Northern Australia Insurance Inquiry – Update 2

Full Replacement Cover- An Alternative Solution to the Issues Raised and Recommendations Relating to Underinsurance and Sums Insured

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Executive Summary

The Northern Australia Insurance Inquiry Second Update Report, released in July 2019, contains recommendations around sums insured in home buildings insurance policies. These recommendations inherently are seeking to reduce the problems associated with underinsurance although it is noted that they do not solve it.

This submission suggests an alternative that may eliminate the risk of underinsurance that currently faces consumers – the full replacement policy.

The experience of an insurer in Australia that already offers a full replacement policy is considered, as is the experience in New Zealand following the 2011 Christchurch Earthquakes.

Importantly, the capabilities required of insurers to meet Recommendation 16: *Insurers should estimate a sum insured for customers* also would allow them to offer a full replacement policy with little additional effort. Indeed, the effort required would arguably be less.

It is suggested that mandating this style of policy in Australia would eliminate the underinsurance problem entirely.

Beyond the elimination of underinsurance, a number of benefits exist in this approach;

- Simpler disclosure on quotes and policy documents
- Simpler policy sale and renewal process
- Removes potential for dispute to arise over property value at the time of sale or renewal (this is likely to arise under recommendation 16)
- Moves the mis-estimation risk from the insured to the insurer – the professional risk manager.

Claims processes are unlikely to change materially as most total loss claim processes under sum-insured policies involve a step to estimate the cost to rebuild prior to settling the claim (or rebuilding as the case may be).

Potential disadvantages that may be furnished on deeper analysis are found to be marginal or non-existent. Many insurers already have the internal capability to manage risk in a world without a 'sum insured' and would need to have it anyway to meet the requirements of Recommendation 16.

Background

The Australian Competition and Consumer Commission (ACCC) is currently undertaking its Northern Australia Insurance Inquiry (NAII) in response to Australian government's request to help address concerns about insurance availability and affordability in northern Australia and promote more informed and more competitive insurance markets.

The NAII has released a recent (second) update, reporting on its progress and summarising responses to its previous report which outlined thirteen (13) draft recommendations for changes to market practice or regulation. A number of those recommendations have now been updated as relevant and 28 final recommendations are included in this update.

The update also has provided more information on the NAII's current focus areas and in particular seeks feedback in relation to those areas. These focus areas include:

- Measures to improve affordability and availability
- Case studies
- Examination of premium adjustments
- Barriers to expansion (or re-entry)

This paper includes observations in relation to recommendations relating to sums insured for home buildings (especially Recommendation 16, also Recommendations 9 and 18) and the virtuous circle that product design can create with under-insurance.

Sum Insured in Buildings Insurance

Over many years, the insurance industry has highlighted the issue of underinsurance in buildings insurance. ASIC has also sought to educate consumers about underinsurance and encourage insurers to provide tools to allow consumers to better estimate their sum insured.

The NAII report has recommended actions to further advance efforts to reduce the level of underinsurance.

Recommendation 16: Insurers should estimate a sum insured for customers

The Insurance Contracts Regulations should be amended to require insurers to estimate an updated sum insured for their home insurance customers and advise them of this estimate on their renewal notice.

This estimate should note when the information used by the insurer to form the estimate was last updated by the consumer, and direct the consumer to contact the insurer if renovations/alterations to their home had occurred since then. Where the sum insured estimate is materially higher than provided for under the policy, the renewal notice should also include a warning to the customer about the dangers of their property being underinsured.

Chapter 7 of the Corporations Act should be amended to exclude advice by an insurer fulfilling this obligation from being considered personal financial advice.

Recommendation 9: Disclose costs that count towards 'sum insured'

The Insurance Contracts Regulations should be amended to require that insurers clearly disclose the types of costs that will count towards the sum insured amount for buildings (such as the costs of demolition, debris removal or for professional fees) where these are not provided for through a separate allowance under the policy. This information should be provided on any sum insured calculators used by the insurer and alongside the sum insured figure.

This will help consumers understand why and how calculator estimations can differ and empower them to make more informed decisions about their nominated sum insured. It should be provided alongside the sum insured amount for a property, including in quotes for new policies, renewals and on certificates of insurance.

Recommendation 18: Disclose premium impacts of optional inclusions or exclusions

The Insurance Contracts Regulations should be amended to require that insurers disclose the premium costs or saving for each optional inclusion or exclusion they offer to a consumer. ***Insurers should also indicate the premium cost or saving associated with incremental changes*** *in excess levels and* ***sums insured****. This information should be provided to a consumer when an insurer provides a quote for a new policy and on a renewal notice.*

Providing consumers with information about the cost impact of optional inclusions/exclusions (e.g. flood cover, accidental breakage cover) as well as variable costs (such as changing an excess or sums insured) will allow consumers to make more informed decisions about their choice of cover.

Lower Sum Insured = Lower Premium

Many of the issues relating to sums insured and related underinsurance are a function of the clear connection between the sum insured and the premium charged. Where a consumer may seek to lower the cost of their insurance and for various reasons is willing to accept a lower sum insured, the premium responds directly. This tension between seeking a lower price and having an adequate sum insured, combined with the fact that the sum insured is only a material parameter in claim settlement in infrequent situations, means that *even with better communication and resources, underinsurance in current policy design will remain an issue*.

The alternate issue of overinsurance is seldom discussed. This is usually where a consumer selects a sum insured either to satisfy requirements of a lender (eg to the loan amount) or believes they should be selecting an amount that covers the total value of their property, not just the replacement cost. In some portfolios, the proportion of grossly overinsured consumers have been seen to exceed the proportion of underinsured consumers.

There is little discussion on alternative product design approaches which could remove the issue of mis-estimation of the sum insured entirely.

Alternative Product Design (Full Replacement)

One such alternative product design approach is the **Full Replacement policy**. In this case there is no requirement to have a sum insured because in the case of a total loss the house will be rebuilt as it was, or the claim would be settled by an equivalent cash payment. In either situation, the consumer would not face the financial risks that might normally be seen if a sum insured was required and they were underinsured.

Past Experience

For a period of time, AAMI insurance solely offered buildings insurance policies with full replacement cover. Subsequently and to this day, AAMI reintroduced the sum insured approach as the default for new policies and made the full replacement cover an optional extra (at a considerable price premium).

New Zealand buildings insurance policies prior to the Christchurch Earthquake in 2011 were almost entirely sold on a full replacement basis. Losses experienced in the event exceeded by a considerable margin the expected losses per property. This was partially due to complexities associated with the event itself, including liquefaction, as well as changes to building designs required after the earthquake.

After that event, many NZ insurers moved to a sum insured based policy, largely to placate the concerns of their reinsurers and as an attempt to cap the possible losses that could arise in their portfolios in future earthquakes. In essence, by changing from full replacement to a sum-insured policy basis **the risk of mis-estimation** (or at least the sum insured being insufficient to rebuild after an event) **was moved to the consumer**. A few insurers in NZ still solely offer complete replacement policies or offer the option to choose between complete replacement and a sum insured based policy.

Consumer Aspects

Sum insured based policies place all the risk of mis-estimation (i.e. underinsurance risk) in the hands of the consumer. The various efforts aimed at assisting consumers with this problem will never succeed in completely removing this risk for all consumers, especially whilst the clear connection remains to the premium paid.

A full replacement policy, if mandated for the whole industry in Australia, removes apparent 'savings' that can arise through different cover levels and ultimately makes buildings insurance a far more consumer-friendly product.

A full replacement policy design moves the mis-estimation risk to the insurer. Insurers as professional risk managers are clearly better placed to be able to manage this risk and at an aggregate portfolio level, the inevitable over- and under-estimation at individual policy level is expected and manageable.

Claim Management Aspects

Underinsurance on policies with a Sum Insured basis arises in total loss situations where the cost of reinstatement exceeds the sum insured amount. For the insured/claimant, this can lead to a dire financial situation. In theory, a full replacement policy removes this risk for the consumer entirely. However, there have been disputes in claim settlement with full replacement policies. Indeed, AAMI had a number of disputes arising in relation to settlements offered following the Wye River bushfires in December 2015.

https://www.smh.com.au/business/consumer-affairs/insurance-hell-aami-refusing-to-pay-out-wye-river-bushfire-victims-20160412-go4cje.html
A number of disputes also remained in 2019 from the Christchurch 2011 event, requiring a special legislative act to be passed in May 2019 to assist with their resolution.

The fact that there are documented examples of disputes in claim settlement does not necessarily make full replacement policies unsuitable for consumers. In many cases the issues are specific to the claim management practices of a particular insurer and are not witnessed across all insurers. Disputes also arise on other policy types and consequently AFCA exists in Australia to assist in resolving these. The claims limit ($1m) and compensation limit ($500,000) for AFCA disputes may need to be extended for home buildings policies to ensure that all potential full replacement disputes fall within the AFCA mandate.

Reinsurance Aspects

It is suggested that reinsurers pressured insurers to switch away from full replacement. This is not necessarily a valid reason to not consider a mandatory full replacement policy design. Indeed, there are other cases where reinsurers would prefer not to have a particular situation (such as unlimited cover in CTP) however accept that it is the market practice or requirement in that region.

In a full replacement environment, reinsurers are likely to focus on the estimation methods that the insurers use to determine their exposures. In many cases they already do take an interest in understanding how insurers determine the extent of underinsurance in their portfolios and thus how much they need to adjust sums insured by to make appropriate exposure estimates and arrange suitable reinsurance cover.

It is arguable that a move – across the whole industry – to full replacement would lead to no material change in the cost of catastrophe reinsurance at an industry level. This is because the cost of events in the aggregate would see little change as the majority of event claims are not total-loss claims and the cost of those 'working' claims would not change in a switch from sum insured to full replacement cover.

Pricing Aspects

Many of the pricing algorithms used by insurers that depend on the sum insured can be easily adapted to use an inferred value from the exposure models that insurers will use. Some minor recalibration may be required to account for the different distribution of values that will be produced, compared to the former sums insured distribution.

An argument may be furnished that premiums will need to go up in order to pay for the full replacement cover feature however such an argument either confirms that there is widespread underinsurance that insurers don't price for or that insurers have not been adequately assessing their exposures in existing pricing bases. Some of the responses to the earlier draft NAII recommendations would suggest that this is not the case and therefore there should be no argument that compulsory full replacement design should lead to price increases for many (or even any) consumers.

Industry Aspects

Recommendation 16 requires insurers to have the capability to provide to the policyholder an estimate of the sum insured from the information they hold and/or can obtain externally. In a full replacement model, the requirement to calculate the value of a building remains for the insurer's risk management (and pricing) purposes, however it does not need to be displayed to the customer and thus will not be a source of dispute at new policy inception or policy renewal.

Therefore, a switch from a sum insured basis to a full replacement basis leaves the onus on the industry to do calculations but removes the disclosure requirements, thereby being easier to implement.

As competent risk managers, many insurers already have these estimation models in place. Even if they are not actively used in the quote/sale/renewal process or disclosed to consumers, many maintain models to ensure that they have a robust estimate of their exposures when determining their reinsurance requirements.

With perhaps a small number of exceptions, insurers should be well placed to switch to a full replacement regime without a great amount of development required.

Claims processes for total losses under a sum insured policy still result in a manual estimate of the rebuild cost in any case. This is because in some cases is it lower cost to rebuild a property than declare a total loss under the policy and pay the full sum insured. A move to a full replacement policy therefore won't place additional burden on claims resources to estimate the replacement cost in these rare events as they are doing it already.

In any case, as professional risk managers, it is more appropriate that any risk relating to mis-estimation is carried by the insurer rather than individual consumers.