance but not on those who do not.

If we accept that governments are reluctant to withdraw stamp duty on property insurance for revenue reasons, we can at least advocate that these two forms of inequity be remedied. Two ideas can be considered –

1. Modify the base of the duty from the insurance premium to some other insurance property characteristic. A convenient and more equitable basis would be sum insured -
 - it is notable that in jurisdictions where stamp duty applies to life insurance policies, the stamp duty is typically based on sum insured rather than premium
2. Widen the scope of stamp duty from insured properties to all properties, whether insured or not, or even to all residents or all taxpayers. A charge based on council rates or some other item measurable for the government would need to be used.

ESL (NSW) and FSL (Tasmania)

Fire services levies have a long and quaint history from the time that State governments brought fire brigades into government hands to replace a system where each insurance company operated its own fire engines to deal with fires in properties that they had insured.

Apart from NSW and Tasmania, all jurisdictions have now dispensed with these levies and replaced them with other levies collected by councils.

As with stamp duty, there has been a chorus of government enquiries and other reports and submissions calling for abolition of these levies and the Tasmanian government is in the process of doing so.

Many documents have been written on the topic and they include three informative submissions from NIBA and the ICA which explain the situation comprehensively –

- NIBA submission to the Royal Commission into National Natural Disaster Arrangements (April 2020 following the 2019 bushfires in NSW and Victoria)
- NIBA submission to the Tasmanian Fire Services Act Review (December 2021)
- ICA submission “A stronger NSW – Policy recommendations for the next NSW Government”, section on State tax reform (February 2023).

Terrorism levies

These levies are collected by the ARPC as a Commonwealth agency and are separate from State and Territory taxes and charges. They only apply to strata properties in some instances, namely -

- strata properties regarded as commercial, being those with 20% or more floor space designated commercial and
- strata properties regarded as residential, being those with more than 80% floor space designated as residential, and whose value exceeds \$50m.

As a result the levy applies to only a minority of residential strata properties. No levies apply to individual residential properties.

⁵ Stamp duty is a very long-standing tax that was ostensibly to be removed by State and Territory governments when GST was introduced in the 1990s. Only the ACT has taken this step.

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The rates are applied to the base premium and vary according to location. The rates are 16% in specified capital city locations and 5% or 2.6% in other locations specified by the ARPC.

GST

Consumer purchased insurance policies (such as home, contents, motor and strata) are not generally entitled to any GST exemptions, as is the case with most other goods and services.

It is difficult to make a case for consumer insurance being exempt from GST

Potential affordability steps for government taxes and charges

In the interests of insurance affordability and improved equity across the community, for both insured property owners and other members of the community, the Productivity Commission position from 2014 quoted above is a sensible position to take. The implications on a national basis are that State and Territory governments should be pressed to make the following changes –

1. Stamp duty: if unwilling to abolish this tax, change the calculation base from insurance premium to either insured property value (usually indicated currently by sum insured) or some other measure such as council rates that is not dependent on insurance
2. ESL in NSW: follow the precedent introduced by other jurisdictions (and almost introduced in NSW in 2017 but abandoned at the eleventh hour) by allocating the aggregate required

and, for the Commonwealth, the ARPC to be requested to review its Terrorism levy rates for strata properties, given their high impost on some commercial and higher value residential strata properties.

FORUM INPUT

There was almost unanimous support for the efforts being made currently by the ICA and NIBA to bring about changes to these government charges.

Affordability topics

TOPIC 13: Replacement value cover: whose responsibility?

... or the sum insured conundrum

Legislation in each state and territory requires owners' corporations (OCs) to obtain cover for replacement value of the building(s) including reinstatement in the event of a total loss. The cover is for construction or reconstruction costs that include removal of debris, professional fees and cost escalation associated with reconstruction. Valuations are required at maximum intervals of five years in all states and territories except NSW.

Sums insured in recent years for many strata properties have not kept pace with construction costs. Many SMs and brokers complain of difficulties in obtaining current valuations through their OCs.

It is a legal responsibility of the OC to see that this cover, referred to hereinafter simply as replacement value, is the sum insured recorded in the policy **BUT no underwriters offer replacement value cover – see further below.**

The general response of underwriters and brokers to apparent under-insurance and to increases in known construction and other costs is to implore SMs and their OC clients to obtain valuations regularly so that the OCs will meet their legal obligations.

In NSW, the absence of a minimum frequency of valuation has exacerbated under-insurance by allowing OCs to avoid updating their valuations if they so choose.

Proposition: there is a flaw in this system.

The system works as follows –

- Legislation requires replacement value insurance
- No underwriters offer such cover: they say they require a sum insured that is nominated by the OC as client that corresponds to replacement value
- Underwriters charge premiums linked to sums insured (not necessarily rising in proportion to sums insured but, certainly, the higher the sum insured, the higher the premium)
- OCs make their own decision on sum insured. Often it is less than replacement value.

BUT

- Underwriter and broker bear no responsibility for its adequacy
- Total losses of strata properties almost never occur
- The premium scale may give owners a financial incentive to under-insure and that incentive is stronger in a rising market, which we are witnessing at present.
- Insurers need a proper estimate of value to manage their own internal affairs including, most importantly in this context, their capital positions and their reinsurances (exposures, treaty terms and reinsurance premiums).

First conclusion: *These points call into question the approach taken by underwriters on both pricing and the setting of sums insured.*

The current practices are not well founded. Owners have a predicament which arguably is created by the insurers and their underwriting agencies. –

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- Underwriters' premium scales by sum insured do not generally reflect with any great analytical accuracy the nature and profile of claims costs. It is self-evident that the more valuable a strata property, the more insurance cover is needed *but* it is equally self-evident that the probability of total loss of strata properties is almost zero.

The outcome should be that there is little if any additional premium associated with lifting the sum insured from below replacement value up to full replacement value because there is little if any risk of a higher claim on account of the higher sum insured.

In practice, however, the way that insurers usually link premiums to sums insured means that a higher nominated sum insured leads to a higher premium, irrespective of the relationship between sum insured and replacement value.

So why this sum insured system?

Why then does the underwriter put the owners in a position where they have a financial incentive to under-insure yet the underwriters will almost never have to meet any claims that are remotely close to replacement cost?

At one level, the traditional insurance industry position, this situation is entirely rational. It is an age-old industry practice that every insured building requires a sum insured nominated by the insured party.

This approach is intended to protect both insurers themselves and their reinsurers from risks that their insureds have not adequately identified. It is an important consideration for underwriters.

The fact that legislation requires insurance for full replacement value is also entirely rational from a government perspective. The primary goal is to see that individual lot owners are protected from a situation where failure to obtain adequate insurance could put all members of an OC at risk.

The overall outcome, however, is not rational. Indeed at the owner level it could be seen as absurd –

- the law obliges full insurance
- owners often rely on others whom they assume are expert in offering sum insured advice
- owners also know that the chance of a total loss in any one year is negligible so they have no practical interest, only a legal interest, in the adequacy of the sum insured
- insurers can be suspected of exploiting the law because they can charge higher premiums for higher sums insured despite knowing that their risk exposure and hence their maximum potential cost is rarely more than say 30% of the sum insured.

Second conclusion:

This sum insured problem warrants attention but can only be solved if insurers and reinsurers are willing to take initiatives aimed at solving it. It is both an exposure question and a rating or pricing question – hence the conundrum.

The primary concern of insurers is of course being on risk for claims that are beyond their risk appetite and unquantified.

So is the problem one for the OCs themselves or others in the insurance chain?

To summarise so far, it is the OCs who are seeking protection and, in general, the reinsurers and insurers are prepared to offer the required protection. The OCs, however, cannot be expected to

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assess for themselves the potential replacement costs. SMs and brokers can assist, for example by arranging advice from property valuers, and underwriters can give guidance. A concomitant issue, however, is the premium scales used by underwriters. That is where the incentive lies for owners to under-insure.

Illustrating the conundrum

By way of example, consider a property with 50 apartments where external guidance (from say an underwriter or broker or real estate agent) suggesting replacement costs of \$300,000 per lot or \$15m in total. Assume that the base premium is \$20,000 because the underwriter is satisfied that that is a fair price, on a portfolio basis, to meet all claims costs and other costs that need to be built into the premium.

Let us now assume that a new and more detailed valuation of the property persuades the owners that \$15m is an understatement of replacement costs and that they should have 20% more insurance, for a sum insured of \$18m instead of \$15m. What should the premium now be –

- (1) Is it $\$20,000 + 20\% = \$24,000$?
- (2) Is it still \$20,000?
- (3) Is it more than \$20,000 but less than \$24,000?

The right answer on an analytical basis is either (2) – still \$20,000 - or else a limited application of (3), namely \$20,000 plus a small margin [of say 1% or 2% (?), which is another \$200 or \$400] on the premium.

... and if that were the case, the incentive on owners to under-insure for price reasons would likely disappear.

In practice, underwriters typically adopt a stronger version of (3) where the premium for the extra cover is likely to be 10% or more on the additional sum insured –

... hence the incentive on owners to under-insure.

To illustrate further, there is an interesting aside to this proposition. It is that a premium of \$20,000 for a \$15m sum insured is at a rate of 13.3 cents per \$100 sum insured. The same premium on \$18m sum insured is say 12.5 cents per \$100 (a lower rate, which is proper) for a total of \$22,500, hence a 12½% increase for no change in exposure (only a change in the underwriter's perception of the exposure) and yet, from an insurer's conventional perspective, a reduction of 9.4% (12.5/13.3) in the premium rate for the same risk!).

How can this problem be addressed effectively in the strata insurance market? and whose responsibility is it to find a solution?

At law, it is the OC's responsibility to be properly insured but there are three main impediments –

- for owners, assessing replacement cost with any reliability is a difficult problem
- underwriting agencies, insurers and reinsurers are unaccustomed to accepting responsibility for full replacement cover without an owner-determined assessment of value
- SMs and brokers have limited ultimate influence –
 - SMs and brokers can also run into a barrier with the OC when they see what they believe is under-insurance: sometimes they are accused of wanting to see premiums

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lifted in their own interests (because of the flow-on effect for commissions and broker fees).

Third conclusion: *There has to be a better way! ... but what is it?*

In principle, there is actually a simple answer:

underwriters to offer replacement value cover and design their premium scales and policy offerings accordingly.

As simple as it sounds, however, orchestration of such a solution would require a change of mindset and a change of practice within the insurance industry.

This idea is not new. It has been rarely used in Australia for home building insurances but it does exist, for example through AAMI⁶. To my knowledge it is not currently used at all in strata insurance.

Devising the solution

Insurers could contribute in two ways –

- they could reduce their reliance on the owner-determined sum insured which in any event is a proxy for replacement value
- they could set up premium scales that are better aligned to the profile of claims costs.

Both techniques would require insurers and underwriting agencies to accept more responsibility for the adequacy of insurance cover.

So how might such an outcome be achieved?

Any solution will have to take account of the disparate strata property population. It ranges from the very small (duplexes) to a small to medium range of 4 to 5 units up to say 20 or 30 units, a medium to large range from say 30 to 50 units per building and a higher range above 50 units. There is also a wide range of ages of buildings, from 50 years or more to the newly constructed, type of construction, quality of construction and quality of building condition.

There is more than one possibility. Ideas might include, for example –

- (1) *On value*: insurers to make their own estimates of replacement value. They could –

⁶ One insurer offering full replacement cover for home buildings, as an option in place of sum insured cover, is AAMI. Its current PDS states on p66 that -

“You may be able to insure the building under our Complete Replacement Cover[®] option, instead of on a building sum insured basis. This option can only be added to your policy at certain times, such as when you purchase your policy or renew it. If you would like this option, please ask us. We may ask you to supply additional details about the building. Your answers to our questions will be shown on your certificate of insurance and we will rely on your answers as the basis of our assessment of the cover we will provide. If the Complete Replacement Cover[®] option is added to the building insurance policy and you pay for this optional cover, it will be shown on your certificate of insurance and you will not have a building sum insured.”

Phase 3 - ENERGISING THE STRATA INSURANCE MARKET
Affordability and availability of strata insurance

- (a) rely on, as is commonly the case today, a professional valuer's valuation or similar that the underwriter is satisfied to use, and/or
 - (b) obtain construction cost data on the property (original cost plus improvements, with dates), adjusting the costs upwards to the present time using a recognised construction cost index, and/or
 - (c) obtain building information such as number of units, average floor space per unit, number of storeys, common property description, age and condition of building, standard and type of construction (for which an insurance industry categorisation may need to be developed) and possibly some other features
- (2) *On insurance protection*: insurers to offer replacement cover as a matter of course and to do so by obtaining a valuation as at (1) above, possibly also loading that value by say 10% or 20% to cover contingencies
- (3) *On pricing*: underwriters to price in the same manner as today based on the assessed value, which would automatically include estimated full replacement value but, on a portfolio basis, should not require any increase in the premium pool
- (4) *On capital management and reinsurance*: insurers to treat the exposure (i.e. the sum insured) as at (3) as 110% or 120% of the assessed value.

if a system of this nature is to be introduced, investigation will be needed to ascertain whether, for example –

- the idea as developed so far could serve effectively as the basis for solving much or all of the under-insurance problem and mis-pricing that currently occurs
 - individual underwriting agencies and their insurers could introduce it without first mover disadvantage (i.e. could it be achieved without regulation of any kind, simply through the individual initiatives of one or more insurers? or would there need to be a regulatory foundation, either by legislation or through self-regulation through the Insurance Council?)
 - a 10% or 20% addition to the estimated value is the right adjustment for replacement value purposes
 - it could be conveyed and presented effectively to the relevant parties, being in the first instance insurers and their underwriting agencies, and secondly SMs and OCs such that they would embrace it
 - underwriters whose exposures are currently limited to modest levels, say \$5m or \$10m maximum, would be willing and able to adapt to the arrangement without any reduction in capacity.
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